Publication A02.1

Massachusetts Coalition for Healthy Communities

P.O. Box 644 • Lexington, MA 02420 • Tel. 781-674-2422
info@masschc.org • www.masschc.org

Better Ways to Fund Vital Services

Options for Fair Tax Reform in Massachusetts

April 4, 2003

Tax Policy Working Group
Massachusetts Coalition for Healthy Communities

CONTENTS

About this Report

This report describes a range of tax reform options that can be employed to resolve the Massachusetts budget crisis. The fiscal analyses herein are based on a variety of published studies and readily available data sets. This report has benefited greatly from published analyses conducted by the Massachusetts Budget and Policy Center, The Institute for Tax and Economic Policy, The Center for Tax Justice, and the Massachusetts Department of Revenue.

The figures presented are subject to refinement as additional data becomes available and as the economic conditions change. In some cases, the state Department of Revenue must be tasked with refining the revenue estimates using data that is not publicly available (such as figures from personal income tax filings).

The Fair Tax Proposal is intended to initiate and not conclude a public debate on our tax system and our approach to funding government services. Any tax reform package should be subject to democratic deliberations in which citizens affected by budget cuts and tax policies, are allowed to participate and to provide guidance to the legislators who write tax law. Any tax reform package that emerges from this process should be examined in its entirety to ensure that it delivers tax fairness and adequate revenues. In this process, Massachusetts Coalition for Healthy Communities (MCHC) looks forward to working with both public and private groups, and to making sure that the citizens of our Commonwealth play an active and informed role in shaping our state budget policy.

A number of tax reform measures not described in this report may be proposed during the budget deliberations. MCHC will support such measures so long as they are part of a package that furthers tax fairness and adequacy of revenues.

Executive Summary

Massachusetts is in the grip of a budget crisis that is imposing harmful cuts upon programs supporting health care, human services, education and the environment. These cuts go far beyond routine "belt-tightening". They are producing a fundamental deterioration of the health of our communities and the integrity of the social fabric in Massachusetts. While many citizens are dismayed at the situation, they have been silenced by being told again and again that "the state is broke" and that the only choice is to dismantle programs. This report shows that real, viable alternatives do, in fact, exist. We can raise adequate revenues that are sufficient to maintain vital services, even during an economic slowdown. We do not have to impose burdensome fee increases upon state residents to generate revenues. The secret is to recognize the close connection between tax fairness and tax adequacy, and to put additional options on the table.

In this report we describe a basic "Fair Tax Package" of tax reforms that could produce over $2.5 billion in additional tax revenues. The package does not include any "one-time" measures or accounting gimmicks, nor does it include regressive fee increases. It does, however, address the *structural* problems in our tax structure that fuel and exacerbate the Massachusetts budget crisis.

Three types of tax changes are identified in the Fair Tax Package: (1) *Fairness Taxes* that are designed to achieve a more equitable distribution of tax contributions among all individual tax payers; (2) *Loophole Closures* that repeal corporate loopholes or other special treatments; and (3) *Smart Taxes* that create economic incentives for more efficient and healthier patterns of production and consumption. Smart taxes often produce cost savings that go far beyond the revenues associated with them.

The tax code changes described in this report emerge from three basic strategies for improving the tax system:

- *Make taxes fairer*. For many years, wealthier taxpayers and corporations have been taxed at lower rates than less fortunate citizens with low and moderate incomes. A movement toward fairness is not only the right thing to do - it is essential to win public support for raising adequate revenues. Massachusetts does not have to, and should not increase regressive taxes and fees in order to balance the budget. There are plenty of design options that will ensure that when a package is completed, increased contributions are required only from those who are best able to pay.

- *Close tax loopholes and eliminate costly tax giveaways*. Tax breaks that have been granted to corporations and to wealthier taxpayers over the past fifteen years have resulted in billions of dollars disappearing annually from state revenues. Recapturing part of these giveaways allows us to resolve our budget crisis.

- *Use "smart taxes" that clean up the environment and strengthen our economy*. Such taxes can produce environmental and social benefits in addition to needed revenue. For example, we can tax pollution rather than subsidizing it, thus motivating cost-effective investments in cleaning up the environment. Smart taxation pays off in reduced costs of regulation and environmental clean-up and reduced health costs.

Among the revenue options included in the Fair Tax Package are:

- A selective repeal of the sales tax exemption on certain services that are used primarily by corporations and wealthier households.

- An intangible property tax applied to ownership of stocks, bonds, and other instruments of wealth that exceed a deductible threshold.

- Income tax changes to increase the personal exemption and rental deductions while increasing the base rate, with the result that revenues increase without imposing additional taxes on low and moderate income taxpayers.

- Repealing certain corporate tax loopholes that are not justified by their economic benefit, such as the tax breaks given under the "Raytheon" and "Fidelity" tax measures.

- Repeal of a real estate sales tax exemption for commercial real estate and residential properties in the high end of the real estate market.

- A per-pound tax on the emission of toxic pollutants into the environment.

Better Ways to Fund Vital Services

1. Introduction

This memorandum describes a package of tax reform measures that can provide adequate revenues for vital programs and move toward a fairer tax system for Massachusetts.

The concept of tax fairness upon which our tax package is based has grown out of analyses of the relative contributions of different income groups to state and local government. When all state and local taxes, fees, exemptions, and deductions are considered, lower income residents contribute almost twice as much, as a percentage of their income, to support state programs than do higher income residents [ITEP1]. This is counter to the common notion of a progressive tax system. It also violates traditional concepts of fairness such as the notion that individuals should provide a "tithe" - a common fraction of their income - to support community purposes. Finally, it also produces a number of undesirable consequences, such as resentment of all taxes, and a sense that adequate revenues cannot be obtained because it would mean imposing painful tax increases on economically distressed taxpayers. In considering changes to the tax system, we seek to move toward greater fairness by reducing the gap between the percentage tax rate imposed on the wealthy and that imposed upon low and moderate-income citizens.

We believe that tax fairness should also consider the following goals:

(a) Tax contributions should be related to *ability to pay* and should recognize that taxes paid by people earning less than a "living wage" result in very real hardships for individuals and families.

(b) Both state *and* local taxes should be considered in designing the tax system. This is because state aid is an important factor in determining the level of local property taxes and local fees. If we consider state and local taxes in isolation, we fall into traps such as celebrating a tax cut at the state level and finding out that it results in a commensurate tax increase at the local level. In a similar way, analyses should consider an individual taxpayer's total contribution to support of government programs - including the income tax, property tax, excise taxes, sales tax, and fees. Furthermore, all exemptions and deductions should be considered to arrive at a bottom-line measure of who is contributing what.

(c) No company or industry should be given special treatment unless such treatment results in a clear commensurate public benefit for the Commonwealth as a whole. The burden of proof in such cases should be upon those who ask for special treatment. Many loopholes and tax breaks in the current tax code were inserted as political favors. They have never been subjected to objective economic analysis and have never been evaluated to determine whether they area actually producing public benefits. It is unfair to ask ordinary taxpayers to pick up the bill for tax breaks given to the well-connected interests simply because they were able to focus a high-power lobbying presence on Beacon Hill.

(d) Tax policy should be consistent with the broad public purposes being pursued by tax-funded programs. We should avoid encouraging pollution with tax policy and then raising taxes to help clean up pollution. A well-designed tax system is consistent with the public purpose, and helps give everyone a chance to live in a healthy community.

What specific reforms can be taken to produce a better tax system? By replacing regressive taxes with *Fairness Taxes*, we can provide tax relief and move toward a fairer tax system. By enacting *Loophole Closures*, which eliminate tax loopholes and repeal tax gifts that are not justifiable in terms of the public interest, we can produce revenues to fund vital services. By introducing *Smart Taxes*, we can encourage the development of healthier communities.

Reforming our tax system to provide fairness and adequate revenues is not a one-time job. The package must be frequently adjusted to adapt to changing economic conditions. Any changes should be measured against clearly defined fairness goals, and should be subjected to objective economic analysis. The current state tax system has resulted from a long period of patching and tinkering in which special tax breaks were inserted in a political environment characterized more by secrecy and insider horse-trading than sound economic analysis. Such a process does not serve the people of the Commonwealth, and cannot build public trust in the institutions upon which our communities depend. It is time for a new dialogue on the subject of taxes, and this memorandum is intended to contribute to that dialogue.

Section 2 provides the list of specific tax measures that comprise the base package. Section 3 describes some of the implementation considerations. Section 4 summarizes the findings.

2. A Fair Tax Solution to the Budget Crisis

This sections describes a Fair Tax Package that would generate over $2.5 billion in additional revenues, eliminate the fee hikes proposed in the Governor's FY04 budget, and move toward greater tax fairness. This is not the only possible such package, and it is possible to modify it by altering the parameters as well as adding or deleting components. However it does provide an alternative to the budget of devastating cuts that is currently under consideration on Beacon Hill.

A helpful document for understanding current tax code is the "Tax Expenditures Budget" [EOAF1] published each year by the Massachusetts Executive Office of Administration and Finance. This document lists the revenue losses that are thought to result from each exemption and deduction contained in the state tax code. The term "tax expenditure" reflects the fact that giving some individual or business a special tax reduction is fiscally equivalent to making an expenditure of public funds to that individual. In this memorandum, we will often refer the reader to a particular numbered item in the Tax Expenditure Budget, e.g., EOAF1 2.401 refers to item 2.401 in the Tax Expenditure Budget.

Table 2.1 provides a list of the revenue options included in the Fair Tax Package. It also lists the expected revenue changes. Further information on each of these options is provided in Appendix A.

The largest revenue options included in the Fair Tax Package are:

- $531 from a selective repeal of the sales tax exemption on certain services that are used primarily by corporations and wealthier households.
- $506M from repeal of a real estate sales tax exemption for higher -priced properties
- $500M from an intangible property tax applied to ownership of stocks, bonds, and other instruments of wealth that exceed a deductible threshold.
- $316M from adjustments to the income tax parameters that result in tax decreases for lower income taxpayers and tax increases for other taxpayers.
- $292M for taxes on the emission of toxic pollutants into the environment.

Further details on each of the tax options are provided in Appendix A of this report.

Table 2.1 Elements of the Fair Tax Package

No.	*Change*	*Revenue Impact ($M)*	*Note*
	Fairness Taxes		
1	Apply Transfer Tax to Sales of Higher End of Real Estate Market	506.0	Assumes 5% tax on amount of sale price exceeding a specified deductible. Deductible is selected to be well above the median selling price of single-family homes, so no tax would be paid for purchase of moderately priced residences. [EOAF1 3.501]
2	Intangible property tax	500.0	Assume rate of $2 per $1,000 with $30,000 personal exemption
3	Sales tax on selected services	531.0	Current sales tax exemption would be repealed on services such as lobbying, legal and accounting services, engineering services, business consulting, public relations and financial management.
4	Increase income tax rate/deductions	265.0	Increase tax rate to 5.6% while increasing personal exemptions and rental exemptions by $1,700 to shield low/moderate income taxpayers from the increase.
	Loophole Closures		
5	Repeal "Raytheon" single sales factor tax break	70.8	Total of this and the "Fidelity" tax break is $221.2M in EOAF1. [TEAM1] [EOAF1 2.401]
6	Repeal "Fidelity" tax break	150.4	[TEAM1] [EOAF1 2.401]
7	Close corporate tax loophole with "combined reporting"	97.3	Close reporting loopholes that allow corporations active in more than one state to hide income and thus escape paying corporate income tax. [CBPP1, MBPC1]
8	Repeal exemption of business real estate from the excise tax.	90.8	Currently corporate real estate holdings are exempt from the state excise tax. The tax rate is only $2.60 per $1,000. [EOAF1 2.502]
	Smart Taxes		
9	Tax on Pollution	291.6	Taxes applied to toxic releases at either 30 cents/pound or 15 cents/pound. [ELM1]
10	Apply sales tax to non-renewable electricity purchased by businesses.	126.9	This measure will encourage the conversion to renewable energy sources and will provide associated economic and environmental benefits. [EOAF1 3.401]
11	Repeal sales tax exemption for commercial fuel oil purchases.	20.5	This encourages energy conservation and has health and environmental benefits. The $40.0M figure includes both residential and commercial purchases. Revenue shown here assumes that 35% of purchases are commercial. [EOAF1 3.402]
	TOTAL	$2.651B	

Note: References indicate where further information is available from organizations that have analyzed the option. It should not be assumed that the referenced organization necessarily advocates the revenue option or is responsible for the specific formulation used in this document.

3. Associated Benefits of Adequate Taxation to the Massachusetts Economy

Good arguments can be made for keeping the overall level of taxation at the lowest level that is consistent with protecting vital services and investing adequately in the social and environmental underpinnings of society. However the loudest and best-funded voices in the public debate on taxes often paint a distorted and ultimately deceptive picture of the role of taxation and its "burdens". It is worth noting that increasing taxation to adequate levels often has associated benefits that greatly soften the presumed "burden". Some of these considerations are mentioned here in the interests of a more balanced consideration of the consequences of tax policy.

Tax increases at the state level often result in reduction of taxes and fees at the local level. This is because state aid assists communities in avoiding operating budget overrides and in reducing the size of any overrides that must be imposed. This is particularly important with regard to avoiding increases in local property taxes, one of the more problematic tax mechanisms.

Another mitigating factor is that a considerable fraction of the tax increases proposed in the Fair Tax Package do not fall upon Massachusetts residents. This is because a large fraction of corporate tax increases are paid for by corporate stockholders in the form of slightly reduced dividends or stock values. A study of tax incidence by the Minnesota Department of Revenue estimated that 90% of corporate taxes were paid for by out-of-state taxpayers (whereas 95% of the property tax was assumed to fall upon in-state residents). Thus, corporate taxes that are collected in Massachusetts create wealth and jobs in Massachusetts that would otherwise be siphoned off to other states.

It is also true that a significant part of taxes paid by upper income taxpayers represent dollars that would otherwise leave the state and go to the Federal government. This is because state taxes are deductible from taxable income on the Federal income tax form if a taxpayer itemizes her or his deductions. Thus a state tax increase of $1,000 for a wealthier taxpayer in the 35% income bracket will be accompanied by a $350 decrease in Federal tax liability, thus costing the taxpayer only $650 in the final analysis.

A further factor that makes tax increases less burdensome than they first appear is the fact that state Medicaid expenses are matched by Federal contributions. Thus, a tax increase of $1 million that is used to maintain Medicaid results in $1 million of Federal revenues coming into the state to create jobs and provide health benefits to residents.

When all these factors are considered, it is seen that tax contributions not only provide valuable services - they also result in significant benefits to the state economy by capturing dollars for local needs and local job creation that would otherwise be lost to other states or to Federal priorities.

4. Implementation Issues

The speed with which each revenue option can be implemented is dependent upon political will and other practical considerations. Some require only a parameter change in existing tax code. Others require the writing and publication of new rules. The speed of implementation must be considered separately for each revenue generation option.

Because few of the measures in the Fair Tax Package have been advanced during the past two years of fiscal crisis, we are at a disadvantage in our ability to fully resolve the FY04 budget shortfall in the short time available before the fiscal year begins. But one approach to making up for the delay exists: a fraction of anticipated future revenues from tax reforms can be brought forward through borrowing. Careful economic analysis should be used to set a prudent limit on the fraction of future revenues that would be committed in this way.

Some of the tax increases in the package - such as the pollution taxes - are designed so that tax liabilities can be reduced by simply reducing waste and reducing pollution. To the extent that this happens, the projected tax revenues will decrease. Normally, this is a desirable occurrence, since the benefits that result from pollution reduction or fuel efficiency are well worth the loss in revenues. Savings to the overall economy in such cases will usually far exceed any lost tax revenues. However, if tax revenues from these areas decline too much, and economic growth does not fully compensate, then the total tax package must be adjusted to maintain adequate revenues. We expect any revenue declines to occur slowly enough to provide sufficient time to retune the overall tax package to keep revenues stable.

As the economy recovers from its current slowdown, revenues will naturally increase. Careful attention should be given to the disposition of this increase. Some portion of any increase can be targeted to rebuilding the state's "rainy day fund" to a level that provides a cushion against future revenue downturns. Another portion can be used to restore cuts to vital programs imposed during the FY02 and FY03 budget deliberations. Likewise, growth should be used to provide further tax relief to low and moderate income taxpayers, with special attention to property tax relief and reductions in the sales tax.

5. Summary and Conclusions

The Fair Tax revenue options shown in Table 2.1 total over $2.5 billion. This package allows the current budget shortfall to be largely eliminated without imposing a package of regressive fees.

Several conclusions emerge from this analysis:

- The basic package of tax reform measures produces over $2.5 billion in additional tax revenues. The package does not include any "one-time" measures or accounting gimmicks, nor does it include regressive fee increases. It is sufficient to address the structural deficit problem that underlies the ongoing Massachusetts budget crisis.

- There is no reason for Massachusetts to increase regressive taxes in order to balance the budget. There are plenty of design options that will ensure that increased contributions are required only from those who are best able to pay.

- Fair tax options should be pursued regardless of whether a budget shortfall exists or not. When economic recovery eases the current fiscal stress, tax cuts should be focused on those who are now paying more than their fair share.

- There are opportunities for revising the tax code to produce economic, social and environmental benefits in addition to needed revenue. For example, we can tax pollution rather than subsidizing it, thus motivating cost-effective investments in cleaner production and consumption. This will produce economic savings in the areas of health care, lost time at work, and pollution clean-up as well as reduced costs of regulation and environmental remediation. A more complete analysis would make these options even more attractive than indicated here.

While this memorandum has focused on the problems of an obsolete and inadequate tax system, we should not overlook the fact that opportunities also exist for program reforms that will save money for taxpayers and consumers. We can find more cost-effective ways of providing health care, protecting public safety, invigorating the economy, and dealing with social problems. These reforms should be pursued. Where "seed money" is needed to transition to a more cost-effective way of doing business, that money should be provided. Such investments for efficiency are characteristic of businesses in the private sector that thrive over the long haul, and we should not allow our public institutions to decay for lack of a sound investment strategy. In the long run, a more prudent approach to investing in the future of the Commonwealth will pay off in healthier communities, fairer taxes, and an economy that provides prosperity to all.

References

CBPP1 "Closing Three Common Corporate Tax Loopholes Could Raise Additional Revenue for Many States", Center on Budget and Policy Priorities, April 9, 2002,<*www.cbpp.org/4-9-02sfp.htm*>

CBPP2 McNichol, Elizabeth C., "Using Income Taxes to Address State Budget Shortfalls", Center on Budget and Policy Priorities, Revised February 14, 2003

CBPP3 Mazerov, Michael, "Massachusetts, Raytheon Company, and the Sales-Only Formula: Payoffs for Layoffs", Center on Budget and Policy Priorities,

ELM1 "Environmental Tax Shifting in Massachusetts - Taxes that Work for Our Environment and the Economy", The Tellus Institute and the Environmental League of Massachusetts, August 2001

EOAF1 "Tax Expenditure Budget - Fiscal Year 2004", Executive Office for Administration and Finance, Commonwealth of Massachusetts, February 2003, <*www.massdor.com/stats/*>

EOI1 Economic Opportunity Institute, "Discussion Brief: Intangible Property Tax", <*www.econop.org/TaxPolicy-IntangibleWealthTax.htm*>

EPI1 Economic Policy Institute, "The State of Working America 2002-3"

FTA1 Federation of Tax Administrators, "State Individual Income Taxes: Tax rates for tax year 2002", <*www.taxadmin.org/fta/rate/ind_inc.html*>

GAW Heinrich, Phil, "Job Creation Tax Options", Get America Working, 2000

ITEP1 "Who Pays? - A Distributional Analysis of the Tax Systems in All 50 States, 2nd Edition", Center for Tax Justice, January 2003. An analysis of what makes a tax system regressive. Tax rates by income level in all 50 states. Appendix has state-by-state listings.

MBPC1 "Combined Reporting: A Comprehensive Method of Closing Corporate Tax Loopholes", Massachusetts Budget and Policy Center, March 27, 2003

MTF1 "State Budget '02: Heading for a Crash", Massachusetts Taxpayer's Foundation, January 2002

NEA1 Breslow, Marc, "Three Corporate Tax Loopholes that Need to be Closed", Northeast Action Issue Brief, May 2002

TEAM1 "Potential Sources of Tax Revenue", Tax Equity Alliance Education Fund, 2002

Appendix A

Tax System Changes in the Basic Package

Fairness Taxes

A.1 Apply Transfer Tax to Sales of Higher End of Real Estate Market

Currently real estate transactions are exempt from sales tax. This option would repeal this exemption for that portion of a transaction that exceeded a deductible value. For single-family homes, the deductible value is selected to exceed the median selling price of approximately $350,000. This ensures that most house transactions, including those involving moderate-priced homes, would not generate additional taxes following this repeal.

There would be no deductible for most commercial property, although consideration could be given to a deductible for small businesses expansions resulting in increased employment.

This tax applies primarily to the speculative value of residential property or to residential properties that have luxury features. Its effect is to reduce speculative inflation of selling prices or provide slightly less return on investment in luxury features. The deductible to approximately $350,000 would appear to impose almost no additional taxes on residential homes in lower income communities.

Simple calculations show that the transfer tax on a home of $500,000 with a deductible of $350,000 would be $7,500. This can be compared to the real estate broker's commission, which would be about $30,000 (at the industry standard commission of 6%). It should be noted that insofar as real estate transfer revenues are used to maintain local aid from the state to the community, local property tax relief would result from this type of tax. This would be welcome relief to homeowners living on fixed incomes who find it difficult to pay local property taxes.

In EOAF1 3.501 it is estimated that a 5% "transfer" tax on all real estate transactions in Massachusetts would produce revenues of $2.02B. This implies that the total annual real estate sales volume is approximately $40.5B in annual sales. If deductibles are set so that 75% of the total home sales are tax-free, the remaining 25% would produce revenues of $506M.

Estimated revenues: $506M.

A.2 Intangible Property Tax

Most standard property taxes are regressive in nature. This is because the value of real estate and tangible personal property does not generally increase in proportion to income and wealth. For example, a taxpayer with $300,000 annual income does not usually drive a car that costs 10 times more than the automobile of a taxpayer with $30,000 income. Financial assets, often referred to "intangible personal property", are disproportionately owned by persons of higher income and higher wealth. A step toward tax fairness would be to make intangible property part of the tax base rather than exempting it. Intangible property includes stocks, bonds, loans, and business ownership interests. However, an intangible property tax would not apply to IRAs, 401(k)s, and other retirement accounts. It would include a substantial exemption so that intangible property owned by people of low and moderate wealth would not be significantly affected.

The assets that are taxed by an intangible property tax are heavily distributed toward upper income levels. Lower income people tend to have more of their net worth in real estate (their homes) while upper income people tend to have more in stock. For example, in 1998, the top 1 percent of Americans owned 47.7% of all stocks while the bottom 80 percent owned 4.1%. Over 86% of the value of stocks and bonds are held by the wealthiest 10% of taxpayers. [EPI1] [*] This calculation is borne out by the number of Massachusetts income tax filers who report long term capital gains, which are generated almost exclusively by the purchase and sale of financial assets. In 1996, the most recent year for which such statistics are available, when less then 10% of filers in the lowest 60% of income reported long term capital gains. Almost one-half of persons with income in excess of $100,000 reported capital gains. This rises to 62% of filers who reported income of over $200,000.[†]

Extending property taxes to intangibles provides a broader tax base and helps ensure revenue stability and equity. Taxes such as the intangible property tax cannot be avoided by wealthier taxpayers who claim paper losses to show little income. It prevents the current situation in which millionaires can pay no taxes while families struggling for economic survival are paying to support state services. The principle of making tax contributions match ability to pay is achieved by ensuring contributions based on assets held more proportionately by the wealthier taxpayers.[‡]

Florida and Kentucky, and some local jurisdictions have already enacted intangible property taxes. In Florida, where the most notable intangibles tax has been collected by the state for over 30 years, non-exempt financial assets are taxed at a rate of $1 per thousand dollars of value (“1 mill”), subject to an exemption for the first $20,000 ($40,000 for married couples) of total taxable assets. Since fiscal year 1999, Florida has averaged collections of approximately $477M per mill annually from this source.

The revenue that could be generated from an intangibles tax in Massachusetts depends on the tax rate adopted. Using total income within a state as an approximate measure of total wealth within that state, the 2000 United States Census shows that the total income for Massachusetts is 47.8% of the total state income for Florida. Under a similar exemption scheme, this would suggest that Massachusetts could collect $225M at a tax rate of 1 mill.

---

[*] See also Edward N. Wolff, “Recent Trends in Wealth Ownership, 1983- 1998”, Levy Institute Working Paper No. 300. (Levy Economics Institute: April, 2000).)

[†] 1996 Massachusetts Statistics of Income (Department of Revenue: 2000).

[‡] Massachusetts does tax wealth accumulated through intangible property through a capital gains tax, which almost exclusively derives from the purchase and sale of financial assets. However, the capital gains tax does not reflect the inherent value of the assets owned, only the gain (or loss) recognized upon a transaction. In determining the effective rate of taxation that is used to determine tax fairness we will include both the capital gains tax and the intangible property tax.

A study developed in Washington state [EOI1] found that, using a flat $30,000 exemption, a 1 mill tax on intangibles would generate $245M. Because Massachusetts's total income is 121.7% of Washington's income, this extrapolates to tax revenues of approximately $300M. Conservatively, under a Florida-like scheme of exemptions, Massachusetts could expect to collect at least $250M for each mill rate of tax. A $2 per $1,000 rate would yield approximately $500M.

Estimated revenues: $500M

A.3 Repeal Sales Tax Exemption on Certain Services

The Department of Revenue estimates that the state foregoes $4.25 billion annually due to the exemption of services from the sales tax [EOF1 3.503]. Since services have greatly increased as a part of the economy, the exemption of services has made the sales tax less efficient and less fair as a tax mechanism.

Since a sales tax on all services would have regressive characteristics, a carefully targeted repeal of the exemptions is required. The repeal should focus on those services that are used primarily by corporations or by taxpayers who are currently paying less than others.

This package proposes to recover about *one-eighth* of the lost revenue by repealing exemptions that are focused on services such as:

- lobbying of the Massachusetts Legislature;
- legal services, including arbitration and mediation;
- accounting, auditing, bookkeeping, tax preparation and similar services;
- engineering, surveying and architectural services;
- business consulting and management services;
- public relations, advertising, and marketing services; and
- financial management and consulting services.

Seven-eighths (87.5%) of the total tax exemptions would remain in place. The repeals would not apply to services delivered as part of direct health care or services provided to government or to non-profit tax-exempt organizations.

Estimate revenues: $531M

A.4 Income Tax Parameter Adjustments

Adjustment of state income tax parameters can be used to provide additional revenues while providing tax relief to low and moderate income taxpayers. As a rough rule of thumb, the Massachusetts income tax at a nominal 5.3% rate produces about $10B in annual revenues. Thus, increasing the rate by 10% to 5.8% should produce about $1B in increased revenues. A more precise calculation will reflect the amount of taxable income in each of the three categories (Part A, Part B, and Part C) and consider deductions and exemptions.

The effect of an income tax rate increase on lower income taxpayers can be cushioned by simultaneously increasing the deductions. In general, the taxes owed are

$$T = r\,(I - D)$$

where r is the nominal tax rate, I is the gross income, and D is the total of all deductions and exemptions. If the rate is increased by Δr and deductions/exemptions are increased by ΔD, then the net change in taxes is

$$\Delta T = \Delta r\,(I - D) - \Delta D\,(r + \Delta r)\ .$$

While there is considerable flexibility in setting rates, we will propose the following as a starting point:

- Increase the personal exemption by $700 (from $3,300 to $4,000).
- Increase the ceiling on the rental deduction by $1,000 (from $2,000 to $3,000).
- Increase the tax rate for Part A and Part B income to 5.6% (from the current 5.3%).
- Keep all other deductions/exemptions the same.

The total deductions/exemptions claimed by a taxpayer claiming the rental deduction would then increase by $1,700.

The following table shows the approximate income tax change for the above parameters. Note that taxpayers with under $35,000 in taxable income would see a tax decrease with these parameters. This effectively shields most taxpayers who are earning less than a living wage.

INCOME	TAX CHANGE
$15,000	-$66.10
$20,000	-$51.10
$25,000	-$36.10
$30,000	-$21.10
$35,000	-$6.10
$40,000	$8.90
$60,000	$68.90
$80,000	$128.90
$100,000	$188.90
$1,000,000	$2,888.90

The additional revenue produced by this change is approximately $265M. It should be noted that increasing the tax rate to 5.9% with $2,900 increase in deductions/exemptions would raise approximately $802M in additional revenues and produce the same "break even" income level.

Estimated revenues: $265M

Loophole Closures

A.5 Repeal the "Raytheon" Single Sales factor tax break

This tax break, originally advanced as a benefit for the Raytheon Corporation, was given to all defense manufacturers on the premise that it would preserve jobs in Massachusetts. It involves a change in the formula used to apportion taxable income between different states. The economic justification was always questionable. Raytheon has in fact invested its corporate funds in expansion of facilities in other states and reduced employment in Massachusetts.

According to EOAF1, the total of this and the "Fidelity" tax break is $221.2M. This can be allocated according to TEAM1 to attribute 32% of the total to the single-sales factor for at final amount of $70.8M.

Estimated revenues: $70.8

References: TEAM1, CBPP3

A.6 Repeal "Fidelity" Tax Break

In 1996 the Massachusetts Legislature provided a substantial tax break to mutual fund companies by changing the rules regarding how their taxes were computed. This tax break is often called the "Fidelity" tax break since Fidelity Investments was the major lobbying presence behind the measure. In exchange for the tax break, mutual fund companies had to increase the number of Massachusetts-based jobs by 5 percent annually for the next five years. Fidelity met the standard for five years during the booming economy of the late 1990's. But since 2002, Fidelity has laid off about 1,200 employees in Massachusetts. As written the tax breaks were permanent, while the requirement for job growth expired after five years. The economic justification for the measure was questionable because, during a period of high economic growth, the employment increases were likely to have occurred even without the tax break. If an economic slowdown had then occurred, the law had an escape clause that would have given Fidelity a waiver.

According to EOAF1, the total of this and the "Raytheon" tax break is $221.2M. This can be allocated according to TEAM1 to attribute 68% of the total to "Fidelity" for an estimated tax expenditure of $150.4M.

Estimated revenues: $150.4 M

References: EOAF1, TEAM1, CBPP3

A.7 Combined Reporting to Close Loopholes

Corporations that are active in more than one state are allowed to apportion their tax liabilities between states. The intention is that each state be allowed to tax corporate income only according to the approximate presence the corporation has in that state as either a manufacturer, employer, or seller. Unfortunately, this apportionment offers an opportunity for corporations to shift profits out of a higher tax state and into a lower tax state. This is sometimes accomplished by starting a subsidiary in a low tax state and using accounting tricks to make the corporate profits show up as profits made by the subsidiary rather than the parent company. [CBPP1, MBPC1].

Sixteen states have closed this loophole by requiring "combined reporting". This makes it more difficult for a corporation to hide income. The Massachusetts Budget and Policy Center examined the experience with combined reporting in three states and concluded that similar results in Massachusetts would produce an additional $76.5M to $195.8M in FY04 revenues. The revenues would be even greater as the economy moves out of the current economic slowdown.

For purposes of our baseline calculation, we will use the midpoint of the MBPB estimates - $136M - as an estimate of the revenue yield from combined reporting.

Estimate revenues: $136M

References: CBPP1, MBPC1, NEA1

A.8 Repeal Exemption of Business Real Estate from Excise Tax

Currently real estate owned by corporations is exempt from the state excise tax. The excuse for this exemption is that this leaves local communities free to impose property taxes of their own. However, under Proposition 2½, local property tax is already limited and has grown slower than it otherwise would. Communities that attempt to raise local corporate taxes are subject to blackmail by businesses that threaten to move across the town line to escape the tax. Repealing this exemption will result in an excise tax that more realistically reflects the true value of business holdings and will allow local property tax relief without the threat of economic blackmail. The current state excise tax of $2.60 per $1,000 is only about one-fifth the typical local property tax, and will not result in a substantial change in the tax structure.

Estimated revenues: $90.8M

Smart Taxes

A.9 Tax on Pollution

Each year Massachusetts industry emits approximately 6.5M tons of reported pollutants according to the EPA's Toxics Release Inventory. The Toxics Use Reduction Act reports approximately 1.38B pounds (0.69M tons) of reportable toxics. Of this amount, 383M pounds are on OSHA's list of the top 10 carcinogens.

Traditional attempts to reduce pollution involve prohibiting certain types of activities, issuing permits that cap pollution, and various underfunded voluntary programs that have no explicit financial incentives. Putting an explicit tax on pollution provides an important complement to conventional approaches. It will encourage businesses to reduce pollution below the maximum level permitted by conventional regulations when such reductions can be achieved in a cost-effective manner. Pollution taxes are somewhat analogous to cigarette taxes, which create an immediate financial incentive to reduce tobacco use.

Pollution reduction produces environmental and health savings that are an additional financial benefit. Pollution taxes also compensate government for the cost of addressing the effects of pollution, such as inspections, clean-ups, and health costs paid by government. By imposing increased rates for substances of most potential harm, this tax can encourage conversion to safer and healthier manufacturing processes.

A possible schedule for implementing the pollution tax might begin with the toxics listed by TURA. Let the top 10 carcinogens be taxed at 30 cents per pound and the remainder at 15 cents per pound. Also, assume that 90M pounds of toxics of concern not currently listed by TURA are evaluated by EPA models and are assessed at an equivalent rate of 30 cents/pound through a facility pollution permitting arrangement. (For example, if EPA emission factors indicate that a facility of a certain type typically emits 10,000 pounds of pollutants, the tax liability could be set to $3,000.) This schedule would produce revenue as indicated in the table below:

Table 2.1 Example of revenues from the pollution tax.

	Pounds/year	*Tax/pound*	*Revenues*
Top 10 carcinogens	384M	$0.30	$115.2M
Other TURA	996M	$0.15	$149.4M
Modeled non-TURA	90M	$0.30*	$27.0M
		Total	$291.6M

The rate for each of the various classes or types of pollutant could be adjusted to reflect new scientific findings concerning the level of environmental harm or health risk from that type of pollutant. State environmental agencies would be asked to conduct studies of environmental damage that would be factored into the rate setting process.

Estimated revenues: $292M

A.10 Apply Sales Tax to Non-renewable Electricity Purchased by Businesses.

This has the benefit of encouraging electricity conservation. It also encourages businesses to purchase electricity from green sources that would continue to be exempt from the sales tax. Businesses that use less electricity in production gain a competitive advantage over businesses that waste electricity. Businesses that purchase all their electricity from renewable sources will pay no sales taxes at all. EOAF1 estimated that applying the sales tax to all electricity purchases would produce $169.2M in revenues. We will assume that

* This is the average rate per pound. Actual rate would be adjusted to reflect toxic equivalencies.

in the next few fiscal years, 25% of total purchases will be renewable and that 75% of purchases will be taxed.

Estimated revenues: $126.9M

A.11 Repeal Sales Tax Exemption for Fuel Oil to Businesses

This has health and environmental benefits by encouraging fuel conservation. Businesses that use less fuel oil in production gain a competitive advantage. Substitution of renewable energy and conservation for fuel oil purchases will have secondary economic benefits for Massachusetts since the local economic stimulus of such alternatives is greater than that resulting from purchases of imported fossil fuels.

EOAF1 estimates a total $58.7M tax expenditure that includes both residential and commercial fuel oil purchases. Assuming that 35% of purchases are commercial, the net revenues would be $20.5M.

Estimated revenues: $20.5M

References: EOAF1 3.402