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Rhode Island Officials Consider Income Tax Reform

By Joseph Henchman and Kail Padgitt

Rhode Island officials are taking steps that may result in a tax reform effort with positive implications.

The Challenge

The Ocean State currently suffers from a 12.5% unemployment rate, higher than every state except California, Nevada, and Michigan. The state is the tenth-highest in state-local tax burden, has the seventh-highest state-local property tax collections, and has the fifth-highest state-local debt per capita. The 9.9% top individual income tax rate is among the highest in the country, as is the 9% corporate income tax rate, and the 7% sales tax is high as well. The cigarette tax is also the highest in the country. The state puts heavy reliance on the usual corporate giveaways through the tax code (job credits, research-and-development credits, investment credits, film credits, etc.). These programs are generally more about photo-ops and handouts to the politically connected than broad-based economic development.

Our 2010 *State Business Tax Climate Index* ranked Rhode Island 44th in the country in favorable business tax climate, comparing unfavorably with its immediate neighbors:

Table 1
Rhode Island and Its Neighbors' Business Tax Climate Ranks

State	2010 *Index* Overall Rank
Rhode Island	44
Connecticut	38
Massachusetts	36

Source: Tax Foundation *2010 State Business Tax Climate Index*

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As we put it last year, Rhode Island faces a tough tax situation because it has significantly lower per-capita income than its two neighbors, and therefore must impose higher taxes to raise revenues in line with its neighbors. Unfortunately, those high tax rates add further incentive for wealthy people and businesses to leave Rhode Island for its lower-tax neighbors, or for other parts of the country.

Consensus for Change: Optional Flat Tax and Carcieri 2009 Proposal

Consequently, a consensus has developed among Rhode Island policymakers that the state's tax system is a hindrance to long-term economic growth. In 2006, officials began phasing in an optional flat tax, whereby taxpayers could eschew the 9.9% rate coupled with myriad credits and deductions, and instead pay one rate on all their income. The rate began at 7% and has been stepping down each year. In 2009, the optional flat tax rate stood at 6.5%; in 2010, it is 6%; and in 2011 it will reach 5.5% where it will stay.

If the 5.5% optional flat tax was in place in 2010, Rhode Island would rank 43rd in the *State Business Tax Climate Index* instead of 44th.

The optional flat tax has been the key driver to the state's modest improvement in the *State Business Tax Climate Index*, from dead last (50th) in 2006 to 44th in 2010. (Note: We give a state credit only for tax changes that are in effect as of our annual snapshot date, and not for legislated changes that have not yet taken effect. Sometimes legislated tax reductions are postponed or cancelled, as happened in Ohio this year.)

Last year, Rhode Island Gov. Don Carcieri (R) proposed a plan to phase out the state's corporate income tax over four years, joining four other states without a major business tax. The plan also eliminated many deductions and credits and reduced the top individual income tax rate to 5.5%. Carcieri also proposed to raise the cigarette tax still further, by $1 to $3.46 per pack, the only part of the proposal that was enacted.

The 2009 Carcieri plan was ambitious but would have given Rhode Island a chance to step out from its neighbors' shadows and specialize in attracting capital, business activity, and economic growth. Last year we estimated that had the Carcieri plan been enacted in 2009, the state would have moved from 46th to 16th in the nation in our *State Business Tax Climate Index*.

Current Proposal

In late May 2010, Rhode Island legislative leaders began outlining a tax reform proposal. As we understand it at press time, the plan would incorporate these elements:

- Replace the state's current individual income tax structure with three brackets, with a top rate of 6%.
- Raise the amounts of the lump-sum standard deduction that most taxpayers claim, but eliminate the option to make a detailed list of deductions - a process known as itemizing.
- Allow only a handful of tax credits, including one for taxes paid to other states, the earned-income tax credit, the statewide property-tax relief credit and a credit for residential lead-paint abatement. Tax credits for investment, research-and-development, and job creation would be repealed but the film tax credit would remain.
- The optional flat-tax method of calculating one's Rhode Island income tax would be eliminated.

Minor differences between House and Senate versions remain to be worked out, but if the outline of the proposal were in place in 2010, Rhode Island would rank 41st in the *State Business Tax Climate Index* instead of 44th. This indicates the plan would be a modest but positive change for the state's tax system.

Table 2
Rhode Island and Its Neighbors' Business Tax Climate Ranks With Changes

State	2010 *Index* Overall Rank	2010 *Index* Overall Rank with Fully Phased-In Flat Tax	2010 *Index* Overall Rank with May 2010 Tax Proposal
Rhode Island	44	43	41
Connecticut	38	38	38
Massachusetts	36	36	36

Source: Tax Foundation.

Conclusion

Rhode Island has shown its willingness to tackle its problematic tax system. Tax pundits were surprised when the state became a flat-tax pioneer, and the broad consensus for improvement means that this may be the Ocean State's moment. Rhode Island can compete with its border states and beyond, and it has recently shown the political will to do so. As the economy improves, capital and investment will flow to those states best positioned for it. Rhode Island has a chance to welcome that opportunity, and frankly, the state has nowhere to go but up.

The state should not get rid of the optional flat tax lightly but the proposal under discussion is an improvement, albeit a modest one. Tackling the state's high corporate income tax rate, particularly as they eliminate credits and deductions used by many businesses, may be politically essential. But the plan echoes the advice of tax experts everywhere: broad bases and low rates.

Note: After press time, we were informed that legislative leaders may only eliminate tax credits and deductions in the individual income tax code. Our report assumes the elimination of tax credits and deduction in both the individual and corporate tax codes.