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MEMORANDUM

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NEW ENGLAND PUBLIC POLICY CENTER

Re: Testimony before the Rhode Island Senate Finance Committee Regarding the Proposal to Phase Out the State's Corporation Income Tax
By: Robert Tannenwald, Vice President and Economist, Federal Reserve Bank of Boston, New England Public Policy Center
Date: May 2009

Chairman DaPonte, Vice Chairman Pichardo, and other members of the Committee, thank you for the opportunity to testify before you this afternoon. For the record, I am Robert Tannenwald, Vice President and Economist at the Federal Reserve Bank of Boston and Director of its New England Public Policy Center. I have been with the Bank for 27-1/2 years. My principal area of expertise is state and local public finance. In addition to publishing extensively in this field, I have served on five state tax commissions, study groups, or work groups in three New England states: Massachusetts, New Hampshire, and Rhode Island. I have directed the research of three of them. Most recently, I served as a member of Governor Carcieri's Strategy Tax Workgroup, which finished its work in early 2009. In 2007, I served as President of the National Tax Association in 2007, its Centennial Year.

I intend to confine my remarks exclusively to Article 37, which proposes to phase out the state's corporation income tax by 2014. Much of my research has focused on state tax competitiveness; consequently I feel that I can best contribute to debate on this proposal.

Any views that I express today are my own. They are not necessarily those of the Federal Reserve Bank of Boston or the Board of Governors of the Federal Reserve System.

I think that the most fruitful way to proceed is 1) to evaluate the competitiveness of Rhode Island's Business Taxes, 2) to estimate how much the competitive standing of Rhode Island's business taxes would improve if the proposal to phase out the corporate income tax were fully implemented, and 3) to speculate on the amount of additional economic growth that Rhode Island would enjoy as a result of this proposal.

There are many indicators of a state's business tax competitiveness. Each has strengths and weaknesses. There are too many aspect of tax competiveness for which timely data do not exist to develop the "perfect" indicator. In my opinion, the best indicator available on a regular timely basis for every state and the U.S. as a whole is computed by Ernst and Young LLP and published by the Council on State Taxation. The indicator of competiveness is computed according to the following steps:

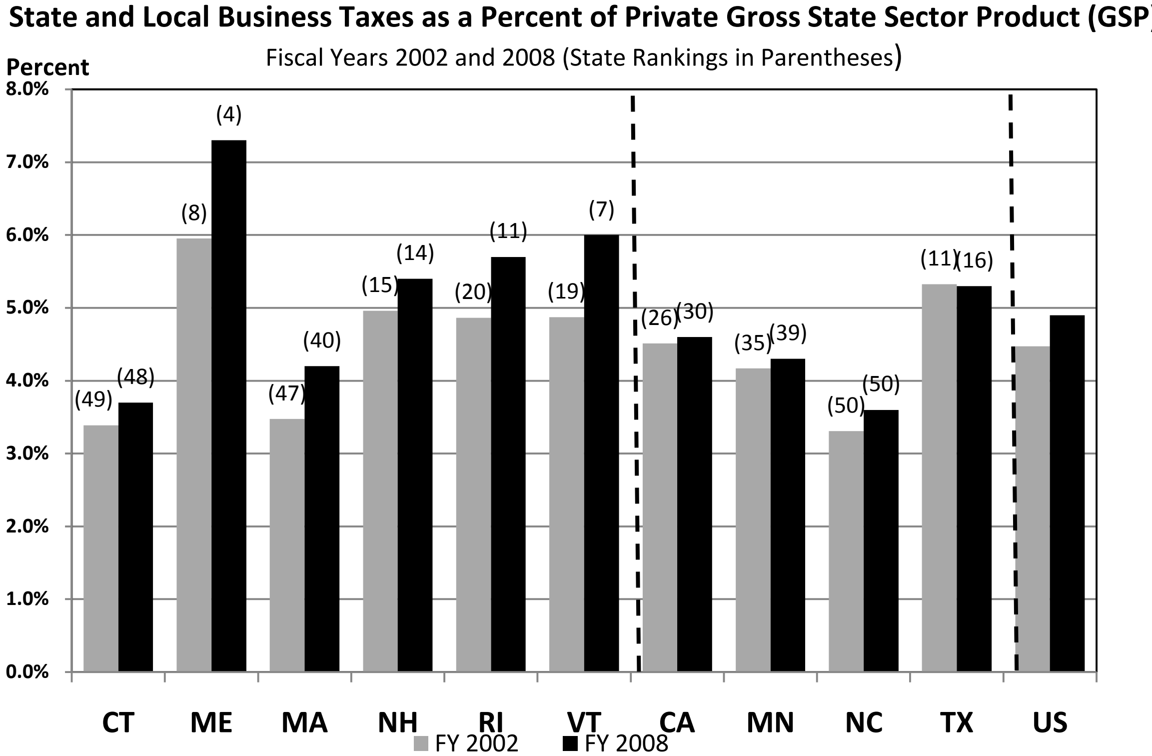
1) All state and local taxes for which businesses are liable are summed.
2) The value of Gross State Product originating in the state's private sector is divided into this sum. The denominator, private sector GSP, is a proxy for profits earned by businesses in state.

The Strategic Tax Policy Workgroup's Business Taxes Subgroup recognized the value of this measure in its chapter of the Strategy Workgroup's Final Report (Report of the Governor's Tax Policy Strategy Workgroup, March 6, 2009, p. 35).

Some taxes are easy to identify as business taxes. Corporate income taxes and unemployment insurance taxes are cases in point. Others, like property taxes have to be divided into household and business components. Property taxes paid by homeowners occupying their homes are household taxes. Just about every other property tax bill is paid by a business—even taxes paid by landlords on land classified as residential constitute business taxes. Sales taxes and consumer goods versus intermediate business purchases have to be factored out too.

The strength of this measure is that it tries to estimate the bite that business taxes take out of profits, which in my opinion, a business person cares most about.

The chart on page three presents this measure of business tax burden for both FY2002 and FY2008 for all the New England States, the U.S. as a whole, and a selection of states often identified as competitors; California, Minnesota, North Carolina, and Texas. In 2008 Rhode Island's business tax burden ranked 11th in the nation, considerably higher than that of Massachusetts and Connecticut, but lower than that of Vermont and of Maine. Since 2002 there has been a trend toward higher business tax burdens in most states. While several factors account for this (one, perhaps the slightly different position in the business cycle of 2002 and 2008) more aggressive "loophole closing" has played a role.



Source: Ernst and Young LLP 50 State Estimates of State and Local Business Taxes and U.S. Bureau of Economic Analysis. Note: The 2002 estimates are exact numbers, while the Ernst and Young estimates for 2008 are rounded to one decimal point. If the 2002 estimates were to be rounded to one decimal, Connecticut would be ranked 48, Maine would be ranked 7, Massachusetts would be ranked 45, Rhode Island would be ranked 17, Vermont would be ranked 17, California would be ranked 25, and Minnesota would be ranked 34.

So, how much would Rhode Island's business tax burden fall if the corporate income tax were eliminated and replaced with a "minimum" tax whose requirement increased with profitability? How much would its ranking improve, assuming all states keep their tax laws constant? The net cost of the proposal has been estimated at $82 million. However, since the revenue estimate that I was shown was for FY2009, I thought I would estimate the proposal's impact on competitiveness assuming an $80-$90 range of impacts.

Whether the tax cut were 80 million or 90 million dollars, Rhode Island's business tax burden would fall two-tenths of a percentage point, from 5.7 percent to 5.5 percent, rounded off to the nearest tenth of a percent. However, under the assumption of a net cost of $80 million, Rhode Island's business tax burden would fall from the 11th highest to the 12th highest. Under the assumed cost of $90 million, Rhode Island's business tax burden rank would fall to 13th.
How is this possible? How can the virtual elimination of a major business tax produce such a small reduction in the competitive standing of Rhode Island's business tax structure? Because Rhode Island's corporate income tax is an extremely small fraction of its total business taxes. RI's corporate income tax accounts for 6.2 percent of its state and local business taxes, according to Ernst and Young. Nationwide, the comparable percentage is 9.6 percent.

But what about property taxes? In Rhode Island they account for 51 percent of business taxes, one of the highest percentages in the country. The nationwide percentage is 35.5 percent. The real anti-competitive tax albatross hanging around Rhode Island's neck is its onerous taxes on business property. The Tax Policy Strategy Workgroup explicitly recognized this and set forth recommendations for easing property tax burdens on the Ocean State's businesses (*Report of the Governor's Tax Policy Strategy Workgroup,* March 6, 2009, pp. 39-43, 55-56).

Still, at the final meeting of the Commission, some argued that phasing out the corporate income tax would have significant symbolic value that would send a message to the nation and, for that matter, the world, that Rhode Island is "open for business". I fear that this signal will be clouded by a lack of a clear plan for financing the phasing out of the corporate income tax (other than a modification of the corporate franchise tax to bring in a little over 30 million dollars). How will the rest be financed? What other taxes might have to be raised? What spending might have to be reduced? How many Subchapter S and LLPs will change back to the corporate form, further augmenting the possible revenue loss? If these questions are not answered clearly, businesses will be wary of the uncertainties surrounding the tax cut. As the Strategy Workgroup's majority final report asserted:
"A tax system that is **predictable** is preferable. People need to know and count on their tax liability..."(*Report of the Governor's Tax Policy Strategy Workgroup*, March 6, 2009, p.17).

Thank you again for taking the time to listen to my thoughts on these issues. Although I live in Massachusetts, my family has strong roots in Rhode Island. My father, brother, and younger son all attended college here. It is a beautiful state with a long distinguished history of economic innovation.
I hope that your fiscal and economic recovery proceeds faster than expected and that quickly, you are on a path of sustained stable growth, generating widely shared wealth.
I would be happy to answer any questions.