



Keeping Massachusetts Competitive: The Business Climate in Context

by Steve Poftak

Introduction

Massachusetts is a state with many economic and competitive strengths, but policymakers, elected officials, and business leaders must not ignore its weaknesses. Massachusetts offers compelling advantages to companies looking to expand businesses or start new ones, but other states are chipping away at the state's advantages in this area. Of equal concern is the fact that the state's shortcomings--notably, the cost of doing business and an unfavorable and unpredictable tax environment--create a disadvantage when compared to many of the Commonwealth's national and international economic competitors.

States that compete with Massachusetts to attract and retain businesses are working to make their tax environments more supportive of sustainable job and revenue growth, drive down business costs, improve their quality of life, and build highly skilled workforces. In response, Massachusetts must compete for jobs across all dimensions. By this, we do not suggest that the state should embark on a quixotic, ideology-driven quest to be the lowest cost location for businesses. Rather, the state's policymakers must carefully examine how public policy affects business costs and ensure that Massachusetts is competing in all possible areas. To be effective, Massachusetts policymakers must avoid splashy, high profile efforts to attract marquee firms or sectors and focus instead on improving the foundation for our entire tech-based innovation economy to better position Massachusetts as a place where innovators want to work, entrepreneurs want to start companies, and employers want to grow their businesses.

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This policy brief is part of a joint project between the Massachusetts High Technology Council and Pioneer Institute that examines the business climate in Massachusetts. In early October, MHTC and Pioneer will release a White Paper that examines the fiscal and economic impact of reforms involving various components of the tax code.

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This policy brief begins by asking our customers how they perceive the state’s business climate and how they would improve it. It details the findings of the 2010 Massachusetts High Technology Council survey of its CEO members. To provide context for these findings, the brief will compare the Massachusetts tax environment to that of competitor states and review the condition of the Massachusetts job market.

A follow-up study will be conducted to determine the potential job and tax revenue impact of certain reforms to the tax environment in Massachusetts.

What Do Business Leaders Think?

To increase employment in the state, Massachusetts depends both on the leaders of existing businesses and on entrepreneurs. Given a goal of increasing employment in Massachusetts, these leaders’ views of the state’s business environment should be an important factor in developing state policy. The most recent survey, which captures a subset of the organization’s membership, offers insight into how business leaders view the state’s current business climate and offers consistent yearly data gathered since the 1980s for the purposes of comparison over time.

One of the most emphatic findings from the survey is that 77 percent of technology CEOs view tax/

economic policy as the top factor in determining the competitiveness of the state’s business climate (See Figure 1). While certainly other factors – education/workforce, energy, health care costs – come into play when employers make siting or expansion decisions, a vast majority of leaders view tax and economic policy as the most important contributor to a competitive business climate.

In response to a question about the state of the overall business climate for Massachusetts high tech companies, 40% of respondents believed the overall business environment is worsening (See Figure 2). An examination of the results shows a marked change in the perception of the business climate that prevailed for most of the 1990s and in the early years of the current decade, when only a small group of respondents held such negative view. It should be noted that the current year’s figure of 40% of respondents who believe the overall business climate is worsening is only half that of the respondents’ in 1989 and 1990, when the recession and the collapse of the “Massachusetts Miracle” prompted widespread negative assessments of the state’s business climate.

When asked if the Massachusetts tax climate is a positive factor relative to other states when making an investment decision, 56% of respondents felt that the Massachusetts tax climate is less positive than that of other states (See Figure 3).

Finally, technology leaders were asked to rank a number of tax factors in order of importance to

Figure 1. What policy area is most important for determining the long-term competitiveness of the business climate?

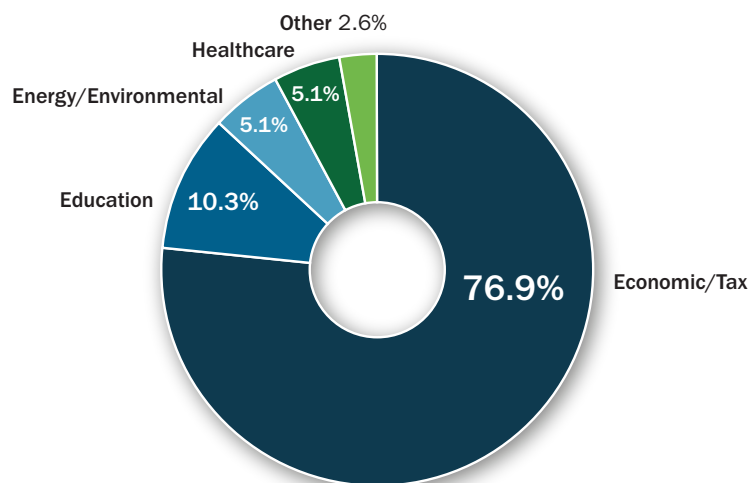
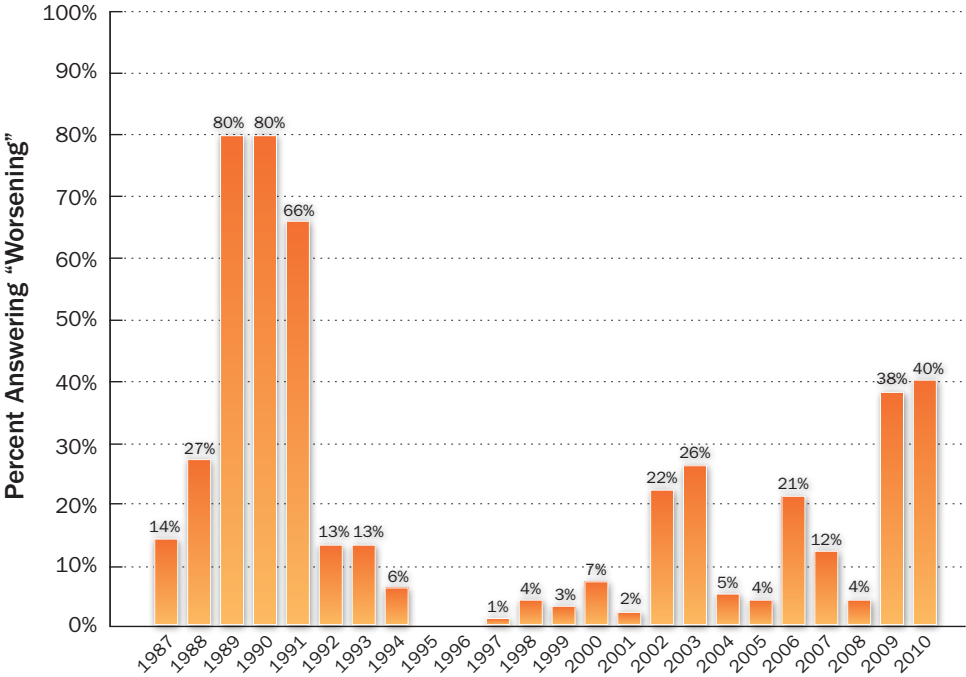


Figure 2. What direction is the business climate headed?
Percent answering “Worsening”



their company’s growth (see Table 1). The corporate income tax ranked as the most important factor among all components of the tax code. Personal income tax, R&D tax credit, unemployment insurance, and investment tax credit followed the corporate income tax in order of importance. As Table 1 demonstrates, technology leaders ranked the following tax climate items from 1 to 15 or most important to least important, with the importance of the state corporate income tax significantly exceeding that of other tax burdens.

In follow-up interviews with a sampling of survey respondents, technology leaders cited several themes related to the Massachusetts tax climate:

- 1) Respondents noted that changes in the tax code seem only to be short-term solution to create increased revenues, and not strategic in nature. Several respondents said that they feel that the state only views them as a source of revenue during difficult times, while it does little to support their businesses on an ongoing

Figure 3. Is Massachusetts business tax climate more or less positive, relative to other states, when making investment/growth decision?

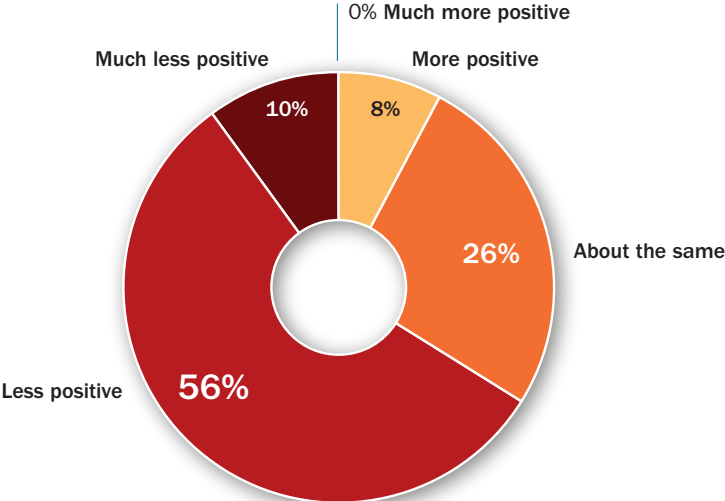


Table 1: Relative Importance of Tax Code Components

Tax Code Component	Averaged Ranking
State Corporate Excise Tax ("Corporate Income Tax")	4.5
State Personal Income Tax Rate	5.3
R&D Tax Credits	5.4
Unemployment Insurance Taxes	5.8
Investment Tax Credit	6.2
State-level Regulatory Burden	7.0
State Capital Gains Taxes	7.0
Local Property Tax Rate	7.5
State Sales Tax	7.7
Industry-specific Tax Credits	7.8
State Net Worth Tax	9.7
Net Operating Loss Carryover Term	9.7
Local Regulatory Burden	10.0
Single Sales Factor Tax Code Change	10.7
Combined Reporting Tax Code Change	10.9

basis. These respondents resent changes to the tax law that they perceive to be motivated by policymakers' desire to fill a revenue gap and not part of a broader strategy.

- 2) Uncertainty and volatility create significant obstacles to hiring new employees. Multiple changes to the tax code, unexpected increases in unemployment insurance and the volatility of health care (across both state and federal dimensions) contribute to employers' reluctance to add new employees.
- 3) Tax policy comprises an important component of business costs and hiring. No business leader cited tax policy as the most important factor driving employment; however, they noted that a state's tax policy and the way it contributes to costs are important factors in the state's ability to win business and to attract skilled employees to the state. Tax policy is also a consideration if a company can be discretionary in the placement and hiring of staff across different locations.

Comparing the Massachusetts Business Climate to its Competitors

Based on the MHTC's survey results, this section examines Massachusetts' overall business cost levels, particularly taxation, in comparison to those of key competitor states, which were selected for their skilled workforces and existing base of technology companies. These states were chosen based on their inclusion in various Mass Tech Collaborative research studies and input from Mass High Tech Council members, and include the following: California, Colorado, Connecticut, Georgia, Illinois, Michigan, Minnesota, North Carolina, New Jersey, New York, Pennsylvania, Texas, Virginia.

The study does not examine Massachusetts' standing relative to other states with the preconceived notion that it should always be the low-cost provider in each category. Massachusetts cannot and will not always be the least expensive location in all, or even most, cases. However, given the importance of business climate, state policymakers should examine each area of business cost to ensure that the state is addressing areas of weakness and competing for jobs to the fullest extent possible.

In the case of corporate taxes, the study considers only competitor states that calculate their corporate tax rates on a unitary basis (See Table 2).

Table 2: Tax Rates

State	2010 Corporate Tax Rate
MN	9.80%
CA	8.84%
MA	8.75% of net income plus \$2.60 per \$1,000 of property or net worth
NY	7.10%
CO	4.63%
IL	4.80%
Other States	
MI	4.95% on business income and 0.80% on gross receipts
TX	1% of 'taxable margin'

As this table demonstrates, Massachusetts is in the upper half of the range on the basis of the corporate tax rate alone. In addition, the state levies an additional net worth tax on corporate property. The average is 7% for the other comparable competitor states. Two additional states that use different methodologies for their corporate tax rates, Minnesota and Texas, are also included in the table for comparative purposes.

In 1992, Massachusetts approved the state's first Research & Development Tax Credit. This innovative policy helped Massachusetts benefit from the boom years of the 1990s by encouraging more employers to invest in R&D operations in the Bay State. Since that time, competitor states have been aggressive in passing R&D tax policies that create a favorable research climate and, as a result, have undercut Massachusetts' advantage in this area.

All competitor states tax capital gains at the same rate as other income.¹ Massachusetts is the sole exception to this practice, with a 12% rate on short-term capital gains, plus it has recently passed a law that reduces the capital gains tax rate to 3% (i.e., lower than the 5.3% rate on general income) for gains generated by Massachusetts-based holdings held for three years or longer.

With respect to Unemployment Insurance, Massachusetts has higher costs than other states, with an average contribution per covered employee of \$659 versus the national average of \$293.² Although some of that difference is driven by higher income levels in the state, it is instructive to note that while the Massachusetts per capita median personal income is 27% higher than the national per capita median, its Unemployment Insurance contributions per employee are 125% higher.³

Massachusetts provides unemployment benefits for the longest period of time in the country among all states, including competitors. Massachusetts provides benefits for up to thirty weeks while competitor states provide benefits for up to twenty-six weeks. Also, many competitor states have more stringent standards for workforce attachment than Massachusetts. Each of these aspects of the

Massachusetts unemployment insurance system increases the state's cost per employee.

Health care costs are another area where Massachusetts has high costs relative to those of its competitor states. Among competitor states, only New York exceeds Massachusetts yearly employer contribution of \$10,635 per family for family health insurance, which was 5th highest among all states. For single coverage, among competitor states, only Michigan exceeded Massachusetts yearly employer contribution of \$3,947 per individual, which was 12th highest among all states.⁴ It should be noted that high employer contribution levels on a dollar basis are driven by high overall health care costs, not high contribution levels on a percentage basis.

Besides the findings on taxes and other costs, it is important to consider the various indices of state business and tax climates. In general, Massachusetts ranks highly on the quality of the state's workforce, the level of innovation, and residents' quality of life. The state scores average-to-poor on other measures, such as business tax burden, business costs, and, most notably, the perception of business leaders nationally. Depending on how each index of business or tax climate weighs various factors noted above, Massachusetts can appear among the top performers or at the bottom.

In CFO Magazine's 2009 survey, Massachusetts ranked 49th in the overall negative impression of the state's tax climate; only California was worse.⁵ CEO Magazine's 2010 survey put Massachusetts 47th in its ranking of the "Best States for Business."⁶ More recently, CNBC ranked Massachusetts 5th in its "Top Places for Business" Rankings. However, it is important to note that in CNBC's disaggregated rankings, Massachusetts ranked 39th for business costs (which includes taxes) and 41st for cost of living.

Changes to the Massachusetts Business Tax Environment

Over the past decade, the state has gained additional revenues through changes to the tax code. These

Keeping Massachusetts Competitive: The Business Climate in Context

increases provided hundreds of millions of dollars to the state, but the changes to the tax code have established a pattern of unpredictability in the tax code which many business leaders believe contributes to a negative business climate.

In 2002, Massachusetts raised the long-term capital gains tax from as low as 0% to a new rate of 6%. In 2003, 2004, and 2005, Massachusetts made a number of additional changes in its tax laws, with the intention of closing so-called 'tax loopholes'. For example, sales tax-related changes resulted in yearly new revenues of \$71 million – \$81 million. Change in tax structure rules raised taxes by \$178 million. Change in REIT (real estate investment trust) structure raised annual taxes on these entities by \$40 million – \$60 million.⁷

The state's changes to corporate tax law passed in July 2008, including the switch to combined reporting, resulted in increased taxes of \$354.2 million in FY 2010, eventually declining due to a phased-in reduction to the corporate tax rate to \$145 million yearly from 2013 on. This is partially mitigated by FAS 109 deductions intended to lessen the impact of the switch to combined reporting, which will result in yearly tax savings of \$76 million - \$79 million from 2012 to 2018.⁸

The two most recent changes to Massachusetts tax laws took place in August 2010. For Massachusetts-based investments held for three years or more, the state reduced the capital gains tax rate to 3%. Also, the net operating loss carry-forward period was increased from five to twenty years, putting Massachusetts in line with most of its competitors and exceeding the level for several others. Estimates of the impact of these changes on state tax revenue are not yet available.

Recession: December 2007 – July 2009

Massachusetts' current economic condition has been impacted by the global recession. Several observers have noted that Massachusetts has fared better than many other states during this recession. This may

be true in a relative sense, but a doubling of the unemployed population is hardly the standard to which Massachusetts should aspire (See Figure 4).

The latest recession began in December 2007 and ended in July 2009, according to the National Bureau of Economic Research. During that period, the number of unemployed in Massachusetts increased from just over 150,000 to over 300,000. Since recessions are calculated on periods of economic growth (not changes in employment), unemployment continued to grow even after the formal end of the recession, rising to over 330,000 by February 2010 (more than 5% of the state's total population).

Massachusetts' long-term problems with jobs and the magnitude of the current recession suggest that simply counting on the state's historical strengths of a skilled workforce and existing industries is not enough. In order to create jobs and attract job-creating activities, the state must actively compete in all aspects of business climate.

Facing Reality: Job Creation Trends and the Lost Decade

Massachusetts has been on the wrong side of the job growth trend for a long period of time, but the issue became particularly acute after the 2001 recession. From 1990 to 2007, the U.S. experienced net job growth of 26.6%; Massachusetts job growth was essentially flat, with a net job loss of -0.3%, or 11,816 jobs, over this period. From 1990 until 2003, Massachusetts job trends roughly followed U.S. trends: losing jobs in 1990-1992 and 2001-2003 due to recessions and gaining jobs in intervening years. From 2003 through 2007, however, the U.S. gained jobs while Massachusetts lost jobs (see Figure 5).

Pioneer's analysis of jobs in Massachusetts reveals several disturbing trends.⁹ Massachusetts has been losing headquarters--which, on average, employ larger numbers than branch offices and standalone companies--at a rapid pace. Massachusetts has lost 5,106 headquarters on a net basis from 1990 to 2007, resulting in a net loss of close to 250,000 jobs during

Figure 4. Total Unemployed in Massachusetts

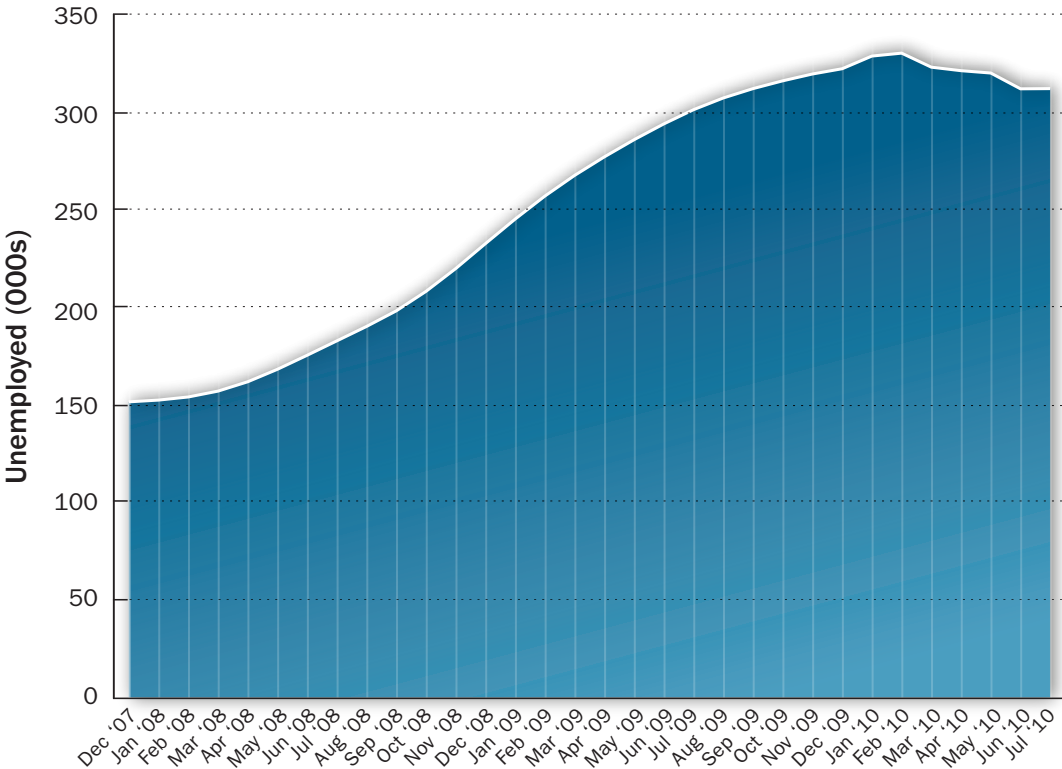
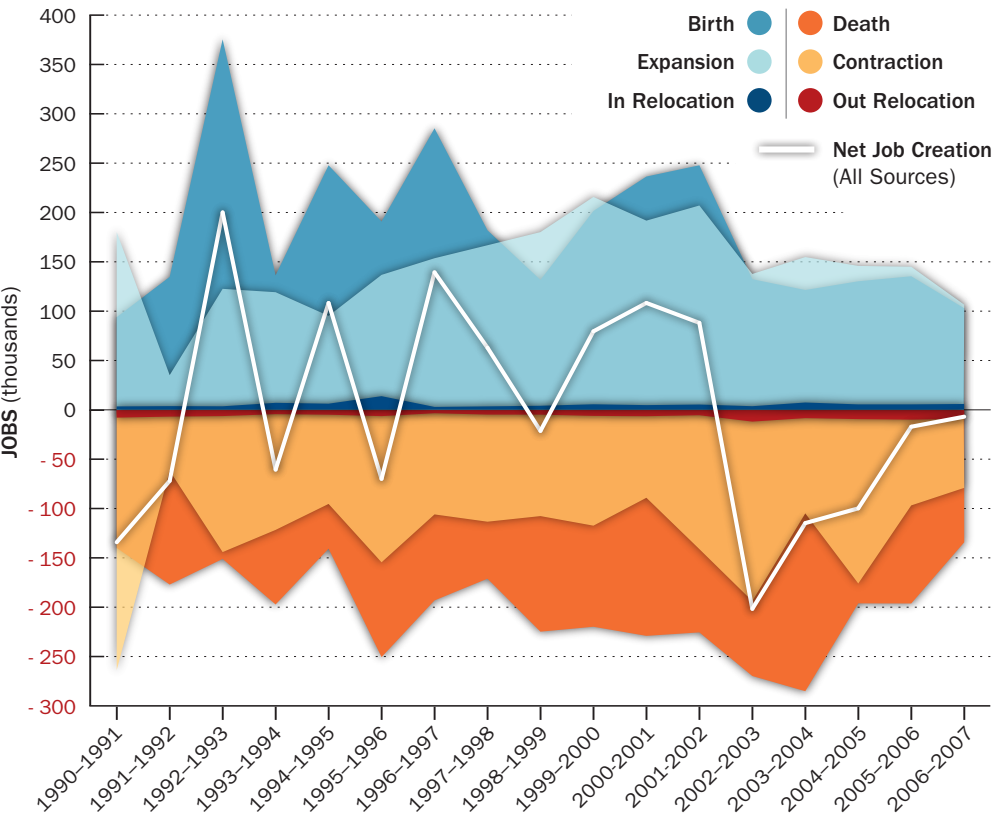


Figure 5. Fundamental Components of Job Growth and Loss



Keeping Massachusetts Competitive: The Business Climate in Context

a period when overall employment was largely unchanged.

Pioneer's examination of the drivers of job creation and loss over the past seventeen years provides a more nuanced view of the dynamics of Massachusetts' job market. The key drivers of job creation are the expansion of existing firms and the creation of new companies. For much of the 1990s, new firm creation generated the most new jobs in Massachusetts, but after the 2001 recession, the creation of new firms has not generated jobs at nearly the same pace. Net job losses following the 2001 recession wiped out the gains of the 1990s, leaving job levels nearly level from 1990 to 2007.

Pioneer's analysis demonstrates that firm relocation, which occupies a significant portion of the public and public sector's attention, is a minor factor in job creation and loss (accounting for less than 2% of total jobs lost or gained). Bearing the relative importance of relocation in mind, however, it is notable that many more establishments have moved out of state than have entered, and the trend has worsened since 2000. An analysis of net gains and losses shows that the state's greatest gains in new businesses come from states with high costs and taxation levels, and the state's largest losses in existing Massachusetts businesses which move out of state are to states with lower tax levels and business costs.

Conclusion

Faced with an inability to create jobs at a rate which matches the state's need for revenues, plus the active attempts of Massachusetts' competitor states and international regions to improve their business climate, the state must assess its current efforts to change its business climate and make improvements wherever possible.

From the MHTC survey, the opinions of key job creators are clear: the state's business climate is worsening and 'inertia' is frequently cited as one of the top reason for staying in the state, hardly a positive building block for future growth.

Other evidence suggests that the state faces serious challenges in the future—the recent recession has cost the state thousands of jobs, but Massachusetts has failed to create new jobs for almost a decade. Furthermore, the state's tax rates and programs are uncompetitive when measured against those of some of its key rivals. Last, the state's willingness to alter the corporate tax code repeatedly in order to capture additional taxes has created the perception of unpredictability that damages its image nationally, and makes it even more difficult to attract corporate investments.

What's next? Over the coming weeks, MHTC and Pioneer Institute will examine potential reforms to the tax code that offer the potential to encourage Massachusetts companies that make up our diverse innovation technology economy to grow and hire more employees. Reforms will be examined for their potential to increase growth, create employment, and provide revenues to the state.

Endnotes

1. State Individual Income Tax Rates 2009, Tax Foundation, last accessed on September 2, 2010 at http://www.taxfoundation.org/files/state_ind_income_rates-20090710.pdf
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4. Kaiser Family Foundation, Average Single Premium per Enrolled Employee For Employer-Based Health Insurance, 2009 and Average Family Premium per Enrolled Employee For Employer-Based Health Insurance, 2009. Last accessed on September 2, 2010 at <http://www.statehealthfacts.org/comparetable.jsp?typ=4&ind=271&cat=5&sub=67> and <http://www.statehealthfacts.org/comparetable.jsp?typ=4&ind=270&cat=5&sub=67>
5. See CFO Magazine Website at <http://bit.ly/9XQ5Wp>; Last accessed on Monday, September 13, 2010.
6. See CEO Magazine Website at <http://bit.ly/cToBgg>; Last accessed on Monday, September 13, 2010.
7. Commonwealth of Massachusetts Official Statement, available at http://www.dacbond.com/GetContent?dctm_r_object_id=0900bbc7800b3f50; Last accessed on Monday, September 13, 2010.
8. p. A-13, A-14, June 8, 2010 Information Statement of the Commonwealth of Massachusetts.
9. See *Failure to Thrive*, January 2010; *Heading Down*, March 2010; *Playing the Lottery*, June 2010; all published by Pioneer Institute.

About Massachusetts High Technology Council

The Massachusetts High Technology Council is composed of CEOs from the state's top technology employers who work to make Massachusetts a more competitive place for technology growth. The nonpartisan Council has a 33-year record of working with state and federal leaders in a decisive and effective manner on issues of education, taxation, economic development, energy, defense technology and more. Council members run leading global companies from all sectors of the state's diverse innovation economy. Visit <http://mhtc.org> for more information.



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