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THE CENTER FOR STATE POLICY ANALYSIS

RISKS AND BENEFITS OF A MILLIONAIRES TAX

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EXECUTIVE SUMMARY

Should Massachusetts introduce a new tax on high-income households — and earmark the revenue for education, roads, bridges, and public transit?

Voters will get to decide as part of a November ballot initiative known as the millionaires tax, which would apply a 4 percent surtax to annual income over $1 million.

Questions abound. Will this tax drive high-earning residents out of state? Can it help address racial inequities? Might the money be diverted for other uses?

In a previous report, we at the Center for State Policy Analysis found that the tax would generate roughly $1.3 billion in revenue in 2023 — and that aggressive tax avoidance would be a bigger challenge than an exodus of high earners.

In this policy brief, we examine additional arguments for and against the millionaires tax.

We find that:

- The explicit commitment to spend all millionaires tax revenue on education, transit, and transportation will be difficult to fully maintain. For every dollar raised by the surtax, spending on these earmarks is likely to increase by 30 cents to 70 cents, with the remainder effectively diverted to other areas of the budget.

- Even accounting for the imperfect effect of earmarks, the millionaires tax would still generate substantial increases in a number of high-priority spending areas — potentially reducing economic and racial inequality. Increased education spending is known to improve student outcomes, particularly for lower-income students; the economic benefits of transit and transportation spending are less clear.

- Revenue from the millionaires tax will be highly volatile, rising rapidly in good economic times and falling sharply in downturns. Setting money aside in boom years would address this volatility, but the ballot initiative currently lacks such a mechanism.

- With the right spending priorities, millionaires tax revenue could directly address racial inequity. However, the real-world impact will depend on the uncertain decisions of future lawmakers.

- Changing the Massachusetts Constitution — as this ballot question does — would introduce some unlikely but potentially worrisome risks. If there are unintended consequences, they could only be fully addressed through a multiyear process. However, legislators would be able to make temporary fixes via regular law.

- The number of people paying this tax will grow over time, but likely at a slow rate.

In the sections that follow, we look at these issues in greater detail, summarizing relevant research where available.

More background on this ballot question, and a summary of the economic impact, is available in our earlier study. This includes fuller details about who will pay the tax, as well as information about the likely effects on individual families and the state economy.

EARMARKS AND THE USE OF MILLIONAIRES TAX REVENUE

The language of this ballot question is exquisitely clear: all money from the millionaires tax must be spent on "quality public education and affordable public colleges and universities, and for the repair and maintenance of roads, bridges and public transportation."

Yet, despite this commitment, not all millionaires tax revenue is likely to be spent in these areas. The problem is fungibility, or the ease with which lawmakers can shift money between programs.

Say, for instance, that the state was planning to spend $15 billion on public education, transportation, and transit in 2023. With the passage of the millionaires tax, they would have an additional $1.3 billion in revenue for these areas.[1] But the state could still:

1) Follow the millionaires tax requirements to the letter, spending the full $1.3 billion of new revenue on public education, transportation, and transit.

2) Take $1.3 billion in other revenue — that they had been planning to spend on public education, transportation, and transit — and redirect it instead for environmental programs, health care, or tax cuts.

3) End up spending $15 billion as initially planned on education, despite the added earmarked revenue.

There is nothing illegal or untoward about this approach; it's a common part of legislative horse-trading. The only real impediment is the normal civic process of lobbying, public pressure, and legislative debate.

Sometimes, this process does keep legislators from shifting money around — especially when there's a clear understanding that certain spending priorities represent the "will of the voters." As an example, Massachusetts is still implementing tax policy changes that voters approved in a ballot question decades ago.

But other times, even money that's set aside with a clear purpose gets diverted to new ends, as happened when state antismoking funds were repurposed for economic development.

Researchers have looked into the question of whether — and to what extent — earmarks generate real funding increases. And while conclusions vary, the consensus is that: a) earmarks work to some degree, generating meaningful funding increases in targeted areas; and b) they don't work perfectly, with some of the earmarked revenue ending up in unexpected places.

Broadly speaking, somewhere between 30 cents and 70 cents of earmarked revenue reaches its explicit target, depending on the type of earmark, the commitment of lawmakers, and the strength of various interest groups.

Union power is one reason to expect millionaires tax revenue will end up in the specified spending buckets, as some studies suggest that strong teachers unions help to keep earmarked education dollars flowing in the planned direction.

But there's a countervailing reason the millionaires tax might generate smaller funding increases in targeted areas: The earmarks and spending requirements are extremely broad, allowing for funding across the entirety of public education (pre-K through college) in addition to roads and bridges and buses and subways and rail (and more).

This breadth of options provides valuable flexibility but it also makes it hard to track spending over time. And that will complicate efforts to maintain public pressure. How can advocates hold politicians accountable for the promises of the millionaires tax if they can't easily gauge whether those promises are being upheld?

Is this a reason to oppose the millionaires tax? Not necessarily.

Even if earmarked money does ultimately leak into other areas of the budget, that doesn't mean it will disappear or be wasted; it will simply support other programs the state deems worthy of funding: maybe health care, maybe climate resilience, maybe corporate tax reform.

ADDRESSING RACIAL AND ECONOMIC INEQUITIES

Part of the motivation for introducing a millionaires tax is to address growing racial and economic divides in the Commonwealth — divides that shape the lives of families all across the state.

The evidence is legion, but to cite some of the more dramatic examples:

- For every dollar earned by white households in 2020, the typical Black household in Massachusetts made 60 cents and the typical Hispanic household 53 cents.
- The homeownership rate among Black and Hispanic families in Massachusetts is roughly half that of white families.
- In education, a stark and persistent achievement gap remains between students of color and white students.
- In recent decades, high-wage workers have seen their paychecks grow far faster than their low- and median-wage peers.
- White workers are better positioned for the opportunities of the post-Covid world, with jobs that are typically far more amenable to hybrid and remote forms of work.

Effective, targeted spending could go a long way toward redressing these challenges and improving racial and economic equity.

Yet, from the current vantage point, it's impossible to say whether millionaires tax dollars will be used in ways that reduce inequality. Not only will final appropriations be left to future legislatures, but thanks to fungibility, a significant amount of this revenue may end up funding other areas of the budget or being used for tax breaks.

What can be said is that a millionaires tax is likely to shift some resources from wealthier, mostly white households to poorer, more diverse families — simply because of the makeup of the tax.

The typical payer will be white, as roughly 90 percent of all million-dollar earners in the state are. And even if we can't know exactly how millionaires tax revenue will be used, the vast majority of state spending goes to broad social priorities like Medicaid, public education, and child and disability services — things that provide the greatest benefits to more vulnerable residents, including in communities of color.

THE PAYOFF OF EDUCATION AND TRANSPORTATION INVESTMENTS

Increased spending on the areas targeted by the millionaires tax proposal — education, transportation, and transit — could have an array of broader benefits, but the evidence here is somewhat mixed.

Education spending can be a powerful equalizer, and the most recent research finds that increasing K-12 funding really does improve things like student performance, graduation rates, and college-going.

One recent meta-analysis found an extremely strong consensus, with 90 percent of relevant studies supporting a causal link between funding increases and improved outcomes for students.

Interestingly, these findings seem to hold even for high-spending school districts — meaning we aren't up against some limit where additional money brings diminishing returns, as you might fear in an already high-spending state like Massachusetts.

Note that this consensus among studies doesn't extend to all forms of education spending; for instance, expanding the ranks of university administrators is unlikely to have the same real-world effect as spending more on early education.

Looking at transportation and transit spending, however, the picture is different. There's little scholarly support for the familiar idea that increased spending can drive meaningful, long-term economic growth — despite the intuitive power of arguments that improved roads, buses, and subways would smooth the movement of people and goods, ease commutes, reduce traffic congestion, and make it easier for businesses and consumers to connect.

One problem is the high cost of US construction projects; another is the rigidity of built infrastructure, which may meet the needs of the moment but can't easily adapt to a changing environment (as we are witnessing with post-Covid transit ridership). For every example of a city like London, which is powered by effective transit, there are others like Chicago where long-term investments haven't translated into economic dynamism.

And while public transit investments would have other benefits, like reducing emissions that cause health problems and drive global warming, remember that millionaires tax revenue is also earmarked for transportation — which could mean more road-building and continuing car-dependency.[2]

As with so many issues tied to the millionaires tax, the biggest challenge in gauging impact is the uncertainty around the priorities of future legislators — and how much money will leak into other areas of the state budget by way of fungibility.

VOLATILITY OF MILLIONAIRES TAX REVENUE

To maintain vital programs over time, and plan for future needs, it's important for the state to have stable and predictable sources of revenue.

A millionaires tax isn't like that; it is extremely volatile, raising much more money in good economic times than in bad ones. And that's because it's pinned to sources of tax revenue that swing wildly during economic cycles, such as capital gains and business profits.

As an example, consider what would have happened during the budget crisis that accompanied the Great Recession of 2007-2009.

In those turbulent years, total earnings above the $1 million threshold fell by roughly 40 percent, and millionaires tax revenues would have dropped by a similar amount; by contrast, regular income tax receipts fell by a less-cataclysmic 17 percent in that same timeframe.

Solving this volatility issue is made more urgent by the fact that millionaires tax dollars are earmarked for core budgetary programs like education and transportation — rather than ancillary or "nice to have" projects.

A precipitous, recession-driven decline in millionaires tax revenues could generate sudden and significant shortfalls in some of these core programs, requiring some mix of spending cuts for schools, deferred investment in roads and transit, or the reallocation of money from other priorities.

Now, there are proven ways to deal with volatile revenue sources.

With capital gains revenues, for example, the state automatically sets some aside in boom years so it can draw on reserves in lean times.

In theory, this same approach could address volatility in the millionaires tax — ideally via a separate savings account, to ensure that millionaires tax dollars *eventually* flow to education and transportation. As yet, however, there's no plan for this.

RISKS OF CHANGING THE CONSTITUTION

Most ballot questions in Massachusetts are really just new laws, which the Legislature can amend or overrule as needed. But the millionaires tax proposal is something different: an amendment to the state constitution, which makes it much harder to adjust.

Because our constitution requires a flat income tax, the only way to introduce a new surtax on high earners is by changing the constitution. But being forced down the path of constitutional change does introduce some unique, though not unmanageable, challenges.

Most important is the risk of unintended consequences. If — for whatever reason — the millionaires tax doesn't work as expected, a full fix may require years, because changing the state constitution is a very involved process.

This isn't just theoretical, either. Policy changes sometimes have unintended results that require quick action.

- Last year, a package of changes to the unemployment insurance system overlooked a technical side-issue that created large bills for employers.
- At the federal level, Covid-era stimulus bills helped to trigger the current squall of inflation.

With the millionaires tax, there are a number of unlikely but potentially serious risks that might require speedy remediation.

For instance, what if the rise of remote and hybrid work has so thoroughly altered people's mobility that the tax drives an unexpectedly large number out of state? Or what if the tax ends up affecting small businesses more dramatically than anticipated? Or — pointing in the other direction — what if it raises far more money than estimated?

In each of these cases, there are steps the Legislature could take to limit impacts in the near term. Faced with an unexpected exodus, they might reduce short-term capital gains taxes; if small businesses are hurting, they could offer grants or loans; if revenues are far higher than expected, they could lower the overall income tax rate.

But what they can't quickly do is adjust the language of the millionaires tax or play with the 4 percent surtax rate; these will be fixed in the constitution until another amendment process can be completed.[3]

SLOW GROWTH OF MILLIONAIRES TAX BASE

The cutoff for the millionaires tax won't always be $1 million. Over time it will rise to account for inflation. So in 2024 it might apply to people earning over $1,040,000 and by 2050 it might apply to those earning over $2 million.

This is an important safeguard, ensuring that the millionaires tax remains limited to high-income residents. But the adjustment isn't quite fast enough to keep up with the pace of real-world income growth — particularly among high earners.

It's hard to make precise estimates, due to a lack of information about the full distribution of incomes in Massachusetts. But our rough calculations suggest that this risk is limited.

The number of people paying any millionaires tax would barely increase over the first decade — and even by 2083 it would still hit only about 2 percent of households.

To be sure, there are scenarios where the millionaires tax would affect many more families, particularly if the exclusion for capital gains on home sales isn't increased.

But this is not an issue likely to emerge suddenly or spread quickly, so lawmakers should have ample time to address it.

CONCLUSION

As we approach November, arguments about the millionaires tax are likely to get more heated, and debates more polarized. Our goal is to be a source for the best research and evidence.

In this analysis of divisive questions surrounding the millionaires tax, we've found that:

- Some millionaires tax revenue is likely to get diverted to other areas.
- Even limited spending increases in education could bring real benefits, potentially including greater racial and economic equity; the benefits of transit and transportation spending are less clear.
- Lawmakers will need to address the volatile nature of millionaires tax revenues.
- Enshrining this change in the state constitution will make it harder — but not impossible — to address unintended consequences.
- The number of people paying the millionaires tax is not likely to expand very quickly over time.

We at the Center for State Policy Analysis do not take a position on this question — or any ballot initiative — but we will continue to provide voters with the information they need to make informed choices about the future of our Commonwealth.

Contributors

In assembling this report, the Center for State Policy Analysis was aided by a number of experts in public finance and elsewhere. However, the final contents reflect our best judgment and are not necessarily endorsed by reviewers.

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Endnotes

[1] To avoid confusion, we've used our earlier estimate of $1.3 billion in expected millionaires tax revenue. But that's not really the best estimate for the amount of money subject to the spending requirements. Our $1.3 billion is a net figure, reflecting $1.8 billion in direct millionaires tax receipts against a loss of $500 million in income tax dollars as a result of tax avoidance and emigration.

[2] What does seem true is that transit and transportation can shape where economic activity occurs, even if it can't always drive economic growth. So millionaires tax revenue could still play a key role in shaping the economic geography of Massachusetts, including a potential impact on racial equity.

[3] It's quite unusual for a state constitution to set precise tax rates.