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News Release

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Ballot Questions: MTF Unveils Alternative Tax Cut Plan; Opposes Toll/Auto Excise Credit; Supports Charitable Deduction

The Massachusetts Taxpayers Foundation today unveiled a plan to cut the income tax rate to 5 percent in gradual steps tied to growth in the state's economy, an alternative to the Governor's ballot proposal to reduce the rate over three years.

Under MTF's plan, the current 5.85 percent income tax rate would be reduced to 5.75 percent on January 1, 2001, a year earlier than provided by legislation adopted last year. Further reductions in the tax rate would be triggered by growth in total Massachusetts personal income, adjusted for inflation, with each 2.5 percent of income growth triggering a 0.1 percent cut in the tax rate until the rate reaches 5 percent. By linking the pace of tax cuts to economic growth -- which in turn drives state revenues -- the plan provides an important fiscal hedge against a slowing of the economy and protects the state's ability to address a range of critical spending issues.

The Foundation also announced its opposition to the initiative petition to provide a dollar-for-dollar income tax credit for tolls and auto excise taxes, which have long been recognized as fair and reasonable user fees to pay for road and bridge projects. This proposal would shift to taxpayers at large the modest share of Central Artery project costs that are to be borne by users of the greater Boston highway system, reducing revenues by over $600 million at a time when the state needs to put more, not fewer, resources into capital investments. At the same time, MTF supports a third tax cut initiative that would establish a Massachusetts charitable deduction, with a manageable revenue impact of $200 million, bringing the Commonwealth in line with the practice in most other states.

Reducing the income tax rate to 5 percent is an important step to improve the competitiveness of the Massachusetts economy. Despite recent major tax cuts, Massachusetts' personal income tax burden remains among the highest in the nation. The Foundation's proposal would reach this objective while recognizing the significant pressures on both revenue and spending. By tying the pace of tax cuts to growth in the economy, the state will be able to manage largely unavoidable spending increases in areas such as health care and address major education and capital funding needs, as well as accommodate the impact of the many tax cuts adopted in recent years. The combination of previously enacted tax cuts that have been phasing in since 1998 and the cuts proposed in the three initiative petitions -- when fully implemented in 2003 -- would reduce the state's 1999 tax revenue base by almost 25 percent.

MTF President Michael J. Widmer said, "The state clearly cannot accommodate revenue reductions approaching $2 billion over the next three years -- the combined impact of the two major tax cutting initiatives now under consideration. With the enormous cost pressures in areas such as education, health care, the Central

Artery and other critical capital needs, a more measured approach to tax cuts is needed. The Foundation's proposal would bring the rate down to 5 percent while allowing the Commonwealth to address its spending needs and to protect its hard-won fiscal recovery."

Toll/Auto Excise Credit

The Foundation opposes the ballot initiative to provide an income tax credit for tolls and automobile excise taxes paid by individuals or corporations in Massachusetts, beginning in 2001. The tax credits would cut state personal and corporate income tax revenues by more than $600 million in fiscal 2002, the first year in which the credits would be claimed, and would grow to over $700 million within five years. The impact of the credits would be even greater if tolls are increased more than currently planned to provide additional funding for the Central Artery project, or if traffic on the toll roads increased because of the availability of the tax credits. The impact would fall entirely on the Commonwealth's general fund; toll revenues collected by the Turnpike Authority and Massport, and auto excise taxes collected by cities and towns, would not be reduced.

While the ballot measure would not actually eliminate tolls, they -- and all of the Central Artery costs they support -- would be covered by state taxpayers through the tax credits. The share of Artery costs borne by tollpayers would fall from about 10 percent to near zero. Taxpayers, who are already paying for 90 percent of the Artery through state and federal taxes, would pick up the entire bill.

Auto excise taxes, which are paid to cities and towns, were instituted in 1928 so vehicle owners would pay part of the growing cost of building and maintaining local roads and bridges. Auto excises currently cover all of local government operating spending on highways and a portion of capital project costs as well.

Charitable Deduction

The Foundation supports the initiative to provide a state personal income tax deduction for contributions to charitable organizations. All Massachusetts taxpayers, whether or not they itemize deductions on their federal return, would be eligible to deduct the full amount of donations, beginning in 2001.

This proposal, with an estimated annual revenue impact of $200 million, would bring the Commonwealth in line with federal policy and the vast majority of other states. Of the 41 states that have a broad-based income tax, Massachusetts is one of only six that does not provide a deduction for charitable contributions.
Despite a strong nonprofit sector that supports more than 350,000 jobs and invests hundreds of million of dollars in the state economy, Massachusetts has a poor record of contributing to charities relative to other parts of the country. The Commonwealth ranks 48th among the states in a recently published "generosity index" that measures contributions as a percentage of income. While this initiative alone may not stimulate a major increase in charitable giving, it is a positive step in supporting a climate of giving in Massachusetts.

Founded in 1932, the Massachusetts Taxpayers Foundation is an independent, nonprofit organization which conducts research and policy analysis on state and local taxes, government spending and the economy. Dedicated to the public interest, MTF ranks as one of the largest and most effective organizations of its kind in the country. The Foundation has won four national awards in as many years for its work on capital spending, business costs, and managing the state's budget surpluses.

Reducing the Income Tax Rate to 5 Percent

Why Cut The Income Tax?

Despite recent major cuts, Massachusetts' personal income tax burden remains among the highest in the nation. Measured per capita, the Commonwealth places third among the 50 states, at twice the national average. Based on personal income, the state ranks fifth, 63 percent above the U.S. average. When only state (and not local) personal income taxes are considered, Massachusetts has the highest personal income taxes in the country on a per capita basis and the second highest on the basis of income.

The increase in the tax rate from 5.0 percent during the fiscal crisis was intended to be temporary. In its initial response to the state's fiscal crisis, the Commonwealth in 1989 increased the income tax rate from 5.0 percent to 5.375 percent, a hike that state leaders promised would be temporary. As the economic recession intensified and the state's fiscal condition worsened, the administration and the Legislature raised income tax rates further, to 5.95 percent in 1990 and 6.25 percent in 1991. The 1990 statute providing for these increases dropped the tax rate back to 5.95 percent in 1992. The additional tax dollars from the rate increases were needed to fill a recession-driven gap between revenues and spending and to repay $1.4 billion of fiscal recovery bonds that were issued to eliminate the 1990 budget deficit.

During the 1990s the state adopted a series of other major tax cuts totaling more than $2 billion, and since 1998 has doubled the personal exemption, reduced the tax rate on interest and dividend income from 12 percent to 5.95 percent, and enacted other more narrowly focused income tax cuts. However, the 5.95 percent income tax rate remained in effect throughout the decade. In late 1999 the state took a first step in reducing the tax rate by authorizing a cut to 5.85 percent in 2000, 5.80 percent in 2001 and to 5.75 percent in 2002.

Proposal and Rationale

MTF is proposing that the current 5.85 percent income tax rate be reduced to 5.75 percent on January 1, 2001, with further cuts to 5.0 percent phased in over several years and tied to the rate of growth in the state's economy. These additional cuts would be triggered by an index linked to increases in total personal income in the state, adjusted for inflation. It is this trigger mechanism which most distinguishes the Foundation's approach from the initiative petition backed by Governor Cellucci, which would cut the income tax rate on a fixed three-year schedule to 5.6 percent in 2001, 5.3 percent in 2002 and 5.0 percent in 2003.

The Foundation's proposal would enable the Commonwealth to reduce the income tax to 5 percent while preserving the state's extraordinary financial progress in the 1990s and meeting the enormous challenges now confronting the state, including uncertainties about revenues and a host of major cost pressures.

<u>Revenues</u>

Over the next three years, the state will have to accommodate the $550 million revenue impact of previously adopted tax cuts that are still being phased in, a reduction which has been incorporated in the Foundation's proposal. The two major tax cut initiatives now under consideration would cut taxes by at least $1.6 billion more.

The initiative petition to cut the income tax rate to 5.0 percent would reduce revenues by over $1 billion over the next three years. While the schedule of reductions proposed by the Governor might be manageable if revenues continue to grow strongly, the current pace of revenue growth cannot be sustained indefinitely. In fact, there is substantial evidence that the recent growth in state revenues owes much to stock market euphoria that could end abruptly. Although incomes in the state remain robust, job growth has already slowed, and the combination of low population growth and a shortage of skilled labor will limit future job creation.

The initiative to provide a dollar-for-dollar state tax credit for toll and auto excise payments beginning in 2001 -- which the Foundation opposes -- would reduce revenues by $600-700 million with an impact that would have to be absorbed in a single fiscal year. MTF's proposal does not assume passage of this initiative. On the other hand, the initiative petition to adopt a charitable contribution, a question the Foundation supports, would have a manageable $200 million revenue impact which is accommodated in MTF's proposal. In addition, the Foundation's alternative plan factors in expected surplus revenues for fiscal 2000 in the range of $250-500 million.

<u>Spending</u>

Looking ahead, the state must accommodate a surge of costs in our troubled health care system, finance the rapidly growing bill for the massive Central Artery project while dealing with other urgent capital needs across the state, and sustain the financial commitment to education reform.

In developing its tax cut proposal, the Foundation has taken into account the largely unavoidable cost increases that lie ahead in the former "budget busters" of medical care for the poor, employee health benefits, pensions and debt service, and also factored in at least $100 million of additional annual appropriations to maintain adequate levels of school spending under education reform. (The growth in state support for the MBTA, the other former budget buster, is expected to moderate after 2001 as a result of the financial reforms enacted last year.)

The proposal also presumes that approximately $120 million of existing state revenues (for example, the portion of gas tax receipts not already pledged to repay highway project borrowing) would be made available to support the costs of the Central Artery or other capital projects. At the same time, the proposal would require a tight rein on spending growth in other areas of the budget.

Specific Proposal

Under MTF's proposal, the amount of additional cuts -- beyond a decrease to 5.75 percent in 2001 (one year earlier than in current law) -- would be tied to the rate of growth in total state personal income, adjusted for inflation. For each 2.5 percent of growth in personal income from the base year 1999, the tax rate would be reduced by an additional 0.1 percent, until the tax rate equals 5.0 percent.

The proposed mechanism uses an index of the annual growth in total Massachusetts personal income as reported by the federal Bureau of Economic Analysis (BEA). The index would be calculated as the ratio of personal income in a given year to personal income in 1999, adjusted for inflation based on the consumer price index for the greater Boston area.

There are several strong arguments for using personal income as the trigger measure. It is closely related to tax revenues, it is measured independently by a third party (the federal government), and it is not subject to legislative changes in the way revenue or spending decisions would be. Adjusting for inflation ensures that the trigger responds to real changes in the economy, rather than to changes in the general level of prices. In addition, relying on the accumulated growth in personal income relative to a base year -- rather than the year-to-year variation in personal income -- avoids triggering a cut based upon growth in a single, perhaps aberrant, year.

The choice of a "step" of 2.5 percent for the trigger is intended to allow the Commonwealth sufficient fiscal flexibility to meet its obligations and commitments while phasing in tax rate reductions. A smaller step, say 2.0 percent, would speed up the phase-in but could lead to budget deficits, while a larger step would unnecessarily delay the phase-in.

In addition, the proposal is designed to ensure that the tax rate for a given year will be determined before the Governor submits his budget for the year, using the most current personal income figures then available.

How the Phase-In Mechanism Would Work

In tax year 2001, the proposal sets the income tax rate at 5.75 percent, compared to the 5.8 percent rate provided under current law.

In 2002, the tax rate would be based upon the value of the proposed index of personal income growth. The index for 2002 would be calculated as personal income in the second quarter of 2000, adjusted for inflation to 1999 dollars, divided by personal income in the second quarter of 1999, times 100. (BEA reports second-quarter personal income in late October of each year, making the 2000 second-quarter figure the most recent available at the time this calculation would need to be made.)

The lag in this calculation -- using income growth from 1999 to 2000 to set the 2002 tax rate -- ensures that the 2002 income tax rate will be known at the time the Governor is preparing the administration's proposed fiscal 2002 budget in the fall of 2000, for submission to the Legislature in January 2001.

Under the proposed mechanism, for each 2.5 percent that the index exceeds 100 percent, the 2002 tax rate would be 0.1 percent less than 5.75 percent. If, for example, the index were 103.4 percent, reflecting 3.4 percent growth in inflation-adjusted income from the second quarter of 1999 to the second quarter of 2000, the tax rate for 2002 would drop to 5.65 percent.

For 2003, the tax rate again would depend upon the index of personal income growth, calculated as the ratio of inflation-adjusted personal income in the second quarter of 2001 to personal income in the second quarter of the base year 1999. Note that this ratio accounts for all the growth since 1999, and the tax rate would be determined by reducing the tax rate by 0.1 percent from 5.75 percent for each 2.5 percent that the index for this two-year period exceeds 100 percent. A similar calculation would be made in subsequent years until the tax rate was reduced to 5.0 percent.

Illustration

A historical illustration will help make this clear. The table below shows the impact of the proposed trigger mechanism if it had been implemented beginning in 1993. The first column reflects the actual growth in total Massachusetts personal income -- based upon BEA-reported income for the second quarter for each year and adjusted for inflation as measured by the consumer price index for the Boston area.

MTF Proposal Had It Been Implemented In 1993
With 1991 as Base Year

	Inflation-Adjusted Personal Income Percent Growth	Index of Cumulative Percent Growth	Tax Rate With Proposed Trigger
1991	--	--	--
1992	0.7%	--	--
1993	1.3%	100.0%	5.75%
1994	4.0%	100.7%	5.75%
1995	3.6%	102.0%	5.75%
1996	3.1%	106.0%	5.55%
1997	2.7%	109.8%	5.45%
1998	3.9%	113.2%	5.25%
1999	3.1%	116.3%	5.15%
2000*	3.1%	120.8%	5.00%

* Estimated.

The second column shows the value of the index based upon these income figures. The index value for 1993 is set at 100.0 percent, reflecting the amount of personal income in 1991. The third column shows the resulting income tax rate, assuming that a starting rate of 5.75 percent would be set in 1993.

Looking at 1994, the first year that the trigger mechanism would apply, the index value is 100.7 percent, based upon the growth in income from the second quarter of 1991 to the second quarter of 1992. The index exceeds 100 percent by only 0.7 percent, less than the 2.5 percent trigger level, and the tax rate for 1994 would remain unchanged at 5.75 percent.

In 1995, the index value is 102.0 percent, reflecting the inflation-adjusted income growth from the second quarter of 1991 to the second quarter of 1993. Again, the increment in the index is less than 2.5 percent, and the tax rate for 1995 would stay at 5.75 percent.

In 1996, the index value is 106.0 percent as a result of the income growth in the three years from 1991 to 1994. The index exceeds 100 percent by 6.0 percent; with a 0.1 percent reduction in the 5.75 tax rate for each 2.5 percent increase in the index, the tax rate for 1996 would be 5.55 percent. This example illustrates that it is possible for the tax rate to be reduced by more than one step -- or more than 0.1 percent -- in a single year. The trigger does not allow the tax rate to increase under any circumstances.

In each following year, a similar calculation would be made -- for each 2.5 percent increase in the index above 100 percent, the 5.75 percent tax rate would be reduced by 0.1 percent. In this illustration, the tax rate would reach 5.0 percent in 2000.

A table is attached showing Massachusetts total personal income and inflation from 1969 to the present, as well as a calculation of inflation-adjusted personal income and the value of the proposed index had it been implemented during this period. The right hand column of the table indicates when an incremental cut in the tax rate would have been triggered.

Massachusetts Personal Income Growth
Adjusted for Inflation
2nd Quarter 1969 - 2nd Quarter 1999

	State Personal Income	Percent Change	Consumer Price Index Boston Area	Percent Change	Inflation-Adjusted Personal Income (1999 $)	Percent Change	Index of Cumulative Percent Growth Since 1969	Tax Cut Triggered (*)
1969	23,943	--	37.9	--	110,744	--	--	
1970	25,837	7.9%	40.0	5.5%	113,231	2.2%	--	
1971	27,340	5.8%	42.2	5.5%	113,571	0.3%	100.0%	
1972	29,557	8.1%	43.7	3.6%	118,566	4.4%	102.2%	
1973	32,139	8.7%	46.1	5.5%	122,212	3.1%	102.6%	*
1974	34,764	8.2%	51.5	11.7%	118,333	-3.2%	107.1%	*
1975	37,032	6.5%	56.1	8.9%	115,717	-2.2%	110.4%	*
1976	39,990	8.0%	60.3	7.5%	116,256	0.5%	106.9%	
1977	43,493	8.8%	63.5	5.3%	120,068	3.3%	104.5%	
1978	48,321	11.1%	66.4	4.6%	127,570	6.2%	105.0%	
1979	53,899	11.5%	73.7	11.0%	128,202	0.5%	108.4%	
1980	60,700	12.6%	82.9	12.5%	128,356	0.1%	115.2%	*
1981	67,836	11.8%	91.6	10.5%	129,822	1.1%	115.8%	
1982	74,157	9.3%	96.1	4.9%	135,273	4.2%	115.9%	
1983	80,190	8.1%	99.7	3.7%	140,996	4.2%	117.2%	
1984	90,642	13.0%	104.9	5.2%	151,473	7.4%	122.1%	*
1985	98,128	8.3%	109.3	4.2%	157,382	3.9%	127.3%	*
1986	105,664	7.7%	111.3	1.8%	166,423	5.7%	136.8%	*
1987	114,350	8.2%	116.3	4.5%	172,361	3.6%	142.1%	*
1988	126,776	10.9%	123.8	6.4%	179,514	4.2%	150.3%	*
1989	135,893	7.2%	130.3	5.3%	182,825	1.8%	155.6%	*
1990	139,660	2.8%	137.6	5.6%	177,924	-2.7%	162.1%	*
1991	141,403	1.2%	145.1	5.5%	170,834	-4.0%	165.1%	*
1992	146,072	3.3%	148.9	2.6%	171,971	0.7%	160.7%	
1993	151,526	3.7%	152.5	2.4%	174,180	1.3%	154.3%	
1994	159,001	4.9%	153.9	0.9%	181,110	4.0%	155.3%	
1995	168,891	6.2%	157.8	2.5%	187,621	3.6%	157.3%	
1996	178,781	5.9%	162.0	2.7%	193,459	3.1%	163.5%	
1997	189,367	5.9%	167.1	3.1%	198,660	2.7%	169.4%	*
1998	200,905	6.1%	170.7	2.2%	206,319	3.9%	174.7%	*
1999	212,737	5.9%	175.3	2.7%	212,737	3.1%	179.4%	*

Sources: Bureau of Economic Analysis; Bureau of Labor Statistics