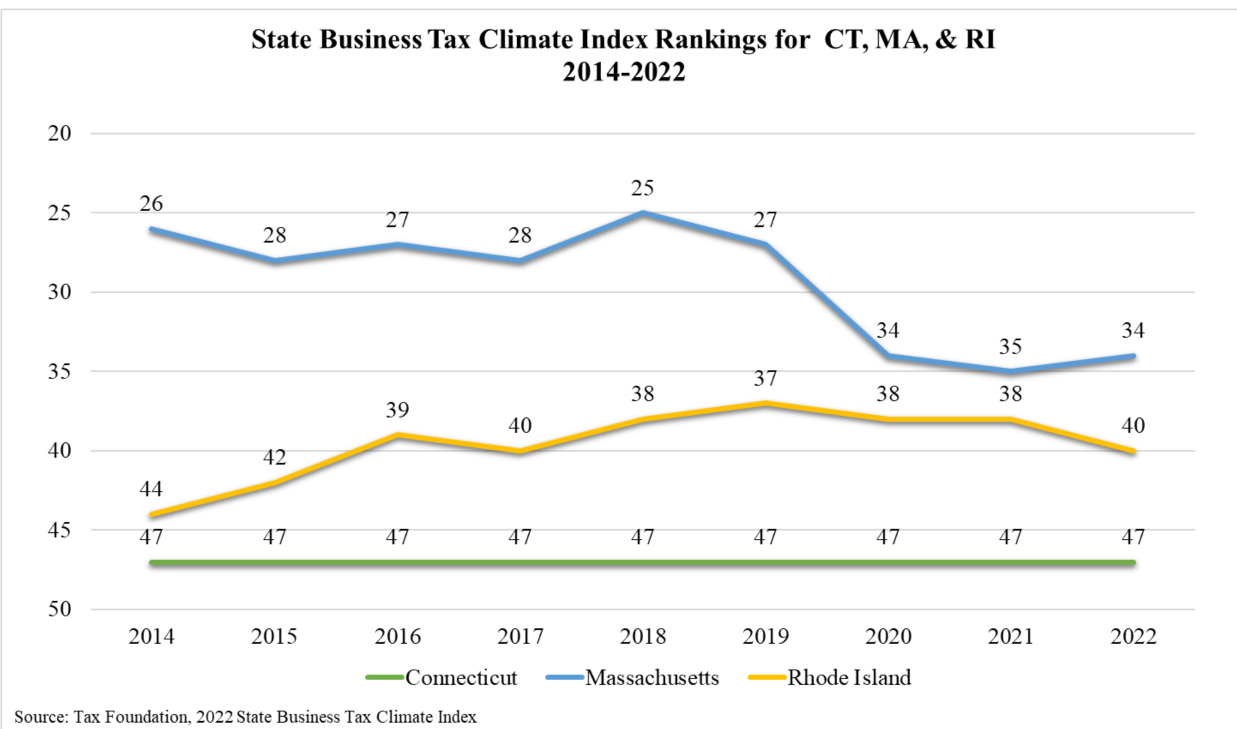
# RIPEC Analyzes Rhode Island's Drop from 38th to 40th in Business Tax Climate Index State Rankings

RIPEC

## Executive Summary
## January 2022

The Tax Foundation, a think tank based in Washington D.C., has annually issued its *Business Tax Climate Index* since 2003. This fifty-state ranking provides a comparative analysis of each U.S. state's business tax climate and is based on the principle that tax systems which are favorable to business give states advantages in attracting new businesses and generating economic and employment growth. A corollary premise of the *Business Tax Climate Index* is that, even in our global economy, states are in greater competition with each other than with foreign countries. The Ocean State, moreover, faces the greatest competition with other New England states, particularly its bordering states—Massachusetts and Connecticut.

Rhode Island's ranking on the 2022 *Index* is 40th highest, two spots lower than its 2021 ranking of 38th. Rhode Island's rank followed a generally positive trajectory between 2014 and 2019, improving from 44th best (or seventh worst) in the country to 37th, but in the last three years, the state has backslid. Rhode Island never cracked the top two-thirds of states during this period, but its improved score has positioned it farther ahead of Connecticut and moved it closer in line with Massachusetts.



Rhode Island's rank did not worsen over the last few years because of proactive tax policy choices. Rather, while Rhode Island made no major changes—positive or negative—to the elements of its business tax climate captured in the *Index*, other states that are similarly ranked enacted policies that improved their business tax climates.

A state's overall ranking on the *Business Tax Climate Index* is determined by comparing 125 variables across five major tax categories that are weighted differently, with the most weight attributed to those taxes with the greatest variability between states:

- **Individual Income** (31.2 percent) – Rhode Island ranks in the bottom half of states on individual income tax (31st). Rhode Island is more competitive in this category than Connecticut and Vermont, but less competitive than Maine, and significantly less competitive than Massachusetts and New Hampshire. New Hampshire does not tax wages and salaries while Massachusetts has a relatively low rate (5.0 percent) and only one income tax bracket (Rhode Island has three). Rhode Island's individual income tax structure has not undergone significant change in the last nine years, but its ranking has slipped six spots due to positive changes made by other states.

- **Sales** (23.7 percent) – Rhode Island ranks in the middle of states on sales tax (24th) but below every other New England state. Rhode Island's system of sales taxation has not undergone large structural change since 2014, but it has experienced shifts relevant to its overall score, including a broadening of its sales tax base to include certain business services.

- **Corporate Income** (20.9 percent) – Like the rest of the New England region, Rhode Island ranks in the bottom half of states in corporate income tax (37th). Rhode Island's rank improved in 2016 due to the reduction of its rate from 9.0 to 7.0 percent, but the state has since become less competitive both because of actions taken by other states to improve the competitiveness of their tax structures and because Rhode Island did not adopt state tax changes incentivized by the federal Tax Cuts and Jobs Act (TCJA) of 2017.

- **Property** (14.4 percent) – Rhode Island performs poorly in the property tax subindex along with the rest of the New England region (ranked 42nd). Rhode Island's rank is in part explained by aspects of its property tax laws that shift the tax burden away from homeowners and towards businesses—such as the enabling of split roll property taxation and the taxation of tangible personal property. Rhode Island also ranks poorly because of its outsized reliance on property tax. However, Rhode Island's ranking improved with the full phase out of its capital stock tax on January 1, 2015.

- **Unemployment Insurance** (9.8 percent) – Due largely to its high rates and taxable wage base, Rhode Island ranks poorly on UI tax (49th); only Massachusetts has a less competitive UI system. Rhode Island's rank has been largely consistent since 2014 but improved between 2017 and 2018—from 50th to 46th—due primarily to a law change that reduced the level of reserves that the state's UI trust fund must maintain and significantly decreased the taxes paid by the average employer. However, as other states enacted policies to make their UI tax systems more competitive, Rhode Island's position worsened to 49th the following year.

While reducing the tax burden for business always implicates fiscal challenges, Rhode Island arguably is in the best position in many years to make its tax structure more competitive Large inflows of federal pandemic relief funding to state and local governments, along with surprisingly strong state general revenues, have greatly improved Rhode Island's fiscal situation. In the context of the opportunity presented by these extraordinary circumstances, RIPEC recommends several areas for policymakers to prioritize:

- **Rhode Island should continue to improve its property tax structure**. Businesses pay a disproportionate share of the state's relatively high property taxes, and as assessed values for residential property have increased sharply in relation to commercial property, policymakers should resist increasing the proportional tax burden imposed on businesses even further.

- **Rhode Island should explore changes to make its corporate income tax more favorable to business**. Despite improving its ranking for this category between 2015 and 2016, Rhode Island's rating has slipped back to 37th, largely because of decisions to forego state tax law changes incentivized by the TCJA. At minimum, policymakers should consider improving the ability for taxpayers to deduct net operating losses.

- **Calls to increase individual income tax rates for high wage earners should be resisted**. The individual income tax is the most heavily weighted tax subindex in the rankings. The great majority of businesses in Rhode Island are organized as S corporations, sole proprietorships, and partnerships, and report their profits as individual income. Rhode Island's ranking of 31st for this category is already in the bottom half of states and is considerably less competitive than that of Massachusetts (ranked 11th).

- **The state should use federal pandemic relief funding to provide relief to employers.** Because the UI trust fund, entirely paid for by employers, was severely impacted by government-mandated shutdowns caused by the pandemic and by unprecedented UI fraud, the state should consider using some of its discretionary federal relief money to build up its UI trust fund balance and shield employers from future rate increases.