



*The Beacon Hill Institute for Public Policy Research*

## **New Tax Loophole Proposal Produces Less Economic Damage than the Original**

In January, Governor Mitt Romney and the legislature proposed giving the Massachusetts Department of Revenue (DOR) Commissioner Alan LeBovidge carte blanche to close tax loopholes and aggressively pursue corporations that use them. The Governor, in his Fiscal Year (FY) 2006 Budget Recommendations, projected that closing the loopholes would raise an additional \$170 million in revenue, marking the third consecutive year that the Governor and the legislature proposed legislation to close corporate tax loopholes.

In 2003, lawmakers enacted legislation that tightened the tax rules pertaining to real estate investment trusts and that stopped companies from avoiding state taxes by transferring intellectual property to shell companies incorporated in tax haven states like Delaware. These measures continue to plug state coffers to the tune of \$120 million annually, according to DOR estimates.

Last year, state policymakers continued their campaign against tax loopholes by approving another \$90 million in changes. The measures raised the tax rate on businesses that exclusively buy and sell securities to the same rate currently paid by other businesses; applied the state sales tax to goods bought and modified out of state (but used in Massachusetts) which were previously avoiding this tax; and ended a sales-tax break on printing costs enjoyed by department stores and other catalog publishers.

The legislation (House Bill 21) proposed in January would have brought the total revenue generated from the three-year effort to close loopholes to \$380 million. However, the Governor's third trip to the "loophole well" proved too much for local business leaders. Their outcry prompted the Governor to file House Bill 2606 in March, a modified proposal that closes fewer loopholes than the earlier proposal.

The new legislative package leaves intact three loopholes that were slated to be closed under the original: the importation of losses from out of state, inter-company pricing reform, and deed excise tax avoidance. According to the DOR, the new plan will generate an estimated \$85 million in additional revenue, half the estimated \$170 million from the original legislation. Table 1 contains a comparison of the individual measures to address corporate tax loopholes included in the two plans and the additional tax revenue the DOR anticipates will be generated by each.

**Table 1: Fiscal Year 2006 Tax Loophole Closings ( \$, million)**

Tax Loopholes Closed	Revenue Generated	
	House Bill 21 (Jan 2005)	House Bill 2606 (March 2005)
Federal Rules for Business Income of Not-for-Profits	5	5
Tax Shelter Penalties	5	5
Enforcement of Tax Compliance for License Renewals	8	8
Software Programs Delivered in Intangible Form	50	50
Non-Resident Partnership Sales of MA Real Estate	15	15
Elimination of Exemption for Electricity Sales	2	2
Deed Excise Tax Avoidance	20	NA
Importation of Losses	15	NA
Inter-Company Pricing Reform	50	NA
<b>Total</b>	<b>170</b>	<b>85</b>

### Economic Effects of Closing the Loopholes

Policymakers need to focus on the economic consequences of closing the loopholes and not just the additional revenue raised by these actions, especially now that Massachusetts economic recovery is finally beginning to show signs of strengthening.

The Beacon Hill Institute at Suffolk University, using its Massachusetts STAMP<sup>®</sup> Computable General Equilibrium Model, has calculated the economic effect of implementing each of the loophole proposals. The model simulates the effects of increasing corporate income taxes and sales taxes, effective FY 2006. Table 2 details how the each proposal would affect employment, capital investment, disposable income and the wage rate over the period covering FY 2006 to 2008.

**Table 2: Comparison of the Economic Effects of the Proposals**

Economic Indicator	2006	2007	2008
<b>Change in Private Employment (jobs)</b>			
House Bill 21 (January)	-525	-559	-617
House Bill 2606 (March)	-456	-460	-469
Difference	<b>69</b>	<b>99</b>	<b>148</b>
<b>Change in Gross Wage Rate, nominal (\$/worker/year)</b>			
House Bill 21 (January)	-43	-51	-60
House Bill 2606 (March)	-13	-15	-17
Difference	<b>30</b>	<b>36</b>	<b>43</b>
<b>Change in Nominal Investment (\$,million)</b>			
House Bill 21 (January)	-467	-489	-510
House Bill 2606 (March)	-108	-114	-119
Difference	<b>359</b>	<b>375</b>	<b>391</b>
<b>Change in Real Disposable Income (\$, million)</b>			
House Bill 21 (January)	-48	-59	-68
House Bill 2606 (March)	-26	-28	-30
Difference	<b>22</b>	<b>31</b>	<b>38</b>

Under the original legislation filed in January, both investment and disposable income experience significant reductions, while employment remains virtually unchanged. By 2008, investment plummets by over \$500 million, or .79% of total annual investment in Massachusetts. The proposal also leaves consumers with \$68 million less in disposable income in real terms, and pushes down the gross wage rate of Massachusetts workers by \$60 per year. The plan has very modest effects on employment by eliminating only 617 private sector jobs.

The picture outlined above brightens considerably under the Governor’s revised loophole closing plan filed in March. Investment drops by only \$119 million or 23% of the \$510 million lost under the original plan. The loss to real disposable income experienced by taxpayers is reduced to \$30 million compared to \$68 million under the original plan, making for a difference of \$38 million or 68% of the original loss. The new plan also restores \$43 to workers annual pay, making the reduction only \$17 annually per worker; and the new plan pares private employment losses by 148 jobs.

The DOR estimates of the amount of revenue generated by closing the loopholes is overstated, in as much as it relies on a “static,” rather than a “dynamic,” revenue analysis. A dynamic revenue analysis differs from a static revenue analysis in that it takes into account the secondary effects of tax changes. Here the principal dynamic effect is the reduced investment that takes place as the increase in the corporate tax reduces the after-tax return to investment. Also, the reductions in investment, wages and disposable income, resulting from closing loopholes will reduce revenue collections for other taxes, including taxes collected at the local level. Thus, the overall effect on total tax collections would be less than anticipated by the administration.

The BHI STAMP<sup>®</sup> Model incorporates the dynamic effects of the decline in investment, real disposable income and wages. As a result we project lower revenue gains from closing the loopholes than the Department of Revenue. See Table 3 for details.

**Table 3: Tax Revenue Effects of Closing Tax Loopholes (\$, million)**

Total Tax Changes (state + local)	2006	2007	2008
<b>House Bill 21 (January)</b>			
Department of Revenue	170	170	170
BHI	112	109	105
Difference	<b>58</b>	<b>59</b>	<b>65</b>
<b>House Bill 2606 (March)</b>			
Department of Revenue	85	85	85
BHI	65	64	63
Difference	<b>20</b>	<b>21</b>	<b>22</b>

Under the loophole closing scenario proposed in January, we estimate the increase in state tax revenue at \$112 million for Fiscal Year (FY) 2006, or \$58 million less than the DOR estimate of \$170 million, and the difference expands to \$65 million by FY 2008. The results are similar for the March proposal as BHI and DOR revenue estimates differ by between \$20 and \$22 million for FY 2006 – FY 2008.

Closing corporate tax loopholes is a policy on which the Governor and legislature have been able to agree, a situation that has proven elusive over the past three years in other policy areas. However, this year business leaders have convinced the Governor to reduce the scope of his initial proposal by half. Our analysis indicates that the damage to the Massachusetts economy, in terms of investment, disposable income, and wages, would be substantially mitigated under the new plan unveiled in March. Moreover, our analysis indicates that the DOR estimates for the additional revenue generated under either plan are overstated.