Commonwealth of Massachusetts

The Massachusetts Personal Income Tax

Special Commission on Tax Reform

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This introduction is part of an interim report of the Massachusetts Special Commission on Tax Reform to be filed with the Clerk of the House of Representatives of the General Court of the Commonwealth of Massachusetts.
Executive Summary

This thoughtful, comprehensive study is virtually a textbook on the Massachusetts personal income tax. Dr. Tresch describes and explains the current provisions of the tax, outlines its history in great detail, carefully elucidates established principles of taxation, and uses them to evaluate the tax. He gives special attention to the distribution of the income tax burden, "tax preferences", mechanisms of low income protection, and rate structure. He has produced an informative, illuminating work, useful to those interested not only in the income tax but all state and local taxes and fees levied in the Commonwealth.

Dr. Tresch's study is one of two on the Massachusetts personal income tax sponsored by the Massachusetts Special Commission on Tax Reform. The other is Dr. Andrew Reschovsky's Who Pays Massachusetts' Taxes? The Personal Income Tax. While Dr. Tresch's study is a background study covering all issues germane to the tax, Dr. Reschovsky's study focuses exclusively on the distribution of the tax. Both studies are best read together.

Dr. Tresch's major findings include the following:

The Commonwealth's personal income tax is reasonably efficient, simple, stable, and fair.

--Overall, the Commonwealth's personal income tax gets high marks. In general, it discourages neither saving nor work effort. It imposes minimal recordkeeping requirements on Massachusetts residents; once a resident must file a federal income tax return, filing a state income tax return is not much additional bother.
Its revenues are stable relative to those collected from personal income taxes imposed by other states. It does a fairly good job of protecting low-income households from taxation. In short, the Massachusetts personal income tax is reasonably efficient, simple, stable, and fair. The Commonwealth's heavy reliance on it is not necessarily bad.

The income tax is not a flexible instrument of state economic policy.

--Several uncontrollable factors limit the ability of policy-makers to use the income tax to influence the Commonwealth's economy or the distribution of tax burdens. These factors include:

(1) **Tax shifting via market reactions.** In particular, businesses may try to raise prices to gain tax benefits or avoid tax burdens. In the process, the distribution of tax burdens may change in ways unintended by policy-makers. For example, landlords may raise rents to take advantage of the increase in demand for rental units stimulated by the rent deduction.

(2) **Administrative limits on the ability of the Department of Revenue to tax the investment income of nonresidents.** Massachusetts attracts investment from all over the world. Nonresidents dominate the Commonwealth's capital markets. Yet, because nonresident owners of capital are extremely difficult to track down, their unearned income generally escapes Massachusetts taxation. Consequently, tax provisions that treat capital income preferentially, such as the 50 percent deduction of long-term capital...
gains and the interest exemption, do not benefit, and therefore cannot influence, those controlling most business investment in Massachusetts. Trying to accelerate capital formation in the Commonwealth by taxing capital income preferentially is like trying to make the Charles River flow faster by rowing upstream.

By the same reasoning, the higher 10% rate on unearned income does not stifle capital formation. Most income taxable at the 10% rate redounds to nonresidents, who in practice usually do not pay tax on their unearned income.

(3) Federal tax policy. Three features of the federal income tax significantly influence the effective burden of the Commonwealth's personal income tax, how its burden is distributed, how the benefits of its tax preferences are distributed, and the "cost-effectiveness" of these preferences, that is, how much incentive they provide per dollar of tax revenue foregone:

(a) The deductibility of state and local taxes at the federal level, sometimes referred to as the federal tax offset,
(b) Given the offset, the federal income tax's graduated rate structure, and
(c) The mix of federal income tax preferences.

The federal tax offset reduces the average effective burden of the Commonwealth's personal income tax. In combination with graduated federal rates, the federal offset:

(a) Diminishes the overall progressivity of the Commonwealth's income tax, to the point where 60% of
the Commonwealth's households with incomes in excess of $15,000 face proportional effective tax rates.

(b) **Causes the benefits of state tax preferences to be distributed less in favor of upper-income households than would otherwise be the case.**

State tax preferences are more effective if they conform to preferences already offered at the federal level because recordkeeping requirements are thereby reduced. Similarly, disallowing a federal tax preference at the state level usually complicates tax compliance and enforcement. In this manner, the menu of tax preferences offered by the federal government effectively limits the discretion of state tax policymakers.

The constraining effect of federal tax law explains why state tax policymakers are so concerned about federal tax reform. Proposals to eliminate the federal tax offset, change the federal rate structure, and eliminate many federal tax preferences have profound implications for the effects of the Commonwealth's personal income tax.

(4) **The constitutional prohibition against graduated rates.** Massachusetts' constitution requires that each class of income be taxed at a uniform rate. This requirement, in combination with the federal tax offset, severely limits the ability of the Commonwealth to achieve progressivity at the highest income levels. The 10% rate on unearned income increases effective tax rates on households with incomes in excess of $75,000, but only by a few tenths of a percentage point. Exclusions, deductions, no tax status, and the declining personal exemption create a considerable degree of progressivity over the lower half of the income scale. The Massachusetts income tax, more
so than other states' income taxes, protects low income households from taxation. Nevertheless, although evidence is limited, among the 44 state personal income taxes levied in the Nation, Massachusetts' ranks among the less progressive, especially over the upper half of the income scale.

Conflicting tax policy goals are difficult to reconcile.

--Even when not constrained by uncontrollable factors, state tax policymakers face severe tradeoffs. Particularly difficult to reconcile are the three goals of low income protection, avoidance of large revenue losses, and avoidance of severe work disincentives to some low income workers. All mechanisms of low income protection fail to resolve the inherent incompatibility of these principles, whether they be straight personal exemptions, declining personal exemptions, no tax status provisions, or refundable credits.

Some income tax provisions have no clear benefits.

--The rationales underlying some provisions of the Massachusetts personal income tax are unclear. In particular, Dr. Tresch questions the rationales of the 50% capital gains deduction and the spousal exemption.

At the federal level, the exclusion of some proportion of capital gains protects taxpayers who rely heavily for their income
on the appreciation of assets realized unevenly over time. These taxpayers are thrust into higher-than-average marginal tax rates in years when their capital gains are realized. As a result, without the capital gains exclusion, they are more likely to pay more income tax over the course of their lives than taxpayers with equal lifetime incomes earned more evenly over time. This bunching problem does not exist under a proportional rate structure, such as that used in Massachusetts.

The capital gains deduction is also justified as an incentive to capital formation. As pointed out above, it is ineffective because Massachusetts capital markets are controlled primarily by nonresidents, whose capital income is generally not taxed. Some support the capital gains deduction as a crude adjustment for the eroding effect of inflation on the value of capital assets. Such an adjustment, however, could be more accurately accomplished by other means. (For example, by adjusting the value of the base on which capital gains are computed.)

The full inclusion of capital gains in the Commonwealth's income tax base would not impose additional recordkeeping requirements on taxpayers since they must determine the full value of their gains anyway in order to calculate the value of their federal capital gains exclusion.

With respect to the spousal exemption, Dr. Tresch cites two traditional justifications: ensuring that 1) income sufficient to purchase the necessities of life for both spouses are not taxed, and 2) marriage itself does not change the combined tax liabilities of husband and wife on income above that required for subsistence. Both goals are satisfied by a spousal exemption about one quarter of the personal exemption, reflecting that a couple can subsist on a budget only about 25% larger than that required by a single individual. Massachusetts spousal exemption, however, depends on the income of the spouse with the lower earnings, in violation of both principles.