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Capital Gains: Avoiding Harm to the State Budget

BY CAMERON HUFF

GOVERNOR DEVAL PATRICK RECENTLY took dramatic action to repair a $1.4 billion deficit in the state budget, a hole that is roughly the size of the state's annual spending on higher education. The plan to fill the gap includes $1 billion in spending cuts and the layoff of 1,000 employees.[1]

The need to act has been driven by a sharp drop in expected tax revenues. Although the ongoing worldwide turmoil in financial markets is unprecedented, the resulting decline in capital gains revenues in response to economic events is all too familiar. So too is the harm to the state budget that ensues.

While every state is scrambling to respond to the budgetary impacts of the economic downturn, Massachusetts has been especially affected. This is due in part to the high concentration of financial services in the state, which, like capital gains, flourish or falter in response to the stock market.

It is also due to our heavy reliance on the income tax to fund the budget, rather than the broad and varied mix of revenue sources recommended by fiscal experts. While our next-largest source of tax receipts, the sales tax, is more stable than the income tax, its ability to act as a counterweight to the swings in the income tax is weakened because of its relatively narrow base.

Despite the known volatility of capital gains, the Commonwealth's dependence on them has grown markedly since the beginning of the decade. At the same time, however, our preparedness for managing that volatility has declined. In 1999, Massachusetts was already one of the states most dependent on capital gains revenues, ranking 7th in the nation in the relative importance of capital gains for its state budget. By 2006, the importance of capital gains had grown. Massachusetts is now third most at risk among the 50 states if capital gains income declines.

The state has been increasingly relying on capital gains income to fund ongoing spending, including new expenditures that have added considerably to the budget. From 2002 to 2006, capital gains were responsible for $1.2 billion or 54% of the state's tax growth revenues.[2] This year, roughly $1.5 billion of the budget was funded with expected capital gains receipts, much of which are now in jeopardy.

Just six years ago, inflation-adjusted capital gains revenues plummeted by more than $1 billion, helping to drag the state into a severe budgetary crisis. This was not the first time such a huge drop had occurred. In the early 1990s, capital gains receipts collapsed by almost $900 million, again with dire consequences to the budget.

Learning from that earlier fiscal crisis, state leaders had by the end of the 1990s built up a sizeable budget stabilization or "rainy day" fund that proved critical in blunting the impact of large revenue shortfalls in 2002-2003. Unfortunately, the state has come up short in rebuilding the fund in the ensuing years, even as it has

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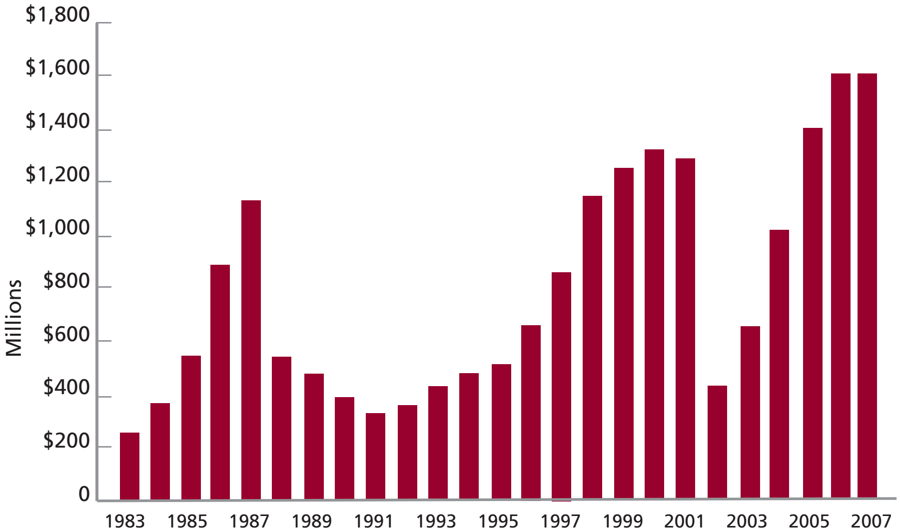
Figure 1

Capital Gains Tax Revenues, Millions of Fiscal Year 2007 Dollars



*Massachusetts Department of Revenue, December 2007, actual receipts 1982-2006, estimated 2007.

KEY FINDINGS

- In recent years, Massachusetts has become increasingly reliant on capital gains. In 2006, Massachusetts ranked 3rd in the nation in the relative importance of capital gains, up from 7th place in 1999. The overall importance of capital gains in Massachusetts is 47 percent greater than the national average.

- From 2002 to 2006, capital gains tax revenues accounted for 54 percent of the state's growth in tax revenues. The state relies on capital gains receipts to fund ongoing programs including new expenditures. This year's budget relied on capital gains to fund approximately $1.5 billion of state programs.

- At the same time the state has become more dependent on capital gains tax revenues, the state's rainy day reserve is almost $400 million lower today than it was in 2002, after adjusting for inflation. The reserve's share of the budget has declined from about 10 percent to 6 percent.

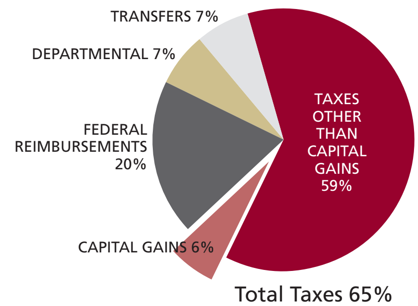
- Capital gains — and capital gains taxes — are volatile and tied to a large degree to the boom and bust cycles of the stock market. In addition, unlike other major sources of income, capital gains are by their nature a series of one-time events.

- The vast majority of capital gains taxes are paid by a very small percentage of taxpayers. In 2006, 9,521 Massachusetts taxpayers — less than 0.4 percent of the state's 2.7 million filers — paid nearly two-thirds of all capital gains taxes. These taxpayers all had incomes of $1 million or more. The Commonwealth's state budget depends on the choices of a handful of taxpayers about when and how they will realize their gains.

- Capital gains have a ripple effect on a state's economy, especially in Massachusetts because of the high concentration of financial services. The success of these companies is linked to the same activities that generate capital gains. For instance, in 2002, the decline in bonuses led to a drop of $300 million in income taxes, which came on top of the $1 billion drop in capital gains revenues.

Figure 2

Fiscal 2007 Total Revenues



Note: Based on Commonwealth Fiscal 2007 Statutory Financial Report, adjusted to include sales tax revenue dedicated to the MBTA and school construction and certain off-budget revenues for health care.

increased its reliance on uncertain capital gains.

The balance in the fund is almost $400 million lower today than it was at the beginning of 2002 after adjusting for inflation (see Figure 11). Its share of the budget has shrunk from roughly 10 percent at the fund's peak in 2006 to only 6 percent for 2009. If the fund's balance were used to replace 100% of the potential loss in capital gains receipts, most of it would be drained this year, with no end to the current crisis in sight.

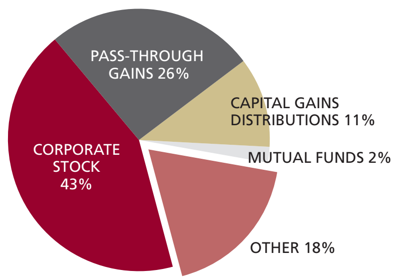
Much of the harm from the current decline in capital gains might have been avoided. It is almost certainly too late to protect the budget from that harm. This reality only underscores the need for serious action to fend off future damage to programs and services from difficult-to-predict capital gains.

What are capital gains?

Capital gains are the profits individuals make on the sale of the capital assets they hold. Their investments in stocks, bonds, real estate, their motor vehicles, in fact, almost everything they own, are

Figure 3

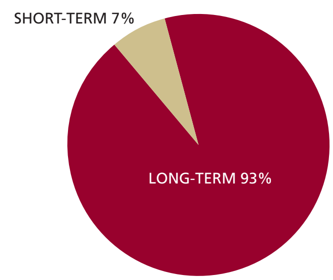
Net Capital Gains Realizations, US Total 1999



Note: "Pass-through" gains are primarily from the investment activities of limited liability companies and partnerships; capital gains distributions are periodic payments from mutual funds to their investors.

Figure 4

2005 Taxable Capital Gains



Source: Massachusetts Department of Revenue

assets that can produce a capital gain if the selling price is greater than what was originally paid. While the sale of their principal home is the largest source of capital gains for most people, the majority will pay little or no tax on those gains. The law excludes up to $250,000 of the profits from the sale ($500,000 for joint filers) if they are used to purchase another primary residence.

In 2007, capital gains revenues accounted for 11 percent of taxpayer income in the Commonwealth. Prior to the recent downturn in gains, they accounted for the majority of the state's tax revenue growth.

Like other forms of income, capital gains of Massachusetts residents are taxable by both the federal and state governments. The Massachusetts tax rate on long-term capital gains is 5.3%, the same as the tax rate on wages and salaries.[3] The tax rate on short-term gains is 12%.

Capital gains—and capital gains taxes—are both volatile and hard to predict. Unlike other major sources of income, such as wages, salaries, interest, and dividends, they are by their nature a series of one-time events tied to a large degree to the boom and bust cycle of the stock market.

Almost all gains come from financial investments. In 1999, roughly four out of five dollars of gains in the country were from investment activity—corporate stock, capital gains distributions of mutual funds, and "pass-through" gains of partnerships and limited liability companies.

Taxpayers choose how long they hold their capital assets—whether stocks, rental properties, or collectibles—and in many cases when they will "realize" their gains by selling the assets.

Those choices affect how much tax they will pay. If the asset is sold more than a year after it was purchased, the gain is considered long-term and taxed at a lower rate; if the asset was held a year or less, the gain is considered short-term and taxed at a higher rate.

The majority of gains are long-term. For example, in 2005 more than 90 percent of the capital gains reported by Massachusetts residents were long-term, with most of those gains on assets that had been held for six years or more.

Some taxpayers can choose between capital gains and ordinary income by receiving compensation from their employers in the form of stock options or other ownership interests, rather than a regular salary. At the federal level, capital gains get favorable tax treatment, with a top tax rate of 15 percent, compared to 35 percent for ordinary income. Although the number of individuals with this kind of flexibility is very small, the amount of compensation—and the impact on state tax revenues—can be large.

Changes in law, especially federal law, can also have a big impact on capital gains. The huge spike in capital gains in 1986—as seen in Figure 1—was almost

RECOMMENDATIONS

- ✔ Strictly limit the budget's annual reliance on capital gains revenue
- ✔ Establish a new capital gains reserve account to even out the flow of capital gains revenues to the budget
- ✔ If there are excess revenues above the reserve account's ceiling, first use them to help build up the stabilization (rainy day) fund
- ✔ After both the reserve account and the rainy day fund are filled, dedicate any additional excess capital gains receipts to one-time purposes directed to the state's long-term priorities
- ✔ Improve the quality of capital gains tracking and forecasting
- ✔ Consider broadening the state's tax base

Figure 5

How Capital Gains are Taxed in Massachusetts

- Individuals, sole proprietorships and partnerships are subject to capital gains taxes.
- The tax is imposed on the taxpayer's net gains, i.e., gains minus losses.
- The current tax rate on long-term gains is 5.3 percent. From 1996 through 2001, the rate varied from 5 percent to zero, based on how many years an asset had been held.
- The tax rate on short-term gains is 12 percent.
- Those rates are applied to the amount of gains reported to the IRS, as adjusted for Massachusetts law.
- Taxpayers can exclude up to $250,000 – $500,000 for joint filers — of their gains from the sale of their home.

Note: The 12 percent rate also applies to gains from the sale of collectibles, whether short- or long-term. The exclusion for gains from the sale of personal residences must meet conditions of federal tax laws.

entirely a response to such a change, as investors rushed to take their gains before an increase in the federal tax rate became effective in 1987.

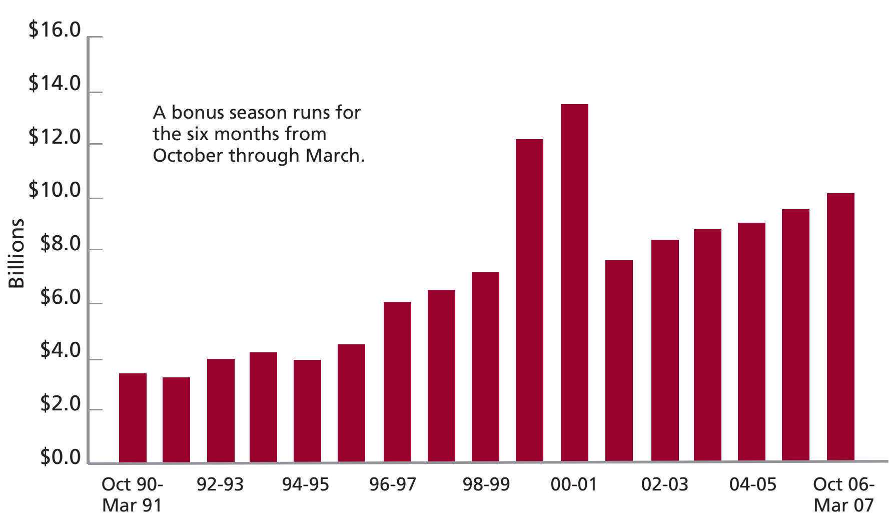
In addition, capital gains have a ripple effect on the state's economy and revenues that goes beyond the amount of gains reported on annual income tax returns — an effect that is especially important in Massachusetts because of the high concentration of financial services. (In 2007, financial services as a share of private employment in the state was more than double that of the nation.)

The success of these financial services companies is linked to the same activities that generate capital gains. If stock market profits are up, these companies do well, and their employees — especially top investment managers — benefit. Conversely, if profits are down, the employers do less well, their employees earn smaller bonuses, and the state collects less revenues.

The amount of tax dollars at stake — and at risk in the event of a falling stock market — is large. According to Alan Clayton-Matthews of the University of Massachusetts Boston, estimated earnings from bonuses totaled $10.2 billion in 2007 — translating into more than $500 million of state income taxes. In 2002, the drop in bonuses from the 2001 record high reduced incomes by almost $6 billion — and reduced state income taxes by $300 million, a decline that came on top of the $1 billion drop in capital gains revenues.

Figure 6

Massachusetts Estimated Bonus Payments By Bonus Season



Source: Alan Clayton-Matthews, Associate Professor, McCormack Graduate School of Policy Studies, University of Massachusetts Boston.

The State's Reliance on Capital Gains

Massachusetts now ranks 3rd in the nation in the relative importance of capital gains. This is a big jump from 1999, when the state ranked 7th.[4] Over the last seven years, the state's dependence on this volatile and too often unpredictable revenue source has grown considerably.

These rankings are based on an index of the relative importance of capital gains.[5] The index was developed at the Fiscal Studies Program of the Nelson A. Rockefeller Institute of Government of the State University of New York. We used the Institute's methodology to update the index for 2006; the results for all 50 states are shown in Figure 8. An index number that is greater than 100 means that the state's share is greater than the U.S. average. An index less than 100 means that the state's share is less than the U.S. average.

The index is based on two factors.

The first factor is the percentage share of the state's total income that comes from capital gains realizations (not the taxes paid but the actual capital gains).[6] The second is the percentage share of the state's total revenues that comes from income taxes, including capital gains.

Combining these two indices gives a third index indicating the overall relative importance of capital gains in the state and which states are most at risk if capital gains tax revenues decline. That composite index is calculated by adding together a state's percentage shares of capital gains and income tax revenues, and then dividing the result by the sum of the two percentage shares for the U.S. as a whole.

Looking at Figure 8, the first factor (shown in column 4) is based on the total capital gains realizations reported on federal income tax returns for each state, expressed as a percentage share of the total income reported on those returns. The capital gains realizations in several states have been adjusted to take into account exclusions of some capital gains from income. (For example, South Carolina excludes 44% of capital gains held for two or more years.) The percentage share is turned into an index that compares the capital gains share in the state to the average share for all states.

The second factor, in column 5, is based on total income tax collections in each state, calculated as a share of the state's total general revenue, again indexed to the national average.[7] This factor measures the importance of the income tax to the state's finances.

The sixth column combines the first two, yielding an index of the overall importance of capital gains in each state, relative to the country as a whole.

Column 7 shows each state's ranking for the 1999 index of relative importance of capital gains, for comparison with the ranking for 2006 shown in the first column.

Taking a closer look at the figures for Massachusetts reveals the large proportion of the state's income that comes from capital gains—the 2006 index of 118 in column 4 means the share of income was 18 percent above the national average, 5th highest among the 41 states that tax capital gains (8th highest among all 50 states). The Commonwealth's heavy reliance on income taxes to fund programs and services shows up in column 5, with a third-ranked index of 162.

Combining the two measures yields the composite score of 147 in column 6. In other words, the overall importance of capital gains in Massachusetts is almost 50 percent above average, resulting in a ranking of 3rd place. This was substantially higher than our 7th place ranking in 1999, itself an indication of heavy reliance on capital gains.

The jump from 7th to 3rd place over the last 7 years is largely a result of change in how Massachusetts taxes capital gains. In 1999, long-term capital gains were taxed on a sliding scale of tax rates that on average were substantially lower than the current rate. In the original analysis published by the Rockefeller Institute, the lower rates were taken into account by excluding a portion of capital gains from the calculation of gains as a share of income. The result was an index of 77 (that is, 23 percent below the average for all states), compared to 118 in 2006.

Nine states do not tax capital gains. Seven of those nine have no income tax. Two states—New Hampshire and Ten-

Figure 7

The Index of Relative Importance of Capital Gains

The index of relative importance of capital gains was developed at the Fiscal Studies Program of the Nelson A. Rockefeller Institute of Government of the State University of New York. The rankings for 1999 shown in Figure 9 are drawn from the Institute's original study in June 2000. Using the same methodology, we have updated to the index to 2006.

Ideally, we would want to know what share of the budget—or what share of the growth in the budget—is supported by capital gains taxes in every state. However, there is no centralized source that reports how much capital gains taxes each state collects. And since most states that tax capital gains have graduated income taxes, it is not possible to use tax rates to get good estimates of their capital gains receipts.

The index we are using here does not make that direct comparison, but it does suggest which states are most at risk from declining capital gains. It does not—as no simple index can—take into account all the ways in which the stock market or capital gains can affect the income tax, such as the impact on bonuses in the financial services industry.

Nor does it capture the impact of capital gains on other tax sources. For example, while Florida has no income tax, a drop in capital gains income for the many retirees living in that state would no doubt have a negative effect on Florida's sales tax, which accounts for almost two-thirds of its tax revenue.

Figure 8

Relative Importance of Capital Gains in 2006

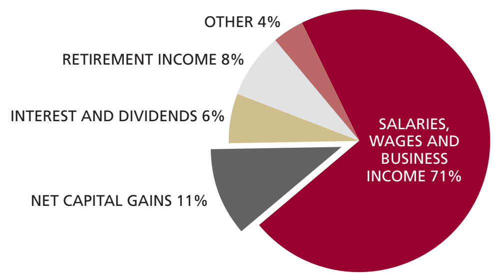
RANK IN 2006	STATE	2006 TOP TAX RATE ON CAPITAL GAINS	ADJUSTED INDEX OF CAPITAL GAINS AS % OF AGI	INDEX OF INCOME TAX AS % OF GENERAL REVENUE	INDEX OF CAPITAL GAINS IMPORTANCE	RANK IN 1999
1	Oregon	9.0	98.2	185.0	155.6	2
2	Connecticut	5	122.1	167.3	152.0	4
3	**Massachusetts**	**5.3**	**118.0**	**161.7**	**146.9**	**7**
4	California	10.3	114.2	153.1	139.9	5
5	New York	6.85	127.1	140.5	136.0	3
6	Colorado	4.63	123.9	137.2	132.7	1
7	Virginia	5.75	85.3	156.7	132.5	8
8	Georgia	6	90.7	140.0	123.3	13
9	Idaho	7.8	129.6	115.2	120.1	9
10	North Carolina	8.25	79.0	137.2	117.4	12
11	Minnesota	7.85	73.7	139.6	117.3	6
12	Maryland	4.75	78.5	131.9	113.8	10
13	New Jersey	8.97	75.8	127.5	109.9	23
14	Utah	6.475	97.5	108.8	105.0	14
15	Hawaii	7.25	103.7	102.2	102.7	32
16	Kansas	6.45	68.5	118.2	101.3	17
	United States	**15**	**100.0**	**100.0**	**100.0**	
17	Illinois	3	99.8	98.7	99.1	11
18	Nebraska	6.84	78.9	108.2	98.3	15
19	Missouri	6	67.4	113.1	97.6	19
20	Montana	6.9	116.7	87.8	97.6	25
21	Wisconsin	2.7	34.1	129.5	97.1	34
22	Maine	8.5	84.3	101.8	95.9	16
23	Oklahoma	6.25	87.3	95.5	92.7	29
24	Delaware	5.95	82.1	96.4	91.5	20
25	Ohio	7.185	58.3	108.4	91.4	27
26	Arizona	5.04	112.8	79.2	90.6	26
27	Rhode Island	5	83.5	92.7	89.6	21
28	Iowa	7.633	59.7	101.2	87.2	24
29	Pennsylvania	3.07	76.9	91.7	86.7	28
30	Alabama	4.25	76.6	76.8	76.7	33
31	Kentucky	6	63.5	82.0	75.7	31
32	Indiana	3.4	60.2	83.4	75.5	22
33	South Carolina	3.92	58.8	79.1	69.8	37
34	Arkansas	4.9	43.9	82.8	69.6	38
35	Michigan	3.9	55.5	76.3	69.2	30
36	Louisiana	5.1	78.5	61.5	67.2	35
37	Vermont	5.7	64.5	68.5	67.1	18
38	West Virginia	6.5	40.6	71.2	60.8	40
39	Mississippi	0	64.9	48.4	54.0	39
40	New Mexico	3.48	54.4	52.3	53.0	36
41	North Dakota	5.54	70.5	42.3	51.9	41
	New Hampshire	0	99.2	8.8	-	
	Tennessee	0	85.8	4.6	-	
	Alaska	0	61.9	-	-	
	Florida	0	161.7	-	-	
	Nevada	0	168.7	-	-	
	South Dakota	0	110.3	-	-	
	Texas	0	100.1	-	-	
	Washington	0	115.0	-	-	
	Wyoming	0	190.9	-	-	

Since taxpayers in every state have capital gains income, the index of capital gains as a percent of adjusted gross income can be calculated for all states. These gains have been adjusted to reflect the portion of capital gains, if any, that are excluded in a state. In the original study, an estimated exclusion of 39% was used for 1999 to take into account Massachusetts' graduated tax rate structure for long term capital gains. Although the tax rate for short-term gains is 12% in Massachusetts, we show the long-term rate 5.3% since almost all gains taxed in Massachusetts are long-term. New Hampshire and Tennessee have a limited income tax on dividends and interest, allowing an index of income tax as a percent of general revenue to be calculated for the two states. Since Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming have no state income tax, no calculation of the income tax as a percent of income or the overall index was possible.

nessee—have a limited income tax that does not tax capital gains. However, even these states that do not have capital gains taxes—and for which no index is calculated—will likely be affected by their declines because of the ripple effect throughout the economy.

Figure 9

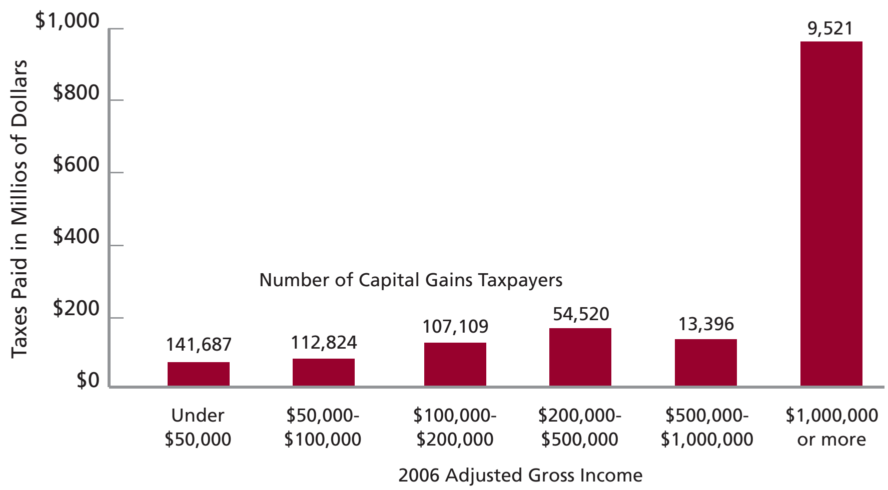
Capital Gains and Other Components of Taxpayer Income



Source: IRS, Individual Income and Tax Data, by State and Size of Adjusted Gross Income, Tax Year 2006, Table 2, Massachusetts.

Figure 10

2006 Massachusetts Capital Gains Taxes by Income Bracket with Number of Taxpayers in Each Bracket



Source: Mass. Department of Revenue, unpublished tax year 2006 data.

Who Pays Capital Gains Taxes?

Capital gains account for 11 percent of taxpayer income in Massachusetts, support approximately $1.5 billion of state spending, and generated more than half of the growth in tax revenues from 2002 to 2006.

Given the prominence of revenues from capital gains in the state's finances, it may be surprising that the vast majority of these taxes are paid by a small percentage of taxpayers at the high end of the income scale.

According to the state Department of Revenue, 9,521 taxpayers with incomes of $1 million or more—less than 0.4 percent of the state's 2.7 million filers—paid for 63% of 2006 capital gains taxes. From a fiscal perspective, the most striking aspect of these figures is that the Commonwealth's capital gains revenues depend largely on the choices of a handful of state taxpayers who choose when and how they will realize their gains.

Minimizing the Effects of Capital Gains Volatility on the Budget

In a March 2008 Policy Brief, "A Point of Reckoning: Two Decades of State Budget Trends," MassINC identified volatile capital gains as one of the greatest threats to the state's budgetary stability. For the short term, taking more hard steps of the kind that have already been approved—and taking greater advantage of what remains in the stabilization fund—may be the only realistic ways of dealing with the growing budget gap. At the same time, the crisis offers the best possible opportunity to lay the groundwork for avoiding a future capital gains "crunch"—to consider new approaches and to lay good ideas back on the table.

Strictly limit the budget's annual reliance on capital gains revenue

Ultimately every year, there is a choice about how much money is to be spent, and one way to deal with declining capital gains is to cut spending. There are choices as well about taxes—for example, new exemptions, "loophole" closing, or rate reductions—that affect the steadiness of the state's revenues.

Regardless of these decisions, the risk from capital gains will remain largely unchanged unless the state significantly reduces the amount of on-going spending that is supported by those gains, or takes steps to increase the overall stability of its revenue system.

Figure 11

Budget Stabilization Fund

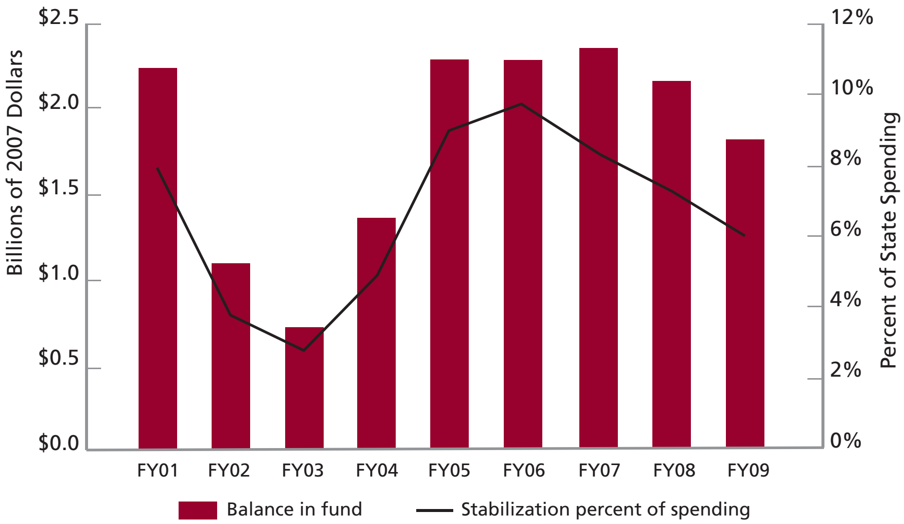


Figure 12

Administrative Factors Add to Uncertainty about Capital Gains

While volatility is inherent in capital gains, lack of information is another source of uncertainty in forecasting capital gains. One basic problem is the mismatch between the timing of realizations by investors and the state's fiscal year. As December approaches, investors with an eye on the end of the tax year make decisions — such as selling an asset at a loss — that will affect how much they owe on April 15. Then starting in January, the Commonwealth's tax forecasters develop their estimates of expected capital gains receipts for the upcoming new fiscal year that begins on June 1. Their estimates — which will be used in planning the budget for the new fiscal year — must be made before there is any solid information on how much capital gains were earned in the previous 12 months. A variety of other administrative factors lead to poor information during the course of the year:

- Taxes on capital gains — unlike those on wages and salaries — are not withheld and paid to the state at the time that the income is realized.
- The estimated taxes on capital gains that must be paid quarterly are often based not on actual capital gains to date, but instead on the taxpayer's initial projection of gains for the year.
- The last estimated tax payment falls on January 15, after the end of the year, before most taxpayers know what their final gains are.
- On the April 15 tax deadline, most taxpayers report capital gains for the previous year on their income tax returns, but it usually takes many months to process those returns.
- Taxpayers who request an extension on filing their returns must pay the tax they expect to owe for the year by April 15, but do not have to report the portion that is due to capital gains until they file their returns six months later.

Many financial officials would argue that capital gains should be considered as one-time revenues to be used only for one-time expenses. Although this would be the most fiscally conservative approach, it fails to recognize that capital gains do recur over time, albeit with great variation from year to year.

The most straightforward way of reducing the risk to the budget from that volatility would be to set a specific dollar cap on how much spending from capital gains revenue could be built into each year's budget. Such a cap might be based on historical collections performance over, say, seven years, adjusted for inflation and any changes in tax rates.

It will be critical to put the proposed cap on annual spending from capital gains in place now—in the bad times —so that the growth in capital gains when the good times return will not again be misdirected to pay for ongoing programs.

Establish a new capital gains reserve account to even out the flow of capital gains revenues to the budget

When capital gains receipts go above the annual spending cap, the excess would accumulate in the new account. When capital gains fall below the cap, the account would be drawn upon to fill the gap between the cap and actual receipts.

Both deposits of excess capital gains revenue to the new reserve account, and withdrawals from the account to fill a shortfall in capital gains revenues, would occur automatically.

MassINC recommends that a ceiling at least equal to the annual spending cap —and preferably as much as double the cap—be established for the new account. Experience has proven that virtually all of the annual revenue from capital gains can disappear over the course of a few months. Given such extreme variability, setting a ceiling of less than the annual cap would almost certainly expose the budget to revenue shortfalls that could only be offset by spending cuts.

If there are excess revenues above the ceiling, use them first to help build up the existing stabilization (rainy day) fund

After the reserve account is filled, the next priority for using excess revenues should be to help bolster the rainy day fund.

The $1 billion dollars of emergency spending cuts that are now underway are ample evidence that the state has insufficient rainy day savings. Depending on how long and how deep the current fiscal crisis lasts, the state may soon exhaust what savings it has.

When revenue growth returns to the state, it will be critical to deposit any excess capital gains revenues into the rainy day fund (in addition to any budgetary surpluses), and to continue making those deposits until the fund is filled to its statutory maximum.

The current ceiling for the rainy day fund is 15 percent of state revenues, at the top end of the 5-15% minimum recommended by the Government Finance Officers Association (GFOA). The GFOA cautions that this range is a minimum—some governments will need higher balances because of the volatility of their revenues and other factors.

Figure 13

Strengthening the State's Existing Stabilization Fund

Although annual excess capital gains receipts could be put into the state's existing stabilization (rainy day) fund—rather than into the proposed new reserve account—that would be a bad idea, largely because the fund has been abused in the budget process for the last several years. Despite solid growth in revenues until very recently, it has become routine for budget plans—including this year's—to rely on the stabilization fund to finance spending in excess of expected revenues, on the gamble that collections will exceed forecast. That reckless practice, like chickens, has now come home to roost.

Despite having in 2001 what was seen as a sizable rainy day fund, severe spending cuts were required to balance the budget in 2002-2003. That experience should have led to a redoubled effort to build up an even larger balance in the fund. Instead, as this fiscal year began the balance in the fund was less than it was in 2002, after adjusting for inflation, and as a percent of the budget had declined from more than 10 percent to less than 6 percent (Figure 11), even as dependence on capital gains has grown.

The law governing the existing stabilization fund is so loose as to permit withdrawals for essentially any purpose. Simply having a clearer and more precise definition of what is a legitimate use of rainy day funds would go a long way toward preserving the fund for times of serious revenue shortfalls. In the final analysis, however, the fate of the fund will depend upon state leaders' shared commitment to use it responsibly. The best way of achieving this would be passing a law that would tighten the use of the fund and holding legislative leaders and the executive branch accountable for adhering to the law.

The amount of money in the state's rainy day reserve has declined.

After both the reserve account and the rainy day fund are filled, dedicate any additional excess capital gains to one-time purposes directed to the state's long-term priorities

Ideally, those uses would be limited to a short list of priorities that have been identified as elements of a long-term plan to improve the financial health of the Commonwealth.

At the top of the priority list should be accelerating projects that are part of the state's five-year capital spending plan, reducing the state's high burden of bonded debt, and paying down the still huge unfunded pension liability and a similar looming obligation for health care costs of retirees. All of these would strengthen the fiscal health of the Commonwealth and reduce the amount of annual revenues consumed by fixed obligations.

Improve the quality of capital gains tracking and forecasting

The nature of capital gains makes them much more difficult to project than wages and earnings. Even so, the state needs to improve its ability to track and forecast capital gains, and to identify the level of risk in those forecasts. Currently, the Department of Revenue is not complying with a requirement adopted in 2003 to report monthly on the amount of revenues estimated to be collected in each month from capital gains income.[8]

Unlike wage and salary withholdings, there can be a long delay between when the capital gain realization occurs and when the taxes are paid. Currently, the estimated taxes on capital gains must be paid quarterly.

One of the simplest—and most direct—ways to improve the state's collection of capital gains would be to require taxpayers with gains above some predetermined, reasonable amount to make a payment of their estimated tax liability on those gains within 30 days of realizing them. If a taxpayer subsequently reported in their annual tax return losses that offset a portion of those gains, the excess tax payments would be refunded to them, just as excess withholding of wage earnings is refunded to other taxpayers.

This would have the side benefit of improving the information on which the state's forecasts of capital gains are based. It would eliminate some of the uncertainty about what taxable capital gains have already been realized, which in turn would make it possible to develop better projections of future gains.

Until the state accumulates sufficient dollars in the reserve account to protect itself from capital gains volatility, a more conservative approach needs to be taken in setting the forecast of capital gains revenues used in the budget. While it is unlikely that any forecaster could have foretold the 30 percent or more decline in capital gains receipts now expected for fiscal 2009, it was a mistake to ignore the 17 percent decline predicted by the only economic forecasting firm that projects capital gains realizations for the state.[9]

Consider broadening the state's tax base

While addressing the current and future threat of capital gains to the budget is clearly the most pressing priority, fiscal leaders should also be looking more widely at ways to improve the overall stability of the state's tax system.

Among the many options that could be considered, MassINC believes that one alternative—broadening the sales tax—is especially suited to serve as a springboard for a much needed discussion of the "big picture" question of stabilizing our tax system. Broadening the sales tax (in Massachusetts, the second largest source of tax revenue) is recommended by the majority of tax policy experts, and has been considered extensively in other states. It stands as a potentially viable alternative to increasing our relatively low sales tax rate, which would be another way to reduce our dependence on the income tax.

At the same time, our sales tax has traditionally been a narrow one, excluding many purchases that are taxable in other states. In Massachusetts, clothing, food, and services as diverse as hair styling, carpet cleaning, tire repair, and video rentals are not subject to the sales tax. Massachusetts taxes 18 of 168 services identified in a recent survey, compared to an average of 55 in other states.[10]

Although it has not been quantified, the gradual expansion of exemptions from the tax since it was introduced in the 1960s has undoubtedly narrowed its base even further. Given the goal of greater revenue stability, broadening of the sales tax could be made revenue neutral, with any gains in sales tax receipts offset by reductions in other taxes.

Less than 0.4 percent of the state's tax filers paid nearly two-thirds of all capital gains taxes.

Making any major change in the state's tax system is controversial, and broadening the sales tax would be no exception.

That said, just as there are no easy answers to the current fiscal dilemma, there are no trouble-free or quick fixes for the state's vulnerability to capital gains and other volatile taxes. However, ignoring the risks as we have done for the last six years has only added to the severity of the current crisis. Continuing to ignore this source of avoidable harm to state programs and services will only keep us on this painful path.

ENDNOTES

1. The Governor identified a total fiscal 2009 shortfall of $1.421 billion from a projected $1.1 billion reduction in tax revenues and $321 million in anticipated spending need not appropriated in the original budget. The $1 billion in spending cuts to close the gap included reductions of $755 million in programs and services, $152 million in scheduled pension contributions, and $146 million of the $321 of anticipated additional spending. The plan also withdrew $200 million from the rainy day fund (on top of the $300 million withdrawal authorized in the initial budget) and counted $168 million of largely one-time new revenues. The final package approved by the Legislature provided for approximately $80 million less cuts in program and services than proposed by the Governor.
2. Business taxes accounted for 41% of the remaining growth. This growth was partially offset by declining collections in other taxes, primarily the sales tax, non-capital gains income taxes, and the gas tax.
3. Long-term gains on collectibles are taxed at 12%.
4. Donald J. Boyd, "State Fiscal Issues and Risks at the Start of a New Century." June 2000: The Nelson A. Rockefeller Institute of Government.
5. The following description closely follows that of the 2000 study.
6. The $24.0 billion of 2006 gains for Massachusetts tax filers reported by the IRS is $4.3 billion less than what is reported by state Department of Revenue. There are three main reasons for this difference: Capital gains reported by IRS are only from personal income tax returns with Massachusetts addresses, while the state's figure includes non-residents; unlike the state number, the IRS capital gains exclude fiduciary returns; IRS capital gains do not include those reported by corporate trusts, which file under the income tax in Massachusetts.
7. The figures for total state tax collections and general revenues are from by the Census Bureau.
8. Chapter 29, section 5B of the General Laws, as amended by section 24 of Chapter 184 of the acts of 2002.
9. Economy.com forecasted declines in capital gains realizations of four percent in calendar 2007 and 13 percent in 2008, or a total of 17 percent, followed by an increase of 24.9 percent in 2009. Because of the July 1-June 30 timing of the state's fiscal year, the calendar 2007-2008 decline in gains would continue to be felt in fiscal 2009.
10. Federation of Tax Administrators 2007 survey of state sales taxes on services.

MASSINC'S MISSION

The mission of MassINC is to develop a public agenda for Massachusetts that promotes the growth and vitality of the middle class. We envision a growing, dynamic middle class as the cornerstone of a new commonwealth in which every citizen can live the American Dream. Our governing philosophy is rooted in the ideals embodied by the American Dream: equality of opportunity, personal responsibility, and a strong commonwealth.

MassINC is a non-partisan, evidence-based organization. We reject rigid ideologies that are out of touch with the times and we deplore the too-common practice of partisanship for its own sake. We follow the facts wherever they lead us. The complex challenges of a new century require a new approach that transcends the traditional political boundaries.

All of MassINC's research and *CommonWealth* articles are available free-of-charge through our website, **www.massinc.org.**