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FOUR KEY QUESTIONS ON THE GOVERNOR'S TAX CUT PROPOSAL

Executive Summary

Earlier this year, Governor Mitt Romney filed legislation (House No. 4800) to reduce the personal income tax rate from its present level of 5.3 percent to 5.0 percent beginning in 2005. The Department of Revenue estimates that the effect of the Governor's legislation would be to reduce personal income tax collections by $227 million in FY 2005 and by $737 million in FY 2007, when the full ramifications of the legislation would first be felt.

This paper examines four questions surrounding the Governor's proposed rate reduction:

- **Can Massachusetts afford to reduce the personal income tax rate?**

  Despite higher than anticipated revenue collections in FY 2004, Massachusetts likely will continue to face structural budget deficits in the years ahead. Those deficits are likely to be considerably smaller than the ones the Commonwealth has confronted since FY 2002 – mainly due to sizable and permanent reductions in state spending – but they still can only be resolved by instituting even deeper cuts in spending or by raising additional revenue. The Governor's tax cut proposal would increase the size of such deficits by anywhere from $500 million to $750 million over the next three fiscal years, forcing spending cuts of far greater number or severity or requiring increases in other forms of taxation, such as the sales or corporate excise taxes, in order to eliminate this long-term imbalance.

- **Should reducing the personal income tax rate be the Commonwealth's top public policy priority?**

  Since the onset of the fiscal crisis in FY 2002, spending in many areas has been cut well below the level necessary to maintain services. For instance, after adjusting for inflation, support for areas as diverse as higher education, public health, environmental affairs, and housing and community development has been reduced by more than a fifth. Over the long-run, such cuts could harm the Massachusetts economy, as public investments in education, training, health care, and infrastructure play a large role in attracting and retaining employers. Reducing the personal income tax by $596 million in FY06 – as the Governor's proposal would do – would likely not only require further spending cuts in order to balance the budget, but also keep the cuts of the past several years in place indefinitely.

- **Who would benefit from a reduction in the personal income tax rate?**

  The personal income tax in Massachusetts is modestly progressive; as a result, reductions in the personal income tax rate disproportionately benefit upper-income taxpayers. According to the Institute on Taxation and Economic Policy, nearly one of out of every five dollars from the Governor's proposed tax cut would go to the top 1 percent of taxpayers in the Commonwealth, a group that had an average family income of more than $1.27 million in 2003.

- **Is a reduction in the personal income tax rate an effective means of stimulating the Massachusetts economy?**

  Claims that reducing the personal income tax rate would help to spur employment in Massachusetts run counter to the international, national, and local evidence on the relationship between taxes, public spending, and economic growth. To cite just one example, President Bush's second tax cut, enacted in May 2003, was projected by the Council of Economic Advisors to create 306,000 jobs per month nationwide. Yet, according to the Economic Policy Institute, employment growth has fallen short of that target level in ten of the first twelve months that the tax cut was in effect and by a total of more than 2.2 million jobs to date. For Massachusetts, the CEA's nationwide projection translates into an increase of 71,400 jobs by May 2004. Rather than growing, however, employment in Massachusetts has declined by nearly 16,000 jobs since the tax cut was implemented.

Introduction

Earlier this year, Governor Mitt Romney filed legislation (House No. 4800) to reduce the personal income tax rate from its present level of 5.3 percent to 5.0 percent beginning in 2005. The Department of Revenue estimates that the effect of the Governor's legislation would be to reduce personal income tax collections by $227 million in FY 2005 and by $737 million in FY 2007, when the full ramifications of the legislation would first be felt.

The Governor's proposed rate reduction raises a number of questions, chief among which are as follows:

- Can Massachusetts afford to reduce the personal income tax rate?
- Should reducing the personal income tax rate be the Commonwealth's top public policy priority?
- Who would benefit from a reduction in the personal income tax rate?
- Is a reduction in the personal income tax rate an effective means of stimulating the Massachusetts economy?

This paper examines these four questions, with a view to both the Commonwealth's fiscal past and its fiscal future. Looking back, the more than two score of tax cuts that were put in place between 1990 and 2001 not only helped to create Massachusetts' recent fiscal crisis but to exacerbate inequities in the Commonwealth's tax system. Looking ahead, the Commonwealth faces a host of challenges – from resolving its somewhat smaller, but still ongoing, structural deficit; to repairing the damage done by several years of sharp, repeated, and widespread spending cuts to education, health care, and other essential services; and on through to fulfilling new demands such as more equitable financing for public education and universal access to early childhood education and care. The loss of revenue associated with the Governor's proposed rate reduction would make meeting these challenges a virtually impossible task and would likely lead to further reductions in spending.

Can Massachusetts Afford to Reduce the Personal Income Tax Rate?

In announcing his legislative proposal, Governor Romney argued that, since "the worst is behind us and revenue collections are once again robust," the Commonwealth should reduce the personal income tax rate.[1] While it is true that revenue collections for FY 2004 were higher than anticipated, that does not necessarily mean that future revenue will be sufficient to support future spending, nor does it mean that Massachusetts could reduce taxes without any consequences. To the contrary, Massachusetts likely will continue to face structural budget deficits in the years ahead. Those deficits are likely to be considerably smaller than the ones the Commonwealth has confronted since FY 2002 – mainly due to sizable and permanent reductions in state spending –

[1] *Romney Delivers First Dividend on Reform*, The Commonwealth of Massachusetts, Executive Department, June 3, 2004.

but they still can only be resolved by instituting even deeper cuts in spending or by raising additional revenue.[2] Thus, if enacted, the Governor's tax cut proposal would force spending cuts of far greater number or severity or require increases in other forms of taxation, such as the sales or corporate excise taxes, in order to eliminate this long-term imbalance.

FY 2004 and FY 2005 Tax Collections in Perspective

On January 15, 2004, the chairpersons of the House and Senate Committees on Ways and Means, Representative John Rogers and Senator Therese Murray, as well as the Secretary of Administration and Finance, Eric Kriss, announced the consensus revenue estimate for FY 2005 – that is, the agreed-upon projection for the amount of tax revenue the Commonwealth is expected to collect in the current fiscal year. At the same time, they announced that the tax revenue estimate for FY 2004 would be revised, the second time it had been changed since the FY 2004 budget was adopted in June of 2003.[3] Specifically, they announced that anticipated tax collections would be $15.230 billion for FY 2004 and $15.801 billion for FY 2005, implying growth rates of about 1.8 percent for FY 2004 and 3.75 percent for FY 2005. In the end, according to preliminary data from the Department of Revenue, tax collections for FY 2004 totaled $15.942 billion, $712 million more than anticipated and 6.5 percent higher than FY 2003 collections.

Higher-than-anticipated tax collections in FY 2004 obviously have implications for the amount of tax dollars the Commonwealth can expect to see in FY 2005. For instance, if the initially projected FY 2005 growth rate of 3.75 percent holds, then FY 2005 collections could rise to $16.666 billion. Alternatively, if higher-than-anticipated FY 2004 collections indicate, in turn, that a sustained economic expansion is underway in Massachusetts, then total collections in FY 2005 could of course be higher. For example, if they were to grow at the same rate at which personal income in Massachusetts has grown over roughly the last two decades, then tax collections could reach as much as $16.816 billion.[4]

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[2] According to the Center on Budget and Policy Priorities, "A state has a structural deficit when the normal growth of revenues cannot pay for the normal growth of expenditures from year to year." (Lav, Iris J., *Structural Deficits: Will the Pain Persist?*, presentation to the Funding State Services Conference, November 16, 2003.)

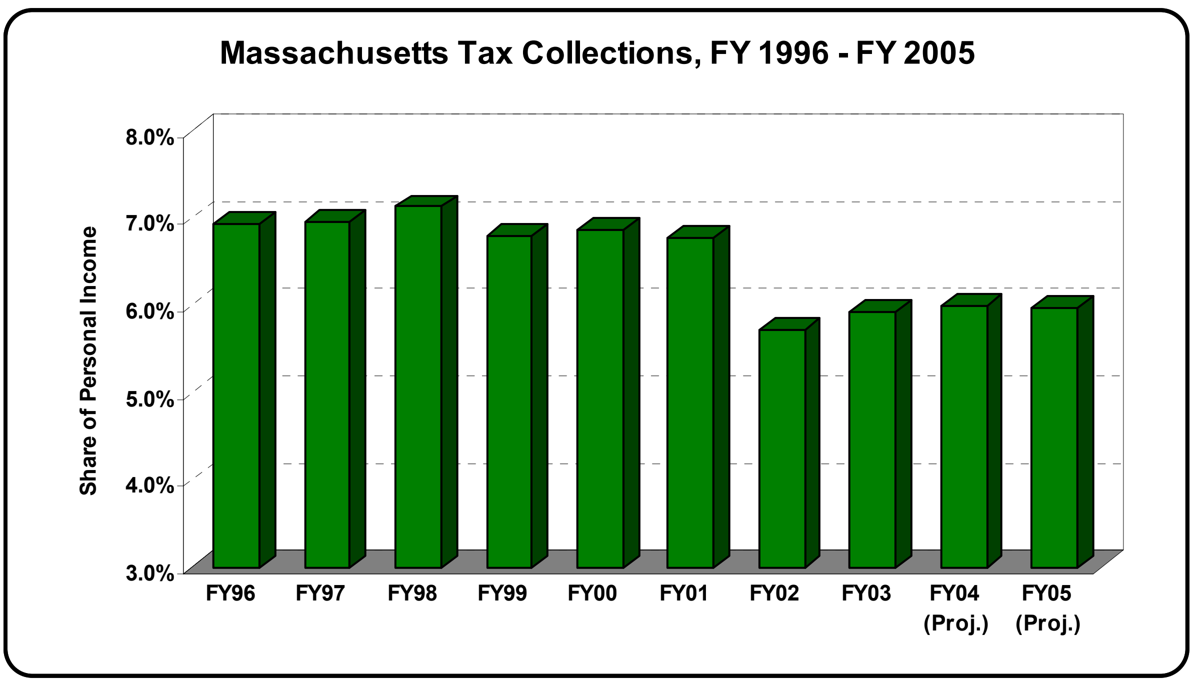
[3]Following the adoption of the FY 2004 budget, the Department of Revenue projected that tax revenue for that fiscal year would total $14.808 billion. Then, in October 2003, the Department reduced this projection to $14.796 billion.

[4] These amounts reflect growth of 3.75 percent and 4.69 percent from the FY04 total of $15.942 billion, plus the effect of policy changes adopted as part of, or anticipated by, the FY 2005 budget, less the effect of Chapter 186 of the Acts of 2002 (discussed in more detail later in this paper). Specifically, the FY 2005 budget assumes that stepped up enforcement efforts at the Department of Revenue will yield an additional $65.5 million in the current fiscal year, while pending legislation to close a variety of tax loopholes is estimated to produce an additional $89 million this year. Provisions of Chapter 186 of the Acts of 2002 will likely lead to a roughly 8 percent increase in the personal income tax exemption for 2005, thus producing a revenue loss of approximately $28.1 million in FY05. Two other points relative to the FY 2005 budget are worth noting here: first, despite the prospects that FY05 revenue collections would exceed the January consensus revenue estimate, policymakers chose not to revise that estimate and second, Section 380 of the budget stipulates, "If tax revenues for the commonwealth exceed benchmarks set by the department of revenue … by the third quarter of fiscal year 2005, consideration shall be given to reduce [sic]…" the $340 million transfer from the Commonwealth Stabilization Fund to the General Fund for expenditure in FY 2005.

While higher-than-anticipated tax collections should be viewed positively, it is worth putting recent collections – and apparent surpluses – in perspective. In particular, total state tax collections, when measured relative to the size of the Commonwealth's economy, remain significantly below the levels that existed just ten years ago. As Figure 1 shows, in FY 1996, total state tax collections amounted to 7.0 percent of personal income in Massachusetts; the MBPC estimates that they will equal 6.0 percent of personal income in FY 2005.[5]

Just as importantly, a fairly large fraction of the real tax revenue growth the Commonwealth has witnessed since FY 2002 can be accounted for by changes in tax policy and administration adopted since the advent of the fiscal crisis. That is, if the Legislature had not enacted the 2002 tax package and closed a variety of corporate tax loopholes in 2003, then current tax revenue would be, at best, only moderately higher than its FY 2002 level. For instance, after adjusting for inflation, total tax revenue was \$14.89 billion in FY 2002 and \$15.94 billion in FY 2004, an increase of \$1.06 billion. Yet, the 2002 tax package, as well as other tax policy changes adopted since then, may be responsible for as much as \$750 million of that difference. In other words, only a comparatively small fraction of real revenue growth over the past few years is attributable to the expansion of the Commonwealth's economy. If nothing else, this suggests that it may be imprudent to begin to undo recent policy changes before the Commonwealth's economic recovery is fully underway.

Figure 1.[6]

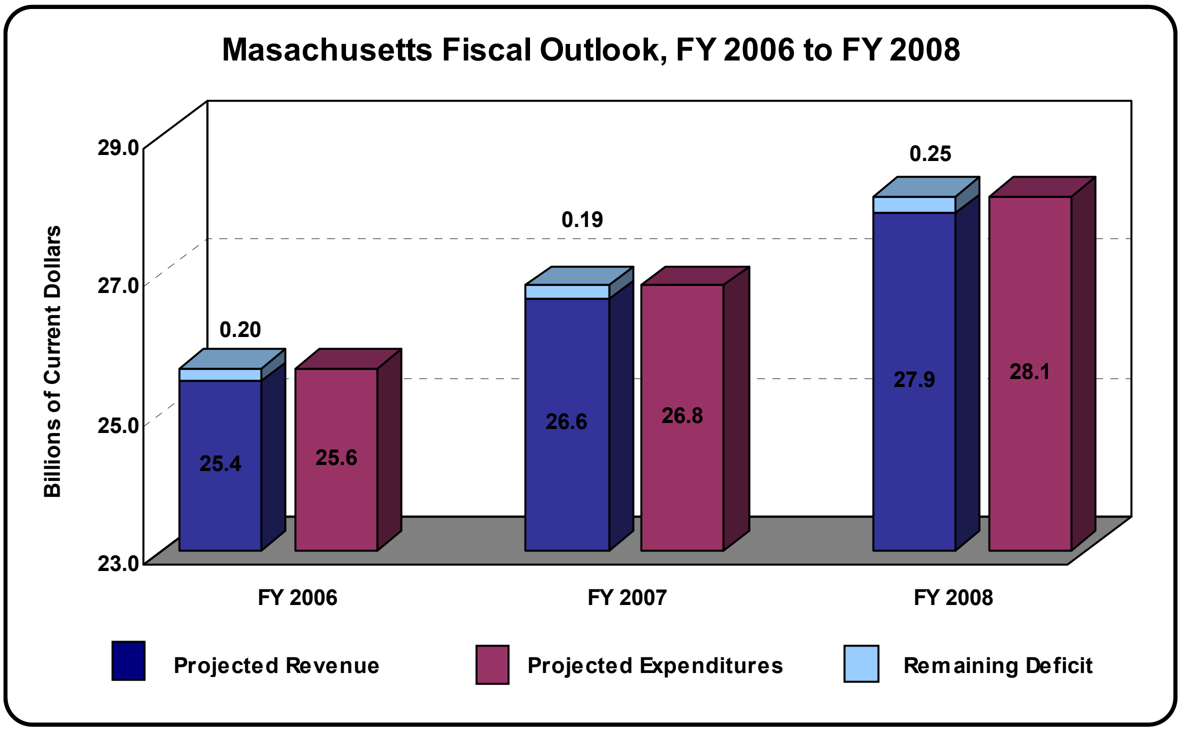


[5] In calculating this figure, the MBPC assumes that total tax revenue in FY 2005 will be \$16.666 billion (as discussed earlier in this paper) and that personal income will be \$278.224 billion. The most recent fiscal year for which complete Bureau of Economic Analysis data on state personal income is available is FY 2003. The MBPC's estimate reflects a real average annual growth rate of 2.99 percent from that point.

[6] Unless otherwise noted, all graphical and tabular Figures are based on MBPC calculations.

The prospect of higher than anticipated collections is likely part of the basis for the Governor's proposal to reduce the personal income tax rate. Yet, the possibility – or even the likelihood – that tax collections may be higher than originally projected does not necessarily mean that they will be sufficient to support public expenditures into the future. Figure 2 below presents the MBPC's projections of total spending and total revenue for fiscal years 2006 through 2008. It suggests that, despite higher than anticipated tax collections, Massachusetts will likely continue to face a relatively modest – but still significant – structural budget deficit of $190 million to $250 million in each of the next several years.

Figure 2.



Appendix A reviews the assumptions underpinning the MBPC's projections, but a pair of points is worth noting here. First, as has been the case in recent years, two of the most significant determinants of state spending in Figure 2 are MassHealth and the Commonwealth's pension funding obligation. These two areas comprise about one-third of total spending and are expected to continue to grow at rates substantially above inflation. Thus, any change in their anticipated growth rates will likely have a noticeable affect on the Commonwealth's budget outlook. Second, Figure 2 presumes fairly robust tax revenue growth, ranging from 4.90 percent to 5.26 percent annually, rates that would be sufficient to set in motion the phasing out of certain elements of the 2002 tax package (discussed at greater length below). Obviously, if tax collections rise more quickly or more slowly, then the size of the Commonwealth's projected budget deficit will be materially affected.

Personal Income Tax Already Scheduled to Fall Under Current Law

On July 24, 2002, the Massachusetts General Court enacted, over then-Governor Jane Swift's veto, House No. 5250, An Act Enhancing State Revenues, a measure that has helped to reduce the size of the Commonwealth's structural deficit by generating approximately $1 billion in annual tax revenue. The act consists of six main elements:

- a 25 percent reduction in the personal exemption available to income tax filers;
- the suspension of the 2000 ballot initiative known as Question 4, which had been scheduled to reduce the personal income tax rate to 5.0 percent in 2003, thus leaving the rate at 5.3 percent;
- the suspension of the income tax deduction for charitable contributions;
- the elimination of preferential rates of taxation for capital gains income so that such income is now taxed at the same rate as earned income (again, currently 5.3 percent);
- an increase in the cigarette tax to $1.51 per pack; and
- the preservation of the Massachusetts estate tax, which, in the absence of legislative action, would have been eliminated due to changes in federal law.

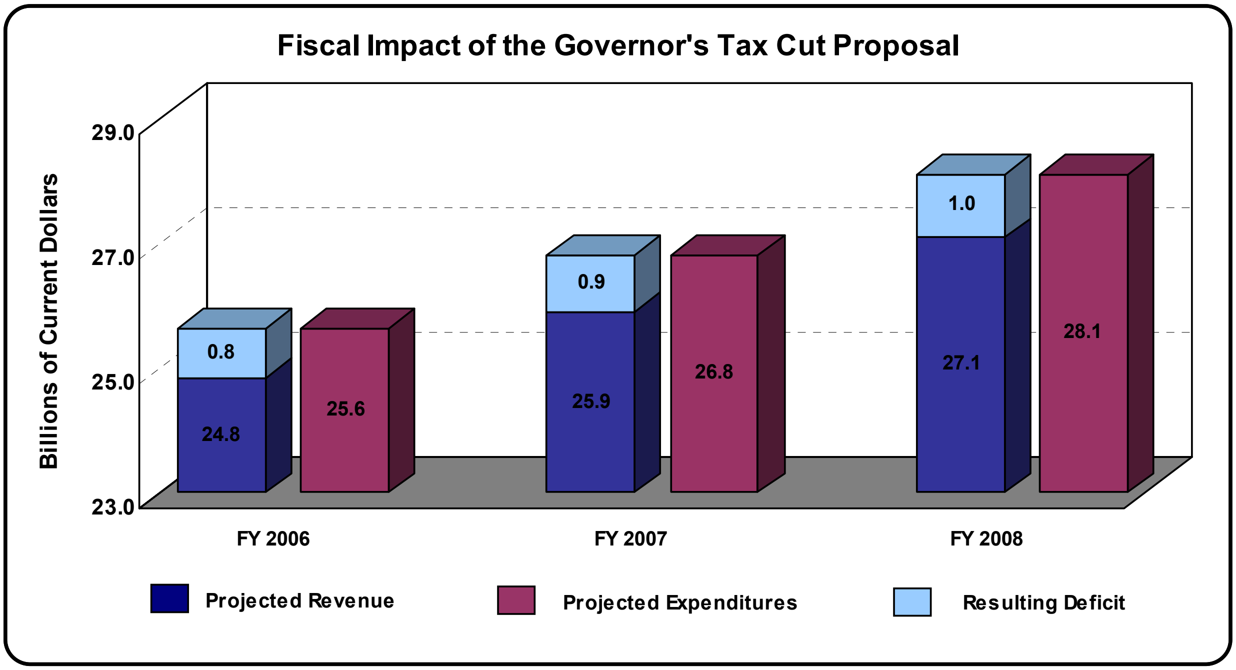
Under the provisions of the act, the first three elements above – the reduction in the personal exemption, the "freezing" of the personal income tax rate, and the suspension of the charitable deduction – are scheduled to be phased out (contingent upon revenue growth), thus providing an automatic and fairly sizable tax cut over time. More specifically, if real baseline tax revenue growth exceeds 2.5 percent each year into future, then the personal exemption will gradually rise to its 2001 levels by 2008, the personal income tax rate will fall, in stages, to 5.0 percent by 2014, and the charitable deduction will return in 2015.[7] As a result, Massachusetts taxpayers will likely receive a tax cut of roughly $55 to $70 million in 2005. In turn, assuming sustained baseline tax revenue growth, that tax cut would increase in value by no less than $55 million per year, culminating in a total tax cut of approximately $1.6 billion in 2015, an amount that may well prove unaffordable over the long-run.

The Fiscal Impact of the Governor's Tax Proposal: Larger than Advertised

Reducing the personal income tax rate to 5.0 percent would only exacerbate this structural deficit. Figure 3 below reprises Figure 2, but with one key difference – it accounts for the long-term revenue loss that would result if the Governor's proposal were enacted. The structural deficit in FY 2006 would grow to roughly $800 million and would continue to expand thereafter, reaching about $1 billion in FY 2008 – or about three-quarters of a billion dollars more than if the tax cut were not adopted.

[7] For each year that real baseline tax revenue growth does not exceed 2.5 percent, these dates would be increased by one year.

Figure 3.



Importantly, the revenue loss depicted above consists of more than a reduction in the personal income tax rate, as Figure 4 details. As noted previously, under current law, if tax revenue continues to grow at certain rates, three major changes will gradually be made to the personal income tax over roughly the next decade: the return of personal exemptions to their 2001 levels, the reduction in the personal income tax rate to 5.0 percent, and the restoration of the income tax deduction for charitable contributions. At the earliest, these changes would be completed by 2015. However, given the manner in which it is written, the legislation introduced by the Governor interacts with current law in such a way as to trigger the restoration of the charitable deduction within a year's time; at the same time, it leaves intact the current schedule for the return of the personal exemption.

Figure 4.

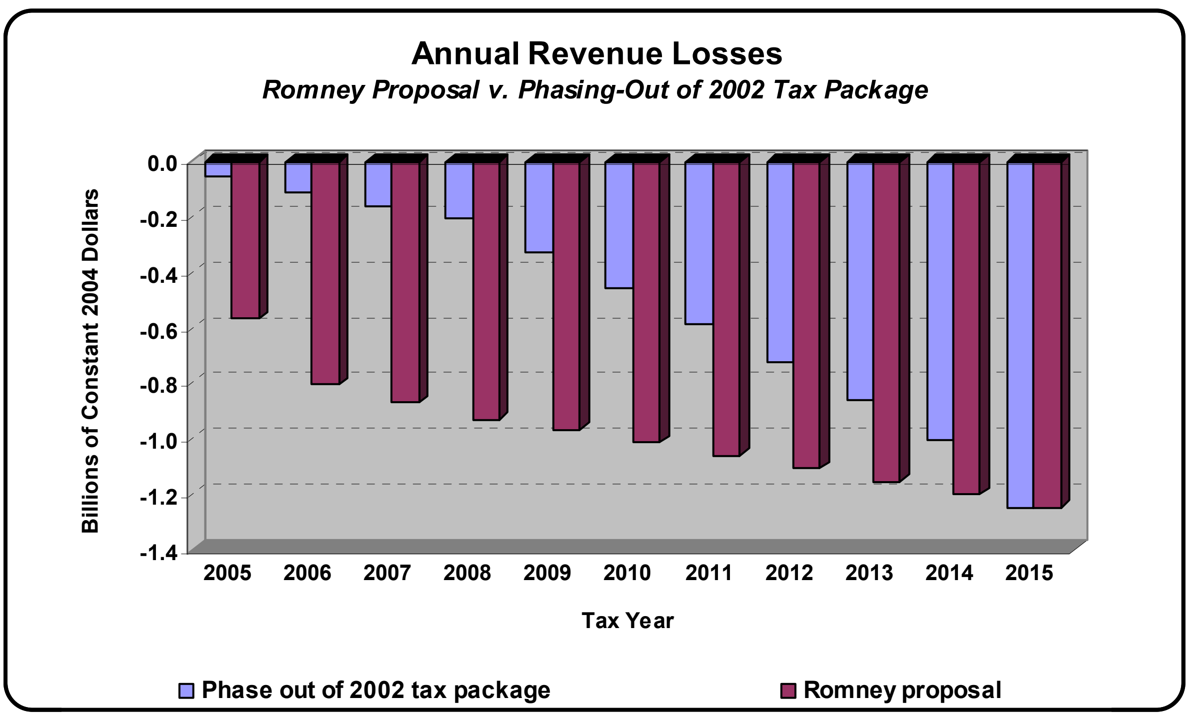
Tax Year (TY) and Fiscal Year (FY) Revenue Losses Resulting from House No. 4800
in millions of current dollars

	Rate reduction to 5.0%		*Restoration of Charitable Deduction*		*Total Impact*	
	TY	FY	TY	FY	TY	FY
2005	-520	-227	0	0	-520	-227
2006	-533	-554	-191	-42	-724	-596
2007	-558	-545	-197	-192	-755	-737
2008	-582	-569	-207	-203	-789	-772

Source: Massachusetts Department of Revenue (all figures represent mid-points of the Department's range of losses)

In other words, the Governor's proposal would greatly accelerate changes in tax policy that are now expected to be made over a decade's time. In fact, if the Governor's proposal were to become law, those changes could be completed as early as 2008. This, in turn, would mean that the full revenue loss associated with those changes would be felt much more quickly and for a much longer period of time, as Figure 5 demonstrates.[8] For instance, in tax year 2005, it is expected that the first stage of the phase-out of the 2002 tax package (i.e. a roughly 8 percent increase in the personal exemption for each class of tax filer) will yield a tax cut of approximately $55 million in constant 2004 dollars. In contrast, the Governor's proposal, including the effects of the phase-out of the 2002 tax package, would produce a total tax cut of $567 million, a difference of some $512 million. That difference would expand to $727 million (again, in constant 2004 dollars) by 2008, when the Governor's proposal would reduce taxes by $934 million and the phase-out of the 2002 tax package would generate a tax cut of $207 million. All told, the revenue loss engendered by the Governor's proposal would exceed the loss resulting from the phase-out of the 2002 tax package by $4.5 billion between tax years 2005 and 2015, assuming that the 2002 tax cut were phased-out as quickly as possible under current law. To compensate for this difference, the Commonwealth would likely be forced to cut spending considerably, thus threatening existing programs and services, precluding the restoration of past spending cuts, and forestalling any new initiatives.

Figure 5.



[8] Figure 5 assumes that tax revenue growth over the next decade will be sufficient to trigger the phase-out of the 2002 tax package as quickly as possible. However, if the pace of revenue growth slackens, then the period over which the package will be phased-out will be extended, meaning that the relative impact of the Romney tax cut would be that much greater.

Additional (and Significant) Fiscal Challenges Await

The preceding projections likely understate the magnitude of the fiscal challenges Massachusetts will encounter in the years ahead. Two potential challenges not included in the above analysis stand out; both are related to the education of Massachusetts' children. First, on April 26, in a report to the Supreme Judicial Court concerning the pending *Hancock v. Driscoll* case, Suffolk Superior Court Justice Margot Botsford found that, despite the progress the Commonwealth has made since the adoption of the Education Reform Act in 1993, "the plaintiff children are not receiving the education to which they are constitutionally entitled…" and that "inadequate financial resources are a very important and independent cause" of that shortcoming.[9] The SJC will ultimately decide the *Hancock v. Driscoll* case and what it will mean, in practical terms, for public education funding in Massachusetts, but it is worth noting that in its most recent bond prospectus, the Commonwealth states that "the increased spending that could result from the case could total $2 billion."[10] Second, as part of the FY 2005 budget, the Legislature took the first steps towards creating a system of universally-accessible early childhood education by establishing a new Department of Early Education and Care. While it is unclear how the Legislature intends to proceed following the creation of this new Department and what the size and timing of any new costs may be, the most comprehensive assessment currently available suggests that they could be substantial. According to Early Education for All, a universal early education system could cost as much as $1.2 billion per year once fully realized, although the net costs to the Commonwealth could be lower depending on the scope of implementation, any fees that may be charged as part of that system, and the reallocation of budgetary resources currently devoted to such ends.

Should Reducing the Personal Income Tax Rate be the Commonwealth's Top Public Policy Priority?

One other fiscal challenge confronting the Commonwealth is the mitigation of the damage wrought by successive years of spending cuts. Since the onset of the fiscal crisis, spending in many areas has been cut significantly below the level necessary to maintain services. As Figure 6 reveals, support for areas as diverse as higher education, public health, environmental affairs, and housing and community development has been reduced dramatically since FY 2001. In fact, over that span, once inflation is taken into account, spending in many of these areas has fallen by more than a fifth. Over the long-run, such cuts could harm the Massachusetts economy, as public investments in education, training, health care, and infrastructure play a large role in attracting and retaining employers.

Of course, reducing the personal income tax by $596 million in FY06 – as the Governor's proposal would do – would not only require further spending cuts in order to balance the budget, but would keep the cuts of the past several years in place indefinitely. The following, then, are just some of the likely real costs associated with still another tax cut.[11]

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[9] Commonwealth of Massachusetts, *Hancock v. Driscoll* Report, Superior Court Civil Action No. 02-2978 and Supreme Judicial Court SJ-1990-0128, April 26, 2004.
[10] Commonwealth of Massachusetts, *Official Statement*, March 4, 2004, p. A-18.
[11] The dollar figures below are not adjusted for inflation; the percent changes displayed in Figure 6 do, however, take inflation into account.

- *The end of efforts to reduce class sizes for young students.* From FY 2001 through FY 2003, annual appropriations to reduce class sizes in kindergarten through the third grade totaled $18.0 million. In FY 2004, support for this initiative was eliminated and has not yet been restored.

- *A dramatic reduction in the resources available to help students struggling to pass the MCAS.* In FY 2004, funding for MCAS remediation was cut 80 percent – from $50.0 million to $10.0 million. Funding for MCAS remediation programs for elementary school students was completely eliminated, while the allocation for high school programs was cut in half. The FY05 appropriation for this initiative – $14.1 million – only partly restored these monies.

- *Smaller investments in higher education – and the Commonwealth's economic future.* Financial aid appropriations have fallen 18 percent over the past several years – from $100.1 million in FY01 to $82.4 million in FY05. Direct support for the University of Massachusetts, as well as for community and state colleges, has fallen since FY01 as well. Appropriations for UMass have declined $70.0 million or 14 percent, support for community colleges has dropped $18.2 million or 8 percent, and funding for state colleges was reduced $11.0 million or 6 percent. Finally, state funding for library reference materials, which amounted to $14.0 million in FY01, fell noticeably in recent years before being eliminated from the budget in FY04.

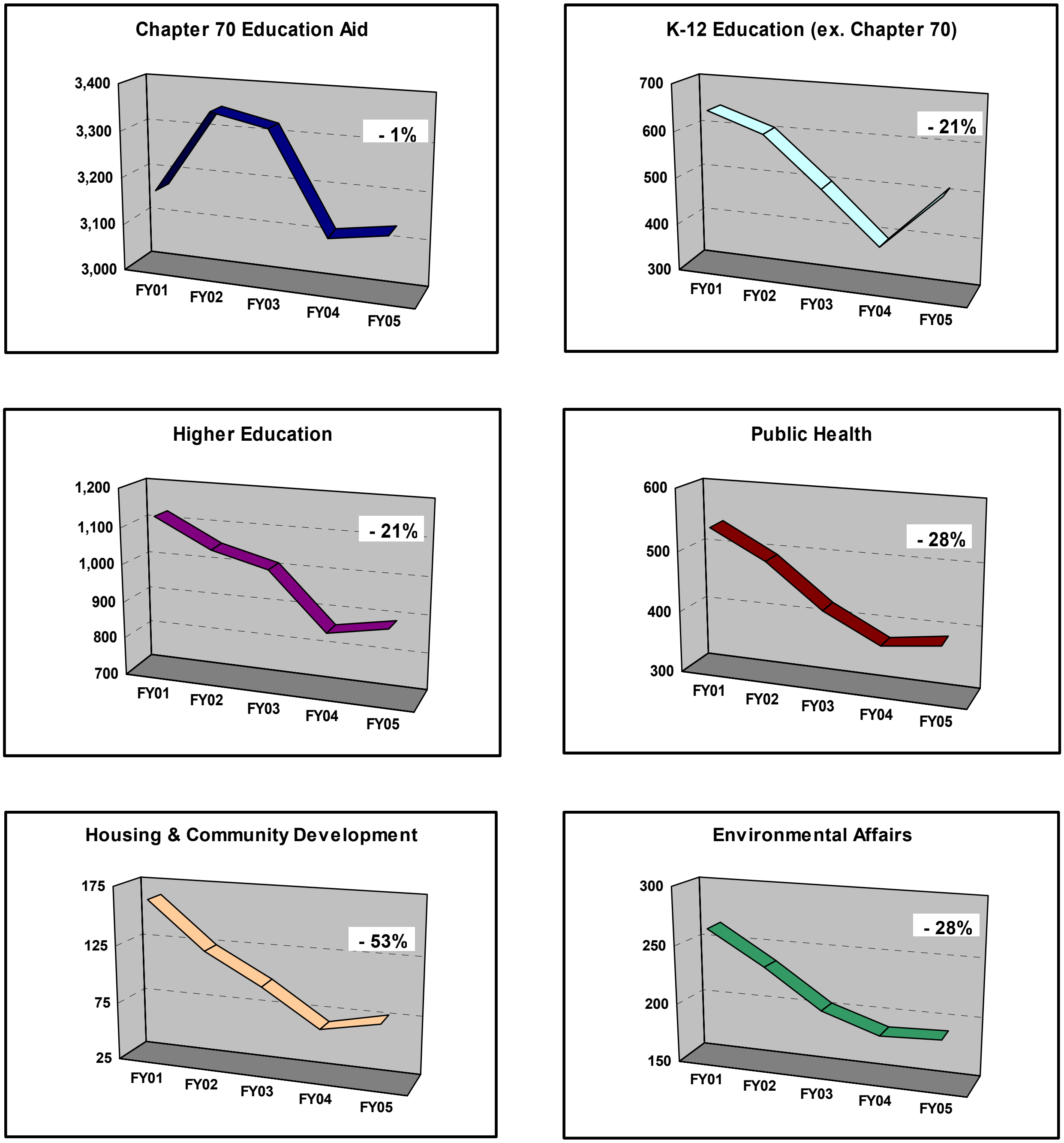
- *A significant retreat in the fight against HIV/AIDS and other sexually-transmitted diseases.* In FY 2001, funding for treatment, counseling, education, and other services for individuals suffering from these diseases amounted to $51.1 million. In FY 2005, it was just $31.6 million, forcing the near elimination of community prevention programs, causing the discontinuation of roughly one-third of treatment and counseling sessions, and curtailing outreach and early identification efforts.

- *A sharp decline in assistance for families trying to find affordable housing.* Between FY01 and FY05, funding for the Massachusetts Rental Voucher Program (MRVP) and the Alternative Housing Voucher Program (AHVP) – both of which provide rental vouchers to low-income families – fell from $39.3 million to $26.6 million, a 32 percent decline.

- *The nearly complete abandonment of the Massachusetts Tobacco Control Program (MTCP).* In FY 2001, the MTCP received an appropriation of $50.5 million, but, by FY05, that amount had plummeted to $2.5 million. Massachusetts made great progress in tobacco control during the 1990s, with the number of packs of cigarettes sold within the Commonwealth dropping by almost 50 percent since 1992, but budget cuts appear to have jeopardized such advances. For instance, in localities that eliminated their tobacco control programs, the rate of cigarette sales to minors climbed from 7.7 percent in 2002 to 15.4 percent in 2003.[12]

[12] Smith, Stephen, "As tobacco controls lessen, sales to minors seem to rise," Boston *Globe*, March 16, 2004, p.A1.

Figure 6.



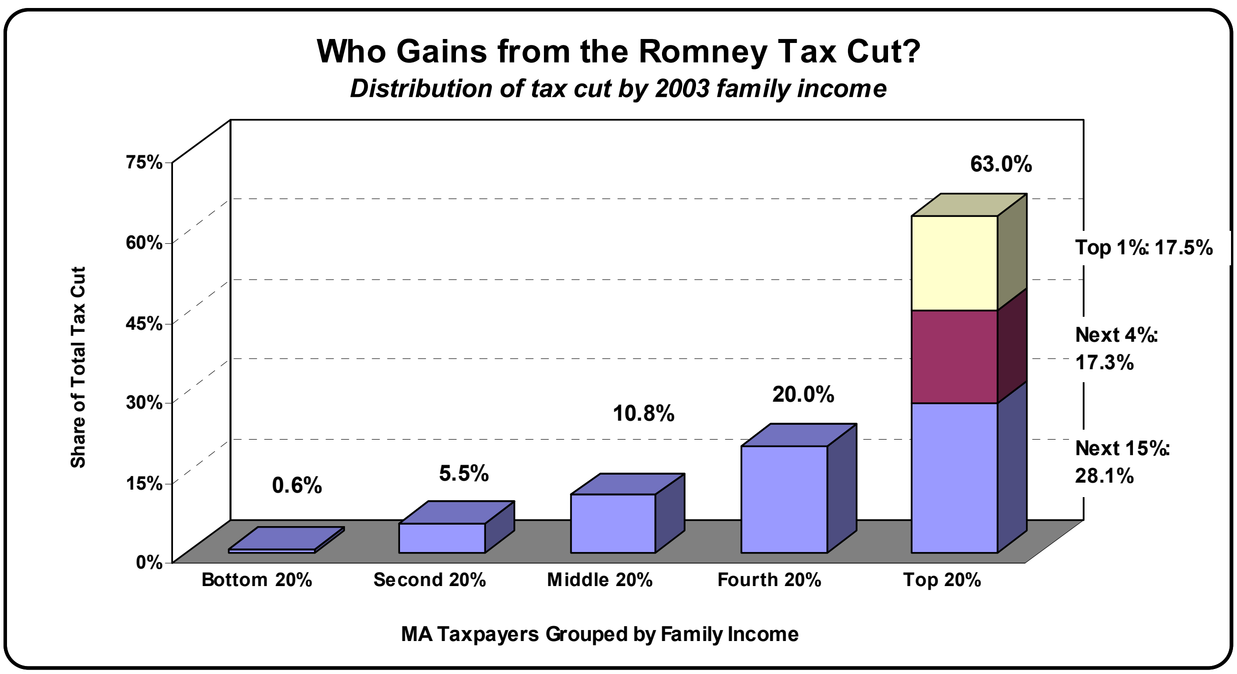
All dollar amounts in Figure 6 are in millions of constant FY04 dollars.

Who Would Benefit From a Reduction in the Personal Income Tax Rate?[13]

The personal income tax in Massachusetts is modestly progressive.[14] That is, upper-income taxpayers pay a larger share of what they earn in personal income taxes than lower-income taxpayers do. Massachusetts may not have a graduated rate structure like some states – the current 5.3 percent rate applies uniformly to all earned income – but other features of the tax, such as a sizable personal exemption, an Earned Income Tax Credit, and the "no-tax" threshold and the related low-income credit, ensure that the largest source of revenue for the Commonwealth's budget is determined by one's ability to pay.

Given these attributes, any change in the personal income tax rate is disproportionately felt by upper-income taxpayers. When the rate is increased, as it was in 1990 and 1991, such taxpayers bear the largest portion of the burden. When it is reduced, as it was in 1992 and in each year from 2000 to 2002, they reap the largest share of the gain. Thus, the benefits of a further reduction in the rate, which the Governor's proposal seeks to accomplish, would accrue largely to the most affluent taxpayers in the Commonwealth, as Figure 7 shows.

Figure 7.



Source: Institute on Taxation and Economic Policy

[13] As noted earlier, the Governor's proposal would also trigger the reinstatement of the personal income tax deduction for charitable contributions; this section of the paper focuses solely on the distributional effects of the rate reduction portion of the Governor's proposal.

[14] For instance, according to the Institute on Taxation and Economic Policy, in 2002, the personal income tax burden for the poorest 20 percent of taxpayers in Massachusetts amounted to 0.8 percent of family income, while, for the wealthiest 1 percent it equaled 4.8 percent of family income. For more information, see *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*, Institute on Taxation and Economic Policy (Washington, DC), January 2003.

According to the Institute on Taxation and Economic Policy (ITEP), a non-partisan research group based in Washington, DC, if the personal income tax rate in Massachusetts dropped to 5.0 percent, the bottom 20 percent of taxpayers in the Commonwealth – those with incomes of less than $17,200 in 2003 – would receive less than 1 percent of the resulting $550 million tax cut.[15] In fact, only about one out of every five taxpayers in this income range would receive any benefit at all from such a rate reduction; consequently, the average tax cut for taxpayers in this group would be less than $5. Taxpayers in the middle quintile – those with incomes between $33,500 and $51,200 – would receive 10.8 percent of the total tax cut; their average tax cut would be $78. Taxpayers comprising the top quintile would enjoy nearly two-thirds of the total reduction – 63.0 percent. Of particular note, nearly one of out of every five dollars from the tax cut would flow into the pockets of the top 1 percent of taxpayers in the Commonwealth. In 2003, this group had an average family income of more than $1.27 million, while their average tax cut would be in excess of $2,500.

Recent news reports on the Governor's proposed rate reduction largely overlook its inequitable distribution, suggesting instead that it would result in an average tax cut of $100 per taxpayer.[16] As seen in Figure 8, however, examples produced by the Department of Revenue (DOR) of what such a rate reduction might mean for taxpayers at specified income levels and of a specified family type only serve to reinforce ITEP's findings. For instance, according to the DOR, dropping the rate to 5.0 percent would result in a tax cut of $240 for family of four with a total income of $100,000 per year and two young children. In contrast, a family of four earning just $40,000 and renting its residence, rather than owning it, would receive a cut of just $57. In short, bringing the personal income tax rate down to 5.0 percent would provide significantly smaller benefits to those families with demonstrably greater needs.

Figure 8.

Income	$40,000	$50,000	$60,000	$80,000	$100,000
Marital Status	Married	Single	Married	Married	Married
Number of Children	2	0	0	2	2
Number of Children Under 12	2	0	0	2	2
Number of Adults Working	1	1	2	2	2
Homeowner/Renter	Renter	Homeowner	Homeowner	Homeowner	Homeowner
Tax Savings - 5.3% to 5.0%	**$57**	**$134**	**$148**	**$180**	**$240**

Source: Massachusetts Department of Revenue

[15] ITEP treats married couples filing jointly as one taxpayer for the purposes of its analyses; it also counts as taxpayers individuals and families residing in the Commonwealth who do not file personal income tax returns but who may pay sales taxes and any of the various excise taxes (e.g. on gasoline, tobacco, or alcohol) that the Commonwealth levies.

[16] For examples, see Greenberger, Scott, "Romney Seeks $225M in Tax Cuts," Boston *Globe*, May 4, 2004, p. A1 and Levenson, Michael, "Death Penalty and Income Tax Rollback on Radar Screen," *The Mariner* (Abington Edition), May 14, 2004. A recent op-ed by John Donahue (Boston *Globe*, June 24, 2004) also notes that the Governor's tax cut would amount to "about $100 for the average taxpayer."

Is Reducing the Personal Income Tax Rate an Effective Means of Stimulating the Massachusetts Economy?

One argument that is often made in support of tax cuts is that taxes are an impediment to economic growth. For instance, last April, in criticizing the 2002 tax package that has helped to shrink the Commonwealth's structural deficit, Governor Romney stated, "Taxes hurt working people, kill jobs and will make it harder to attract businesses to our state."[17] Consequently, the argument continues, cutting taxes will lead to economic growth and higher levels of employment. Indeed, several days after the Governor submitted legislation to reduce the personal income tax rate to 5.0 percent, the Beacon Hill Institute released a report claiming that the reduction, by FY 2008, would lead to 7,885 new jobs and would produce $17.1 million in new investment.[18]

Yet, this argument runs counter to recent reviews of the international, national, and local evidence of the relationship between taxes, public spending, and economic growth. What's more, due to the interaction between federal and state tax systems, reducing the personal income tax rate in Massachusetts would result in millions of dollars flowing *out* of the Commonwealth and into the U.S. Treasury, thus creating a dead-weight loss for the Massachusetts economy.

Writing in the New York *Times* earlier this year, Jeff Madrick heralded a new book written by the economic historian Peter Lindert, a professor at the University of California, Davis. Entitled *Growing Public,* it compares the levels of social spending throughout much of the twentieth century in 19 developed nations, including the United States, Canada, Japan, and much of Europe. It finds that high spending on social programs like education, health care, and income supports such as Social Security does not have a statistically significant impact on productivity growth or on gross domestic product per capita. In fact, Professor Lindert's research leads him to the following conclusion: "It is well known that higher taxes and transfers reduce productivity. Well known – but unsupported by statistics and history."[19]

Similarly, Johnathan Weisman pointed out in the Washington *Post* in March of this year that, "an examination of historical tax levels and unemployment rates reveals no obvious correlation" between changes in federal tax policy and employment levels in the United States.[20] In particular, he showed that three of the most prominent changes in federal tax levels over the past several decades – the Reagan tax cut of 1981, the Clinton tax increase of 1993, and the Bush tax cut of 2001 – each produced results contrary to the expectations of tax cut advocates. Following the Reagan tax cut of 1981, unemployment rose from 7.6 percent to 9.6 percent, while unemployment dropped, from 6.9 to 6.1 percent, in the wake of the Clinton tax increase. Again, in 2001, when George W. Bush was successful in winning passage of the tax cut that had been the centerpiece of his presidential campaign, unemployment rose, from 4.7 percent to 5.8 percent.

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[17] "Romney Warns Taxpayers of Consequences of Tax Hike," Commonwealth of Massachusetts, Executive Department, April 1, 2003.
[18] *FaxSheet – The economics of a 5% income tax: Getting the numbers right*, The Beacon Hill Institute, June 2004.
[19] Madrick, Jeff, "Does Big Government Hurt Economic Growth?", New York *Times*, April 15, 2004.
[20] Weisman, Jonathan, "Link Between Taxation, Unemployment Is Absent", Washington *Post*, March 15, 2004, p. A10.

Indeed, President Bush's second tax cut, enacted in May 2003, has also failed to stimulate employment, both nationally and locally. In February 2003, the Council of Economic Advisors (CEA) projected that that tax cut would create 5.5 million jobs nationwide by the end of 2004 – or 306,000 jobs per month, beginning in July 2003, when the tax cut took effect. Yet, according to the Economic Policy Institute, employment growth has fallen short of those target levels in ten of the first twelve months that the tax cut was in effect and by a total of more than 2.2 million jobs to date. For Massachusetts, the CEA's nationwide projection translates into an increase of 71,400 jobs by May 2004 or 117,000 jobs by year's end. Rather than growing, however, employment has declined in Massachusetts – since the tax cut was expected to begin boosting employment, Massachusetts has lost 15,800 jobs. In order to reach the target level of 117,000 jobs by year's end, employment will have to climb by 19,000 jobs per month.

Personal Income Tax Cuts Drain Millions Out of the Massachusetts Economy

Some may argue that a personal income tax cut would be good for the Massachusetts economy, but the reality is that it would *reduce* the resources available within Massachusetts for consumption and investment. That is, the Governor's proposed tax cut would reduce the amount of public sector consumption and investment by over $700 million per year once fully implemented, but would not increase the funds available within the private sector for spending or saving by the same amount. Rather, due to interactions between the federal and state tax codes, a sizable fraction of that $700 million – perhaps as much as $119 million and possibly even more – would flow out of Massachusetts and into federal coffers.

Individuals who itemize their federal income tax deductions are allowed to deduct the cost of their state and local income and property tax payments. As a result, these state and local taxes help to reduce the amount of federal income taxes they owe; the more they owe in state and local taxes, the lower their federal income tax liability. In the aggregate, this interaction – often referred to as the "federal offset" – functions as a federal subsidy to states and localities. This interaction works in reverse, too. As state and local taxes fall, the value of one's federal income tax deduction shrinks as well, thus leading to higher federal income tax payments.

In short, if the Massachusetts personal income tax rate were to fall to 5.0 percent, Massachusetts residents might pay less in state taxes, but they would pay more in federal taxes. Thus, a reduction in the personal income tax rate would lead to a direct loss for the Commonwealth as a whole. Annual public investments in areas such as education, health care, and physical infrastructure would ultimately be $700 million lower than they would otherwise be, but individual taxpayers' capacity for consumption or investment would not grow by the same amount. Indeed, if tax reductions of this magnitude were to force cuts in MassHealth spending – for which the Commonwealth receives roughly $1 from the federal government for every $2 spent – then they would have an even more deleterious effect on the Massachusetts economy, as they would reduce the flow of funds into the Commonwealth still further.

Further, in an op-ed in the Boston *Herald* in November of last year, Ed Moscovitch, the President of Cape Ann Economics, reviewed the recent record of tax cuts and employment trends here in the Commonwealth. He noted that the slew of state tax cuts enacted between 1991 and 2002 reduced state taxes from 6.4 percent of personal income to 5.0 percent, but that over roughly the same stretch – the first quarter of 1991 through the third quarter of 2003 – employment in Massachusetts grew just 11 percent, 43rd in the nation and significantly below the national mark of 16.2 percent. He further observed that job losses have been sharper in Massachusetts since the start of the 2001 recession that any other state in the country. In the end, he concluded: "Given the overwhelming evidence that tax cuts don't create jobs, we should no longer sacrifice our schools, our universities, our health care, our parks and our transportation network to a mean-spirited notion with no data to back it up."[21]

Finally, reducing the personal income tax at the present time would move the Commonwealth in a direction opposite that recommended by Joseph Stiglitz, the 2001 Nobel Laureate in Economics, and Peter Orszag in their April 2003 op-ed in the Boston *Globe.* They pointed out that:

> In a weak economy, it is particularly important to minimize reductions in overall spending. And reductions in government spending on goods and services, or reductions in transfer payments to lower-income families, would result in relatively large declines in total expenditures in the state. But tax increases on higher-income families tend to reduce saving, not spending, since such families save a large portion of their income.[22]

By that logic, then, the Governor's proposal could create a drag on the Commonwealth's economic recovery. It would likely force reductions in government spending, but would not lead to commensurate increases in private spending, since the benefits from his personal income tax cut would accrue disproportionately to upper-income taxpayers. That is, for the same reasons that Stiglitz and Orszag indicate that a tax increase would lead to a reduction in saving among such taxpayers, a tax reduction would prompt them to increase their personal savings, thus diminishing the total amount of the tax cut devoted to private spending.

Conclusion

Over the past several months, higher than anticipated tax revenue collections have seemed to point towards the end of the Commonwealth's fiscal crisis and the start of a sustained economic recovery. While such collections should be viewed positively, serious fiscal problems remain and new challenges await. Now more than ever, policymakers must continue to consider the longer-term consequences of the policy options put before them. As this paper has demonstrated, the consequences of the Governor's recent tax cut proposal are clear: it would likely exacerbate projected budget deficits, prevent the Commonwealth from restoring funding to vital public services, and predominately benefit the wealthiest taxpayers in Massachusetts.

[21] Moscovitch, Ed. "Lowering taxes doesn't ensure growth", Boston *Herald*, November 17, 2003.
[22] Orszag, Peter R. and Joseph E. Stiglitz, "Biting the budget bullet", Boston *Sunday Globe*, April 27, 2003, p. E5.

Appendix A. Revenue and Spending Projections, FY 2006 through FY 2008

Revenue

Tax Revenue

For the purposes of this paper, the MBPC assumes that tax revenue will total $16.666 billion in FY 2005. This figure is derived by taking the preliminary total for FY 2004, $15.942 billion, increasing it by 3.75 percent (that is, the rate of growth initially projected in January 2004), and then making two further adjustments: first, adding the $154.6 million that the FY 2005 budget anticipates will be generated by changes in tax policy and administration and second, subtracting $28.1 million to account for the first stage of the phasing out of the 2002 tax package, which will likely take effect on January 1, 2005.

This FY 2005 total is then used to project tax revenue totals for FY 2006, FY 2007, and FY 2008. Specifically, the MBPC assumes that, during these next three fiscal years, tax revenue will grow at the same real average annual rate at which Massachusetts personal income rose between 1982 and 2002 – or, in nominal terms, by 4.90 percent, 5.15 percent, and 5.26 percent respectively. Consequently, the MBPC further assumes that the 2002 tax package will continue to be phased out in each of these three fiscal years, yielding revenue losses of $84.3 million, $140.4 million, and $196.6 million respectively. Once these two effects are combined, the results are tax revenue totals of $17.398 billion in FY06, $18.154 billion in FY07, and $18.912 billion in FY08.

Finally, these totals are adjusted to account for transfers of sales tax revenue to the MBTA and for mandatory deposits into the Commonwealth Stabilization Fund (equal to 0.5 percent of the prior year's total tax revenue).

Other Sources of Revenue

The FY 2005 budget projects that the Commonwealth will receive $3.3 billion in revenue from departmental fees, budgetary transfers, and other sources. MBPC adjusts this figure to remove any non-recurring sources of revenue and then increases it for inflation and population growth. In addition, the FY05 budget expects that the Commonwealth will receive $5.038 billion in federal reimbursements for expenditures on programs such as MassHealth or Temporary Assistance to Families with Dependent Children. The MBPC assumes that a portion of these reimbursements will grow in line with MassHealth spending and that the remainder will simply keep pace with inflation and population growth.

Spending

MBPC's spending projections for FY 2006 through FY 2008 are estimates of the levels of spending necessary to provide the same level of public services – whether education, health care coverage, public safety, environmental protection, or any other governmental program – in each of those years as will be provided in FY 2005.

Generally speaking, such "maintenance" funding is determined by the rate of growth in the cost of providing a particular service as well as by the rate of growth in the number of people who use a given service or who receive a specific benefit. For the most part, then, to arrive at maintenance estimates for FY06 through FY08, appropriations for FY05 have been adjusted to account for inflation (i.e. the growth in the cost of providing services) and population growth (i.e. the rise in the number of people who use those services). Based on Congressional Budget Office estimates for the Consumer Price Index for all Urban Consumers (CPI-U) for calendar years 2005 through 2009, the MBPC projects that inflation will be 1.85 percent in FY06, 2.1 percent in FY07, and 2.2 percent in FY08. As for population growth, the Massachusetts Institute for Social and Economic Research at the University of Massachusetts (Amherst) projects that the total population of the Commonwealth will grow from 6.349 million in 2000 to 6.557 million in 2010, implying an average annual growth rate of 0.36 percent.

There are, of course, exceptions to this general rule. Maintenance funding in some areas, such as the Commonwealth's pension funding obligation, may be determined by statutory or contractual schedules; alternatively, the cost of providing services in some areas, as is the case with MassHealth, may grow more rapidly than the basic rate of inflation. The specific assumptions employed by the MBPC in these areas are as follows:

- Pensions: Section 81 of the FY 2005 budget stipulates the level of appropriations to the Commonwealth's Pension Liability Fund for FY 2006 and FY 2007 – $1.274 billion and $1.335 billion respectively. According to the Public Employee Retirement Administration Commission, the level of funding that would be consistent with this schedule in FY 2008 would be $1.399 billion.

- MassHealth and the Uncompensated Care Pool: Most analysts agree that health care costs have been rising much more quickly than the generally rate of inflation. Consequently, the MBPC assumes that spending for MassHealth and the Uncompensated Care Pool will rise by 8.9 percent per year, the rate at which the Office of the Actuary at the Centers for Medicare and Medicaid Services anticipates state and local Medicaid spending will climb over the next decade.[23]

- School Building Assistance: Legislation approved by the General Court on July 14, 2004 would alter the manner in which the building of schools in Massachusetts is financed. In particular, the bill would ultimately dedicate one-fifth of all sales tax revenue to providing school building assistance to cities and towns and specifies the minimum amounts of sales tax revenue that would be devoted to such purposes in each of the next several fiscal years. For FY 2006 through FY 2008, these amounts – which the MBPC uses in its projections – are $488.7 million, $557.4 million, and $634.7 million respectively.

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[23] Heffler, Stephen, Sheila Smith, Sean Keehan, M. Kent Clemens, Mark Zezza, and Christopher Truffer, *Health Spending Projections Through 2013*, Health Affairs, February 11, 2004, available at http://content.healthaffairs.org/cgi/reprint/hlthaff.w4.79v1.