

# **UNDERSTANDING OUR TAX SYSTEM: A PRIMER FOR ACTIVE CITIZENS**

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## AN INTRODUCTION TO THE MASSBUDGET TAX PRIMER

Taxes are the way that we combine our resources, through government, to accomplish things that we can't do as well, or perhaps at all, as individuals: educate our children, build and maintain transportation infrastructure, provide police and fire protection, keep our air and water clean, promote public health, and maintain a social safety net. In a democracy, people are ultimately responsible for deciding how much of their resources to commit to paying for these public goods, and how to share those costs. That's what tax debates are about.

This guide will provide tools for everyone who wants to understand and participate in those discussions. The primer explains the five principal criteria used to assess a tax system. It then provides an overview of the Commonwealth's current tax system, describing how much revenue is collected from the most important categories of state and local taxes. Placing the Massachusetts tax system in a broader context, the primer moves on to show how Massachusetts compares to other states and to the U.S. as a whole, and how the Commonwealth's system has changed over time. Finally, the primer provides a closer look at each of the six major kinds of taxes which together compose the Massachusetts tax system, trying to answer a number of basic questions: How does each of these taxes work and how much revenue does it raise? How has each of these taxes changed over time? How does each of these taxes affect different income groups?

A number of key observations emerge from the data provided in this primer. As readers will see, the Commonwealth's tax system has changed significantly over the last three decades. During that time -- and contrary to common belief -- Massachusetts has become a relatively low-tax state for residents and for businesses. At the same time, these comparatively low levels of overall taxation do not fall evenly upon all income groups; low-income residents pay more than twice as much of their income toward state and local taxes than high-income residents do. Readers of this primer will explore these ideas in much greater detail and many other ideas as well.

With the help of this guide, readers can achieve a solid understanding of how the Massachusetts tax system works and how it affects the people who live here. Armed with that knowledge, readers will be in a position to participate more fully and effectively in the ongoing discussions about state and local taxes.

## CHAPTER 1: FIVE CRITERIA FOR ASSESSING TAXES & TAX SYSTEMS

A tax system is composed of many distinct types of taxes. Common tax types include sales, income, property, and corporate profit taxes, to name a few. Using these and other kinds of taxes, states and local governments create an overall “tax system.”

There are an unlimited number of possible designs for a state and local tax system. Of course, the federal and state constitutions, federal law, social and political culture, history, and economics all act to constrain the practical choices. Still, the possibilities are large in number and variety. Given this great variety, how should the people of a state choose among the options? Public finance experts have identified a number of criteria on which to judge a tax system. Chief among these criteria are five core concepts: fairness, adequacy, simplicity, efficiency, and stability. These are not formulaic measures, but rather a set of concepts that together provide a framework for examining alternatives. In a democracy, people must apply their own values, experiences, and preferences to these criteria, which, in turn, serves to support and enrich policy debates around taxation. Agreeing that fairness is important does not resolve the question of what is fair. Recognizing that a system should raise an adequate amount of revenue does not answer the question of what is adequate. Nonetheless, these five concepts help create a structure that makes meaningful debate easier.

It is important to remember that the goal of these public debates is to design an overall tax system that meets the needs – and is in line with the values of – the people who operate within that system. No individual tax is perfect in all respects. That is one of the reasons to employ a variety of taxes; the weaknesses of one type of tax may be counterbalanced by the strengths of others. So, while the individual taxes that make up a tax system usually will fall short when measured against one or more of the five core criteria, the overall tax system may do a much better job of satisfying many or all of the criteria.<sup>1</sup>

### A NOTE ON DATA & MEASUREMENT

**DATA:** Throughout this report we have sought to provide analysis based on the most current data available. Official data on the topics covered in this guide, however, often can run several years behind the present due to the time it takes to collect, check, and disseminate these data. This is particularly true of nationwide Census Bureau data. Despite the two-year lag time, this Census data allows for accurate cross-state comparisons. Analyses that focus solely on Massachusetts and that do not depend on data from federal sources (such as the U.S. Census, U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics, and I.R.S.) typically are based on more current data.

**MEASUREMENT:** To best compare states and periods in history, this report generally expresses taxes as a share of personal income. This allows for meaningful comparisons among states with different-sized economies and between different time periods. In some contexts taxes are presented on a per capita basis, but this report generally does not do so. Such a methodology does not allow a reader to keep separate the issue of the level (or rate) of taxation from the effects of different income levels in different states or time periods.

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<sup>1</sup> For more detailed discussions of these criteria see: C. Eugene Steuerle, *Contemporary US Tax Policy*, (Washington, DC: Urban Institute Press, 2004); *The Encyclopedia of Taxation & Tax Policy* (Washington DC, Urban Institute Press, 2005).

**(Note continued)**

This issue of measurement is best understood by thinking about a specific example and considering just one tax: the income tax. If state A has an income tax rate of 5 percent and an average income of \$100,000 and state B has an income tax rate of 8 percent and an average income of \$50,000, which state has a higher rate of taxation? Obviously, the tax rate is higher in state B: for every dollar you earn in state B you pay 8 cents in taxes while you pay only 5 cents in state A. However, under a *per capita* measurement, taxes are higher in state A, because per capita tax in state A is \$5,000 ( $\$100,000 \times 0.05$ ) and per capita tax in state B is \$4,000 ( $\$50,000 \times 0.08$ ). Of course, the per capita tax payments in state A are higher due to their higher income levels, even though the tax rate is lower.

**FAIRNESS**

One important criterion for a tax is that it should be fair. It should not arbitrarily target groups, individuals, or activities. It also should distribute costs in a way that recognizes the varying abilities of people of different income levels to pay those costs. Fairness in taxation is usually looked at in two ways – by assessing horizontal equity and vertical equity.

*Horizontal Equity* addresses questions of whether or not a tax system makes arbitrary distinctions among taxpayers, or distinctions based on irrelevant criteria. These questions would seem to get at the very heart of the notion of fairness. For example, it violates the principle of horizontal equity if one person buys an item in a local store and must pay sales tax, while another person buys the same item over the Internet, and does not pay sales tax. Horizontal equity is widely accepted by people across the political spectrum as an important principle of tax fairness.

*Vertical Equity* addresses questions of how people at different income levels should be taxed, taking into account their relative abilities to pay. A “regressive tax” is one that requires lower-income people to pay a greater percentage of their incomes in taxes than do people with higher incomes. A “progressive tax,” on the other hand, is one in which higher-income people pay a larger percentage of their income in taxes than lower-income people. A “proportional tax” is one in which all income groups pay the same percentage of income in taxes.

While there is acceptance across the political spectrum of the virtue of horizontal equity, the meaning and importance of vertical equity is more controversial. Though there is general agreement that there should be some connection between ability to pay and level of taxation, there are different opinions on whether a fair tax asks everyone to pay the same percentage of their income in taxes or whether higher-income people, who have more disposable income, should be asked to pay a higher percentage of their income in taxes. A progressive tax, such as the federal income tax, recognizes that people with lower incomes must use far more of their income on basic needs such as housing, food, and clothing, and thus taxes them at lower rates. There are, however different opinions as to whether taking ability to pay into account in this manner is appropriate. Some believe that a fair tax is one that requires everyone to pay the same share of their income in taxes, regardless of means. This type of proportional tax, like a single rate income tax, is often called a “flat tax.”

In general, there is agreement that a fair tax is either flat or progressive. Most state tax systems, however, are neither.<sup>2</sup> Remarkably, most state tax systems are regressive – lower- and middle-income people pay a larger share of their income in taxes than do people with higher incomes. This is primarily because state and local governments often rely heavily on sales taxes and property taxes. The sales tax, as this report will examine in more detail later, ultimately taxes lower income people at higher rates than higher income people. This is because a sales tax places a tax on consumption rather than savings. Lower-income people generally need to consume all of their resources simply to get by, while higher-income people often save or invest a substantial portion of their income, and thus a large share of their income is not subject to a sales tax.

Property taxes likewise are regressive. Rather than being based directly on income (a good indicator of ability to pay), property taxes depend instead on the potential resale value of a given property and the costs of public services in a given community, neither of which may correspond to a taxpayer's income. In addition, the cost of many core public services varies relatively little between communities; filing a pothole or heating a town offices costs as much in an economically depressed community as it costs in a wealthy one. The result is that people in lower-income communities must pay more of their income (through the property tax) to fund a given level of public services than do people in a high-income community.

The *Benefit Principle* is another concept sometimes considered in the context of tax fairness. This is the idea that those who benefit from particular government services should pay for those services. In this view, taxes are seen as the price of government services. To some degree, this principle can confuse tax debates. At their core, most general taxes fund programs and services that society thinks should be provided for everyone. Our whole society is stronger when we have good schools, safe neighborhoods, clean air, and well maintained roads. Few would argue that the fire department should be financed only by those who experience a fire in a given year or the police only by those who are victims of crime.

The benefit principle may have limited utility when examining entire tax systems, but it is relevant in particular situations. For example, gas taxes that fund highway repair assign more of the cost to those people who use the most gas – which should be related to utilization of roads. Still, it is important to recognize that the benefit principle may conflict with the other principles of fairness and equity. Since lower-income people often spend a greater share of their income on transportation than higher income people, the benefit principle collides with the goal of vertical equity. The various principles for evaluating tax systems will often conflict, and thus are best thought of as tools to create a meaningful structure for democratic decision making rather than rules that provide formulaic answers to questions about how a tax system should be structured.

The benefit principle is particularly relevant when deciding how to allocate costs and benefits among generations of taxpayers. Particularly at the federal level -- where deficit spending is allowed -- the benefit principle is important to consider when making decisions about when it is appropriate to borrow in order to pay for current spending, and when to make sure that spending that benefits the current generation is paid for by the current generation. There are cases where borrowing to pay for current spending is consistent with the benefit principle. This occurs when the product of the spending will benefit people for many years: that is why states sell bonds to pay for roads, schools, and other

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<sup>2</sup> See The Institute on Taxation and Economic Policy (ITEP), "Who Pays? A Distributional Analysis of the Tax Systems in All 50 States," 3<sup>rd</sup> Edition, November 2009: <http://www.itepnet.org/whopays.htm>

infrastructure, all of which will benefit both present and future generations of taxpayers. In contrast, when taxes are reduced and current needs are met through borrowing, a society is shifting costs onto future generations while realizing the benefits of that borrowed money in the present, violating the benefit principle.

## SIMPLICITY

The tax system should be easy to comply with and to understand; in a word, the system should be simple. Satisfying this criterion would tend to limit the overall number of different taxes, special tax breaks and other complexities. Related to simplicity is the principle of transparency. *Transparency* requires that the goals and underlying policy choices of the tax system be presented openly, and that information about collections -- including which groups pay how much in taxes -- be publicly available.

While simplicity is usually suggested as a fundamental criterion in most tax reform efforts, it is often lost or significantly diluted in an attempt to fulfill the other criteria discussed in this report. Each potential improvement in a tax system -- to make it fairer, or to encourage or reward certain types of activities, or to promote stability -- can introduce new complexities. Other goals may outweigh simplicity in particular circumstances, but it is important always to consider the relative disadvantages of added complexity when considering specific changes to a tax code.

## EFFICIENCY

A tax system should raise the required resources for government, while creating as few incentives as possible for people to change their economic decisions simply to avoid taxation or take advantage of tax breaks. Such decisions typically reduce the overall efficiency and productive capacity of the economy. Generally, a tax system that is as simple and as horizontally equitable as possible will be most efficient. Such a system keeps compliance simple and less costly and, to the extent possible, by taxing all economic activity as similarly as possible, it allows economic efficiency to guide people's decisions. For example, providing tax breaks to some industries but not to others can alter investment decisions and may reduce economic efficiency. Each special tax break, exemption, or loophole for certain types of businesses or activities risks reducing the efficiency of the overall system.

With that said, it also is true that the importance of other criteria at times may outweigh the wish to maximize efficiency. Exempting food and clothing from the sales tax, for example, certainly changes consumers' spending choices. These sales tax exemptions also, however, make essential items more affordable to low-income residents and make the overall tax system more equitable. In this case, a desire for greater vertical equity has outweighed concerns about maximizing efficiency.

## ADEQUACY

The tax system must provide sufficient and sustainable revenue to pay for the things that people want to achieve through government. One way that this could be done is to determine each year how much revenue is needed, and then adopt a set of taxes and other funding mechanisms to provide that level of revenue. Such an approach is not used in modern government because it would be too unpredictable and would tend to cause disturbances in the economy and community. In addition, politically and

economically it would be difficult to adopt a completely new tax system for each fiscal year budget. Furthermore, such effort is unnecessary, since a tax system that works in one budget year is likely to work in the next. Instead, governments adopt ongoing taxes and tax systems, making adjustments as needed or desired.

A well-designed tax system not only must provide for current levels of public expenditure, however, it also must provide for the needs of the community over time. A feature of good tax systems, therefore, is that they are able to keep pace with growth in the overall economy, allocating an appropriate share of economic growth to public goods. It is not a simple thing, however, either to create or maintain such a system.

On the positive side, the economy tends to grow over time, typically outpacing inflation, and thereby provides a larger real base from which to draw the tax revenues required to support shared goals. A tax system that can continue to allocate a constant share of the overall economy to public goods therefore may be enough to finance public costs, even when those costs may grow faster than inflation. A problem, however, is that tax systems often fail to keep up with the economy. Sales tax growth in Massachusetts, for example, has lagged economic growth. Explanations for this lag include increasing Internet commerce, and a greater share of our economy taking place in the service sector, where the sales tax generally does not apply. Finally, the adequacy of a tax system -- even a system that is keeping pace with overall economic growth -- may be at risk due to other factors, such as changes in the composition of the state or local population. Older and younger people, for example, typically require more public services than do most working-age adults. Shifts in age distributions, therefore, are one reason that otherwise stable tax systems still may require periodic changes.

## STABILITY

Long-term trends and short-term fluctuations in the economy both have important impacts on the stability of a tax system. As the economy cycles through growth and recession, the government is still required to provide public goods and services. The tax system should be stable enough to provide resources through unstable economic times. For this reason, the tax system needs to include revenue sources that are less subject to economic cycles, and also should be designed in conjunction with other policies -- such as mechanisms for accumulating reserves in good times -- to provide protection in bad times.

In examining particular taxes, one option to be considered for any tax that meets other criteria but is very unstable is to use that tax to finance one-time expenditures or to build reserves. When a tax is used in this manner its instability is less of a concern, as the money saved in good times can be used when needed and new one-time spending can simply be suspended.

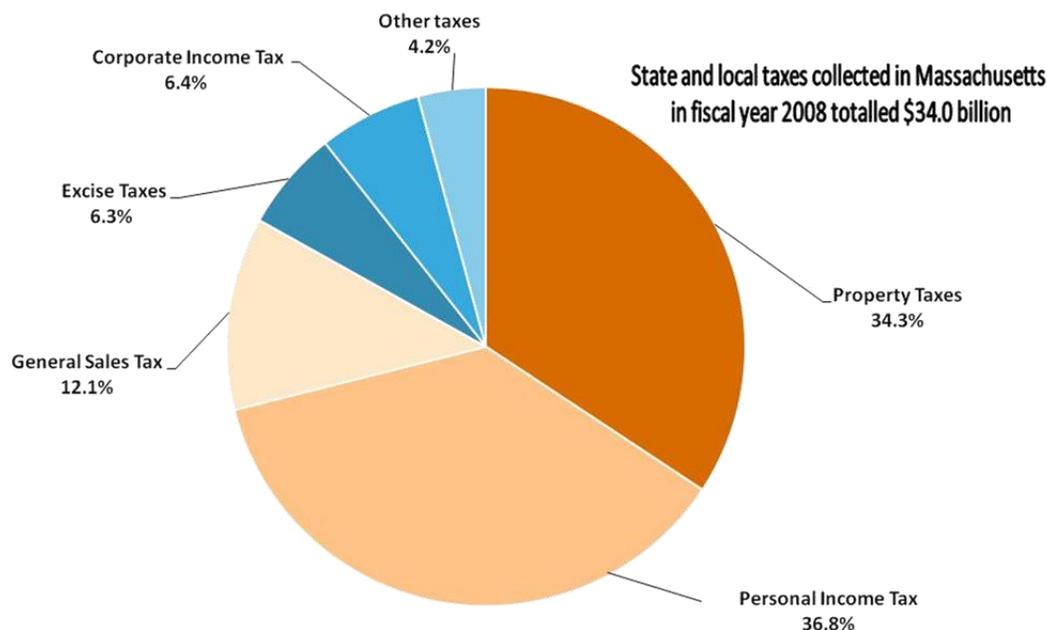
## CHAPTER 2: THE MASSACHUSETTS TAX SYSTEM

Massachusetts’ revenue system is made up of a variety of state and local taxes: the property tax which cities and towns collect to pay for municipal services; the state personal income tax; the general sales tax; excise taxes on specific goods such as gasoline or tobacco; and the corporate income tax.<sup>3</sup> While we will look at each of these tax categories in greater detail later, in this chapter we will look at the overall tax system in Massachusetts. This includes: the percentage of revenue raised by each tax and how that compares with the U.S. and with other states; historical changes in the composition of taxes in Massachusetts and the percentage of total state wealth paid in taxes; and an analysis of the share that households, at different income levels, pay in state taxes.

### HOW MUCH OF THE TOTAL TAXES COLLECTED IN MASSACHUSETTS COMES FROM EACH TAX?

Figure 1 illustrates the composition of tax revenue in the Commonwealth. The largest source of tax revenue in FY 2008 (the most recent year for which comprehensive state and local financial data is available from the U.S Census Bureau) was the personal income tax, producing over a third (36.8 percent) of total tax revenues.<sup>4</sup> The second-largest source was the property taxes levied by cities and towns, which generated 34.3 percent of total tax revenue in that year. The general sales tax yielded 12.1 percent of the total in Fiscal Year 2008, and corporate income tax accounted for another 6.4 percent of the total. Special sales -- or excise -- taxes provided 6.3 percent, and other minor taxes (such as license taxes) were responsible for a significantly smaller share, yielding 4.2 percent of total tax revenues.

**Figure 1. Massachusetts State & Local Taxes FY 2008 (Percent of Total Taxes)**



<sup>3</sup> The state also raises revenue through other means such as fees and fines. In addition, Massachusetts receives federal funding for particular programs such as Title I education funds for low-income children or federal reimbursements for Medicaid spending. This report does not look at these sources of revenue but instead focuses on the various taxes levied by the state and its cities and towns to raise revenue.

<sup>4</sup> U.S. Census Bureau, *State and Local Government Finances by Level of Government and by State: 2007-08*. The 2007-08 Census data is the most recent available: <http://www.census.gov/govs/estimate/>

In FY 2008, Massachusetts’ state and local general revenue from all sources totaled \$58.9 billion.<sup>5</sup> The majority of those funds -- \$47.7 billion or 80.9 percent -- came from sources within the Commonwealth (the federal government provided the remaining 19.1 percent -- or \$11.2 billion -- through grants, matching funds, and other means). The \$47.7 billion generated within the state is commonly referred to as “own-source” revenue, as it comes directly from the residents of the Commonwealth. This is also the funding stream over which state and local officials exert the most control.

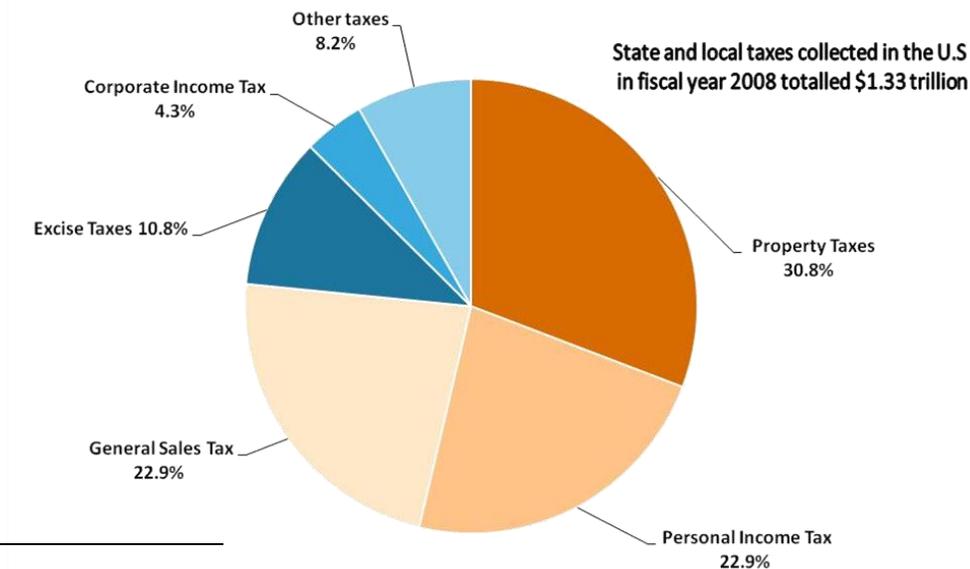
Under the Census Bureau’s classification system, own-source revenue can likewise be separated into two categories: revenue generated by taxes and revenue generated by fees, charges, and sources such as tuition for public higher education and highway tolls. In FY 2008, state and local tax revenue in Massachusetts amounted to \$34.0 billion or 71.3 percent of total own-source revenue, while fees, charges, and miscellaneous revenue equaled \$13.7 billion, thus providing the remaining 28.7 percent.<sup>6</sup> Again, these data are from 2008 and do not reflect the recent sales tax rate increase (from 5 percent to 6.25 percent) enacted in the FY 2010 budget. Had this rate been in effect in FY 2008, sales tax collections would have constituted about 14 percent of total tax state and local revenue.<sup>7</sup>

This report will focus on tax revenue when comparing Massachusetts to other states, since the other forms of own-source revenue are influenced in large part by state specific factors that are beyond the scope of this primer.

## HOW MUCH OF THE TOTAL TAXES COLLECTED IN THE U.S. COMES FROM EACH TAX?

The composition of Massachusetts' tax revenue is different than the national picture of state and local tax revenues, as Figure 2 reveals.

**Figure 2. Overall U.S. State & Local Taxes FY 2008 (Percent of Total Taxes)**



<sup>5</sup> Ibid.

<sup>6</sup> Ibid.

<sup>7</sup> *MassBudget* estimate based on U.S. Census data. With a 20 percent rate increase (from 5 percent to 6.25 percent), sales tax collections would have risen by \$820 million in FY 2008 to \$4.92 billion, and total tax revenues therefore would have been \$34.82 billion. As with all *MassBudget* estimates in this report, these estimates do not take into consideration complex behavioral responses to tax changes or possible interactions with other taxes.

Looking again at FY 2008 U.S. Census Bureau data, general sales and excise taxes produced a larger share of total tax revenue nationally (a combined 33.7 percent) than they did here in Massachusetts (18.4 percent).<sup>8</sup> States, on the whole, relied less on property and personal income taxes than Massachusetts did. These differences enhance the progressivity of the Massachusetts state tax system relative to other states, since sales and excise taxes tend to be particularly regressive (as will be discussed later in this primer). However, Massachusetts has a flat rate personal income tax, which means our income tax is less progressive than many other states.<sup>9</sup> As a result, Massachusetts has a more regressive overall tax system than states that have both low dependence on the sales tax and a personal income tax with a progressive rate structure.<sup>10</sup>

## HOW DO STATE & LOCAL TAX REVENUE IN MASSACHUSETTS COMPARE TO OTHER STATES?

Overall, Massachusetts is a relatively low tax state. Massachusetts ranks well below the US average in terms of total state and local tax revenue as a share of personal income. In FY 2009 (the most current year for which comparable data for all states is available from the US Census Bureau), total state and local tax revenue equaled 9.8 percent of personal income in Massachusetts, placing the Commonwealth 33<sup>rd</sup> out of the 50 states (see Figure 3).<sup>11</sup> By contrast, state and local taxes equaled 10.4 percent of personal income nationally. Such differences may appear quite small, but, had Massachusetts been at the national mark, the Commonwealth and its cities and towns would have collected an additional \$2.1 billion in taxes in FY 2009.<sup>12</sup>

Since 2009, Massachusetts has increased several types of state taxes. At the same time, however, with ongoing revenue shortfalls, 29 other states have enacted tax increases of their own since the start of the recession.<sup>13</sup> Therefore, while nationwide data more current than 2009 are not available, it is likely that Massachusetts' ranking still remains well below the U.S. average, even given Massachusetts' recent tax increases.<sup>14</sup>

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<sup>8</sup>U.S. Census Bureau, *State and Local Government Finances by Level of Government and by State: 2007-08*. The 2007-08 Census data is the most recent available:

<http://www.census.gov/govs/estimate/>

<sup>9</sup> For an explanation of "regressive" and "progressive" taxes, please see the discussion of vertical equity in Chapter One of this primer. Many states have a more progressive income tax and overall tax system than does Massachusetts. For comparative income tax analysis among states, please see: The Institute on Taxation and Economic Policy, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*, 3<sup>rd</sup> Edition, November 2009: <http://www.itepnet.org/whopays.htm>

<sup>10</sup> Ibid..

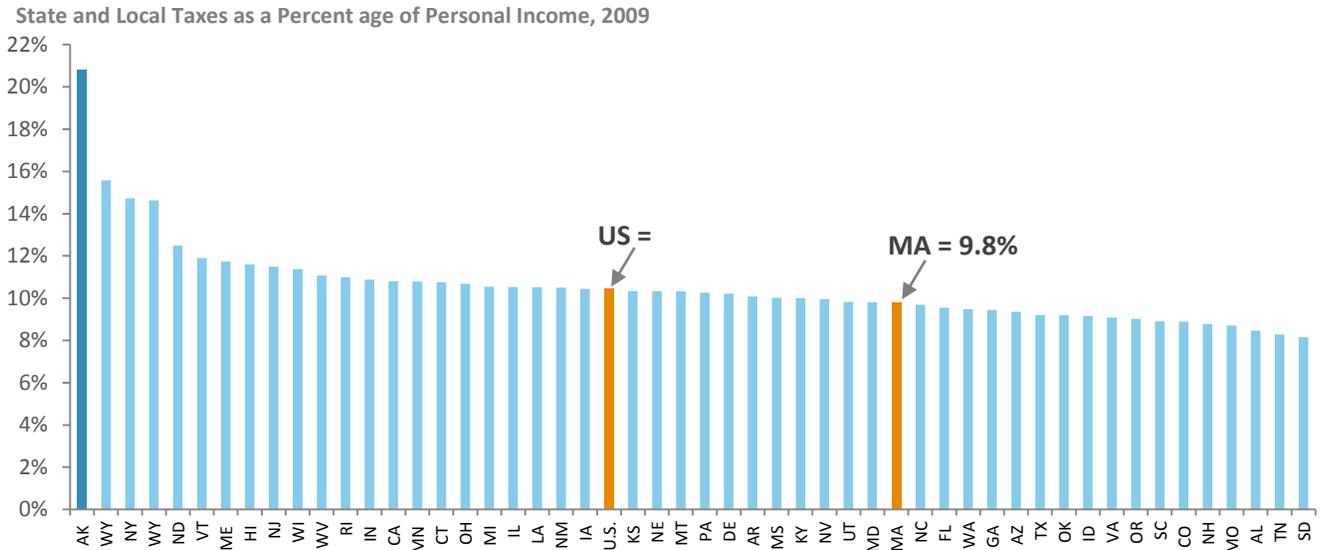
<sup>11</sup> State and local tax revenue data is drawn from the U.S. Census Bureau, *State and Local Government Finances by Level of Government and by State*, an annual survey. State personal income data is drawn from US Bureau of Economic Analysis data. The District of Columbia is included in the U.S. average, but is not shown in Figure 3. For purposes of state ranking, DC is not included.

<sup>12</sup> In fiscal year 2009, BEA state personal income in MA was \$330.0 billion. If MA taxes as a share of personal income (9.78 percent) had been at the national average of 10.44 percent (0.66 percentage points higher than MA), MA would have taken in an additional \$2.18 billion (0.66 percent x \$330.0 billion = \$2.18 billion).

<sup>13</sup> See Center on Budget and Policy Priorities, "Update on State Budget Cuts," May 25, 2010, pg 4: <http://www.cbpp.org/files/3-13-08sfp.pdf>

<sup>14</sup> In addition, the total value of the tax increases enacted in 2009 is significantly less than the amount by which Massachusetts lagged the national average in 2008, in terms of taxes as a percent of personal income.

**Figure 3. In 2009, Massachusetts Ranked Well Below the US Average for Taxes as a Share of Personal Income**

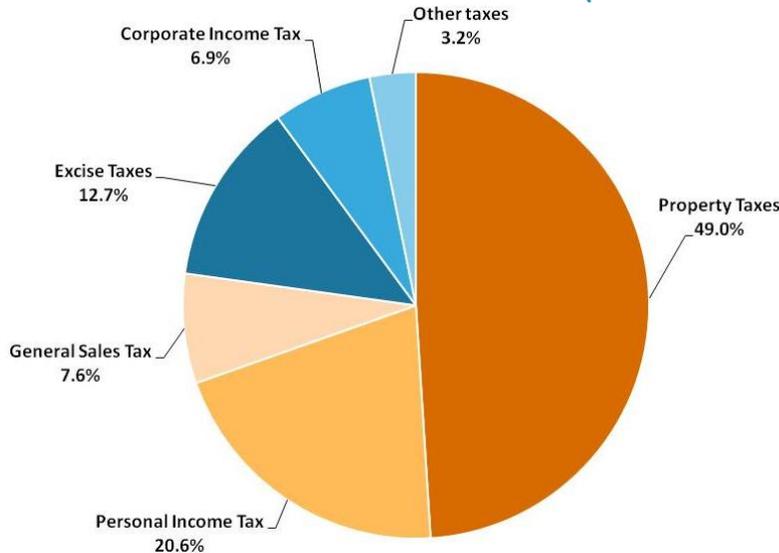


Source: US Census Bureau (tax data), US Bureau of Economic Analysis (personal income data)  
 \* Alaska’s high tax-to-income ratio (of 20.8%) is in large part the result of “severance taxes” charged to oil companies for the extraction of this natural resource.

**HISTORY OF CHANGES IN THE STRUCTURE AND LEVEL OF TAXATION IN MASSACHUSETTS**

Comparing the composition of total tax revenue in Massachusetts in FY 2008 to that of FY 1977 shows just how much the state tax composition changed over those three decades (compare Figures 1 and 4).<sup>15</sup>

**Figure 4. Massachusetts State & Local Taxes FY 1977 (Percent of Total Taxes)**



<sup>15</sup> FY 1977 is the first year for which detailed state and local finance data is available from the United States Bureau of the Census.

First and foremost, in the late 1970s -- before the property tax-cutting initiative known as Proposition 2 ½ was adopted -- Massachusetts was far more dependent on property taxes than it is today. In FY 1977, property taxes composed almost half (49.0 percent) of total tax revenue, compared to roughly one third (34.3 percent) in FY 2008.<sup>16</sup> In addition, the personal income tax was not nearly as important to the state’s fiscal condition in FY 1977 as it is today. It amounted to 20.6 percent of total tax revenue in FY 1977 compared to 36.8 percent in FY 2008.

Figure 5 displays state and local tax data, measured as a share of personal income, for both Massachusetts and the United States as a whole for the period FY 1977 to FY 2008.<sup>17</sup>

**Figure 5. State & Local Tax Revenue as a Percent of Personal Income Has Fallen Steadily in Massachusetts While Growing for the U.S. as a Whole (FY 1977- FY 2008)**

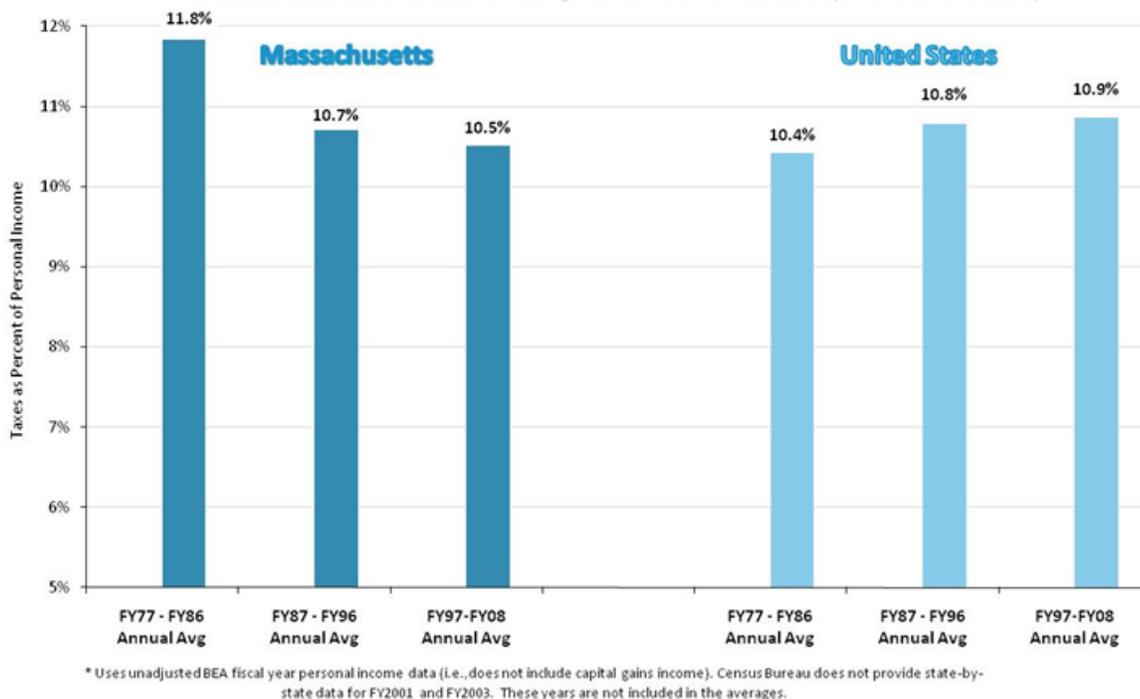


Figure 5 demonstrates that taxes are currently lower in Massachusetts, relative to the size of the Commonwealth’s economy, than the national average. It also shows that taxes in Massachusetts are lower in the most recent period for which there is data (FY 1997 to FY 2008) than they were near the end of the 1970s and for most of the 1980s and 1990s.

This reduction in taxes is even clearer when we consider that the personal income measure used in Figure 5 -- the standard measure provided by the U.S. Bureau of Economic Analysis (BEA) -- does not include income generated from capital gains.<sup>18</sup> Most capital gains are, however, subject to taxation, and

<sup>16</sup> U.S. Census Bureau, *State and Local Government Finances by Level of Government and by State: 1977*. Data for years prior to 1992 are available from the Census Bureau upon request. These Census data are not available for years prior to 1977. [http://www.census.gov/govs/estimate/historical\\_data.html](http://www.census.gov/govs/estimate/historical_data.html)

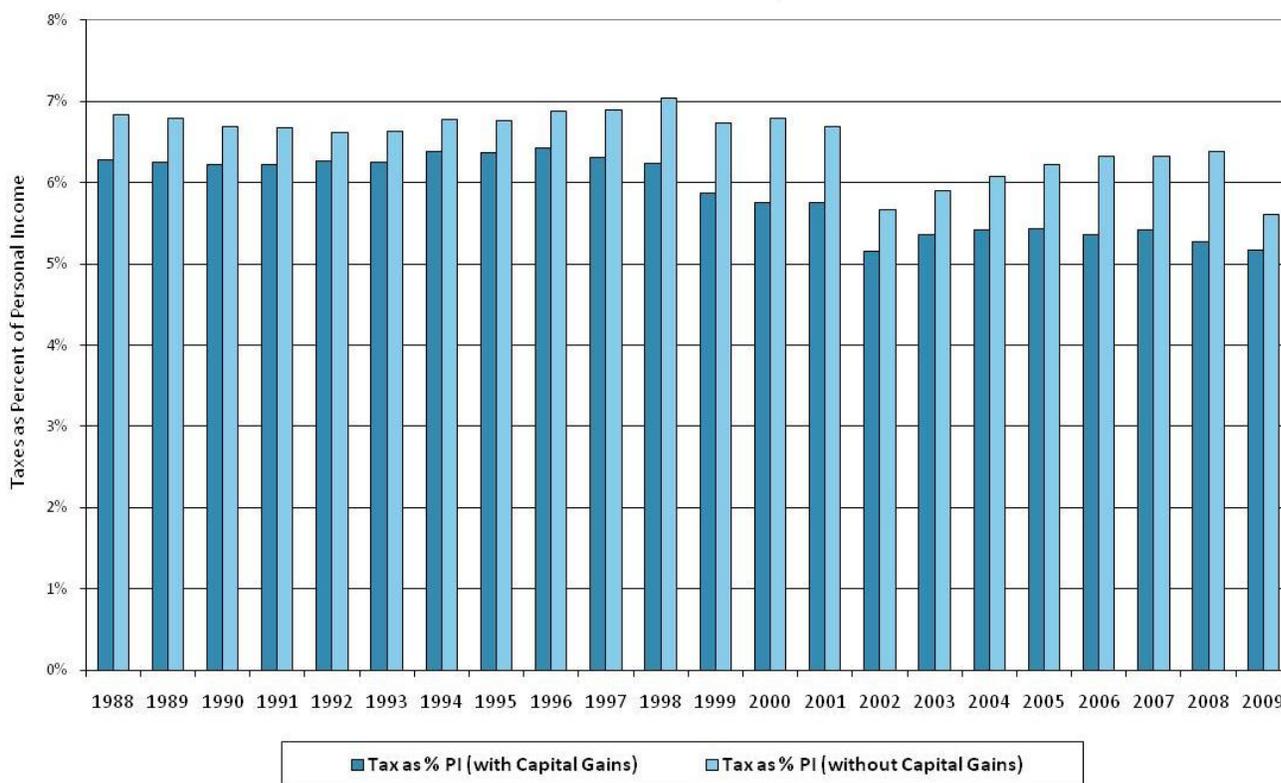
<sup>17</sup> This particular measure -- “taxes as a share of personal income” -- allows us to see how affordable a given level of taxation is for a state’s residents. It also permits us to make meaningful comparisons between states, and to compare changes in a single state over time.

<sup>18</sup> For the purposes of the primer, personal income that excludes capital gains will be referred to as “BEA income,” while personal income that includes capital gains income will be referred to as “total personal income.”

these taxes are included in the annual tax collection totals compiled by the U.S. Census. Excluding capital gains income from the calculation of total income, while including the taxes collected on this capital gains income tends to exaggerate the amount of taxes collected as a percent of personal income.

Reliable and comparable state-by-state measures of capital gains are not available, but -- using data from the Massachusetts Department of Revenue -- we have been able to estimate the effect of including capital gains income in the measure of personal income for Massachusetts in the period from FY 1988 to FY 2009.<sup>19</sup> Figure 6 shows that the increasing magnitude of capital gains income from the 1990s to 2009 has meant that taxes actually have declined even more as a percentage of total personal income (i.e., income that includes capital gains income), than as a percentage of BEA personal income.

**Figure 6. Percent of Personal Income (With & Without Capital Gains) Paid in State Taxes in Massachusetts, Fiscal Years 1988-2009**



Focusing exclusively on the decline in the percentage of total personal income *including capital gains income* collected in taxes during the period from 1988 to 2009 (see the lower set of bars in Figure 6, above), we see that the peak was reached in the period from 1994-1996, when state taxes were equal to 6.4 percent of total personal income.<sup>20</sup> By 2009, taxes had declined to 5.2 percent of total personal

<sup>19</sup> Capital gains estimates combine non-taxable capital gains data from annual Tax Expenditure Budgets published by the Massachusetts Department of Revenue, and add an estimate for taxable capital gains income, also from the Massachusetts Department of Revenue. Not all capital gains income is separable from other kinds of income in the Tax Expenditure Budgets, so it is likely that the estimates of capital gains income used here is somewhat low.

For a discussion of adjusting personal income to better reflect growth in the economy, see the paper from the New England Public Policy Center of the Federal Reserve Bank of Boston, "Assessing Alternative Measures of State Income," (memorandum), July 30, 2008, available at: <http://www.bos.frb.org/economic/neppc/memos/2008/weinerpopov073008.pdf>. For the analysis in this primer, we follow the methodology recommended by the Federal Reserve Bank, which includes adding in the income earned (and taxed) in MA by non-residents.

<sup>20</sup> Data come from the US Census and the Massachusetts Department of Revenue. They are the most current, complete data available.

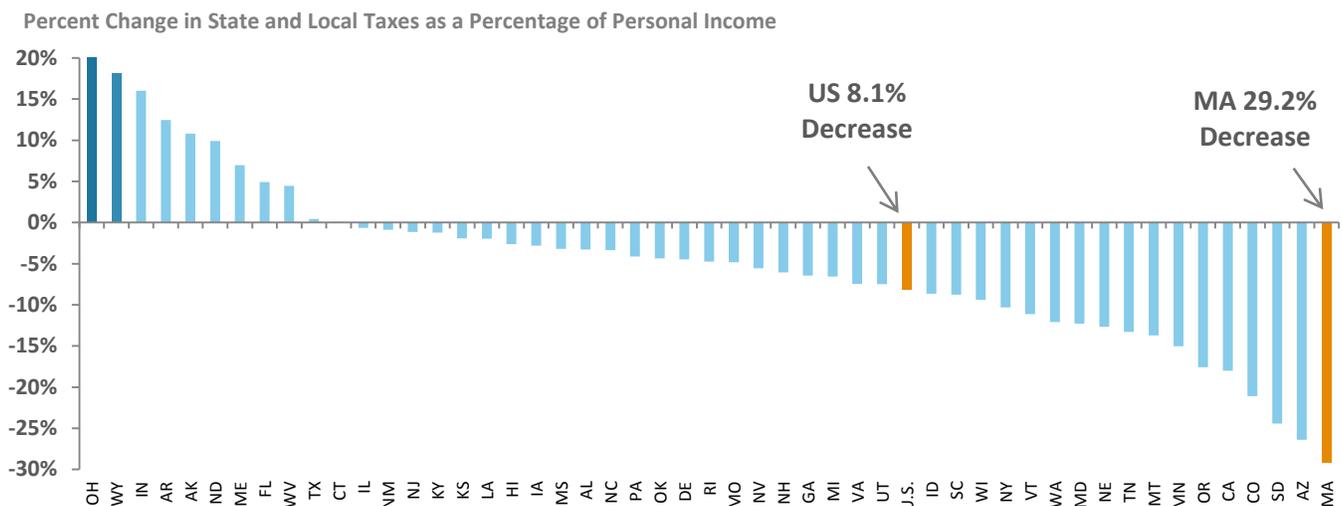
income. Had this decline (from 6.4 percent to 5.2 percent of total personal income) not occurred, the state would have collected approximately \$4.3 billion dollars in additional revenue in 2009. The decline in the percentage of personal income devoted to taxes can be explained by three primary factors:

1. Tax changes -- most notably a reduction in the personal income tax rate;
2. Weak growth in sales tax revenue, partly due to the increase in purchases made online;<sup>21</sup> and,
3. Growth in “tax expenditures” (i.e., tax breaks) that leave some kinds of income untaxed.

Returning to comparison of the Commonwealth with other states, from 1977-2009, Massachusetts reduced tax collections relative to its available economic resources (BEA state personal income -- without an adjustment for capital gains income) by 29.2 percent, more than any other state (see Figure 7).<sup>22</sup> While Massachusetts had higher levels of taxes than most other states at the start of this period -- thereby earning the title of “Taxachusetts” -- by the end of the period, Massachusetts was collecting a smaller percentage of state personal income in state and local taxes than thirty-two other states (Figure 3). In Massachusetts, state and local taxes dropped from 13.8 percent of personal income to 9.8 percent (a 29.2 percent decline) between 1977 and 2009.<sup>23</sup>

For the nation as a whole, state and local taxes as a share of personal income fell only 8.1 percent between 1977 and 2009. Taxes as a share of personal income actually increased in 11 states over this period, but there were substantial decreases in California and New York which pulled the national average more deeply into negative territory (between them, CA and NY represent a large share of the overall national economy, and thus have a large impact on national averages).

**Figure 7. Massachusetts Reduced Taxes More than Other States, FY 1977- FY 2009**



\* The change in Ohio’s taxes as a share of personal income (at 20.2%) slightly exceeds the scale of this graph.

<sup>21</sup> Massachusetts Department of Revenue, Briefing Book: FY09 Consensus Revenue Estimate Hearing. Available online at:

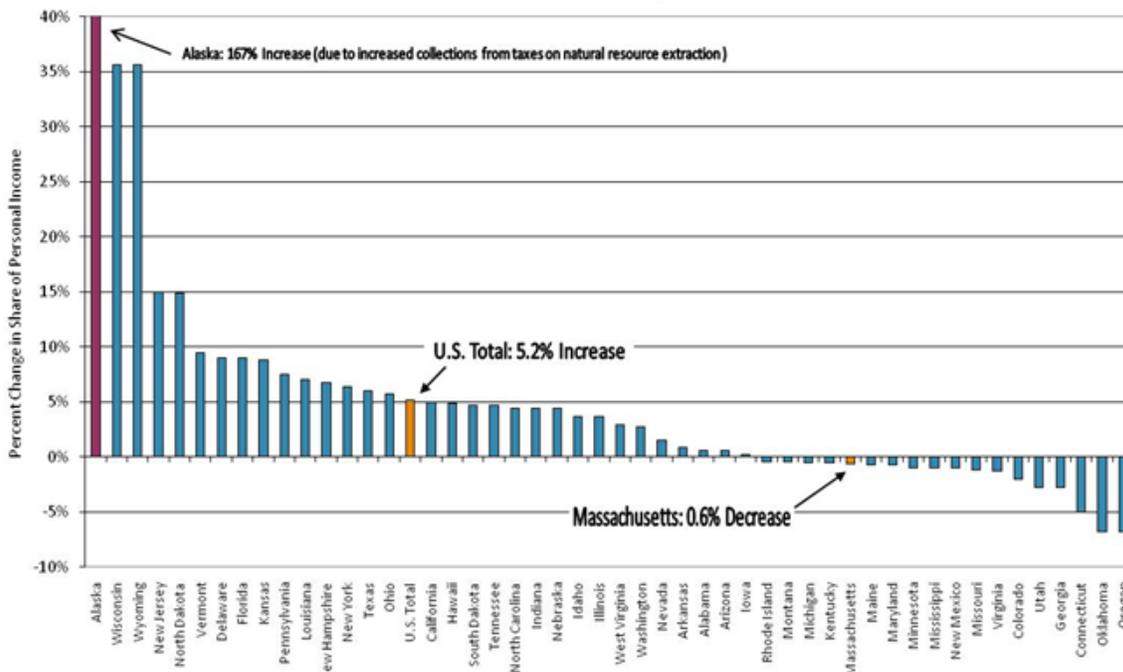
<http://www.mass.gov/Ador/docs/dor/Stats/Briefing%20Book/09briefingbook.pdf>

<sup>22</sup> These data use U.S. Bureau of Economic Analysis data for state personal income and do not include adjustments for capital gains income. *MassBudget* estimates for “total personal income,” which includes capital gains income (see Figures 6 and 9) rely on data supplied by the MA DOR, and are available only for Massachusetts.

<sup>23</sup> FY 1977 = 13.811 percent, FY 2009 = 9.778 percent

Over the medium-term (between FY 2000 and FY 2008), state and local taxes as a percentage of personal income decreased slightly in Massachusetts, a decline of 0.6 percent (see Figure 8). By contrast, for the nation as a whole, the percent of personal income paid in state and local taxes increased, for a percent change of positive 5.2 percent over this same time span.

**Figure 8. Medium-Term Change in State & Local Tax Revenue as a Share of BEA Personal Income, FY 2000 - FY 2008**



When we look again at state tax collection data for Massachusetts alone, between 1998 and 2008, we see that revenues (as a percent of total personal income, including capital gains income) in all of the major tax categories fell significantly during that period (see Figure 9, below).<sup>24</sup> The revenue declines seen between 1998 and 2008 were in large part the result of specific policy choices that have cut tax rates, in particular on both individual income and corporate income. The result is that Massachusetts collected only 5.3 percent of total personal income in taxes in FY 2008 compared to 6.2 percent in FY 1998, a 16 percent drop.<sup>25</sup>

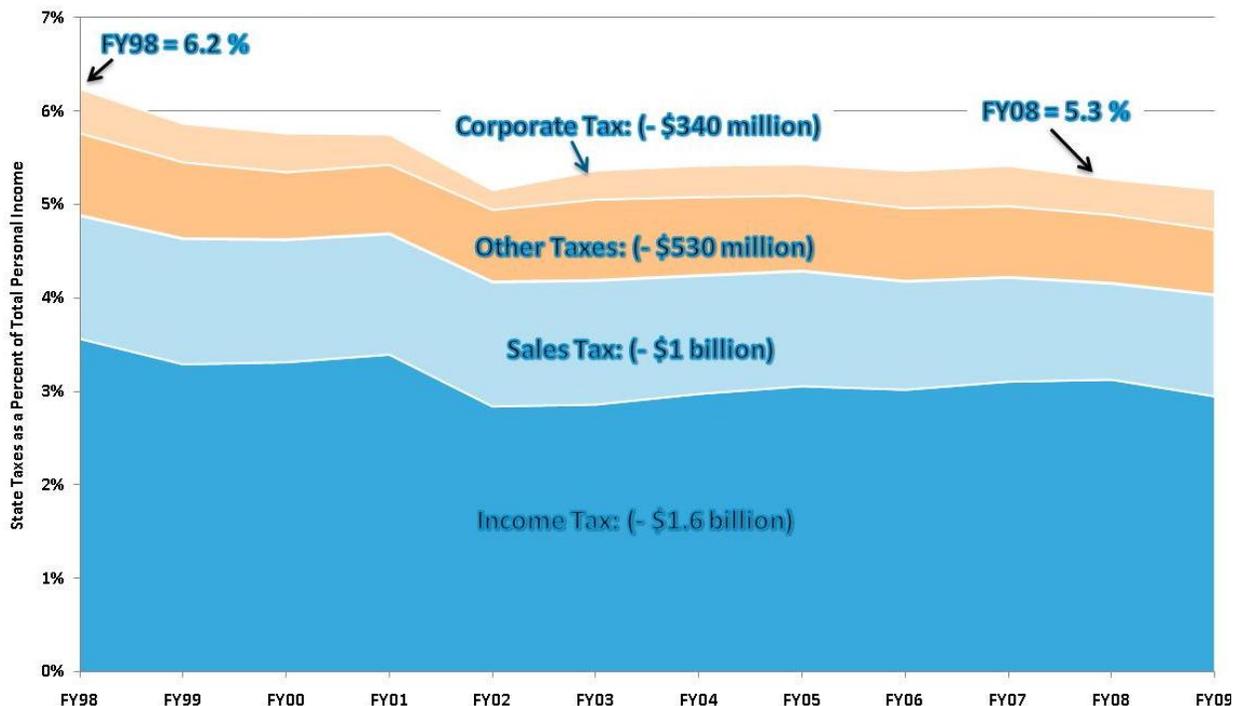
Important differences between the years include substantial tax rate reductions on ordinary income and on interest and dividend income, and an increase in the personal exemption amount, all of which reduced revenues (see Chapter 4 for a more detailed discussion). Likewise, a number of changes to the laws governing corporate taxes were phased in over this period, thereby reducing corporate tax collections (see Chapter 7 for a more detailed discussion). At the same time, sales tax collections saw a steady decline as consumers shifted away from goods (generally subject to the sales tax) and toward services (generally not subject to the sales tax), as well as a shift toward online purchases, while current law does not require some online merchants to collect sales taxes on these Internet transactions (see Chapter 5 for a more detailed discussion).

<sup>24</sup> Each of these years (FY 1998 and FY 2008) is six years into an economic recovery, providing a reasonable, apples-to-apples comparison of two years similarly situated in terms of their place in the business cycle.

<sup>25</sup> Ibid.

More recently, a number of changes to the tax laws have taken place that will increase revenue collections in the years ahead. In 2008, tobacco taxes were increased (see Chapter 6 for a more detailed discussion). In 2009, the General Sales Tax rate was increased (from 5 percent to 6.25 percent) and reforms went into effect that make corporate tax avoidance more difficult (though these reforms were combined with corporate income tax rate reductions). While these actions together will increase revenue collections, they will offset only a portion of the revenue losses resulting from tax cuts made during the previous two decades.

**Figure 9. State Tax Revenues Have Declined Significantly as a Percent of Total Personal Income (Including Capital Gains)**



### THE BIG PICTURE: WHO PAYS HOW MUCH TAX?

The preceding discussions help us understand both the level of taxation in Massachusetts over time, and in comparison to other states and to the nation as a whole. These discussions also help us compare the level of taxation in Massachusetts to levels in other states and to the nation as a whole. All of these discussions, however, have treated Massachusetts taxpayers as a single group. Missing from the preceding analyses is information that will help us to understand how people with differing incomes are affected differently by the Massachusetts tax system. In the discussion below, we now examine how taxes are distributed among those with low, middle, and high income.

In Massachusetts, as in most states, high-income households pay a smaller share of their income in taxes than do lower- and middle-income households (see Table 1, below).<sup>26</sup> This is primarily because

<sup>26</sup> All tax distribution data in this report are provided by the Institute for Taxation and Economic Policy (ITEP). MASSACHUSETTS BUDGET AND POLICY CENTER • [WWW.MASSBUDGET.ORG](http://WWW.MASSBUDGET.ORG)

high-income households pay a much smaller share of their income in sales taxes and property taxes than do lower income people, as can be seen in Table 1.<sup>27</sup>

The 20 percent of the population with the lowest income pays 10.5 percent of their income toward state and local taxes, mostly through sales, excise, and property taxes.<sup>28</sup> The top 1 percent of the state's earners, by contrast, pays 6.1 percent of their income toward state and local taxes (resulting in a net cost to these top filers of only 5.0 percent of their income after factoring in reductions in their federal tax bills based on the amount of state taxes paid). This kind of tax structure -- where low-income earners pay more of their income in taxes than do high-income earners -- is termed "regressive."

**Table 1. Taxes in Massachusetts by Income Group**

<b>State &amp; Local Taxes in 2009</b>							
<b>Shares of family income for ALL AGES</b>							
2009 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than \$19,200	\$19,200 - \$38,200	\$38,200 - \$61,600	\$61,600 - \$102,400	\$102,400 - \$211,500	\$211,500 - \$556,300	\$556,300 Or More
Average Income in Group	\$11,300	\$28,500	\$49,600	\$79,000	\$138,700	\$311,400	\$1,695,400
<b>Sales &amp; Excise Taxes</b>	<b>5.0%</b>	<b>3.8%</b>	<b>2.8%</b>	<b>2.3%</b>	<b>1.7%</b>	<b>1.1%</b>	<b>0.5%</b>
General Sales—Individuals	2.0%	1.7%	1.4%	1.2%	0.9%	0.6%	0.3%
Other Sales & Excise—Ind.	1.4%	0.9%	0.6%	0.4%	0.3%	0.1%	0.0%
Sales & Excise on Business	1.6%	1.2%	0.9%	0.7%	0.5%	0.3%	0.2%
<b>Property Taxes</b>	<b>4.8%</b>	<b>3.7%</b>	<b>3.6%</b>	<b>3.6%</b>	<b>3.4%</b>	<b>2.5%</b>	<b>1.1%</b>
Property Taxes on Families	4.8%	3.7%	3.5%	3.5%	3.2%	2.3%	0.6%
Other Property Taxes	0.1%	0.0%	0.0%	0.1%	0.1%	0.3%	0.5%
<b>Income Taxes</b>	<b>0.7%</b>	<b>2.7%</b>	<b>3.7%</b>	<b>4.1%</b>	<b>4.2%</b>	<b>4.5%</b>	<b>4.6%</b>
Personal Income Tax	0.6%	2.6%	3.7%	4.0%	4.2%	4.4%	4.3%
Corporate Income Tax	0.0%	0.0%	0.0%	0.1%	0.1%	0.1%	0.3%
<b>TOTAL TAXES</b>	<b>10.5%</b>	<b>10.2%</b>	<b>10.1%</b>	<b>9.9%</b>	<b>9.3%</b>	<b>8.1%</b>	<b>6.1%</b>
Federal Deduction Offset	-0.0%	-0.2%	-0.5%	-1.1%	-1.6%	-0.9%	-1.2%
<b>TOTAL AFTER OFFSET</b>	<b>10.5%</b>	<b>10.0%</b>	<b>9.6%</b>	<b>8.8%</b>	<b>7.8%</b>	<b>7.2%</b>	<b>5.0%</b>

Notes: Table shows 2009 tax law updated to reflect permanent changes in law enacted through October 2009.

Due to rounding, column totals may not add exactly

Source: Analysis performed for *MassBudget* by the Institute on Taxation & Economic Policy, March 2010.

Regressivity is most pronounced in Massachusetts' sales and excise taxes, with low-income residents paying 10 times more of their income toward these taxes than earners in the top 1 percent. The state income tax, however, is quite "progressive" (for reasons discussed in greater detail later in the primer), because it taxes high-income earners much more heavily than those with lower incomes, leading toward greater balance in the overall system. The income tax therefore offsets some of the regressive effects of the state's sales, excise, and property taxes.

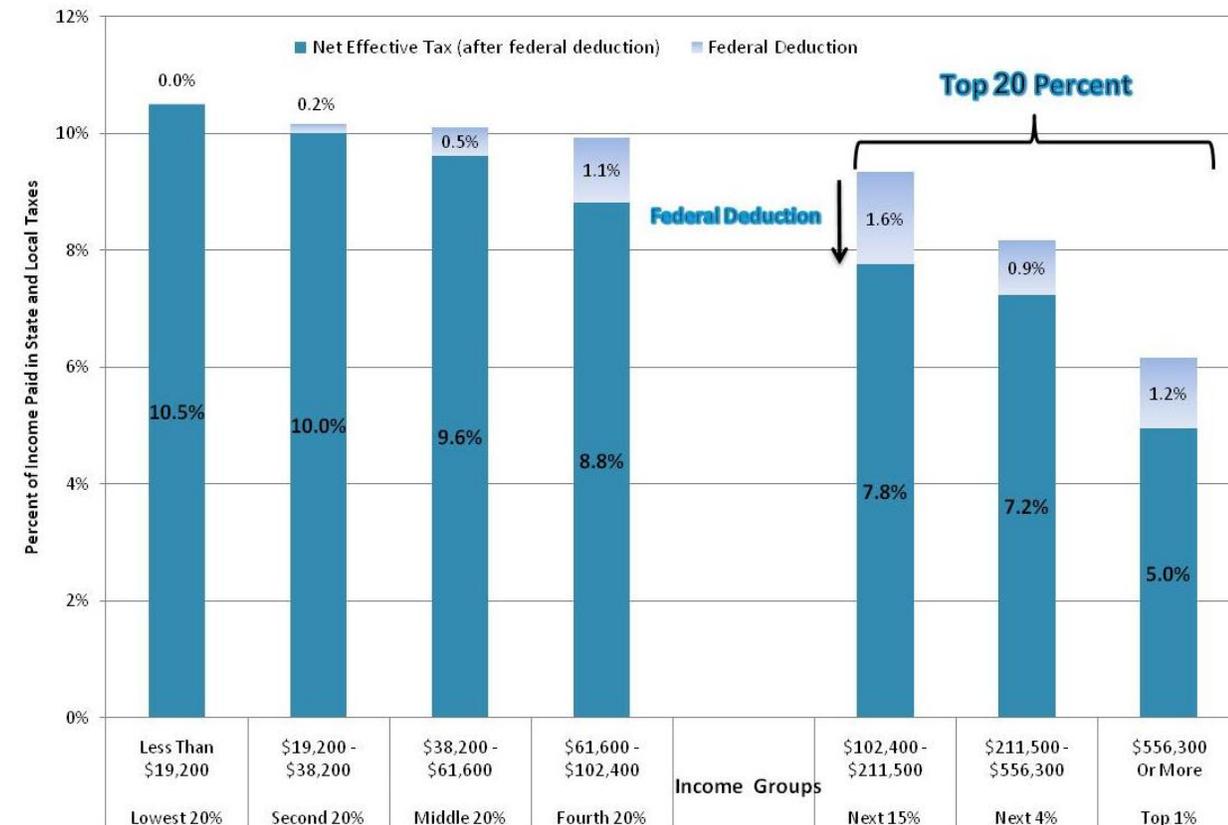
When the deductibility of state income taxes on federal income tax returns is considered, however, we see that the net effect of the income tax on regressivity is reduced. Since persons with higher incomes

<sup>27</sup> Data presented in Table 1 come from different source data than Figures 5 and 6. So while the data are similar, they are not identical.

<sup>28</sup> The ITEP modeling applies 2009 state and federal tax laws to distributional income data for 2009.

are in higher tax brackets at the federal level,<sup>29</sup> the fact that state income taxes can be deducted from federally taxed income is particularly beneficial to high-income taxpayers. The result is that, due to this federal deduction, top income earners reduce their federal taxes as a percent of income by 19 percent (equivalent to the 1.2 *percentage point* reduction, shown in Figure 10). The combined impact therefore is that the Commonwealth’s top earners pay an effective rate of 5.0 percent of their income in state taxes, while low-income taxpayers pay an effective rate of 10.5 percent, an effective tax rate more than twice that of those with the highest incomes.

**Figure 10. Top Earners in Massachusetts Pay Less of Their Personal Income in State & Local Taxes Than Do Low Income Earners (2009)**



With an understanding of how the overall tax system in the Commonwealth affects different income groups, we now turn to a discussion of the six basic types of taxes, beginning with the property tax.

<sup>29</sup> This is not true for state income taxes in Massachusetts, where income is taxed at a flat rate of 5.3 percent.

## CHAPTER 3: THE PROPERTY TAX & RELATED TRANSFER TAXES

States employ a variety of taxes to pay for public expenditures on education, roads and bridges, public safety, public health and many other services. Chapters Three through Eight provide a detailed look at the six major types of taxes levied in Massachusetts. For each of the six tax types we comment on the relevant assessment criteria described in Chapter One; provide a history of the tax; discuss tax changes over time and the effect of these changes on state revenue collections; and compare Massachusetts to the U.S. and to other states with regards to the amount of revenue raised through each tax. We also include discussion of “revenue options,” describing the likely effects on revenue collections and to the progressivity or regressivity of the tax system that would result from various changes to the tax code.

We begin with an examination of the Property Tax, a tax collected at the *local* level in Massachusetts, and one that generated over a third (or some \$11.7 billion) of all tax revenue in the Commonwealth in 2008.<sup>30</sup> Later in this chapter we discuss a state program that offsets the cost of property taxes for some lower income filers, and take a closer look at another tax applied to the *transfer* of property.

### THE PROPERTY TAX

The property tax is generally a stable tax. Once an assessment has been made of the value of the property subject to tax in a given jurisdiction, a tax rate then may be set that will bring in a determined amount of revenue. In many states there are property tax limits that curtail the ability of governments to set tax rates (see the information box “Proposition 2 ½ in Massachusetts”). In Massachusetts, property tax revenues have risen over the last business cycle as a share of personal income (share of personal income being a good measure to use for an apples-to-apples comparison of affordability over time, see Figure 11). Local governments collected some \$988 million more in property tax revenues in FY 2008 than in FY 2001 (though these revenue increases from the property tax were offset by steep declines in state aid to local governments).<sup>31</sup>

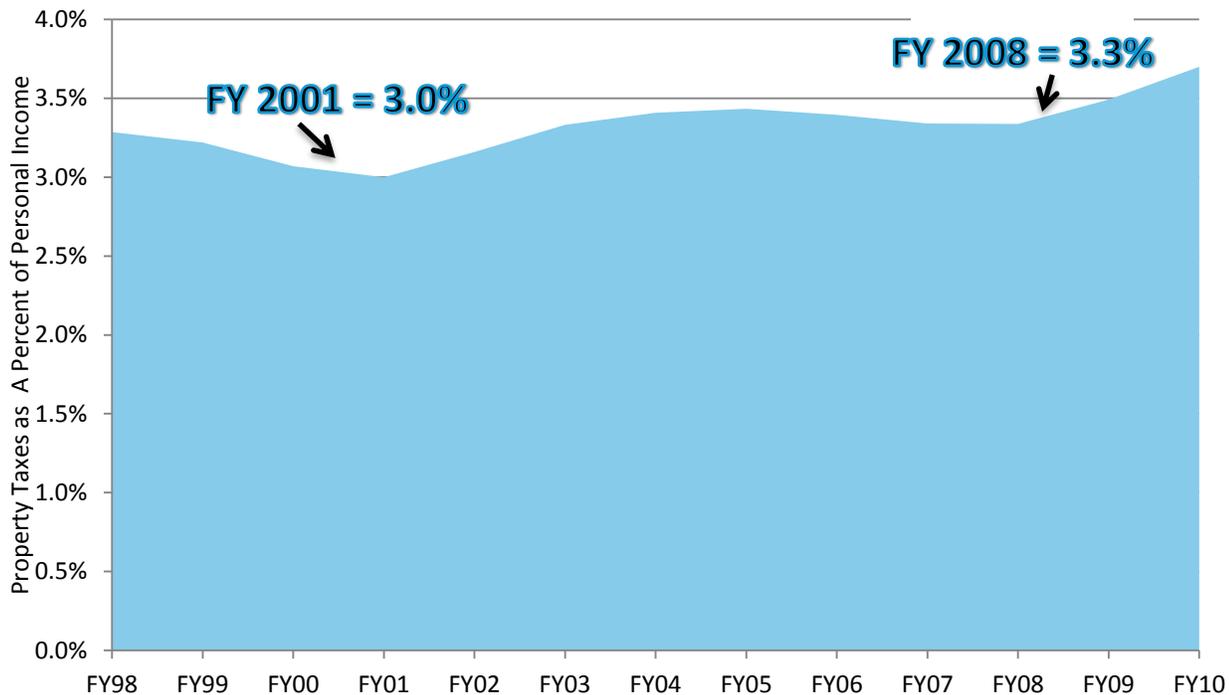
Nevertheless, “adequacy” (or sufficient revenues) still can be a problem when caps on the property tax, over time, limit the ability of property tax revenue to finance the services desired in a given community. This is particularly likely in periods of high inflation. This means that local governments can face a shrinking capacity to finance local services. As a result, it becomes especially important to maintain accurate, up-to-date assessments as the value of property changes, a task that can prove difficult for local governments (though this process works reasonably well in most communities throughout the Commonwealth).

<sup>30</sup> U.S. Census Bureau, *State and Local Government Finances by Level of Government and by State: 2007-08*. The 2007-08 Census data is the most recent available: <http://www.census.gov/govs/estimate/>

<sup>31</sup> From FY 2001 to FY 2008, general state aid to local governments dropped by an inflation adjusted \$404 million per year, and state Chapter 70 funding for local schools fell by an inflation adjusted \$343 million a year, for a combined total loss of \$747 million annually.

While it may appear then that local governments still gained an added \$240 million a year through increased property tax collections (\$988 million - \$747 million = \$241 million), this fails to take into account growth in personal income over the period. If state aid to local governments is to remain a constant share of the overall economy (ie, a constant share of personal income), then this aid should have grown by an inflation adjusted 8 percent from FY 2001 to FY 2008 (as did personal income), or about \$480 million. Adding this figure to the \$747 million decline in state aid to municipalities produces a funding loss figure of some \$1.23 billion annually. This suggests that even with growth in property tax collections, total resources available annually to local governments (as a share of the economy) fell by about \$240 million over the period (\$1.23 billion - \$988 million = \$240 million).

**Figure 11. Massachusetts Property Taxes Have Increased Over the Last Business Cycle as a Share of Personal Income**



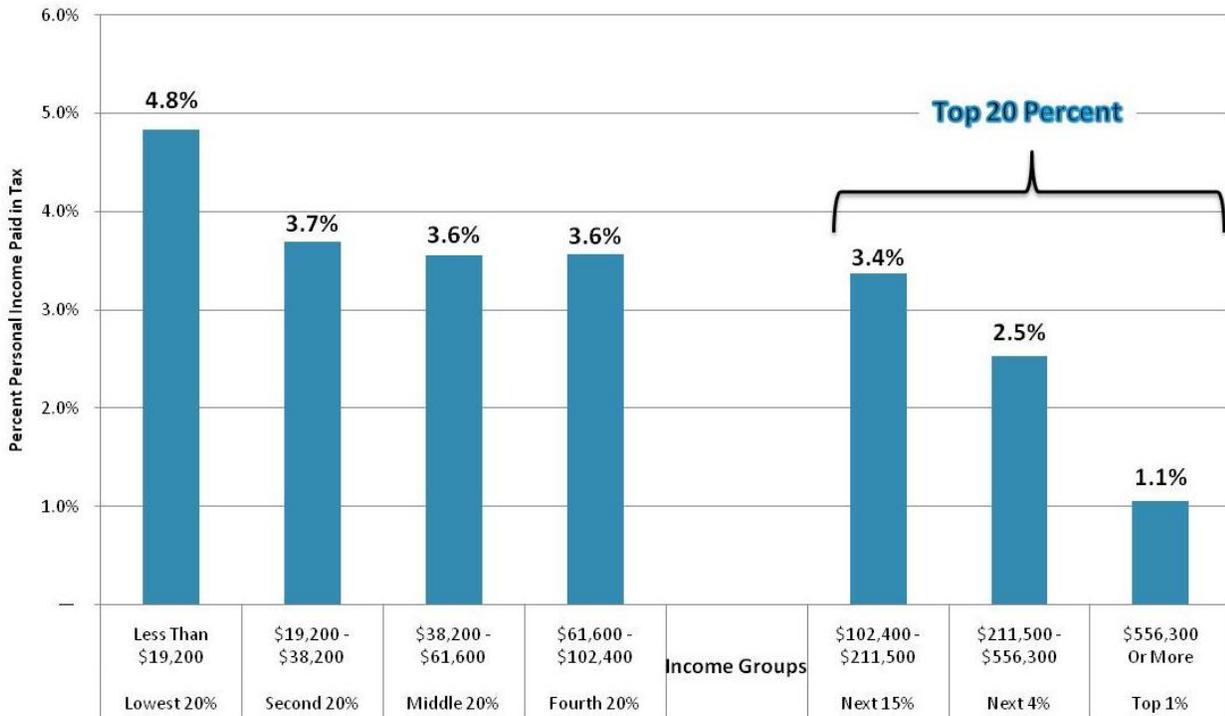
**Note: FY 2001 and FY 2008 are both years that were at the leading edge of prolonged economic downturns. Using these data allows for a more appropriate, apples-to-apples comparison of change over time.**

When examined under the criterion of fairness, the property tax has additional weaknesses. Since property tax rates usually are set for relatively small local areas -- towns, school districts, etc. -- when viewed from the statewide perspective, there can be problems with horizontal and vertical equity. A community with high property values (which often corresponds to residents with high incomes) can raise more money at a given tax rate than can a community with lower property values. The cost of providing local services, however, may not vary significantly between these two communities (basic public service costs being relatively comparable among like-sized communities). The result, therefore, may be that in order for the two communities to raise comparable amounts of revenue, the high property value community can adopt a significantly lower tax rate than can the low property value community. A house in the low-income community, therefore, will be taxed at a higher rate than a similarly-valued house in the high-income community. In addition to the equity problem described above, there are other challenges to applying the property tax in a manner that fully satisfies the criterion of fairness. Even within a single property tax jurisdiction it often is the case that retired people will have property of significant value but have a low current annual income, while a younger person may have a high income but little property. The result is that retired home owners (or other owners with relatively low incomes) may shoulder a disproportional share of the cost for local services.

As a result of the factors described above, property taxes consume a large part of the income of lower income people. The Institute on Taxation and Economic Policy (ITEP) has found that, on average, Massachusetts taxpayers with incomes in the lowest 20 percent paid 4.8 percent of their incomes in

property taxes in 2009, while Massachusetts taxpayers with incomes in the top 1 percent paid only 1.1 percent of their income in property taxes (see Figure 12).<sup>32</sup>

**Figure 12. Top Earners in Massachusetts Pay Less of Their Personal Income in Property Taxes Than Do Low Income Earners**



**Proposition 2 ½ in Massachusetts**

In 1980, Massachusetts voters approved an initiative called Proposition 2 ½. This law constrains both the total amount that a jurisdiction may collect each year through the property tax, and limits the *growth rate* of property tax levies for all towns and school districts throughout the Commonwealth. The law’s major features are:<sup>33</sup>

- The “levy ceiling”, which restricts the total tax levy (the amount collected) to no more than 2.5 percent of the total “full and fair cash value” of all taxable property. A town’s levy ceiling cannot be increased through a voter-approved override.
- The “levy limit”, which is slightly different than the “levy ceiling”, also limits the maximum amount of property tax that a jurisdiction can collect in a given year. The levy limit is equal to the previous year's limit with 2.5 percent growth factored in, plus an adjustment for new growth and any voter-approved overrides. The levy limit always must be lower than the levy ceiling.

<sup>32</sup> Using a variety of industry data sets in combination with US Census ACS data, ITEP produces state-level estimates of the share of property tax costs borne by renters, by income group. These estimates are included in the income group totals provided in Figure 12.

<sup>33</sup> For more information, please see: <http://www.mass.gov/Ador/docs/dls/publ/misc/levylimits.pdf>

(Continued from preceding page)

- Voter-approved “general overrides”, which allow residents to increase the levy limit. General overrides of the limit permanently increase the levy limit.
- Voter-approved “debt exclusions”, which *temporarily* increase the levy over the levy limit (or even over the levy ceiling) for certain capital projects and specified debt service costs.

Overall, Proposition 2 ½ has resulted in the reduction in the share of state and local taxes collected through the property tax.

### *A BRIEF HISTORY OF THE PROPERTY TAX IN MASSACHUSETTS*

The taxation of property in Massachusetts dates back to 1646.<sup>34</sup> Until the early 20<sup>th</sup> century there was a general property tax on all kinds of property, including land, houses, furnishings, livestock, and tools. It was essentially a tax on the items that, at that time, constituted a family’s wealth. Eventually, the ability of the property tax to raise sufficient revenue, however, became quite limited, as many forms of property were exempted from the tax, and income (rather than property) grew as a share of family resources. During the 20<sup>th</sup> century, the property tax was replaced as the primary *state* tax by taxes on income and sales, and by various excise taxes.<sup>35</sup> Now, Massachusetts, like most other states, has no *state* property tax. The property tax is instead a *local* tax, used to pay for local government services.

Property tax rates vary widely among cities and towns throughout the Commonwealth. In communities with very high assessed property values, a low tax rate still can raise a significant amount of total revenue, enough to pay for the local services people in that community elect to provide. In FY 2009, the town of Gosnold (a town comprised of islands west of Woods Hole) had the lowest rate in Massachusetts, at \$1.79 per \$1,000 of assessed value for residential property, while the town of Pelham (in Western Massachusetts) had the highest rate, at \$18.06 per \$1,000 -- more than 10 times higher.<sup>36</sup> These differences in tax rate per \$1,000 of assessed value are primarily the result of differences in property value between municipalities (and to a lesser extent, differences in the kinds of public services people in different communities require or elect to provide).

### *HOW MASSACHUSETTS MEASURES UP IN PROPERTY TAXES*

Property taxes made up 24.5 percent of Massachusetts’ state and local own-source revenues in FY 2008, and 34.3 percent of state and local tax revenues.<sup>37</sup> In Massachusetts, municipalities and school districts collect essentially all property tax revenues, some \$11.7 billion in FY 2008.<sup>38</sup>

<sup>34</sup> United States Department of Treasury, *Fact Sheets: Taxes: State and Local Taxes*, [www.treas.gov](http://www.treas.gov)

<sup>35</sup> Ibid.

<sup>36</sup> Massachusetts Department of Revenue website (see “Tax Rates by Class” for FY 2009): [http://www.mass.gov/?pageID=dorterminal&L=4&L0=Home&L1=Local+Officials&L2=Municipal+Data+and+Financial+Management&L3=Data+Bank+Reports&sid=Ador&b=terminalcontent&f=dls\\_mdmstuf\\_proptax&csid=Ador](http://www.mass.gov/?pageID=dorterminal&L=4&L0=Home&L1=Local+Officials&L2=Municipal+Data+and+Financial+Management&L3=Data+Bank+Reports&sid=Ador&b=terminalcontent&f=dls_mdmstuf_proptax&csid=Ador)

<sup>37</sup> U.S. Census Bureau, *State and Local Government Finances by Level of Government and by State: 2007-08*. The 2007-08 Census data is the most recent available: <http://www.census.gov/govs/estimate/>

<sup>38</sup> Ibid.

At the national level, property taxes were 21.1 percent of state and local own-source revenue in FY 2008, and 30.7 percent of national state and local taxes.<sup>39</sup> Local governments collected 97 percent of property tax revenue nationwide in FY 2008.<sup>40</sup>

In FY 2008, Massachusetts ranked 16<sup>th</sup> among the states in terms of property taxes as a share of personal income (see Figure 13).<sup>41</sup> Property taxes equaled 3.5 percent of personal income in the Commonwealth in 2008, higher than the average level of property taxes for the United States as a whole (3.4 percent).

Northeastern states typically rely more on property taxes than states in other parts of the country. Of the states in the Northeast, Massachusetts has a relatively low level of property tax collections as a share of state personal income. In fact, it is the only state in the region not to rank among the top ten states by this measure (see Figure 13).<sup>42</sup>

In FY 2008, of all states, property taxes relative to state personal income were highest in New Hampshire, equaling 5.4 percent. They were lowest in Alabama, where they generated revenue amounting to 1.5 percent of state personal income

#### *POSSIBLE TAX POLICY CHANGES RELATING TO THE PROPERTY TAX*

The actual changes in property tax rates in Massachusetts are the result of many independent local decisions. If the same percentage change was to occur in all communities at once, each one percent increase or decrease in all property tax rates would raise or lower collections by a little over \$100 million for local governments throughout the Commonwealth.<sup>43</sup>

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<sup>39</sup> Ibid.

<sup>40</sup> Ibid.

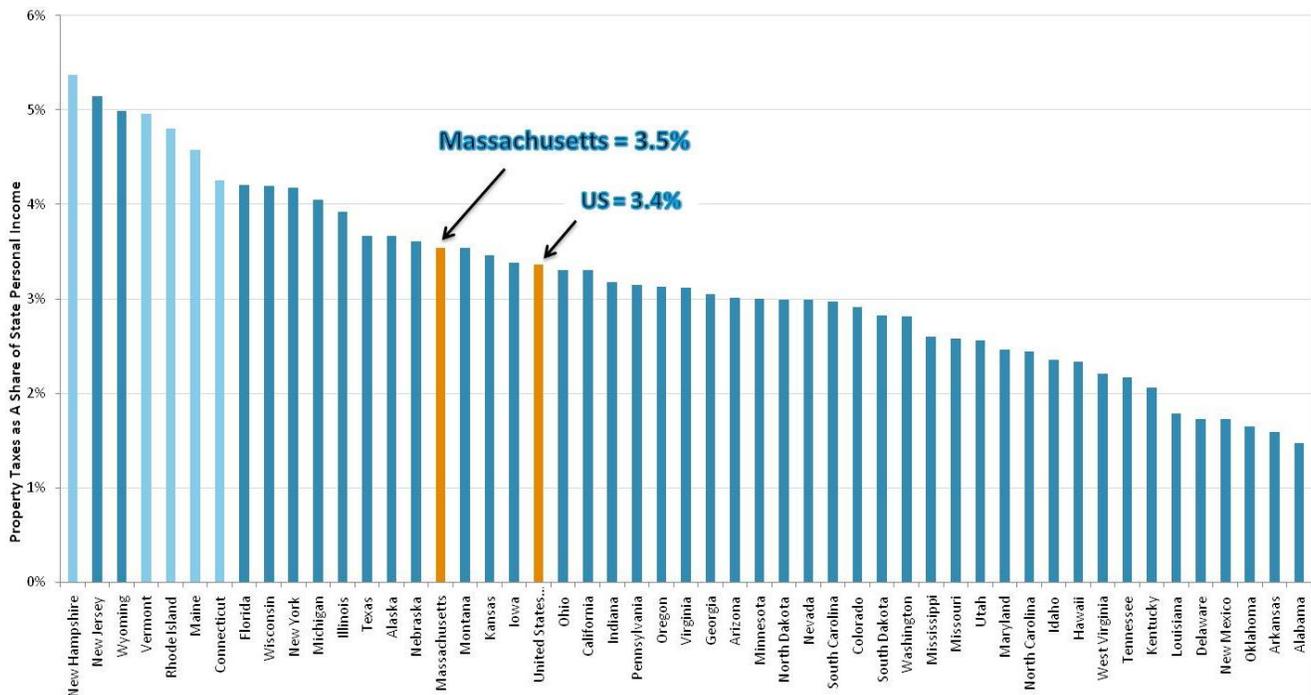
<sup>41</sup> Center on Budget and Policy Priorities analysis (of U.S. Census data for State and Local Government Finances) examining property taxes as a share of total State Personal Income.

<sup>42</sup> Ibid.

<sup>43</sup> This and all subsequent tax change estimates do not take into account complex economic interactions that can result from tax changes (often termed “dynamic estimates”), but are a purely illustrative, simple calculation showing the magnitude of the likely effect of these tax changes (or “static estimates”). All tax effect estimates use a FY 2007 base, unless otherwise noted. This particular calculation is based on U.S. Census data for FY 2007 showing total property tax collections in Massachusetts of \$11.042 billion:

[http://www2.census.gov/govs/estimate/0722masl\\_1.txt](http://www2.census.gov/govs/estimate/0722masl_1.txt)

**Figure 13. Property Taxes in Massachusetts are Higher Than the U.S. Average, But Lower Than in Other New England States (2008)**



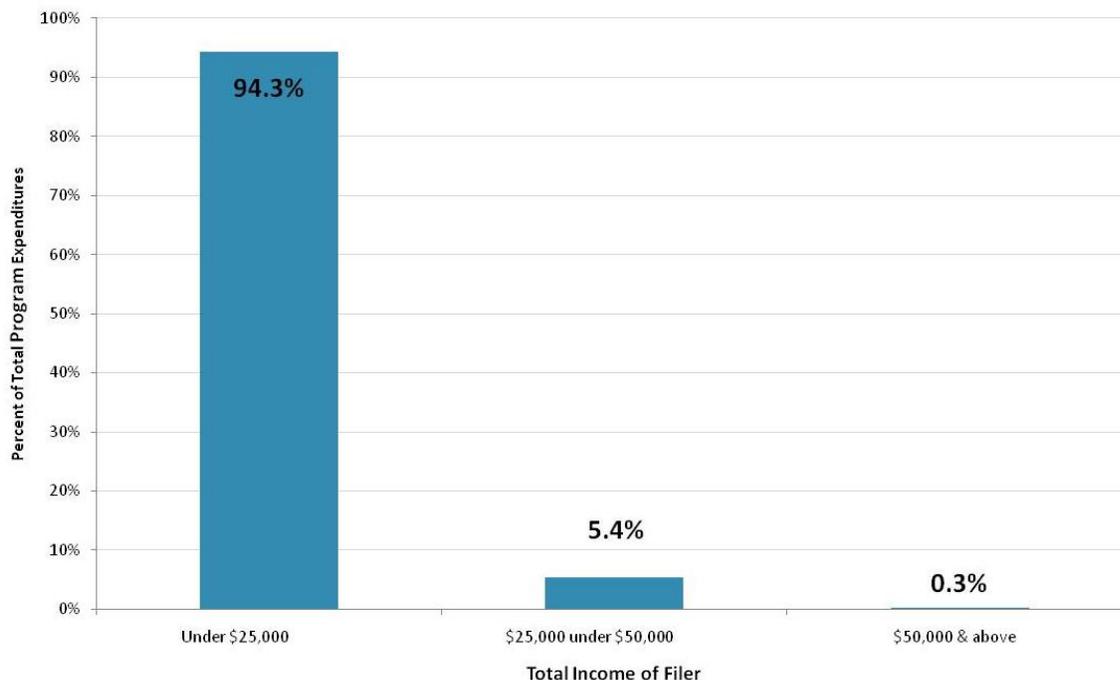
Changes in property tax rates themselves are, however, largely a matter for local communities to determine. Other changes that affect the impact of property taxes on owners’ and renters’ household budgets, nevertheless, can be made at the state level. Many states have attempted to address issues of fairness and affordability associated with the property tax (see discussion, above) by linking property taxes to household incomes.

Massachusetts joins 32 other states and the District of Columbia in offering a statewide program that helps offset the cost of property taxes. Often referred to as property tax “circuit breakers,” these programs provide income tax reductions for people whose property taxes represent a disproportionately large share of their income. Different states use a variety of criteria for eligibility, including income level and age criteria. In 2007 (the most current complete data available), the Massachusetts circuit breaker program delivered \$45.2 million in tax reductions to over 64,000 filers.<sup>44</sup> Just less than 95 percent of the 2007 total tax reduction went to filers with incomes under \$25,000 (see Figure 14).<sup>45</sup>

<sup>44</sup> Massachusetts Department of Revenue, Circuit Breaker data for 2007 (see Appendix A)

<sup>45</sup> Ibid.

**Figure 14. Almost 95 Percent of Massachusetts' Circuit Breaker Tax Credits in 2007 Went to Filers With Incomes Under \$25,000**



#### *HOW DOES THE CIRCUIT BREAKER PROGRAM WORK?*

Every state designs its own circuit breaker program with its own set of criteria for eligibility. Established in 1999, the Massachusetts program currently is available only to people age 65 and older with total incomes under \$77,000 for married joint filers (under \$64,000 for head of household filers or under \$51,000 for single filers).<sup>46</sup> The program is open to both property owners and renters. To qualify for a tax credit, property taxes must exceed 10 percent of the filer's total income (for renters, the calculation to determine eligibility is slightly more complicated).<sup>47</sup> The state will provide eligible filers with an income tax credit (i.e., a direct reduction in their taxes) equal to the amount of property tax that exceeds 10 percent of their income. For tax year 2009, the maximum credit the state provided was \$960 dollars per filer. As with the income thresholds, the cap amount increases annually to keep pace with inflation.

#### *WHAT MIGHT BE THE EFFECTS OF VARIOUS CHANGES TO THE CIRCUIT BREAKER PROGRAM?*

While the current circuit breaker program is helpful to many lower-income seniors, there are ways in which the program could be redesigned to provide greater help to seniors and to *non-elder*, lower-income Massachusetts residents as well. Modeling performed by the Institute on Taxation and

<sup>46</sup> Income limits are updated yearly. Figures for the 2009 tax year are provided by the Massachusetts Department of Revenue: [http://www.mass.gov/?pageID=dorterminal&L=6&L0=Home&L1=Individuals+and+Families&L2=Personal+Income+Tax&L3=Current+Year+Tax+Information&L4=Guide+to+Personal+Income+Tax&L5=Credits&sid=Ador&b=terminalcontent&f=dor\\_help\\_guides\\_abate\\_amend\\_personal\\_issues\\_realestate&csid=Ador](http://www.mass.gov/?pageID=dorterminal&L=6&L0=Home&L1=Individuals+and+Families&L2=Personal+Income+Tax&L3=Current+Year+Tax+Information&L4=Guide+to+Personal+Income+Tax&L5=Credits&sid=Ador&b=terminalcontent&f=dor_help_guides_abate_amend_personal_issues_realestate&csid=Ador).

<sup>47</sup> For renters, the state assumes that 25 percent of rent goes toward payment of the property taxes on a dwelling (even though the actual property tax bill, in fact, is handled by their landlord). For purposes of calculating the value of the circuit breaker credit, a renter's property tax bill is therefore assumed to equal one quarter of annual rent.

Economic Policy (ITEP) using 2009 tax law and 2009 income data for Massachusetts provides cost and impact estimates for a number of possible scenarios.<sup>48</sup>

If the current program were changed to double the maximum credit from \$960 to \$1,920, ITEP estimates that program costs would increase by \$24 million annually, affecting some 37,000 “filing units” (including both individuals and “married couples filing jointly”).<sup>49</sup> If the eligibility criteria of the current program were changed to include senior filers whose property taxes exceeded 8 percent of their total income (rather than 10 percent, as is now required), ITEP estimates that some 65,000 senior “filing units” would be affected by the change, at an additional cost of \$17 million annually.<sup>50</sup> If the property tax-to-income eligibility level were reduced instead to 5 percent (from the current 10 percent), ITEP estimates that some 150,000 senior “filing units” would be affected by this change, with added costs exceeding current costs by some \$81 million annually.<sup>51</sup>

It also is possible to open the program to lower-income filers of all ages, rather than having the program available only to eligible seniors, as is now the case. ITEP estimates that including eligible non-seniors in the current program (both owners and renters) would have an added cost of \$205 million annually. Using ITEP data, *MassBudget* estimates that some 189,000 non-elderly “filing units” would see their taxes decline as a result of this change. Were maximum benefit levels in this expanded program (seniors and non-seniors) increased from \$960 to \$1,920, ITEP estimates that the total additional program cost above current costs would be \$252 million annually.

If the eligibility criteria for the expanded program (seniors and non-seniors, maximum benefit set at \$960) were changed to include low-income filers whose property taxes exceeded 8 percent of their total income (rather than 10 percent, as is now required), ITEP estimates that a total of 387,000 elderly and non-elderly “filing units” would be eligible for the tax credit at an added annual cost of \$270 million (beyond current annual costs). If the property tax-to-income eligibility level were reduced instead to 5 percent (from the current 10 percent), ITEP estimates that approximately 615,000 elderly and non-elderly filing units would benefit from this change, with added costs exceeding current costs by \$459 million annually.

As with the current program, under all of the possible changes outlined above, the large majority of additional program dollars would go to filers with moderate and lower incomes. Depending on the specific changes, between 85 percent and 95 percent of total additional program dollars would go to households with incomes under \$62,000, with between 55 percent and 70 percent of total additional program dollars going to households with incomes below \$38,200.<sup>52</sup>

## THE REAL ESTATE TRANSFER TAX

Massachusetts joins 35 other states (and the District of Columbia) in levying a tax on the sale or transfer of real estate property located in the state.<sup>53</sup> Roughly two-thirds of the states that levy a Real Estate

<sup>48</sup> Estimates include ITEP analysis performed upon request by *MassBudget*, March 2010 (see Appendix B).

<sup>49</sup> A tax return may be filed by an individual filer or by a “married couple filing jointly”. In this second instance, a single return includes tax information for two people. The actual number of *people* receiving a tax cut under any of these changes therefore will be higher than the figure provided for the number of affected “filing units.” ITEP, however, does not provide estimates for the number of people affected.

<sup>50</sup> This scenario assumes a maximum credit of \$960.

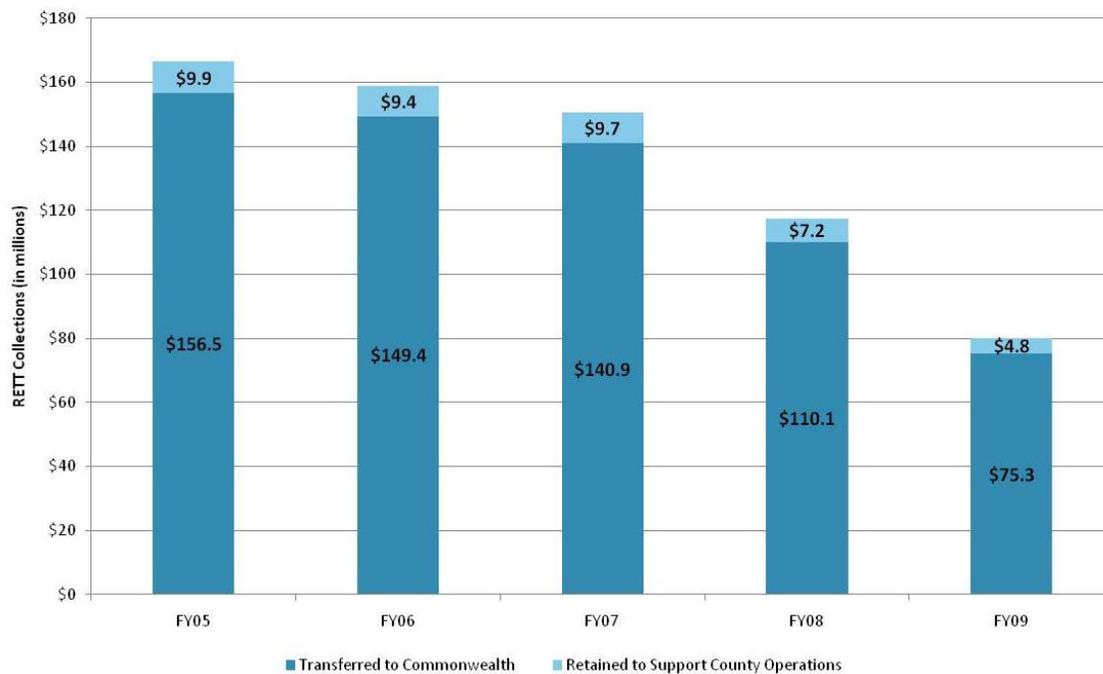
<sup>51</sup> This scenario assumes a maximum credit of \$960.

<sup>52</sup> ITEP analysis performed upon request by *MassBudget*, March 2010 (see Appendix B)

<sup>53</sup> Federation of Tax Administrators, “State Real Estate Transfer Taxes,” February 16, 2006 <http://www.taxadmin.org/fta/rate/B-0306.pdf>.

Transfer Tax (RETT), including Massachusetts, apply a tax rate of less than 0.5 percent to the value of the transferred property.<sup>54</sup> The rate in Massachusetts is 0.456 percent. The total amount of revenue collected in Massachusetts annually varies depending on the value of taxable real estate transferred in a given year. In fiscal year 2009, Massachusetts collected \$80.1 million through the RETT (Figure 15). By contrast, during the midst of the recent real estate boom, Massachusetts collected over twice that amount (\$166.4 million) in a single year (FY 2005).<sup>55</sup>

**Figure 15. Massachusetts Real Estate Transfer Tax (RETT) Collections, Fiscal Years 2005- 2009**



### *HOW DOES THE REAL ESTATE TRANSFER TAX WORK?*

The RETT is paid by the seller and is collected by the county Registry of Deeds at the time of sale. For each \$500 dollars of real estate value transferred, a tax of \$2.28 (0.456 percent) is collected. The majority of this revenue is returned by the county registries to the Commonwealth, though a small percentage -- roughly six percent of the annual total -- is retained by some counties to help fund the County Corrections Program, Registry of Deeds operations, and general county government expenses.<sup>56</sup>

### *HOW DOES THE MASSACHUSETTS RETT COMPARE TO OTHER STATES?*

Relative to several neighboring states, the Massachusetts single-rate RETT is quite low. New Hampshire, for example, applies a single rate of 1.5 percent to all property transfers. In addition to New Hampshire's higher, single-rate system, several other states in the Northeast have multi-rate

<sup>54</sup> Ibid.

<sup>55</sup> Massachusetts Department of Revenue, Division of Local Services (see Appendix C).

<sup>56</sup> Most county governments in Massachusetts no longer exist. Functions formerly provided at the county level now are provided by the state. As such, most Registries of Deeds now remit all RETT collections directly back to the state.

systems, applying a second, higher rate to the transfer of properties with values above a certain limit. In Vermont, if the property is owner-occupied, a rate of 0.5 percent is applied to the first \$100,000 of value, with a rate of 1.25 percent applied to value that exceeds this limit (if not owner-occupied, the 1.25 percent rate applies to the full value of the property.) Connecticut applies a rate of 0.5 percent to properties with values under \$800,000 but bumps the rate up to 1.0 percent on the value of the property that exceeds \$800,000.<sup>57</sup> New York and New Jersey set initial rates at 0.4 percent, but apply a higher rate (1.4 percent) to property value exceeding \$1 million.<sup>58</sup>

#### REVENUE OPTIONS FOR THE RETT

Massachusetts could move toward a RETT structure similar to either of these systems (a single, higher-rate structure or a structure with multiple rates). A system in which the Commonwealth levied a higher RETT rate on property of greater value (similar to CT, NY, and NJ) would be more progressive than the current Massachusetts RETT system. Depending on the design of such a system, the total revenues collected through the RETT could be less than, greater than, or equal to revenue amounts collected under the current structure.

If Massachusetts continued to employ a single rate structure for its RETT but matched the higher rate used either by Vermont or New Hampshire, the progressivity of the RETT itself would not be altered. Adopting the 1.25 percent rate used in Vermont would increase RETT collections in Massachusetts by 175 percent, raising FY 2009 collections from \$80.1 million to \$220.3 million (a net revenue gain of \$140.2 million, an amount that would be substantially higher in years with stronger real estate sales).<sup>59</sup> If Massachusetts adopted the 1.5 percent rate used in New Hampshire, RETT collections in the Commonwealth would increase by almost 230 percent.<sup>60</sup> With a RETT at this level, Massachusetts would have collected \$264.3 million in FY 2009, or \$184.2 million more than it actually did collect. These estimates do not include the probable (though difficult to estimate) effects of higher transfer taxes on total sales volume.

If Massachusetts instead adopted a two-tiered system similar to that used in NY and NJ -- increasing the RETT to 1 percent on the portion of transferred property with value exceeding \$1 million -- additional revenue would be generated. Using real estate sales and transfer data supplied by the Federal Reserve Bank of Boston, *MassBudget* estimates that such a system would have generated an additional \$17.2 million in FY 2009 (a 21 percent increase over actual collections).<sup>61</sup> All of this added revenue would come from transfers of properties valued at over \$1 million each, and almost 50 percent (some \$8.4 million) of the new revenue would come from transfers of properties valued at more than \$3 million each.

Finally, the state could increase collections by closing a tax loophole that allows some sellers to avoid paying the RETT on their property transfers. As discussed above, the RETT applies specifically to the

<sup>57</sup> National Conference of State Legislatures, January 2007: <http://www.ncsl.org/default.aspx?tabid=12661>

<sup>58</sup> Ibid..

<sup>59</sup> Massachusetts Department of Revenue, Division of Local Services (see Appendix C).

<sup>60</sup> Ibid.

<sup>61</sup> The Federal Reserve Bank of Boston, drawing on data compiled by the Warren Group, estimates that \$3.64 billion worth of taxable properties exceeding \$1 million in value was transferred in FY 2009. The *MassBudget* estimate of revenue increases derived from a two-tiered system is based on average 2009 sale prices for properties within each of five sale-price categories, ranging from \$1 million to properties valued above \$3 million. This estimate does not account for the complex effects that higher tax rates likely would have on the number and value of real estate transfers undertaken.

direct transfer of real estate from one owner to another. Under current law, however, it is possible to create a business entity that acts as a kind of “shell company,” with this company assuming direct ownership of one or more pieces of real estate. The owners of this company then are able to sell the company, rather than selling the real estate per se. Ownership of the underlying real estate continues to reside with the shell company, and therefore, technically, there has been no transfer in direct ownership of the real estate itself. As a consequence, no RETT can be collected on the sale. The Department of Revenue has estimated that this loophole created a loss in RETT collections of \$20 million in FY 2009.<sup>62</sup> Other states, including New York and Maryland have closed this loophole.

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<sup>62</sup> The Governor’s website: [http://www.mass.gov/bb/fy2008h1/bills08/loophole\\_primer.shtml](http://www.mass.gov/bb/fy2008h1/bills08/loophole_primer.shtml).

## CHAPTER 4: PERSONAL INCOME TAXES

The property tax -- discussed in Chapter Three, above -- is the principal tax levied at the local level in Massachusetts. At the state level, the largest source of tax revenue is the personal income tax. In 2008, the state personal income tax accounted for over one third (36.8 percent or \$12.5 billion) of combined state and local taxes in Massachusetts, and 57 percent of state-only tax revenue.<sup>63</sup> In Chapter Four, we look both at personal income taxes applied to wage and salary income, and at personal income taxes applied to dividend and interest income.

As with each of the other five tax categories covered in this primer, we will examine how the personal income tax meets the relevant assessment criteria described in Chapter One of this primer; provide a history of the particular tax; discuss how the tax has changed over time and the effect these changes have had on state revenue collections; and compare Massachusetts to the US and to other states with regards to the amount of revenue raised through the personal income tax. We also include discussion of "revenue options," ways in which the personal income tax might be changed, with the result being either an increase or decrease in progressivity of the system (usually accompanied by either an increase or decrease in tax revenues).

### THE PERSONAL INCOME TAX

#### *AN OVERVIEW OF PERSONAL INCOME TAXES*

The personal income tax tends to be a very good tax from the standpoint of adequacy; revenues generated by a personal income tax generally grow in sync with growth in the overall economy. The personal income tax likewise is very good from the standpoint of horizontal equity: except for special exemptions, people with comparable incomes tend to pay similar shares of their income toward the income tax. This may be modified by definitions of taxable income, but the tendency of the personal income tax is toward a high level of horizontal equity. In terms of vertical equity, typically the personal income tax is somewhat to very progressive (depending on the exact design of the system); higher-income people generally pay a greater share of their income toward this tax than do lower-income people. All personal income taxes in the United States have exemptions and deductions that exclude some income from taxation. Many -- including the federal individual income tax -- have higher rates for higher incomes.

Personal income taxes, however, have stability problems. While incomes (and hence revenues) tend to keep pace with the economy over the long term, during periods of economic recession, incomes (and therefore income tax revenues) can decline very rapidly. This instability is due largely to the taxation of capital gains, bonuses, and other kinds of related income, which can soar or plunge depending on the state of the stock market and the general economy. The bulk of personal income tax collections are from salaries and wages, however, and are much more stable -- though still influenced by economic events.

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<sup>63</sup> U.S. Census Bureau, *State and Local Government Finances by Level of Government and by State: 2007-08*. The 2007-08 Census data is the most recent available: <http://www.census.gov/govs/estimate/>

Massachusetts has a flat rate income tax structure for most income. This is in contrast to the federal individual income tax and many other states' income taxes, which apply higher tax rates to higher levels of income (a structure commonly referred to as a "graduated income tax").

Despite the flat rate structure, there nevertheless are features of the Massachusetts income tax that make it progressive. First, there is a "personal exemption" that removes a fixed amount of each tax filer's income from the total amount of their income that is subject to the tax. In 2009, the personal exemption stood at \$4,400 for single taxpayers and \$8,800 for married couples filing jointly.<sup>64</sup> This exemption provides greater benefit (on a percentage basis) to lower-income earners than to higher-income earners since the exemptions represent a larger portion of lower-income earners' incomes. Second, when a taxpayer's income is under a particular threshold the taxpayer qualifies for No Tax Status and pays no income tax for that year. The thresholds for Tax Year 2009 are \$8,000 for single taxpayers and \$16,400 for married couples filing jointly (plus \$1,000 per dependent).<sup>65</sup> Taxpayers who do not qualify for No Tax Status are eligible for a Low Income Tax Credit if their income does not exceed \$14,000 for single taxpayers and \$28,700 (plus \$1,750 per dependent) for married couples filing jointly.<sup>66</sup>

In addition to these elements, there also is a state Earned Income Tax Credit (EITC) that further reduces the share of taxes paid by lower-income persons. Massachusetts also used to apply a higher tax rate (12.0 percent) to income derived from dividends and interest, a form of income enjoyed overwhelmingly by those with higher incomes. While in effect, this provision also improved the overall progressivity of Massachusetts' personal income tax system. Currently, Massachusetts applies a higher tax rate (12.0 percent) to income derived from short-term capital gains (investments held for less than one year). Though this type of income represents only a small percentage of total capital gains income, this higher rate also adds to the overall progressivity of the system.

Analysis from the Institute on Taxation and Economic Policy (ITEP) shows the current progressivity of the personal income tax in Massachusetts (see Figure 16). On average, taxpayers with the lowest 20 percent of incomes paid only 0.7 percent of their incomes in personal income taxes in 2009. The middle 20 percent paid 3.7 percent of their incomes in personal income taxes, and the top 20 percent paid from 4.2 percent to 4.6 percent of their incomes in income taxes -- a rate roughly 9 times higher than for those in the lowest quintile.

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<sup>64</sup> For details see Mass DOR website:

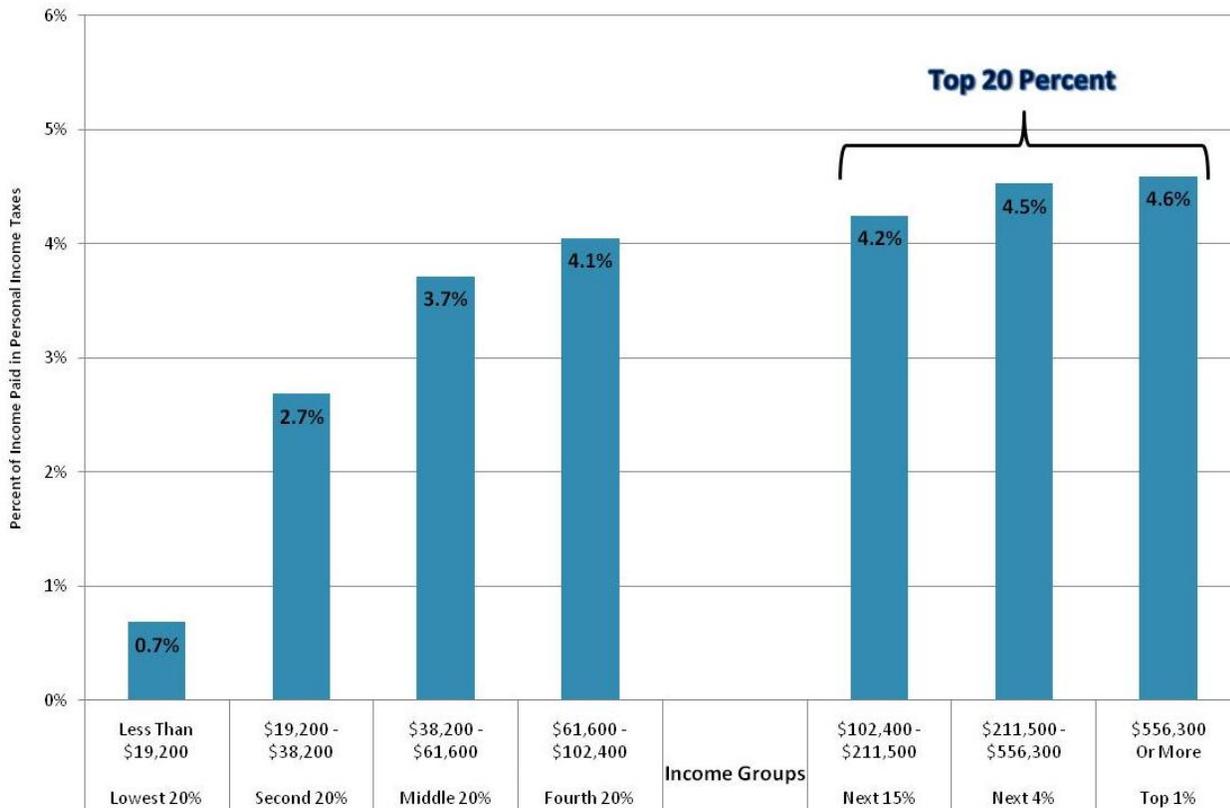
[http://www.mass.gov/?pageID=dorterminal&L=6&L0=Home&L1=Individuals+and+Families&L2=Personal+Income+Tax&L3=Current+Year+Tax+Information&L4=Guide+to+Personal+Income+Tax&L5=Exemptions&sid=Ador&b=terminalcontent&f=dor\\_help\\_guides\\_abate\\_and\\_personal\\_issues\\_exemptionsform1&csid=Ador#Personal](http://www.mass.gov/?pageID=dorterminal&L=6&L0=Home&L1=Individuals+and+Families&L2=Personal+Income+Tax&L3=Current+Year+Tax+Information&L4=Guide+to+Personal+Income+Tax&L5=Exemptions&sid=Ador&b=terminalcontent&f=dor_help_guides_abate_and_personal_issues_exemptionsform1&csid=Ador#Personal)

<sup>65</sup> See Mass DOR website:

[http://www.mass.gov/?pageID=dorterminal&L=6&L0=Home&L1=Individuals+and+Families&L2=Personal+Income+Tax&L3=Current+Year+Tax+Information&L4=Guide+to+Personal+Income+Tax&L5=Filing+Requirements&sid=Ador&b=terminalcontent&f=dor\\_help\\_guides\\_abate\\_amend\\_personal\\_issues\\_nts&csid=Ador#Table](http://www.mass.gov/?pageID=dorterminal&L=6&L0=Home&L1=Individuals+and+Families&L2=Personal+Income+Tax&L3=Current+Year+Tax+Information&L4=Guide+to+Personal+Income+Tax&L5=Filing+Requirements&sid=Ador&b=terminalcontent&f=dor_help_guides_abate_amend_personal_issues_nts&csid=Ador#Table)

<sup>66</sup> Ibid.

**Figure 16. High Income Earners in Massachusetts Pay More of Their Income in Personal Income Taxes Than Do Low-Income Earners (2009)**



*A BRIEF HISTORY OF THE PERSONAL INCOME TAX IN MASSACHUSETTS*

Massachusetts adopted a personal income tax in 1916. The Massachusetts State Constitution requires that this be a flat tax, meaning that all levels of income are taxed at the same rate. However, there is a personal exemption and various deductions that keep the Massachusetts personal income tax progressive in its overall effect. The rate has varied over time. From 1977 to 2010, it was as high as 6.25 percent and as low as 5 percent. As of 2010, the tax rate on personal income stands at 5.3 percent. Over just the last two decades, Massachusetts has made a number of significant changes to its tax code, some of them related to personal income taxes. The Department of Revenue (DOR) summarized some of most important tax law changes (including changes to personal income taxes) in a 2010 release.<sup>67</sup> This DOR release (see Appendix D) helps us understand both the chronology and kinds of changes made from 1991-2010, as well as the impact on FY 2010 revenues associated with each of the various changes. Among the more notable changes made over this period to tax rates on personal income are the following:

- Between 1990 and 2002, the tax rate on “Part B Income” (wage and salary income) was raised from 5.95 percent to 6.25 percent and then dropped from 6.25 percent to the current 5.3 percent. DOR estimates that the rate reduction from 6.25 percent to 5.3 percent on long-term capital gains income resulted in a \$1.44 billion loss of revenue in FY 2010.<sup>68</sup>

<sup>67</sup> DOR, Revenue Impact of Certain MA Tax Law Changes since January 1991, see Appendix D

<sup>68</sup> Ibid.

- A series of changes from 1998 to 2002 reduced the tax rate on dividend and interest income from 12.0 percent to 5.3 percent. DOR estimates this reduction resulted in a revenue loss of \$629 million in FY 2010.<sup>69</sup>
- Between 1996 and 2001, the tax rate on long-term capital gains was reduced gradually from 6.0 percent to 0 percent, and then in 2002 was raised to 5.3 percent, matching the rate on other types of personal income. (Short-term capital gains income – from investments held for less than one year – is taxed at 12.0 percent. These short-term investments, however, make up a small percentage of total taxable capital gains in Massachusetts.) DOR estimates that the rate reduction from 6.0 percent to 5.3 percent cost the Commonwealth \$188 million in forgone revenue in FY 2010.<sup>70</sup>

In addition to these rate reductions, several other changes made over this period to the laws governing taxation of personal income in Massachusetts produced substantial additional revenue losses:

- In 1998, the personal exemption amount was doubled, followed by a 25 percent reduction in 2002. Between 2005 and 2008, a series of phased increases brought the amount of the personal exemption back to the higher, 1998 levels. DOR estimates that the current personal exemption (\$4,400/individual, \$8,800/married couples filing jointly) resulted in a FY 2010 loss to the Commonwealth of \$614 million in forgone revenue.<sup>71</sup>
- Massachusetts implemented a state Earned Income Tax Credit (EITC) in 1997 worth 10 percent of the federal EITC, and in 2001 raised the value of the credit to 15 percent of the federal EITC. DOR estimates that this tax credit – available principally to low-income working families with children – cost the Commonwealth \$112 million in forgone revenue in FY 2010.<sup>72</sup>
- In 2001, Massachusetts significantly increased the tax deductions for expenses incurred for providing care to disabled dependents (either children or elderly dependents). DOR estimates that this set of changes resulted in a revenue loss of \$110 million in FY 2010.<sup>73</sup>
- In 2001, Massachusetts established a Property Tax Circuit Breaker program for seniors who have particularly high property taxes relative to their incomes (see Chapter Three for a more complete discussion). The Circuit Breaker program reduces income taxes for these seniors. DOR estimates this tax credit cost the state \$60 million in FY 2010.<sup>74</sup>

#### *HOW MASSACHUSETTS MEASURES UP IN PERSONAL INCOME TAXES*

Massachusetts collected \$12.5 billion in personal income taxes in FY 2008. This amounted to 36.8 percent of state and local taxes and 26.2 percent of state and local own-source revenue.<sup>75</sup> This revenue was collected entirely at the state level.

<sup>69</sup> Ibid.

<sup>70</sup> Ibid.

<sup>71</sup> Ibid.

<sup>72</sup> Ibid.

<sup>73</sup> Ibid.

<sup>74</sup> Ibid.

<sup>75</sup> U.S. Census Bureau, *State and Local Government Finances by Level of Government and by State: 2007-08*. The 2007-08 Census data is the most recent available: <http://www.census.gov/govs/estimate/>

For the nation as a whole, personal income taxes were 22.9 percent of total state and local taxes, and 15.7 percent of total state and local own-source revenue.<sup>76</sup> State governments (as opposed to local governments) collected 91 percent of this personal income tax revenue.<sup>77</sup>

Massachusetts has a flat personal income tax rate of 5.3 percent on most types of income, including wage and salary income, dividend and interest income, and capital gains income (except for short-term capital gains which are taxed at 12 percent). Most other states have graduated rate structures, some with top rates of 8 or 9 percent (California, for example, has a 9.55 percent top rate, plus an additional 1 percent tax on incomes over \$1 million, for an effective 10.3 percent rate).<sup>78</sup> Top rates for neighboring states are: 8.95 percent in Vermont, 8.97 percent in New York, and 6.5 percent in Connecticut.<sup>79</sup> New Hampshire has an income tax limited to dividend and interest income. Each state also has different thresholds for the top rate, different amounts for personal exemptions, and different deductions.

For FY 2008, personal income taxes in the Commonwealth yielded revenue equal to 3.8 percent of state personal income. Only three states -- New York, Maryland, and Connecticut -- generated more revenue from the personal income tax than Massachusetts when measured as a share of personal income. It is important to note that the income tax is only one of many taxes in the total state and local tax system; the Commonwealth collects more of its tax revenue from the income tax and less from the sales tax than most states. In terms of *total* taxes collected at the state and local level, Massachusetts ranks below 30 other states for the amount of personal income collected in taxes (see Figure 3 in Chapter 2). Seven states, including Texas and Florida, do not have a personal income tax (see Figure 17). Both New Hampshire and Tennessee have very limited personal income taxes, not taxing wage or salary income.

For the nation as a whole, personal income taxes produced revenues equal to 2.5 percent of personal income in FY 2008. New York, at just less than 5 percent, ranked highest in the amount of personal income collected through state and local personal income taxes.

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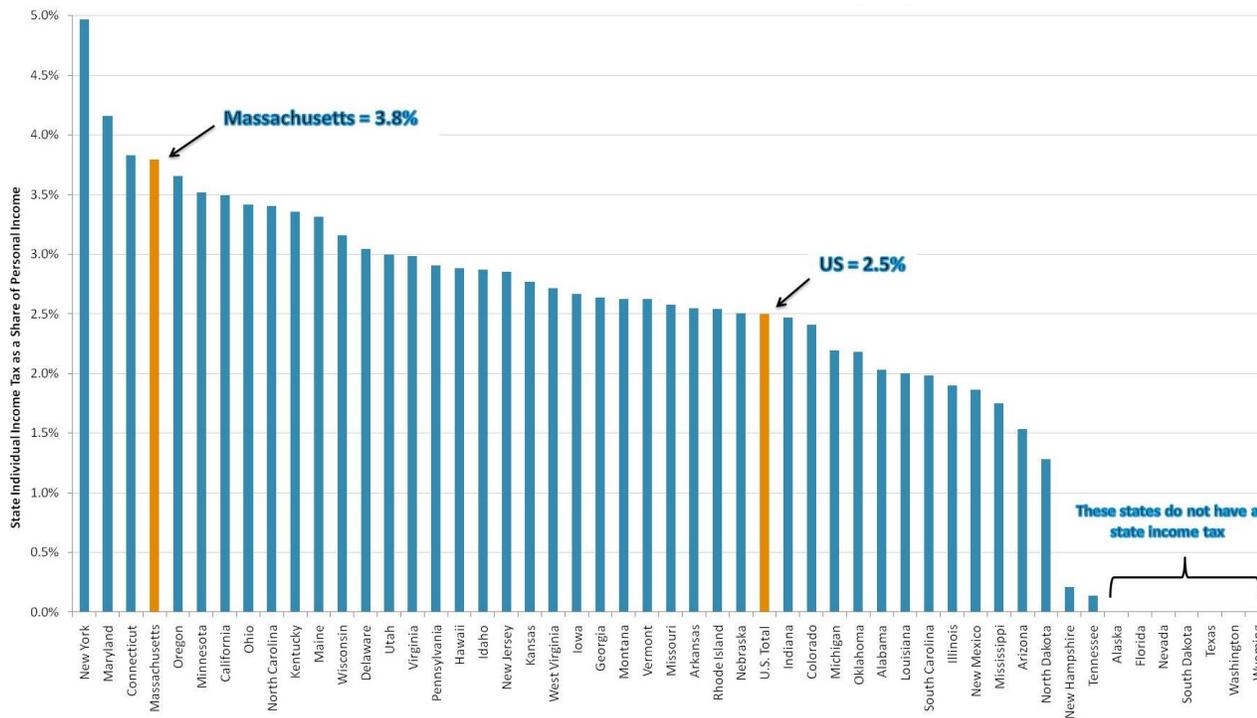
<sup>76</sup> Ibid.

<sup>77</sup> Ibid.

<sup>78</sup> Federation of Tax Administrators website (data accurate as of 6-15-2010): [http://www.taxadmin.org/fta/rate/tax\\_stru.html](http://www.taxadmin.org/fta/rate/tax_stru.html)

<sup>79</sup> Ibid.

**Figure 17. Massachusetts Collects a Larger Share of Personal Income Through the Individual Income Tax Than Do Most Other States (2008)**



*HOW DOES THE PERSONAL EXEMPTION MAKE THE INCOME TAX MORE PROGRESSIVE?*

As discussed above, the personal exemption reduces a tax filer’s taxable income by a set amount. The exempted amount is the same for all filers, regardless of income. For tax year 2009, individual filers are allowed a personal exemption of \$4,400, while joint filers get an \$8,800 personal exemption.

The personal exemption makes the income tax more progressive. Because the amount of income exempted from taxes is the same for all filers, the *percent* of income exempted from taxes is much higher for low-income filers than it is for high-income filers. For example, if someone makes \$40,000 a year, the \$4,400 personal exemption reduces their taxable income by 11 percent. For someone making \$100,000, however, the same personal exemption (\$4,400) reduces their taxable income by only 4.4 percent.

At the very low end of the income spectrum, increasing the personal exemption has an additional progressive effect. Doing so would increase the number of joint filing households eligible for the state’s low and no-tax status categories, effectively eliminating the income tax obligation for more of the state’s poorest tax filers.

The personal exemption reduced state revenues by \$1.1 billion in FY 2010.<sup>80</sup>

<sup>80</sup> Executive Office for Administration and Finance, Commonwealth of Massachusetts, *Tax Expenditure Budget, Fiscal Year 2010*, (see footnote 3, pg 8-24): <http://www.mass.gov/bb/h1/fy10h1/dnld10/taxexpend10.pdf>

## REVENUE OPTIONS FOR THE PERSONAL INCOME TAX

Several options exist for altering the Commonwealth's income tax laws. Rules laid out in the state constitution determine which options are legally permissible.

Broadly stated, the Massachusetts state Constitution requires that income be taxed at a single rate. There are two "wrinkles," however, to this simplified depiction of state constitutional law. First, the Constitution allows the Legislature to divide income into different categories (or "classes of property" as they are referred to in the state constitution) such as "wage and salary income" or "dividend and interest income." The Constitution then permits these different categories to be taxed at different rates (though all income within a single category must be taxed at a uniform rate).<sup>81</sup> Second, the Constitution permits the Legislature to establish "reasonable exemptions" for each category (an "exemption" being a set amount of income not subject to taxation).

Working within these constitutional parameters, there are permissible changes to current tax law that would result in significant changes to state revenues and/or help to rebalance, if only modestly, the regressive nature of Massachusetts', overall tax system.

The simplest change to the personal income tax laws would be an increase or decrease in the flat tax rate applied to personal income. Currently set at 5.3 percent, if the tax rate on all income were raised (or lowered) by 1 percentage point, *MassBudget* calculations indicate that the Commonwealth's revenues would increase (or decline) by about \$2.0 billion annually.<sup>82</sup> Modeling performed by the Institute on Taxation and Economic Policy (ITEP) indicates that a straight rate change, up or down, would affect taxpayers in all income groups, but an *increase* in the rate would make the overall tax system more progressive, as the tax on income is the state's most progressive major tax. With a straight rate increase, low- and moderate- income taxpayers would see relatively small average tax increases, while upper-income taxpayers would see substantial increases.<sup>83</sup>

The top 20 percent of filers (the top quintile) would provide 67 percent of all additional revenues, with the top 5 percent of earners providing 40 percent of all additional revenues.<sup>84</sup> The lowest and second lowest quintiles would provide just 1 percent and 5 percent, respectively, of all additional revenues resulting from this rate increase.<sup>85</sup>

<sup>81</sup> Massachusetts State Constitution, see Articles of Amendment, Article XLIV: <http://www.mass.gov/legis/const.htm>

<sup>82</sup> The methodology used to produce this estimate (\$2.0 billion) is as follows: Currently, FY 2011 income tax revenues are coming in at rates higher than anticipated in the FY 2011 Consensus Revenue Estimate (CRF). With this in mind, *MassBudget* uses the high-end estimate from the FY 2011 CRF – a figure of \$10.869 billion – from which we deduct the anticipated revenues derived from short-term capital gains as these are taxed at a higher rate of 12.0 percent (and thus would not be subject to an increase from 5.3 percent). The high-end estimate for all capital gains revenues in the FY 2011 CRF is \$892 million. Five-year historical averages indicate that short-term capital gains account for some 13.1 percent of all capital gains revenues or what would be about \$117 million of this high-end FY 2011 capital gains estimate. Deducting this amount from the total income tax revenue estimate (\$10.869 billion) and applying the higher rate (6.3 percent, an increase of one percentage point) to the remaining \$10.752 billion (\$10.869 billion - \$117 million = \$10.752 billion). *MassBudget* arrives at an estimate of additional annual revenues of \$2.029 billion for FY 2011 from the rate increase alone (were this rate to have been in effect in FY 2011).

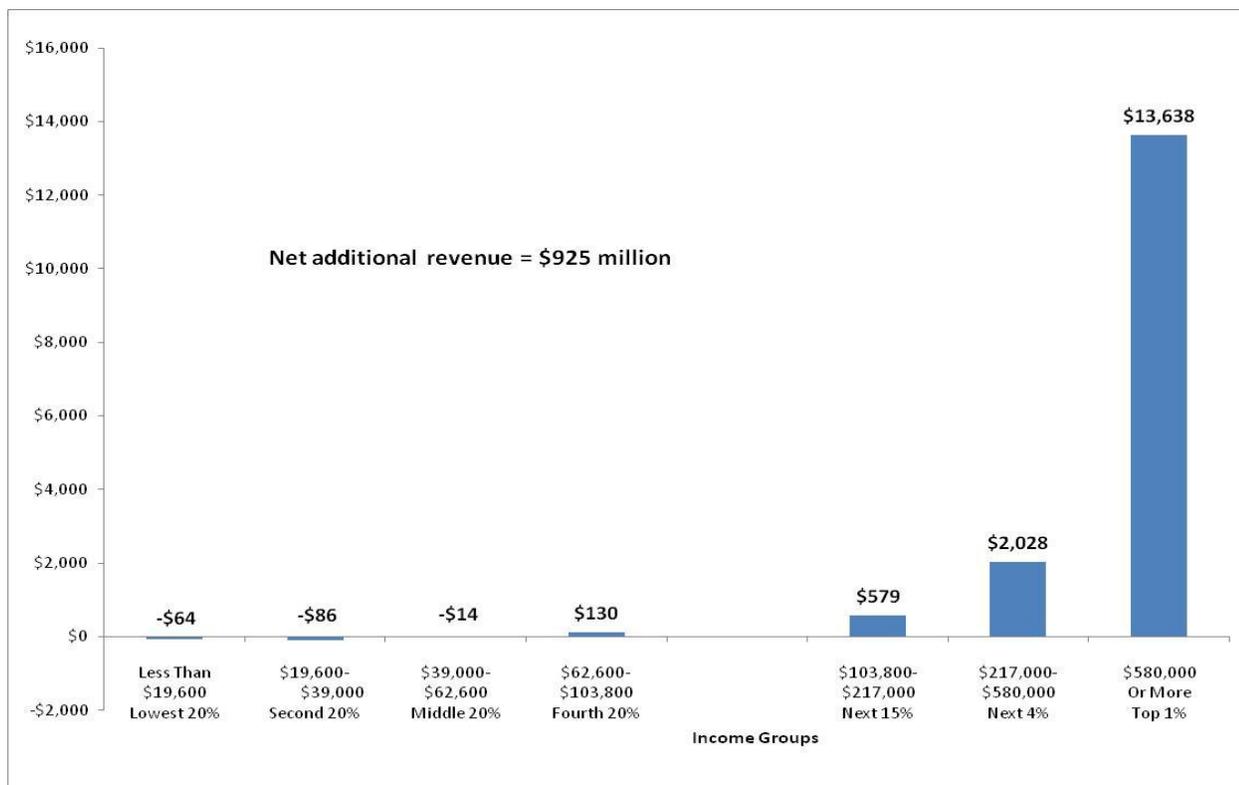
<sup>83</sup> Modeling performed by ITEP, December 2010 (see Appendix H). Many low- and moderate- income taxpayers would not see an increase in their tax bills, though almost all upper- income filers would. DOR-based estimates and ITEP estimates for net additional revenues differ slightly due to differing methodologies. *MassBudget* relies on DOR figures to provide a more accurate gauge of likely actual collections.

<sup>84</sup> *Ibid.*

<sup>85</sup> *Ibid.* ITEP estimates that less than a third of the state's lowest-income taxpayers would see any increase (and on average these would be quite small), while 98 percent of filers in the top quintile would see an increase (which, on average, would be quite substantial).

Another option would be to combine an increase in the personal income tax rate with an increase in the personal exemption amounts -- again, a change permissible under the current state Constitution. Taking this approach, the Commonwealth could generate additional revenue while also increasing the progressivity of the overall tax system *and* the personal income tax itself.

**Figure 18. Average Tax Increases/Decreases Resulting from Raising Income Tax Rate to 6.3% (from Current 5.3% Rate) and Doubling the Personal Exemption Amounts (2010)**



Raising the income tax rate to 6.3 percent (from the current 5.3 percent rate) while simultaneously doubling the personal exemption (to \$8,800 for an individual and \$17,600 for joint filers) would increase state revenues by approximately \$925 million annually.<sup>86</sup> Most low- and moderate-income

<sup>86</sup> Distributional effects based on analysis performed by the Institute on Taxation and Economic Policy (ITEP), December 2010 (see Appendix H).

Using methodology explained in footnote 82, above, *MassBudget* estimates that a one point increase in the income tax from 5.3 percent to 6.3 percent would raise \$2.029 billion. From this subtotal (\$2.029 billion) we then deduct the revenue losses resulting from higher personal exemption (PE) amounts. Using DOR estimates of revenue losses from the current PEs (see FY 2010 Tax Expenditure Budget (TEB), pg 8-24, footnote 3: <http://www.mass.gov/bb/h1/fy10h1/dnld10/taxexpend10.pdf>), we assume that the losses would not quite double with a doubling of PE value, as some people who now use all or only some of the total credit would not be able to take advantage of the full increase in tax reduction. We assume that only 95 percent of the additional PE benefit actually would be used, giving us a direct PE subtotal loss of \$1.068 billion (including an additional \$170 million loss above that derived from directly adjusting DOR's estimates, due to the now one percentage point higher tax rate). Similarly, the DOR estimates provided in the TEB for revenue losses related to No Tax Status and Low Income Credit (same page in TEB) would likely increase were the PE values to increase. *MassBudget* assumes that a doubling of the PE values would increase these combined revenue losses by 100 percent, for a net additional loss of \$35 million. The net annual revenue gain from this combined set of changes (increasing the rate to 6.3 percent while doubling PE values) thus would be \$926million (\$2,029 million - \$1068 million - \$35 million = \$926 million).

Absent the availability of official revenue growth projections for FY 2012 (which will be released in mid-December with the FY 2012 Consensus Revenue Forecast), *MassBudget* does not adjust this FY 2011-based estimate to reflect potential revenue growth (or inflation adjustments) in FY 2012.

taxpayers would see modest decreases in their tax bills while upper-income filers would see increases (see Figure 18, above).

Under this scenario – an income tax rate increase to 6.3 percent combined with a doubling of the personal exemption amounts – almost three-quarters (73 percent) of the additional revenue would come from households in the top 5 percent of the income distribution (households with annual income above \$217,000, using 2010 income estimates).<sup>87</sup> Close to half (46 percent) of the additional revenue would come from households in the top 1 percent of the income distribution (households with annual income above \$580,000).<sup>88</sup>

By collecting more taxes from households with the highest incomes, this scenario would help to reduce the regressivity of the overall tax system in Massachusetts. Even with these changes, however, low-income households would continue to pay a much larger share of their income (9.2 percent) toward state and local taxes than would households with high incomes (6.8 percent) (see Figure 19). High-income households also would receive substantial reductions in their federal taxes based on the state income and local property taxes they would pay, an element of the federal tax code from which most low-income households derive no benefit.<sup>89</sup>

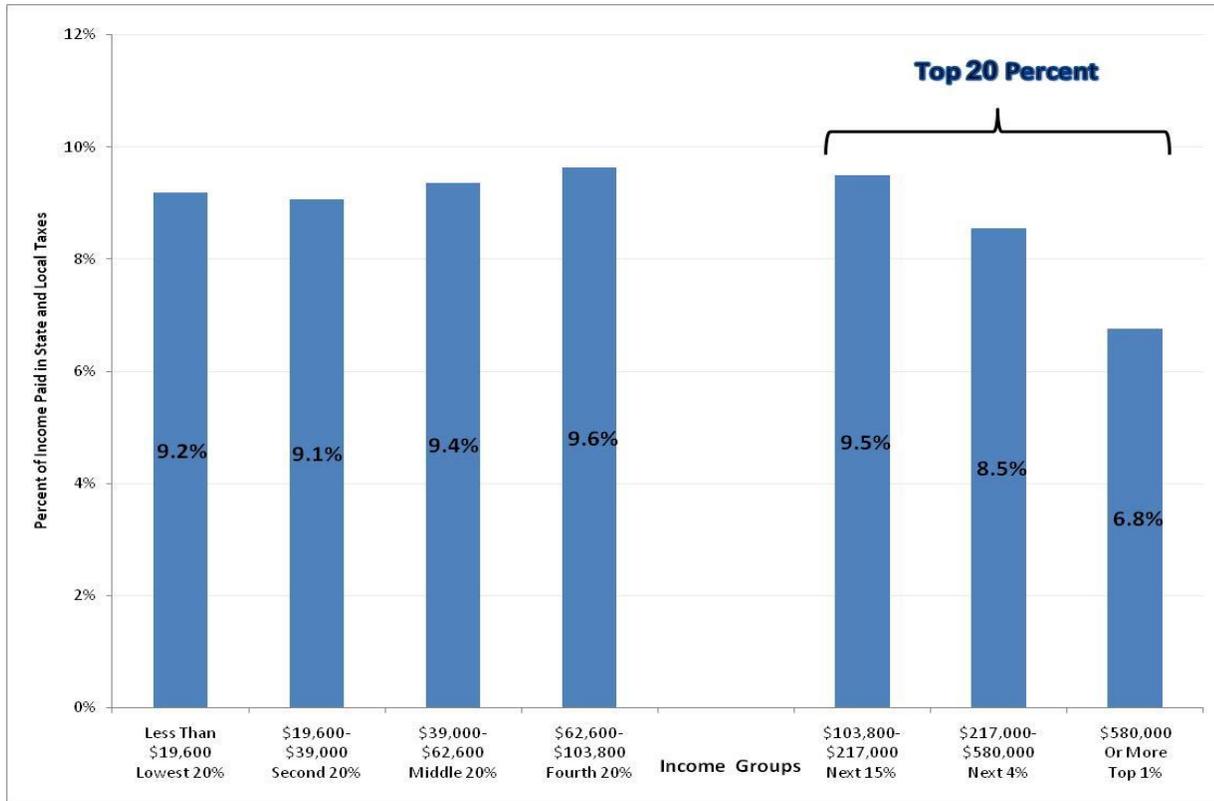
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<sup>87</sup> Distributional effects based on analysis performed by the Institute on Taxation and Economic Policy (ITEP), December 2010 (see, Appendix H)

<sup>88</sup> Ibid. Average annual incomes of households in the top 1 percent stood at \$1.84 million in 2010.

<sup>89</sup> *MassBudget* calculations based on ITEP distributional analysis, provided to *MassBudget* December 2010 (see Appendix H).

Figure 19. With Income Tax Rate Increase to 6.3 Percent & Doubling of Personal Exemptions, MA Tax System Remains Regressive (2010)

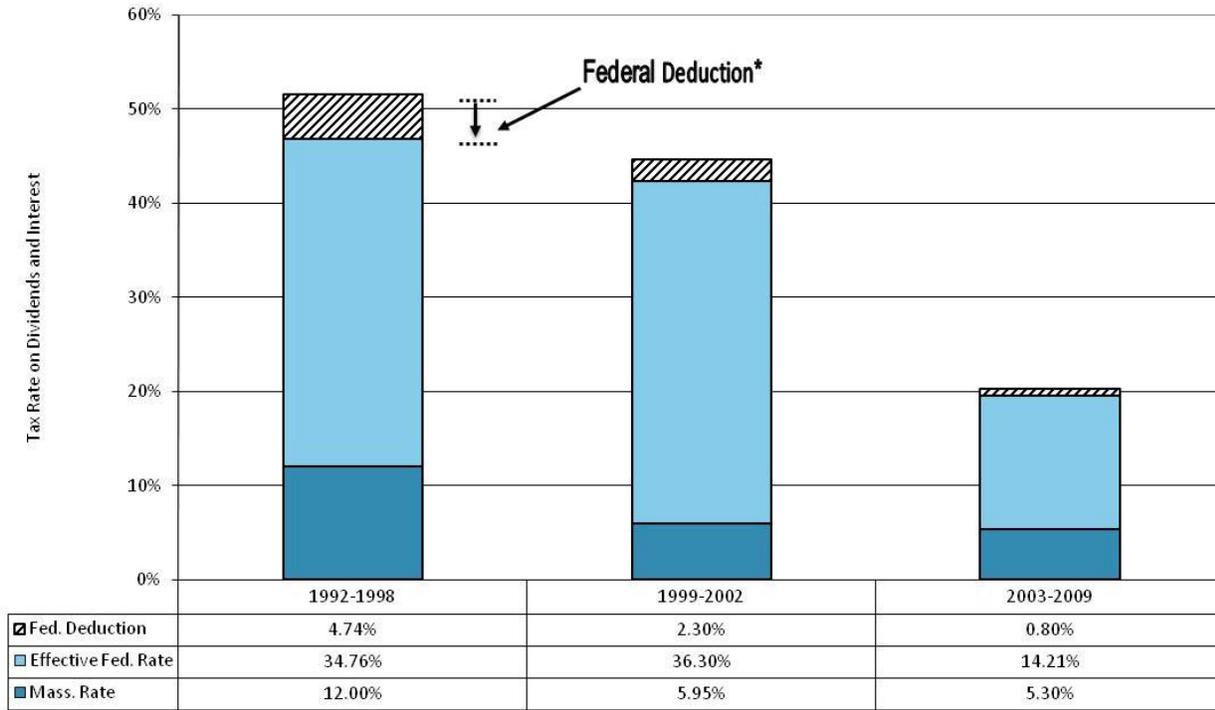


### THE DIVIDEND & INTEREST TAX

After the above review of the income tax in general, we now take a closer look at the taxes applied to a particular type of personal income, dividend and interest income (D&I).

Massachusetts law recognizes -- and taxes -- several separate categories of personal income. Wage and salary income is the category with which most people are familiar. Another type of personal income is "dividend and interest income." While wage and salary income is direct payment for work performed by an individual, dividend and interest income is the return an individual receives from certain types of investments. Dividends are the portion of corporate profits paid out to a company's shareholders. Interest income is the income derived from investments like savings accounts and certificates of deposit. As explained below, the manner in which the state taxes dividend and interest income has significant implications for the overall progressivity of the state tax system.

**Figure 20. Combined Federal & Massachusetts Dividend & Interest Tax Rates (with Downward Adjustment for Federal Deduction Shown), 1992-2009**



\* The federal deduction reduces a filer's federal tax liability based on the amount of state taxes the filer paid

Currently, Massachusetts taxes dividend and interest income at the same rate as wage and salary income (5.3 percent).<sup>90</sup> As recently as 1998, however, dividend and interest income was taxed at 12 percent in Massachusetts, a rate more than twice that applied to wage and salary income at that time (and the rate still applied to short-term capital gains). In Figure 20 above, we see that the combined effective federal and state tax rate on dividend and interest income has been cut more than in half since 1998 (reduced from over 46 percent to 19.5 percent).<sup>91</sup>

In 2006 (the latest year for which DOR has complete data), Massachusetts individuals received some \$12.4 billion in income from dividends and interest on which state tax was due.<sup>92</sup> Massachusetts collected approximately \$658 million in taxes on this dividend and interest income.<sup>93</sup> It should be noted that during recessions (like the one we currently are in), dividend and interest income tends to drop sharply, with related tax collections on this income declining as a consequence.

<sup>90</sup> All but seven other states levy some form of tax on dividend and interest income.

<sup>91</sup> An "effective tax rate" is a term used to describe the total, overall rate a tax filer actually pays once all the deductions, exemptions and other special tax treatments are taken into account. As in the case shown in Figure 17, the effective tax rate typically is lower than the official tax rate.

<sup>92</sup> Data provided by the Massachusetts Department of Revenue (see Appendix F).

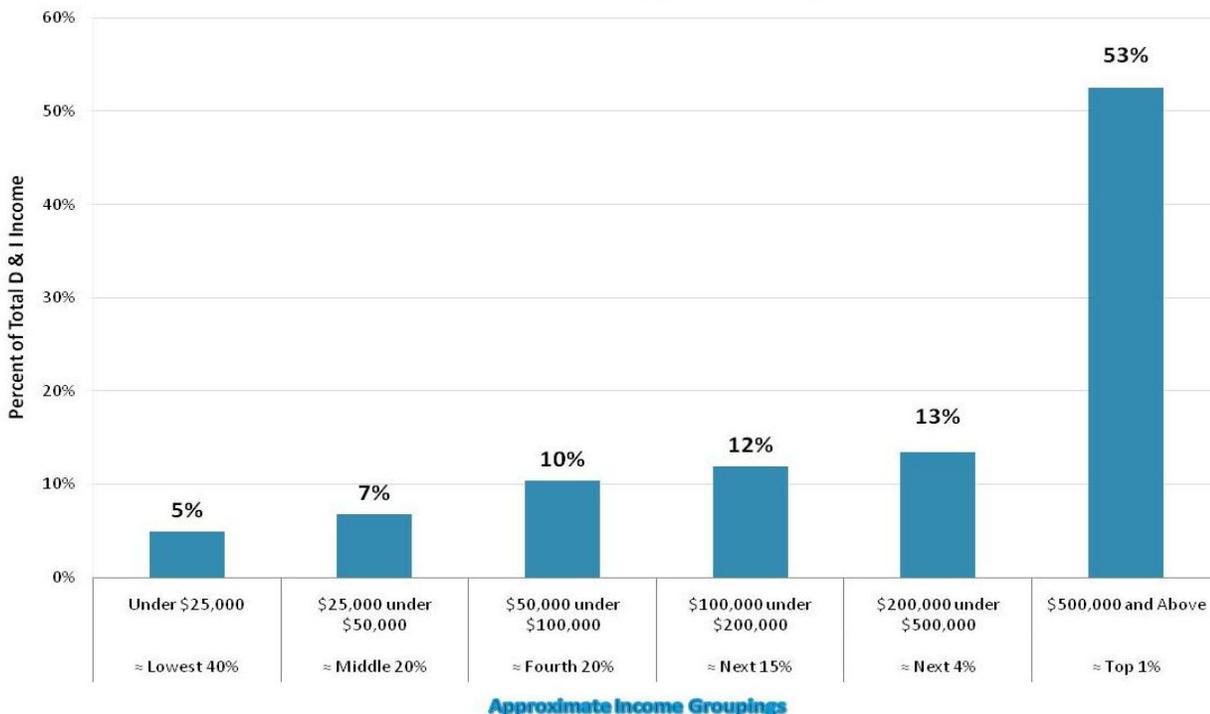
Certain types of dividend and interest income are not taxed at the state level and therefore are not included in these figures. IRS data show that MA residents reported \$13.6 billion in total dividend and interest income to the federal government in 2006, well above the total amount on which MA state taxes were collected.

<sup>93</sup> *MassBudget* calculation at 5.3 percent tax rate. Data provided by the Massachusetts Department of Revenue (see Appendix F).

PROGRESSIVITY OF THE DIVIDEND AND INTEREST TAX

As shown in Figure 21 below, most dividend and interest income goes to people at the high end of the income scale. In 2006, 53 percent (some \$6.6 billion) of all taxable dividend and interest income in Massachusetts (\$12.4 billion) went to filers with incomes of \$500,000 or higher, people in approximately the top one percent of the income distribution.<sup>94</sup>

**Figure 21. The Large Majority of Dividend & Interest Income in Massachusetts Goes to Filers with High Incomes (2006).**



These filers (with annual incomes of \$500,000 and more) represented less than one percent (0.8 percent) of all Massachusetts tax filers.<sup>95</sup> Filers with incomes of \$1 million or more took in over 44 percent of all D & I income in 2006, some \$5.5 billion.<sup>96</sup> Sixty-six percent (or two-thirds) of all taxable income from dividends and interest collected by Massachusetts filers in 2006 went to the roughly 5 percent of filers with incomes over \$200,000.<sup>97</sup>

<sup>94</sup> *MassBudget* calculations based on MA DOR data for 2006 (the most current, complete data available from DOR, see Appendix F). The “approximate income groupings” shown in Figure 21 are based on ITEP modeling of 2009 income groups with adjustments made for inflation. They are, however, only rough approximations.

<sup>95</sup> *MassBudget* calculations based on MA DOR data (see Appendix F).

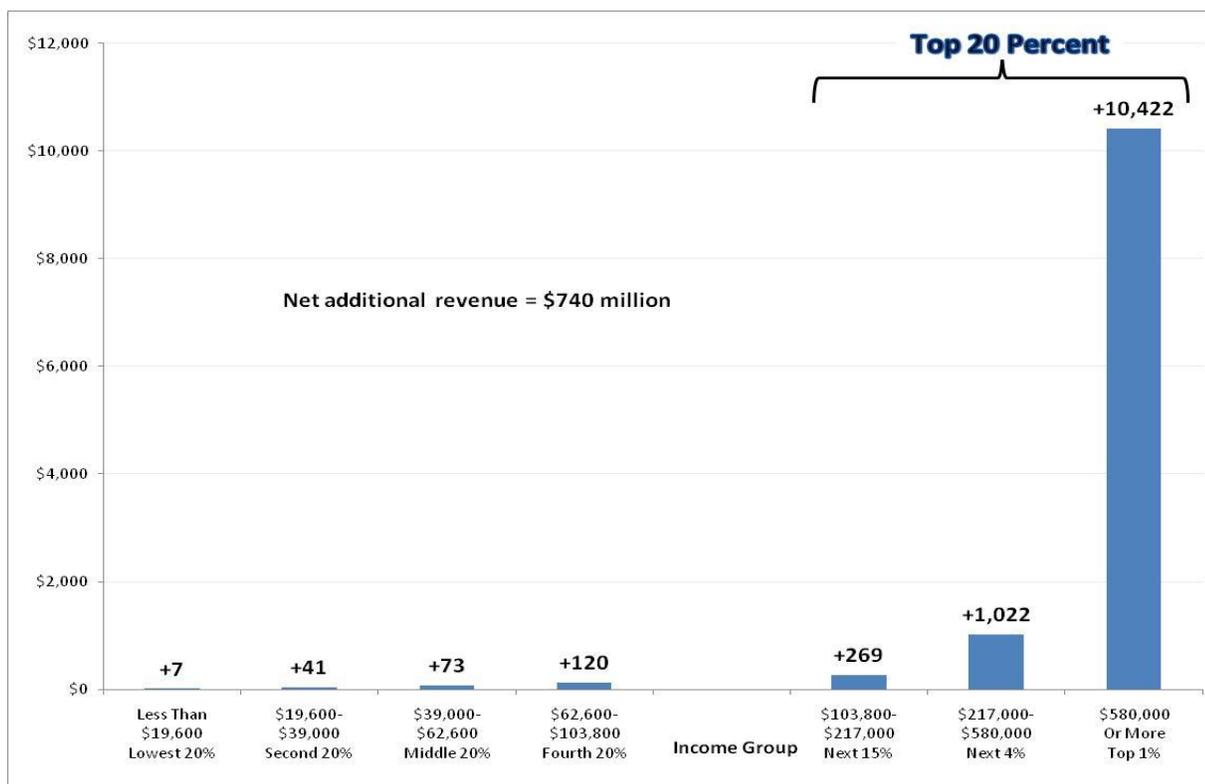
<sup>96</sup> *Ibid.*

<sup>97</sup> *Ibid.*

The “approximate income groupings” shown in Figure 21 are based on ITEP modeling of 2009 income groups with adjustments made for inflation (DOR does not provide such fine-grained distributional analysis to accompany this data). The groupings are, however, only rough approximations. Using these rough income groups, we can see that filers with incomes above \$500,000 enjoy more than four times the D & I income of filers with incomes between \$200,000 and \$500,000, of whom there are four times as many. This means that the top 1 percent of filers, on average, are enjoying more than 16 times as much D & I income per filer than even those filers in the next highest income group. The wealthiest 1 percent of filers, on average, received more than 424 times as much D & I income per filer in 2006 than did filers in the lowest 40 percent of incomes.

Working with 2010 income and economic data, estimates produced by the Institute on Economic and Taxation Policy (ITEP) indicate that restoring the D & I rate to the rate in effect before the 1998 cut (i.e., raising the rate back up to 12 percent) would have very different effects on Massachusetts tax filers depending on their income. On average, those in the lowest 95 percent of incomes would see reasonably modest increase in their annual D & I taxes (from \$7 to \$269), while those in the top 5 percent would see larger increases (see Figure 22, below).<sup>98</sup> Those filers in the top 1 percent of incomes would see an average increase of more than \$10,000 in their annual D & I taxes.

**Figure 22. Average Tax Increase from Raising Dividend & Interest Tax Rate to 12% (from Current 5.3%), 2010**



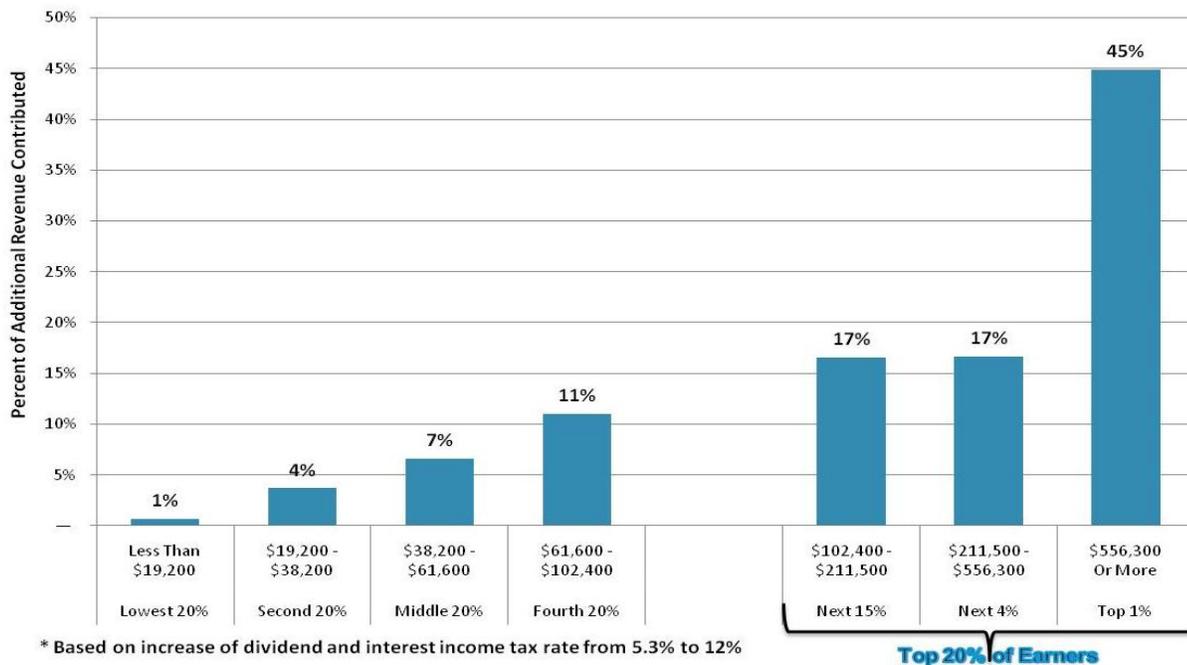
Clearly, the large majority of dividend and interest income goes to those with high incomes, and tax changes that affect this type of income will impact those with the highest incomes most heavily. At the same time, looking more broadly at the regressive overall structure of the Massachusetts tax system, we see that those with high incomes pay less of their total income in taxes than do people with low incomes (for a more complete explanation of “regressive” and “progressive” tax structures, please see the discussion of vertical equity in Chapter One of this primer). Restoring the higher rate (12 percent) would make the overall system flatter, with lower- and higher-income people paying a somewhat more similar percentage of their incomes toward state and local taxes.

<sup>98</sup> Modeling performed by ITEP upon request by *MassBudget*, December 2010 (see Appendix H).

REVENUE OPTIONS FOR DIVIDEND AND INTEREST INCOME TAXES

Working with 2010 income and economic data, ITEP has modeled the effects of restoring the 12 percent dividend and interest rate that was in place until the rate cut of 1998. ITEP estimates that the Commonwealth would collect an additional \$740 million annually from this change.<sup>99</sup> Almost half of the additional revenue would come from the top 1 percent of earners, those taxpayers with incomes of \$556,300 or more, who also are the people currently paying the least of their income in taxes (see Figure 23).<sup>100</sup> Eighty percent of additional revenues would come from the top 20 percent of earners (taxpayers with incomes of \$102,400 or more).<sup>101</sup> Just 12 percent of additional revenue would come from the bottom 60 percent of Massachusetts earners, those with incomes of \$61,600 or less (who also are the people currently paying the largest share of their income in state and local taxes).<sup>102</sup> Thus, by raising more revenue from income that is enjoyed largely by upper-income earners, a straight tax rate increase on dividend and interest income would make the overall Massachusetts tax structure less regressive.

**Figure 23. With an Increase of the Dividend & Interest Tax Rate to 12%, Close to Half of All Additional Revenues Would Be Collected from the Top 1 Percent**



A second approach would be to raise the rate while also creating a significant exemption specifically for dividend and interest income.<sup>103</sup> This approach would generate less additional revenue than a straight increase in the tax rate (described above). However, the additional revenue generated by this second approach would come overwhelmingly from those with the very highest incomes. The number

<sup>99</sup> Modeling performed by ITEP upon request by *MassBudget*, December 2010 (see Appendix H).

<sup>100</sup> *Ibid.*

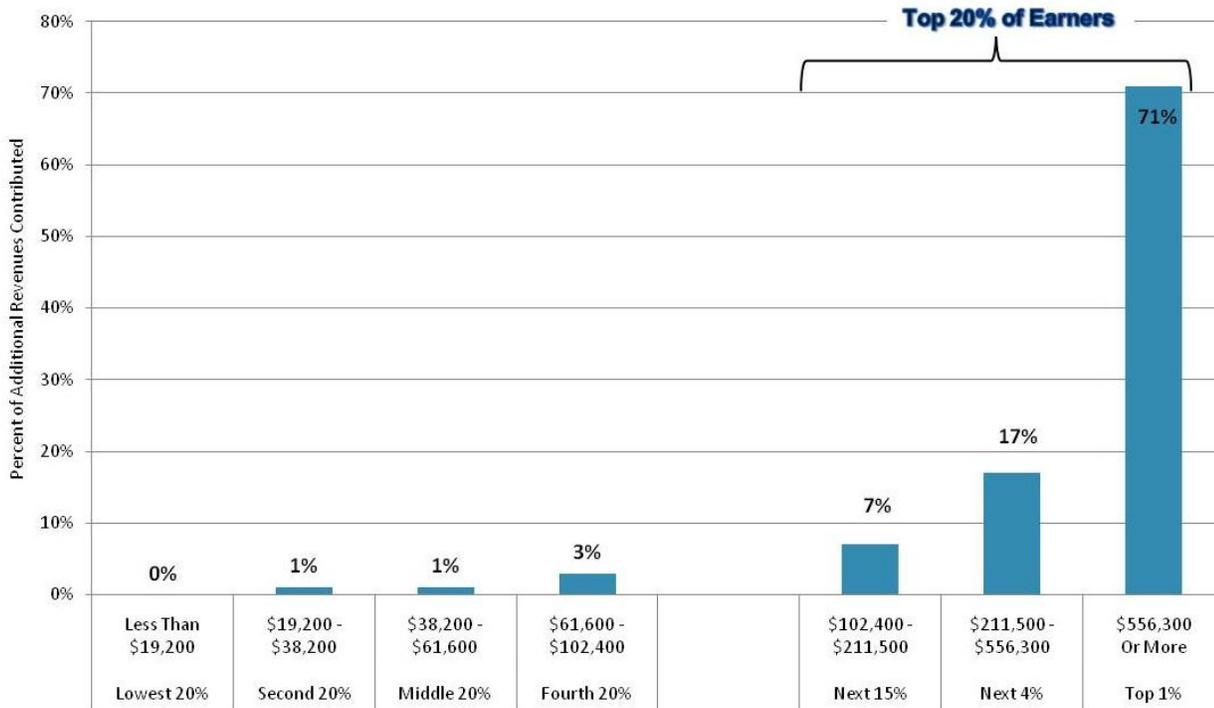
<sup>101</sup> *Ibid.*

<sup>102</sup> *Ibid.*

<sup>103</sup> A tax exemption is a fixed amount of income that is not subject to taxation. The state constitution allows for the creation of “reasonable” exemptions, the argument being that some limited amount of income is necessary in order to pay for basic living expenses, and that the state can reasonably exempt this “essential income” from taxation.

of possible combinations of exemption amounts and tax rate increases is nearly limitless, but we look at the effects of one such combination, modeled by ITEP, below in Figure 24.

**Figure 24. With a Higher D&I Rate and New D&I Exemptions,\* the Top 1 Percent of Earners Pay 71% of All Additional Revenues Collected**



\* Models an increase in the D&I income tax from 5.3% to 12% in combination with an exemption for D & I income of \$2500 for single filers and \$5000 for married couples filing jointly

ITEP modeling suggests that the state would collect about \$465 million annually in additional revenue if an exemption for dividend and interest income of \$2,500 per filer (\$5,000 for married couples filing jointly) were combined with a tax rate increase from the current 5.3 percent to 12 percent.<sup>104</sup> Under this scenario, approximately 70 percent of the additional revenues would come from those residents in the top 1 percent of income earners, and some 95 percent of additional revenues would come from the top 20 percent of filers.<sup>105</sup> Again, such a change would reduce the overall regressivity of the current Massachusetts tax system. People in the lowest 80 percent of incomes would see, on average, very small changes in their dividend and interest taxes with this reform, ranging from small tax decreases of several dollars to small increases of \$24 or less.<sup>106</sup> People in the top 5 percent of incomes would see average tax increases of \$64 to more than \$9,600 (for the top 1 percent), with the tax increase rising along with rising income.<sup>107</sup>

<sup>104</sup> Modeling performed by ITEP upon request by *MassBudget*, December 2010 (see Appendix H). This estimate of \$465 million in additional annual revenue is a *MassBudget* calculation based on a combination of ITEP models, using both 2009 and 2010 income data (see note in Appendix H).

ITEP estimates that, due to the federal deduction for state taxes paid, the actual net cost to Massachusetts taxpayers would be some \$65 million - \$75 million less than the \$465 million figure presented here.

<sup>105</sup> See Appendix E. These figures are based on ITEP modeling that uses 2009 income data. Given the relatively small changes in income brackets and in the estimated net revenue gain, we assume the relative share of additional taxes that would come from each quintile remains roughly constant under the 2009 and 2010 income models.

<sup>106</sup> *Ibid.*

<sup>107</sup> *Ibid.*

## CHAPTER 5: THE GENERAL SALES TAX

After the personal income tax (see Chapter 4), the general sales tax produces the second largest share of tax revenue for the Commonwealth, accounting for 18.7 percent (some \$4.1 billion) of state-only tax revenue in FY 2008.<sup>108</sup>

In Chapter Five, we take a closer look at the sales tax, examining how it meets the relevant assessment criteria described in Chapter One; provide a history of the sales tax; discuss how the sales tax has changed over time and the effect these changes have had on state revenue collections; and compare Massachusetts to the US and to other states with regards to the amount of revenue raised through the sales tax. We also include a detailed discussion of the effect that growing Internet sales have had on overall sales tax collections, and discuss various “revenue options” for recapturing some of these lost revenues.

### OVERVIEW OF THE SALES TAX

As part of the total state and local tax system in Massachusetts, the Commonwealth collects a general sales tax. The sales tax is applied to the sale of most tangible goods. In Massachusetts, most non-essential items are subject to the sales tax. Most food, clothing, health care items, and home energy supplies are not subject to the tax.

One rationale behind the sales tax is that business transactions (sales) depend in part on the public structures and systems maintained by state government. A successful business sector requires functioning highways, courts, departments of public safety, educated citizens and much more. From this perspective, the sales tax is, in part, a way to ensure that the economic activities supported by government expenditures help to pay for these public programs and services.

The current rate in Massachusetts for the sales and use tax is 6.25 percent of the value of the item purchased. The rate was raised in 2009 from 5 percent to the present 6.25 percent. Typically, collection of sales taxes is performed by vendors (the business from which you purchased an item) on behalf of the Commonwealth at the time of sale. Once collected, these taxes then are transferred (or “remitted”) back to the state (individual taxpayers, by contrast, typically are responsible for paying “use taxes” directly to the state).<sup>109</sup>

#### *STABILITY OF THE SALES TAX AS A REVENUE SOURCE*

The general sales tax tends to be a stable tax. While purchases of items covered by the general sales tax tend to decline during economic recessions, purchases do not decline as rapidly as incomes; typically,

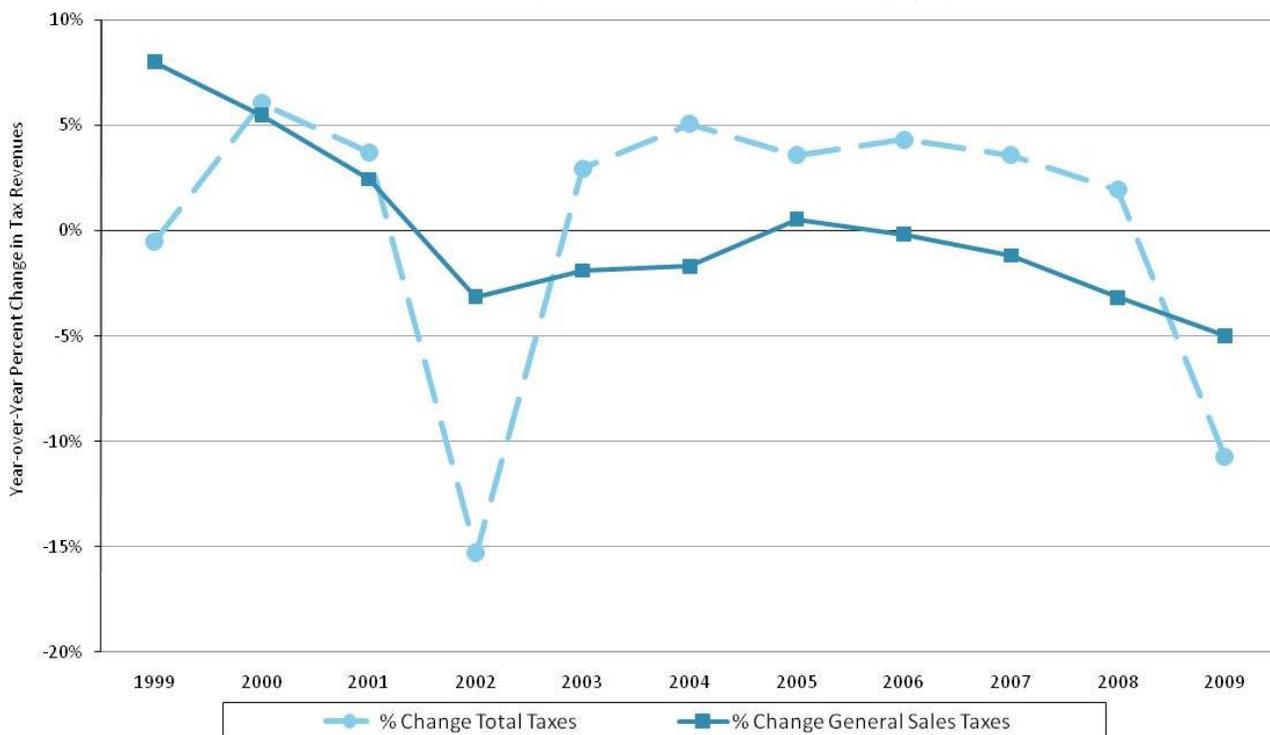
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<sup>108</sup>U.S. Census Bureau, *State and Local Government Finances by Level of Government and by State: 2007-08*. The 2007-08 Census data is the most recent available: <http://www.census.gov/govs/estimate/>. FY 2009 data from the Massachusetts Department of Revenue (not available for all states) show that \$3.9 billion was collected in general sales taxes, or 21 percent of state-only tax revenue in that year.

<sup>109</sup>Closely related to the sales tax is the “use tax” (together, the two often are referred to as “the sales and use tax”). Use taxes are applied to goods and services that normally would be subject to the sales tax but that, for various reasons, go partially or completely untaxed. A common example would be goods purchased out-of-state but intended for use in the Commonwealth. These items escape Massachusetts sales taxation, and therefore a use tax on these purchases is due. Use taxes also apply to in-state rentals of some kinds of tangible property (DVD rentals or office furniture rentals, for example). Use taxes can be thought of as a method for collecting sales taxes on appropriate items regardless of where or how residents of the Commonwealth acquire these items. Because the use tax relies on self-reporting (while the sales tax is collected by retailers at the time of sale), it often goes unpaid.

consumers continue to purchase taxed items, even during downturns. In terms of revenue collections, the sales tax therefore is a fairly predictable tax. Once the rate is set, the general sales tax tends to produce a predictable amount of revenue over the short term. As shown in Figure 25, while recessions in FY 2002 and FY 2009 produced sharp declines in overall tax collections (dashed line), the corresponding declines in sales tax revenue were much less dramatic (solid line).<sup>110</sup>

**Figure 25. Generally, Year-over-year Percent Change is Smaller for Sales Tax Revenues Than for Total Tax Revenues (MA, Fiscal Years 1999-2009, Inflation Adjusted)**



Annual growth in sales tax revenues, however, continues to diminish. Over the last few decades, more of the economy has moved to the service sector (the purchase and sale of services rather than goods), much of which currently is not subject to the sales tax. There are also more sales taking place between Massachusetts residents and out-of-state sellers, usually through the Internet, and these sales often go untaxed. The result is that sales tax collections are becoming a less reliable source of revenue for the Commonwealth.

*ISSUES OF EQUITY WITH THE SALES TAX*

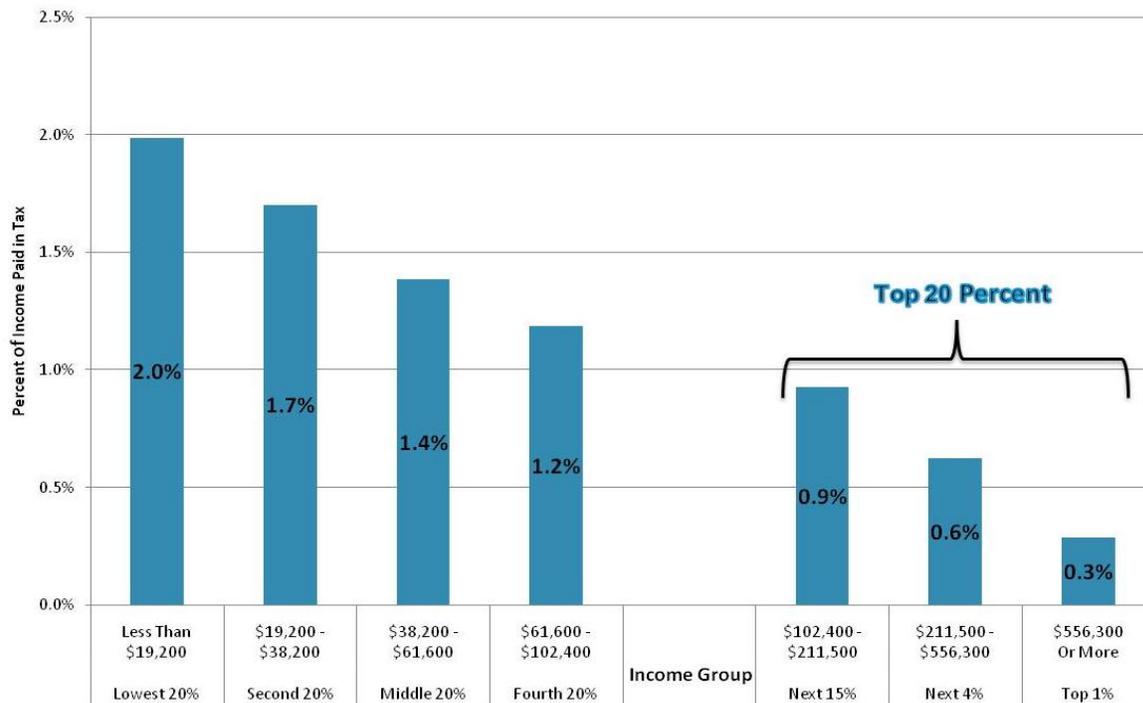
There are some significant problems with the sales tax when it comes to fairness. The Institute on Taxation and Economic Policy finds that, on average, in 2009 Massachusetts taxpayers in the lowest 20 percent of incomes paid 2.0 percent of their incomes in direct general sales taxes.<sup>111</sup> The share of

<sup>110</sup> US Census, *State Government Tax Collections*: <http://www.census.gov/govs/statetax/>  
 During this period, Massachusetts enacted a number of changes to sales tax law. The effects of these changes on collections, however, were small, both individually and cumulatively. They do not alter substantively, therefore, the percent change figures presented in corresponding figure.

<sup>111</sup> Modeling performed by ITEP upon request by *MassBudget*, March 2010 (see Appendix E). “Direct” general sales taxes do not include sales taxes initially paid by businesses but ultimately passed along to consumers through higher prices for goods and services.

income going to direct general sales taxes drops off steadily as income rises, with the top one percent paying only 0.3 percent of their total income toward these taxes (see Figure 26). This can be explained by the difference between the consumption patterns of low- vs. high-income taxpayers. People with low incomes usually must spend all of their income in order to make ends meet (or even more than their total income in some years if borrowing and use of savings is taken into account). This means that much of their income becomes subject to the sales tax through the purchases they make. People with high incomes, by contrast, typically spend only a portion of their income, saving or investing the remainder.

**Figure 26. Low-Income Massachusetts Taxpayers Pay Far More of Their Income in Direct General Sales Taxes Than Do High-Income Taxpayers, 2009**



*A BRIEF HISTORY OF THE MASSACHUSETTS GENERAL SALES TAX*

Massachusetts did not adopt a state general sales tax until 1966. Of the 46 states that have a sales tax, only three adopted the tax later than Massachusetts. Massachusetts has always had a relatively generous set of exemptions from the sales tax, designed to reduce the tax’s regressivity. These exemptions include food, clothing (items valued up to \$175), prescription drugs, and home energy sales. The current state sales tax rate is 6.25 percent, increased from 5 percent in 2009.

*HOW MASSACHUSETTS MEASURES UP IN GENERAL SALES TAXES*

The latest year for which the US Census has complete national data is FY 2008 and these data therefore do not reflect the tax changes enacted in 2009. Using the 2008 data, Massachusetts collected \$4.1 billion in general sales taxes or 18.7 percent of state-only tax revenues, the second-largest source of tax revenue for the Commonwealth.<sup>112</sup> This \$4.1 billion was 12.1 percent of combined state and local taxes,

<sup>112</sup> U.S. Census Bureau, *State and Local Government Finances by Level of Government and by State: 2007-08*. The 2007-08 Census data is the most recent available: <http://www.census.gov/govs/estimate/>

and 8.6 percent of state and local own-source revenue.<sup>113</sup> In Massachusetts, this tax was collected entirely at the state level.

In the 50 states, general sales taxes made up 22.9 percent of state and local tax revenue and 15.7 percent of state and local own source revenue. States collected 79.2 percent of this general sales tax revenue. Localities collected the remaining 20.8 percent.<sup>114</sup>

As noted, Massachusetts' state sales tax rate is now 6.25 percent. This rate is similar to other southern New England states but higher than rates in northern New England. There is a range in state-level general sales tax rates across the rest of the US as well. California, for example, has a rate of 8.25 percent while some states have rates of 4 percent or lower.<sup>115</sup>

Tax rates themselves, however, are not an especially useful measure by which to compare the actual impact of taxes in different states. While only 12 states have state-level general sales tax rates equal to or higher than Massachusetts,<sup>116</sup> a number of factors make the impact of the Massachusetts general sales tax much smaller than in most other states:

- Massachusetts exempts many necessities from the general sales tax (including most food, clothing, prescription medicine, and home energy purchases).
- Massachusetts applies the general sales tax to far fewer services (as opposed to “tangible goods”) than do many other states.<sup>117</sup>
- Massachusetts allows very little “add on” sales tax revenue to be collected at the local level through local option sales taxes.<sup>118</sup> (Unlike New York, for example, which has a 4 percent state sales tax with local option sales taxes of 3 to 5 percent added on top of the state tax, for a combined average rate of 8.3 percent.)<sup>119</sup>

The result of these features is that in Massachusetts a much smaller percentage of personal income is spent on general sales taxes than in most other states. General sales tax revenue in Massachusetts was equal to 1.2 percent of personal income in FY 2008, placing the Commonwealth at a rank of 45<sup>th</sup> out of 46 states that levy a general sales tax (see Figure 27).<sup>120</sup>

<sup>113</sup> Ibid.

<sup>114</sup> Ibid.

<sup>115</sup> Ibid. Four states (including New Hampshire) have no state-level general sales tax.

<sup>116</sup> Ibid.

<sup>117</sup> Federation of Tax Administrators, July 2008 Bulletin: <http://www.taxadmin.org/fta/pub/services/btn/0708.pdf>

The Center on Budget and Policy Priorities estimates that Massachusetts forgoes hundreds of millions -- if not billions -- of dollars annually in potential sales tax revenue as a result of excluding so many commonly taxed services from its general sales tax (July 2009):

<http://www.cbpp.org/files/8-10-09sfp.pdf>

<sup>118</sup> Along with the change in Massachusetts law that increased the state sales tax from 5 percent to 6.25 percent, localities were permitted to adopt both a “local option” tax of 0.75 percent on meals and raise their hotel room tax from 4 percent to 6 percent. As of November 2009, less than 20 percent of communities had adopted the increases. Massachusetts DOR Website:

[http://www.mass.gov/Ador/docs/dls/publ/bull/2009/2009\\_15B.pdf](http://www.mass.gov/Ador/docs/dls/publ/bull/2009/2009_15B.pdf)

[http://www.mass.gov/?pageID=dorterminal&L=4&L0=Home&L1=Businesses&L2=Current+Tax+Year+Information&L3=Recent+Tax+Chan](http://www.mass.gov/?pageID=dorterminal&L=4&L0=Home&L1=Businesses&L2=Current+Tax+Year+Information&L3=Recent+Tax+Changes%3a+Sales%2c+Meals+%26+More&sid=Ador&b=terminalcontent&f=dor_budget_updateFY2010&csid=Ador)

[ges%3a+Sales%2c+Meals+%26+More&sid=Ador&b=terminalcontent&f=dor\\_budget\\_updateFY2010&csid=Ador](http://www.mass.gov/?pageID=dorterminal&L=4&L0=Home&L1=Businesses&L2=Current+Tax+Year+Information&L3=Recent+Tax+Changes%3a+Sales%2c+Meals+%26+More&sid=Ador&b=terminalcontent&f=dor_budget_updateFY2010&csid=Ador)

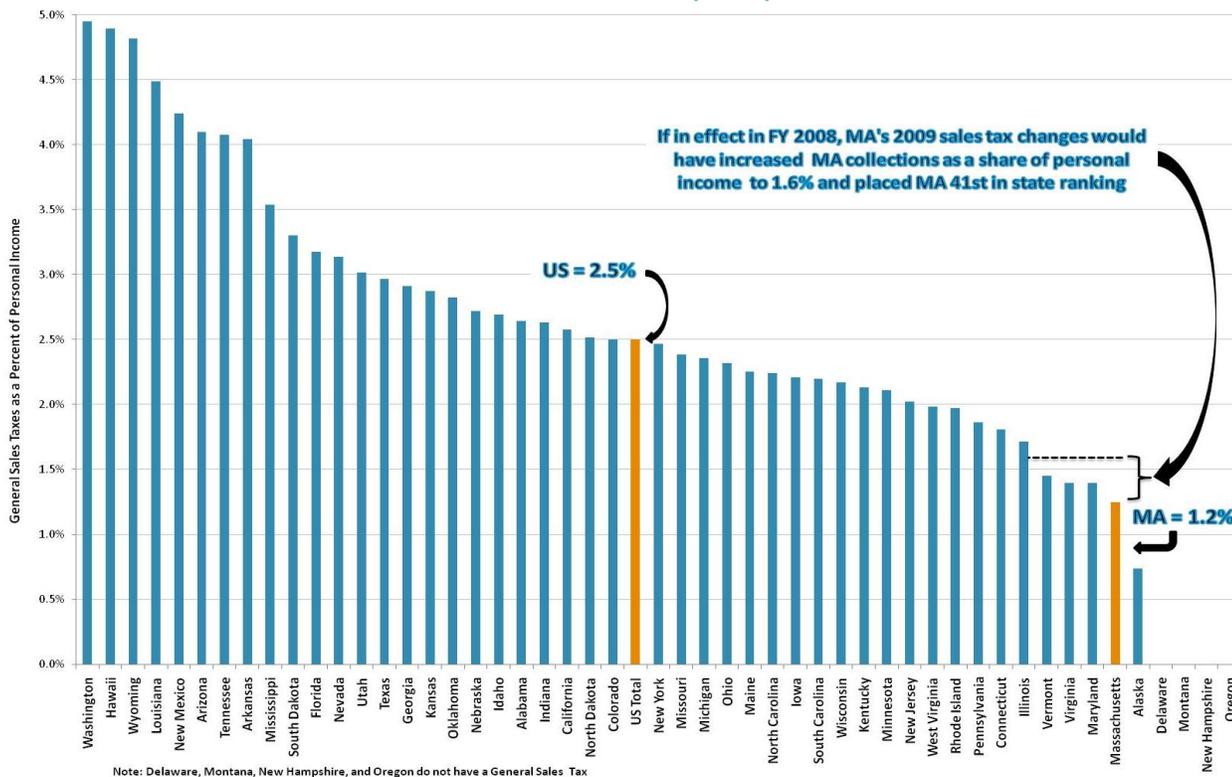
<sup>119</sup> Tax Foundation, *Updated State and Local Option Sales Tax*, October 2009: <http://www.taxfoundation.org/files/ff196.pdf>

In another Tax Foundation report (“Major Metropolitan Area Sales Tax Rates,” August 19, 2010) Boston is found to be among the cities with the lowest overall sales tax rates (see Tables 2 and 3):

<http://www.taxfoundation.org/publications/show/26622.html>

<sup>120</sup> In addition to the design features of the Massachusetts general sales tax that tend to reduce its impact on households (including exempting many necessities from the tax, excluding many services from the tax, and limiting local option taxes), Massachusetts also has high levels of personal income relative to other states which means that sales taxes as a share of income tends to be lower in Massachusetts than in other states.

**Figure 27. Compared to Other States, People in Massachusetts Pay Very Little of their Personal Income Toward State & Local General Sales Taxes (2008)**



These 2008 data, however, do not take into account the sales tax increases enacted in 2009. Had the 2009 general sales tax rate of 6.25 percent been in effect in FY 2008 (along with the changes to the meals tax rate and taxation of alcoholic beverages, discussed below), general sales tax revenue in Massachusetts as a percent of personal income would have been slightly higher, equaling 1.6 percent of personal income.<sup>121</sup> This increase would have shifted the Commonwealth’s ranking from 45th to 41st among all states. Collectively, in all 50 states, general sales taxes accounted for 2.5 percent of personal income in FY 2008. Four states have no general sales tax (and Alaska has only local option general sales taxes).

*EFFECT OF GENERAL SALES TAX CHANGES IN MASSACHUSETTS*

In 2009, Massachusetts revised its sales tax laws. Among the more important changes, the general sales tax rate was raised from 5 percent to 6.25 percent and alcoholic beverages were made newly subject to the general sales tax (separate from the longstanding *selective* sales tax already applied to alcoholic

U.S. Census Bureau, *State and Local Government Finances by Level of Government and by State: 2007-08*. The 2007-08 Census data is the most recent available: <http://www.census.gov/govs/estimate/>

State personal income data is drawn from US Bureau of Economic Analysis data: <http://www.bea.gov/regional/sqpi/>

<sup>121</sup> This *MassBudget* estimate assumes no change in the collection totals of other states and no effect on consumer spending due to the tax increase in MA. We increase the Census’ 2008 MA sales tax revenue figure (\$4.098 billion) by 25 percent (to \$5.123 billion), add in an inflation adjusted \$190 million for the combined sales taxes derived from a) alcoholic beverage sales (\$99 million in 2008 dollars) and b) the local option meals tax (\$89 million in 2008 dollars), and divide by BEA 2008 MA personal income (\$329.8 billion).

beverages -- see Chapter Six).<sup>122</sup> These 2009 sales tax law changes will increase revenues in FY 2011 by approximately \$1 billion.<sup>123</sup> The specific components of this estimated \$1 billion increase include:

<b>Regular Sales</b>	<b>\$633 million</b>
<b>Meals Sales</b>	<b>\$159 million</b>
<b>Motor Vehicle Sales</b>	<b>\$118 million</b>
<b>Alcoholic Beverage Sales</b>	<b>\$110 million</b>
<b>TOTAL</b>	<b>\$1.02 billion</b>

In addition to these changes affecting state-level revenue collections, municipalities were given the option to levy an additional local tax on meals of up to 0.75 percent. Approximately one third of the towns and cities in the Commonwealth have adopted this tax and the Department of Revenue expects that together they will raise some \$85 million to \$90 million in additional revenue in FY 2011.<sup>124</sup> During 2010, as part of the budgeting process for Fiscal Year 2011, several measures to increase tax revenues were proposed. One proposal would have added candy and soda to the list of items subject to the general sales tax, generating an estimated \$61.6 million in additional revenues in FY 2011.<sup>125</sup> Currently, these items are exempted from the sales tax. Another proposal would have eliminated the sales tax exemption on the sale of aircraft. It is estimated that this change would have raised another \$5 million annually.<sup>126</sup> Neither proposal was adopted in the final budget.

## ONLINE SALES AND THE GENERAL SALES TAX

The growth in online sales presents a special set of challenges for sales tax collections. As noted earlier, the only practical way for states to collect sales taxes of any kind -- including those due on Internet sales -- is to require businesses to collect these taxes at the time of sale and remit them to the state.<sup>127</sup> US Supreme Court decisions, however, prohibit states from requiring many online vendors to collect sales taxes. Generally speaking, vendors that do not have in-state stores, warehouses, employees, or sales representatives cannot be required to collect state sales tax. For the remaining vendors -- those which have some in-state business operations and which the state, therefore, feasibly might require to collect the sales tax under federal law -- state tax laws can add to the problem. State laws often do not go as far as the federal law appears to allow in requiring businesses with some activities in the state to collect state sales taxes.

<sup>122</sup> As part of the package of changes made to the sales tax in 2009, Massachusetts raised its "meals tax" rate from 5 percent to 6.25 percent as well. Though technically a separate tax, the meals tax -- with a rate that matches that of the general sales tax -- effectively functions as one of several components of the general sales tax. In addition to this change, the 2009 package also permitted local governments to adopt a "local option" meals tax of 0.75 percent. Revenues from this change will fund local government functions and are not included in the \$1 billion FY 2011 estimate of increased state-level revenues.

<sup>123</sup> From DOR revenue estimates as of July, 2010

<sup>124</sup> *MassBudget* adjusts DOR's 8-month FY 2010 estimate to reflect a full 12 months of collections in FY 2011. Massachusetts DOR Website: [http://www.mass.gov/Ador/docs/dls/publ/bull/2009/2009\\_15B.pdf](http://www.mass.gov/Ador/docs/dls/publ/bull/2009/2009_15B.pdf)  
[http://www.mass.gov/?pageID=dorterminal&L=4&L0=Home&L1=Businesses&L2=Current+Tax+Year+Information&L3=Recent+Tax+Changes%3a+Sales%2c+Meals+%26+More&sid=Ador&b=terminalcontent&f=dor\\_budget\\_updateFY2010&csid=Ador](http://www.mass.gov/?pageID=dorterminal&L=4&L0=Home&L1=Businesses&L2=Current+Tax+Year+Information&L3=Recent+Tax+Changes%3a+Sales%2c+Meals+%26+More&sid=Ador&b=terminalcontent&f=dor_budget_updateFY2010&csid=Ador)  
[http://www.mass.gov/?pageID=dorterminal&L=4&L0=Home&L1=Local+Officials&L2=Municipal+Data+and+Financial+Management&L3=Data+Bank+Reports&sid=Ador&b=terminalcontent&f=dls\\_mdmstuf\\_localoptions&csid=Ador](http://www.mass.gov/?pageID=dorterminal&L=4&L0=Home&L1=Local+Officials&L2=Municipal+Data+and+Financial+Management&L3=Data+Bank+Reports&sid=Ador&b=terminalcontent&f=dls_mdmstuf_localoptions&csid=Ador)

<sup>125</sup> *MassBudget, Budget Monitor*, February 8, 2010: [http://www.massbudget.org/documentssearch/findDocument?doc\\_id=645&dse\\_id=1080](http://www.massbudget.org/documentssearch/findDocument?doc_id=645&dse_id=1080)

<sup>126</sup> *Ibid.*

<sup>127</sup> Massachusetts law currently requires state residents who make online purchases to report these purchases and pay any applicable taxes if the online vendor does not collect sales tax on the purchase. In practice, for online sales where the vendor does not automatically collect the sales tax, many of these transactions go unreported and the tax remains uncollected.

While many large online vendors do collect sales tax from Massachusetts customers, others do not (generally, those online vendors that *also* have stores, warehouses, or employees working in the state tend to collect the sales tax from their online customers). Because some online vendors do not collect Massachusetts sales taxes, the Commonwealth loses millions of dollars annually in forgone tax revenue. Official estimates for lost sales tax revenue in Massachusetts resulting from the shift to online purchasing do not exist at present. Economists at the University of Tennessee, however, have estimated that such tax losses nationwide will reach \$11.4 billion annually by 2012.<sup>128</sup> This same study estimates that revenue losses in Massachusetts totaled \$80 million in 2009 and will exceed \$160 million in 2012.<sup>129</sup>

Beyond the loss of revenues, when businesses diverge from best practices in order to avoid collecting sales taxes they tend to introduce inefficiencies into the overall economy, creating added, though hidden, costs to consumers. In addition, the ability of some online sellers to avoid sales tax collections creates an unfair price advantage over local businesses and those online sellers that do collect the tax. Finally, to the extent that lower-income residents have less access to online vendors -- and thus make more purchases in local shops (where sales taxes are collected) -- these residents are placed at a disadvantage relative to residents with greater Internet access.

Other states have taken steps to address these issues by updating their sales tax laws. Some of these remedies are discussed below.

#### *WHICH ONLINE VENDORS CAN BE REQUIRED TO COLLECT THE STATE SALES TAX?*

Under the Commerce Clause of the United States Constitution, the online vendors that can be required by states to collect state sales taxes are those that have what is termed “physical presence” in the state. “Physical presence” in this legal context means that these businesses have other connections to the state beyond their online customer base. This might include actual stores, or it might be warehouses, employees, or sales representatives. Both Target and Wal-Mart, for example, clearly have sufficient legal presence in the state due to their many physical store locations. Both businesses, therefore, collect sales taxes from Massachusetts residents who make online purchases from them.

For businesses that have absolutely no presence in Massachusetts, the Commerce Clause prohibits Massachusetts from requiring these businesses to collect the sales tax. Instead, for online purchases made by Massachusetts residents from these out-of-state vendors, the state must rely on individual taxpayers to report these purchases and pay the appropriate tax.

There is a third category of businesses, however, those that have a small but nevertheless identifiable presence in the state. Whether this presence is legally sufficient (under federal and state law) to permit the Commonwealth to require them to collect state sales taxes remains a contested grey area in the law. Headquartered outside the state, some of these online vendors argue that their in-state business activities are not sufficient to be covered under current law. They have no stores, warehouses, or direct employees, and rather than using in-state sales representatives to promote their business, some of these

<sup>128</sup> Donald Bruce, “State and Local Government Sales Tax Revenue Losses from Electronic Commerce,” April 2009: <http://cber.utk.edu/ecom/ecom0409.pdf>

The same study estimates that annual US losses could reach \$12.7 billion if more optimistic assumptions about sales growth are employed.

<sup>129</sup> The study does not take into account the increase in the Massachusetts sales tax rate (from 5% to 6.25%) made mid-year in 2009. The figure we offer in this report (above) for 2009 makes no adjustment to Prof. Bruce’s estimate. The 2012 figure, however, has been adjusted upwards by 25 percent to reflect the impact of the increased rate on a *full year’s collections*. A similarly adjusted figure for lost collections -- under a more optimistic assumption about the national economic outlook -- pegs the loss at more than \$180 million in 2012.

vendors instead use extensive networks of online “affiliates.” Affiliates are smaller, in-state online vendors that use links on their own websites to promote another online vendor -- often a large, national vendor headquartered out-of-state -- thereby driving business to that larger vendor’s website (a service for which the smaller vendor is paid a commission based on the amount of goods purchased).<sup>130</sup>

Some states (including New York, Rhode Island, and North Carolina) have revised their laws to ensure that the use of affiliate networks is included within the state’s definition of “physical presence.” New York State, for example, amended its sales tax code in 2008 in order to clarify that affiliates serve essentially the same promotional function as sales representatives and that online sellers using affiliates therefore indeed have sufficient “physical presence” and must collect appropriate sales taxes on behalf of New York State.<sup>131</sup> Whether state and federal courts ultimately will permit this interpretation remains to be seen. Thus far, however, the New York trial court has upheld the constitutionality of the New York law.<sup>132</sup> While some major vendors currently are complying with the New York law, they also are appealing the court’s decision.

Extrapolating from New York data,<sup>133</sup> were Massachusetts to achieve similar results through enactment of such a law, *MassBudget* estimates that in FY 2009 the Commonwealth would have collected some \$4 million of the \$80 million in Internet sales tax that the University of Tennessee Study estimated went uncollected in that year.<sup>134</sup> Because federal law and most state tax codes (including that of Massachusetts) have not been updated to respond clearly to the realities of our 21st century, online economy, this revenue currently goes uncollected.

#### *OTHER OPTIONS FOR SECURING ONLINE SALES TAX REVENUES*

In March 2010, the Colorado State Legislature adopted a novel approach to securing online sales tax revenue.<sup>135</sup> The new law will give online vendors a choice; they can either, collect and remit appropriate sales taxes to the state, or they can do the following:

1. For every transaction, the vendor must show the online purchaser a total figure for the tax due and explain on the webpage that the purchaser is responsible for making this payment to the state.
2. Every year, the vendor must send a letter to each purchaser providing a sum total of all taxable purchases and the total tax due to the state.

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<sup>130</sup> For more extensive discussion of this online business model and the related ongoing legal battles, please see papers authored by Michael Mazerov at the Center on Budget and Policy Priorities:

<http://www.cbpp.org/files/11-16-09sfp.pdf>

<http://www.cbpp.org/cms/index.cfm?fa=view&id=2876>

<sup>131</sup>New York State Department of Taxation and Finance: [http://www.nystax.gov/pdf/memos/sales/m08\\_3s.pdf](http://www.nystax.gov/pdf/memos/sales/m08_3s.pdf)

Rhode Island Department of Revenue: <http://www.dor.ri.gov/Reports/RI%20Revenue%20Changes%202009%20Session.pdf>

Wisconsin Department of Revenue: <http://www.revenue.wi.gov/taxpro/news/090701a.html>

<sup>132</sup> *Ibid.*

<sup>133</sup> New York was the first state to enact its law (in 2008) and now has more than a year of collection data with which to gauge the law’s effects.

<sup>134</sup> New York’s Department of Finance and Taxation estimates that they will collect an additional \$25 million in 2009 due to enactment of their new Internet sales law, or 4.7 percent of the \$528 million figure that the University of Tennessee study estimates New York loses annually to untaxed Internet sales. New York estimates that their rate of collection on Internet purchases will continue to grow in 2010.

See Michael Mazerov, Center on Budget and Policy Priorities: <http://www.cbpp.org/files/11-16-09sfp.pdf>

<sup>135</sup> Michael Mazerov, Center on Budget and Policy Priorities, March 2010: <http://www.cbpp.org/cms/index.cfm?fa=view&id=3113>

3. The same “annual total” information must be provided yearly to the state for each purchaser (this annual total does not show the specifics of what was purchased, thereby addressing privacy concerns).

The new law applies only to online vendors with more than \$100,000 in annual in-state sales. Some large online vendors are challenging the law in court. However, the law took effect on May 1, 2010, and vendors appear to be complying with minimum requirements as they are interpreting the language of the law.<sup>136</sup>

As part of an alternate, national approach to the loss of Internet sales tax revenue, several dozen states are working together to establish uniformity in the way that sales taxes are applied by the many state and local governments which have sales taxes. Such a nationwide system would remove practical obstacles and undercut legal arguments against collection requirements, thereby encouraging Internet sellers to report interstate sales and to collect appropriate sales taxes. This “Streamlined Sales and Use Tax Agreement” ultimately would require approval by the US Congress in order to make compliance mandatory. Federal legislation has been submitted again in the current Congress.

At present, 23 of the 45 states with a state sales tax have brought their state systems into compliance with the requirements of the agreement.<sup>137</sup> Massachusetts remains in the minority of sales tax states that have yet to adopt the required changes.

While the Massachusetts Study Commission on Corporate Taxation recommended that Massachusetts join the Streamlined Sales Tax Agreement and state legislators have introduced legislation that would change Massachusetts tax law to comply with the agreement, Massachusetts lawmakers have not approved the changes. Concerns about joining the agreement include the effects some of the changes might have on the progressivity of the Massachusetts sales tax; the potential for revenue losses once changes are made at the state level but prior to approval of the agreement at the federal level;<sup>138</sup> and the percentage of collected tax revenues that vendors would be allowed to keep as compensation for collecting and remitting the tax.

#### ONLINE MUSIC AND MOVIE DOWNLOADS

Another -- though slightly different -- source of revenue losses attributable to online sales is the growing popularity of downloading music and movies from the Internet. While current law clearly stipulates that Massachusetts sales tax is legally due on the purchase of a CD or DVD online (though this tax may be difficult for the Commonwealth to collect, as discussed above), current law does *not* address the question of *downloading* music or movies. With a download, one is not purchasing a physical object, but rather the electronic bytes that one’s computer then reassembles into songs or movies. The inapplicability of current sales tax law to these forms of purchases represents an

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<sup>136</sup> Emergency regulations promulgated by the CO DOR to clarify vague language in the law currently place some vendors out of compliance when they are meeting only these minimum requirements. These vendors appear to be awaiting a court ruling as to whether the CO DOR has overstepped its authority in issuing regulations with more stringent reporting requirements (*MassBudget* communication with Michael Mazerov of the Center on Budget and Policy Priorities, 6/15/2010).

<sup>137</sup> Streamlined Sales Tax Governing Board (see map in lower left of webpage):

<http://www.streamlinedsalestax.org/index.php?page=modules>

<sup>138</sup> A bill currently pending before Congress would move the federal government toward approval of the agreement. For more detailed discussion see the website of the National Conference of State Legislatures: <http://www.ncsl.org/default.aspx?TabId=20322>

unintended legal loophole. Again, technology has outpaced the tax laws that govern this growing area of commerce.

Estimates produced by the Massachusetts Department of Revenue indicate that the Commonwealth loses some \$6 million to \$12 million in sales taxes on movie downloads, \$2 million to \$4 million on music downloads, and \$1 million to \$3 million on digital book downloads every year.<sup>139</sup> Currently, Massachusetts is in the slight minority of sales tax states that do not tax digital downloads of movies, music, and books (24 sales tax states do, 21 sales tax states do not).<sup>140</sup> Massachusetts law does tax explicitly the digital transfer of “pre-written” computer software (such as operating system, word processing, or anti-virus software).<sup>141</sup>

We now leave behind this detailed look at Internet sales tax collections and return to our broader discussion of the general sales tax.

## LINKING THE INCOME AND SALES TAX TO RAISE REVENUE AND INCREASE PROGRESSIVITY

As we have seen in our discussions of the income tax (Chapter Four) and the sales tax (Chapter Five), these two taxes have very different impacts on lower- versus higher-income earners. Likewise, the two taxes have very different prospects for growth or “adequacy” over the long-term. Making simultaneous (or “linked”) changes to these two taxes offers the possibility of improving the overall progressivity and long-term adequacy of the Massachusetts tax system, while also raising more revenue for the Commonwealth.

As one possibility, Massachusetts could raise the income tax rate to 5.95 percent (the rate in effect as recently as 1999) while reducing the general sales tax rate to 5.5 percent (a half a percentage point higher than the rate in effect prior to August 2009). As discussed in Chapter Four, lower-income earners pay relatively little of their income toward income taxes, and thus an increase in the income tax rate (to 5.95 percent) would raise additional revenue primarily from the state’s higher-income earners. Conversely, sales taxes consume a relatively large share of household income for those with lower-incomes, and thus any reduction in this tax would provide larger benefits (as a share of household income) to these households. The combined effect of these changes would be to reduce taxes for low-income households and to offset these revenue losses -- and indeed generate a net increase in revenues -- from those earners with the highest incomes (see Figure 28).

Raising the income tax rate from the current 5.3 percent rate to 5.95 percent while reducing the sales tax by 3/4ths of a penny (to 5.5 percent) would increase state revenues by approximately \$750 million annually.<sup>142</sup> The roughly \$1.3 billion raised by the income tax change would be reduced by a \$570

<sup>139</sup> *MassBudget* email communication with MA DOR, November 24, 2009.

<sup>140</sup> *MassBudget* communications with Michael Mazerov, Center on Budget and Policy Priorities, February, 2010.

<sup>141</sup> MA DOR website:

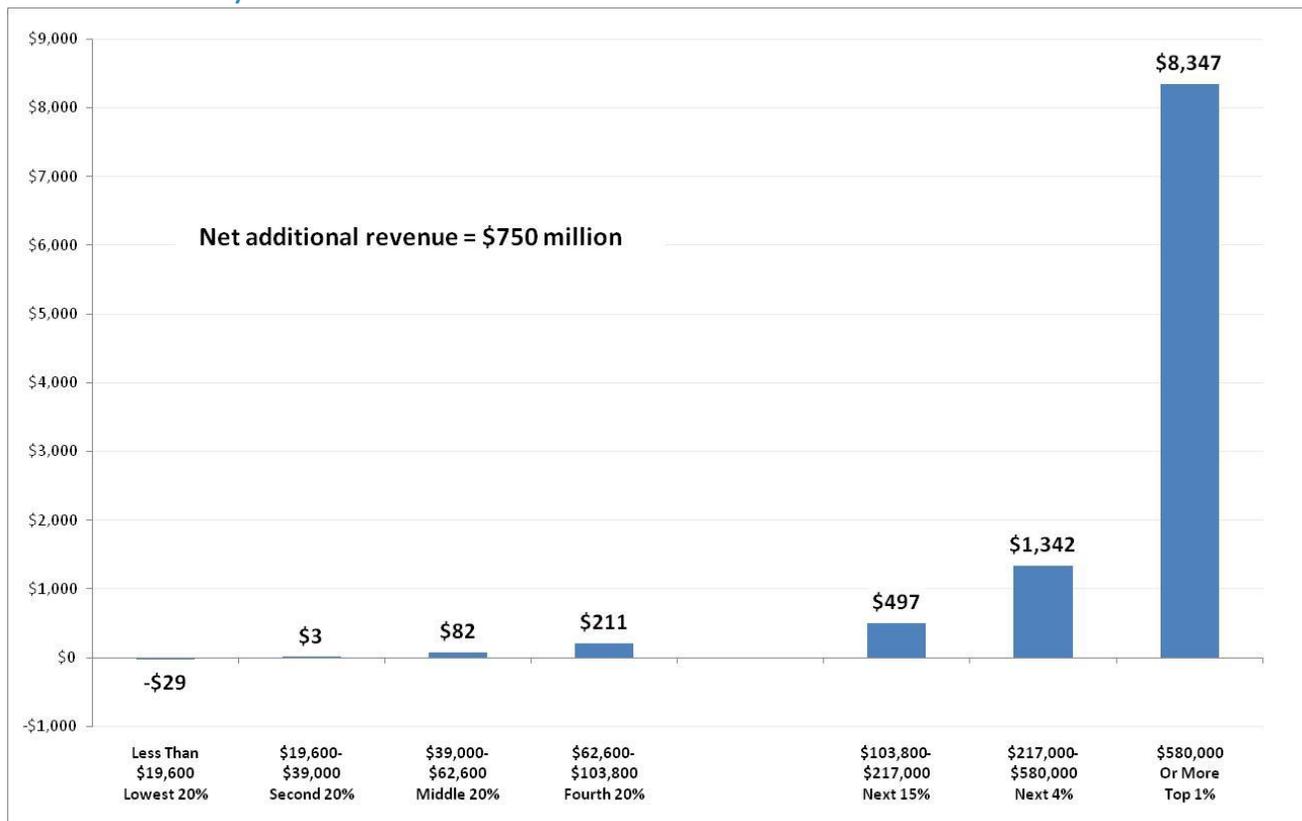
[http://www.mass.gov/?pageID=dorterminal&L=7&L0=Home&L1=Businesses&L2=Help+%26+Resources&L3=Legal+Library&L4=Technical+Information+Releases&L5=TIRs+-+By+Year%28s%29&L6=2005+Releases&sid=Ador&b=terminalcontent&f=dor\\_rul\\_reg\\_tir\\_tir\\_05\\_15&csid=Ador](http://www.mass.gov/?pageID=dorterminal&L=7&L0=Home&L1=Businesses&L2=Help+%26+Resources&L3=Legal+Library&L4=Technical+Information+Releases&L5=TIRs+-+By+Year%28s%29&L6=2005+Releases&sid=Ador&b=terminalcontent&f=dor_rul_reg_tir_tir_05_15&csid=Ador)

<sup>142</sup> Using methodology explained in footnote 82, above, while applying the higher rate (5.95 percent, an increase of 0.65 percentage points) to the remaining \$10.752 million, *MassBudget* arrives at an estimate of additional revenues of \$1.319 billion for FY 2011 (were this rate to have been in effect in FY 2011).

From this total we then deduct the revenue losses resulting from a sales tax rate reduction. Using DOR’s high-end estimate of FY 2011 sales tax revenues (from the FY 2011 CRF) - with revenues from the now-repealed addition of alcoholic beverages to the sales tax base removed

million revenue decrease resulting from the general sales tax change. Shifting the Commonwealth’s tax structure toward greater reliance on the income tax would have the added benefit of improving revenue adequacy over the long term (for a more complete discussion of “adequacy,” please see Chapter One of this primer).

**Figure 28. Average Tax Change by Income Group (Increase Income Tax Rate to 5.95 Percent, Lower Sales Tax Rate to 5.5 Percent)**



Implementing the tax changes described above would lower average taxes modestly for the first quintile of income taxpayers in Massachusetts (the bottom 20 percent of earners would see average savings of about \$30 a year). Earners in the middle-income quintile -- those making between \$39,000 and \$62,600 in 2010 -- would see modest increases, while the fourth quintile would see average increases of about \$211 a year. Those in the top 20 percent of earners would see average annual tax increases ranging from about \$500 up to about \$8,350 depending on their income.

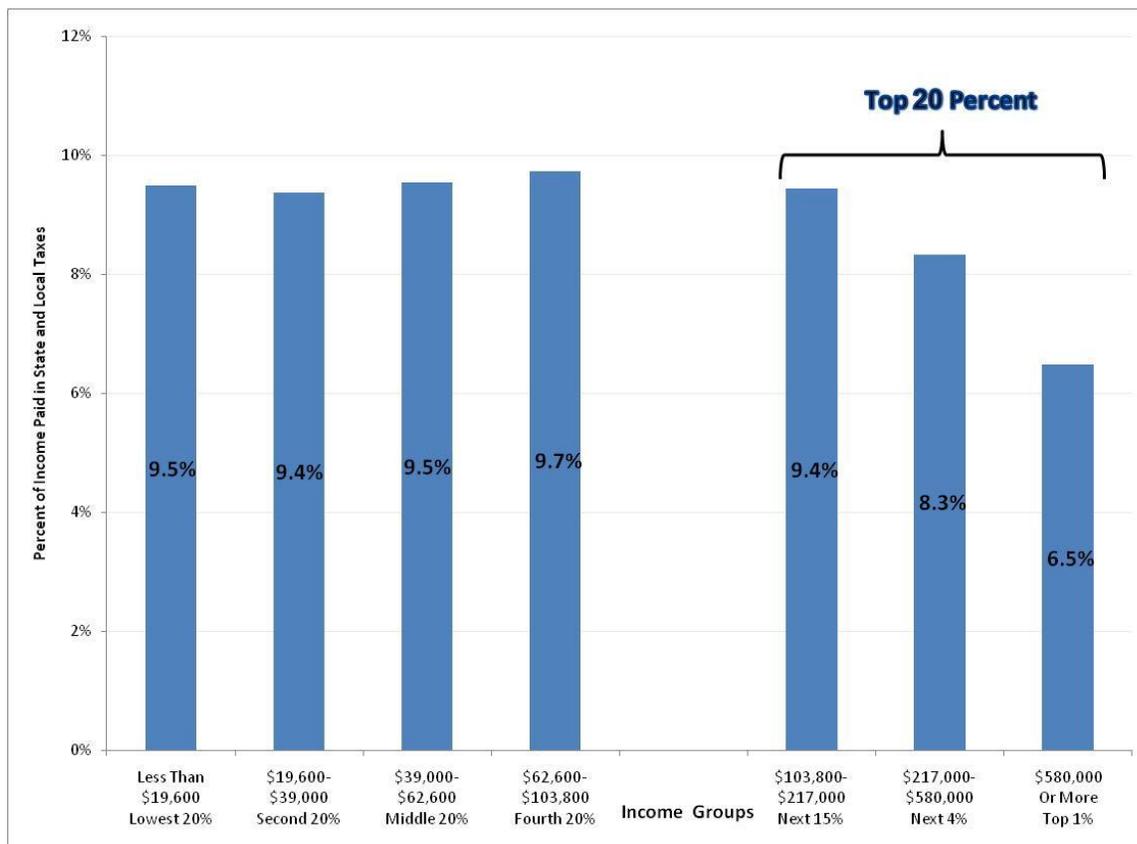
Under this scenario – raising the income tax rate to 5.95 percent and reducing the sales tax rate to 5.5 percent – more than 50 percent of the additional revenue would come from households in the top 5

(\$4,860 million - \$112 million = \$4748 million) - *MassBudget* calculates that a 3/4ths penny reduction in the rate (a 0.75 percentage point reduction in the rate, to 5.5 percent) would reduce revenues by \$570 million annually. The net revenue gain from this combined set of changes (increasing the rate to 5.95 percent while decreasing the sales tax by 3/4ths of a penny) thus would be \$1.319 billion - \$570 million = \$749 million.

Absent the availability of official revenue growth projections for FY 2012 (which will be released in mid-December with the FY 2012 Consensus Revenue Forecast), *MassBudget* does not adjust this FY 2011-based estimate to reflect potential revenue growth in FY 2012 (or adjustments for inflation).

percent of the income distribution (households with annual income above \$217,000 in 2010).<sup>143</sup> Almost one-third (32 percent) of the additional revenue would come from households in the top 1 percent of the income distribution (households with annual income above \$580,000 in 2010).<sup>144</sup>

**Figure 29. An Income Tax Increase Combined with a Sales Tax Decrease\* Would Reduce Taxes for Low-Income People and Increase Taxes for High-Income People (2010)**



By collecting more taxes from households with the highest incomes, this scenario would help to reduce the regressivity of the overall tax system in Massachusetts. As shown in Figure 29, even with these changes, however, low-income households would continue to pay a much larger share of their income (9.5 percent) toward state and local taxes than would households with high incomes (6.5 percent).<sup>145</sup> High-income households also would receive substantial reductions in their federal taxes based on the state income and local property taxes they would pay, an element of the federal tax code from which most low-income households derive no benefit.<sup>146</sup>

<sup>143</sup> Based on modeling performed by the Institute on Taxation and Economic Policy (ITEP), December 2010, using 2010 income data.

<sup>144</sup> Ibid. Average annual incomes of households in the top 1 percent stood at \$1.84 million in 2010.

<sup>145</sup> Based on modeling performed by the Institute on Taxation and Economic Policy (ITEP), December 2010, using 2010 income data.

<sup>146</sup> For further discussion of this issue, please see pg 19 of this Primer.

## CHAPTER 6: THE SELECTIVE SALES TAXES

Apart from the General Sales Tax (covered in Chapter Five), the Commonwealth also collects a number of sales taxes on specific items. These kinds of specific sales taxes are referred to as “selective sales taxes.” In Chapter Six, we take a closer look at these selective sales taxes, examining how they meet the relevant assessment criteria described in Chapter One of this primer; provide a history of the these taxes; discuss how these taxes have changed over time and the effect these changes have had on state revenue collections; and compare Massachusetts to the US and to other states with regards to the amount of revenue raised through selective sales taxes. In closing, we examine revenue options involving taxes on tobacco products.

### OVERVIEW OF SELECTIVE SALES TAXES

Selective sales taxes, also called excise taxes, are taxes that are collected on the sales of particular classes of items. The majority of these are taxes applied to the sale of alcoholic beverages, tobacco products, or to gasoline and other fuel sales. These taxes are usually determined not by the value of the item being sold (as with the general sales tax), but by the quantity of the item being sold: a pack of cigarettes, a gallon of gas, a gallon of beer, etc.

In FY 2008, selective sales taxes generated \$2.1 billion in Massachusetts, or about half as much revenue as was generated by the General Sales Tax. These selective sales tax revenues represented 6.3 percent of all state and local tax collections for the Commonwealth.<sup>147</sup> Over 92 percent of this revenue was collected at the state level (rather than by local governments).<sup>148</sup>

Selective sales taxes are usually stable in the short term, but will tend to decline as a revenue source over the long term, since the tax per unit is usually not adjusted for inflation at frequent intervals (an exception has been the selective sales taxes on tobacco, which have tended to increase significantly faster than inflation across much of the country). Adding to the tendency for selective sales tax revenues to decline over time is the fact that these taxes often are levied not only in order to generate revenues but also with the conscious intent of discouraging people from using the item being taxed. Taxes on alcohol and tobacco (commonly referred to as “sin taxes”), for example, are levied in part with the goal of reducing consumption of these products.<sup>149</sup> When infrequent adjustments to these selective sales tax rates do occur, the increases often are quite large. People respond to these disincentives (higher costs) by buying less alcohol and tobacco. Thus, while the higher tax rate will generate more revenue per item sold, some of the per-item revenue increase is offset by lower overall sales volumes. As consumption drops overtime, revenues from these sources tend to decline.

The gasoline tax, though also a selective sales tax, is viewed somewhat differently. Rather than a “sin tax” aimed in large part at reducing consumption, the revenue from the gasoline tax is usually dedicated to highway upkeep and repair, making it a kind of a highway user’s fee.

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<sup>147</sup> U.S. Census Bureau, *State and Local Government Finances by Level of Government and by State: 2007-08*. The 2007-08 Census data is the most recent available: <http://www.census.gov/govs/estimate/>

<sup>148</sup> Ibid.

<sup>149</sup> “Sin taxes” often are viewed both as a way to reduce the consumption of products seen as harmful to society and to individuals, *and* as means of raising revenues to pay for the higher costs associated with these individual and social harms. Tobacco taxes, for example, often are seen as a way to help pay for higher state medical costs resulting from the negative health effects of tobacco use.

Vertical equity issues are a significant consideration with regards to selective sales taxes. Lower-income people tend to spend a greater proportion of their income on things like gasoline, alcohol, and tobacco products (purchasing identical quantities of these items will consume more of a low-income person's income than it will for a high-income person). Taxing these items therefore has a regressive effect. In addition, the tax system's horizontal equity is reduced since some individuals will use more of the items subject to selective sales taxes (see Chapter One for a discussion of equity). For instance, smokers are the only ones who pay the tobacco tax and people with long commutes will end up paying more in motor fuels taxes. At the same time, violating the principle of horizontal equity by increasing selective sales tax rates is a policy choice that can make sense. The poorer health of many smokers tends to drive up health care costs generally and tobacco taxes can help both to offset some of these higher costs and help to reduce tobacco consumption. Similarly, discouraging consumption of fossil fuels can have positive benefits for the environment and for public health.

#### *A BRIEF HISTORY OF MASSACHUSETTS SELECTIVE SALES TAXES*

The gasoline tax was adopted in 1929. It was increased to 21 cents a gallon in 1991 and has not been changed since. The tax on alcoholic beverages was adopted in 1933 (after the repeal of Prohibition). The tax on distilled spirits (liquor) is currently \$4.05 a gallon; wine is taxed at 55 cents a gallon and beer is taxed at 11 cents a gallon.<sup>150</sup> The selective sales taxes on alcoholic beverages have not changed in over 20 years. In 2009, however, Massachusetts added alcoholic beverages to the list of items subject to the *general* sales tax. Thus, alcoholic beverages now are subject to both a *selective* sales tax and the *general* sales tax (for a detailed discussion of the general sales tax, please see Chapter 5).

The tax on cigarettes was adopted in 1939, and set at a rate of two cents per pack of 20 cigarettes. By 1992, the tax had been set at 26 cents a pack, and in that year legislators increased the tax by 25 cents a pack. In 1996 the tax was raised by another 25 cents to 76 cents a pack, and in 2002, a 75-cent tax increase brought the tax up to \$1.51 per pack. In 2008, the Legislature increased the tax by \$1.00, bringing the per-pack cigarette tax up to \$2.51. This 2008 increase is expected to raise approximately \$105 million in additional revenue in FY 2010.<sup>151</sup> The Massachusetts Department of Revenue estimates that the cigarette tax increases enacted from 1993 through 2008 will generate collectively an additional \$444 million in revenue in FY 2010.<sup>152</sup>

#### **HOW MASSACHUSETTS MEASURES UP IN MOTOR FUELS TAXES**

Massachusetts collected \$672.7 million in motor fuels taxes, including gasoline taxes, in FY 2008.<sup>153</sup> This was 1.4 percent of state and local own-source revenue, and 2.0 percent of state and local taxes.<sup>154</sup> This tax was collected entirely at the state level.

<sup>150</sup> MA DOR website:

[http://www.mass.gov/?pageID=dorterminal&L=5&L0=Home&L1=Businesses&L2=Help+%26+Resources&L3=Legal+Library&L4=Administrative+Procedures&sid=Ador&b=terminalcontent&f=dor\\_rul\\_reg\\_adminprocedure\\_ap115&csid=Ador](http://www.mass.gov/?pageID=dorterminal&L=5&L0=Home&L1=Businesses&L2=Help+%26+Resources&L3=Legal+Library&L4=Administrative+Procedures&sid=Ador&b=terminalcontent&f=dor_rul_reg_adminprocedure_ap115&csid=Ador)

<sup>151</sup> *MassBudget, Budget Brief*, June 29, 2009 : [http://www.massbudget.org/documentsearch/findDocument?doc\\_id=679&dse\\_id=911](http://www.massbudget.org/documentsearch/findDocument?doc_id=679&dse_id=911)

<sup>152</sup> DOR, *Revenue Impact of Certain MA Tax Law Changes since January 1991*, see Appendix D.

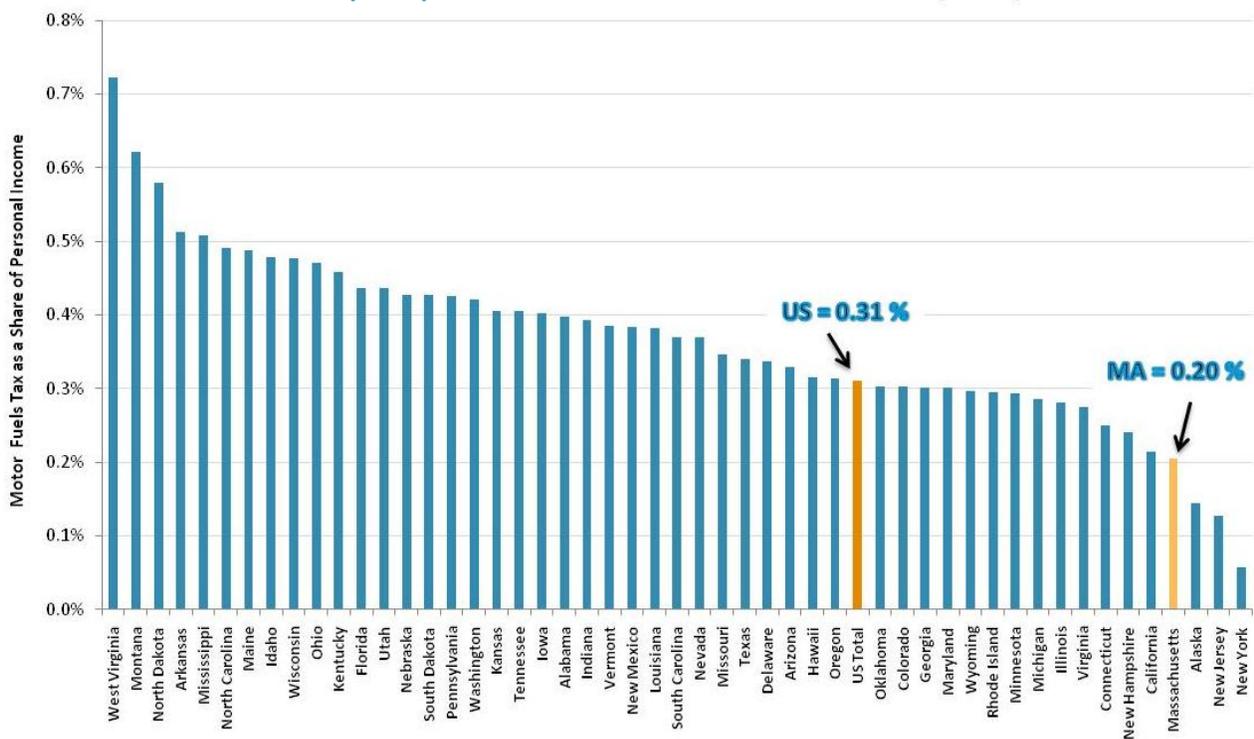
<sup>153</sup> U.S. Census Bureau, *State and Local Government Finances by Level of Government and by State: 2007-08*. The 2007-08 Census data is the most recent available: <http://www.census.gov/govs/estimate/>

<sup>154</sup> *Ibid.*

Motor fuels tax revenue in Massachusetts was equal to 0.20 percent of state personal income in FY 2008.<sup>155</sup> Only three states collected less revenue as a share of state personal income from motor fuels taxes than Massachusetts did (Figure 30).

For the US as a whole, motor fuels taxes accounted for 0.31 percent of state personal income in FY 2008.<sup>156</sup> The state with the highest share of state personal income going to the motor fuels tax was West Virginia with 0.72 percent. New York collected 0.06 percent of state personal income in motor fuels taxes for the lowest share.

**Figure 30. Massachusetts Collected a Smaller Share of State Personal Income from Its Motor Fuels Tax than Most Other States (2008)**



*EFFECT OF MOTOR FUELS TAX CHANGES IN MASSACHUSETTS*

Each 1-cent change in the motor fuels tax (currently 21 cents a gallon) in Massachusetts would be worth about \$32 million annually.<sup>157</sup> Even a substantial increase or decrease in the gas tax, however, would be overshadowed by ongoing, at-the-pump price fluctuations that occur regularly as the result of shifts in global demand and US refining capacity. Using US Bureau of Labor Statistics Consumer Price Index data, *MassBudget* calculates that during the 2004-2009 period, per-gallon gasoline costs rose or fell by an average of 39 percent every six months.<sup>158</sup>

<sup>155</sup> Ibid. State Personal Income data are those provided by the Bureau of Economic Analysis.

<sup>156</sup> Ibid.

<sup>157</sup> With annual motor fuels tax collections of \$672.6 million (FY 2008 US Census data) raised from a 21 cent/gal tax, each 1cent change in the rate would increase/decrease collections by \$32.0 million.

<sup>158</sup> Based on seasonally-adjusted rate percent change for six-month periods ending in July and January (with the exception of 2009, which uses periods ending in May and November 2009 as a proxy for data identical to that available for 2004-2008).

US Bureau of Labor Statistics: [http://www.bls.gov/cpi/cpi\\_dr.htm#2009](http://www.bls.gov/cpi/cpi_dr.htm#2009)

Given market-driven fluctuations of this magnitude, a change in the gas tax equivalent to 10 or 20 percent of the per-gallon cost of gasoline would have substantially less short-term impact on consumers than do ongoing shifts in market prices. If a tax increase were phased in over a longer period of time, consumers could respond by purchasing more fuel-efficient vehicles, thereby offsetting their higher per-gallon tax costs through reduced gas consumption. A decline in gas consumption, however, would reduce gas tax collections, offsetting some of the revenue gains from a gas tax rate increase.

## HOW MASSACHUSETTS MEASURES UP IN ALCOHOLIC BEVERAGE TAXES

Massachusetts collected \$71.9 million from the selective sales tax on alcoholic beverage in FY 2008.<sup>159</sup> This was 0.15 percent of state and local own-source revenue, and 0.21 percent of state and local taxes.<sup>160</sup> This tax was collected entirely at the state level.

Selective sales tax revenue from alcoholic beverages in Massachusetts was equal to 0.02 percent of state personal income in FY 2008. Massachusetts ranked 41<sup>st</sup> in the share of state personal income collected from these taxes (see Figure 31).

For the 50 states, the selective sales tax on alcoholic beverages accounted for 0.05 percent of state personal income in FY 2008. The state with the highest share of state personal income going to the alcoholic beverages tax was Alaska with 0.15 percent. Three states -- Oregon, Maryland, and Wyoming -- collected an amount less than or equal to 0.01 percent of state personal income in selective sales taxes on alcoholic beverages.

### *EFFECT OF ALCOHOLIC BEVERAGES TAX CHANGES IN MASSACHUSETTS*

Alcoholic beverages are taxed at different rates depending on the type of beverage. Each 10 percent change in all alcoholic beverage rates would alter revenues by \$7.2 million annually.<sup>161</sup>

In addition to the Alcoholic Beverage Tax (a selective sales tax), in 2009, Massachusetts added alcohol to the list of items subject to the state's general sales tax (prior to 2009, alcoholic beverages were not subject to the general sales tax). With the sales tax currently set at 6.25 percent, it is estimated that applying the general sales tax to alcoholic beverages will increase FY 2010 revenues by \$93 million (during the 10-month period it will be in effect in FY 2010), and \$112 million over the full 12 months of FY 2011.<sup>162</sup>

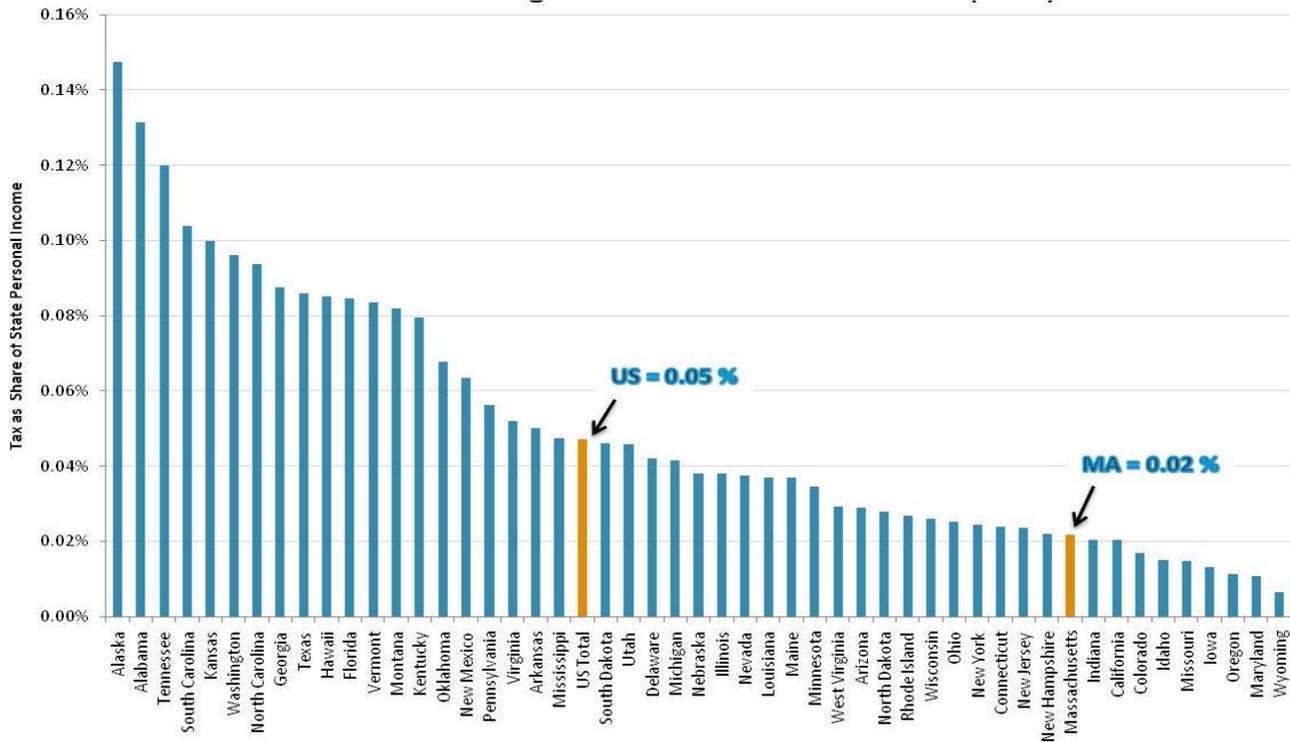
<sup>159</sup> U.S. Census Bureau, *State and Local Government Finances by Level of Government and by State: 2007-08*. The 2007-08 Census data is the most recent available: <http://www.census.gov/govs/estimate/>

<sup>160</sup> *Ibid.*

<sup>161</sup> US Census data for FY 2008 show total MA collections from the alcoholic beverages tax to be \$71.9 million. A 10% change therefore would equal about \$7.2 million annually. As with all *MassBudget* estimates in this document, this estimate does not take into account any changes in consumer's spending choices that might occur as a result of changes in price.

<sup>162</sup> The FY 2011 estimate is a *MassBudget* calculation for a full 12-month period and is based on DOR's 10-month estimate for FY 2010 from their *Revenue Impacts of Certain MA Tax Law Changes Since January 1991* (see Appendix D).

**Figure 31. Massachusetts Collected a Smaller Share of Personal Income from Its Alcoholic Beverage Tax than Most Other States (2008)**



**HOW MASSACHUSETTS MEASURES UP IN TOBACCO TAXES**

Massachusetts collected \$436.9 million in taxes on tobacco products, including cigarettes, in FY 2008.<sup>163</sup> This was 0.9 percent of state and local own-source revenue, and 1.3 percent of state and local taxes.<sup>164</sup> This tax was collected entirely at the state level.<sup>165</sup> Not included in these figures is a \$1.00 per pack increase in the cigarette tax enacted in 2008. It is estimated that this increase will raise an additional \$105 million in FY 2010.<sup>166</sup>

Tobacco tax revenue in Massachusetts was equal to 0.13 percent of personal income in FY 2008. Massachusetts ranked 28<sup>th</sup> in share of personal income collected from tobacco taxes (see Figure 32). For the 50 states, tobacco taxes accounted for 0.14 percent of personal income in FY 2008. The state with the highest share of state personal income going to the tobacco tax was Delaware with 0.36 percent. Tobacco producing states had among the lowest taxes on tobacco products, with South Carolina collecting only about 0.02 percent of state personal income in tobacco taxes.

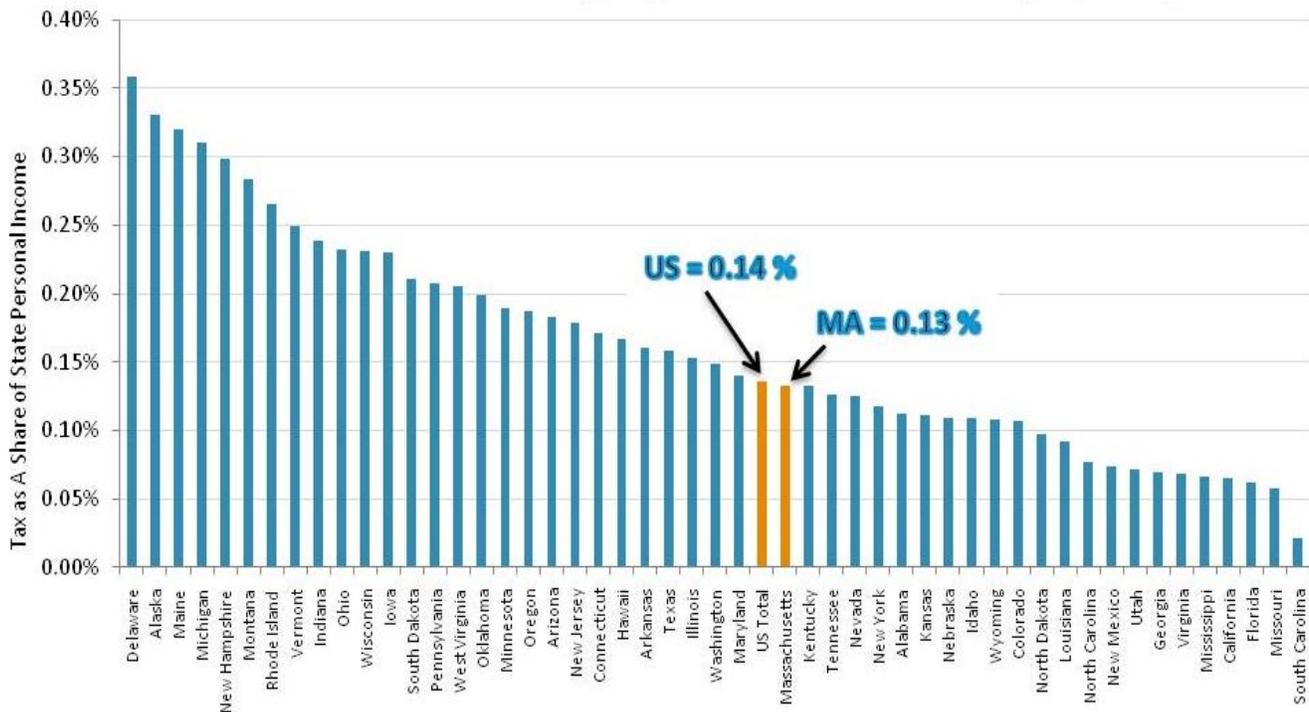
<sup>163</sup> U.S. Census Bureau, *State and Local Government Finances by Level of Government and by State: 2007-08*. The 2007-08 Census data is the most recent available: <http://www.census.gov/govs/estimate/>

<sup>164</sup> Ibid.

<sup>165</sup> Ibid.

<sup>166</sup> *MassBudget, Budget Brief*, June 29, 2009 : [http://www.massbudget.org/documentsearch/findDocument?doc\\_id=679&dse\\_id=911](http://www.massbudget.org/documentsearch/findDocument?doc_id=679&dse_id=911)

**Figure 32. Massachusetts' Tobacco Tax Collections as a Share of State Personal Income Were Slightly Below The U.S. Average (2008)**



*RECENT TOBACCO TAX CHANGES IN MASSACHUSETTS*

The tax on cigarettes was adopted in 1939, and set at a rate of 2 cents per pack of 20 cigarettes. By 1992, the tax had been set at 26 cents a pack, and in that year legislators increased the tax by a further 25 cents a pack. In 1996, the tax was raised by another 25 cents to 76 cents a pack and, in 2002, a 75-cent tax increase brought the tax up to \$1.51 per pack. In 2008, the Legislature increased the tax by \$1.00, bringing the per-pack cigarette tax up to \$2.51. The Massachusetts Department of Revenue has estimated that the cigarette tax increases enacted from 1993 through 2008 will generate an additional \$444 million in revenue in FY 2010.<sup>167</sup> At the time of the most recent tax increase, taxes on other tobacco products were not made equal to the tax on cigarettes.

*REVENUE OPTIONS FOR TOBACCO TAXES*

It is possible to raise tax rates on other forms of tobacco (such as roll-your-own cigarette tobacco, chewing tobacco, and cigars), so that all tobacco products are taxed at the same rate -- for example, on a per-dose basis, or as a percentage of their wholesale price. Such a tax structure would create horizontal equity in taxation among all tobacco products, and would remove price incentives for teens and adults simply to shift their tobacco use from pre-rolled cigarettes to other tobacco products rather than to quit using tobacco altogether. The fewer tobacco users there are in Massachusetts, the lower will be the Commonwealth's medical and other related costs -- both public and private.

One outcome of increasing taxes on other forms of tobacco is that these taxes will tend to consume a larger portion of total income from lower-income rather than higher-income households (purchasing identical quantities of these items will consume more of a low-income person's income than it will for a high-income

<sup>167</sup> DOR, Revenue Impacts of Certain MA Tax Law Changes Since January 1991 (see Appendix D).

person). Higher tax rates on tobacco products are therefore likely to be regressive in their impact, falling more heavily on those users with lower incomes. The Massachusetts Department of Revenue estimates that applying the cigarette tax rate to cigars and smokeless tobacco would raise \$20 million annually for the Commonwealth in FY 2011.<sup>168</sup>

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<sup>168</sup> DOR fiscal impact estimates for floor amendments to House FY 2011 budget: <http://massbudget.org/doc/745>

## CHAPTER 7: BUSINESS TAXES

In Chapter Seven, we'll discuss the taxation of businesses, reviewing the major types of taxes that businesses in the Commonwealth pay. We will explore how these individual taxes operate as part of a complete system of business taxation, and discuss how the overall level of business taxation in Massachusetts compares to levels in the other states and in the nation as a whole.

### OVERVIEW OF BUSINESS TAXES

Businesses pay several different kinds of taxes in Massachusetts (see Table 2), including a share of some kinds of taxes that are paid primarily by individuals, like the property tax and sales taxes. Business taxes are therefore a subsystem of the overall state and local tax system. Overall, business taxes in Massachusetts are significantly lower than the national average. Massachusetts, however, receives an unusually large share of the tax revenue it does collect from businesses from the taxation of corporate income. Massachusetts collected \$2.2 billion in corporate income tax in FY 2008, or 6.4 percent of the Commonwealth's total state and local tax collections.<sup>169</sup>

Offsetting the relatively high corporate income tax levels, businesses in Massachusetts pay substantially less in sales taxes, excise and gross receipts taxes, and licensing fees than do businesses in many other states (see Table 2). While the 2009 sales tax increase in Massachusetts means that businesses will pay more in sales taxes to the Commonwealth, these taxes will remain a far smaller percentage of state Gross Domestic Product (GDP) than is true in most other states throughout the US.

**Table 2. Business Taxes (Ernst & Young, FY 2009)**

	Massachusetts % of GDP	United States % of GDP	State Ranking
Property Tax	1.7%	1.7%	26
Sales Tax	0.5%	1.0%	44
Excise & gross receipts	0.2%	0.6%	49
Corporate Income	0.6%	0.4%	7
Unemployment Insurance	0.5%	0.2%	3
Individual Income tax (on pass-through businesses)	0.4%	0.3%	13
Licenses & Other Taxes	0.2%	0.5%	48
<b>Total Business Taxes</b>	<b>4.0%</b>	<b>4.7%</b>	<b>43</b>

A study conducted by Ernst & Young for the Council on State Taxation (COST), a Washington, D.C.-based trade association that represents over 600 multi-state and multinational corporations,<sup>170</sup> found that 42 states collected a greater share of private GDP by State<sup>171</sup> in business taxes in FY 2009 than did Massachusetts.<sup>172</sup> For the US as a whole, this study found that business taxes were 4.7 percent of GDP

<sup>169</sup>U.S. Census Bureau, *State and Local Government Finances by Level of Government and by State: 2007-08*. The 2007-08 Census data is the most recent available: <http://www.census.gov/govs/estimate/>

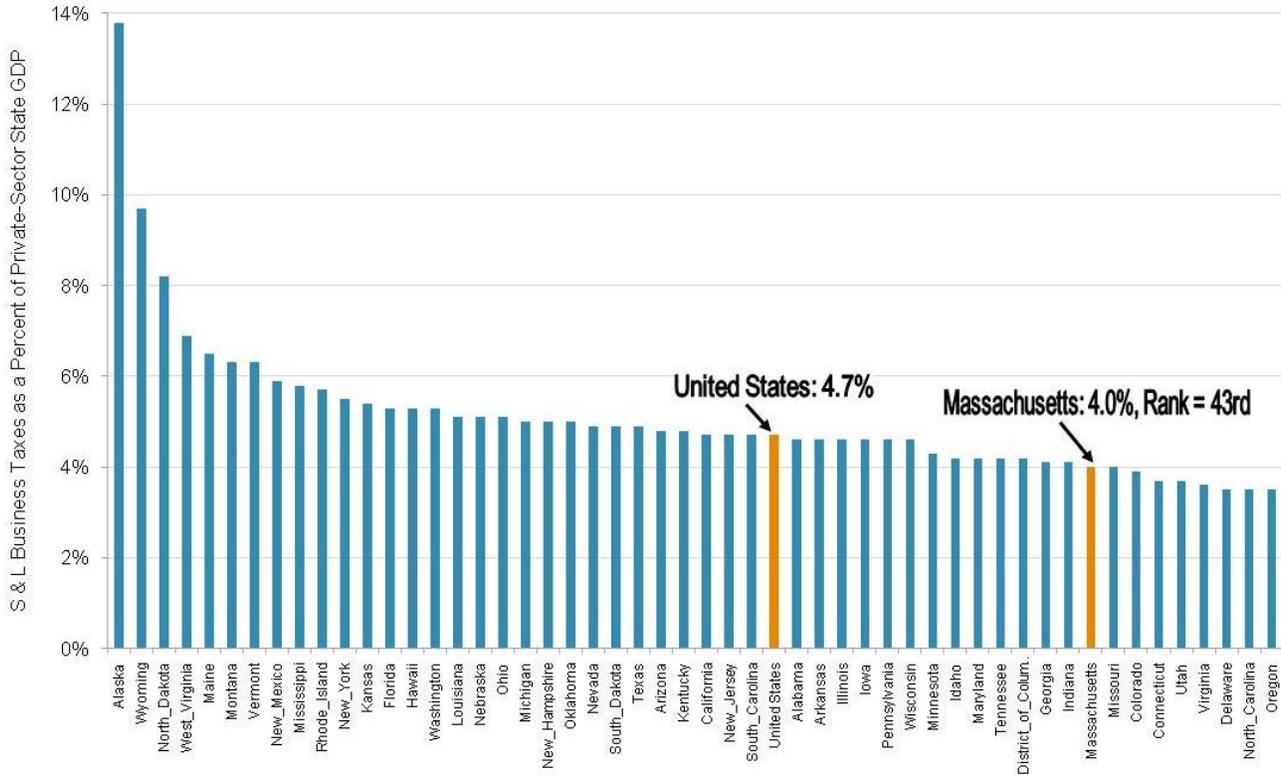
<sup>170</sup> Council on State Taxation: <http://www.cost.org/AboutCost.aspx>

<sup>171</sup> Previously called Gross State Product (GSP).

<sup>172</sup> Philips, Andrew, Robert Cline, and Tom Neubig, *Total State and Local Business Taxes: State-by-state estimates for fiscal year 2009*, Council on State Taxation, March 2010: <http://www.cost.org/Page.aspx?id=69654>

by state, significantly higher than in Massachusetts where state and local business taxes amounted to 4.0 percent of private sector GDP in the state (see Figure 33). These findings suggest that state and local business taxes in Massachusetts were \$2.3 billion lower in FY 2009 than they would have been if businesses had been taxed at the national average as a share of GDP by State.<sup>173</sup>

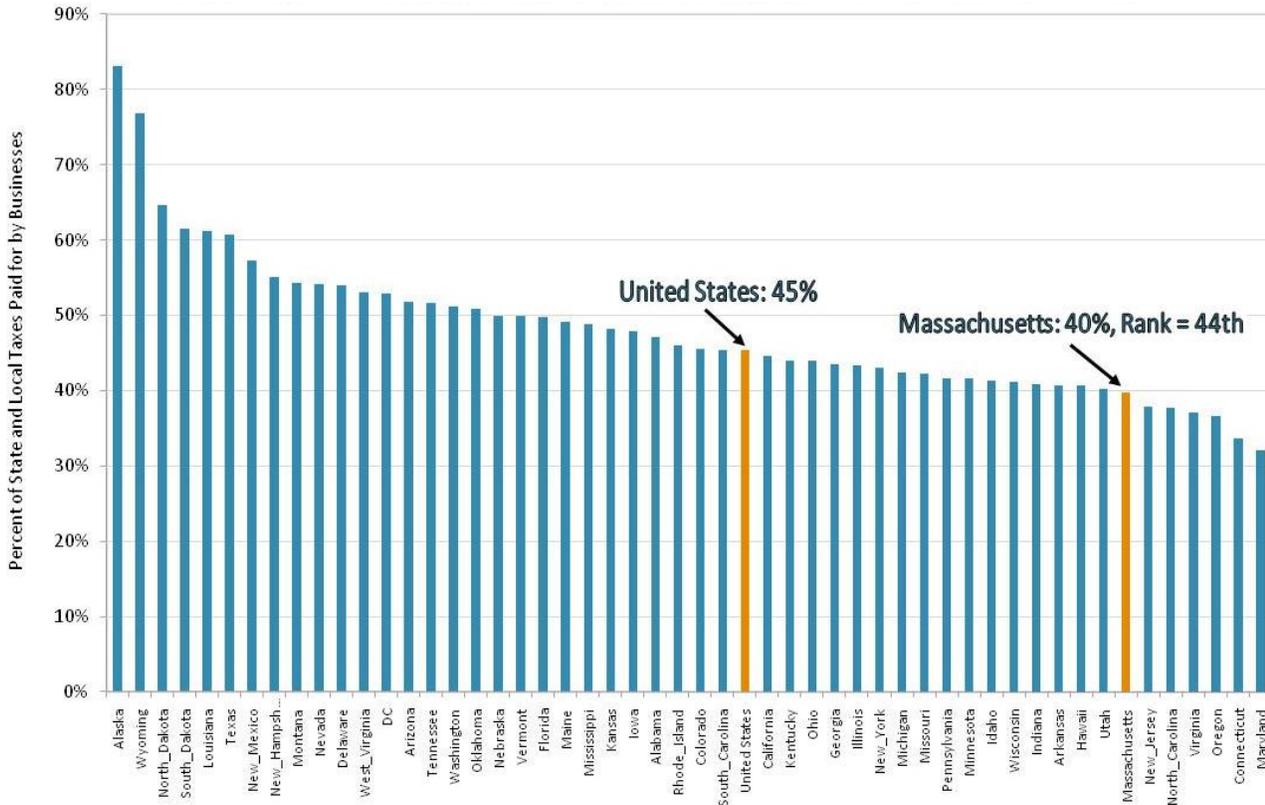
**Figure 33. In Massachusetts, State & Local Business Taxes Were Smaller Relative to the Overall State Economy Than in 42 Other States (FY2009)**



Using data from the same Ernst and Young report, we also see that businesses paid a smaller percentage of total state and local taxes in Massachusetts than in all but six other states in the nation (see Figure 34). In FY 2009, according to this study, businesses paid 45.4 percent of total state and local taxes in the US, while in Massachusetts this figure was 39.8 percent, placing us 44<sup>th</sup> among all states. On average, the percentage of total state and local taxes paid by businesses was more than 12 percent higher in the US as a whole than in Massachusetts.

<sup>173</sup> Calculation: 4.7%-4.0%= 0.7%, \$332.5 billion x .007= \$2.33 billion.

**Figure 34. In Massachusetts, State & local Taxes on Business Were a Smaller Percentage of Total State & Local Taxes Than in 43 Other States (FY 2009)**

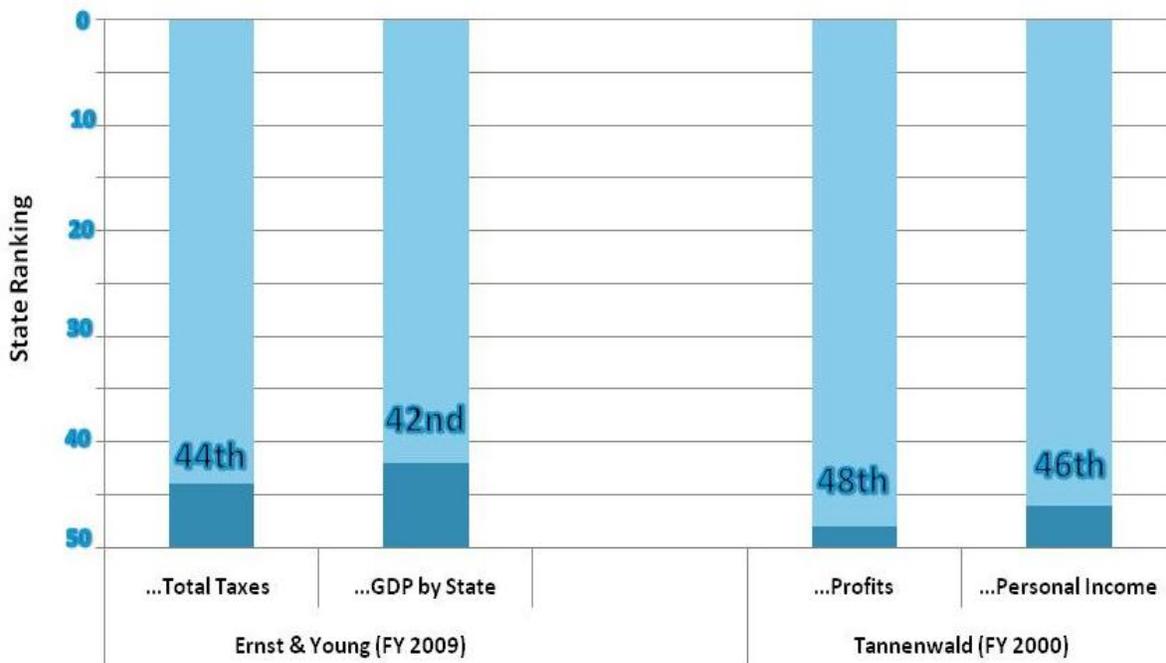


A second study -- by then-Federal Reserve Bank of Boston economist, Robert Tannenwald -- used data from FY 2000. This 2004 study found that business taxes as a portion of business profits were lower in Massachusetts than in 47 other states (see Figure 35, below), and that business taxes relative to personal income were lower in Massachusetts than in 45 other states.<sup>174</sup>

Between them, these two national studies examine four different measures of business taxation: business taxes as a share of all taxes collected; business taxes as a share of GDP; business taxes as a share of state business profits; and business taxes as a share of state personal income. By each of the four measures, Massachusetts ranked among the 10 states with the lowest business taxes.

<sup>174</sup> Tannenwald, Robert, "Massachusetts Business Taxes: Unfair? Inadequate? Uncompetitive?," Federal Reserve Bank of Boston Public Policy, Discussion Papers, No. 04-4, August 20, 2004: <http://www.bos.frb.org/economic/ppdp/2004/ppdp0404.pdf>

Figure 35. Where Massachusetts Ranks Relative to Other States: *Business Taxes as a Share of...*



So, while Massachusetts collects a higher percentage of its total state and local business taxes through application of its *corporate income tax* (thus placing Massachusetts 7<sup>th</sup> in rank among all states by this measure -- see Table 2, above), many of the *other* taxes that businesses pay (sales tax, excise and gross receipts taxes, license taxes) are significantly lower in Massachusetts than in other states. In fact, by the four more comprehensive measures discussed above (and shown in Figure 35), it is clear that Massachusetts provides a comparatively low-tax business environment, one in which businesses enjoy high profits relative to the amount of taxes they pay.

## CORPORATE INCOME TAX

The corporate income tax is usually seen as a progressive tax (see Table 3, below), since the direct beneficiaries of corporate profits tend to cluster at the top end of the income scale.<sup>175</sup> The immediate incidence of the corporate income tax, however, is on the corporation itself, not the owners of the corporation. This complicates an analysis of who ultimately pays the tax. But it points to a further logic for imposing reasonable taxes on corporations: corporations rely on government services such as transportation infrastructure, and police and fire protection, and they benefit from good public schools that can train the highly skilled workers businesses increasingly need.

<sup>175</sup> Congressional Budget Office, *Historical Effective Federal Tax Rates: 1979 to 2004*, December 2006.

**Table 3. Share of Corporate Income Tax Liabilities for All Households by Comprehensive Household Income Quintile, 2005**

Lowest Quintile	0.6%
Second Quintile	1.4%
Middle Quintile	3.0%
Fourth Quintile	6.2%
Highest Quintile	87.8%
Top 10%	81.6%
Top 5%	74.9%
Top 1%	58.6%

Source: Congressional Budget Office, *Historical Effective Federal Tax Rates: 1979 to 2005*, December, 2005

While stockholders and investors pay the short-term costs of the corporate income tax, over the long-term some of these costs may be shifted to consumers through higher prices and to workers through lower wages. Therefore, looked at long-term, the corporate income tax is not quite as progressive as it at first seems to be.<sup>176</sup>

The corporate income tax is even less stable than the personal income tax, since corporate profits tend to react even more strongly to economic conditions than does personal income. Additionally, there is a fundamental adequacy issue with the corporate income tax, since corporations often are able to find ways to shield their income from state taxation as they shift income among subsidiaries and pursue other tax avoidance strategies. This can create horizontal equity problems as well, as some corporations will have the resources to be more successful in finding tax law loopholes than will others. With the introduction of “combined reporting” in Massachusetts, however, corporations are no longer able to shield income from state taxation by shifting income between subsidiaries. One of the principal means for corporate tax avoidance, therefore, has been eliminated in the Commonwealth (see discussion below of “*Corporate Tax Loopholes*”).

#### *A BRIEF HISTORY OF AND SOME RECENT CHANGES TO THE MASSACHUSETTS CORPORATE INCOME TAX*

A corporate income tax, called the “corporation excise tax,” was adopted by Massachusetts in 1919. For Tax Year 2010, Massachusetts will apply a rate of 8.75 percent flat rate on most taxable corporate income, a rate significantly lower than that applied in 2009 (9.5 percent). A 2008 tax law change for corporations will reduce steadily the corporate excise tax rate to 8.0 percent by 2012.<sup>177</sup> These changes (discussed in greater detail below), along with a number of other changes to the corporate income tax laws made in the last 15 years or so, have had a substantial impact on the amount of revenue collected from corporations by the Commonwealth.

#### *SINGLE SALES FACTOR*

Unlike the income of most individuals, whose earnings often are reasonably straightforward, determining the taxable earnings of businesses -- and particularly businesses with subsidiaries

<sup>176</sup> Congressional Budget Office, *The Incidence Of The Corporate Income Tax*, March 1996.

<sup>177</sup> Massachusetts Session Laws of 2008, Ch.173: <http://www.mass.gov/legis/laws/seslaw08/sl080173.htm>

operating in multiple states -- can be quite complicated. To determine how much of a multi-state company's profits should be taxed in a state, states generally use a formula that looks at how much of the company's sales, property, and payroll is in the state. Historically, Massachusetts used such a formula, though it counted sales twice ("double weighting" sales relative to other factors). In 1995, however, Massachusetts enacted a law implementing use of a single-sales formula for manufacturers (i.e., counting only sales, and not counting property or payroll). In 1997, a similar formula for mutual fund companies went into effect. These three changes (double weighting sales, single sales for manufacturers, single sales for mutual funds) work to the benefit of many companies operating in the Commonwealth, and together cost the state about \$300 million in revenues each year.<sup>178</sup> (For a more extensive discussion, see Michael Mazerov, *The "Single Sales Factor" Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway?*<sup>179</sup>).

### CORPORATE TAX LOOPHOLES

In July of 2008, Governor Patrick signed legislation aimed at reducing corporate tax avoidance. The most significant reform in the legislation was the adoption of "combined reporting." This system, now used in about half of the country, makes it more difficult for multi-state companies with numerous subsidiaries to reduce their taxes by shifting income between subsidiaries. It does this by requiring businesses with numerous subsidiaries that are engaged in what is termed a "unitary business" to file a combined return, with the income and losses of all of the subsidiaries included.<sup>180</sup> As a result, shifting income between subsidiaries -- as multi-state companies previously had been able to do to exploit loopholes in the tax system -- no longer works as a tax avoidance strategy.

The 2008 legislation also brought Massachusetts in line with the rest of the country by requiring that companies be classified as the same type of legal entity for both state and federal tax purposes. Under federal laws, some companies can choose the type of entity they will be considered to be for tax purposes (a corporation or a partnership, for example). The company's choice may have implications for their federal and/or their state tax liability. The company indicates their choice by checking a box on federal forms indicating their choice (known as "check-the-box reporting"). Other states automatically treat those companies the same way for state tax purposes as they are treated for federal tax purposes. Until 2008, however, Massachusetts did not. As a result, companies were able to reduce their state taxes by being treated as one type of entity in Massachusetts and as another in other states and federally. The 2008 legislation will require conformity between federal and state treatments of these companies under Massachusetts tax law.

In addition to closing loopholes in the state's corporate income tax laws, the 2008 legislation included a series of tax rate reductions for different types of corporate entities. The corporate income tax rate will

<sup>178</sup> The cumulative \$300 million estimate comes from the Massachusetts Tax Expenditure Budget Fiscal 2010, January 2009 ( pg #8-59):

<http://www.mass.gov/bb/h1/fy10h1/dnld10/taxexpend10.pdf>

DOR estimates that the single sales factor apportionment formula for manufacturers will cost the Commonwealth \$87 million in forgone revenue in FY 2010. They further estimate that the apportionment changes made on behalf of mutual fund companies will cost \$129 million in FY 2010: DOR's *Revenue Impacts of Certain MA Tax Law Changes Since January 1991* (see Appendix D).

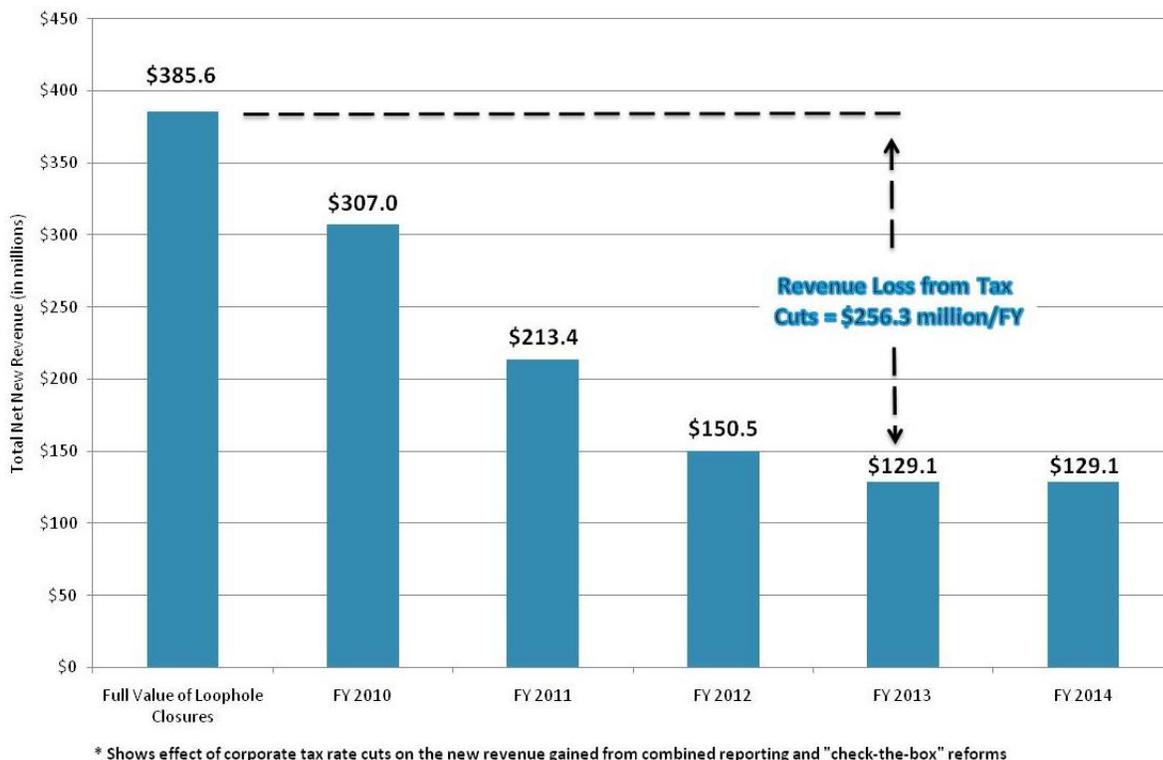
<sup>179</sup> Center on Budget and Policy Priorities, Revised Sept. 2005: <http://www.cbpp.org/files/3-27-01sfp.pdf>

<sup>180</sup> For example, if a corporation owned a television assembly plant in Massachusetts and also owned out-of-state subsidiary businesses that produced parts used in the television assembly plant, this collection of subsidiaries likely would be considered a "unitary business" and would be subject to combined reporting requirements. On the other hand, if a corporation owned both an in-state car dealership and an out-of-state sheep farm, these business entities likely would have little overlap in operations and therefore likely would not be considered a "unitary business." Thus, the corporation would be free from the combined reporting requirements as regards these two separate business operations; that is, the state could tax the profits of the car dealership, but could not require it to combine its profits with the out-of-state sheep farm.

drop from 9.5 percent to 8.0 percent over four years (2009-2012), and the rates for financial institutions will drop from 10.5 percent to 9.5 percent over the same period.<sup>181</sup> A comparable modification in tax assessments on S-corps also was included in the 2008 legislation, dropping their rates from 10.5 percent to 9.0 percent over the 2009 to 2012 period.<sup>182</sup>

Estimates produced by DOR indicate that -- even given the troubled economic landscape -- absent the planned reductions in corporate tax rates, combined reporting will generate an additional \$250 million annually for the Commonwealth, while "check-the-box" reporting will generate an additional \$135 million each year.<sup>183</sup> The phased corporate tax rate reductions included in the law, however, will steadily reduce these revenue gains such that by FY 2013 the Commonwealth will forgo annually \$256.3 million of the \$385.6 million gained through loophole closures (see Figure 36).<sup>184</sup>

**Figure 36. Corporate Tax Cuts Will Reduce the Revenues Gained from Loophole Closures by Over \$250 Million Annually by 2013\***



<sup>181</sup> Massachusetts Session Laws of 2008, Ch.173: <http://www.mass.gov/legis/laws/seslaw08/sl080173.htm>

<sup>182</sup> Ibid.. Taxation of S-corps is not set at a single rate, but instead depends on a more complicated formula that factors in the size of each S-corp annual receipts as well as taxes paid through the personal income tax. In its analysis, DOR does not provide a disaggregated estimate for revenue gains or losses resulting from changes to the S-corp tax formula.

<sup>183</sup> *MassBudget* here provides the DOR estimates released in October 2009. These figures are for a full year of revenue gains and do NOT include the loss of revenue that will result as corporate and financial institution tax rate reductions are phased in starting in 2010. The FY 2010 DOR estimates provided in Appendix A (combined reporting gains at \$238 million and check-the-box gains at \$124 million) are slightly lower than these figures as they factor in the loss of revenue resulting from tax rate cuts in FY 2010.

<sup>184</sup> DOR Projections, October 2009 (see Appendix G). In a revised estimate for FY 2010 (from June 2010, see Appendix D), DOR has made a modest downward adjustment to its figure for combined revenue losses from corporate/ financial institution tax rate cuts for FY 2010 (from a revenue loss of \$55.6 million to a loss of \$51 million). However, this revision provides an estimate only for FY 2010. As our discussion focuses on longer-term, cumulative revenue losses, *MassBudget* presents here the figures from the very similar, five-year set of estimates produced by DOR in October, 2009.

Of the \$256.3 million in forgone revenue gains, the corporate income tax rate reductions will account for about three-quarters of the annual revenue losses, while reductions in the tax rate for financial institutions will account for the other quarter (once the changes are fully implemented.)<sup>185</sup>

Reducing corporate tax rates (which will reduce collections) in combination with closing certain corporate tax loopholes (which will increase collections) is projected, however, to *increase net* revenues for the Commonwealth by some \$129 million annually once all the changes are fully implemented (by FY 2013, see Table 4 below).<sup>186</sup> Improvements in the economy would increase both the revenues derived from loophole closures and the revenue losses from tax rate reductions. Growth in revenue gains, however, would outstrip the growth in losses, leading to a still greater net increase in revenue collections from these corporate tax law changes when economic conditions improve.

**Table 4. Massachusetts' 2008 Corporate Tax Law Changes: Revenue Gains & Losses**

Fiscal Year	Full Annual Value of Loophole Closures (millions)	Revenue Los Due to Tax Reductions (millions)	Net Revenue Gain (millions)
2010	\$386	(\$79)	\$307
2011	\$386	(\$172)	\$213
2012	\$386	(\$235)	\$151
2013	\$386	(\$257)	\$129
2014	\$386	(\$257)	\$129
2015	\$386	(\$257)	\$129

\* Figure includes additional revenues from both combined reporting and "check-the-box" 2008 corporate tax reforms.

Source: MassBudget calculations based on Massachusetts Department of Revenue estimates.

Importantly, however, DOR also has determined that yet another provision of the law (which relates to the "Statement of Financial Accounting Standards (FAS) No. 109") will have a significant negative impact on collections during the years 2012 to 2018. This provision is expected to cost the Commonwealth at least \$535 million over these seven years, with over 80 percent of this lost tax revenue benefiting just nine companies, and over 50 percent of the lost revenue benefiting just three companies.<sup>187</sup> This provision, DOR estimates, likely will cost the Commonwealth between \$76 million and \$79 million during each of these seven years, thus further reducing the net gains (of \$129 million annually, see Table 4) described above. The resulting net gain, therefore, is likely to be something closer to \$55 million annually during the FY 2013-2018 period, after taking into account the effects of this provision.

In addition to the revenue impacts described above (resulting from the 2008 corporate tax law changes), in 2010, the Legislature approved and the Governor signed into law a series of changes that

<sup>185</sup> Ibid.

<sup>186</sup> Ibid..

For additional discussion of these issues, please see *MassBudget's Facts at a Glance: Corporate Tax Update II*: <http://www.massbudget.org/doc/707>

<sup>187</sup> A more complete explanation of this provision can be found on the *MassBudget* website at: <http://www.massbudget.org/doc/694>. Also, see memo from the Massachusetts Department of Revenue: [http://www.massbudget.org/file\\_storage/documents/FAS%20109%20Report.pdf](http://www.massbudget.org/file_storage/documents/FAS%20109%20Report.pdf)

will provide additional tax breaks to businesses and investors.<sup>188</sup> Estimates by DOR indicate that these changes will cost the state a combined \$70 million a year within a decade, and as the impact of the changes grows with time, will cost the state some \$130 million a year twenty years from now.<sup>189</sup>

#### *HOW MASSACHUSETTS MEASURES UP IN CORPORATE INCOME TAXES*

Massachusetts collected \$2.2 billion in corporate income taxes in FY 2008.<sup>190</sup> This was 4.6 percent of state and local own-source revenue, and 6.4 percent of state and local taxes.<sup>191</sup> This tax was collected entirely by the state rather than local governments.

Nationwide, in FY 2008, corporate income taxes made up 3.0 percent of state and local own source revenue, and 4.3 percent of national state and local taxes.<sup>192</sup> States (as opposed to local governments) collected 87.8 percent of these corporate income taxes.

Corporate income tax collections were equal to 0.7 percent of personal income in Massachusetts in FY 2008. Massachusetts ranked 7<sup>th</sup> in corporate income taxes paid as a share of total state personal income (see Figure 37). As discussed earlier, however, by many different measures, the *total* amount of taxes collected from businesses (including all different types of taxes paid by businesses) is lower in Massachusetts than in most other states. Massachusetts simply collects more of its business taxes through the corporate income tax, while other states rely more heavily on their sales tax, excise and gross receipts taxes, and license fees.

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<sup>188</sup> *MassBudget, Facts At A Glance, July 13, 2010*: [http://www.massbudget.org/documentsearch/findDocument?doc\\_id=736](http://www.massbudget.org/documentsearch/findDocument?doc_id=736) The estimates contained in this Tax Primer reflect updated DOR estimates as of September 15, 2010. These updated estimates are slightly lower than the, then current DOR estimates reported in the *Facts At A Glance* from July 13, 2010.

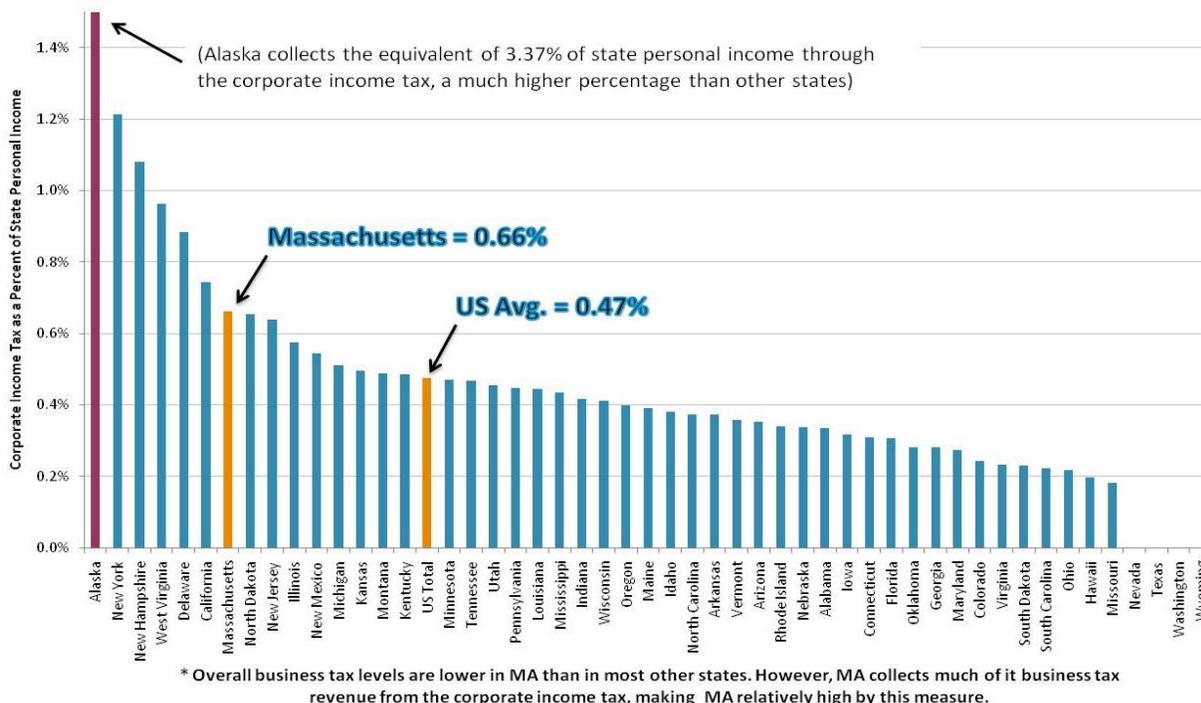
<sup>189</sup> *Ibid.*

<sup>190</sup> U.S. Census Bureau, *State and Local Government Finances by Level of Government and by State: 2007-08*. The 2007-08 Census data is the most recent available: <http://www.census.gov/govs/estimate/>

<sup>191</sup> *Ibid.*

<sup>192</sup> *Ibid.*

**Figure 37. While the Overall Level of Business Taxation in Massachusetts is Low Compared to Other States,\* the Corporate Income Tax is Relatively High (2008)**



*CORPORATE TAXATION AND ECONOMIC DEVELOPMENT TAX EXPENDITURES*

Another important aspect of corporate taxation is the substantial amount of state taxes that businesses in the Commonwealth are permitted to avoid through what are known as “tax expenditures.” “Tax expenditures” is a term that describes the long list of tax deductions, exemptions, credits, deferrals, and the special tax rules that the Commonwealth offers to businesses and to individuals.<sup>193</sup> In terms of their impact on the budget, these various kinds of tax breaks are no different than other kinds of spending; they reduce the total amount of revenue available for other programs and services. As such, the relative costs and benefits of these “expenditures” must be weighed against the costs and benefits of other public spending.

Some tax expenditures are designed to benefit individuals and families by augmenting their after-tax household incomes (for example, the exemption of most food items from the general sales tax, or the exemption of Social Security benefits from income taxes). Other tax expenditures, however, are designed instead to reduce taxes on businesses. Proponents argue that these business-focused tax expenditures (i.e., tax reductions) attract new businesses to the state and encourage existing businesses to remain here and expand operations, leading to the state’s overall economic growth.<sup>194</sup> These types of

<sup>193</sup> A tax credit directly reduces the amount of tax due. A tax deduction, by contrast, reduces the amount of income on which taxes are due. A deferral allows a taxpayer to delay the payment of a tax for a certain period of time, and an exemption excludes a taxpayer (or some component of their income) from being subject to a certain tax.

<sup>194</sup> Considerable debate exists about the effectiveness of business-focused tax expenditures and their ability to generate and sustain economic growth in a cost effective manner. A recent report by researchers at the Federal Reserve Bank of Boston (December, 2009) explores this question with regards to several specific types of economic development tax expenditures: <http://www.bos.frb.org/economic/neppc/dp/2009/dp093.htm>

tax expenditures are called “economic development tax expenditures” and include such things as tax breaks for investing in research and development or in capital improvements (new equipment, buildings, vehicles, etc.).

Many economists who study such expenditures find they have limited impact on business decisions or on a state’s long-term economic development.<sup>195</sup> Meanwhile, others argue that they drain public resources from more reliable and cost-effective growth strategies, such as public investments in a state’s people and infrastructure.<sup>196</sup>

Each year, the Massachusetts Department of Revenue (DOR) publishes a “Tax Expenditure Budget” that catalogs all the tax expenditures that the Commonwealth makes. The annual DOR report includes estimates of the amount of revenue lost through each specific tax expenditure. DOR estimates that, together, these forgone revenues will exceed \$20 billion in FY 2010 (this figure includes *all* tax expenditures, including such things as the nontaxation of employer provided health insurance, nontaxation of social security benefits, deductions for various expenses related to dependent children and many others).<sup>197</sup>

As noted, however, only some of this \$20 billion in expenditures is aimed directly at producing economic development. In a 2009 report, *MassBudget* examined the DOR publication in detail and determined that some \$1.7 billion in revenues will be lost in FY 2010 through economic development tax expenditures.<sup>198</sup> This figure far exceeds direct budgetary spending on economic development programs such as workforce training and employment services, technical and financial assistance to businesses, and tourism promotion. These economic development programs -- funded directly through the budget rather than through tax expenditures<sup>199</sup> -- will amount to only \$138 million in FY 2010, or less than 10 percent of the Commonwealth’s economic development tax expenditures.<sup>200</sup>

Massachusetts, however, makes other large, on-budget investments that help achieve the goals of economic development, though they would not be categorized specifically as economic development appropriations. These include long-term strategies to increase the productivity of our workforce and our economy by investing in higher education and in our infrastructure. Notably, however, spending on economic development through tax expenditures is growing far more quickly than the state budget

<sup>195</sup> Ibid.

<sup>196</sup> Robert Lynch, Economic Policy Institute, *Rethinking Growth Strategies*, March 2004:

[http://www.epi.org/publications/entry/books\\_rethinking\\_growth/](http://www.epi.org/publications/entry/books_rethinking_growth/)

MassBudget, Building a Strong Economy, June 2007:

[http://www.massbudget.org/documentsearch/findDocument?doc\\_id=564](http://www.massbudget.org/documentsearch/findDocument?doc_id=564)

<sup>197</sup> *MassBudget* Brief, Dec. 2009: [http://www.massbudget.org/documentsearch/findDocument?doc\\_id=710](http://www.massbudget.org/documentsearch/findDocument?doc_id=710)

Tax Expenditure Budget 2010: <http://www.mass.gov/bb/h1/fy10h1/dnld10/taxexpend10.pdf>

<sup>198</sup> The overwhelming majority of the \$1.7 billion in tax expenditures that *MassBudget* defines as being for “economic development” go to benefit businesses rather than individuals. The single exception is the “Tuition and Student Loan Interest Deduction” which it is estimated will cost the state \$34.8 million in forgone revenue in FY 2010.

<sup>199</sup> Tax expenditures are in many ways similar to direct appropriations. Both seek to achieve certain policy goals through the use of the state’s economic resources, and both have an effect on the state’s bottom line. A primary difference is that budget appropriations must be reauthorized by the Legislature each year, while tax expenditures remain in effect without the Legislature having to review or renew them.

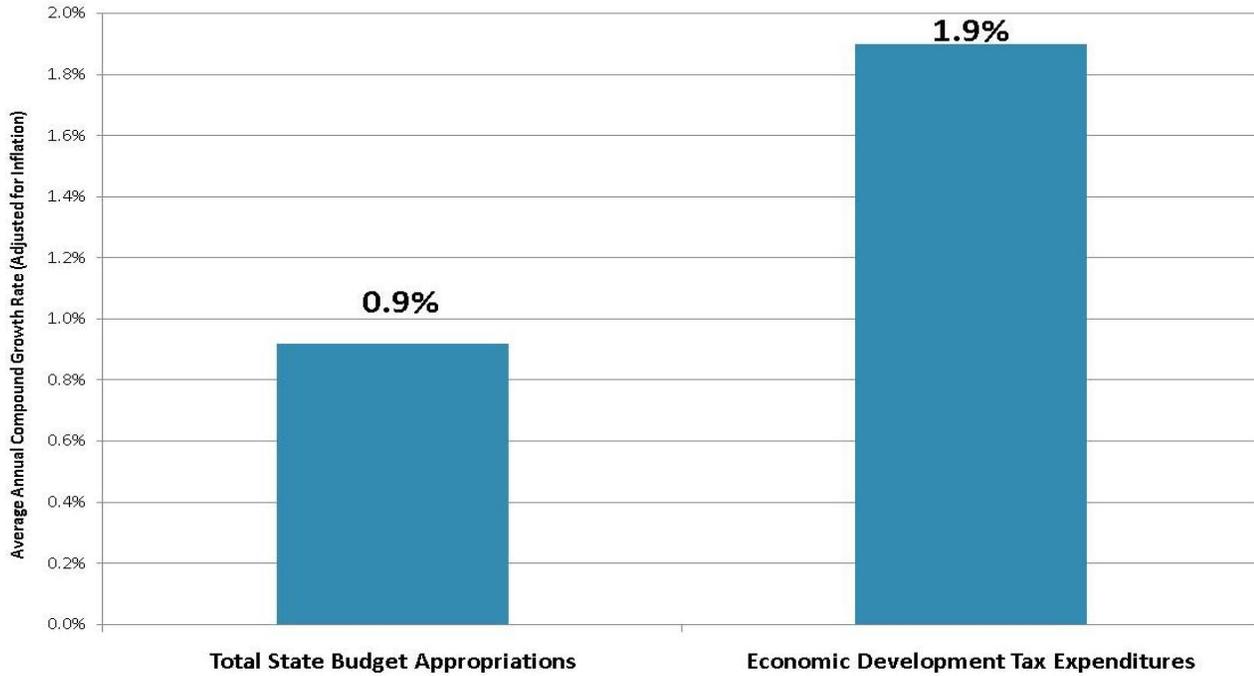
<sup>200</sup> *MassBudget* Brief, *Economic Development Tax Expenditures* (Dec. 2009):

[http://www.massbudget.org/documentsearch/findDocument?doc\\_id=710](http://www.massbudget.org/documentsearch/findDocument?doc_id=710)

Direct budget appropriations for economic development were defined as those funds allocated for workforce training programs, job placement services, providing technical and financial assistance to businesses, aid to small businesses, tourism, infrastructure, and research. This includes programs within state and community colleges that are geared toward workforce or economic development, but does not include all of the higher education spending included in the budget.

as a whole (see Figure 38).<sup>201</sup> The effectiveness of economic development tax expenditures, however, is rarely examined in any detail and very little data is available to help researchers analyze their effectiveness.

**Figure 38. Real Annual Spending on Economic Development Tax Expenditures Has Grown at Twice The Rate of the State Budget, 2002-2010**



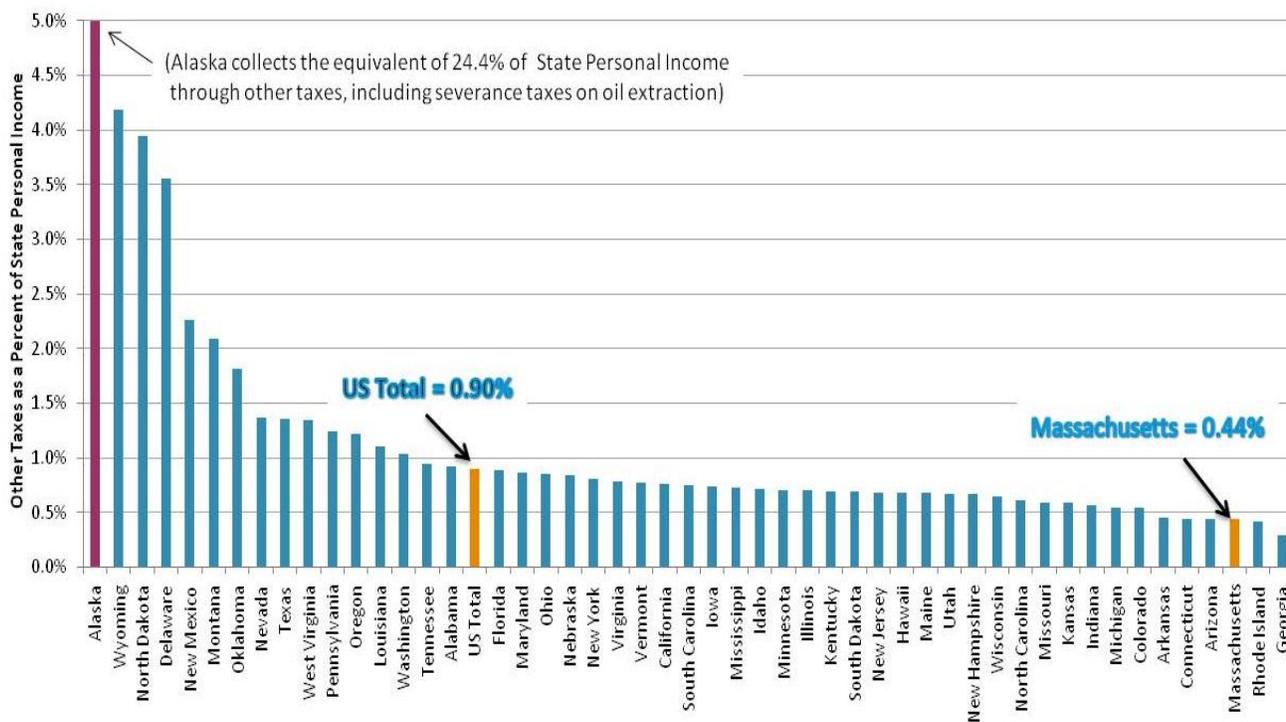
<sup>201</sup> *MassBudget Brief, Economic Development Tax Expenditures* (Dec. 2009): [http://www.massbudget.org/documentsearch/findDocument?doc\\_id=710](http://www.massbudget.org/documentsearch/findDocument?doc_id=710)

## CHAPTER 8: OTHER TAXES

The last piece of the state and local tax picture is revenue generated from such miscellaneous taxes as severance taxes on natural resources, business franchise taxes, taxes on public utilities, and estate taxes. In this chapter we will take a closer look at only one of the many taxes in the “Other Tax” category, the Massachusetts Estate Tax.

Together, Other Taxes accounted for \$1.4 billion in revenue for the Commonwealth in FY 2008, or 4.2 percent of all state and local tax revenues.<sup>202</sup> Other Taxes amounted to 0.44 percent of state personal income in Massachusetts. Only two other states derived a smaller amount of revenue (measured as a share of state personal income) from these sources in FY 2008 (Figure 39).

**Figure 39. Massachusetts Collected a Smaller Share of Personal Income Tax in Other Taxes Than Did Most States (2008)**



Other Tax revenue in Alaska -- which garners a considerable amount of state revenue from severance taxes on natural resources (particularly oil) -- amounted to 24.4 percent of state personal income in FY 2008, the highest level of any state. Overall, the 50 states generated revenue equal to 0.90 percent of state personal income in FY 2008 from these other tax sources.

<sup>202</sup> U.S. Census Bureau, *State and Local Government Finances by Level of Government and by State: 2007-08*. The 2007-08 Census data is the most recent available: <http://www.census.gov/govs/estimate/>

## THE ESTATE TAX

Massachusetts is one of 23 states that now collect an estate tax (or an inheritance tax, or both) on property and possessions passed down from the deceased to family members or other beneficiaries.<sup>203</sup> As is true of the Real Estate Transfer Tax (see Chapter 3), the estate tax is levied on the *transfer* of property rather than on *possession* of the property. Nevertheless, like the property tax, the estate tax is a form of “wealth tax,” applied not to annual income but to holdings that historically have been understood as a measure of material security and well-being. In Massachusetts, an estate is subject to the estate tax if its gross value exceeds \$1 million (or \$2 million for an estate that was held by a married couple).

### *HOW DOES THE ESTATE TAX WORK?*

Estate taxes are applied to possessions and property of a deceased person prior to being distributed to family members or other beneficiaries (with the exception of a spouse, to whom the estate can pass, free of taxation). In Massachusetts, there is an “exclusion” for the estate tax of \$1 million per individual. This means that estates with a gross value of less than \$1 million are not subject to the tax. Estates held originally by a married couple have an exclusion of \$2 million when passed along at the time of death of the surviving spouse.

For estates that are subject to the estate tax, the amount owed is based on the size of the estate. Applicable rates range from 0.8 percent up to 16 percent (the highest rates apply to the portion of estates exceeding \$10 million in value).<sup>204</sup> If the gross value of an estate exceeds the \$1 million exclusion, the Massachusetts estate tax is applied to the entire value of the estate -- not just the amount above the exclusion.<sup>205</sup>

Because so few Massachusetts estates have a gross value that exceeds the exclusion amount, the estate tax affects only a small percentage of families in the Commonwealth. In 2009, less than 3,300 estate tax filings were submitted in Massachusetts, of which less than a third (1,021) owed any estate taxes.<sup>206</sup> Given that some 53,000 deaths occurred in Massachusetts in 2008 (estate filings typically lag by 9 months to one year after the date of death, so 2008 is the appropriate corresponding data on deaths), this suggests that less than 2 percent of Massachusetts residents owe any state estate taxes upon their death.<sup>207</sup>

In FY 2008, the estate tax generated \$254 million for the Commonwealth and in FY 2009 it generated \$260 million.<sup>208</sup> In FY 2010, the Massachusetts estate tax generated \$221 million.<sup>209</sup>

<sup>203</sup> An “estate tax” is collected before the estate passes from the deceased to his/her inheritors, while an “inheritance tax” is collected from the inheritor once the estate has transferred from the deceased.

Center on Budget and Policy Priorities, Dec. 2009: <http://www.cbpp.org/cms/index.cfm?fa=view&id=337>

<sup>204</sup> Massachusetts uses rates established by the IRS and in effect in 1999, presented in Form 706: [http://www.mass.gov/Ador/docs/dor/Forms/Est\\_Tax/PDFs/f706instr.pdf](http://www.mass.gov/Ador/docs/dor/Forms/Est_Tax/PDFs/f706instr.pdf)

<sup>205</sup> By contrast, the federal tax is applied only to the portion of the estate that exceeds the federal exclusion amount.

<sup>206</sup> Communication between MA DOR and the Center on Budget and Policy Priorities, March 19 and March 23, 2010.

<sup>207</sup> Centers for Disease Control and Prevention, *National Vital Statistics Report, 2008* (see Table 1b):

[http://www.cdc.gov/nchs/data/nvsr/nvsr57/nvsr57\\_19.htm#table1](http://www.cdc.gov/nchs/data/nvsr/nvsr57/nvsr57_19.htm#table1)

<sup>208</sup> Massachusetts Department of Revenue Blue Book data (see annual June reports, Table B, “Estate and Inheritance Tax”):

[http://www.mass.gov/?pageID=dorterminal&L=3&L0=Home&L1=Tax+Professionals&L2=News+and+Reports&sid=Ador&b=terminalcont&f=dor\\_stats\\_bluebook\\_blue&csid=Ador](http://www.mass.gov/?pageID=dorterminal&L=3&L0=Home&L1=Tax+Professionals&L2=News+and+Reports&sid=Ador&b=terminalcont&f=dor_stats_bluebook_blue&csid=Ador)

<sup>209</sup> MA DOR Blue Book data for June 2010: [http://www.mass.gov/Ador/docs/dor/Stats/BlueBook/FY2010/June\\_2010\\_Prelim.pdf](http://www.mass.gov/Ador/docs/dor/Stats/BlueBook/FY2010/June_2010_Prelim.pdf)

## HOW DOES MASSACHUSETTS' ESTATE TAX LAW INTERACT WITH THE FEDERAL LAW?

Starting in 2001, the federal government began increasing the exclusion for the estate tax, on a timeline that would eliminate the tax altogether starting in 2010. Since 2001, the federal estate tax exclusion has increased steadily from \$675,000 to \$3.5 million.<sup>210</sup> This means that estates with a gross value of less than \$3.5 million (or \$7 million for a married couple) pay no estate tax to the federal government. In addition, the federal government has reduced the estate tax rates. In 2001, the maximum federal estate tax rate was 55 percent. This rate applied only to that portion of total taxable value that exceeded \$3 million (lower rates -- increasing steadily from 18 percent to 53 percent -- applied to the portion of total taxable value below \$3 million).<sup>211</sup> By 2009, the maximum federal tax rate had dropped to 45 percent.<sup>212</sup>

Following the changes enacted at the federal level in 2001, Massachusetts chose to “decouple” from the federal law, meaning that Massachusetts’ estate tax law no longer would be linked directly to federal law. Prior to 2002, the Massachusetts estate tax exclusion was equal to that of the federal government. With decoupling, unlike the federal government, Massachusetts has held its estate tax exclusion at \$1 million (\$2 million for a married couple). In addition, estate tax rates in Massachusetts are applied according to a federal rate schedule that was in place before the 2001 tax changes were enacted.<sup>213</sup> This rate schedule was used to calculate the maximum amounts of state-level estate taxes that the federal government would permit filers to deduct from any federal estate tax they might owe (this deductible amount is termed a “tax credit”). Prior to 2001, most states taxed eligible estates at these rates in order to maximize state collections, knowing that any estate taxes they did not collect would simply be collected by the federal government instead.<sup>214</sup> Either way, the filer would pay the same net total in combined state and federal estate taxes.

### PROGRESSIVITY OF THE ESTATE TAX

The Massachusetts estate tax is progressive because it is applied only to estates worth \$1 million (\$2 million for a married couple) or more. As noted above, very few estates in Massachusetts therefore pay any estate tax to the Commonwealth. For estates subject to the estate tax, however, the progressivity of the tax in Massachusetts is limited because the range in rates is modest (from 2 percent to 16 percent), and the top rate applies to all of the estate value exceeding \$10 million (rather than rising steadily with increasing estate value beyond \$10 million).

<sup>210</sup> Center on Budget and Policy Priorities: <http://www.cbpp.org/files/policybasics-estatetax.pdf>

<sup>211</sup> Congressional Research Service, “Calculating Estate Tax Liability: 2001 to 2011 and Beyond” <http://www.nationalaglawcenter.org/assets/crs/RL33718.pdf>

<sup>212</sup> The Center on Budget and Policy Priorities estimates that less than one quarter of one percent (0.25 percent) of all estates in the US - or about 2 out of every 1000 estates - will owe any federal estate tax in 2009, and that on average, these estates will pay an effective federal tax rate of less than 20 percent: <http://www.cbpp.org/slideshows/?fa=estateTax>

<sup>213</sup> Massachusetts chooses to use these older federal rates, but is no longer legally “coupled” to the federal system. IRS, *Instructions for Form 706* (see pg 12): [http://www.mass.gov/Ador/docs/dor/Forms/Est\\_Tax/PDFs/f706instr.pdf](http://www.mass.gov/Ador/docs/dor/Forms/Est_Tax/PDFs/f706instr.pdf)

<sup>214</sup> An example: Prior to 2001, if Table B indicated that an estate’s maximum federal credit would equal \$50,000, the state could tax that estate \$50,000 and not increase the estate’s net tax liability. The \$50,000 paid in state-level estate taxes would be deducted from whatever federal estate taxes that estate might be liable for. Thus, if the estate was liable for \$350,000 in federal estate taxes, they instead would have paid the federal government \$300,000, having already paid the state \$50,000. As part of the 2001 federal estate tax changes, this credit system was replaced with a system that does not automatically offset all state taxes, dollar for dollar, up to a certain level. Instead, a percentage of an estate’s state-level taxes are credited against their federal liability. The result is that states now are placed in competition with each other to lower their estate tax rates well below Table B rates, driving down estate tax collections. Massachusetts has not joined other states in competing for the lowest rates of estate taxation.

*REVENUE OPTIONS*

In order to increase or decrease revenues from the estate tax, the two major options are either to change the exclusion amount for estates or to change the tax rates on estates of higher value.

**Changing the exclusion:** Among states that have an estate tax, exclusion amounts vary from \$675,000 to \$3.5 million (equal to the current federal exclusion). By lowering Massachusetts' estate tax exclusion to \$675,000 - the same rate as New Jersey and Rhode Island - Massachusetts would increase its estate tax collections. Using federal tax data, along with tax data from Rhode Island and Massachusetts, the Center on Budget and Policy Priorities estimates that Massachusetts would collect an additional \$20-25 million annually by lowering its exclusion to \$675,000 per individual (\$1.35 million per married couple).<sup>215</sup> Lowering the exclusion would reduce the progressivity of the tax; the new revenue generated would come from estates less wealthy than those currently subject to the tax.

Raising the exclusion to the federal level of \$3.5 million would result in a significant reduction in estate tax revenues. *MassBudget* cannot produce a good estimate of the amount of revenue that would be lost due to such a change; the Massachusetts Department of Revenue (DOR) does not keep data on the size of estates subject to the estate tax, and other states do not present useful models for the purposes of comparison.

**Changing tax rates on higher value estates:** By creating additional brackets that would tax high value estates at rates above the current 16 percent level, Massachusetts would increase the amount of revenue generated through the estate tax. At present, all taxable estate value exceeding \$10 million is taxed at a flat rate of 16 percent. Unlike reducing the exclusion on the state's estate tax, applying higher tax rates to estates of greater value would increase the progressivity of the state's estate tax while generating additional revenue. The additional revenue generated under such a rate structure would be collected from a small number of very wealthy estates.

As noted, however, the Massachusetts DOR does not provide distributional data on estate values. It is not possible, therefore, to provide detailed analysis of how tax rate changes would affect state revenues or provide estimates of the number of estates affected by these changes (along with average impacts) broken out by estate value.

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<sup>215</sup> Analysis performed by Center on Budget and Policy Priorities upon request from MassBudget, April 2010

## APPENDIX A: THE MASSACHUSETTS CIRCUIT BREAKER PROGRAM (2007 PARTICIPATION & COST DATA)

**TABLE 1: 2007 MA CIRCUIT BREAKER CREDIT & NET AGI FOR FILERS OVER 65 BY INCOME BRACKETS**

MASS NET AGI	TOTAL FILERS	SENIOR CIRCUIT BREAKER CREDIT		MASS NET AGI		TAX AFTER CREDIT		FILERS & SPOUSES	FILERS, SPOUSES & DEPENDENTS
	(# OF FILERS)	(# OF FILERS)	(\$ 1,000's)	(# OF FILERS)	(\$ 1,000's)	(# OF FILERS)	(\$ 1,000's)	(# of individuals)	(# of individuals)
Under \$5,000	80,185	27,332	20,203	62,500	-140,818	6,774	3,742	106,435	108,904
\$5,000 under \$10,000	51,237	13,926	9,658	51,237	386,013	17,633	2,932	67,895	69,395
\$10,000 under \$15,000	48,582	9,981	6,635	48,582	603,099	29,599	10,241	66,469	68,238
\$15,000 under \$20,000	40,182	5,920	3,882	40,182	699,916	34,823	15,792	57,845	59,548
\$20,000 under \$25,000	32,864	3,430	2,243	32,864	736,402	31,269	22,123	48,295	49,824
\$25,000 under \$30,000	27,012	1,902	1,261	27,012	740,798	26,151	24,811	40,780	42,157
\$30,000 under \$35,000	23,471	929	603	23,471	761,155	22,848	27,383	36,106	37,362
\$35,000 under \$40,000	19,685	501	340	19,685	736,457	19,310	27,790	30,884	31,943
\$40,000 under \$45,000	16,553	250	170	16,553	702,073	16,328	27,523	26,244	27,149
\$45,000 under \$50,000	14,025	120	74	14,025	665,275	13,859	26,810	22,721	23,592
\$50,000 & above	122,448	173	125	122,448	26,240,159	121,908	1,296,921	209,023	218,272
<b>TOTAL</b>	<b>476,244</b>	<b>64,464</b>	<b>45,195</b>	<b>458,559</b>	<b>32,130,529</b>	<b>340,502</b>	<b>1,486,069</b>	<b>712,697</b>	<b>736,384</b>

source: MA Dept. of Revenue

**TABLE 2: 2007 MA CIRCUIT BREAKER CREDIT & NET AGI FOR FILERS OVER 65 - SELECTED INCOME BRACKETS**

Mass Net AGI	TOTAL FILERS	SENIOR CIRCUIT BREAKER CREDIT		MASS NET AGI		TAX AFTER CREDIT		FILERS & SPOUSES	FILERS, SPOUSES & DEPENDENTS
	(# OF FILERS)	(# OF FILERS)	(\$ 1,000's)	(# OF FILERS)	(\$ 1,000's)	(# OF FILERS)	(\$ 1,000's)	(# of individuals)	(# of individuals)
Under \$25,000	253,050	60,589	42,621	235,365	2,284,612	120,098	54,831	346,939	355,909
\$25 under \$50,000	100,746	3,702	2,448	100,746	3,605,759	98,496	134,317	156,735	162,203
\$50,000 & above	122,448	173	125	122,448	26,240,159	121,908	1,296,921	209,023	218,272
<b>TOTAL</b>	<b>476,244</b>	<b>64,464</b>	<b>45,195</b>	<b>458,559</b>	<b>32,130,529</b>	<b>340,502</b>	<b>1,486,069</b>	<b>712,697</b>	<b>736,384</b>

source: MA Dept. of Revenue

## APPENDIX B: ESTIMATED IMPACTS OF CHANGES TO THE PROPERTY TAX CIRCUIT BREAKER PROGRAM

### Impact of Various 'Circuit Breaker' Reform Options

All Massachusetts, 2009 Income Levels

2009 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%	
Income Range	Less Than \$19,200	\$19,200 – \$38,200	\$38,200 – \$61,600	\$61,600 – \$102,400	\$102,400 – \$211,500	\$211,500 – \$356,300	\$356,300 – Or More	
Average Income in Group	\$ 11,300	\$ 28,500	\$ 49,600	\$ 79,000	\$ 138,700	\$ 311,400	\$ 1,695,400	State Tax Change (\$1000)

#### Expand existing elderly circuit breaker to include all non-elderly homeowners and renters; maintain all other eligibility requirements and benefit calculations

Tax Change as % of Income	-1.1%	-0.4%	-0.1%	-0.0%	-0.0%	-0.0%	-0.0%	
Average Tax Change	-126	-118	-58	-9	-9	—	—	\$ -205,000
Share of Total Tax Change	38%	36%	18%	3%	2%	0%	0%	

#### Details

Average Tax Cut for Affected Taxpayers	-812	-798	-805	-774	-960	—	—	
% of Income Group Affected	16%	13%	7%	1%	1%	0%	0%	% of Massachusetts With Tax Cut - Total 8%

#### Expand existing elderly circuit breaker to include all non-elderly homeowners and renters; reduce the percentage of income threshold for all claimants from 10 percent to 8 percent

Tax Change as % of Income	-1.3%	-0.6%	-0.2%	-0.0%	-0.0%	-0.0%	-0.0%	
Average Tax Change	-144	-159	-95	-17	-10	—	—	\$ -270,000
Share of Total Tax Change	33%	36%	22%	4%	2%	0%	0%	

#### Details

Average Tax Cut for Affected Taxpayers	-640	-723	-726	-691	-951	—	—	
% of Income Group Affected	22%	22%	13%	3%	1%	0%	0%	% of Massachusetts With Tax Cut - Total 12%

#### Expand existing elderly circuit breaker to include all non-elderly homeowners and renters; reduce the percentage of income threshold for all claimants from 10 percent to 5 percent

Tax Change as % of Income	-1.6%	-0.9%	-0.4%	-0.1%	-0.0%	-0.0%	-0.0%	
Average Tax Change	-180	-246	-204	-85	-14	—	—	\$ -459,000
Share of Total Tax Change	24%	33%	28%	12%	1%	0%	0%	

#### Details

Average Tax Cut for Affected Taxpayers	-655	-755	-809	-752	-948	—	—	
% of Income Group Affected	27%	33%	23%	11%	1%	0%	0%	% of Massachusetts With Tax Cut - Total 20%

#### Expand existing elderly circuit breaker to include all non-elderly homeowners and renters; increase the value of the maximum credit for existing elderly circuit breaker from \$960 to \$1,200

Tax Change as % of Income	-1.4%	-0.5%	-0.1%	-0.0%	-0.0%	-0.0%	-0.0%	
Average Tax Change	-138	-143	-71	-11	-11	—	—	\$ -252,000
Share of Total Tax Change	39%	35%	18%	3%	2%	0%	0%	

#### Details

Average Tax Cut for Affected Taxpayers	-850	-850	-905	-897	-1,200	—	—	
% of Income Group Affected	19%	17%	8%	1%	1%	0%	0%	% of Massachusetts With Tax Cut - Total 9%

SOURCE: Institute on Taxation and Economic Policy, February 2010

Impact of Various 'Circuit Breaker' Reform Options

All Massachusetts, 2009 Income Levels

2009 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%	% Offset	State Tax Change (\$1000)
Income Range	Less Than \$19,200	\$19,200 - \$38,200	\$38,200 - \$61,600	\$61,600 - \$102,400	\$102,400 - \$211,500	\$211,500 - \$556,300	Or More		
Average Income in Group	\$ 11,300	\$ 28,500	\$ 49,600	\$ 79,000	\$ 138,700	\$ 311,400	\$ 1,693,400		

Reduce the percentage of income threshold for existing elderly circuit breaker from 10 percent to 8 percent

Tax Change as % of Income	-0.1%	-0.0%	-0.0%	-0.0%	--	--	--		\$ -17,000
Average Tax Change	-9	-12	-7	-0	--	--	--		
Share of Total Tax Change	32%	42%	25%	1%	--	--	--		

Details

Average Tax Cut for Affected Taxpayers	-181	-286	-488	-173	--	--	--	% of Massachusetts With Tax Cut - Total	2%
% of Income Group Affected	5%	4%	1%	0%	0%	0%	0%		

Reduce the percentage of income threshold for existing elderly circuit breaker from 10 percent to 5 percent

Tax Change as % of Income	-0.2%	-0.2%	-0.1%	-0.0%	--	--	--		\$ -61,000
Average Tax Change	-28	-51	-29	-23	--	--	--		
Share of Total Tax Change	22%	39%	22%	18%	--	--	--		

Details

Average Tax Cut for Affected Taxpayers	-328	-576	-713	-889	--	--	--	% of Massachusetts With Tax Cut - Total	5%
% of Income Group Affected	9%	9%	4%	3%	0%	0%	0%		

Increase the value of the maximum credit for existing elderly circuit breaker from \$960 to \$1,920

Tax Change as % of Income	-0.2%	-0.0%	-0.0%	-0.0%	--	--	--		\$ -24,000
Average Tax Change	-21	-11	-6	-0	--	--	--		
Share of Total Tax Change	55%	27%	14%	0%	--	--	--		

Details

Average Tax Cut for Affected Taxpayers	-696	-531	-794	-960	--	--	--	% of Massachusetts With Tax Cut - Total	1%
% of Income Group Affected	3%	2%	1%	0%	0%	0%	0%		

SOURCE: Institute on Taxation and Economic Policy, February 2010

## APPENDIX C: THE MASSACHUSETTS REAL ESTATE TRANSFER TAX

### Real Estate Transaction Tax (MA DOR)

	Total Collections	Paid to Counties through County Correction Fund	Retained by Commonwealth in the General Fund
<b>FY05</b>	166,427,579.19	9,902,328.51	156,525,250.68
<b>FY06</b>	158,819,062.99	9,412,542.19	149,406,520.80
<b>FY07</b>	150,557,134.62	9,688,977.64	140,868,156.98
<b>FY08</b>	117,367,222.97	7,226,041.39	110,141,181.58
<b>FY09</b>	80,076,199.47	4,807,454.43	75,268,745.04

## APPENDIX D: DOR REVENUE IMPACT ESTIMATES FROM CERTAIN TAX LAW CHANGES, 1991-2009 (PARTIAL LIST)\*

Source: DOR, June 2010

### Revenue Impacts of Certain Massachusetts Tax Law Changes Since January 1991 (in \$ millions)

Tax Law Changes Between FY91 & FY10		Effective Date	Tax Type	FY10 Net Revenue Impact	FY10 Revenue Impact -- Tax Cuts Only	FY10 Revenue Impact -- Tax Increases Only
1	Reduce Part B income tax rate from 5.95% & 6.25% to 5.3%	1990-2002	Income	-1,437	-1,437	NA
2	Corporate Research Tax Credit	1991	Corporate	-70	-70	NA
3	Increase Corporate Investment Tax Credit from 1% to 3%	1993	Corporate	-30	-30	NA
4	Cigarette Tax Increase from \$0.26/pack to \$2.51/pack	1993, 1996, 2002, 2008	Cigarette	444	NA	444
5	Single Sales Factor Apportionment Formula for Manufacturers	1996-2001	Corporate	-87	-87	NA
6	Long-Term Capital Gains Tax Rate Reduction from 6.0% to 0% phased in 1996-2001, then raised to 5.3% in 2002	1996 - 2001, 2003	Income	-188	-188	NA
7	Apportionment Changes for Mutual Fund Companies	1997	Corporate	-129	-129	NA
8	Tuition Deduction	1997	Income	-21	-21	NA
9	Implemented 10% Earned Income Tax Credit, then Increased it from 10% to 15% of Federal Credit	1997, 2001	Income	-112	-112	NA
10	Sales Tax Exemption for Internet Access	1997, retroactive to 1990	Sales	-115	-115	NA
11	Convention Center Surcharges	1998	Rooms, Sales	71	NA	71
12	Reduce Tax Rate on Interest/Dividend Income from 12.0% to 5.3%	1998, 2000, 2001, 2002	Income	-629	-629	NA
13	Personal Exemptions Doubled in 1998, Reduced by 25% in 2002, Increased in 2005, and 2006, 2007, and 2008	1998, 2002 2005-2008	Income	-614	-614	NA
14	Senior Circuit Breaker	2001	Income	-60	-60	NA

### Revenue Impacts of Certain Massachusetts Tax Law Changes Since January 1991 (in \$ millions)

Tax Law Changes Between FY91 & FY10	Effective Date	Tax Type	FY10 Net Revenue Impact	FY10 Revenue Impact --Tax Cuts Only	FY10 Revenue Impact -- Tax Increases Only
15 Increase Dependent Under 12 Deduction from \$1,200 to \$3,600/\$7,200, Extend it to Elderly and Disabled Dependents. Estimate is combined with Under 13 Dependent Care Expensed Deduction Below since taxpayers may claim one or the other but not both.	2001	Income	-110	-110	NA
16 Raise Child Under 13/Dependent Care Expense Deduction from \$1,200 to \$4,800/\$9,600. Estimate Combined with Dependent Under 12 Deduction.	2001	Income			
17 Historic Rehabilitation Tax Credit	2005	Income, Corp/Business	-50	-50	NA
18 Film Tax Credit	2006/2007	Excises, Income, Corp/Business	-125	-125	NA
19 Combined Reporting	2009	Excises, Income, Corp/Business	238	NA	238
20 Check-the-Box	2009	Excises, Corp/Business	124	NA	124
21 Corporate/Bank Tax Rate Cuts from 9.5% to 8.75% 10.5% to 9.75%	2010	Excises	-51	-51	NA
22 Fort Devens Tax Credit		Corporate	-35	-35	NA
23 Satellite TV Tax**	2009	Corporate	11	NA	11
24 Sales Tax Rate Increase from 5% to 6.25%**	2009	Sales	705	NA	705
25 Eliminate Sales Tax Exemption for Alcoholic Beverages**	2009	Sales	93	NA	93

\*\*These tax law changes were in effect for a portion of FY10; Not a full year impact.

**\*As of the publication date of the MassBudget Tax Primer, DOR had not finished a complete update of its revenue impact estimates for all tax law changes from 1991-2009).**

## APPENDIX E: ESTIMATED IMPACTS OF CHANGES TO THE PERSONAL INCOME TAX AND D&I INCOME TAX (2009)

Impact of Various Tax Reform Options  
All Massachusetts, 2009 Income Levels

2009 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%				
Income	Less Than \$19,200	\$19,200 – \$38,200	\$38,200 – \$61,600	\$61,600 – \$102,400	\$102,400 – \$211,500	\$211,500 – \$556,300	\$556,300 – Or More				
Range	\$19,200	\$38,200	\$61,600	\$102,400	\$211,500	\$556,300	Or More	% Offset	State Tax Change (\$1000)	Federal Tax Change (\$1000)	Total Tax Change (\$1000)
Average Income in Group	\$ 11,300	\$ 28,500	\$ 49,600	\$ 79,000	\$ 138,700	\$ 311,400	\$ 1,695,400				

**INCREASE THE INCOME TAX RATE FROM 5.3 TO 6.3 PERCENT**

Tax Change as % of Income	0.2%	0.5%	0.6%	0.7%	0.8%	0.8%	0.8%				
Average Tax Change	+21	+136	+302	+563	+1,071	+2,497	+13,164	-13%	\$ +1,861,000	\$ -246,000	\$ +1,615,000
Share of Total Tax Change	1%	5%	10%	19%	27%	17%	22%				

**Details**

Average Tax Increase for Affected Taxpayers	+66	+175	+328	+569	+1,076	+2,520	+13,337				
% of Income Group Affected	31%	78%	92%	99%	99%	99%	99%		% of Massachusetts With Tax Increase - Total		79%

**INCREASE THE INCOME TAX RATE FROM 5.3 TO 6.3 PERCENT AND DOUBLE THE PERSONAL EXEMPTION (WITHOUT ADJUSTING "NO-TAX" THRESHOLD)**

Tax Change as % of Income	-0.5%	-0.4%	-0.1%	0.2%	0.4%	0.6%	0.7%				
Average Tax Change	-62	-107	-40	+121	+560	+1,979	+12,678	-18%	\$ +850,000	\$ -156,000	\$ +694,000
Share of Total Tax Change	-5%	-8%	-3%	9%	31%	29%	47%				

**Details**

Average Tax Increase for Taxpayers with Tax Increase	—	+22	+130	+242	+595	+2,000	+12,850				
% of Income Group With Tax Increase	0%	8%	43%	69%	95%	99%	99%		% of Massachusetts With Tax Increase - Total		43%
Average Tax Cut for Taxpayers with Tax Cut	-198	-158	-196	-157	-163	-237	—				
% of Income Group With Tax Cut	31%	69%	49%	30%	4%	0%	0%		% of Massachusetts With Tax Cut - Total		36%

SOURCE: Institute on Taxation and Economic Policy, February 2010

Impact of Various Tax Reform Options  
All Massachusetts, 2009 Income Levels

2009 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%				
Income	Less Than \$19,200	\$19,200 – \$38,200	\$38,200 – \$61,600	\$61,600 – \$102,400	\$102,400 – \$211,500	\$211,500 – \$556,300	\$556,300 – Or More				
Range	\$19,200	\$38,200	\$61,600	\$102,400	\$211,500	\$556,300	Or More	% Offset	State Tax Change (\$1000)	Federal Tax Change (\$1000)	Total Tax Change (\$1000)
Average Income in Group	\$ 11,300	\$ 28,500	\$ 49,600	\$ 79,000	\$ 138,700	\$ 311,400	\$ 1,695,400				

**TAX DIVIDEND & INTEREST INCOME AT THE SAME RATE (12%) AS SHORT-TERM CAPITAL GAINS INCOME**

Tax Change as % of Income	0.1%	0.1%	0.1%	0.2%	0.2%	0.3%	0.6%				
Average Tax Change	+8	+42	+74	+124	+250	+940	+10,130	-13%	\$ +705,000	\$ -95,000	\$ +610,000
Share of Total Tax Change	1%	4%	7%	11%	17%	17%	43%				

**Details**

Average Tax Increase for Affected Taxpayers	+112	+216	+179	+223	+326	+1,038	+10,368				
% of Income Group Affected	7%	19%	41%	55%	77%	91%	98%		% of Massachusetts With Tax Increase - Total		40%

**TAX DIVIDEND & INTEREST INCOME AT THE SAME RATE (12%) AS SHORT-TERM CAPITAL GAINS INCOME; CREATE AN EXEMPTION OF \$2500 (\$5000 MFJ) FOR ALL SUCH INCOME**

Tax Change as % of Income	-0.0%	0.0%	0.0%	0.0%	0.0%	0.2%	0.6%				
Average Tax Change	-2	+10	+4	+23	+64	+591	+9,628	-15%	\$ +426,000	\$ -63,000	\$ +361,000
Share of Total Tax Change	-0%	1%	1%	3%	7%	17%	72%				

**Details**

Average Tax Increase for Taxpayers with Tax Increase	+173	+335	+324	+618	+980	+1,937	+10,849				
% of Income Group With Tax Increase	1%	5%	7%	8%	12%	34%	89%		% of Massachusetts With Tax Increase - Total		8%
Average Tax Cut for Taxpayers with Tax Cut	-33	-46	-55	-55	-81	-123	-139				
% of Income Group With Tax Cut	8%	15%	34%	47%	66%	97%	9%		% of Massachusetts With Tax Cut - Total		33%

SOURCE: Institute on Taxation and Economic Policy, February 2010

## APPENDIX F: DOR DIVIDEND & INTEREST INCOME TAX DATA (2006)

### Massachusetts Dividend and Interest Income, 2006

Totals for "Int and Div" int and divi range	All Filers 2006 (\$ in 1000s)					Totals for "MA Bank Interest" interest after deduct.	All Filers (\$ in 1000s)				
	count2	Sum2	average	percent c	percent s		range	count2	Sum2	average	percent c
Under \$5,000	7026	\$ 58,055	\$ 8,263	0.86%	0.59%	Under \$5,000	3711	\$ 19,553	\$ 5,269	0.52%	0.78%
\$5,000 under \$10,000	17785	\$ 30,036	\$ 1,691	2.17%	0.30%	\$5,000 under \$10,000	15471	\$ 30,280	\$ 1,957	2.18%	1.21%
\$10,000 under \$15,000	28320	\$ 52,283	\$ 1,846	3.45%	0.53%	\$10,000 under \$15,000	27943	\$ 68,690	\$ 2,458	3.94%	2.74%
\$15,000 under \$20,000	34628	\$ 72,774	\$ 2,102	4.22%	0.73%	\$15,000 under \$20,000	34969	\$ 100,363	\$ 2,870	4.93%	4.00%
\$20,000 under \$25,000	34544	\$ 80,671	\$ 2,335	4.21%	0.81%	\$20,000 under \$25,000	33709	\$ 96,714	\$ 2,869	4.75%	3.86%
\$25,000 under \$30,000	34449	\$ 86,385	\$ 2,508	4.20%	0.87%	\$25,000 under \$30,000	33033	\$ 91,157	\$ 2,760	4.65%	3.64%
\$30,000 under \$35,000	33984	\$ 89,557	\$ 2,635	4.15%	0.90%	\$30,000 under \$35,000	32303	\$ 84,875	\$ 2,627	4.55%	3.39%
\$35,000 under \$40,000	33708	\$ 92,506	\$ 2,744	4.11%	0.93%	\$35,000 under \$40,000	31463	\$ 77,910	\$ 2,476	4.43%	3.11%
\$40,000 under \$45,000	32501	\$ 91,733	\$ 2,822	3.96%	0.93%	\$40,000 under \$45,000	30368	\$ 72,024	\$ 2,372	4.28%	2.87%
\$45,000 under \$50,000	31305	\$ 89,453	\$ 2,857	3.82%	0.90%	\$45,000 under \$50,000	28330	\$ 66,245	\$ 2,338	3.99%	2.64%
\$50,000 under \$60,000	58170	\$ 176,485	\$ 3,034	7.10%	1.78%	\$50,000 under \$60,000	52343	\$ 121,550	\$ 2,322	7.37%	4.85%
\$60,000 under \$70,000	52616	\$ 166,694	\$ 3,168	6.42%	1.68%	\$60,000 under \$70,000	45823	\$ 104,956	\$ 2,285	6.47%	4.19%
\$70,000 under \$80,000	47589	\$ 161,756	\$ 3,399	5.80%	1.63%	\$70,000 under \$80,000	40054	\$ 94,370	\$ 2,356	5.64%	3.76%
\$80,000 under \$90,000	42824	\$ 156,674	\$ 3,659	5.22%	1.58%	\$80,000 under \$90,000	35210	\$ 84,078	\$ 2,388	4.96%	3.35%
\$90,000 under \$100,000	38403	\$ 148,880	\$ 3,877	4.68%	1.50%	\$90,000 under \$100,000	31254	\$ 79,167	\$ 2,533	4.40%	3.16%
\$100,000 under \$150,000	127331	\$ 604,370	\$ 4,746	15.53%	6.10%	\$100,000 under \$150,000	101226	\$ 268,276	\$ 2,650	14.26%	10.70%
\$150,000 under \$200,000	59001	\$ 454,603	\$ 7,705	7.20%	4.59%	\$150,000 under \$200,000	47184	\$ 155,505	\$ 3,296	6.65%	6.20%
\$200,000 under \$500,000	77034	\$ 1,328,209	\$ 17,242	9.40%	13.41%	\$200,000 under \$500,000	61902	\$ 333,722	\$ 5,391	8.72%	13.31%
\$500,000 under \$1,000,000	17542	\$ 895,229	\$ 51,033	2.14%	9.04%	\$500,000 under \$1,000,000	14289	\$ 158,134	\$ 11,067	2.01%	6.31%
\$1,000,000 or Over	11115	\$ 5,066,123	\$ 455,792	1.36%	51.16%	\$1,000,000 or Over	9127	\$ 399,388	\$ 43,759	1.29%	15.93%
<b>Total</b>	<b>819853</b>	<b>\$ 9,902,475</b>	<b>\$ 12,078</b>	<b>100.00%</b>	<b>100.00%</b>	<b>Total</b>	<b>709812</b>	<b>\$ 2,506,956</b>	<b>\$ 3,532</b>	<b>100.00%</b>	<b>100.00%</b>
				<b>% Total D &amp; I Income</b>						<b>% Total D &amp; I Income</b>	
Under \$25,000	122283	\$ 293,818	\$ 2,403	14.92%	2.97%	Under \$25,000	115803	\$ 315,600	\$ 2,725	16.31%	12.59%
\$25,000 under \$50,000	165945	\$ 449,634	\$ 2,710	20.24%	4.54%	\$25,000 under \$50,000	155497	\$ 392,210	\$ 2,522	21.91%	15.64%
\$50,000 under \$100,000	239602	\$ 810,490	\$ 3,383	29.22%	8.18%	\$50,000 under \$100,000	204784	\$ 484,120	\$ 2,364	28.85%	19.31%
\$100,000 or Over	292023	\$ 8,348,533	\$ 28,589	35.62%	84.31%	\$100,000 or Over	233728	\$ 1,315,026	\$ 5,626	32.93%	52.46%

Total 2006 MA filers of all kinds: 3,412,923

Source: DOR, October 2009

\* MassBudget Note:

MA Bank Interest is a distinct category from other types of interest only because the first \$100 (\$200 for joint filers) are exempt from taxation. As a consequence, DOR tracks these categories separately. Figures shown here are for taxable income (ie, exempt amounts have been deducted from these figures).

## APPENDIX G: DOR ESTIMATES OF REVENUE IMPACTS FROM 2009 CORPORATE TAX REFORMS

## Original Estimates:

Tax Year	Combined Reporting	Check-the-Box	Reduction in Corporate Tax Rate	Reduction in Financial Inst. Tax Rate	Fiscal Year	Combined Reporting	Check-the-Box	Reduction in Corporate Tax Rate	Reduction in Financial Inst. Tax Rate
2009	\$312.9	\$169.1	-\$9.6	\$0.0	2009	\$187.8	\$101.5	-\$5.8	\$0.0
2010	\$288.2	\$145.8	-\$91.8	-\$17.5	2010	\$298.1	\$155.1	-\$59.0	-\$10.5
2011	\$271.8	\$138.0	-\$146.8	-\$35.0	2011	\$278.3	\$141.1	-\$124.8	-\$28.0
2012	\$263.5	\$122.5	-\$172.2	-\$52.5	2012	\$266.8	\$128.7	-\$162.0	-\$45.5
2013	\$263.5	\$122.5	-\$172.2	-\$52.5	2013	\$263.5	\$122.5	-\$172.2	-\$52.5
2014	\$263.5	\$122.5	-\$172.2	-\$52.5	2014	\$263.5	\$122.5	-\$172.2	-\$52.5
2015	\$263.5	\$122.5	-\$172.2	-\$52.5	2015	\$263.5	\$122.5	-\$172.2	-\$52.5

## Recession Adjusted Estimates:

Tax Year	Combined Reporting	Check-the-Box	Reduction in Corporate Tax Rate	Reduction in Financial Inst. Tax Rate	Fiscal Year	Combined Reporting	Check-the-Box	Reduction in Corporate Tax Rate	Reduction in Financial Inst. Tax Rate
2009	\$250.3	\$135.3	-\$7.7	\$0.0	2009	\$150.2	\$81.2	-\$4.6	\$0.0
2010	\$230.6	\$116.6	-\$73.5	-\$14.0	2010	\$238.5	\$124.1	-\$47.2	-\$8.4
2011	\$217.4	\$110.4	-\$117.4	-\$28.0	2011	\$222.7	\$112.9	-\$99.8	-\$22.4
2012	\$210.8	\$98.0	-\$137.7	-\$42.0	2012	\$213.5	\$103.0	-\$129.6	-\$36.4
2013	\$210.8	\$98.0	-\$137.7	-\$42.0	2013	\$210.8	\$98.0	-\$137.7	-\$42.0
2014	\$210.8	\$98.0	-\$137.7	-\$42.0	2014	\$210.8	\$98.0	-\$137.7	-\$42.0
2015	\$210.8	\$98.0	-\$137.7	-\$42.0	2015	\$210.8	\$98.0	-\$137.7	-\$42.0

## APPENDIX H: Impact of Various Tax Reform Options

Impact of Various Tax Reform Options								
All Massachusetts, 2010 income levels								
2010 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%	
Income Range	Less Than \$19,600	\$19,600 – \$39,000	\$39,000 – \$62,600	\$62,600 – \$103,800	\$103,800 – \$217,000	\$217,000 – \$580,000	\$580,000 – Or More	State Tax Change (\$1000)
Average Income in Group	\$ 11,700	\$ 29,100	\$ 50,500	\$ 80,100	\$ 141,400	\$ 321,600	\$ 1,844,300	
<b>Increase Interest/Dividends Rate to 12%</b>								
Tax Change as % of Income	0.1%	0.1%	0.1%	0.2%	0.2%	0.3%	0.6%	\$ +741,000
Average Tax Change	+7	+41	+73	+120	+269	+1,022	+10,422	
Share of Total Tax Change	1%	4%	6%	10%	17%	17%	45%	
% of MA resident tax hike from each group	1%	4%	6%	10%	17%	17%	45%	
<b>Details</b>								
Average Tax Increase for Taxpayers with Tax Increase	+108	+231	+185	+216	+345	+1,081	+10,614	
% of Income Group With Tax Increase	6%	18%	40%	56%	78%	95%	98%	
<b>SOURCE:</b> Institute on Taxation and Economic Policy, December 2010								
ITEP stimated revenue loss from D&I personal exmptions at \$275 million, using 2009 data.								
<i>MassBudget</i> "grows" this 2009 loss estimate (\$275 million) to produce a comparable 2010 figure of \$290 million, making the new loss figure proportional to the increase in projected revenues from 2009 (\$705 million) to 2010 (\$740 million), a 5 percent increase.								