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Five Questions Concerning the Income Surtax Ballot Initiative for Legislators to Consider Before Changing the Constitution

Legislators will hold a constitutional convention during this 192nd session of the General Court and are likely to vote on whether or not to advance a ballot initiative[1] that amends the Massachusetts Constitution to impose an additional four percentage point tax on annual taxable income in excess of one million dollars[2]. If it is approved, there is no turning back. This question will appear on the 2022 statewide ballot for voters to decide without any additional opportunity to compromise, amend, reconsider, or otherwise take action.

MTF is asking legislators to delay the vote until the second year of the legislative session. A delay will provide sufficient time to assess the rapidly changing state and national economic landscape and consider the shortcomings of this method for effectuating tax policy as outlined in this analysis.

More specifically, this report poses five questions for legislators to consider prior to casting a vote:

- Does this income tax surcharge meet the standards of a sound tax policy?
- How has the pandemic affected the likelihood of collecting the projected new tax revenue?
- Will overall spending on transportation and education increase as the initiative suggests to voters?
- If this policy fails, what options are available to repeal it?
- Does the constitutional amendment still make sense?

[1] Proposal for Constitutional Amendment S.16 (malegislature.gov)

[2] Full text of the ballot initiative: which reads: Article 44 of the Massachusetts Constitution is hereby amended by adding the following 2 paragraph at the end thereof: 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. In addition to the taxes on income otherwise authorized under this Article, there shall be an additional tax of 4 percent on that portion of annual taxable income in excess of $1,000,000 (one million dollars) reported on any return related to those taxes. To ensure that this additional tax continues to apply only to the commonwealth's highest income taxpayers, this $1,000,000 (one million dollars) income level shall be adjusted annually to reflect any increases in the cost of living by the same method used for federal income tax brackets. This paragraph shall apply to all tax years beginning on or after January 1, 2023.

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 apply commonly cited principles of sound tax policy[3] to these tax law changes to avoid unintended economic distortions.

Key principles include:

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

The 4 percent surtax fails on all four counts.

The proposed four percent surtax is not neutral in that it is not broad-based or a low rate. This policy is targeted at a small group of taxpayers (0.5%) whose tax rate on the effected income will increase by 80%.

It fails the adequacy test on two grounds. The projected tax revenues are unpredictable and highly volatile and not a good predictable revenue stream for supporting annual operating expenses. Much of the taxable revenue will be from capital gains. In the thirteen of the twenty years between FY 2000 and FY 2019, year-over-year capital gains collections fluctuated by more than 20 percent on average. In six instances, these fluctuations exceeded 40 percent. This level of volatility is incompatible with budget planning.

Although the tax appears to be a straightforward surcharge on income over $1 million, it fails with respect to simplicity, too. Many terms, such as "taxable income" are undefined and the rules for applying the tax are omitted. For example, the petition is silent as to how a taxpayer with annual income of $1.5 million in income, half of which is from short-term capital gains, would apply the tax. Does the short-term capital gains income count towards the $1m so that it remains taxable at the current rate of 12% or will it be the portion of the income be subject to the surtax so that the effective rate becomes 16%? Absent additional legislative action, these interpretive decisions will be left to the Department of Revenue, an administrative agency, rather than the legislature, a lawmaking body. These omissions will cause varying interpretations and likely lead to litigation because of the sizeable new tax liability it imposes.

The income surtax does not minimize economic distortions either. In fact, it misaligns with the state's economic interests. The tax will impact investors, small business owners, entrepreneurs and others who play an important role in our innovation economy at a time when it has never been easier for taxpayers

[3] Association of International Certified Public Accountants Guiding principles of good tax policy: A framework for evaluating tax proposals - tax-policy-concept-statement-no-1-global.pdf (aicpa.org)

to relocate with minimal professional disruption. The surtax will hurt Massachusetts' ability to compete for talent at a time when competition for talent is intensifying.

Question 2: Will the projected new tax revenue materialize?
Answer: Unlikely

The Massachusetts Department of Revenue (DOR) projected 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 based on 2014 tax filing data, which does not account for recent changes to the federal tax code[4], current economic circumstances or the large year-over-year fluctuations in non-withholding income that occurs.

Static Revenue Estimate

DOR's revenue estimate is static, meaning it assumes all else stays the same other than the tax change. It does not consider the affected taxpayers' change in behavior as a result of this tax increase, or its impact on the larger economy, which makes its results less reliable than if a dynamic estimate which considers these factors were conducted.

Affected taxpayers are likely to react to the tax increase in ways that could have a material impact on the estimated revenue collections. This taxpayer group's tax burden will rise from 21 percent to 29 percent of total income tax revenues collected each year for the Commonwealth. Fewer than one thousand of the 19,600 impacted tax filers – those making more than $10 million annually – contribute 53 percent of the projected 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. This concentration of tax liability in such a small group of taxpayers means that changed behavior by a few such taxpayers can have a sizeable impact. As New Jersey learned, one taxpayer's move out of state caused a multi-million budget gap for them.[5]

Federal Tax Law Changes

Federal tax law changes since the income surtax was first proposed have significantly increased the cost of the proposal to impacted taxpayers. Prior to enactment of the Tax Cuts and Jobs Act (TCJA) in 2017, taxpayers could deduct all state and local taxes from their federal taxable income, offsetting about one-third of the increased state tax obligation from the income surtax. The TCJA instituted a $10,000 cap on the deductibility of state and local taxes on federal returns, greatly limiting the federal tax offset. The imposition of the federal SALT cap makes taxpayers more sensitized to and more motivated to reduce their overall state tax burden.

Post-pandemic Changes to the Economy

Changes to the economy resulting from the pandemic are also likely to cause revenue collections to fall short of projections. The pandemic has resulted in much greater mobility with the trend towards remote working. If one-third of the 900 tax-filers projected to make more than $10 million annually were to change residency, total income tax revenues would drop by approximately $990 million ($544 million in

[4] One noteworthy change is the Tax Cut and Jobs Act of December 2017 which limits the federal deduction for state and local tax paid to $10,000. This change is likely to sensitize taxpayers to their state tax burden.
[5] One Top Taxpayer Moved, and New Jersey Shuddered - The New York Times (nytimes.com)

taxes from the current rate and $446 million in projected taxes from the 4 percent rate hike (See Table 1). Since over 80 percent of income for this group derives from capital gains, Schedule E earnings, and interest, and only 15% comes from wages, these taxpayers would have the motivation and flexibility to avoid the additional tax burden. [6]

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

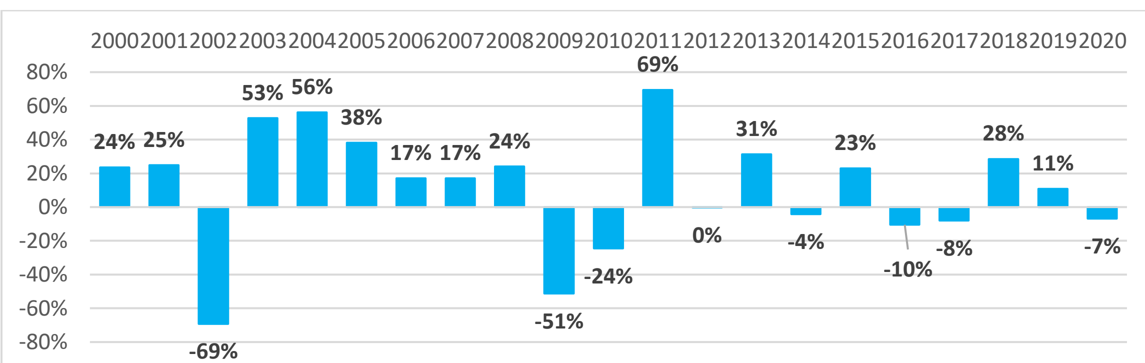
Taxfilers	Tax at current rate	Additional tax at 4%	Total lost revenue
1	1.8	1.5	3.3
50	90.7	74.3	165.0
100	181.4	148.6	329.9
200	362.7	297.1	659.9
300	544.1	445.7	989.8

Proponents of the income surtax suggest that state taxes do not cause high earners to move. They cite studies that suggest millionaires are not mobile due to their demographic profile (married with school-aged children), and proximity to job, social networks and/or family. These findings are refuted by other academic research and do not account for the impact of the pandemic on the ability and willingness of high wage earners to work remotely or relocate. The actual experiences of several states that have imposed such a tax bear out the very real behavioral impacts of tax surcharges.[7]

Volatility of Non-withholding

The volatility of non-withholding tax revenues is another reason that projected revenues may not be realized. Historically, non-withholding tax revenues (capital gains, interest, dividends, Schedule E income), have proven to be sensitive to shifts in the economy, changes in tax rates, and individual tax planning considerations. As shown in Figure 1, growth in non-withholding tax revenues mirrors the economic cycle, accelerating during economic expansions and plummeting in economic downturns.[8] For example, during the recessions of 2002 and 2008, non-withholding tax revenues fell $1.37 billion and $1.75 billion, respectively, or more than 70 percent from their pre-recession peaks.

Figure 1 – Growth in Non-withholding Income



[6] "Taxation and Migration: Evidence and Policy Implications" published by the National Bureau of Economic Research found that high-income workers and professions that are not tied to a location can be quite responsive to taxation when deciding where to locate.
[7] MTF released a separate, detailed report On State Policy and Migration in February 2018.
[8] 2 For a detailed analysis of capital gains tax revenues, see Capital Gains Revenue in Massachusetts, Massachusetts Taxpayers Foundation, March 8, 2016

Citing the unreliability and volatility of tax revenues from high-income individuals, researchers from Stanford University recommend that states set aside approximately 25 percent of new revenues to be deposited into the state's Stabilization Fund. They also suggest *"… 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."*[9]

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. The revenue swing during the next economic recession would be even more pronounced for the state than the last two recessions (70% decline) because these revenues would comprise a greater share of total tax revenue.

MTF's analysis indicates that non-withholding income tax revenues would comprise approximately 70 percent of new revenues. If past recessions provide a guide, tax revenues in the next economic downturn could plummet by $1.1 billion or more (Table 2) from the loss of capital gains tax revenues alone. The state would face an enormous budget shortfall requiring more drastic cuts than it has in the past.

To avoid over-reliance on capital gains revenues, lawmakers limited the amount of capital gains tax revenues that could be used in the operating budget by requiring that excess collections above a statutory threshold be deposited into the state's Stabilization Fund. Rating agencies cited this policy change as a reason to upgrade the state's credit rating. Conversely, the state's failure to comply with this policy in 2017 caused a downgrade. More recently, credit agencies praised the state's re-adherence to the policy of depositing excess capital gains tax revenues into the Stabilization Fund rather than diverting them for operating expenses as they did in prior years.

Since capital gains tax revenues comprise such a significant portion of the projected $1.9 billion increase in tax revenues if this proposal passes, the state will face a dilemma. Lawmakers can either: (1) acknowledge the volatility of these revenues by abiding by the statutory threshold, thereby limiting the amount of capital gains tax revenues used for the operating budget while improving reserves; or (2) appropriate all capital gains tax revenues and ignore lessons from the previous two recessions, thereby 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	608	183	-426
Cap gains at existing rate	999	300	-699
Cap gains tax revenues	**1,607**	**482**	**-1,125**

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

Question 3: Will the income surtax result in additional spending on education and transportation?
Answer: There is no guarantee

Despite wording in the proposed initiative indicating that these new tax revenues would be devoted to transportation and education, these funds are subject to appropriation. Thus, the decision on how best to spend all additional funds will be made each year by future legislatures – a fact affirmed by the Attorney General in court proceedings challenging an earlier version of the petition.[10]

Even if the legislature took pains to conform to the intent of the law by dedicating these new revenues to education and transportation, the end result could be no net gain in spending on them. The ballot initiative does not require revenues from the income surtax to be dedicated to education and transportation on top of current spending levels. Rather, it merely requires that income surtax revenue support education and transportation. Thus, even if all the new revenue from the surtax were applied to these two spending categories, that amount falls far short of existing spending levels. Policymakers could then re-direct current resources used for transportation and education to other unrelated areas resulting in no spending increases and/or potentially spending cuts while fully conforming to the requirements of the proposal.

The likelihood of increased investment in education and transportation is even more questionable in economic downturns when state tax revenues are likely to dip and other resources become scarce. During these periods, the state would be hard-pressed to maintain current spending levels, thereby further diminishing the chance of additional funds being allocated to education or transportation. That is, in fact, what happened during the period from FY2015 until FY2019 when the state was confronted by budget gaps of $1 billion or more. Lawmakers used all available funds to close shortfalls, including trust fund balances and other dedicated revenues. These structural budget gaps emerged, in large part, because of the excessive growth in non-discretionary accounts. During this period, MassHealth and pensions grew at nearly three times the rate of revenues, consuming the lion's share of new spending. Absent meaningful cost controls on these accounts, there is no reason to believe that future recessions will be any different, requiring that a large portion of whatever new taxes are collected be used to plug existing budget shortfalls again in the future as the state has done in the past.

In the current fiscal climate in which the state has received substantial federal assistance, the diversion of these funds to close budget gaps is unlikely. On the contrary, the amount of federal assistance targeted to both education and transportation makes additional tax revenues unnecessary in the near term. If, however, federal funds are used to expand services in ways that are not financially sustainable, new budgetary pressures could arise when federal funds are depleted.

[10] The proposed amendment would impose a new surtax on incomes over $1 million and would direct the Legislature to spend the resulting revenue on education and transportation purposes. Because that direction is expressly subject to legislative appropriation, the proposed amendment would not remove the decision how to spend the surtax revenue from the discretion of the Legislature and, therefore, would not make a "specific appropriation." (Pp. 14-18)Brief Of The Appellees Maura Healey As Attorney General And William F. Galvin, As Secretary Of The Commonwealth.

Question 4: If embedding the income surtax in the Constitution ends up being the wrong policy choice, what options are available to fix it?
Answer: None before 2027, and very few after that

Utilizing the ballot initiative process for enacting major policy changes is fraught with peril. It forecloses the ability of the legislature to amend, clarify and otherwise change the language as the process unfolds. Ballot initiatives are even less conducive for implementing complicated tax law changes that can often result in unintended consequences. As history demonstrates, Massachusetts lawmakers have been forced to amend or repeal tax law changes on a number of occasions in the recent past, soon after implementation, for a variety of reasons.

In the first instance, the Legislature extended the sales tax to services in 1991, only to repeal the law within months of passage once major problems became apparent. More recently, lawmakers enacted a sales tax on computer and software services to help balance the FY 2014 budget. The tax raised a myriad of concerns: a broader than anticipated application, an adverse impact on the state's economy, uncertainty over the revenues that would be collected, and compliance difficulties due to a lack of clarity regarding 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. More recently, amendments had to be made to the paid family and medical leave law in order to avoid ERISA issues[11].

The Legislature also has routinely amended laws enacted by petition initiatives when necessary. In 2000, voters overwhelmingly passed a 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. Facing a deepening recession and plummeting revenues, lawmakers altered the timeframe for reducing the income tax rate based on a formula that considered economic and fiscal conditions. The rate reduction took 20 years to achieve, rather than the three years approved by voters.

In 2017, the Legislature delayed by six months the implementation of parts of the law to legalize the commercialization of marijuana, passed by ballot initiative in November, 2016. During implementation, concerns arose regarding the amount of marijuana people could possess, the number of plants that an individual could grow, the amount of products retailers could sell, as well as the sales tax rate.

The proposed 4 percent income surtax is fundamentally different and far riskier than previous initiative petitions because it changes 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. To make a change will require the same four-year process followed to enact it. Citizens or lawmakers will have to introduce a petition to amend the Constitution, gather sufficient signatures in support, have it certified by the Attorney General, then approved by legislators 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 the change for it to become law.

The dynamics of repealing the language are fundamentally different from those to establish it. There is no obvious legislative or popular champion to lead an effort to undo unforeseen consequences. Legislators will be reluctant to alter or repeal a constitutional amendment passed by the electorate,

[11] A technical correction to the PFMLA law was required to avoid a potential federal preemption issue affecting multi-employer benefit funds governed by the Employee Retirement Income Security Act ERISA, 29 U.S.C. 1001 et seq.

particularly given how rare changes are made to the constitution. It has been 20 years since the last such change was made. Moreover, the likelihood of legislators and the electorate agreeing on how best to proceed is exceedingly small, and even if agreement were reached, the process would take at least four years. There is no likely voter class to spearhead the repeal effort either. Many of the affected taxpayers are one-time millionaires[12] who attained the status as a result of the sale of a business or real estate or some other extraordinary circumstance. They will not be motivated to champion an effort. Those most affected, taxpayers with recurring annual income over a million dollars, will be disinclined to seek a repeal because they will likely have relocated, established their legal domicile elsewhere, or structured their financial affairs to avoid the tax altogether. Thus, this constitutional change is likely to be with us for a long time.

Question 5: Does advancing the income surtax still make sense?	
Answer:	Absolutely not

Changed Circumstances

The surtax was first introduced several years ago under a very different set of circumstances. The state was facing recurring structural deficits and the growth of non-discretionary annual spending was crowding out other spending priorities. Since that time, the state's finances have notably improved and the nature of the economic mobility has fundamentally changed. The economy and the state's fiscal situation had improved steadily in the years just prior to the pandemic. The onslaught of a global pandemic last year has upended the way we live and work. The aftershocks from the near shut-down of the economy are still being felt and the path forward is not clear. In response to these circumstances, the federal government has provided billions to Massachusetts, including billions for education and transportation.

We are in a period of transition and it would be a mistake to implement policies, not easily undone, that could harm our recovery. Waiting to take a vote on this initiative will allow for a better understanding of what additional resources, if any, are needed. With discussions underway in Washington about new taxes on high earners, a delay will also provide a clearer sense of the broader tax and competitive landscape in which to evaluate the income surtax's efficacy. Massachusetts does not want to drive away talent because of its high marginal rates.

Better Alternatives

Education and transportation are core public services that should be adequately funded to provide the best possible service levels; however, there are more preferable ways to accomplish this without impeding the state's ability to attract top talent and maintain its long-standing competitive edge. Expanding job opportunities for all Massachusetts residents is a key component of closing the wealth gap and building a sustainable tax base; therefore, maintaining Massachusetts competitiveness in attracting and retaining businesses that provide employment is critical to our long-term success of providing economic opportunity for all.

[12] Per DOR data for the 10-year period ended in 2017, 46% of millionaires were one-time millionaires and 60% were millionaires twice or less.

MTF has long supported additional investments in transportation infrastructure. MTF and other stakeholders developed a viable way to infuse dollars into our public transit system necessary for capital investments and improvements. The T3 plan[13] relies on a combination of user fees, new taxes and redeployment of existing funds. The House passed a transportation financing plan in 2020 that includes some of the same components. Both plans provide additional resources without doing harm to the state's economy and should be considered as viable alternatives to the income surtax.

The Student Opportunity Act was enacted in 2019, after the income surtax was introduced. This bill encapsulates the recommendations of Foundation Budget Review Commission and provides $1.5 billion in new resources targeted to low-income students for our elementary and secondary schools over the law's seven-year phased-in implementation. Lawmakers indicated that the state could fully fund this law without additional state tax revenues and do so in the FY22 budget. Robust tax collections that are exceeding benchmark provide a positive outlook for continuing these commitments in the coming years without an income surtax.

Flawed Process

Even if one were to assume that more money is necessary for education and transportation, embedding a tax rate in the constitution is not the way to address it. This approach is unprecedented and impractical. Delegating the decision about important tax policy to voters, who will have different considerations than the General Court, does not make sense is arguably a dereliction of duty. The Legislature is best positioned to take the requisite time to carefully consider the structural changes to our economy taking place and adopt policies that best respond to them. Moreover, given the degree of economic uncertainty the pandemic has caused, the legislature needs to retain the authority to amend the rules as necessary and in response to these changing circumstances. All of these considerations argue against embedding a tax policy in the constitution. They also highlight the inherent flaws of using the initiative process to affect major policy changes.

In summary, the context for considering the income surtax ballot initiative is markedly different now than when it was first introduced. The income surtax proposal has to be re-evaluated to determine if it aligns with the state's economic agenda. Therefore, we respectfully request that action on this constitutional amendment be postponed until next year in order for legislators to have adequate time to carefully consider these changed circumstances.

[13] *The Transportation Table (T3) Overview of Recommendations*