MASSACHUSETTS
BUDGET AND POLICY CENTER

September 25, 2003

MASSACHUSETTS' BUSINESS TAXES:
"HIGH AND RISING" OR COMPARATIVELY LOW AND FALLING?

A study conducted by Ernst & Young for the Associated Industries of Massachusetts (AIM) Foundation earlier this year stated that "the level of Massachusetts state and local taxes on businesses is . . . high and rising."[1] In support of this claim, the study argues that the total amount of state and local taxes paid by Massachusetts businesses has grown from $6.6 billion in FY 1992 to $10.1 billion in FY 2002, an apparent rate of growth of 4.3 percent per year.

However, a closer examination of the data presented in the Ernst & Young study shows that, after adjusting for inflation, business taxes have grown at an annual rate of just 1.7 percent since FY92. Even more importantly, since businesses' capacity to pay those taxes has grown substantially in the last decade – as reflected in the growth of personal income in Massachusetts, a statistic that AIM and others have used to approximate corporate profits – the burden that those taxes pose for businesses has fallen over the last ten years. Specifically:

- taxes paid by businesses in Massachusetts – as determined by Ernst & Young – have dropped from 4.5 percent of personal income in FY92 to 4.1 percent in FY02.

- when compared to the total taxes paid by businesses across the country – as calculated in another recent study to which several Ernst & Young employees contributed – taxes paid by businesses in Massachusetts are lower than the national average.

The Ernst & Young study also implies that efforts to curtail corporate tax avoidance or to repeal costly corporate tax breaks are misguided, as they focus solely on the corporate income tax and fail to consider the other taxes businesses may pay. Arguably though, such efforts are consistent with sound tax policy, as their aim is to ensure that the corporate income tax remains an efficient and effective means of generating revenue and that it continues to function in the manner originally envisioned by state lawmakers.

---

[1] *A Comprehensive Evaluation of Massachusetts' Business Taxes*, Ernst & Young LLP, June 20, 2003.

37 TEMPLE PLACE, 3RD FLOOR, BOSTON, MA 02111
TEL: 617.426.1228 • FAX: 617.695.1295 • www.massbudget.org

Inflation Accounts for Much of the Apparent Growth in Business Taxes

As noted above, the Ernst & Young study calculates that the total taxes paid by businesses in Massachusetts totaled $10.1 billion in FY 2002. (The study defines "business taxes" to include, among other levies, corporate income taxes, sales and excise taxes paid on business purchases, property taxes paid by businesses, and employers' shares of unemployment and workers' compensation taxes.) It also finds that this amount rose over the past decade, up from $6.6 billion in FY 1992, an apparent rate of growth of 4.3 percent per year.

Yet, the Ernst & Young study significantly overstates the true growth of business taxes in the last ten years, as it fails to account for inflation in making its calculations. As is easily observed, the prices of goods and services do not remain constant from year to year; rather, due to inflation, they tend to rise over time. As a result, one dollar can not purchase the same amount of goods and services today as it did ten years ago. To understand the real value of that dollar over time, inflation must be taken into account.

Thus, as Figure 1 indicates, in real, inflation-adjusted terms, business taxes did not climb $3.5 billion between FY 1992 and 2002. They rose by less than half that amount, or by $1.6 billion. Moreover, in real terms, such taxes did not grow by 4.3 percent per year, but by a much more modest 1.7 percent annual rate, well below the real rate of growth for personal income over the same period.

Figure 1.

Massachusetts Business Taxes
(all figures are in millions of dollars; all years are fiscal years)

	Total Business Taxes (nominal dollars)	Total Business Taxes (constant FY02 dollars)
1992	6,614	8,527
1993	7,369	9,120
1994	7,872	9,463
1995	8,423	9,979
1996	8,622	9,944
1997	8,922	10,005
1998	9,365	10,317
1999	9,519	10,309
2000	9,898	10,418
2001	10,918	11,111
2002	10,086	10,086
Increase, FY92 to FY02	3,472	1,559
Average annual growth rate	4.3%	1.7%

Massachusetts' Business Tax "Burden" Has Fallen in Recent Years

The Ernst & Young study, on several occasions, refers to the level and the share of taxes paid by Massachusetts businesses as the state's business tax "burden," ultimately concluding that the "combined Massachusetts state and local tax burden is significant." Similarly, in its *Legislative Bulletin* of June 25, Associated Industries of Massachusetts (AIM) maintains that the "Ernst & Young study found . . . that the business community's tax burden has been rising even as the recession has devastated company earnings and reduced the value of commercial and industrial property."

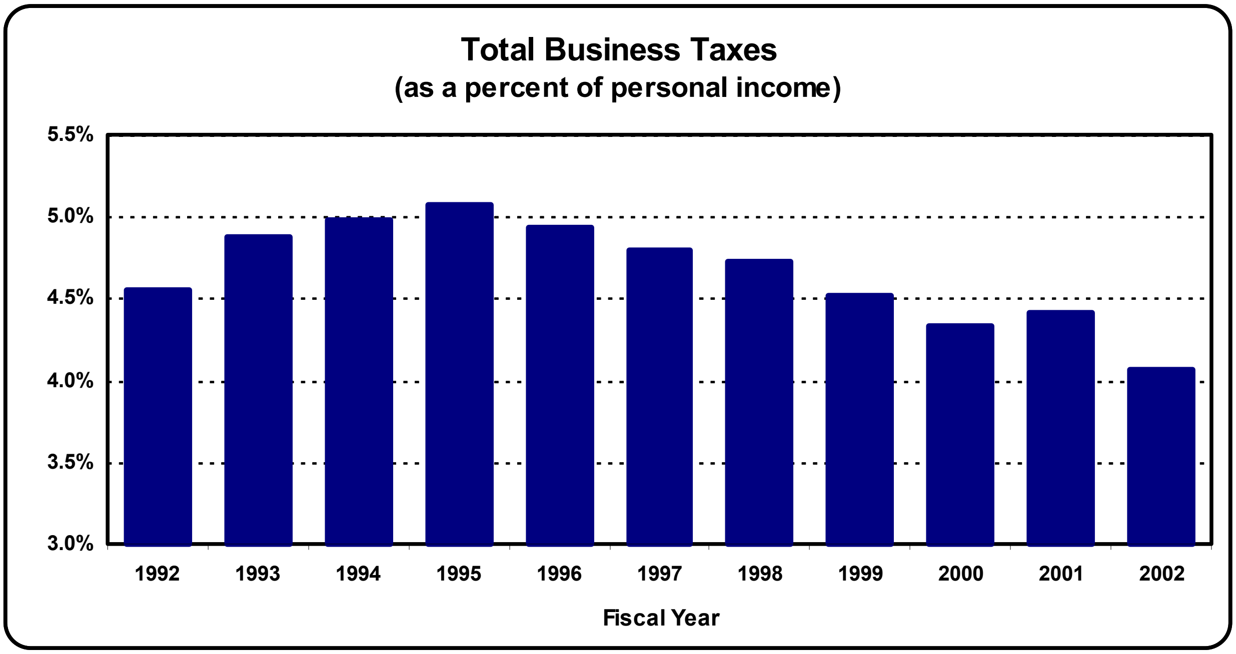
Of course, while business taxes in Massachusetts may have grown modestly in real dollar terms since FY 1992, it does not necessarily follow that the Commonwealth's business tax "burden" is "significant" or "rising." A burden, generally speaking, is a relative concept. For instance, an object that may be difficult for one person to carry may be quite easy for someone else to handle. Simply stating the weight of the object is not enough to classify it as a burden; the physical capacity of the person bearing it must also be considered. Similarly, arguing that a given dollar amount in taxes poses a burden carries little meaning if the capacity of the person or the entity in question to pay such taxes is ignored.

In the case of business taxation, the capacity to bear a tax burden is best reflected in profitability – a certain level of taxation for a highly profitable company or industry is less burdensome than the same level of taxation imposed on a struggling company or industry. Unfortunately, though, it is fairly difficult to measure profitability at the state level; many studies on this topic use personal income – a measure of all of the income received by the residents of a state – as a proxy. For instance, a recent report released by the Massachusetts Taxpayers Foundation, AIM, and the Boston Chamber of Commerce acknowledges the scarcity of reliable state-level data on corporate profits and instead compares corporate income taxes to personal income.[2]

When the data on taxes paid by Massachusetts businesses presented in the Ernst & Young study is measured as a share of personal income, it becomes clear that the business tax burden in the Commonwealth is not, in fact, rising. As Figure 2 indicates, it has fallen since FY 1992. In FY92, business taxes amounted to 4.5 percent of personal income. By FY02, they had dropped to 4.1 percent, significantly below their FY95 peak of 5.1 percent. (Please refer to the Appendix for year-by-year estimates of Massachusetts business taxes as a share of personal income.)

[2] *Fragile Progress: Reining in Massachusetts' High Business Costs*, Massachusetts Taxpayers Foundation, February 2003, p. 27.

Figure 2.



Sources: Ernst & Young; U.S. Commerce Department, Bureau of Economic Analysis

Massachusetts' Taxes are Comparatively Low

The Ernst & Young study also recommends that "from an economic development perspective, Massachusetts policymakers should carefully evaluate the competitiveness of the state and local business tax structure, including all of the business taxes identified in [its] study." Yet, previous research in which Ernst & Young played a major role suggests the share of all taxes paid by businesses in Massachusetts is likely lower than the share of state and local taxes paid by businesses nationally.

In September of this year, the Council on State Taxation (COST) – a non-profit trade association of multi-state corporations – released a report entitled *Total State and Local Business Taxes: Fiscal Year 2003 Update*.[3] Its report – three of the four authors of which are from Ernst & Young – found that, in Fiscal Year 2002, businesses paid 42.0 percent of all state and local taxes nationwide. In contrast, the study that Ernst & Young conducted for the AIM Foundation determined that Massachusetts' businesses paid 40 percent of state and local taxes in FY02. In other words, to the extent that these reports are comparable – and it appears that the methodology used in the two studies is

[3] Cline, Robert; Fox, William; Neubig, Thomas; and Phillips, Andrew, *Total State and Local Business Taxes: Fiscal Year 2003 Update.,* Ernst & Young LLP, September, 2003.

fairly similar – Massachusetts' businesses pay a smaller share of state and local taxes than their counterparts in the rest of the country do. As a result, efforts to protect the corporate income tax base in Massachusetts from further erosion, discussed in more detail below, likely would not cause tax burdens to rise above national levels.

Data from the U.S. Census Bureau on total state and local tax collections further demonstrate that the aggregate tax burden in Massachusetts is below the burden in many other states and the nation as a whole. In FY 2000, the most recent year for which such data are available, total state and local taxes in Massachusetts equaled 10.5 percent of personal income, making Massachusetts 30th out of the 50 states and leaving the Commonwealth under the overall national level of 10.8 percent. Expanding the analysis to include fees and other sources of revenue only widens the gap between Massachusetts and the rest of the country. For FY 2000, total "own-source" revenue in the Commonwealth – that is, all of the taxes, fees, and other charges collected by the state, cities, and towns – amounted to 13.9 percent of personal income, earning Massachusetts a ranking of 44th out of the 50 states.[4] While these measures include the taxes – and fees – paid by private citizens as well as by businesses, it would still be difficult to conclude that the overall tax structure in Massachusetts diminishes its ability to compete economically with other states.

Focusing on the Corporate Income Tax is Appropriate

Finally, the Ernst & Young study contends that "the corporate income tax cannot be evaluated independently of the other state and local taxes imposed on businesses." While it is important to look at the overall context when examining an individual tax, it is just as vital to look at individual taxes in detail and to ask such questions as: are they producing expected levels of revenue; are they fair; are they distorting behavior in any way?

Indeed, many of the major corporate income tax reform proposals now being discussed seek to achieve one of two goals: first, to protect the Commonwealth's corporate income tax base from further erosion (most notably, by adopting combined reporting in order to prevent corporations from shifting profits out of Massachusetts) and, second, to repeal tax breaks, such as single sales apportionment formulae for manufacturers and mutual fund companies, that were intended to foster employment in certain sectors but that have not produced measurable results. In short, the aim of such proposals is to ensure that the corporate income tax continues to operate in an effective and efficient fashion and that it adheres to some of the most basic principles of tax policy – namely, that tax bases should be as broad as possible, that tax policies should not favor one individual, company, or industry over another, and that the tax system as a whole should be easy to administer and readily enforceable.

[4] McLynch, Jeff and St. George, James R., *Measuring Up: Taxes and Spending in Massachusetts, FY 2000*, Massachusetts Budget and Policy Center, January 2003.

Furthermore, altering some of the taxes included in Ernst & Young's assessment of total taxes is either beyond the jurisdiction of the Legislature or would require fairly comprehensive changes in other program areas. For instance, property taxes – Proposition 2 ½ notwithstanding – are still most directly set by cities and towns, while the revenue that such levies generate is used for local purposes. In addition, the funds yielded by workers' compensation and unemployment insurance taxes either pay for current benefits or are set aside for future payments; altering those taxes would require direct reductions in the benefits available through those programs, either immediately or over the long-run.

Conclusion

The perspective offered by Ernst & Young's study on the taxes paid by Massachusetts businesses is a valuable one, suggesting that changes to the Commonwealth's corporate income tax ought to be considered in a larger context. More specifically, the study hints at two factors that should be weighed: the competitiveness of the state's business tax structure and the burden that it imposes on companies operating here. In the end, a closer reading of the data presented in the study indicates that the business tax burden in Massachusetts is low relative to the rest of the country and, when measured as a share of personal income, has fallen by 10 percent over the course of the past decade.

APPENDIX

Massachusetts Business Taxes

(all figures in millions of nominal dollars; all years are fiscal years)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
State and local taxes on businesses	6,614	7,369	7,872	8,423	8,622	8,922	9,365	9,519	9,898	10,918	10,086
MA personal income	145,388	151,166	158,079	166,194	174,696	186,088	198,000	210,701	228,810	247,666	248,453
Business taxes as a share of personal income	*4.5%*	*4.9%*	*5.0%*	*5.1%*	*4.9%*	*4.8%*	*4.7%*	*4.5%*	*4.3%*	*4.4%*	*4.1%*

The data in the above table form the basis for Figure 2 in the text of this report. The data on state and local taxes on Massachusetts businesses were taken directly from the Ernst & Young study, while data on Massachusetts personal income were obtained from the U.S. Department of Commerce, Bureau of Economic Analysis.