FAXSHEET

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The economics of a 5% income tax: Getting the numbers right

Governor Mitt Romney has called for a reduction of the state personal income tax from 5.3% to 5%, citing an expanding economy that is boosting state tax revenues. The governor's announcement comes as the latest report from the Massachusetts Department of Revenue indicates that year-to-date tax collections are running $787 million, or 5.9%, over the previous fiscal year.

In 2000, voters approved a ballot measure reducing the income tax rate from 5.85%, where it then stood, to 5% by 2003. Then, in 2002, the state legislature froze the rate at 5.3% in response to a plunge in tax revenues that occurred as a result of the economic downturn then underway. Now that revenues are surging rather than plunging, the governor wants to reduce the rate to 5%, as mandated by the voters in 2000.

Table 1: Comparison of FY 2004 Tax Revenue Forecasts ($000)

Tax Revenue Forecasts	
Projected FY 2004 Tax Revenues, as of June 2004	
The Beacon Hill Institute	15,745,935
Projected FY 2004 Tax Revenues, as of December 2003	
The Beacon Hill Institute	15,532,000
The Massachusetts Taxpayers Foundation	15,417,000
Consensus Estimate	15,230,000
Department of Revenue	14,796,000
DOR based on Global Insight Assumptions	15,285,000
DOR based on NEEP Assumptions	15,275,000
DOR based on Economy.com Assumptions	15,238,000

The governor's proposal has engendered a negative reaction in some quarters. Michael J. Widmer, President of the Massachusetts Taxpayer Foundation, reacted negatively to the idea, arguing that the state is "not out of the woods yet" and continues to face a substantial "structural deficit."[1] This deficit is supposed to measure the difference between what the state expects to get in revenue and what it needs to spend in order to maintain current services.

Absent so far from the debate has been a consideration of the benefits the proposed tax cut would confer on the state economy. The Beacon Hill Institute (BHI) has undertaken to fill this void.

Measuring the Economic Effects

As we near the end of FY 2004, BHI is poised to come closer than any other recognized forecasting entity for predicting FY 2004 tax revenues. In December 2003, less than halfway through FY 2004, we predicted that the Commonwealth would receive $15.532 billion in tax revenues for the fiscal year. See Table 1. Now, with six more months of data in hand, it appears that the actual amount will be $15.746 billion, meaning that BHI's forecast will be within 1.4% of the actual amount and closer than any other forecast, including those provided by the Massachusetts Taxpayers Foundation and the state Department of Revenue.[2]

BHI combines regression methods with simulations of its Massachusetts State Tax Analysis Modeling Program (STAMP®) to forecast revenues. The revenue forecast produced by this approach takes into account information about the effects of tax-rate changes on economic activity, along with information about the effects of cyclical fluctuations in the economy. Other models commonly fail to recognize the effects of tax rate changes on economic activity.

We ran STAMP to simulate the effects of reducing the Massachusetts income tax to 5%, effective January 1, 2005. Table 2 details how the governor's proposal would affect employment, capital investment (factories, com

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puters and other means of production), disposable income and state and local tax revenues over FY 2005-08. By FY 2008 there would be 7,885 new jobs in place as a result of the tax cut, $17.1 million annually in new investment and $469 million more in real (inflation-adjusted) disposable income.[3]

Governor Romney expects the tax cut to reduce tax revenues by $225 million in FY 2005. As indicated in Table 2, this figure comes close to that obtained from the STAMP simulation. We find that the tax cut would cause the state to lose $237.1 million in revenue in FY 2005.[4] In light of the fairly significant loss of revenue to the state, it is necessary to consider the effect of the tax cut on the state's ability to meet its spending obligations.

Table 2: The Economic Effects of Personal Income Tax Cut to 5%

Fiscal Year	Employment	Investment ($ million)	Real Disposable Income ($ million)	Change in State Tax Revenue ($ million)
2005	3,683	7.3	243.0	-237.1
2006	7,512	15.5	480.0	-486.7
2007	7,671	16.4	474.0	-501.3
2008	7,885	17.1	469.0	-518.7

Ordinarily, as here, a tax rate cut will cause tax revenues to fall permanently below the level that those revenues would have attained had the tax rate not been cut. The tax cut would cause the revenue brought in by the state in FY 2006 to be $486.7 million less than it would have been without the tax cut.[5] The revenue loss would reach $518.7 million by FY 2008.

Worries about "structural deficits" seem to find confirmation in this reality. But this worry is misplaced; once the tax cut is in place, normal revenue growth will resume. Thus, even though the state would bring in less revenue than it would have without the tax cut, the total amount of revenue that it would bring in would grow with the economy.

The "Structural Deficit" Illusion

It is worth remembering that the whole idea of a "structural deficit" is based on illusive assumptions about what the state needs to spend in order to maintain current services, predictions about tax revenue collections not to be realized until many months in the future and policy changes yet to be conceived or implemented.

The shakiness of any estimate of the structural deficit is perhaps best illustrated by a February 2003 report of the Massachusetts Taxpayers Foundation. In this report, entitled, *The State Budget 03: The Perfect Storm...Unleashed,* the authors opined that the state faced a structural deficit as large as $2.4 billion in FY 2004 (p. 9).[6]

> However the 2004 gap is measured, the end result is a huge deficit that cannot practically be addressed within the span of a single budget year. Without action on the structural problem that is driving the shortfall in 2004, the Commonwealth will surely face an even larger problem in 2005.[7]

Embarrassingly for this dour outlook, tax revenues (less MBTA transfer) for FY 2004 will be 5% or $775 million greater than for FY 2003. The state will be able to increase spending by 7.57% in FY 2005. Rather than a perfect storm, the state's fiscal crisis begins to look like a passing squall.

Tax Reduction: The Numbers

Still it is necessary to assess the implications of permanently removing some $500 million in tax collections from the state budget. Table 3 provides our assessment for the period FY 2005-08. There we update our December 2003 forecast for FY 2004 to reflect the new tax revenue data that have since become available.[8]

Anticipating a hefty FY 2004 surplus, Governor Romney has filed legislation calling for $457 million in supplemental spending for FY 2005. We assume that the state will finance an equal portion of FY 2005 spending from the FY 2004 surplus.

Under our scenario, spending over the entire period 2004-08 will grow at an average annual rate of 4.65%, from $22.574 billion to $27.055 billion.[9] In light of the governor's stated determination to use a large portion of the emerging FY 2004 surplus to supplement FY 2005 spending, we set the growth in total spending for FY 2004-05 at 7.57%. We then further assume that spending in FY 2006-08 will grow at about the same rate as tax revenues. Through

-out this process, state balances will remain in excess of $1 billion.[10]

Massachusetts is once again awash in tax revenue. It will enjoy a surplus of over $700 million dollars in FY 2004, similar to the huge surpluses that came in during the boom times of the late 90s. This means that the state can, in 2005, reinstate the tax cut mandated by the voters in 2000 and still expand government spending at a healthy clip.

Table 3: Fiscal Impact of an Income Tax Rate Cut to 5% in FY 2005 ($000)

Fiscal Year	2004	2005	2006	2007	2008
Tax Revenues (net of MBTA transfer)	15,054,596	15,598,784	16,271,272	16,948,570	17,616,324
Effect of Tax Cut	***0***	***-237,120***	***-486,670***	***-501,280***	***-518,720***
Total Tax Revenues	15,054,596	15,361,664	15,784,602	16,447,290	17,097,604
Non-Tax Revenues	8,251,200	8,499,800	8,967,289	9,460,490	9,980,817
Transfer from FY 2004 Surplus	NA	457,000	NA	NA	NA
Total Revenues	***23,305,796***	***24,318,464***	***24,751,891***	***25,907,780***	***27,078,421***
Total Expenditures	***22,573,500***	***24,282,277***	***24,726,681***	***25,882,368***	***27,054,928***
Growth of Expenditures	NA	7.57%	1.83%	4.67%	4.53%
Beginning Balance	752,400	1,027,696	1,063,883	1,089,093	1,114,505
Surplus	***732,296***	***36,187***	***25,210***	***25,412***	***23,493***
Ending Balance	1,484,696	1,063,883	1,089,093	1,114,505	1,137,998

Conclusion

The result of cutting the tax rate will be the creation of thousands of new jobs and millions of dollars in new investment. The legislature might prefer to keep the $500 million in yearly tax revenues that will be lost as a result of this action. It might wish to apply the money to additional state spending rather than return it to the taxpayers and, in the process, create new jobs and investment. But it cannot resist the tax cut on the basis of a bleak revenue outlook. When you get the numbers right, you see the sun shining through the clouds.

Endnotes

[1] Scott S. Greenberger, "Romney seeks $225m in tax cuts: says recovering economy allows more spending," *The Boston Globe*, May 4, 2004; Internet; available at http://www.boston.com/dailyglobe2/125/metro/Romney_seeks_225m_in_tax_cuts 2b.shtml, accessed May 4, 2004.

[2] The $15.746 estimate is based on BHI's forecast, updated in June 2004.

[3] The change in disposable income does not equal the change in state tax revenues. This is in part because disposable income is measured in real or inflation-adjusted dollars while state tax revenues are measured in current dollars. Also the change in state tax revenues includes some taxes that do not enter into the calculation of disposable income and excludes others.

[4] The governor's number is numerically less than ours even though we include the positive effects on tax revenues of the expansive effect of cutting the income tax. Thus, for example, in our analysis, increased sales tax revenue will partly offset the loss of income tax revenue, which will be further modified by the expansion in payrolls brought about by the tax cut. The reason why our estimate of lost revenue exceeds the governor's probably lies in differences between our analysis and his relating to cyclical movements in the economy.

[5] For FY 2005 the tax cut would be in effect for only half of the year, while for subsequent years, the tax cut is effective for the entire fiscal year. This accounts for the nearly doubling of the effects of the tax cut between FY 2005 and FY 2006.

[6] See http://www.masstaxpayers.org/data/pdf/reports/03book.pdf.

[7] Ibid., p. 12.

[8] The Commonwealth of Massachusetts, *Information Statement Supplement*, May 13, 2004 provides non-tax revenue figures for FY 2004. The FY 2004 figure includes a onetime $435 million funding increase due to Medicaid and general fiscal relief funds from the federal government. *The Governor's Budget Recommendation: House 1A, Fiscal Year 2005* provides the FY 2005 figures. The figure for FY 2005 was reduced by $480 million to reflect an anticipated loss of revenue due to the failure of the Massachusetts Turnpike Authority and Highway Department merger. For non-tax revenue from FY 2006-08, we assume that non-tax revenues grow at 5.5% in line with past growth rates.

[9] Total expenditures, as measured here, include pension fund transfers. Data on these transfers were obtained from *The Governor's Budget Recommendation* and from Commonwealth of Massachusetts, Office of Administration and Finance. Expenditures for FY 2005 were reduced by $274 million to reflect an anticipated loss of expenditure due to the failure of the Massachusetts Turnpike Authority and Highway Department merger.

[10] *The Governor's Budget Recommendation* provides the state funds beginning balance for FY 2004. The subsequent budget surplus for each year is added to this figure to provide the ending balance for the fiscal year.

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