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Testimony before the Rhode Island Special Joint Legislative Commission to Study the Sales Tax Repeal

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Hearing of the Rhode Island Special Joint Legislative Commission to Study the Sales Tax Repeal

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Mr. Chairman, Members of the Commission:

Good afternoon. It is an honor and a pleasure for me to be in front of you today. For many years now, I've had the chance to come to Rhode Island to discuss tax policy with elected officials and Mr. Simmons has invited me up many times to speak at his events. Visiting the Ocean State is something I always truly look forward to.

We at the Tax Foundation get a lot of mail and e-mail with crazy tax ideas. It's the nature of the business, I suppose. People convinced the Sixteenth Amendment was never ratified. People who have come up with their own new all-encompassing tax idea. Not a week goes by without something like that coming across our desk. Depending on who it is, we try to be polite and explain whatever needs to be explained.

A state doing without a sales tax is not crazy. As you know, of course, there are five states that do without a state sales tax. Before eighty years ago, no state had a sales tax. They came about not as a well-thought-out, well-designed tax but as a crash implementation in the midst of crisis—the Great Depression. In fact, if you got the nation's public finance and state tax experts in a room, and asked them to design a sales tax, it would look very different from the sales tax that many states, including Rhode Island, have today.

What 9 out of 10 public finance experts would say is that the sales tax should apply to all final sales of goods and services, while exempting all business inputs. That way, the tax is neutral, does not distort economic decisions, and keeps pace with the economy. Many state sales taxes—including Rhode Island—do the opposite. Many goods and nearly all services are exempt from tax, while business purchases are taxed. The result is that some items are taxed multiple times and others not at all.

I think you all already know that Rhode Island's sales tax rate is high, both nationally and compared to its neighbors. But you may not know that Rhode Island's sales tax base—what is and is not taxed—is among the narrowest in the country. Only 25 percent of what people buy is subject to Rhode Island's sales tax. Only Illinois, Massachusetts, and New Jersey have narrower sales taxes. You are exempting 75 percent of the economy from the sales tax already and imposing a high rate on the rest that you do tax.

I would say that this means reform of some kind is needed. We've spoken in the past on various reform measures—Governor Chaffee's sales tax broadening plan right after he took office, Governor Carcieri's income tax changes, and so forth. I will be perfectly honest with you, when I first heard of the zero sales tax idea for Rhode Island, my first reaction was—nice idea but how can it possibly happen? Again, and you don't need me tell you this, Rhode Island depends on the sales tax for about 30 percent of its tax revenue—a lower dependence than the average state but still a big number. Almost $900 million.

So if you'll indulge me, there are three points I want to share as I thought about this idea and whether it should happen and, if so, how it can happen.

First, no fiscal expert—not one—would tell you that a sales tax repeal would mean a 100 percent revenue loss of all $887 million. Taxes affect behavior, and that's as true of the sales tax as any other tax. Delaware has no sales tax and on the border with New Jersey—which has the same sales tax rate as Rhode Island—there are a bunch of retail stores that do a brisk business. I was just in Portland, Oregon, another state with no sales tax, and it has about the most vibrant independent retailer market in the country for a big city. People will drive out of their way to avoid that 7 percent. Those added sales will mean added business activity, added jobs, and added income and business tax payments to the state. So called "static" revenue estimates are easy to do but get more and more wrong the bigger the tax change. For a tax change like this, you have to know there will be strong dynamic effects.

Where we start disagreeing is how much will come back of that $887 million. I know you have been hearing from the STAMP people, and the REMI people, and of course Mr. Dion and the DOR, and probably some others. They probably all agree that repealing the sales tax will lose more than $0 and less than $887 million, will create jobs of some positive net number, and will lead to increased business activity of some amount. All of these modelers have a reputation for being conscientious about doing their best to try and get as close as possible. It is, however, difficult to model the decisions of a million people in Rhode Island, and millions more in surrounding states, and estimate how their behavior will change with a bold tax change. Think about their results carefully, but I would agree there would be a revenue loss involved of much less than $887 million.

Second, a spurious argument you should be aware of is the "three legged stool" argument. Now there are plenty of decent and sensible reasons to oppose a sales tax repeal or reduction but this is not one of them. The argument goes something like you need every major tax because that way you have a diversity of revenue options. Much like a stool needs three strong equal legs, a state revenue system needs three separate revenue sources.

There is no academic evidence supporting this urban legend. In fact, the state with the most stable revenue over the last ten years was South Dakota: a state that doesn't even have corporate and individual income taxes, and gets nearly half its revenue from the sales tax. One of the most volatile was California: a state that has every major tax. Believe me—it's my home state—if there's a tax out there, California's got it.

In reality, if you want a stable tax system—stable for government and for taxpayers—what matters is that you have a well-structured tax system with broad bases and low rates. Having three revenue sources achieves nothing if each of them is badly designed, with high rates and narrow bases as in California. There's no magic number of taxes, whether it be 2, 3, or 120. What matters is that the taxes you do have be well-structured.

Third, I cannot understate how intense the interstate competition for jobs and investment and people is becoming now. I chat with governors, economic development officers, site relocation experts, businesses big and small, and they are constantly looking at their options. Instantaneous communication and near-instantaneous transportation for people and goods means that, increasingly, people can live and work just about anywhere. And that means states increasingly need to be thinking about—and if I leave you with one thought, it's this—why my state? Why should a business entrepreneur, a college graduate, or a venture capitalist pick here out of all the places in the world. Now I work at the Tax Foundation, but I freely admit taxes are not the only factor that go into these decisions. State services matter. Housing prices matter. Where you were born matters. Even the restaurant scene matters. New York has an awful tax system but they have the legacy of when they had a good tax system—Wall Street and skyscrapers filled with corporate officers—and you can buy a hot sandwich at 3:00 in the morning. The difficulty confronting Rhode Island is do you keep the awful tax system—one near the bottom of every national ranking—and "make it up" with something else, or do you try do something bold to stand out and make the tax system better?

We ran the sales tax repeal proposal through our State Business Tax Climate Index, where Rhode Island currently ranks 46th out of the 50 states, with a more business friendly tax system than only Minnesota, California, New Jersey, and New York. With no sales tax, Rhode Island would have rocketed up to 31st, a significant improvement. If reform were coupled with some reform of the corporate income tax—taking away some targeted tax credits and lowering the very high rate—Rhode Island could move into the top half of states on taxes.

It can happen. Something bold is needed. New Hampshire and Montana, in particular, are two states with about the same population size as Rhode Island, and without any of the resource or business location miracles that allow Alaska or Delaware to go without a sales tax. I have a handout on these differences but that is how I would characterize this proposal: bold, difficult, but feasible.

Thank you.

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