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Businesses' Share of State and Local Taxes

Businesses in Rhode Island paid 46.0 percent of total state and local taxes according to a study published by Ernst & Young in conjunction with the Council on State Taxes. This RIPEC Comments analyzes the state and local taxes paid by businesses in the Ocean State and compares those tax payments to Massachusetts and Connecticut, as well as to national trends. The report also suggests that business tax changes proposed to help balance the State's FY 2008 State Budget should be evaluated in the context of the State's long-term economic policy objectives.

Highlights in this report include:

- Property taxes on business property in Rhode Island account for the largest share, almost 42.0 percent, of total state and local business taxes;
- Rhode Island businesses paid over 55.0 percent of the total increase in state and local tax collections from FY 2002 to FY 2006; and
- Corporate income taxes represent 12.5 percent of total state and local business taxes in Rhode Island. Nationally it equals 9.4 percent.

State and Local Taxes Paid by Business

Ernst & Young, in conjunction with the Council on State Taxation, periodically publish estimates of state and local taxes paid by business. Information presented below is taken from their latest study – *Total State and Local Business Taxes – 50 State Estimate for Fiscal Year 2006.* This study includes business property, sales and excise taxes levied on businesses for their input purchases, gross receipt taxes, corporate income and franchise taxes, business and corporate license taxes, unemployment payroll taxes, income taxes paid by owners of pass-through businesses (non-corporate), and other statutory state and local taxes.

This data attempts to show how heavily state and local tax structures rely on businesses to support public services and government operations. This study is not meant to be a measure of a state's relative tax competitiveness. As the report states:

> "A state's competitiveness depends on the level of business taxes compared to the level of economic activity that is being taxed and the final incidence of business taxes, after they have been shifted to consumers or factors of production."

Businesses in Rhode Island paid 46.0 percent of total state and local taxes. This compares to the national average of almost 45.0 percent, but is in marked contrast to both Massachusetts and Connecticut where business taxes as a share of state and local taxes are 38.7 percent and 34.3 percent, respectively.

The following table shows the different taxes paid by Rhode Island business along with a comparison with Massachusetts and Connecticut. Analysis of the data presented reveals:

- Property taxes on real, personal and utility property owned by business account for the largest share of total state and local business taxes: 41.7 percent in Rhode Island, 29.7 percent in Connecticut and 45.0 percent in Massachusetts. Nationally property taxes equaled 37.0 percent of all state and local taxes paid by business.
- Sales taxes represent 16.7 percent of all state and local taxes paid by Rhode Island business. This tax ranked second highest of all taxes paid by Rhode Island businesses. In Connecticut 22.0 percent of business taxes were generated by sales tax collections and in Massachusetts 12.2 percent. Nationally sales taxes composed 23.0 percent of all state and local business taxes. Only the taxes paid on business operating inputs and capital equipment purchases are counted. Sales and use taxes collected on sales to final consumers are not included.
- A greater portion of state and local business taxes are generated by the corporate income tax in both Rhode Island and Massachusetts than is the case nationally. Corporate income taxes constituted 12.5 percent of total state and local business taxes in Rhode Island, 8.8 percent in Connecticut, 13.7 percent in Massachusetts and 9.4 percent for the United States.

Rhode Island businesses paid 55.5 percent of the additional state and local taxes collected from FY 2002 to FY 2006. This compares to 33.3 percent in Connecticut and 46.0 percent in Massachusetts. For the nation as a whole, 49.0 percent of the additional state and local tax was generated by businesses during this period.

The share of taxes paid by business reflects a number of factors. These include the state's overall tax structure, unique economic characteristic and the type of business taxes levied including tax features aimed at providing competitive advantages. The level of taxes paid by business results from trade-off between the level and type of public services desired and the need to maintain a fair and competitive business tax climate.

State & Local Business Taxes By Type FY 2006
(dollars in billions)

	Rhode Island		Connecticut		Massachusetts	
	Amount	Percent	Amount	Percent	Amount	Percent
Property Taxes	$1.0	41.7%	$2.7	39.7%	$5.9	45.0%
Sales & Use Taxes for Business Inputs	0.4	16.7	1.5	22.1	1.6	12.2
Excise & Gross Receipts	0.3	12.5	0.7	10.3	0.9	6.9
Corporate Income	0.3	12.5	0.6	8.8	1.8	13.7
Unemployment Insurance	0.2	8.3	0.6	8.8	1.7	13.0
Individual Income*	0.1	4.2	0.5	7.4	0.8	6.1
License & Other Taxes	0.1	4.2	0.2	2.9	0.4	3.1
Total	$2.4	100%	$6.8	100%	$13.1	100%

*Only pass-through business income.

Source: Ernst & Young, *Total State and Local Business Taxes -- 50 State Estimates for Fiscal Year 2006*, February 2007.

Recent Tax Initiative Affects Business

Over the past decade Governors and the General Assembly have initiated several tax changes aimed at enhancing Rhode Island's economic competitiveness. Examples of such landmark tax legislation enacted over the last decade include the following:

- Decreasing the personal income tax rate from 27.5 percent to 25.0 percent based on the federal income rates in effect immediately prior to enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001;
- Providing for a two-year phase out of the tax on capital gains from assets held more than five years beginning in 2007;
- Establishing a historic tax credit equal to 30.0 percent of the rehabilitation costs for historic structures;
- Allowing eligible businesses to provide employees with a 50.0 percent exclusion from adjusted gross income from the personal income tax on performance-based Rhode Island income. As a quid pro quo, the business must pay a tax of 5.0 percent of the total performance-based compensation paid to its eligible employees;
- Modifying the multi-state apportionment formula for manufacturers to give double weight to the sales factor;
- Enacting property tax relief legislation, which limits the growth in property taxes, and a flat income tax option for upper income Rhode Islanders; and
- Enacting and expanding tax credits aimed at encouraging business investment as evidenced by the 22.5 percent Research and Development Tax Credit, Passive Investment Companies legislation, doubling of the Investment Tax Credit, a biotechnology investment tax credit and motion picture tax credits.

The policy objective driving these tax changes is the desire to improve Rhode Island's business tax climate. The Tax Foundation (see *2007 State Business Tax Climate Index*, October 2006) ranked Rhode Island's business tax climate as the worst business tax climate in the country and observed:

> "Examples of companies choosing states due to favorable tax systems are plentiful. A recent example, from 2005, is Intel's decision to build a multi-billion dollar chip-making facility in Arizona due to its favorable corporate income tax system. California struggles to retain business within its borders because Nevada provides a low-tax alternative. Anecdotes such as these reinforce what we know from economic theory: taxes matter to business, and those places with the most competitive tax systems will reap the benefits of business-friendly tax climates."

Fiscal Stress in Business Taxes

Between FY 1998 and FY 2008 State spending increased by 83.7 percent, outpacing the rate of growth in both personal income (61.0 percent) and inflation as measured by the Consumer Price Index (30.6 percent).

Given the growth in State spending and the use of non-recurring revenue to balance State budgets, Rhode Island faces a structural budget deficit and annual out-year deficits averaging $380.0 million.

Therefore, it should not be surprising that proposals to increase business taxes are being offered as an option to help balance the FY 2008 State Budget. Legislation has been introduced to close "so-called" corporate tax loopholes. Examples include legislation affecting the Passive Investment Companies (PIC) and imposing a throwback rule in determining a company's Rhode Island corporate tax liability.

Business tax increases proposed in response to the current fiscal situation should be considered in the context of the long-range economic policy objectives of the Ocean State. To help measure the effectiveness of tax and revenue measures, the General Assembly established a Department of Revenues. One of the functions of this new department will be to assess the costs and benefits of various tax expenditures.

Are the tax expenditures resulting from the favorable treatment afforded business achieving the objective of stimulating permanent investments and job growth? RIPEC's analysis of the proposed FY 2008 State Budget (see *Summary of the Governor's FY 2008 Budget Request – RIPEC Proposed Fiscal Get Well Plan for Rhode Island*) commented:

> "…existing tax credits should be evaluated to determine if they are achieving their objectives. If they are not, they should be modified and used to help eliminate the structural budget gap."