Making the Difficult Possible

Budget Strategy for Repealing or Rolling Back the RI State Sales Tax

January 2014

Perspective on the Challenge

Introduction

Throughout the autumn and winter, the Special Joint Legislative Commission to Study the Sales Tax Repeal has been investigating several aspects of the proposal submitted as legislation last session by Representative Jan Malik (D, Barrington, Warren). Having addressed pros and cons of eliminating the sales tax, as well as estimates of its effects and alternative approaches, the commission arrives at the question of how the state could adjust its budget in order to implement the plan.

Ultimately, bare numbers will have to be hashed out as the Rhode Island House and Senate Finance Committees piece together a budget for fiscal year 2015. But with a view toward developing a framework within which those numbers can be fit, the Rhode Island Center for Freedom and Prosperity proposes a strategy for considering the reform.

The Size of the Project

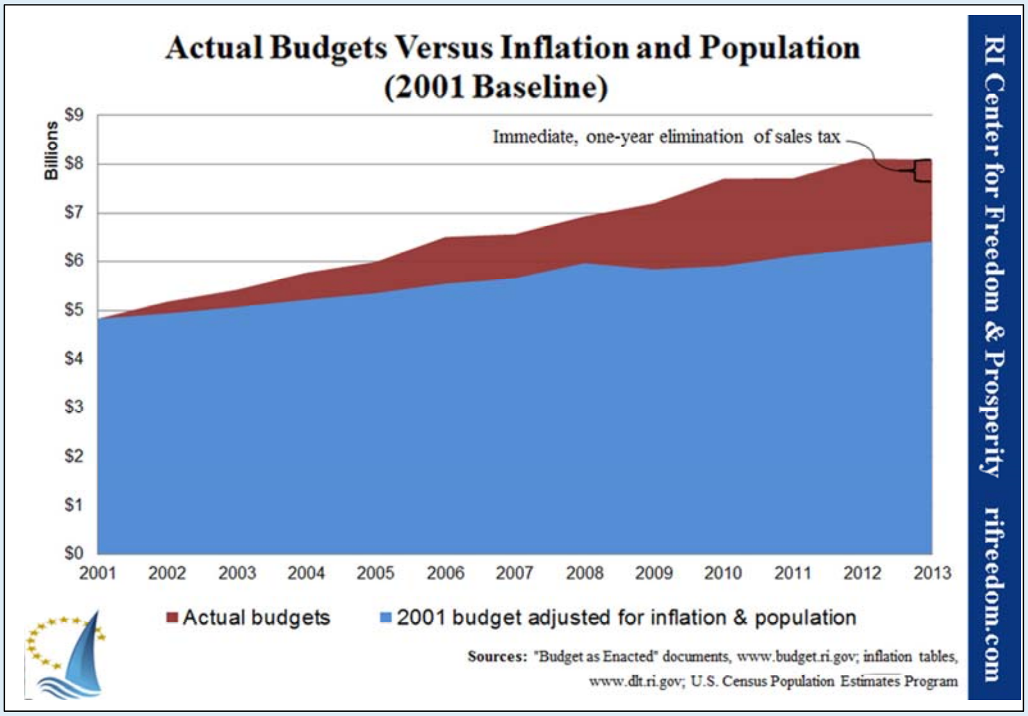
The chart below, drawn from the Center's *Zero.Zero Sales Tax* report published last year, shows that a full repeal of the sales tax is not unimaginable within the context of the budget.

The blue area on the chart shows how the state budget would have grown, this century, had it merely tracked with inflation and the state's population. The red area shows how much additional money the state has collected and spent above that amount.

The small black bracket at the upper right corner represents the amount of money that the budget would have to be reduced to allow a 0.0% sales tax rate, according to the Center's economic modeling tool, Rhode Island State Tax Analysis Modeling Program (RI-STAMP). Had the state eliminated the sales tax as of the beginning of the current fiscal year, last July, we project that it would only have had to return to the size of the budget in 2011.

Recent History of RI State Budget

Since the beginning of this century, the budget of the state government of Rhode Island has grown 25.3% more than inflation and population justified.



Midyear Budget Adjustments Are Normal

The next chart puts the necessary changes to the state's budget to implement the sales tax elimination in the context of the changes that the state makes to its budget midyear, every year. In this case, we applied the RI-STAMP projections to the actual legislation that Representative Malik submitted, which delayed the beginning of the sales tax elimination until the second quarter of the fiscal year, beginning in October.

The red columns show the amount by which the actual expenditures of the state government differed from the budgets enacted at the beginning of each year. Three times, during the first thirteen years of the century, that adjustment amounted to a nine-digit reduction.

The blue columns show the anticipated annual investment that the state would have to make if it eliminated the sale tax as of October 1 in the first year. The chart suggests three important observations:

- The elimination would not require an insurmountable reduction.
- The red bars represent reductions made midway through previous years, while the state has plenty of time to plan for the blue bars.
- Waiting three months to implement the reform would create a natural phase-in of its impact.

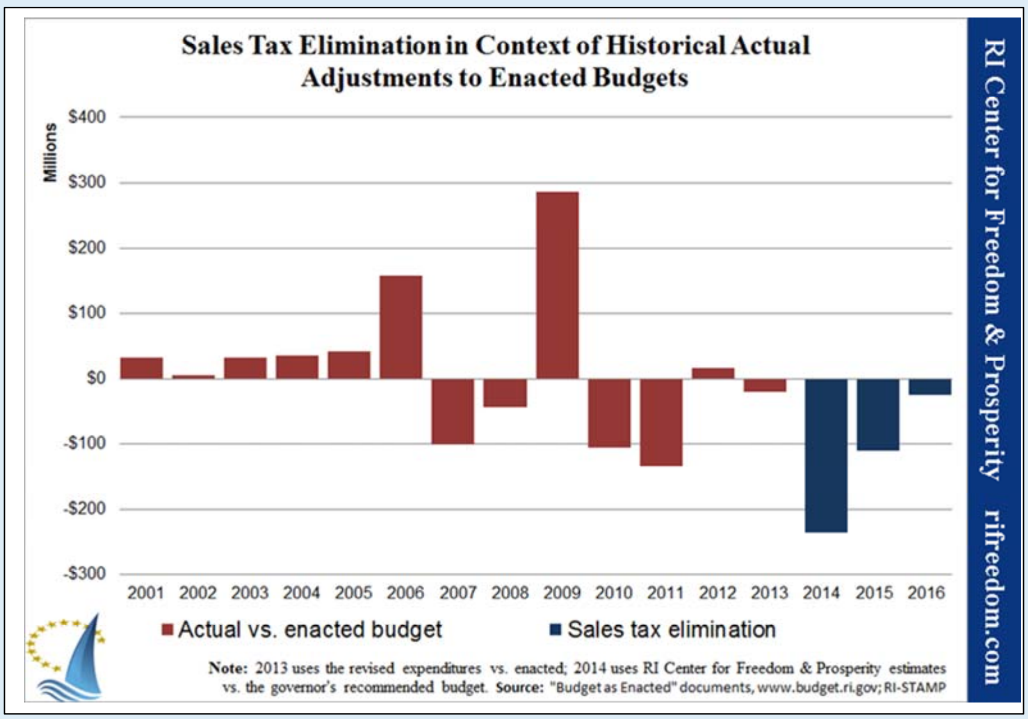
Strategy for Budgeting

Plan to Track Revenue Monthly

With the advance warning that the state would have of the change, revenue analysts could prepare to track the month-by-month effects of eliminating the sales tax, utilizing a strategy such as that described in the following section. As license fees and excise taxes come in, for example, the state should compare them with those that it projects in advance, given the elimination of the sales tax.

Experience Adjusting Budgets

Since the beginning of this century, the state has repeatedly adjusted its budget in response to nine-digit changes in revenue — and that was midyear, not with advance planning.



In this way, missed targets from the models legislators use to predict the policy's effects could be identified early, and predetermined adjustments could be automatic, rather than in a scramble in the late autumn or spring. As the year goes on, officials will have more confidence that they know the direction in which the adjustments are headed.

A Tiered Budgeting Strategy

Among the more contentious questions with which the commission has grappled was whether the RI-STAMP model or the Regional Economic Models Inc. (REMI) software takes a more realistic approach to projecting revenue. STAMP takes a more market-driven view of the economy, whereas REMI assumes a greater effect from government spending, creating very different projections.

Having two contrasting views should actually be a benefit to any strategy to plan for reform. The chart below is a conceptual diagram illustrating tiers into which the state could divide its revenue projections.

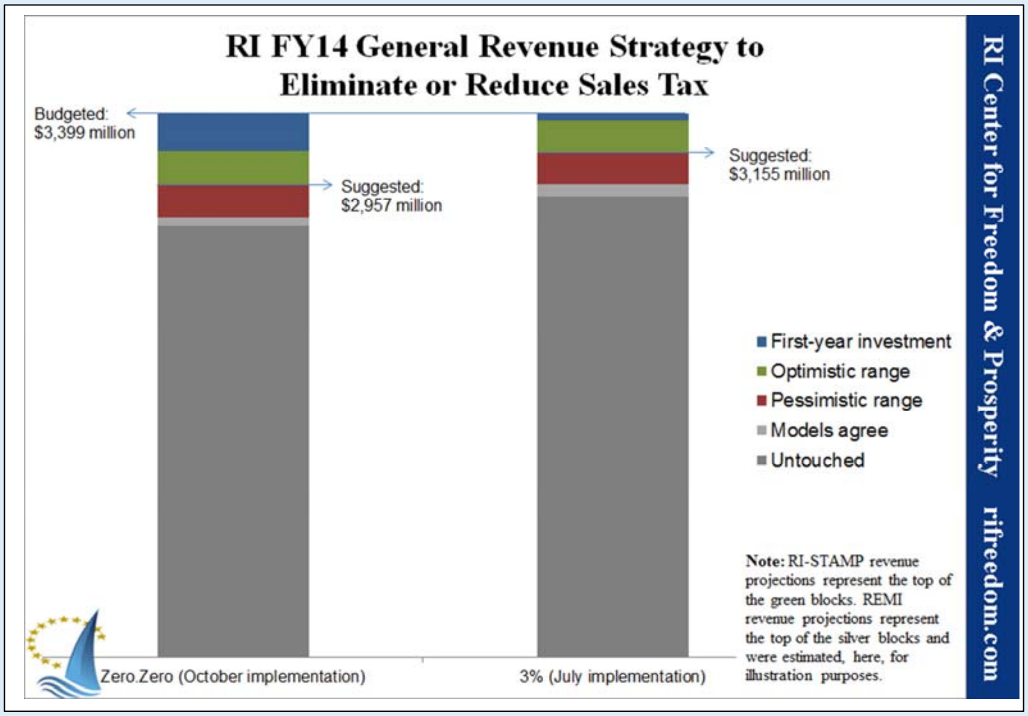
The column on the left represents an elimination of the sales tax, which we recommend to once again be effective as of October 1, for reasons described above. The column on the right represents a reduction of the sales tax to 3% (i.e., a 4 percentage point reduction), which should begin with the new fiscal year because:

- There is no structural change for which the state or businesses must prepare.
- A significant portion of the dynamic revenue under a reduction scenario comes from the states' smaller piece of the larger consumer pie generated by the lower prices, and with summer's being a busy season in the Ocean State, it would be helpful to the economy and the state government to capture the season.

The tops of the bars represent the full amount of expected general revenue for which the state would have budgeted in the absence of a tax reform. For illustration purposes, we use, here, the governor's recommended number for FY14, which was the latest when we last updated our *Zero.Zero* report.

Making Use of Contrasting Predictions

With two models at its disposal that begin with very different assumptions about the economy, the legislature is well-positioned to design a strategy for eliminating the sales tax.



The dark gray portion of the columns represents the portion of the budget that would remain untouched even if there were to be a complete loss of sales tax revenue or, in the case of the 3% column, no dynamic revenue at all. As the chart makes clear the greater part of the budget, by far, would not be under any risk at all, and this is before accounting for federal funds, restricted funds, and other funds.

The silver portion of the columns represents the minimum amount of dynamic revenue that both models — despite their very different results — agree that the state will realize (that is, the amount of dynamic revenue projected by the REMI model used by the state). For planning purposes, the state could treat this tier the same as the "untouched" category.

With these thresholds established, the state could pick a revenue level between the two models' projections. For our purposes, we simply found the midpoint, but the process of planning might raise other considerations making it advisable to move the line. That midpoint would be the actual budget that the General Assembly passes to begin the fiscal year.

The red area — provisionally called the "pessimistic range" — is the distance between the budget that the state would enact and the lower projection achieved with the REMI model. The green area — the "optimistic range" — brings the column up to the height that the RI-STAMP model suggests it will be.

That leaves the blue area, which is the investment that the state should expect to have to make in order to achieve the significant economic benefits of eliminating the sales tax.

Planning Spending Priorities in Advance

The final step would be to find areas of potential savings throughout the budget and to divide them into categories that will adjust depending on what the state's revenue flow actually does following the tax reform, as detailed in the chart below.

The first threshold to achieve in savings would be the distance between the hypothetical budget (what the models would treat as the baseline) and a flat budget that maintains the previous year's spending. A flat budget would lower the challenge to the textured-blue part of the column.

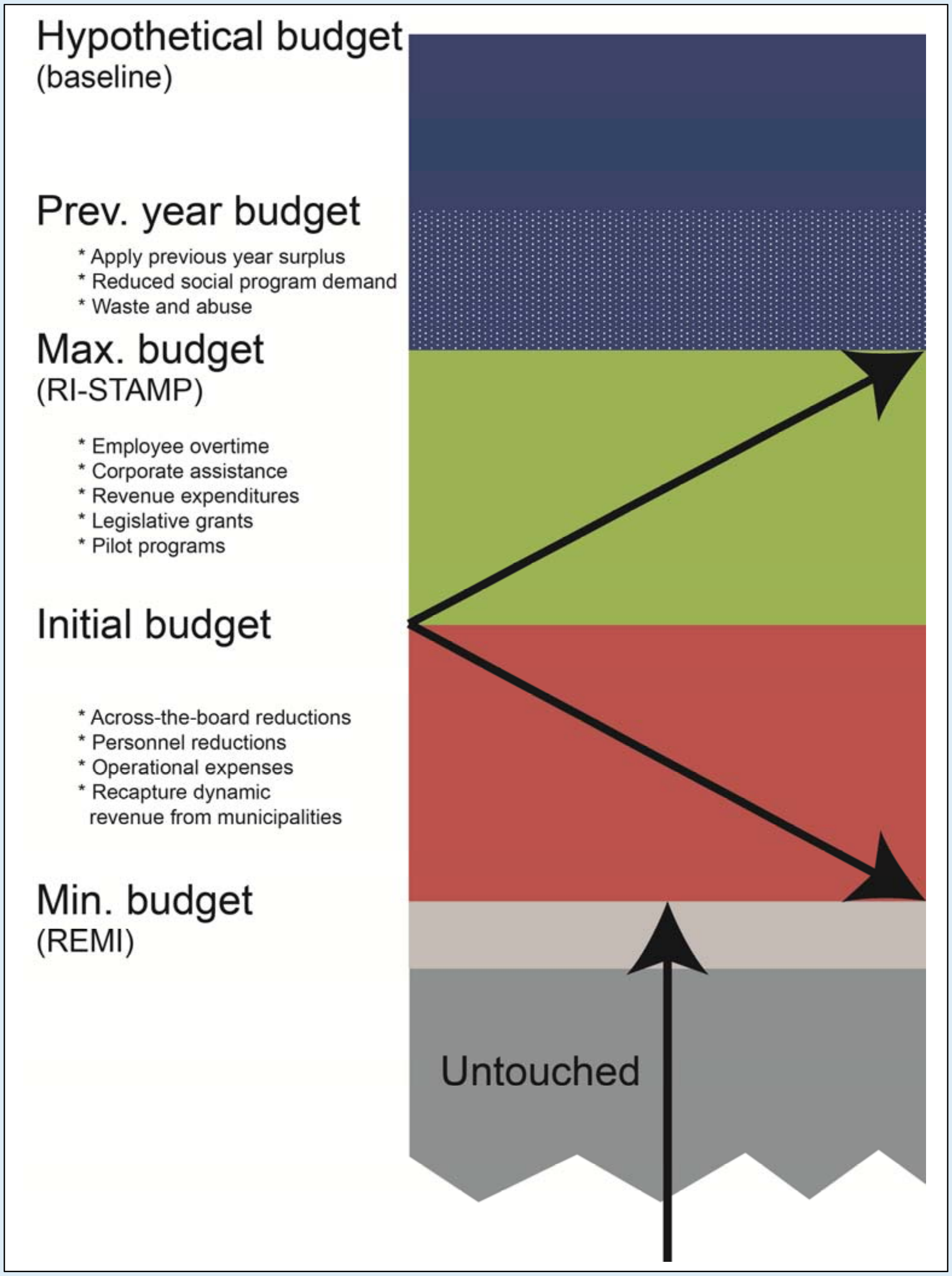
To make the distance from the previous year's budget to the maximum planned budget (i.e., the RI-STAMP projection) legislators should target areas of spending that serve no economic benefit and, it could be argued, should be eliminated anyway, such as applying the previous year's surplus for tax relief, counting on the reduced demand for social services of an improved economy, and eliminating some of the tens of millions of dollars of waste and abuse already publicly identified.

Starting with the initial budget passed for the fiscal year, the General Assembly would identify budget items in the "optimistic range" that would automatically be funded (or see funding increases) to the extent that monthly cash flow exceeds the initial projection. That is, as the economy responds positively to the sales tax reform and revenue increases, there would be budget buckets already planned to be filled.

In general, the line items that would fit well in this space would be those that are nice to have, or sometimes necessary, but that would not greatly disrupt existing programs if they weren't funded. Some examples are employee overtime, corporate assistance programs, revenue expenditures, legislative grants, and pilot programs. Conversely, if reality heads into the "pessimistic range," the General Assembly would identify line items that would initially be funded, but would experience reductions if the monthly revenue disappoints. Such budget items could range from across-the-board reductions to cuts in personnel or operations to recapturing the dynamic revenue that RI-STAMP expects on the municipal level.

Planning for Contingencies

With a considered approach to large-scale reform — defining the budget steps in advance and in context of the goal of economic health — the state government can avoid panic and continual political battles.



Addendum

Opportunities in the Governor's Budget

The following table is from the Center's *Zero.Zero* report and puts some generalized numbers to the categories of spending listed in the chart above.

Zero.Zero (H5365 & S0246) First-Year Budget Impact with Dynamic Projections, FY14 ($ millions)	
	Increase/ Decrease
Governor's recommended sales tax revenue	-904.30
Three months of (adjusted) sales tax from Oct. 1 elimination	205.54
Personal income tax	244.11
Other taxes and fees	218.32
FY13 surplus	79.32
Additional FY14 increase in general fund expenditures	52.18
Balance	***-104.84***
Possible sources of savings	
Savings from reduced social program demand	25.00
Social services waste and abuse	80.00
Corporate assistance programs	50.00
State overtime budget	90.00
Eliminate RI EDC	19.00
Reduce municipal aid by projected STAMP increase	149.36
Low-hanging fruit	***413.36***

Notes: Numbers may not be exact due to rounding.
Sources: Governor's Recommended FY14 budget, RI-STAMP, RI Center for Freedom & Prosperity

With the release of the governor's proposed budget for FY15, some items present themselves for addition to the above list to help cover the distance to a reduction of the sales tax to 3% or a complete elimination of it.

- **HealthSource RI: $23.4 million.** Under the Dept. of Administration, the governor's budget calls for funding of $23.4 million for operation of the health benefits exchange that the governor created via executive order. According to budget documents, the federal government will be fully funding the agency for the next fiscal year, but the expense will fall to the state government soon. Handing the exchange over to the federal government would free up resources in the long-term for tax reform.
- **Governor's proposed tax reform: $77.4 million.** See the following section.

Sales Tax Reform Versus Alternatives

Among the more surprising suggestions in the governor's fiscal year 2015 budget is to modify the law that would go into effect if the federal government allows states to collect sales taxes on transactions happening over the Internet.

Under current law (RIGL §44-18-18), Rhode Island's sales tax rate would be reduced from 7% to 6.5% for all goods and services for which Rhode Islanders pay the tax, although the total sales tax for hospitality services would remain unchanged. Governor Chafee's proposal is to repeal that general tax break and, instead, to reduce the corporate income tax rate to 6% and to exempt businesses from the sales tax on electricity and gas. (Residences and manufacturers are currently exempt in this regard.)

RI-STAMP projects that this reform would reduce total state revenue by $77.4 million, while allowing the economy to create only 540 private-sector jobs.

The following chart adds this proposal to the Center's previously published comparison of various tax reform possibilities. Note the following:

- We used the version of RI-STAMP for FY14 estimates so that it would represent an apples-to-apples comparison with the other policies shown.
- For the energy tax portion of Chafee's proposal, we used FY13 revenue of $19.5 million, provided by the Office of Revenue Analysis.
- RI-STAMP would tend to consider sales tax savings to businesses as more economically beneficial, so that portion of the mixed proposal likely represents a conservative estimate.

Comparing Tax Reforms

Governor Chafee's proposal to reduce the corporate income tax rate to 6% and exempt business energy usage from the sales tax would create only about 540 private-sector jobs, at taxpayer cost of $143,352 each.