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WRITTEN TESTIMONY SUBMITTED TO THE RHODE ISLAND HOUSE FINANCE COMMITTEE REGARDING HOUSE BILL 5737

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Chairman Melo and Members of the Committee, thank you for the opportunity to testify today. I am Carl Davis, Senior Analyst with the Institute on Taxation and Economic Policy (ITEP), a nonprofit research group based in Washington, DC. ITEP's research focuses on federal and state tax policy issues, with an emphasis on tax fairness and adequacy.

My testimony today focuses on House Bill 5737, which would enact a variety of reforms designed to enhance the level of scrutiny applied to new tax credits, deductions, exemptions, and exclusions. This testimony emphasizes how these reforms would help remove counterproductive biases in favor of relying too heavily on tax preferences; how similar reforms have been used in other states; and why the mix of reforms contained in this bill is particularly appropriate.

ADDRESSING TAX PREFERENCE BIAS

As in every state, Rhode Island's current legislative procedures are biased heavily in favor of tax exemptions, exclusions, credits, and other so-called "tax preferences." While a direct spending program designed to boost private industry research, for example, will come up for regular review as part of the legislative appropriations process, a tax break designed to do exactly the same thing usually will not. Add to this the fact that tax preferences tend to be unlimited in size, and protected by tax law confidentiality provisions, and the undeserved bias in favor of these sorts of policies should be abundantly clear.

Biases of this type have no doubt contributed to the massive proliferation of tax preferences in Rhode Island's tax code. The state's most recent tax expenditure report identifies some 227 unique tax preferences, costing the state upwards of $1.67 billion in foregone revenues each year. [1]

House Bill 5737 represents a modest, reasonable attempt to rein-in these biases moving forward. Existing tax preferences would not be impacted by the bill, but tax preferences authorized in the

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[1] State of Rhode Island Department of Revenue, "2010 Tax Expenditure Report," Oct. 12, 2010.

future would be impacted by a variety of procedural reforms that would allow this committee, and other interested parties, to more thoroughly evaluate whether these policies are living up to their original promise.

REFORM #1: STATEMENTS OF PURPOSE

House Bill 5737 would require that legislation creating a new tax preference explicitly identify the purpose of that preference. This reform lays the groundwork for conducting the performance measurements I will discuss in just a moment.

Rhode Island's most recent tax expenditure report lists a huge number of tax breaks with no clearly identifiable purpose. While it may be possible to infer the purposes of some of these tax breaks, this is not always the case. The experience of Washington State's "Citizen Commission for the Performance Measurement of Tax Preferences" provides the clearest evidence of this problem.

The Washington Commission is charged with systematically reviewing the vast majority of the state's existing tax preferences. Unfortunately, the Commission has had to forgo reviewing a significant number of tax preferences due to a lack of information on their intended purposes.[2] While Rhode Island lacks a tax preference commission, the underlying problem is the same in the Ocean State. How are lawmakers, analysts, advocates, the media, and ordinary citizens to have any hope of understanding—much less evaluating—a given tax policy, if a fact as basic as that policy's intended purpose remains a mystery?

REFORM #2: PERFORMANCE INDICATORS AND DATA COLLECTION

House Bill 5737 also requires that detailed performance indicators be identified in new legislation creating a tax preference, so as to facilitate evaluation of that preference by this committee and the General Assembly as a whole. In addition, specific data collection requirements also must be identified, in order to ensure that sufficient information exists to judge each new preference's actual performance. Both of these requirements are crucial to the state's ability to conduct detailed analyses of the tax preferences in question.

While identifying the general purpose of a particular tax preference provides an important foundation for evaluating those preferences, it will be insufficient for this purpose if not accompanied by more detailed information. For example, if the purpose of a particular tax preference is listed simply as "creating manufacturing jobs," the tax preference will have technically fulfilled its purpose if it creates just one job, even if that provision happens to cost the state $10 million in foregone revenue. A detailed performance indicator, by contrast, might identify a target number of jobs to be created per dollar of revenue foregone by the state. And the data collection requirements attached to that preference will require companies to report relevant information that will allow for empirical analysis of the success of said provision.

[2] Citizens for Tax Justice, "Judging Tax Expenditures," Nov. 2009.

REFORM #3: SUNSET DATES

Finally, House Bill 5737 requires that any new tax preference be scheduled to expire within seven years. It is important to note that this provision does *not* require that all new tax preferences *must* actually expire after seven years, nor does it imply that such an outcome would be ideal. Rather, the seven year sunset provision is intended to create the type of action-forcing moment needed to spur serious debate, and serious consideration of the performance information I just described.

Sunset provisions have been used on numerous occasions at both the state and federal levels as a tool for ensuring that tax preferences are periodically revisited. One analysis of sunset provisions in California found that they significantly increased the probability that the state's legislature would modify or terminate a tax preference.[3] Tax preferences that are meeting or exceeding original expectations can of course be allowed to continue, but modifying or terminating those that are yielding disappointing results, or that have outlived their usefulness, is made much easier by the use of sunset provisions.

In Nevada, voters embraced this line of reasoning in 2008 when they approved a constitutional amendment that requires all new tax exemptions to be saddled with a sunset provision.[4] Oregon followed suit in 2009 by enacting a law that requires that vast majority of its tax credits—including both existing credits and new credits—to sunset every six years.[5] And Missouri's "Tax Credit Review Commission" recently recommended a similar reform.[6]

THE RIGHT MIX OF REFORMS

As mentioned earlier, Washington State already possesses a tax preference review system designed to conduct reviews roughly similar to those that House Bill 5737 is seeking to facilitate. Numerous other states have conducted such reviews in a less systematic fashion.

By the same token, a number of states already use sunset provisions as a tool for bringing about the periodic reconsideration of tax preferences that would otherwise likely escape unnoticed for significant lengths of time. Oregon and Nevada are the most notable in this regard.

No state, however, has paired these two categories of reforms as effectively as House Bill 5737 seeks to do in Rhode Island. By requiring that detailed performance information be made available about specific tax preferences, and that those tax preferences be sunsetted and brought up for a regular up-or-down vote, House Bill 5737 has the potential to result in higher-quality and more meaningful tax preference debates than in any other state.

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[3] Mark A. Ibele and Jon David Vasche, "Tax Expenditure Reporting in California: Lessons and Opportunities," in Proceedings of the National Tax Assocation's 92nd Annual Conference on Taxation, Atlanta, Oct. 24, 1999.
[4] Nev. Const. art. 10, section 6.
[5] HB 2067, 2009 OR. Leg. Reg. Sess.; Nev. Const. art. 10, section 6.
[6] Missouri Tax Credit Review Commission, "Report of the Missouri Tax Credit Review Commission," Nov. 30, 2010.

CONCLUSION

House Bill 5737 addresses a glaring asymmetry in the way Rhode Island analyzes and debates tax preferences, as compared with direct spending programs. By pairing an improved informational framework with a sunset system designed to spur real action by Rhode Island's legislature, House Bill 5737 seeks to implement a package of reforms that will be much more effective than the piecemeal approach taken in many other states.

Thank you for the opportunity to testify.

BACKGROUND ON ITEP

The Institute on Taxation and Economic Policy (ITEP) has engaged in research on tax issues since 1980. Since 1996 ITEP has used a *microsimulation tax model* to conduct research on federal, state, and local tax systems. A microsimulation model uses a large sample of tax returns and other data to estimate the impact of tax systems and tax proposals on actual taxpayers at different income levels. This is the same type of tax model used on the federal level by the U.S. Treasury Department, the Congressional Joint Committee on Taxation, and the Congressional Budget Office, as well as by many state revenue departments. A properly constructed microsimulation model can provide accurate estimates of revenue yield and tax incidence by income group.

ITEP's microsimulation model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to 750,000 records. This database is based on federal tax returns, with statistically valid samples from every state and the District of Columbia. The database is augmented with a sampling of records from the U.S. Decennial Census "five percent sample" (which contains a random sample of five percent of all census forms received by the Census Bureau); the Census data are statistically matched with the tax return records. The data on these records is then extrapolated to subsequent years using federal tax micro and tabular data, Census Bureau Current Population Survey micro and tabular data, and other widely respected data sources.

These, and other, data are used by the ITEP model's four modules: Personal Income Tax, Property Tax, Consumption Tax and Business Tax. These modules calculate tax liability on a record-by-record basis and sum the results to provide revenue and tax incidence estimates. (A complete description and methodology for the ITEP model is available on request.)

The ITEP model has the unique capability of analyzing all major taxes for every state and the District of Columbia. In 2009, the ITEP model was used to produce the study *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*. This study shows the distributional impact, by income level, of all major state and local taxes for each of the 50 states. It has been used by many state revenue departments and legislative fiscal offices since its publication.

The ITEP Model is also unique in its ability to forecast the effect of both federal and state tax changes on taxpayers in a given state. This capability is especially important in analyzing the impact of proposed tax changes that affect people on multiple levels. For example, proposals for federal tax reform often impact state tax collections. Similarly, proposals to change state tax structures, such as the bills under discussion today, can affect the federal taxes paid by a state's residents in ways that can drastically affect the overall incidence of these proposals.

In addition to its fifty-state analyses, ITEP often conducts research in individual states. This work has been primarily funded by private foundations. ITEP's full body of research is available at www.itepnet.org.