BUDGET MATTERS

January 2018

The Economic Progress Institute

Making Rhode Island's Tax Structure More Equitable and Adequate

For Rhode Island to achieve its potential as a first-class place to live and do business we need to ensure that we have the public services and amenities that enhance the quality of life and work in our state. Rhode Islanders make a collective investment through taxes, fees, and other forms of revenue to fund the services that businesses and residents count on.

This brief lays out some changes to Rhode Island's tax structure which we hope will catalyze public discussion about the importance of aligning state resources with the needs and aspirations of Rhode Islanders as we build together towards a more prosperous future.

We propose modifying the tax system to improve the equity and adequacy of Rhode Island's tax structure to achieve four complementary goals:

- Raise revenues necessary to build a strong economy
- Make Rhode Island's tax structure fairer by asking Rhode Island's wealthiest residents to pay more, and by increasing the state EITC to help low and modest income earners
- Make sure corporations pay their fair share to support state services
- Modernize the sales tax to reflect shifts in today's economy

An overview of state tax tools

The three main tools Rhode Island has for raising state revenues include the personal income tax, the sales and use tax, and general business taxes, the largest component of which is the business corporations tax, (sometimes referred to as the corporate income tax). Other significant sources of revenue include several excise taxes, and revenue from the lottery, as seen in Figure 1.

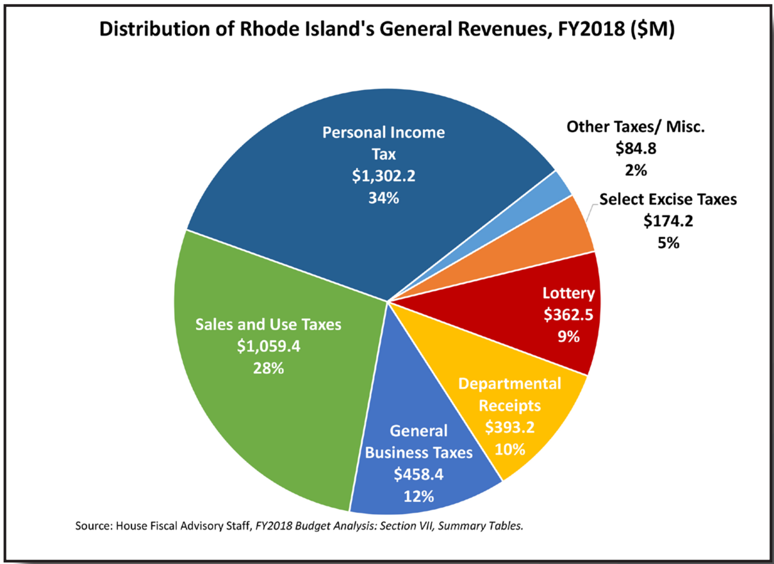


Figure 1

How fair is Rhode Island's overall tax system currently?

Rhode Island's overall tax structure is upside down, with Rhode Island's wealthiest residents paying a smaller share of their income in overall state and local taxes than lower income residents, as seen in Figure 2.[1] Rhode Island families in the bottom quintile (i.e., the bottom 20 percent of filers) pay more than 10 times the amount paid by those in the top 1 percent in sales taxes (7.8 percent of their income versus 0.7 percent for the wealthiest 1 percent). Rhode Island's property tax system is fairer, but still costs lower-income earners a larger share of income.

Rhode Island's personal income tax system introduces a progressive element to the overall tax system, with lower income earners paying a smaller share of their income in personal income taxes than do those at the top. It is also the most efficient mechanism for further increasing the fairness of Rhode Island's tax structure.

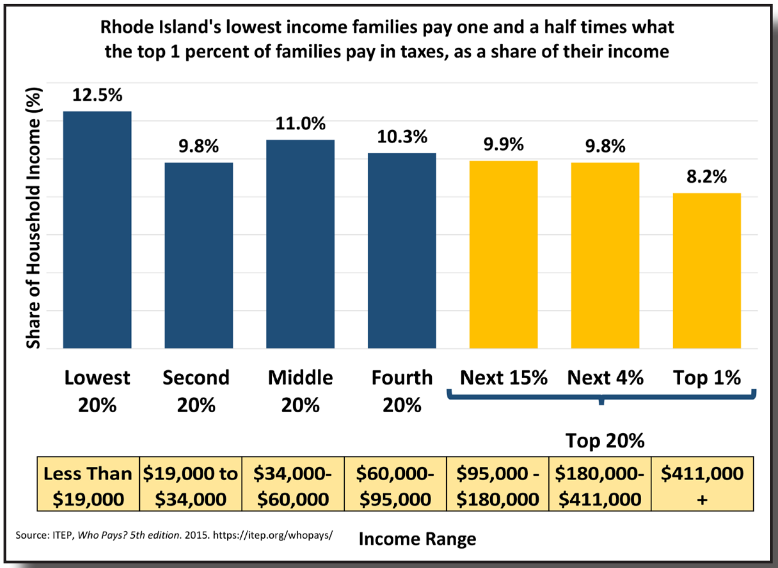


Figure 2

Changes in federal income tax law cut taxes for many, benefit the wealthiest Rhode Islanders the most

The changes that recently passed at the federal level will provide tax cuts to many Rhode Islanders, but the benefits will accrue disproportionately to the wealthiest families, as seen in Figure 3. The reductions in federal taxes for families at the very top of the income ladder open the door for Rhode Island to make its tax structure fairer by increasing state taxes on wealthy residents.

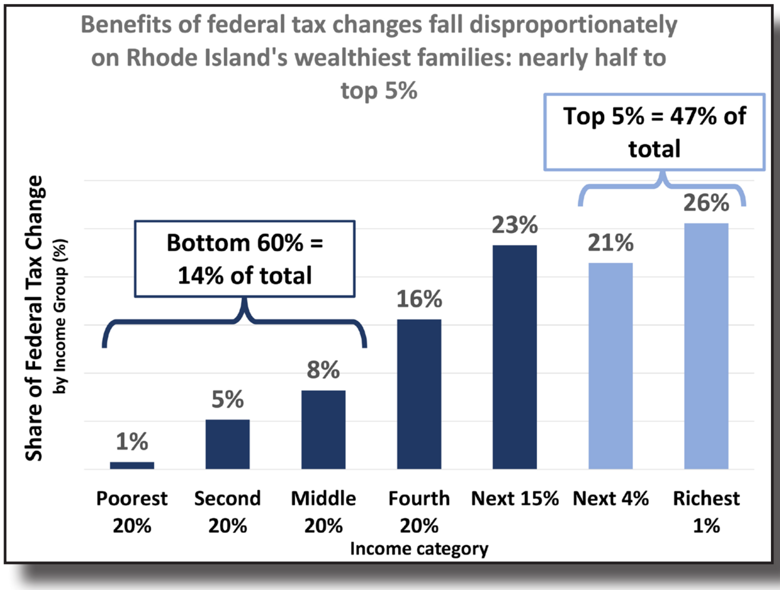


Figure 3

Many lower income earners will see very modest tax reductions under the new federal tax bill (Rhode Island's poorest 20 percent of families will see average savings of just $70/year, and 7 percent will see their taxes increase). Not only are these savings very small, they are also short-lived. By 2027, the average family in the bottom 20 percent will see their annual taxes increase by $130, and even filers in the second to bottom 20 percent and middle fifth will see their taxes increase, on average (by $100/year and $130/yr, respectively).[2] Increasing the state EITC would help these low-and moderate-income families.

[1] The Institute on Taxation and Economic Policy (ITEP) microsimulation model breaks down the incidence of all taxes paid at the state and local levels, including personal income taxes (incorporating state tax rates, tax brackets, exemptions, deductions, tax credits, etc.), consumption taxes (sales and use taxes, excise taxes including gasoline excise taxes, cigarette excise taxes, excise taxes on beer, wine, and alcohol), state and local property taxes, corporate income taxes, and other aggregate local taxes (e.g., the motor vehicle excise tax). Importantly, the ITEP model breaks down the impact of each of these taxes based on who ultimately pays for them, not who is initially legally responsible for payment of the taxes.

[2] ITEP Microsimulation model, January 2018.

Making Rhode Island's personal income tax structure fairer

By raising the tax rates on those with the highest incomes, we can simultaneously increase revenues while making Rhode Island's overall tax structure more equitable. We could also expand Rhode Island's earned income tax credit, currently set at 15 percent of the federal credit--investing in low- and moderate-income earners and improving the fairness of the tax structure.

Options for increasing the personal income tax

Table 1 summarizes four options for new revenue resulting from the creation of new brackets in Rhode Island's income tax system, sorted by the amount of new revenue generated.[3] The options that generate the most new revenue (Options C and D) are those that combine rate increases of two percentage points or more, with the creation of new brackets that apply to income greater than $275,000.

Importantly, none of these options impact filers below the top 5 percent of filers, making them all quite progressive, though in varying degrees. Each of them also imposes three-quarters or more of the total new taxes paid on the wealthiest 1 percent of filers.

The new revenues generated by these income tax increases range from $51 million to $130 million. Option A creates two new brackets, but increases the income tax rate quite modestly (from the current 5.99% for the top bracket, to 6.49% for filers with incomes greater than $200,000, and to 6.99% for filers with incomes greater than $500,000). Option D raises $130 million by creating three new brackets at $275,000, $500,000, and $1,000,000 (with increased rates of 7.99%, 8.49%, and 8.99%, respectively).

Table 1: Four options for expanded income tax revenue

OPTION	IMPACT OF PERSONAL INCOME TAX CHANGES	NEW REVENUE GENERATED ($M)	SHARE OF ALL RI FILERS AFFECTED	AVERAGE 1% TAX INCREASE	AVERAGE 1% TAX INCREASE FOR THOSE WITH TAX INCREASE	SHARE OF TAX HIKE PAID BY TOP 1%
A	Add 2 new brackets: $200k-$500k at 6.49%, $500k+ at 6.99%	$51.0	3.9%	$8,298	$8,374	86%
B	Add a "Millionaire's Tax" tax bracket: $1M+ at 9.1%	$80.0	0.2%	$15,075	$89,682	100%
C	Add two new brackets $275k-$1M at 7.99%, $1M+ at 8.99%	$124.6	2.2%	$21,128	$21,548	90%
D	Add 3 new brackets: $275k-500k at 7.99%, $500k-$1M at 8.49% and $1M+ at 8.99%	$130.2	2.2%	$21,183	$22,624	90%

Source: ITEP microsimulation model, January 2018
Note: This analysis does not incorporate December 2017 Federal tax policy changes

These potential changes to the state's income tax structure should be considered in the context of our immediate neighboring states, Connecticut and Massachusetts. Rhode Island's current top income tax rate falls between the top rates for Massachusetts, which currently has a flat, 5.1 percent rate, and Connecticut, which imposes a 6.99 percent income tax on incomes of $1 million or more.[4]

[3] Rhode Island currently has three income tax brackets. Taxable income between 0-$61,000 is taxed at 3.75%; between $61,000-$139,400 at 4.75%, and above $139,400 at 5.99%.

[4] Connecticut has four brackets that are higher than Rhode Island's top bracket, which begins on incomes of $139,400. Those brackets (and corresponding rates) are: $200k-$400k (6%), $400-500k (6.5%), $500k-$1M (6.9%), and $1M+ (6.99%). Conservative critics have claimed that some of Connecticut's current economic challenges have resulted from the recent imposition of high taxes on the state's wealthiest families. In fact, when you look at Connecticut's total state and local revenues as a share of personal income, the state ranked just 11th overall. Moreover, some of the troubling trends experienced in Connecticut, such as stagnant population growth, are not recent occurrences.

In the forthcoming 2018 election, Massachusetts voters will weigh whether to increase the Commonwealth's top rate to 9.1 percent (i.e., four percentage points higher) than the rate for those below $1M. Option B in Table 1 models the same rate increase on income over $1M for Rhode Island.

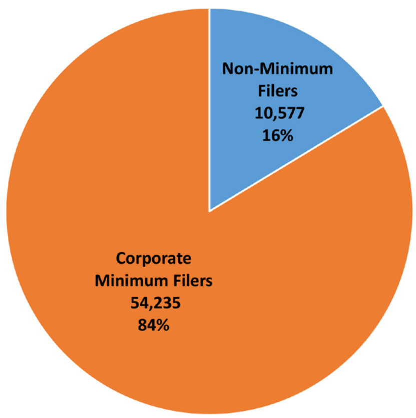
Increasing the Rhode Island earned income tax credit

Another way to improve Rhode Island's tax equity would be to increase the state earned income tax credit, from the current 15 percent of the federal EITC, to 20 percent. Doing so would reduce taxes for Rhode Island's low- and modest-income working families, and move Rhode Island closer to alignment with neighboring Massachusetts and Connecticut, whose state EITCs are both at 23 percent of the federal credit. Increasing the state EITC from 15 percent to 20 percent would put an additional $9 million in the pockets of Rhode Island's lower-wage workforce.

Make sure corporations are paying their fair share to support state services

Rhode Island has been eroding its corporate minimum tax (CMT) in recent years. The TY2015 corporate minimum of $500 was reduced to $450 in TY2016, and to $400 in TY2017. Department of Revenue data show that 84 percent of Rhode Island's business corporation tax filers pay only the minimum tax (Figure 4).[5]

More than 4 in 5 Rhode Island corporations pay only the corporate minimum tax (CMT)



Source: Department of Revenue, Division of Taxation, "Revenue Estimating Conference", November 6, 2017

Figure 4

As a result of reducing the CMT to $450, Rhode Island lost $2.4 million in TY2016. For tax years 2017 and after, the reduction in the corporate minimum from $500 to $400 costs the state an estimated $5.4 million each year.

Restoring Rhode Island's corporate minimum tax to $500 and thus increasing general revenues by about $5.4 million a year would happen at a time when Rhode Island corporations (both C-corps and pass-through entities) will see a substantial windfall resulting from changes in the federal tax bill.

Modernize the sales tax to reflect today's economy

Rhode Island should modernize its outdated sales tax to better reflect today's economy, and to facilitate the investments needed to build a strong economy for the future. Personal consumption patterns have shifted considerably, away from goods to services, and away from bricks and mortar stores to online purchases.

While recent changes to the use tax have helped better align our tax system and our economy by taxing a substantial share of online purchases, more remains to be done.

[5] Of those filers, 10 percent are C-corporations, while 90 percent are "pass-through corporations" which pass their income through to their owners to be taxed as individual income. See Aarun Krupkin and Adam Looney, 2017. 9 Facts About Pass-Through Businesses, Brookings Institution, https://www.brookings.edu/research/9-facts-about-pass-through-businesses/.

There are two main ways to increase revenues from the sales and use tax: increasing the sales tax rate (currently at 7%), or broadening the sales tax base (by taxing items not currently subject to the sales tax). Because Rhode Island's sales tax rate (7%) is already higher than the rates in neighboring Connecticut (6.35%) and Massachusetts (6.25%), increasing the sales tax rate is not a viable option for increasing revenues.

Broadening the sales tax base by taxing more goods and services should be considered. Rhode Island has almost completely refrained from taxing services, a decision that widens the disconnect between our economy, which is increasingly service-based, and the tax structure that we rely on to build vibrant communities and sustain important public services. In 2012, a small number of services, including pet grooming[6], were added to the corporate tax rolls, but the list of those that remain untaxed is extensive. At least 20 states tax services which are currently exempt under Rhode Island law. These include, for example, tuxedo rentals, carpet and upholstery cleaning, diaper services, laundry and dry-cleaning services, shoe repair, clothing repair and alteration services, swimming pool cleaning and maintenance, health clubs and tanning parlors, memberships in private clubs, automotive painting, and rust-proofing and undercoating.

Taxing services such as these – services that are disproportionately used by Rhode Island's wealthiest families – would make our revenue system both more adequate and fair.

The Governor's FY2019 budget takes a step in the right direction to modernize the sales tax. The budget proposes to generate $14.5 million in revenue by extending the sales and use tax to two new services: security services, including investigation, guard and armored car services ($9.7m) and on-line third-party hosted subscription services known as Software as a Service (SaaS), such as subscription-based access to software (e.g., Microsoft's Office 365 and Adobe Acrobat's Creative Cloud) ($4.8m).

Conclusion

Rhode Island should close current and future budget deficits with a balanced approach that looks at both revenue and spending. A "spending cuts only" approach threatens our ability to make the investments necessary to compete for jobs, keep our residents healthy, our schools safe, warm, and dry, and our communities vibrant. We need to pursue revenue options that make our tax system fairer while helping us to meet today's needs and make necessary sound investments for tomorrow.

[6] State of Rhode Island, Division of Taxation, Regulation SU 12-152. http://www.tax.ri.gov/regulations/salestax/12-152.pdf