June 10, 2019

An Update

Changing the Constitution: 5 Questions to Consider

At the upcoming constitutional convention on June 12, legislators will vote on whether to approve a "proposal for a legislative amendment to the Constitution to provide resources for education and transportation through an additional tax on incomes in excess of one million dollars". This proposal will amend the state's constitution to impose an additional four percent tax on annual taxable income in excess of one million dollars. The proposal states "To provide the resources for quality public education and affordable public colleges and universities, and for the repair and maintenance of roads, bridges and public transportation, all revenues received in accordance with this paragraph shall be expended, subject to appropriation, only for these purposes."

The Massachusetts Taxpayers Foundation asks lawmakers to consider five questions before casting their votes:

- Does this income tax surcharge meet the standards of a sound tax policy?
- Will the estimated $1.9 billion in new tax revenue materialize?
- Will overall spending on transportation and education increase by $1.9 billion?
- If this experiment fails, what options are available to fix a constitutional change?
- Is the change to the Constitution that adds the surtax the best option available to the Legislature?

Question 1: ***Does this income tax surcharge meet the standards of a sound tax policy?***
Answer: ***No.***

The fundamental purpose of taxation is to raise sufficient revenue to fund public services. When evaluating tax policies and potential changes to the tax code, it is important to use an analytical framework that considers the best way to raise revenue by comparing the impact of various proposals on taxpayers, the state and the economy. Such a framework would include four commonly cited principles of sound tax policy.

They are:

- **Equity** – applies to the broadest base at the lowest tax rate possible;
- **Adequacy** - provides predictable, reliable and sufficient revenues;
- **Simplicity** - easy to understand and comply with;
- **Neutrality** - minimizes distortion of decision making and aligns with the taxing jurisdiction's economic goals so as not to impede growth.

The 4 percent surtax fails to adhere to any of these four principles.

As this brief will make clear, the proposed 4 percent surtax is neither fair nor neutral in that it is directed towards a small group of taxpayers who will have a substantial incentive and ability to avoid new taxes; nor does it pass the adequacy test as the projected tax revenues are unpredictable and highly volatile. Moreover, the surtax does not align with the state's economic interests because it taxes talent – Massachusetts' principal competitive advantage.

Although the tax appears to be a straightforward surcharge on income over $1 million, it fails in the simplicity regard, too. Many terms are undefined and these uncertainties will likely lead to confusion and litigation because of the sizeable new tax liability it imposes.

It is also noteworthy that this change does not make the tax code more progressive because it does nothing to shift the tax burden from lower income earners to higher income residents. Those who earn less than $1 million would see no change to their tax liability. It merely imposes additional taxes on a small population of taxpayers.

Question 2: Will the estimated $1.9 billion in new tax revenue materialize?
Answer: Unlikely.

The Massachusetts Department of Revenue (DOR) projects that the income tax surcharge would raise $1.9 billion from 19,600 tax filers who represent just 0.5 percent of all tax filers. DOR's analysis is static, meaning it does not consider or factor in the affected taxpayers' change in behavior as a result of this tax increase or the impact on the larger economy. This group's tax burden would grow from 21 percent to 29 percent of total income tax revenues collected each year.

A subset of the 19,600 tax filers – 900 who are projected to make more than $10 million annually – would contribute 53 percent of new tax revenues, or over $1 billion of the additional $1.9 billion. The top 100 earners would see their income taxes soar from an average of $5 million to $9.3 million annually.

Given the probability of changes to the economy and taxpayers predilection to avoid taxes, it's extremely likely that revenue collections will fall well short of projections for two reasons. These concerns are amplified by the federal tax law changes of December 2017 that limit state and local tax deductions to $10,000.

(1) Mobility – If one-third of the 900 tax-filers projected to make more than $10 million annually were to relocate, total income tax revenues would drop by approximately $750 million ($410 million in taxes from the current rate and $335 million in projected taxes from the 4 percent rate hike, Table 1). Since over 80 percent of income for this group derives from capital gains, Schedule E earnings, and interest - with just 15% coming from wages – most taxpayers would have the motivation and flexibility to avoid the additional tax burden.

    While some studies suggest that millionaires are not mobile due to their demographic profile (married with school-aged children) and proximity to job, social networks and/or family, those findings are countered by several reports of increased mobility following high-income tax rate hikes and the actual experiences of several states that have imposed such a tax.[1]

[1] MTF released a separate, detailed report *On State Policy and Migration* in February 2018.

Table 1 – Potential Loss in Income Tax Revenues from 900 Highest Earners
($ Millions)

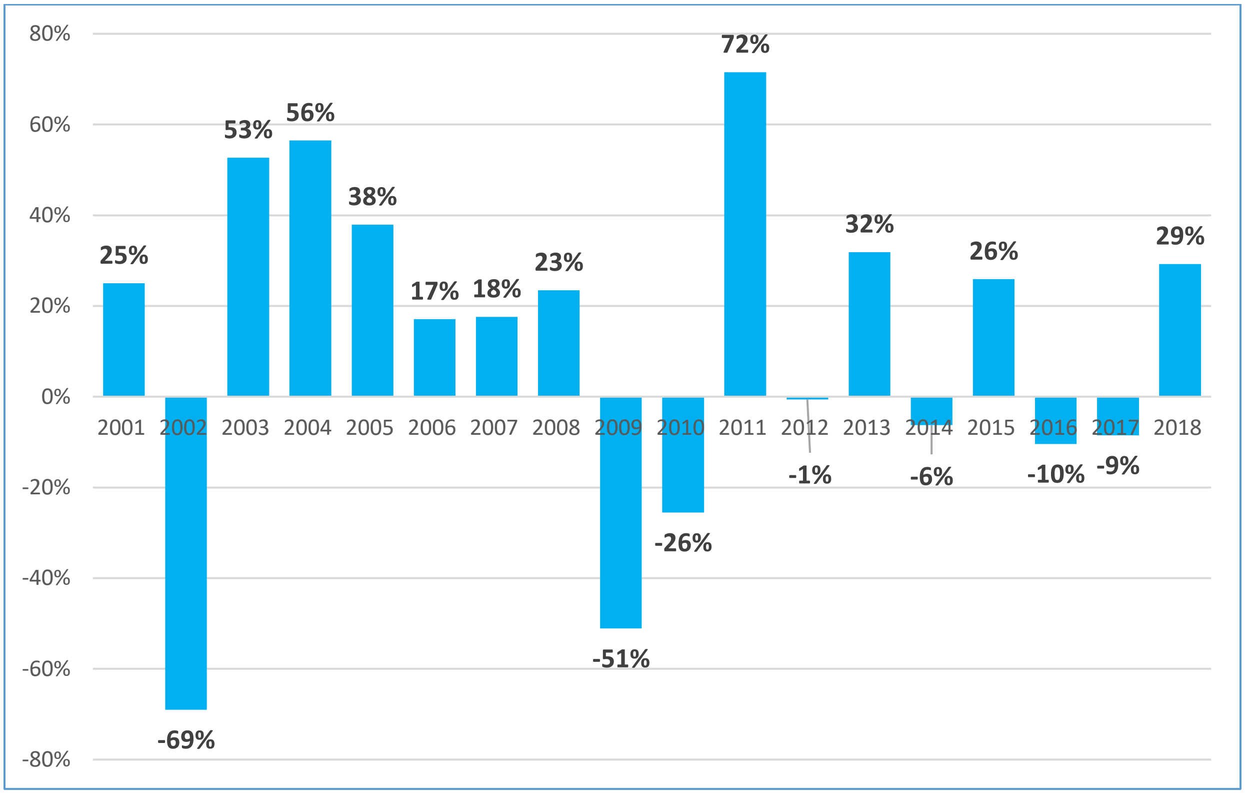
Taxfilers	Additional tax at 4%	Tax at current rate	Total lost revenue
1	1.4	1.1	2.5
50	68.2	55.9	124.0
100	136.4	111.7	248.1
200	272.7	223.4	496.1
300	409.1	335.1	744.2

(2) The volatility of non-withholding tax revenues – approximately 70 percent or $1.3 billion of the $1.9 billion in new revenues from the affected 19,600 tax filers is projected to come from non-withholding income tax revenues with the remaining $600 million from withholding taxes from wages.

Historically, non-withholding tax revenues that includes capital gains tax revenues, income from interest, dividends, and some forms of earned income such as bonuses, have proven to be sensitive to shifts in the economy, changes in tax rates, and individual tax planning. As shown in Figure 1, growth in non-withholding tax revenues accelerates during economic expansions and plummets in economic downturns.[2] In the recessions of 2002 and 2008, for example, non-withholding tax revenues fell $1.37 billion and $1.75 billion, respectively, or over 70 percent from their pre-recession peaks.

[2] For a detailed analysis of capital gains tax revenues, see *Capital Gains Revenue in Massachusetts*, Massachusetts Taxpayers Foundation, March 8, 2016.

Figure 1 - Year-over-Year Change in Non-Withholding Income Tax Revenues



Young and Varner, two researchers from Stanford University who have authored a number of studies on migration patterns of high-income tax filers, make an extremely cogent point in a recent report. Citing the unreliability and volatility of tax revenues from high-income individuals, they recommend that states set aside approximately 25 percent of new revenues to be deposited into the state's Stabilization Fund.

> "Moreover, states should spend millionaires' tax revenues with caution. Millionaire-bracket incomes are especially sensitive to the business cycle, and revenues from the tax will fall sharply during recessions. States would be wise to set aside 20 to 30 percent of these revenues for a "rainy day" fund."[3]

If Massachusetts were to adopt the proposed tax on income over a million dollars, the state would be more reliant than it already is on non-withholding tax revenues, subjecting state finances to even greater volatility. When the state confronts the next economic downturn, the revenue swings of the last two recessions when non-

[3] *Do Millionaires Migrate When Tax Rates Are Raised*?, Cristobal Young and Charles Varner, Pathways, Stanford Center on Poverty and Inequality, p. 7, Summer 2014.

withholding tax revenues dropped by 70 percent would be even more pronounced because these revenues would comprise a greater share of tax revenue.

Tax revenues would plummet by $900 million or more (Table 2) from the loss of capital gains tax revenues alone. The state would face, as it has in the past, an enormous budget shortfall requiring drastic cuts but potentially of an even greater magnitude.

As a result of these revenue collapses, in 2010 the state limited the amount of capital gains tax revenues in the operating budget by requiring that excess collections be deposited into the state's Stabilization Fund. Rating agencies cited this policy change as a reason to upgrade the state's credit rating but in 2017, the state's failure to comply with this policy caused a downgrade. More recently, that agency acknowledged state efforts to return to the policy of depositing excess capital gains tax revenues into the Stabilization Fund and not to support the operating budget.

Since capital gains tax revenues comprise a significant portion of the projected $1.9 billion increase in tax revenues, should this proposal pass, the state will face a difficult choice: abide by the statutory threshold and limit the amount of capital gains tax revenues used for the operating budget while improving reserves; or, appropriate all capital gains tax revenues and ignore lessons from the previous two recessions while subjecting the state to a potential downgrade from credit rating agencies.

Table 2 – Recession Impact on Cap Gains Tax Revenues from 19,600 Affected Tax Filers

19,600 affected tax filers	**DOR estimate**	**Impact of recession**	**Change in cap gains revenues**
Cap gains at 4% surcharge	487	146	-341
Cap gains at existing rate	799	240	-559
Cap gains tax revenues	**1,286**	**386**	**-900**

Neighboring Connecticut, with a revenue structure heavily dependent on taxing its highest earners, offers an abject lesson on how revenue shifts can occur even in periods of economic recovery. Many of its hedge fund operators have decamped to low-tax jurisdictions such as Florida, and the outflow of high-paying jobs at corporate headquarters is well-documented. And as in Massachusetts, federal tax reform prompted high-income residents to hold off on selling assets to limit their tax obligations.

Question 3: Will spending on transportation and education increase by $1.9 billion?
Answer: Highly doubtful.

Despite wording in the proposed initiative stating that funds would be set aside for transportation and education, funds are subject to appropriation. Thus, the decision on how best to spend all additional funds will be made each year by future legislatures.

Past budgets demonstrate why these funds may never be appropriated for education or transportation, even if legislators support these causes. Confronted by budget gaps of $1 billion or more, lawmakers have used all available funds to close shortfalls every year since FY 2015.

Even if the Legislature took pains to conform to the purported intent of the law by spending *new* tax revenues on education and transportation, current funding could be shifted to other budgetary needs regarded as more pressing. In the end, neither transportation nor education would necessarily see significant new net spending.

These structural budget gaps have emerged, in large part, because of the excessive growth in non-discretionary accounts. During this period, MassHealth and pensions have grown at nearly three times the rate of revenues, consuming the lion's share of new spending. Absent cost controls on these accounts, it is highly probable that a large portion of whatever new taxes are collected would be used to plug existing budget shortfalls.

The diversion of those tax dollars away from education and transportation is even more likely should the state face an economic downturn and/or the loss of funds from an austere federal budget. The state would be hard-pressed to maintain current spending levels, thereby foreclosing any chance of additional funds being allocated to education or transportation.

Even assuming that lawmakers plan to dedicate *all* new tax revenues to *new* spending, the long-term structural shortfalls that have plagued past budgets will persist and, even worse, will exacerbate budget gaps when the economic recovery ends because spending will have grown significantly, and there will be insufficient revenues to cover these new expenses. The volatility of the new revenue stream will only magnify these issues.

Question 4:	***If this experiment fails, what options are available to fix it?***
Answer:	***None before 2027.***

Embedding tax rates and a specific policy into the constitution is not an appropriate way to make law and hamstrings the legislature's authority to amend it. Tax policy is complicated and changes to the tax code, whether by legislative action or a ballot initiative, can often lead to unintended consequences. In fact, on several occasions lawmakers have been forced to amend or repeal tax law changes soon after implementation as a result of difficulties with compliance, changes to the economy, or adverse impacts to growth.

On two occasions, the Legislature extended the sales tax to services only to repeal the laws once major problems became apparent. In 1991, lawmakers passed a sales tax on selected services including legal, financial, and accounting. However, the tax was difficult to administer and made more complicated by a small business exemption. The tax was repealed before it took affect[4] within months of passage.

More recently, lawmakers enacted a sales tax on computer and software services to help balance the FY 2014 budget. The tax raised concerns due to its adverse impact on the state's economy, uncertainty over the revenues that would be collected, and the near impossibility of compliance due to DOR's inability to define which types of software services were subject to the tax. Once again, the Legislature acted quickly to repeal the new sales tax law just months after it went into effect.

The Legislature also has routinely amended laws enacted by petition initiatives when necessary.

Facing a deepening recession and plummeting revenues, lawmakers raised the income tax rate from 5.0 percent to 5.375 percent in FY 1989; to 5.95 percent in FY 1990; to 6.25 percent in FY 1991; and back to 5.95 percent in FY 1992 to help balance budgets. A decade later, voters overwhelmingly passed a 2000 ballot initiative lowering the income tax rate in two phases from 5.95 percent to 5.3 percent in 2002 and back to the 5.0 percent base in 2003.

Unfortunately, another recession and a 12 percent drop in tax revenues in FY 2002 forced the Legislature to suspend the statute and freeze the income tax rate at 5.3

[4] Taxes on non-residential telecommunications and utilities remain in effect.

percent. They amended the law to require that certain revenue growth triggers be met before the rate could step down to 5.0 percent. In order to avoid devastating budget cuts, the Legislature altered the statute that voters passed through the initiative process.

In 2017 the Legislature delayed by six months the implementation of parts of the law to legalize the commercialization of marijuana, passed in a ballot initiative in November, 2016. In the interim, the Legislature is considering substantial additional changes to the law including a reduction in the amount of marijuana people could possess, the number of plants that an individual could grow, limitations on what products retailers could sell, and increases to the sales tax rate.

Whether this delay and re-consideration of the sales and use of recreational marijuana is the best policy for the Commonwealth is not the point. What is important is that the Legislature has repeatedly used its authority to amend statutes to fix problems due to unforeseen circumstances to the benefit of the state and its residents.

The proposed 4 percent income surtax is fundamentally different and far riskier than previous initiative petitions because it is a change to the state's Constitution. This means that the Legislature lacks the authority to amend or repeal the language when the flaws in the proposal inevitably surface.

At some point when the Legislature concludes that the income surtax is harmful to the state and must be changed, it must first approve a constitutional amendment by a majority of the 200 members in two successive Constitutional Conventions. Only then could the initiative be placed before the voters on the next general election ballot, and a majority must approve to make the change. That means that should the surtax pass in the 2022 November ballot to take effect January 1, 2023, it would take another 4 years before any modifications or corrections could take place.

As a high cost state with few natural resources, Massachusetts' principal asset and competitive advantage is its extraordinarily educated workforce. Unfortunately, the damage to the state's competitive advantage may be irreparable by that point as businesses find it increasingly difficult to recruit talent and entrepreneurs and innovators opt for more attractive markets. Should the state lose that advantage, the economy could greatly suffer from this ill-conceived experiment.

Question 5: Is the 4 percent surtax the best choice by the Legislature?
Answer: Absolutely not.

The surtax is a far-reaching and unguided experiment that risks the state's economic well-being while likely failing to deliver what's been promised to voters – $1.9 billion in additional funding for education and transportation infrastructure. Making such a drastic change to the state's tax policy while ignoring its potential impact on taxpayers and the state's economy highlights the inherent flaws of using the initiative process to affect major policy changes. By supporting this initiative, the Legislature is delegating its spending and revenue raising authority and responsibilities to the voters – a reckless approach to governing and a clear abdication of its duties.

However strong the case for more funding for education, transportation, and other budgetary needs, or for making the tax code more progressive, the details and the implications of tax policy remain inescapably complex. The Legislature should take the requisite time to develop a comprehensive tax policy that reflects the myriad of changes to work and recreation over the past decades. It must then evaluate the proposal to determine if it is easily understood, fair, predictable and reliable, and in line with the state's economic agenda. Finally, it must make the case to voters for why the change is necessary.

Table 3 – Income Tax is the Only Progressive State Tax

Effective tax rate for income tax and selected consumption taxes*

Quintile	Tax Category							Total
	Income Tax	Regular Sales Tax	Meals Tax	MV Sales Tax	Alcohol Tax	Motor Fuel Tax	Tobacco Tax	
Lowest 20%	0.61%	4.97%	1.76%	0.77%	0.13%	1.14%	2.86%	12.24%
Second 20%	2.40%	2.68%	0.81%	0.41%	0.07%	0.61%	1.06%	8.04%
Third 20%	3.60%	1.36%	0.50%	0.30%	0.04%	0.36%	0.51%	6.68%
Fourth 20%	4.20%	0.91%	0.38%	0.25%	0.03%	0.24%	0.24%	6.25%
Highest 20%	4.75%	0.47%	0.19%	0.11%	0.02%	0.09%	0.06%	5.69%
Total	4.36%	0.82%	0.31%	0.18%	0.03%	0.18%	0.23%	6.11%

* Due to lack of data on non-filers, above table includes only tax filers in 2011 who represent 6.7 million people.

For example, if the goal is to make state taxes more progressive, there are many other taxes to consider. As the Tax Fairness Commission concluded in 2014, *"Notably, as has been mentioned previously in this report, the income tax is the only progressive tax, with high income taxpayers paying a greater percentage of their income to the tax than low income taxpayers. The other taxes identified above are consumption taxes, which are inherently regressive"*[5] (Table 5).

The Legislature could make the state tax structure more progressive by statutorily raising the income tax rate and the amount of personal exemptions or by lowering the sales tax rate to reduce the burden on lower income earners. These changes would make the state's tax code more progressive without putting the economy at risk and could be easily amended by the legislature as fiscal or economic changes dictate.

If the goal is to raise $2 billion to support new spending on education and transportation, there are funding sources that are more equitable, reliable and predictable – particularly so for transportation.

Imposing user fees such as higher gas taxes or tolls follows sound tax principles. They are easily understood and collected, apply directly to those who benefit, are predictable sources that can be used to support long-term capital investments, and are aligned with the goals to reduce traffic congestion and vehicle emissions.

Lawmakers could also consider adjusting the sales tax base to include services while reducing the rate to generate more funding. These are choices that fall under the Legislature's authority and reflect the myriad of considerations that must be taken into account when adopting new tax laws.

The Foundation urges legislators to not ignore the principles of sound tax policy and their fiduciary responsibilities as elected officials by approving a permanent change to our constitution that will create new fiscal, legal and economic challenges for the Commonwealth. There are many options for reforming taxation and increasing revenues. This proposal, unfortunately, combines questionable benefits with an extraordinary level of risk.

---

[5] Report of the Tax Fairness Commission, March 1, 2014, p. 19.