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Long-Term Causes of the Fiscal Crisis: The Role of Tax Cuts

While the immediate cause of the fiscal crisis is the national recession, policy choices over the past decade have weakened the Commonwealth's capacity to weather this storm. In FY2008, while the economy was still strong, the state budget was already structurally unbalanced. This fact sheet summarizes the tax changes in the decade between 1998 and 2008 that erased large budget surpluses and left the state fiscally unstable.

Overall, state taxes as a share of the economy were $3.3 billion lower in FY2008 than they were in FY1998. The two primary causes of this decline were income tax cuts and erosion of the state sales tax.

Income tax:

- The income tax rate was reduced from 5.95 percent to 5.3 percent, costing $1.3 billion.
- The tax rate on dividend and interest income was reduced from 12 percent to 5.3 percent, costing $720 million.
- The personal exemption was increased from $2,200 per person to $4,400 per person, giving each taxpayer a cut of $117, and costing $440 million.
- In 2002 the state repealed the capital gains tax cuts enacted in 1994 which increased revenue by $1.1 billion.

Overall changes in the state income tax resulted in net loss of $1.4 billion in income tax revenues.

Sales tax:

While the sales tax rate remained constant at 5 percent over the period between FY 1998 and FY2008, sales tax revenue was $1 billion lower in FY2008 than it would have been if it had grown with the economy.

- Use of the Internet to purchase goods has increased significantly over the past decade. Under current federal law it is very difficult for merchants to charge state sales taxes for items purchased over the Internet.
- The service sector, which is not subject to the sales tax, is growing as a share of the state's economy.

(For a complete explanation of the structural deficit see MassBudget's report *Substantial Surpluses to Dangerous Deficits: A Look at State Fiscal Policies from 1998 to 2008* available at www.massbudget.org)