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Information and Updates on Current Issues

October 2010



Another Side of Question 3: Private Sector Job Growth and Lower Unemployment

In less than three weeks, Massachusetts residents will go to the polls to elect constitutional officers and members to the state legislature. At the same time, voters will have the opportunity to voice their opinion on three ballot questions. One of these ballot questions is Question 3, which would reduce the sales tax to 3%. Question 3 is largely a response to the increase in the sales tax from 5% to 6.25% in August 2009.

Question 3 would reduce the sales tax from its current level of 6.25% to 3%. Supporters of the measure claim that a reduction in the sales tax would generate economic activity while forcing the state to cut what they believe is wasteful spending. Meanwhile, opponents say that passage of Question 3 would devastate what they believe to be under-funded public services such as education and public safety.

The sales tax increase enacted in 2009 was part of a solution to the lower revenue collections created by the recession. The Governor and other supporters of the increase argued that spending cuts alone could not rectify the state's revenue problem. Supporters downplayed the economic effects, implying that the impetus to shop out of state, particularly in sales-tax-free New Hampshire or online, would be minimal. Addressing the regressive nature of sales taxes, they also argued that the tax increase was fair since Massachusetts continued to exempt food and most clothing purchases.

These supporters, however, offered little in the way of evidence or analysis to back up their sanguine view of how the tax increase would affect the economy. There was no effort to provide a comprehensive analysis of how a 25% increase in the sales tax would affect sales, jobs and tax revenues. It was simply taken as a given that raising the rate by 25% would raise revenues by 25%. In other words, proponents based their case on an entirely naive view that raising the tax would have no effect on economic activity. Contrary to this assertion, increasing the cost of products does decrease the demand for them, while "taxes used to fund general expenditures are associated with significant, negative effects on income growth."¹

Moreover, supporters blew past the question of whether it might be possible to balance the budget by cutting spending rather than by raising taxes. Between 1999 and 2009, state revenue (including federal transfers) has more than doubled, increasing 109% from \$19.3 billion to \$40.4 billion, far outpacing the growth in the Boston Consumer Price Index (CPI).² During the same period, personal income rose from \$219 billion to \$327 billion, a 49% increase. Had growth in state spending trended closer to the Boston CPI, the state budget would have only grown by 33%, an amount that, given the growth in personal income, would have been affordable and sustainable. However, the surge in state spending has grown faster than existing revenue sources, despite the austerity measures recently taken.³

Proponents of tax increases often overlook the beneficial side of cutting taxes. A tax cut has dynamic effects that may result in more jobs, higher payrolls and an increase in capital stock. To estimate the economic effects of tax policy changes such as increasing or decreasing the sales tax, the Beacon Hill Institute at Suffolk University (BHI) has developed a "computable general equilibrium" model. The purpose of the BHI model, called STAMP (State Tax Analysis Modeling Program), is to identify these economic effects and understand how they operate through a state's economy.⁴ Using the STAMP

¹ W. Robert Reed, "The Robust Relationship between Taxes and U.S. State Income Growth," *National Tax Journal* 61, no. 1 (March 2008).

² From Commonwealth of Massachusetts, Office of the Comptroller, *Comprehensive Annual Financial Report, "General and Budgeted Special Revenue Funds,"* http://www.mass.gov/?pageID=oscterminal&L=3&L0=Home&L1=Publications+and+Reports&L2=Financial+Reports&sid=Aosc&b=terminalcontent&f=reports_audits_rpt_caf&csid=Aosc. See also Bureau of Labor Statistics CPI Calculator at <http://www.bls.gov/data/>.

³ Bureau of Economic Analysis. State Personal Income. <http://www.bea.gov/regional/spi/default.cfm?selTable=summary>.

⁴ For a description about the model see http://www.beaconhill.org/STAMP_Web_Brochure/STAMP_EconofSTAMP.html.

model, we find that a reduction in the state sales and use tax to 3% from 6.25% would produce a more competitive business environment, resulting in a growing economy that produces higher employment.

The lower sales tax rate would require the elimination of some public sector jobs, but this would be greatly offset by the creation of new private sector jobs. Table 1 shows these results compared to a baseline assumption of no tax change. The stronger Massachusetts economy would create 27,199 more private sector jobs, while requiring the public sector to shed 9,885 jobs. Increased competitiveness and the demand for labor would result in a \$73.50 million increase in annual investment, while gross wages would increase by \$1.03 billion.

Table 1: Economic Results		
Total Employment	17,314	0.55%
Private Employment	27,199	1.00%
Public Employment	(9,885)	-2.26%
Investment (\$m)	73.50	0.18%
Gross Wages (\$b)	1.03	0.56%

Opponents of Question 3 argue that enactment of a 3% sales tax rate would require the Commonwealth to cut spending by \$2.5 billion. That estimate is defective, however, because it falsely assumes that the reduction in the sales tax would have no effect on business. No serious analyst would assume that a 52% reduction in the sales tax would not help retail business in Massachusetts, yet that is exactly what the architects of the \$2.5 billion estimate took for granted in arriving at this static estimate.

Static estimates assume that there is no change in underlying economic activity in response to a change in tax law. For example, a static estimate of a decrease in the sales tax, as here, from 6.25% to 3%, would cause revenues to decrease by 52% ($= (6.25-3.00)/6.25$). A dynamic estimate would show a smaller decrease in revenue because it would capture the positive effect on the tax base of the decrease in the sales tax. When Massachusetts decreases its sales tax, consumers buy more goods in the Commonwealth. One of the principal purposes of STAMP is to capture such dynamic effects.

The \$2.5 billion estimate ignores the fact that the reduction in the sales tax would induce Massachusetts residents to shift some of their purchases from New Hampshire back to Massachusetts. It also ignores the fact that it would induce residents of New York, Connecticut and Rhode Island to shop here rather than in their home states. The sales tax is 6% in Connecticut and Vermont, 4% in New York and 7% in Rhode Island. Thus the cut in the sales tax would be a boon to businesses not only in Lawrence and Lowell but also to businesses in Pittsfield, Springfield and Attleboro as out-of-staters find those locations to offer shopping bargains.

With the reduction to the sales tax, all taxed products in the state would have a lower price tag, leading to increased demand. This increase in sales creates a dynamic revenue loss from the sales tax of \$2.28 billion, as shown in Table 2. The reduction in the sales tax would also increase the pace of the the state economy as a whole. Total employment would increase by 17,314 workers and average wages would rise, which, in turn, would increase total payroll and profits in the state, leading to an additional \$60.49 million in income tax revenue. As investment and retail sales increase, and corporate income tax revenue swell, all state and local taxes would see the benefit. In total, state coffers would experience a decrease in revenue of \$2.084 billion, compared to a baseline projection of no tax change. Local governments would also see an rise in property tax revenues, leading to \$33.43 million in increased collections. The net effect on state and local revenues would be a decrease of only \$2,050 million.

Table 2: Fiscal Results (\$m)	
State sales tax	-2,277.37
State corporate and business taxes	39.89
State tax on motor fuel	5.68
State personal income tax	60.49
State cigarette tax	6.20
State alcohol tax	5.15
State other taxes	2.58
State fees	73.72
State Total	-2,083.67
Local sales tax	4.49
Local tax on residential property	0.06
Local tax on business property	9.39
Local other taxes	8.30
Local fees	11.19
Local Total	33.43
Net: State and Local	-2,050.24

If approved by the voters in November, the reduction to the state sales and use tax is an overall economic boost for Massachusetts. Opponents of the measure are correct: spending cuts would be needed to balance the budget. Our analysis points to a public sector job loss of 9,885 jobs. But opponents draw their conclusions out of the context of the state's spending history, overlooking the recent acceleration in spending. They also ignore the benefits of a tax cut: lower prices for consumer goods and the creation of 27,000 private sector jobs.

What about the nearly 10,000 public sector jobs that the state would have to shed? That is a matter also for voters to consider. Voters should understand, however, that there is an important difference between how reducing a tax rate stimulates private-sector economic activity and how government copes with the reduced tax revenue that necessarily ensues. The argument that the state has adequately cut the budget to meet the new fiscal reality is a myth. There are numerous ways that workers employed by the state or by state contractors could avoid losing their jobs should revenues shrink by the predicted amount. Wage cuts are one solution. Increased employee contributions to pension funds and health care benefits are another. Privatization of service delivery is yet another. And certainly it would be possible for the state to eliminate some jobs with minimal effect on services. Voters should keep these considerations in mind as well in deciding whether to support Question 3.

The Beacon Hill Institute at Suffolk University in Boston focuses on federal, state and local economic policies as they affect citizens and businesses. The Institute conducts research and educational programs to provide timely, concise and readable analyses that help voters, policymakers and opinion leaders understand today's leading public policy issues.

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