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Analysis of Proposed Tax Cut

Good afternoon. My name is Michael Ettlinger. I am Tax Policy Director for the Institute on Taxation and Economic Policy. ITEP is one of the leading research and education organizations in the country working on government taxation and spending policy. Since its founding in 1980, ITEP's work has played a key role in educating the public and informing federal and state tax policy.

The proposal being considered, to create an alternative flat-rate income tax of 5.75 percent of Federal Adjusted Gross Income, with an exclusion for capital gains income for assets held more than five years, would be a significant tax cut targeted exclusively to the wealthiest people in Rhode Island. Ninety-eight percent of the benefits of this tax cut would go to the highest income one percent of Rhode Islanders, who have an average annual income of $642,000. The average tax cut for this group would be $7,900. The vast majority of the people of Rhode Island would see no reduction in their taxes as a result of this proposal.

Tax Cut by Income Group, Fully Phased-In (at 1999 levels)

	Rhode Island Income Group	Average Tax Cut	% of Total Tax Cut
	Lowest 20%	$ —	0%
	Second 20%	$ —	0%
	Middle 20%	$ —	0%
	Fourth 20%	$ —	0%
Top 20%	Next 15%	$ —	0%
	Next 4%	$ –42	2%
	Top 1%	$ –7,900	98%

Targeting tax breaks to the rich, generally speaking, is not widely popular tax policy. Two reasons come to mind, however, why a state might want to pursue such a course. First, if the most well-off in a state are bearing an inequitably high share of the tax burden, a reduction could make the tax system more fair. Second, if cutting taxes on the well-off would help the economy of the state, more than other uses of the foregone revenue, this too would be a reason for cutting taxes on the affluent.

A Fair Tax Cut?

Are wealthy Rhode Islanders paying more than their fair share in Rhode Island taxes? The table found on the next page indicates that they are not.[1] In fact, Rhode Island has a regressive tax

[1] This table, and most of the other quantitative information I am providing today, was computed using the ITEP Microsimulation Tax Model. This model using a statistically representative sample of tax

system. That is, families at *lower* incomes generally pay a *higher* percentage of their income in Rhode Island state and local taxes than do those with higher incomes. The best-off Rhode Islanders pay 9.9 percent of their income in Rhode Island state and local taxes, while middle income families pay around 11 percent and low-income families pay over 14 percent. The personal income tax, on its own, is progressive—with upper-income taxpayers paying at more than twice the effective rate of middle-income taxpayers. The other elements of the tax system are, however, quite regressive, resulting in a tax structure that, overall, asks more of those with less income.

Rhode Island Taxes in 1999
As Shares of Family Income for All Taxpayers

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	Top 1%
Average Income in Group	$7,800	$18,400	$31,300	$49,400	$81,400	$161,500	$642,000
Income Range	Less than $13,000	$13,000 – $25,000	$25,000 – $39,000	$39,000 – $63,000	$63,000 – $117,000	$117,000 – $262,000	$262,000 – or more
Sales, excise & gross receipts taxes	**8.3%**	**5.6%**	**4.7%**	**3.5%**	**2.7%**	**1.8%**	**0.9%**
General sales tax, individuals	3.3%	2.4%	2.2%	1.7%	1.4%	0.9%	0.5%
Excise & gross receipts taxes, individuals	3.0%	1.7%	1.4%	1.0%	0.7%	0.4%	0.2%
Sales, excise & gross receipts taxes, business	2.0%	1.4%	1.1%	0.9%	0.7%	0.4%	0.3%
Property taxes	**5.9%**	**4.4%**	**4.3%**	**5.2%**	**4.9%**	**4.7%**	**2.8%**
Property taxes on families	5.7%	4.1%	3.9%	4.8%	4.5%	4.0%	1.7%
Business property taxes	0.2%	0.3%	0.4%	0.4%	0.4%	0.7%	1.0%
Income taxes	**0.2%**	**1.2%**	**1.8%**	**2.6%**	**3.4%**	**4.2%**	**6.2%**
Personal income tax	0.2%	1.2%	1.7%	2.6%	3.4%	4.1%	6.1%
Corporate income tax	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.2%
Total	**14.4%**	**11.2%**	**10.8%**	**11.3%**	**11.0%**	**10.6%**	**9.9%**

Furthermore, the well-off have recently received significant reductions in Rhode Island taxes. The state has chosen to phase-down the percentage of federal personal income tax used to calculate Rhode Island tax—from 27 percent to 25 percent. The rate reduction is the same for all taxpayers. An across-the-board cut in a progressive tax, however, disproportionately benefits higher-income taxpayers.

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returns and other data from each of the 50 states to provide distributional and revenue analysis of state tax structures. A detailed description of the model can be found at our web site: www.ctj.org/itep.

The 1997 cuts in the federal personal income tax that have, by virtue of Rhode Island's piggy-back system, been incorporated into the state tax structure, have even more narrowly benefitted the wealthy. The capital gains tax cut, in particular, is skewed to higher income taxpayers.

When the rate reduction and the pass-through of the federal cuts are combined, Rhode Island's well-off have already received a large tax cut. When the rate cut is fully phased-in, the average cut will be $5,200 for the highest-income one-percent, but average only $97 for everybody else. Close to 80 percent of the benefits of these cuts go to the highest income 20 percent of Rhode Island taxpayers.

Thus, not only do wealthy Rhode Islanders pay less, as a share of income, than do their less-well-off compatriots, but their taxes have already been cut substantially. There does not appear to be a strong equity argument for this tax cut proposal.

Change in RI Tax from 1997 Federal Tax Cuts and RI Rate Cut

	Rhode Island Income Group	Average Tax Cut	% of Total Tax Cut
	Lowest 20%	$ –1	0.2%
	Second 20%	$ –18	2.4%
	Middle 20%	$ –42	5.7%
	Fourth 20%	$ –100	13.8%
Top 20%	Next 15%	$ –240	24.3%
Top 20%	Next 4%	$ –680	18.5%
Top 20%	Top 1%	$ –5,200	35.1%
	addendum:		
	Top 20%	$ –570	77.8%

A Tax Cut That's Good for the Rhode Island Economy?

The value of any tax cut has to be weighed against the alternatives. If tax cuts had no consequences other than reducing taxes for a portion of the citizenry, we would just eliminate all taxes and be done with it. Tax cuts for one group, however, mean no tax cuts for others and reduced government services.

For a tax cut of this size, there are some attractive alternatives. $42 million could hire 1,000 teachers. 1,000 teachers could reduce the average class size for 50,000 students from 25 to 17. It is a perfectly fair question to ask which is more important: giving an average tax cut of $7,900 to the richest people in the state, or improving these children's education?[2]

Education is not the only option. 1,000 police officers could be hired instead, infrastructure improved, drug rehabilitation programs initiated or job training programs funded. Or a tax cut could be targeted to lower income taxpayers.

At a time when unemployment is low and the economy is doing well, it is particularly important to ask whether subsidies that, in theory, create jobs, are the best use for a state's resources. Longer-term objectives, and the needs of the people of a state, may be better served by other means.

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[2] The $42 million estimate of the cost of the proposal has been suggested by analysts in Rhode Island. The ITEP model produces a consistent estimate. The precise cost varies depending on what year is analyzed.

A Federal Tax Increase

To assess how this tax cut proposal stacks up against the alternatives, we need to evaluate how it might improve Rhode Island's economic condition. The first thing to note is that a substantial portion of the revenue lost to the state will quickly be separated from the wealthy Rhode Islanders who receive it. As you all know, Rhode Island's personal income tax depends on the federal personal income tax. But, to a lesser degree, the converse is also true.

State income taxes are deductible on the federal tax return. Thus, when a state cuts its personal income tax, the amount deducted on the federal tax return is reduced. With the lower deduction, the federal tax goes up. The higher the federal marginal rate, the larger the portion of a state tax cut that is offset by higher federal taxes. For example, for most taxpayers paying at the top federal marginal rate, every dollar in reduced deductions due to cuts in the state income tax will cause federal tax liability to go up by about 40 cents. Thus, the net cut for the taxpayer is 60 cents even though the state loses a full dollar in revenue.

This proposal is designed so that those in the highest federal tax brackets get nearly all of the state tax cut. Thus, it is not surprising that over one-third of the proposed tax cut will end up going to the federal government via the federal personal income tax. We estimate that the $42 million in reduced collections by Rhode Island would result in Rhode Islanders paying over $15 million more in federal income taxes. Put another way, of $42 million that would otherwise be spent by the state of Rhode Island, in Rhode Island, for the sake of Rhode Islanders, $15 million would be sent to Washington with only $27 million staying in the state.

A Spur to Rhode Island Investment?

Thus, in assessing the economic impact, we start off with the Rhode Island economy down $15 million. But what might the wealthy Rhode Islanders do that would help the state with the $27 million they'll be left with? The first thing to note is that, under the proposal, they can do anything they want with it. They can spend it anywhere or invest it in anything—they get the tax break whether they spend it in Utah or invest it in Timbuktu. Investments in California companies get as big a break as investments in Rhode Island companies.

Even taxpayers with direct ties to Rhode Island businesses benefit from the tax cut no matter what they do. If they lay off Rhode Island employees, they get the tax break. If they move half their business to North Carolina, they get a tax break. As long as they are living in Rhode Island they get a personal tax break no matter what their business does.

Under these circumstances, one would expect that investment opportunities providing the greatest return would attract the bulk of additional investment capital available. While some of those opportunities are in Rhode Island, the vast majority are elsewhere. Hence, of the $27 million in tax break that doesn't go straight to the federal government, most of it is likely to go out of state.

For this reason, it is, to some degree, not even necessary to get to the question of whether savings and investment incentives in personal income taxes are, in principle, a good idea. There is huge disagreement about whether lower federal taxes on capital gains, or other savings and investment incentives, have a positive economic impact. But, it's almost a matter of religion with many people and a debate for another day.

Even if one is a believer in federal capital gains tax cuts, however, it doesn't necessarily follow that the capital gains tax cut proposed here would help the state's economy. Even if lowering the tax rate on capital gains spurs investment—a debatable point in itself—there is nothing in this proposal to steer it particularly to Rhode Island. That's why the only two state government agencies I know of to use their economic models to analyze capital gains tax cuts both came to the conclusion that they would not significantly help their state's economy.

A Magnet for Businesses?

Proponents claim that their tax cut will attract business people, and the jobs they create, to the state. There have been many studies of this issue and taxes have generally been found to be well down the list of reasons for locating a business. Access to markets, quality of the work force, wage levels and other factors typically rank much higher than taxes. Nor is there a consistent correlation between states' overall level of taxation and their general economic well-being.

This proposal is particularly ill-suited to achieving the objective of creating new, and better, jobs in Rhode Island. With any business subsidy, one never knows for certain if the subsidy given really causes the behavior claimed by the recipient. The recipient might have done the same thing without the subsidy. But, the linkage is particularly weak with this proposal. Here, the business, as such, isn't even involved. Some individuals who are in positions of authority would benefit from the proposed tax cut, but their influence and effectiveness would be impossible to assess. Although subsidies directed at businesses are often flawed, at least there can be standards attached to the recipient of the benefit for numbers of jobs created and wage and benefit levels. With this proposal, there is only hope. We hope that those wealthy people who are in positions of authority will do some good for the state in return for their largess.

This seems particularly unlikely in the case of corporate executives. If we were discussing corporate income tax breaks, one could, at least in theory, envision how a corporate executive might determine that it was in the best interest of his or her shareholders to locate a portion of the business in Rhode Island for tax reasons. After all, the lower corporate tax would presumably benefit the shareholders. But how could a corporate executive justify, in good faith, making a decision on where to locate a business based on his or her personal income tax liability? Corporate executives have a fiduciary duty to their shareholders. Their obligation is to maximize profits. If they were to make a corporate decision based on their personal income tax liability they would be violating their responsibility to their shareholders.

Rhode Island, A High Tax State?

One reason that state and local taxes don't make a significant difference is that, for the most part, they do not vary hugely from state to state. Specifically, Rhode Island's overall taxes are not out of line with other states.

In 1996 Rhode Island ranked 17th in taxes as a share of personal income. That put them behind such states as Connecticut, Vermont, Maine and New York. Even the rank of 17th is misleadingly high. With a tax burden of 11.5 percent of personal income, the state was only 0.4 percentage points higher than the national average. Rhode Island is in a broad group of states around the middle of the rankings that have very similar tax burdens.

State & Local Taxes as a Share of Personal Income

	All State & Local Taxes, 1996	US Rank	Personal Income Tax, 1998	US Rank
New York	14.3%	2	4.0%	4
Maine	12.8%	7	3.2%	13
Vermont	12.0%	9	2.6%	30
Connecticut	11.6%	11	2.8%	22
Rhode Island	**11.5%**	**17**	**2.8%**	**20**
Massachusetts	10.9%	28	4.1%	3
New Hampshire	8.8%	51	0.2%	42
All States	11.1%		2.5%	

NOTE: Rankings include DC

SOURCE: Bureau of the Census; BEA

Nor, at number 20, does Rhode Island rank high in personal income taxes. Massachusetts, by way of comparison, ranks third. Again, Rhode Island is in a group of states clustered around the middle of the ranking, all with a similar level of taxation.

Note that this ranking of total personal income tax collections implicitly takes into account all of the aspects of each states' income tax structure: all of the rates, exemptions, deductions, etc.. Those who favor the tax cut proposal, choose, instead, to focus on Rhode Island's top marginal tax rate. Even by this measure, however, Rhode Island is not as far above other states as would appear by overly simplistic comparison.

The Rhode Island top marginal rate will be 25 percent of the federal top rate of 39.6%—9.9 percent—in 2002. This is somewhat higher than most states, but not by much. In addition, unlike most states, Rhode Island, because of its piggy-back system, taxes capital gains at a lower rate than ordinary income. Rhode Island's top rate on capital gains is 5 percent.

Furthermore, the difference between the 9.9 percent and the rates of other states is less than it would appear at first glance. Compare, for example, North Carolina which has a top rate of 7.75 percent. The difference between North Carolina and Rhode Island would appear to be 2.15 percentage points. This is hardly an earth-shattering difference. But even this comparison exaggerates the gap. As I discussed before, if a taxpayer's state income tax goes down, then their federal income tax goes up. Thus, for most taxpayers in the top federal bracket, if they were to move from Rhode Island to North Carolina, the actual drop in net marginal tax rate would be only 1.3 percentage points when the federal tax impact is accounted for. Furthermore, because North

Carolina, like most states, has no preferential treatment for capital gains income, our migrating taxpayer’s capital gains top marginal rate would go up by 2.75 percentage points before accounting for the federal tax effect and 1.7 percentage points after accounting for the federal tax effect.

Thus, even if one focuses on top marginal tax rates, the differences between states are not all that great. And, if the entire structure of the income tax is accounted for, Rhode Island ranks near the middle of the states.

The bottom line is that in the context of all the other costs of doing business and compared to the federal top marginal rate of 39.6 percent, the difference between Rhode Island’s tax rates and those of other states just isn’t very great—and in the case of capital gains is lower than a majority of states.

Another factor mitigating against businesses choosing their location based on taxes is that tax law in not permanent. It is not a phenomena peculiar to Rhode Island that elected officials come and go and tax policy gets changed. Just in this region, Massachusetts is likely to stop the phase-in of its capital gains loophole this year. Also, both houses of the New Hampshire legislature have recently passed versions of a broad-based state personal income tax. The small differences that exist in tax burden, balanced against all of the other costs in locating a business and the lack of constancy in tax policy make moving to chase tax breaks of the type proposed here a poor business strategy.

Finally, as we and others have indicated, this is a tax break to the wealthy. Isn’t one of the points of being rich that you can live where you want? The people affected by this tax change have much less of a financial limit on where they live than most people. I would suggest that they live in Rhode Island because this is where they want to live. A relatively small savings in taxes is not likely to have a major impact on a significant number of these citizens.

Summary

There is a proposal to cut taxes in Rhode Island by $42 million. Of that, $15 million immediately would leave the state for the federal government. The remaining $27 million would go into the pockets of the wealthiest people in Rhode Island and either be spent or invested. Some of what is invested would end up in Rhode Island, but most would probably leave the state. And, the change in taxes is unlikely to make a major difference to business people deciding where to locate.

In the process, the already regressive Rhode Island tax system would become more regressive and the tax cuts would be going to the same wealthy households who have received sizable tax cuts over the last two years.

Rhode Island can choose to pursue this course or one of many others. The state could give tax cuts to lower-income families, giving *them* more to save and spend. Or, the state could invest in its infrastructure or schools. Or, the state could spend the money for subsidies that actually go to businesses and require those businesses to meet specific criteria in order to get their tax breaks. A project of ours, called “Good Jobs First,” has done a great deal of work in how to make businesses accountable for the economic development subsidies they receive.

There are no magic silver bullets in economic development. Government should stick to the basics: maintain and develop infrastructure, provide a safe and healthy community and educate its citizens. Doing these things well is far more likely to improve the long-term prospects of the citizens of a state than providing tax breaks to its best-off residents—no strings attached.