Written Testimony Submitted to the Rhode Island House of Representatives
House Finance Committee
Regarding Governor Chafee's *Sales Tax Modernization Proposal*
April 13, 2011

Thank you for the opportunity to submit this written testimony. My name is Meg Wiehe and I am the State Tax Policy Director for the Institute on Taxation and Economic Policy (ITEP), a Washington-DC-based nonprofit research group. ITEP's research focuses on federal and state tax policy issues, especially as they affect lower- and middle-income taxpayers.

My testimony focuses on Governor Chafee's *Sales Tax Modernization Proposal*, which would generally broaden Rhode Island's sales tax base, lower the general state sales tax rate, and raise additional revenue to help mitigate budget cuts. In particular, my testimony will provide thoughts on two components of the governor's proposal: adding a mix of services to the general sales tax base and applying a 1% sales tax to most goods currently exempted from the general sales tax base. In addition, I will share with you the results of an ITEP analysis of the distributional impact of the governor's plan. Finally, I will end with a recommendation to improve the impact the governor's plan would have on low-and moderate-income households: expanding Rhode Island's state Earned Income Tax Credit.

Governor Chafee's Sales Tax Modernization Proposal

Broaden Sales Tax to Include Many Services and Some Currently Exempted Goods

The sales tax base in Rhode Island is largely limited to tangible goods, exempting the numerous and growing array of intangible services, from haircuts to car repairs, from the sales tax even as services have come to constitute a substantially larger share of consumption. The omission of services from the tax base is not the result of conscious policy choices, but a historical accident: when Rhode Island enacted its sales tax in 1947, services were a relatively small part of consumer spending. In 2007, services represented nearly 65 percent of personal consumption nationally and are currently the fastest-growing area of consumption.[1] Yet only a few states – such as Hawaii, New Mexico, and South Dakota – have successfully adapted to this long-term change in consumption patterns and tax the purchases of services in a comprehensive fashion. Almost every state that has assembled a tax commission in recent years, including Vermont and Georgia most recently, have recommended a comprehensive expansion of the sales tax base to services.

[1] This figure represents household consumption expenditures for services as a share of personal consumption expenditures, as found in the Bureau of Economic Analysis' National Income and Product Account Tables (NIPA), available at: http://www.bea.gov/national/nipaweb/index.asp

Exempting services today virtually guarantees that sales tax revenues will grow more slowly than consumer spending—and more slowly than the economy—over time. Failing to tax services also has the potential to increase the volatility of the sales tax, as the consumption of services is generally a more stable tax base than sales of big-ticket items, which make up a significant share of total sales taxes on goods.

According to a 2007 study conducted by the Federation of Tax Administrators, Rhode Island taxes only 29 out of a possible 168 services. Consequently, to yield an equivalent amount of revenue, Rhode Island must impose a higher sales tax rate than if it used a more comprehensive sales tax base.

Governor Chafee's proposal to tax certain select services currently not subject to the sales tax to and remove the current sales tax exemption for certain goods would broaden the state's sales tax base, raising an additional $196 million in FY12. The governor uses most of the new revenue raised through base broadening to lower the state sales tax rate from 7 to 6 percent, with the net impact resulting in an additional $78 million in revenue. His proposal to add services to the base is not entirely comprehensive, instead he has chosen to include select services such as moving, storage, personal services, maintenance and repair, laundry and dry cleaning, and entertainment and recreation. However, it does add many of the services frequently taxed in other states and makes substantial improvements to Rhode Island's sales tax base.

An expansion of Rhode Island's sales tax base to include most services consumed by individuals and families would yield a more robust and more stable sales tax as it would protect the state against any further shift in consumption towards services. Taxing services will also increase the amount of sales tax collection at any given tax rate which makes it less likely that Rhode Island lawmakers will be forced to raise the sales tax rate in the future to balance budget.

Expanding Rhode Island's sales tax to include more services also has the potential to produce a somewhat less regressive sales tax, to the extent that untaxed services are consumed disproportionately by wealthier taxpayers. However, the sales tax will still be regressive overall no matter how broad the base, and as such, the governor's plan would have the greatest impact on low-income households. Expanding the base would also reduce any advantage service-producing companies may now enjoy over goods-producing ones due to the different manner in which their products are currently treated for tax purposes. Furthermore, taxing goods but not services discriminates against those who prefer goods (low-income households tend to favor goods over services).

Tax Most Currently Exempted Goods at 1%

Unlike with services which were exempted from the sales tax more by historical accident, Rhode Island lawmakers have legislated 82 sales tax exemptions on goods since 1947. Governor Chafee has proposed expanding the sales tax base to include most of the 82 exempted items with the exceptions of food ingredients, prescription drugs, durable medical equipment, and gasoline. Rather than adding these items to the general sales tax base, the governor recommends taxing these currently exempted goods at a 1 percent rate. This change would raise an estimated $87 million in FY12.

Some exemptions, like those on food and prescription drugs, had the good intention of making the sales tax less unfair, but many others were poorly conceived with no justifiable purpose other than to satisfy a few special interests. With few exceptions (including those Governor Chafee made in his plan), exemptions of personal consumption items from the sales tax are not necessary and can be expensive, inefficient, unfair and overly complex, adding to the stability issues Rhode Island's narrow sales tax already faces. If the exempted items were added to the general state sales tax base rather than creating a separate tax rate for them, the general sales tax rate could be lowered beyond the 6 percent proposal and still raise new revenue.

Impact of Comprehensive Sales Tax Plan

In addition to the two components of the governor's sales tax modernization plan discussed, the proposal also includes lowering the general state sales tax rate from 7 to 6 percent, and maintaining the current 8 percent rate for meals and beverages and lodging and room rentals, allocating the non-local share of those taxes to two new dedicated funds. All together, Governor Chafee's sales tax proposal would raise an estimated $165 million in FY12.

While the comprehensive plan will certainly improve the stability and adequacy of Rhode Island's sales tax and level the playing field between goods and services providers and consumers, ITEP found that low- and moderate-income taxpayers will be disproportionately impacted by the plan. This is because no matter what improvements are made to a sales tax, it is still inherently regressive as the lower a family's income, the more of its income the family must spend on things subject to the tax. According to estimates produced by ITEP based using Consumer Expenditure Survey data, low-income families typically spend three-quarters of their income on things subject to sales tax, middle-income families spend about half of their income on items subject to sales tax, and the richest families spend only about a sixth of their income on sales-taxable items.

Virtually every household in Rhode Island will pay slightly more in sales taxes each year as a result of the governor's proposal, but low- and moderate-income households will pay the most as a share of their income. On average, the bottom 20 percent of households with average incomes of $10,000 will pay .8% of their incomes in additional sales taxes while the top 1 percent with average incomes close to $1 million will pay only .2% of their incomes in additional sales taxes. It should be noted that the additional revenue raised will be used to stave off cuts to critical states services such as education and public safety.

Impact of Governor Chafee's Sales Tax Recommendations in Tax Year 2011
All Rhode Islanders, 2011 Income Levels

2011 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than $18,000	$18,000 – $32,000	$32,000 – $57,000	$57,000 – $90,000	$90,000 – $169,000	$169,000 – $390,000	$390,000 – Or More
Average Income in Group	$10,000	$25,000	$44,000	$70,000	$118,000	$238,000	$977,000
Impact of Governor Chafee's Sales Tax Modernization Proposal							
Tax Change as % of Income	+0.8%	+0.7%	+0.5%	+0.5%	+0.3%	+0.2%	+0.2%
Average Tax Change	+83	+163	+224	+341	+413	+546	+1,732

Source: Institute on Taxation and Economic Policy Microsimulation Model

As was stated earlier, adding services to the sales tax base has the potential to make the sales tax slightly less unfair, but it will remain a regressive tax. Continuing to exempt groceries and prescription drugs are also important fairness considerations. Governor Chafee's plan could be improved by devoting a small portion of the revenue generated by a base expansion to improving overall tax fairness in Rhode Island, as greater reliance on what remains a fundamentally regressive tax could make the state's tax system still less fair.

Recommendation to Expand Rhode Island's Earned Income Tax Credit

The single best way to improve the fairness of Governor Chafee's sales tax plan is to expand Rhode Island's Earned Income Tax Credit. ITEP found that converting the current partially refundable credit to a fully refundable credit at 25 percent of the federal EITC would on average more than offset the sales tax change on the bottom 20 percent of households and greatly improve the impact on the next 20 percent.

Impact of Fully Refundable 25 percent EITC for all eligible taxpayers (replace partially refundable EITC)							
Tax Change as % of Income	–0.9%	–0.6%	–0.1%	—	—	—	—
Average Tax Change	–89	–134	–34	—	—	—	—

Combined Impact of Sales Tax Proposal and Fully Refundable EITC							
Tax Change as % of Income	–0.1%	+0.1%	+0.4%	+0.5%	+0.3%	+0.2%	+0.2%
Average Tax Change	–6	+29	+189	+341	+413	+546	+1,732

Source: Institute on Taxation and Economic Policy Microsimulation Model

The cost of converting the current partially refundable EITC to a fully refundable EITC is an estimated $26 million. There would be no change in the number of households receiving the Rhode Island EITC, rather eligible households would see an increase in their average state EITC benefit.

Conclusion

As currently structured, Rhode Island's general sales tax is unsustainable, inadequate, and unfair. The Governor's proposed reforms would take important steps towards repairing each of these problems, in particularly improving the stability of the sales tax. However, the base expansion plan should be paired with an expanded state Earned Income Tax Credit to ensure low-income households are not disproportionately impacted by the good and smart intentions of sales tax modernization.