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Tax Policy Next Steps in 2023

Tax policy is at the forefront of the legislative and fiscal agenda in 2023 as the state implements the income surtax, reassesses a tax package that garnered bipartisan support last year, and welcomes a new gubernatorial administration that has made tax relief a major policy priority.

After increasing tax collections by more than $11 billion over two years and passing the largest tax increase in two decades, Massachusetts is in the position where tax relief is not just affordable, but important. Crafting a package that takes on key costs for historically marginalized communities and working families, while reducing incentives for taxpayer relocation is challenging, but doable.

MTF's has recently projected how tax collections may change in the coming months, put forward a fiscally sound approach for using income surtax revenue, and identified surtax implementation questions that need to be addressed. This MTF Bulletin reviews where tax policy discussions have been over the last year and examines how changing policy and economic conditions affect the need for tax relief. The Bulletin then identifies several core elements of income and estate tax relief that can improve Massachusetts' position as a place that retains and attracts people, jobs, and investment.

Looking Back at 2022

The Baker administration placed tax relief atop the 2022 policy agenda when they proposed a $700 million tax reduction package as a companion to their fiscal year (FY) 2023 budget. While the details of the tax proposal altered as it moved through the House and Senate, it retained three areas of focus first found in the Baker proposal:

- Relief for low-income residents;
- Relief targeted to high cost necessities; and
- Relief to address areas where Massachusetts taxes are out of line with competitor states.

Governor Baker Original Tax Proposal

Category	Title	Current Tax	Proposed Change	Fiscal Impact
Low-income	No-tax threshold	Single filer - $8,000 Head of Household - $14,400 Joint filer - $16,400	Single filer - $12,550 Head of Household - $18,800 Joint filer - $25,100	$89M
High-cost areas	Rental deduction	Maximum deduction $3,000	Maximum deduction $5,000	$77M
High-cost areas	Senior circuit breaker	Maximum credit of $1,200 in 2022	Double the credit	$60M
High-cost areas	Child & dependent tax credit	$180 credit per dependent (max 2) $240 per child for itemized care (max 2)	Double the credit	$167M
Tax outliers	Estate tax	$1M threshold for liability Tax paid on entire value of estate	$2M threshold for liability Tax paid on amount over threshold	$231M
Tax outliers	Capital gains	5% long-term 12% short-term	5% for all capital gains	$117M
Total				**$741M**

Fiscal impact in millions

The House and Senate incorporated tax relief in economic development legislation, which was unanimously passed in both branches. The final tax relief package included many elements of the original proposal, but there were some material adjustments. Notably, the House and Senate did not include an increase to no-tax status or a capital gains tax reduction, but added an increase to the state's Earned Income Tax Credit, which is currently equal to 30 percent of the federal amount. The Legislature also added $510 million in one-time rebates for middle-income tax-filers.

House and Senate Tax Plans

Title	House	Senate
Increase no-tax threshold	Not included	Not included
Increase rental deduction	Capped at $4,000	Capped at $4,000
Senior circuit breaker	Doubled	Doubled
Child & dependent tax credit	$310 per dependent/no cap	$310 per dependent/no cap
Estate tax	$2M threshold; tax applies above; rate increase for $5M+ estates	$99,600 credit for all estates
Capital gains	Not included	Not included
Earned Income Tax Credit	Increase state credit to 40%	Increase state credit to 40%
Taxpayer rebates	$250/$500 rebates for middle income filers	$250/$500 rebates for middle income filers
One-time fiscal impact	***$1,034***	***$1,012***
Ongoing fiscal impact	***$524***	***$502***

$ in millions

In spite of the broad, bipartisan support for these proposals, they did not advance to the final bill. After both the House and Senate had passed their bills, it became apparent that close to $3 billion in tax rebates would go out under a law which requires tax revenues above a certain threshold to be returned to taxpayers, known as Chapter 62F. The scale of the 62F rebates caused lawmakers to pause longer-term tax discussions and ultimately wait until this session to take action.[1]

Changing Landscape

It was only last January that former-Governor Baker proposed his tax package, and only six months since the House and Senate announced agreement on a $1 billion tax framework. Since then, three factors have changed.

1. The state's fiscal situation has further strengthened;
2. The state has passed the largest tax increase in two decades;
3. Cost pressures on families, low-income residents, retirees, and businesses have risen sharply.

The State's Fiscal Picture Goes from Bright to Brighter

Governor Baker included a tax relief package as part of his FY 2023 budget announcement because the state's revenue picture looked bright. After six months of strong collections, the administration upgraded FY 2022 tax revenue targets to $35.948 billion and budget-makers were building their FY 2023 budgets on the assumption that $36.915 billion would be collected. In fact, those predictions underestimated collections by about $8 billion.

Revenue Expectations, February of 2022 v. February of 2023

	February 2022 Expectation	Actual Collections/Current Estimate	Unanticipated Revenue Growth
FY 2022	$35,948	$41,105	$5,157
FY 2023	$36,915	$39,768	$2,853
Total Unanticipated Growth			$8,010

$ in millions

As shown in the figure above, FY 2022 collections beat expectations by a further $5.2 billion and the current benchmark in FY 2023 is close to $2.9 billion ahead of the initial FY 2023 estimate used in Governor Baker's budget and tax proposal. This FY 2023 benchmark does not include $922 million in revenues above benchmark collected through January.

[1] Tax debates were not limited to Massachusetts over the past year. In 2022, according to Tax Foundation date, 15 states put in place permanent income or corporate tax rate changes. Massachusetts' income surtax was the sole permanent rate increase.

The strength of tax collections is not merely an artifact of recovering economic ground lost during the pandemic. Between FY 2021 and FY 2022, state tax collections grew by $11.5 billion. Over the prior ten years, tax collections grew by $11 billion. If pre-pandemic tax revenue trends (about 5 percent annual growth) had held between FY 2020 and FY 2023, total revenue collections would be about $9 billion less than the actual amount.

In addition to a strong revenue base, major tax changes require that the state be prepared to weather unexpected fiscal shocks. At the start of FY 2020, the state's Rainy Day fund boasted a $3.4 billion balance, putting Massachusetts in a very strong position. Heading into the pandemic, the expectation was that the state would need to use much of that savings account to mitigate the budget impact of the economic shutdown.

Rainy Day Fund Growth, FY 2020 – FY 2022

	RDF deposit	**Total balance**	**% of tax collections**
FY 2020	$77	$3,501	11.8%
FY 2021	$1,125	$4,626	13.5%
FY 2022	$2,331	$6,957	16.9%

$ in millions

Instead, record budget surpluses have enabled the state to make more than $3.5 billion in deposits into the fund, doubling its balance in a two-year period. At the end of FY 2022, the Rainy Day Fund equaled almost 17 percent of tax collections.

Budget-makers have also created a host of new trust funds to deposit other surplus state revenues for future use. Combined, these funds contain close to $3 billion in flexible spending capacity, with 60 percent available for general use.

State Reserves, Start of FY 2020 to Current

	Start of FY 2020	**Current**	**Difference**
Rainy Day Fund	$3,424	$7,100	$3,676
FY 2022 Surplus Fund	$0	$1,691	$1,691
SOA Trust Fund	$0	$500	$500
High Quality Early Education & Care Affordability Fund	$0	$490	$490
Total growth in reserves			***$6,357***
Growth in non-Rainy Day Fund			***$2,681***

$ in millions

Finally, rapid growth in budget appropriations has outpaced many departments' ability to spend, resulting in record amounts of line-item spending going unused and 'reverting' to the General

Fund. Prior to the pandemic, the state averaged just under $500 million per year in unspent appropriations. In FY 2020, that figure grew to $791.1 million and in FY 2022 reversions topped $700 million again, meaning that the mismatch between planned and actual spending has grown by more than $200 million annually.

The explosion in tax revenues in FY 2021 and FY 2022 means that even as revenue growth flattens in the current year, collections have outperformed expectations by billions since Governor Baker's $700 million proposal kicked off tax discussions last year. During that time, billions in surplus revenues have been stored away to strengthen the budget's resilience. The strength of the state's fiscal condition was sufficient to support the Legislature's $1 billion response to the Baker plan last year and the fiscal condition is materially stronger now, even before accounting for revenues from the income surtax.

Income Surtax Passes

In November, Massachusetts voters passed a constitutional amendment to add a four percentage point surtax to income over $1 million. The tax, which went into effect in January, will take time to fully annualize, but will ultimately generate an average of $1.5 billion or more to be dedicated to education and transportation.

The surtax has two major implications for the consideration of ongoing tax relief. First, the additional revenues associated with the largest tax increase in twenty years augment state tax collections and reduce the risk of revenue loss in other areas. None of the tax, surplus, and trust fund numbers presented above include surtax revenue. These additional revenues only increase the multibillion dollar disconnect between where revenues were expected to be just a year ago and where they are likely to be over the next year.

Second, the surtax significantly increases the incentives for high-wealth taxpayers to relocate, making outlier elements of our income and estate taxes even more problematic. The new tax will have a big impact on residents who have appreciated significant capital assets, such as home values, businesses that pay income (as opposed to corporate) tax, and high-wealth earners with volatile income. In each case, Massachusetts' existing tax system is out of line with other states and our goals for attracting and retaining people and investment. Massachusetts has the most expansive estate tax in the nation, aggressive 'sting taxes' on businesses that pay the income tax, and the highest short-term capital gains tax rate in the nation. The combination of these existing outlier taxes with the surtax, all of which affect the same small share of Massachusetts residents, enhances the risk that Massachusetts residents will move or plan their taxes in such a way to avoid paying not just the surtax, but other state taxes as well. That same combination also reduces the incentive for businesses and high-income people to move to Massachusetts, at a time when the state is experiencing a declining labor force.

Costs Pressures for Residents Grow

Pressures to leave Massachusetts are building on working families in Massachusetts too. In 2021, the Consumer Price Index rose by 4.8 percent, the highest level in over 30 years, but the real inflation pressures on residents came in 2022.[2] In 2022, the CPI rose by 8 percent, the highest level in 40 years, and hit Massachusetts residents already facing the highest costs in the nation for some of the fundamentals of life and work.

In 2022, Massachusetts ranked behind only Hawaii in the cost of living composite index, compiled by the Council for Community and Economic Research, and housing costs were the biggest factor in Massachusetts' ranking.[3] Housing costs are particularly challenging for low-income and fixed-income residents who have few options other than to pay high housing costs and cut spending on other essential needs. The state's inability to keep up with housing (both rental and ownership) demand has meant that vacancy rates lag far behind the national level and new production is still not enough to meet demand. The combination of these factors puts Massachusetts residents in a cost crunch when it comes to housing and makes staying in the state more difficult.

Child care is another example of a life and work necessity that was often unaffordable for many Massachusetts families before inflation hit over the last year. In 2020, the cost of infant child care in Massachusetts was the highest of any state in the nation, more than 30 percent higher than the national average. Since 2020, the child care system has been rocked by the pandemic, which shrunk already limited supply and spurred a child care workforce shortage that threatens the system. These conditions make it even more challenging for families to find and afford reliable and high-quality placements.

Income and Estate Tax Relief Priorities

The state came close to a $1 billion tax package last year and the fiscal, policy, and political conditions to provide significant tax relief are stronger now. State finances have exceeded expectations, families are under greater cost pressures, and the existing tax code has major risks for future economic growth.

The interrelated themes of last year's proposals remain the right framework: reduce costs for residents, and address problematic tax policies that dis-incentivize living and investing in the Commonwealth. However, the changing circumstances described above require a fresh look at how to achieve these goals.

The income and estate tax proposals outlined below are not exhaustive, but they provide a foundation for relief and are closely aligned with core goals to reassess our tax code in light of the surtax and address fundamental cost pressures on Massachusetts residents.

Attracting and Retaining Residents & Investment

The Massachusetts estate tax, income tax rates on small businesses, and capital gains rates do not make sense following the passage of the surtax. Reducing these taxes must be a core part of tax relief.

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[2] https://www.minneapolisfed.org/about-us/monetary-policy/inflation-calculator/consumer-price-index-1913-

[3] https://meric.mo.gov/data/cost-living-data-series

Estate Tax

Massachusetts is one of twelve states with an estate tax. It is one of two states that taxes estates with values as low as $1 million. It is the only state that taxes the entire value of eligible estates. The Massachusetts estate tax is not competitive with any state where older residents are likely to relocate and it is not consistent with our economic self-interest. Massachusetts is a high-wealth, cold-weather state. Our goal should be to encourage older residents to stay in Massachusetts, in spite of the winters, and not assess a tax on estates that is significantly greater than anywhere else in the country.

Policymakers should increase the Massachusetts estate tax threshold to at least $5 million and eliminate the 'cliff effect'. An estate tax threshold of $5 million would put Massachusetts at the same level as Maryland and Vermont and still well below New York, Connecticut, and Maine. There are two important benefits of raising the estate tax threshold to at least $5 million. First, it prevents house-rich, income-poor families, from being hurt by an estate tax threshold that has not even attempted to keep pace with rising home values. Second, it provides meaningful savings for higher-wealth estates that have the biggest incentive to change residency in light of the surtax.

The revenue generated by the estate tax varies greatly by year and so the fiscal impact of a $5 million threshold will vary as well, but the total cost will be the combination of three factors:

- Raising the threshold – from 2016 to 2020, between $150 million and $243 million in taxes were paid (annually) by estates valued under $5 million. Over the last two years, that number has likely grown, as more families are affected by the $1 million threshold, by 15 percent or so to $250 million.
- Eliminating the 'cliff effect' – the cliff effect refers to the fact that, currently, the entire value of an estate is subject to the state's tax. In other states, amounts below the tax threshold are excluded from the calculation. There are two ways to eliminate the cliff effect. You can exclude the value of the estate below the threshold and (at a threshold of $5 million) a $9 million estate would be treated as a $4 million estate. You can also provide estates with a credit equal to the tax paid below the new threshold level. If the latter approach were used, the cost of eliminating the cliff effect below $5 million would be between $150 million and $250 million, depending on filers.
- The behavioral impact – the estimates above assume that changing the estate tax significantly would have no effect on taxpayer behavior. However, the change should have a major effect for families with estates below $5 million (who would no longer be subject to the tax). Retaining these families will increase income and consumption tax collections, partially offsetting estate tax losses.

S-Corporation Taxes

S-Corporations are businesses, often small businesses, who pass income and losses to their shareholders who in turn report and pay any tax due. Massachusetts is one of a handful of states where S-Corporations are subject to additional tax rates – called a 'sting tax' – over and above the 5 percent income rate, depending on their total revenues and industry. If the S-Corporation generates total revenue between $6 million and $9 million, it must pay an additional tax of about

2 percent on net income, and 2.9 percent or more if revenues exceed $9 million. With the surtax, these additional rates can be as high as 8 percent, on top of the base 5 percent income rate.

The purpose of these sting taxes, created in the 1980s, was to ensure that S-Corporations with higher revenue paid a rate equivalent to the corporate excises. However, the $6 and $9 million thresholds have not been updated in more than 30 years, meaning that smaller and smaller businesses are affected by sting taxes each year. Now, with the surtax, S-Corporations will be paying rates well above the state's corporate excise.

The combination of the surtax and the sting tax will affect several thousand businesses in Massachusetts each year. The state should reduce sting taxes rates and adjust applicable thresholds now that the surtax is in effect. Sting tax collections are volatile and the Department of Revenue does not separate out these revenues in public revenue reports. Given these data challenges, we recommend that policymakers set a target to reduce annual sting tax costs by $125 million annually. Failure to reduce the sting tax greatly increases incentives for these businesses to relocate, which would cost the state surtax and other revenue as well.

Capital Gains

Massachusetts applies a 12 percent tax rate to the selling of short-term capital gains, defined as capital gains held less than one year, while other capital gains are taxed at 5 percent. Even before the surtax, the state's short-term capital gains rate was behind only California as the highest state level income tax rate in the country. With the surtax, short term capital gains income over $1 million will be taxed at 16 percent, higher than even California.

Residents who invest in Massachusetts' businesses and the economy are more likely to pay capital gains taxes and more likely to make tax planning and location decisions that respond to tax rates. Having the highest potential capital gains tax rate in the country is fundamentally misaligned with strengthening the Massachusetts economy.

The state should reduce the short-term capital gains rate to 5 percent – the same rate as all other wage and capital gains income. The fiscal impact of reducing the short-term rate from 12 percent to 5 percent varies significantly from year to year, as collections tend to track the larger economy, but would likely be between $130 million and $200 million. However, the budget impact of reducing the short-term rate would be zero. This is because capital gains collections above $1.48 billion in FY 2024 are held aside from the budget and deposited into the Rainy Day Fund and other reserves. Capital gains collections are far in excess of this level, and so any reduction to the short-term rate would result in smaller reserve deposits and not in less revenue available for the budget.

Easing Cost Pressures for Critical Needs

Child care and housing costs make it hard for families, especially low-income families, to stay in Massachusetts, participate in the economy, and invest in their future. Targeted tax relief on housing and child care will have a beneficial effect for these families and for the larger state workforce and economy.

Child & Dependent Tax Credit

Expanding the state's child and dependent tax credit (CDTC) was common to each of the tax relief proposals debated in 2022 and the House and Senate appeared to have consensus on a $310 per dependent credit and the elimination of the 2 dependent per household cap. Governor Healey has proposed going even further and upping the cap to $600 per dependent with no cap.

More than 500,000 tax filers, who care for more than 1 million children and dependents, would benefit from an expansion of the CDTC. This increase would be especially helpful as the federal credit, which was temporarily expanded by 50 percent or more during the pandemic, has returned to just over $2,000. At its current level, the state credit is set at about 10 percent of the federal amount; adopting Governor Healey's proposal ups that figure by about 30 percent.

The state should increase the CDTC to $600 and remove the dependent cap. This change would cost about $450 million, but would in turn provide direct economic benefit to families that struggle to afford living in Massachusetts. MTF has written extensively on the economic importance of accessible and affordable child care. Expanding a tax credit available to all families with children is an essential complement to investments and reforms in direct state investments in the system.

Rental Deduction

The state provides a tax deduction for 50 percent of annual rent payments with a maximum deduction of $3,000. This means that anyone paying more than $500 per month in rent reaches the maximum deduction. This is less than half the average rent of a studio apartment in Massachusetts.

The rent deduction was last increased in 2001. Since that time, the state's House Price Index has increased by 2.3 times. In 2022, Governor Baker proposed upping the maximum deduction to $5,000, while legislative leaders proposed $4,000. Both of these increases would make a big difference for renters, but still not keep pace with housing inflation since the last increase.

The state should increase the rental deduction to $5,000 and index that cap with inflation. Each $1,000 increase to the rent deduction costs about $35 million, and so Governor Baker's proposal had a cost of $77 million, while the House and Senate versions cost $35 million. Policymakers should increase the cap and adjust for inflation going forward. In addition, the deduction could be higher for lower-income residents, providing more targeted relief for households facing the most difficult economic choices.

Senior Circuit Breaker

The state's Senior Circuit Breaker provides a refundable tax credit to income eligible seniors who have property tax or rent costs that exceed a share of their income. Seniors who pay more than 10 percent of their income on property taxes (or 25 percent of rent exceeds 10 percent of income) are eligible for a credit equal to the difference between the amount paid and ten percent of income. The credit is capped and only seniors with incomes below certain thresholds ($64,000 for single filer/$96,000 for joint returns) are eligible. While the amount of the credit is annually adjusted for inflation, the base has not been changed for about twenty years.

The state should adopt the proposal shared by the Baker administration, House, and Senate in 2022 and double the base credit amount ($1,200 in 2022). This tax change provides an efficient way to provide $60 million to fixed-income residents with high housing costs.

Putting It All Together

The six income and estate tax changes highlighted above would help make Massachusetts a place that residents and employers want to call home. They would provide relief for child care and housing cost pressures, and rationalize elements of the tax code to reduce disincentives for people and employers to locate in the state.

Combined, these changes would have an annualized budget impact of about $1.1 billion. This level of relief is affordable within the current budget and critical to supporting sustainable and equitable economic growth moving forward.

Income and Estate Tax Proposals

	Gross Cost	Budget
Child & Dependent Tax Credit	$450	$450
Estate Tax Threshold	$250	$250
Estate Tax Cliff	$200	$200
Rent Deduction	$77	$77
Senior Circuit Breaker	$60	$60
Sting Taxes	$125	$125
Short-Term Capital Gains	$165	$0
Total	***$1,327***	***$1,162***

$ in millions

As the Healey administration and House and Senate leaders develop their own tax relief proposals, there are several principles that are essential for an effective proposal:

- *Recognize how things have changed* – last year's tax discussions offer a good starting point, but important facts have changed. The state's fiscal situation is stronger, cost pressures on residents are greater, and the surtax makes several historic tax outliers even more problematic. These factors all support a tax package that is larger and goes further than 2022 proposals.
- *Provide immediate relief that positions Massachusetts well in the future* – the tax code should be a key tool in helping Massachusetts retain and attract people and economic investment. Targeting high costs (like child care and housing) and removing or reducing disincentives for living and working in Massachusetts provides benefits now and is important for the state's long-term growth.
- *Get it right, even if it takes a little time* – increasing the estate tax threshold to $5 million and upping the CDTC to $600 both have significant price tags, but they are both the right

policy. Phasing in these changes over time is an option to spread out the fiscal impact and help budget planners adjust.

- *Keep it simple* – each of the tax proposals described above is simple in implementation and effect. Each reduces tax burdens and is consistent with immediate and long-term policy goals. Complicating a tax relief proposal with offsetting revenue raisers or limited eligibility criteria would be counterproductive and is not fiscally necessary. Each component of a tax relief proposal should work to make Massachusetts more attractive for residents and investment.

What's Next

Governor Healey's FY 2024 budget will be released at the start of March and that plan is an opportunity to kick-off tax relief discussions in 2023. As those discussions begin, MTF will build on our recent tax policy analysis and recommendations. This Bulletin makes clear that income and estate tax changes are essential to lessening costs on families and eliminating harmful tax outliers. However, other tax policy priorities must also be part of the discussion in the coming months:

- The state must clarify how the surtax will be implemented and adjust the Pass Through Entity and other taxes to ensure they are consistent with the new tax; and
- The state must look at how corporate and other tax policies can benefit job growth and help employers that choose to invest in the Commonwealth.

MTF will continue to publish research and work with policymakers and stakeholders to provide constructive recommendations and analysis, and assess whether or not tax proposals advance efforts to improve the state's ability to retain and attract people, jobs, and investment.