Comments on Your Government

RIPEC

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An Analysis of Rhode Island's 2012 Sales Tax Modernization Proposal

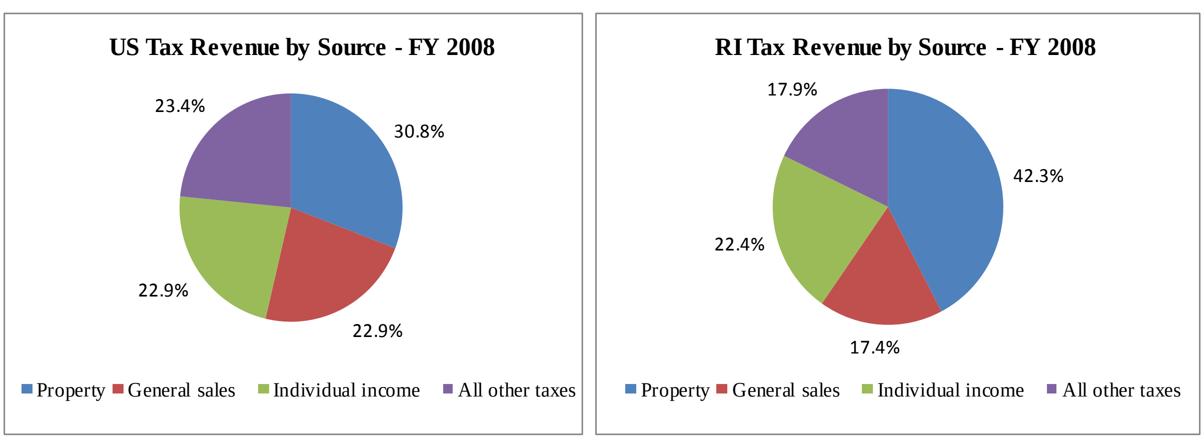
This RIPEC Comments is intended to provide information on the sales tax modernization plan as proposed by Governor Lincoln Chafee. The report reviews the history of the sales tax in Rhode Island, examines how the state compares nationally and to neighboring states, and summarizes the Governor's sales tax proposal to lower the sales tax rate from 7.0 percent to 6.0 percent, expand the current taxable base, and add a 1.0 percent tax to a number of currently exempt items.

Introduction

Sales taxes constitute one of the three primary taxes – income, property and sales – that fund government services. The State of Rhode Island currently has a sales tax rate of 7.0 percent, levied at the point of purchase, on gross receipts of retail sales and a 7.0 percent use tax on taxable goods and services purchased out-of-state but brought into the state for use. The state's 7.0 percent rate is the second-highest in the country (behind California and tied with Indiana, Mississippi, New Jersey and Tennessee). While sales taxes comprise the second largest component of general revenues in the state, Rhode Island tends to rely less on the sales tax to generate total state and local revenue than a number of states; in FY 2008, the Ocean State's sales tax collections as a share of personal income ranked 38th out of the 45 states that levy a general sales tax. As a share of total state and local revenues, the general sales tax accounted for 17.4 percent of total revenues generated in FY 2008 compared to the 22.9 percent nationally.

There are a number of reasons the state's sales tax collections rank as some of the lowest in the country despite having one of the highest rates. First, the state generally does not tax services.

Chart 1
Rhode Island and US Tax Revenue by Source - FY 2008



Source: US Census Bureau, Government Finance, FY 2008 data, RIPEC calculations

Second, the state has a number of exemptions that narrow the sales tax base. Third, in contrast to many states outside of New England, there are no local-option taxes in Rhode Island. Last, due to the state's small size, there may be cross-border shopping that artificially lowers the amount of taxable transactions in the state.

The proposed sales tax plan put forth by Governor Chafee has three components: broadening the base, lowering the rate and creating a two-tiered tax structure. The proposal aims to make the state more competitive by lowering the rate from 7.0 percent to 6.0 percent. This rate reduction would lower the state's sales tax rate ranking from 2nd highest in the country to 14th, and would be lower than the rates in Massachusetts and Connecticut. In addition, the Governor proposes to "modernize" the state's tax structure by broadening the base of taxable goods and services, and adding an additional 1.0 percent rate for specific goods and services. The proposed sales tax modernization plan would increase the number of taxable goods by 20 and services by 77 to include services such as landscaping, dry-cleaning, hairdressing, and automobile service (including car washes) at the 6.0 percent rate. At the 1.0 percent rate, the Governor proposes to tax 37 previously exempt goods and 10 previously exempt services.

Rhode Island's General Sales and Use Tax System

Overview of General Sales and Use Taxes

Rhode Island levies a sales tax that is charged by retailers at the point of purchase and retailers are to remit the sales tax receipts by the 20th of each month in which the sales were made. In general, services are not taxed in the Ocean State. There are also a large number of exemptions including, but not limited to, newspapers, food (excluding food purchased for immediate consumption), clothing, boats, the trade-in value of automobiles and medicine and drugs. There are currently over 80 items that are specifically exempted from the state general sales tax.

Table 1
Rhode Island Sales Tax Rates

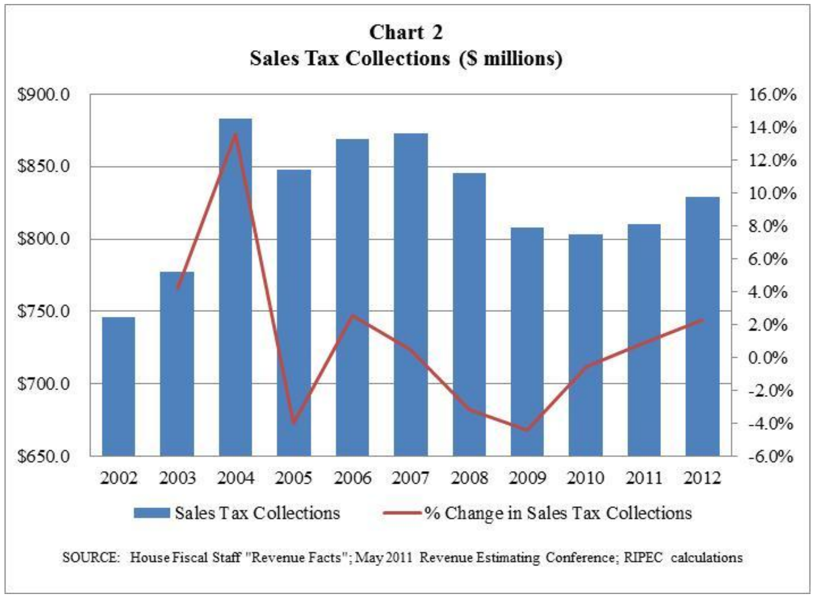
Effective Date	Rate
July 1, 1947	1.0%
June 1, 1951	2.0%
June 1, 1957	3.0%
June 1, 1964	3.5%
June 1, 1965	4.0%
June 1, 1967	5.0%
June 1, 1976	6.0%
July 1, 1990	7.0%

SOURCE: "RI Revenue Facts", House Fiscal Advisory Staff, November 2009

The state first implemented a sales tax in July 1, 1947. The sales tax rate was incrementally raised between 1951 and 1976 to 6.0 percent and was first increased to 7.0 percent July 1, 1990 where it has remained since then. The increase from 6.0 to 7.0 percent was originally enacted to decrease to 6.5 percent July 1, 1991; however, the law was amended in 1991 to retain the 7.0 percent rate.

As with the majority of states, Rhode Island also levies a use tax that applies to goods purchased outside of Rhode Island, but are used, stored, or consumed within the state. Any purchase is subject to a use tax if bought outside of Rhode Island, but used within the state. The use tax only applies to goods that fall under the general sales tax code in Rhode Island. Notably, use taxes are the responsibility of the purchaser, not the seller. States have tried to require the collection of use tax payments by out-of-state vendors. While the Supreme Court has upheld that states have a right to collect these taxes, they may do so only if the seller has a physical presence, or nexus, in the state.

In 2009, Rhode Island adopted the so-called "Amazon Tax", also known as a "click-through nexus" law, which applies a sales tax to internet purchases from companies that enter into formal business relationships with the state. The tax applies to companies with referred sales in excess of $5,000 during a period of four quarters. A number of other states have recently adopted similar statutes which are being challenged on the basis that requiring vendors who do not have a physical presence in the state is unconstitutional under the interstate commerce clause. Connecticut also recently adopted a click-through nexus law.



General Sales and Use Tax Revenues

Together, general sales and use taxes account for roughly one-quarter of state general revenues and are the second-largest source of general revenue for the state (behind the personal income tax). The recent economic downturn resulted in steep declines in sales tax collections; revenue declined by 3.2 percent and 4.4 percent in FY 2008 and FY 2009, respectively, from the prior year. In FY 2007, the state generated $873.2 million in sales taxes. By FY 2008, revenues from sales taxes dropped to $845.4 million and in FY 2009, revenues from the sales tax fell to $808.1 million. Revenues are projected to recover since the low point in FY 2010, when revenues fell to $803.4 million. Chart 2 illustrates the fluctuation in the collections of sales taxes over the past decade. Collections in FY 2011 and FY 2012 reflect projections by the 2011 May Revenue Estimating Conference, which estimated FY 2012 collections of $828.7 million.

Streamlined Sales and Use Tax Agreement

Rhode Island is a member of the nationwide Streamlined Sales and Use Tax Agreement (SSUTA). The Streamlined Sales Tax Governing Board sets forth a series of provisions that apply to participating states. A few of these provisions include: state level administration of sales and use tax, uniformity in the state and local tax bases, simplification of state and local tax rates, simplified administration of exemptions, simplified tax returns, and simplified tax remittances. The intent of the agreement was to reduce the administrative burden and costs for remote sellers that conduct business in varying jurisdictions so that interstate taxation of remote sales would not put an undue burden on interstate commerce. In 2006, the General Assembly conformed to the SSUTA guidelines and the state was incorporated as a full member of SSUTA. As such, the state has agreed to be in compliance with all rules, laws, regulations, and policies. As a member state, Rhode Island has agreed that sellers who collect taxes under the SSUTA will receive amnesty for uncollected or unpaid sales and use taxes.

How Rhode Island Compares

Nationwide, 45 states have adopted a general sales and use tax. Alaska, Delaware, Montana, New Hampshire, and Oregon do not levy statewide general sales taxes. Thirty-seven of the fifty states allow for local option taxes in addition to a statewide tax (except Alaska, which does not have a state sales tax but does authorize a local option tax). Currently, 37 other states tax clothing, 15 tax food and 35 tax

Table 2
New England Sales Tax Summary

State	State Sales Tax Rate	Average Combined Local and State Rate	Food, Drug, and Clothing Exemptions	Streamlined Sales and Use Tax Agreement
Connecticut	6.35%*	6.35%*	Exempts prescription drugs	Not a Member
Maine	5.00%	5.00%	Exempts prescription drugs	Not a Member
Massachusetts	6.25%	6.25%	Exempts prescription drugs and clothing under $175	Not a Member
New Hampshire	No State or Local Sales Tax		N/A	Not a Member
Rhode Island	6.00%**	6.00%**	Exempts prescription drugs, food and clothing	Member of SSUTA
Vermont	6.00%	6.05%	Exempts prescription and non-prescription drugs and clothing under $100	Member of SSUTA

Sources: ITEP
* Connecticut also has a recently-enacted 7.0% tax on luxury goods
** = Proposed

nonprescription drugs. Six of the states that tax food, and one state that taxes all three of the above exemptions, levy a tax at a rate that is different from their general sales and use tax rate.

Vermont is the only state in New England that has a local option tax while New Hampshire does not have a sales tax. The rates in New England vary from a high in Rhode Island of 7.0 percent to a low in Maine of 5.0 percent. Recently, Connecticut increased its general sales tax rate from 6.0 percent to 6.35 percent. The sales tax increase in Connecticut was accompanied by an expansion of the sales tax base (broadening the base by incorporating more services such as pet grooming and personal care) that is similar to the proposed Rhode Island sales tax base expansion. Connecticut also passed legislation that would impose a luxury sales tax of 7.0 percent on certain goods such as boats that sell for over $100,000, motor vehicles that sell at over $50,000 and jewelry that sells for over $5,000.

In general, all of the New England states rank below the national average for sales tax collections, both as a share of personal income and per capita. In FY 2008, the most recent year for which nationally comparable data is available from the Census Bureau, Rhode Island's sales tax collections of $19.84 per $1,000 of personal income ranked 38th highest in the country and were 22.4 percent lower than national collections of $25.57 per $1,000 of personal income. Among the New England states, Rhode Island's FY 2008 sales tax collections as a share of personal income were

Table 3
How Rhode Island Sales Taxes Compare

	Per $1,000 of Personal Income		Per Capita	
	2008	Rank	2008	Rank
US	$25.57	-	$1,009	-
CT	18.10	40	1,012	21
ME	23.21	29	805	34
MA	12.61	45	635	42
NH	0.00	-	0	-
RI	19.84	38	**801**	**35**
VT	14.48	42	554	45

Source: US Census Bureau, Government Finance, FY 2008 and FY 1998 data, Bureau of Economic Analysis for personal income data, RIPEC calculations the second-highest (behind Maine). When measured on a per capita basis, Rhode Island's FY 2008 general sales tax collections of $801 per capita were 35th highest in the country and the third highest in the region.

Proposed Sales Tax Changes

Overview

The "Sales Tax Modernization Plan" refers to a set of tax policies, which include lowering the sales tax rate from 7.0 percent to 6.0 percent, while expanding the base of taxable goods and services. Previously exempt goods and services to be taxed at 6.0 percent include, but are not limited to, waste management services, personal care services nonprescription drugs, and laundry/dry cleaning services. Certain exempt items will be subject to the 1.0 percent rate including sales and services such as clothing and footwear, sales to charitable organizations, and heating fuels for homes and residential premises. This policy broadens the spectrum of taxable goods and services. Food, prescription drugs and gasoline will remain exempt from sales tax under the proposed policy.

The plan is expected to raise approximately $165 million in net new revenue for the State of Rhode Island. The sales tax modernization plan creates a two-tiered sales tax system by taxing some goods and services at 1.0 percent and some at 6.0 percent. The taxable goods and services at 1.0 percent are projected to generate $86.8 million in additional revenue, while the base expansion at 6.0 percent is projected to generate $197.6 million. These revenue increases are offset by the loss of $117.7 million due to the rate reduction and $1.8 million from non-compliance with the SSUTA as a result of the two-tiered tax system; signatory vendors will no longer be compelled to collect and remit these taxes to the state.

Table 4
Proposed Sales Tax Modernization Program

Rate Reduction	**Est. Loss**
Rate from 7% to 6%	-$117.7
Currently Exempt Items at 6%	**Est. Rev.**
Goods	
Pre-written computer software delivered electronically	$7.6
Non-prescription drugs including medical marijuana	9.3
Other goods	5.1
Subtotal: Goods	$22.0
Services	
Building services including landscaping and pest control	$23.3
Employment agencies	19.1
Personal care services including hairdressers and diet centers	18.6
Business support services	8.5
Other services	53.0
Subtotal: Services	$122.6
Recreation and Entertainment	
Amusement parks, campgrounds and related services	$10.0
Membership clubs	4.4
Other recreation and entertainment	6.4
Subtotal: Recreation and Entertainment	$20.8
Maintenance and Repair Labor	
Motor vehicles including car washes	$18.2
Commercial and industrial exempting manufacturers	2.4
Clothing and footware repair, rental and alteration	2.3
Other maintenance and repair	4.2
Subtotal: Maintenance and Repair	$27.1
All Other	$5.1
Total: Currently Exempt Items at 6%	**$197.6**
Currently Exempt Items at 1%	
Manufacturing inputs, clothing, sales to charitable orgs., etc.	$86.8
Streamlined Sales and Use Tax Agreement noncompliance	-1.8
Total: Currently Exempt Items at 1%	**$85.0**
Total: Elimination of Exemptions	**$282.6**
Net Revenue Change - Sales Tax Modernization	**$164.9**

SOURCE: State Budget Office documents, Senate Fiscal Office documents, RIPEC calculations

Impacts of the Proposal

The proposal is designed to address three primary issues with the state's current tax structure as well as to raise additional revenue to balance the state's budget. As noted above, although Rhode Island has one of the highest state general sales tax rates, collections in the state are below the national average and rank in the bottom quintile of states either as a share of personal income or per capita. This is largely due to how the tax is structured, including the following four reasons:

- Changes in personal consumption;
- A narrow tax base as a result of exemptions and limited taxation of services;
- Lack of local-option taxes; and
- Cross-border competition.

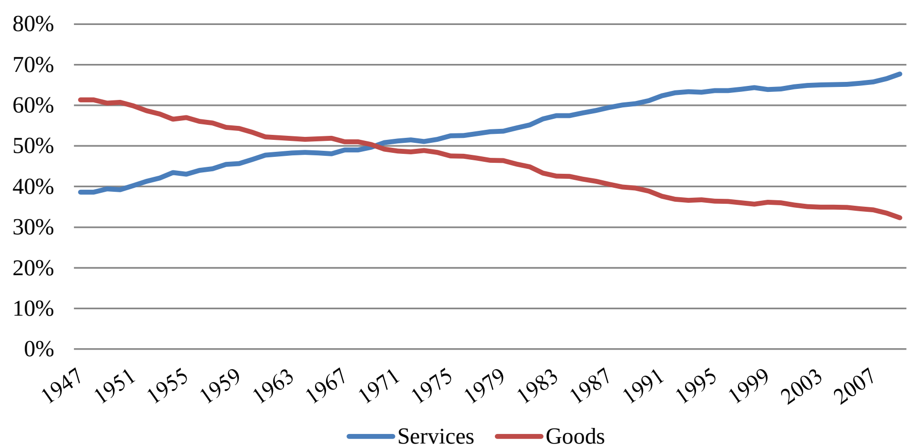
The Governor's proposal seeks to address three of the four issues noted above, specifically, broadening the base to include services and reduce the number of exemptions, and to increase Rhode Island's competitive position vis-à-vis other states in the region. In general, due to the small size of states, and density of population, in New England, local-option sales taxes are thought to be unfeasible. This section examines the "Sales Tax Modernization Plan" in the context of how the proposal would address the remaining issues.

Changes in Personal Consumption

When the sales tax was first implemented in 1947, spending on goods represented roughly 60.0 percent of personal consumption, while spending on services amounted to 40.0 percent of total consumption. However, personal consumption patterns have shifted to be more service-oriented, rather than goods-oriented. By 2009, spending on services grew to account for approximately 70.0 percent of consumption, while spending on goods decreased to just over 30.0 percent. This shift toward services compromising the bulk of economic activity, rather than the purchasing of goods, has had the effect of limiting the amount of revenue that can be generated from the general sales tax. The Governor's proposal to include a number of services, such as landscaping, barber shops and beauty parlors, pet grooming and travel agency services, is designed to ensure that the state's tax base keeps pace with changing consumption patterns.

Another issue that the proposal potentially addresses is the increasing popularity of internet or remote sales, which further erodes the state's sales tax base. The proposed 1.0 percent tax will sunset when federal legislation requiring remote sellers to collect and remit to the state taxes on transactions between remote sellers and state residents. Currently, the Main Street Fairness Act, which meets this criterion, is pending before Congress. The Main Street Fairness Act addresses the price advantage that out-of-state sellers (such as internet and other remote sellers) can take advantage of by not

Chart 3
Change in Personal Consumption, 1947-2009



SOURCE: US Bureau of Economic Analysis; RIPEC calculations collecting tax on items sold over the internet. Estimates indicate that revenues through the taxation of remote sellers would provide enough revenue to repeal the 1.0 percent sales tax (roughly $85 million). The passing of such legislation, and thus the repeal of the 1.0 percent tax would put Rhode Island back in compliance with the SSUTA.

States must ensure that their tax structures are responsive to shifts in economic activity in order to maintain the stability of their tax base over time. Broadening the sales tax base to more accurately reflect the composition of the economy will allow the state to have a more stable revenue stream. However, states must also ensure that their tax structures, specifically the items or entities that are taxed, do not create economic distortions such as sales tax pyramiding or the imposition of a tax on a tax. Pyramiding typically happens when business inputs – either goods or services – are subject to a tax. That tax is then frequently passed on to the consumer who pays a tax on the final product. The more times an item is subject to the sales tax in the business inputs phase, the higher the degree of pyramiding. Taxation of services should be carefully considered in this context.

Narrow Tax Base

Sales tax base expansion and rate reduction have been discussed for many years. Generally, the concepts have broad support from organizations that include the Tax Foundation and the Center on Budget and Policy Priorities. A broader base tends to insulate the tax structure from economic fluctuations, as noted earlier, while a lower rate both minimizes economic distortion and the regressive nature of the tax.

Despite having the second-highest state general sales tax rate in the country, Rhode Island's tax collections remain lower than the majority of states. Rhode Island's general state sales tax collections are lower than collections in states with an equal statewide rate, both per $1,000 of personal income and per capita, as shown on table 5. One of the reasons for this, as noted above, is that the state's tax code contains a number of exemptions that narrow the taxable base.

Table 5
State General Sales Tax Rate and Collections, FY 2009

	Rate	Collections Per $1k	Collections Per Capita
Indiana	7.00%	$28.13	$973
Mississippi	7.00%	33.69	1,030
New Jersey	7.00%	18.76	952
Rhode Island	**7.00%**	**18.63**	**775**
Tennessee	7.00%	29.30	1,023

SOURCE: The Tax Foundation; US Bureau of the Census; Bureau of Economic Analysis; RIPEC calculations

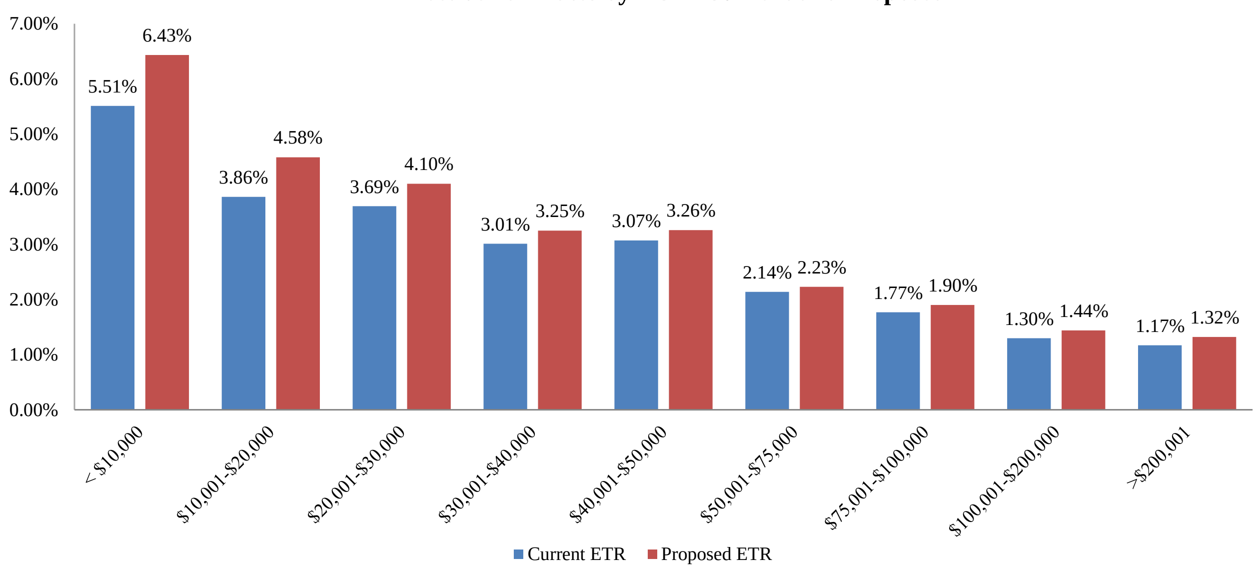
The Governor's budget notes that, since the sales tax has been in place, a total of 82 exemptions have been enacted into law. Of this total, approximately 20 have been enacted in the past 20 years. One of the effects of state's narrow tax base is that sales tax revenues are more susceptible to changes in the economy. As economies falter people tend to purchase fewer tangible goods such as appliances and household décor; however, consumption of services and other – currently exempt – items tends to decline more slowly, thereby stabilizing the tax base during economic downturns.

In addition to stabilizing the sales tax, broader bases may help equalize varying forms of personal consumption. For example, CDs purchased in-store in Rhode Island are subject to the 7.0 percent tax; however, music purchased and downloaded over the internet is not currently taxable. Similarly, the purchase of a lawnmower for personal landscaping is taxed while landscaping services are currently not. In addition to equalizing varying forms of personal consumption, base-broadening in both examples also reflects changing consumption patterns – shifting from bricks-and-mortar purchase to internet-based sales and the change from a tangible goods-based economy to a service-based economy.

Another benefit to sales tax base broadening is the opportunity to lower the rate. Rhode Island's high sales tax rate is often cited as a negative factor in studies of perceived "business-friendliness". While a number of states have higher combined state and local rates, the Ocean State's 7.0 percent rate is seen as putting the state at a competitive disadvantage. In addition to potentially improving the state's business climate, a rate reduction may also help offset the regressive nature of the tax. Lower rates will naturally be more beneficial to lower-income taxpayers. At the same time, an analysis by the Department of Revenue indicates that taxpayers at the lower end of the economic spectrum will see the largest increase in their effective tax rates (the amount of tax paid relative to their income) under the Governor's proposal as outlined in chart 4. This may be due to the fact that the proposal includes taxation of some necessities, such as home heating oil and water for residential use, which may disproportionately impact lower-income taxpayers.

Although broadening the state's sales tax base has a number of positive effects, such as a rate reduction, the two-tiered sales tax system has the potential to produce an undue administrative burden on businesses that sell items with varying tax rates. Integrating these changes into their system may present a challenge, especially for small businesses. For example, integrating multiple rates into a store's sales tax system if a business sells both nonprescription drugs (taxed at 6.0 percent) and flags (taxed at 1.0 percent) can create an administrative burden on businesses. Moreover, the two-tiered system would result in Rhode Island no longer being in compliance with the SSUTA. While the estimated revenue loss is not significant, there may be other benefits to being a member of the agreement that should be considered before adopting a tax structure that is not in compliance with the agreement.

Chart 4
Effective Tax Rates by AGI - Current and Proposed



SOURCE: Senate Fiscal Staff "Governor's FY 2012 and FY 2011 Supplemental Budget", based on distribution analysis provided by the Department of Revenue's Office of Revenue Analysis

Another issue to be considered is that the proposal includes broadening the base by extending the 6.0 percent taxable rate to "Business Support Services". This category includes services that businesses utilize to produce business outputs such as: document preparation, telemarketing companies, copy shops, credit bureaus, collection agencies, court reporting and stenotype services, and establishments "primarily engaged in providing business support services, including but not limited to, bar coding services, mail presorting systems, establishments primarily engaged in providing day-to-day business and other organizational support." Sales taxes levied on such business inputs may have the effect of increasing the degree to which sales tax pyramiding occurs, thereby increasing the cost of doing business and potentially making Rhode Island businesses less competitive.

Cross-Border Effects

Another contributing factor to Rhode Island's low rate of sales tax collections may be due to cross-border effects, that is, individuals or businesses purchasing goods or using services in states with a lower tax rate. While there are few, if any, reliable estimates regarding the border effect of differential tax rates, lower rates, and thus lower final costs, may provide an inducement to some consumers to make purchases out of state to avoid the higher tax liability. Cross-border effects may also have a disproportionate impact in Rhode Island given the state's size and proximity of neighboring states; the most recent Census data indicates that approximately 70 percent of the state's population lives within a 10 mile radius of Massachusetts or Connecticut. Rhode Island's current general sales and use tax rate of 7.0 percent is 0.75 percentage points higher than Massachusetts's rate of 6.25 percent and 0.65 percentage points higher than Connecticut's current rate. If the rate were to be dropped, Rhode Island's rate would be lower than rates in both states. This may provide Rhode Island retailers of durable goods – particularly big-ticket items – a competitive advantage over their counterparts in either neighboring state.

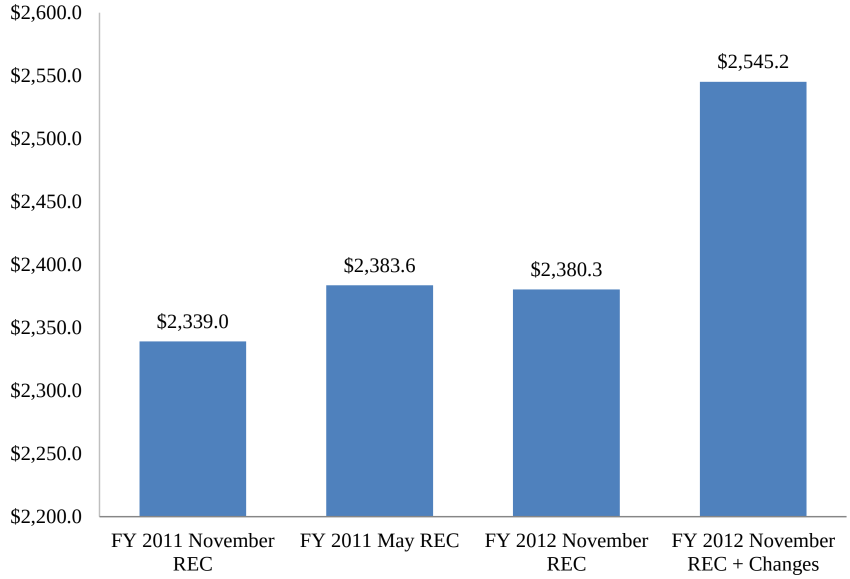
At the same time, the proposed base expansion may have the opposite effect on retailers of services that are not taxed in Massachusetts or Connecticut. The issue of mobility with respect to goods and services will affect not only collections under a sales tax, but also may adversely impact retailers. If a given good or service is taxed at a lower rate in a bordering state – or is not taxed – individuals may be more likely to go across the border to utilize the service or purchase such a good. There are services that cannot be moved out of state due to locality, such as landscaping. There are, however, other services that can be provided in other states at lower rates due to their tax-exempt status, such as salon services. The taxation of business inputs may encourage small businesses to utilize services or goods offered in other states to perform work on business inputs (for example, manufacturing a good in another state if there is no taxation on producing that particular item there).

If the tax on business inputs significantly increases the cost of doing business in Rhode Island, then businesses can choose to either shift that cost to the consumer, or relocate to a state with a lower tax burden. Furthermore, the increased cost of business inputs impacts business outputs. In order to contain the costs of production, businesses can be compelled to reduce investments within the state (such as property and equipment purchases), which may have the secondary effect of reducing the local workforce.

RIPEC Comments

The "Sales Tax Modernization Proposal" is projected to generate $164.9 million in additional revenue for the state in FY 2012 and would make fundamental changes to the state's sales tax system. As proposed, the plan would increase FY 2012 tax revenue from an estimated $2,380.3 million[1] to $2,545.2 million, an overall increase of 6.9 percent (see chart 5). The sales tax itself would increase by approximately 20 percent. When total revenues generated through sales taxes – including the meals and beverage tax and hotel tax, which are collected by the state and remitted to the municipality in which they are collected – are considered, projected sales tax collections would total approximately $1,015 million. This level of collections would be greater than the amount of revenue generated through the personal income tax. Such a significant change should only be undertaken after careful evaluation of the pros and cons of the proposal, particularly as they relate to the state's tenuous economic recovery.

Chart 5
Projected Tax Revenue



SOURCE: May 2011 Revenue Estimating Conference; RIPEC calculations

The guiding principles behind the changes, broadening the base and lowering the rate, are commonly accepted as sound tax policy. Broader bases reduce volatility and are more capable of reflecting the modern economy. Additionally, a broader base with fewer exemptions reduces complexity while taxing similar goods similarly results in a more neutral tax system. Lower rates may help the state attract more business, offset the regressivity of the sales tax, and help in-state businesses be more competitive with businesses in neighboring states.

At the same time, RIPEC would urge lawmakers to consider some of the potentially negative impacts of the proposal, specifically as they relate to the taxation of business inputs. Levying taxes on business – particularly manufacturing – inputs could potentially deter companies from hiring additional staff members, producing goods, or providing certain services due to the rising cost of doing business in Rhode Island. At a time when the state is beginning to see signs of an economic recovery, changes to the tax code that have a negative impact on business growth should be carefully evaluated.

There is no doubt that the state's sales tax system represents an out-of-date model that should be reformed. Ideally, tax structures ought to be capable of growing with, or reflecting, changes in the economic makeup of a state. Consumption habits have changed significantly since the sales tax was first adopted in Rhode Island. Services have surpassed goods as the predominant mode of economic activity, while intangible goods, such as digital downloads, and remote sales have

[1] NOTE: The Governor's budget is based on estimates from the November Revenue Estimating Conference (REC). The May REC increased tax revenue estimates to $2,437.2 million; however, it is difficult to assess how the revised estimates would affect the projected revenues under the Governor's proposal. As such, November estimates are used.

started to erode the traditional sales tax base of tangible goods. However, changes to the tax structure should not be made simply as a means to generate additional revenues. Moreover, any changes should be a part of a thoughtful process that reflects a set of principles upon which the tax system should be based. RIPEC believes that a high-quality sales tax system should:

Minimize distortion in economic decisions: changes to the tax system should minimally affect a taxpayer's decision to engage in, or how they engage in, a transaction. Increasing the costs of business inputs, in particular, may have the effect of creating incentives for businesses to alter purchasing or hiring decisions in order to avoid the tax. Similarly, taxation of a good or service that is not taxed in a neighboring state may provide an inducement for individuals to cross state lines to purchase the good or service in order to avoid the tax. Cross-border effects should be taken into consideration when evaluating which goods and services should be included in the base expansion. In addition, the state should reexamine the taxation of business inputs as this will result in sales tax pyramiding.

Be equitable and treat similarly situated taxpayers similarly: tax systems should minimize regressivity, taking into account a taxpayer's ability to pay, while treating similarly-situated taxpayers, producers and goods equally. Narrow bases require higher rates to generate the same level of revenue as a broad-based, low-rate system, increasing the regressive aspects of the tax. Not only will a lower rate potentially offset this regressivity, a broader base and lower rate may allow for similar goods to be taxed at the same rate, further increasing equity within the tax system. At the same time, base expansion that taxes necessities – e.g., water for residential use – may offset the benefits of a lower rate, potentially increasing the most regressive aspects of the tax. The impact tax changes may have on individual economies should be carefully considered.

Be simple to administer and to comply with in a cost-effective manner: any changes to the tax system should account for the increased administrative cost to the state and increased compliance costs for businesses. A broader tax base will likely lead to more businesses being subject to taxation, potentially leading to an increased administrative burden for both taxpayers and the state. At the same time, a broadened base with fewer exemptions may have the effect of establishing a more simple tax code which may increase compliance. The costs of compliance should also be considered, specifically with regard to the proposed 1.0

Table 6
General Sales Tax Principles

Minimize distortion in economic decisions
Changes to the tax system should minimally affect a taxpayer's decision to engage in, or how they engage in, a transaction.

Be equitable and treat similarly situated taxpayers equally
Tax systems should minimize regressivity, taking into account a taxpayer's ability to pay, while treating similarly-situated taxpayers, producers and goods equally.

Be simple to administer and comply with in a cost-effective manner
Any changes to the tax system should account for the increased administrative cost to the state and increased compliance costs for businesses.

Be transparent and predictable for both retailers and consumers
Tax systems should be structured so that both consumers and businesses are aware of what goods and services are taxed and at what rate.

Generate sufficient revenue in a reliable manner
Changes should be made to the sales tax code in order to create a more stable, balanced system of revenue that adequately supports government services without causing an undue burden on taxpayers or businesses.

percent tax. The two-tiered tax structure will increase compliance costs for the taxpayer, particularly for small businesses providing incentives for non-compliance or changes in economic behavior.

<u>Be transparent and predictable for both retailers and consumers:</u> tax systems should be structured so that both consumers and businesses are aware of what goods and services are taxed and at what rate. Any sales tax changes should be made clear to consumers, retailers, and tax administrators in a timely manner. In addition, while regular review and revision of tax systems is recommended, there should also be a measure of predictability for both sellers and consumers. Frequent changes to taxes may result in a loss of confidence in the state, increase administrative burdens, and reduce compliance. A broader base with limited exemptions may have the effect of creating a more transparent tax structure as exemptions require detailed definitions of what is, and is not, taxed. However, as noted earlier, taxing business inputs can result in pyramiding and higher costs for businesses may lead to cost-shifting to the consumer. This causes price distortion, resulting in a less transparent economic and tax structure.

<u>Generate sufficient revenue in a reliable manner:</u> changes should be made to the sales tax code in order to create a more stable, balanced system of revenue that adequately supports government services without causing an undue burden on taxpayers or businesses. Broader sales tax bases that more accurately reflect the current economy will be able to produce revenue in a more stable, and thus reliable, manner. Specifically, broader bases are less susceptible to economic fluctuations. Additionally, sales tax bases that reflect consumption patterns will be more likely to grow with the state's economy. At the same time, revisions should not be made simply to generate additional revenue. The ideal situation would be to restructure the tax in a revenue-neutral manner that allows for an overall realignment of the sales tax.

The May 2011 Revenue Estimating Conference projected that FY 2011 revenues will increase by $53.8 million over November 2010 estimates while FY 2012 revenues will increase by $65.9 million over the original November 2010 projections. Although the increased revenues both signal economic recovery and provide some measure of budgetary relief, RIPEC encourages lawmakers to use this money efficiently. The first priority for the state should be restoration of the $22 million to the Rainy Day Fund in FY 2011. These additional revenues should also be used to re-examine the items that have been included in the proposed sales tax base, particularly as they relate to business and manufacturing inputs and the proposed 1.0 percent tax.

Reform of the state's sales tax system is something the General Assembly should consider in order to create a more balanced, equitable system of revenue for the state. However, as the legislature considers the current proposal they should be mindful of the fact that additional taxes on various goods and services should be considered within a clearly defined set of principles as to why certain goods and services should be taxed. This report has outlined a set of principles that can be used as a guide for evaluating the pros and cons of the current proposal, and the final legislation can be crafted to create a modern tax structure in the Ocean State.