The Beacon Hill Institute

Earmarking Massachusetts State Income Tax Revenues

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April 25, 2022

*SUPPORTED BY A GRANT FROM THE FISCAL ALLIANCE FOUNDATION.

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EXECUTIVE SUMMARY

On November 8, 2022, Massachusetts voters will choose whether to amend the state constitution to adopt a graduated income tax. Under current law, the state imposes a flat rate of 5 percent on all taxable income. The amendment would impose a surtax of 4% on taxable income over $1 million.[1] If approved, the amendment would go into effect on January 1, 2023.

The amendment states that, upon its adoption, all revenue received "shall be expended, subject to appropriation," only on "quality public education and affordable public colleges and universities" and on "the repair and maintenance of roads, bridges, and public transportation." The following report argues that the amendment's promise to spend revenue raised by the surtax only on education and transportation is misleading.

The commitment to use revenue from a specific source for a specific purpose is known as "earmarking." In this instance, the ballot measure earmarks the revenue it yields for the two designated purposes — education and transportation. The question is what that means in terms of total state spending on those purposes. Without the amendment, BHI projects that the state will spend about $14.2 billion on education and transportation in 2023.[2] The state expects the tax to yield $1.9 billion in new revenue.[3] If the measure were to have

[1] "Massachusetts Income Tax for Education and Transportation Amendment (2022)", Ballotpedia, https://ballotpedia.org/Massachusetts_Income_Tax_for_Education_and_Transportation_Amendment_(2022), (Accessed March 29, 2022).
[2] United State Census Bureau, State & Local Government Finance Historical Datasets and Tables, https://www.census.gov/programs-surveys/gov-finances.html, (Accessed March 29, 2022).
[3] Nik DeCosta-Klipa, "The Massachusetts Millionaire's Tax is Back, and It's a Little Different This Time," (May 5, 2021), Boston.com, https://www.boston.com/news/politics/2021/05/05/massachusetts-millionaires-tax-ballot-question-2022/.

the promised effect, spending on the two targeted items would rise to $16.1 billion.

However, that will be true only if the $1.9 billion in new revenue is not offset by diverting existing revenue to other purposes. The state could apply every dollar raised by the new tax to education and transportation (broadly defined) and divert money already spent on those programs to other uses, with no increase — or perhaps even a decrease — in total current spending on the two promised uses. Indeed, the state could divert every dollar currently spent on education and transportation to other purposes and remain within the letter of the amendment if it spent the $1.9 billion, as promised, on education and transportation. This is owed to the "fungibility" of money. A dollar of earmarked revenue is no different from other revenue already being spent on the targeted programs. For the amendment to yield an increase of $1.9 billion in new spending on education and transportation, it would have to guarantee that its adoption would not reduce revenues currently allocated to those purposes. Otherwise, the earmark is an empty promise.

However, it is impossible to guarantee that revenue earmarked for a particular program will increase spending on that program by the amount of the earmarked revenue. This is important insofar as voters might support the amendment on the expectation that adoption of the amendment guarantees another $1.9 billion in education and transportation spending. If that is the basis of popular support, the earmark is a false promise.

The change in spending, if any, depends in part on the underlying motives of the government. One point of view is that earmarking permits the government to impose taxes as user fees to finance its expenditures. The gasoline tax and its use for highway financing are examples of this idea. Under this interpretation, there is no intention to deceive voters, however the earmark affects spending for the two purposes.

A competing point of view suggests that the government aims to raise as much tax revenue as possible, subject to its accountability to voters. This view is called the Leviathan hypothesis, after the dictator in Thomas Hobbes' treatise on government. Earmarks thus become a way to soften voter opposition to tax increases. Politicians promise to use the new revenue generated by a tax increase in some fashion that appeals to voters and then use the new revenue to divert existing revenue to other purposes. The legislature could take $1.9 billion in revenue currently used to pay for education and transportation and apply that revenue to, say, environmental purposes, simply replacing the diverted revenue with revenue yielded by the surtax. This is what the Leviathan hypothesis predicts.

The user fee view is reflected in Article 78 of the Massachusetts Constitution, under which

> No revenue from fees, duties, excises or license taxes relating to registration, operation or use of vehicle on public highways, or to fuels used for propelling such vehicles, shall be expended for other than cost of administration of laws providing for such revenue, making of refunds and adjustments in relation thereto, payment of highway obligations, or cost of construction, reconstruction, maintenance and repair of public highways and bridges, and mass transportation lines and of the enforcement of state traffic laws, and for other mass transportation purposes; and such revenue shall be expended by the commonwealth or its counties, cities and towns for said highway and mass transportation purposes only and in such manner as the general court may direct; provided, that this amendment shall not apply to revenue from any excise tax imposed in lieu of local property taxes for the privilege of registering such vehicles.

According to the federal publication *Highway Statistics,* Massachusetts user fees subject to Article 78 account for 43.7 percent of Massachusetts highway revenues.[4] On the other hand, Massachusetts education spending is financed almost entirely from general revenues collected at the state and local levels. There is virtually no opportunity to impose a tax earmarked for education as a user fee.

The amendment in question does not impose a user fee on either education or transportation. General revenues earmarked for any kind of spending cannot be seen as a user fee since there is no link between the source of the revenue and the benefits in the form of education or highway maintenance. Therefore, the proposed Constitutional amendment cannot be seen as imposing a fee for educational and highway services. It can be seen only as intended to increase spending on those services.

In this study, we discuss the case of earmarked tax revenue from the cigarette tax in Massachusetts and the state's failure to uphold its promises for designated spending contained in the original ballot initiative. We also review the findings of other studies that have attempted to determine whether earmarks increase spending on targeted programs or, instead, operate mainly to expand government. The results on the state's misuse of tobacco tax funds support the Leviathan hypothesis and provide a cautionary tale for voters contemplating the fall 2022 ballot measure.

[4] Federal Highway Administration, Policy and Governmental Affairs Office of Highway Policy Information, Highway Statistics Series, https://www.fhwa.dot.gov/policyinformation/hss/guide/index.cfm, (Accessed March 29, 2022).

INTRODUCTION

The Commonwealth of Massachusetts has been prohibited from imposing a graduated income tax since 1915, when the Constitution was amended to permit the taxation of income but only at a flat rate. Since 1962, there have been six attempts to amend the Constitution to institute a graduated rate – all failing. The latest and 7th attempt has been filed as Senate Bill (S.B.) 5.

On April 28, 2021, the Massachusetts Senate referred S.B. 5 to the General Court for consideration.[5] The bill would increase the tax rate on income exceeding $1 million from 5 percent to 9 percent. It specifies that all revenues received from the imposition of the new tax would be used "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." If voters approve the measure in 2022, it will become law in January 2023.

In a complaint filed before the state Supreme Judicial Court in 2021, Christopher Anderson of the Massachusetts High Tech Council argues that the earmarking provision of the amendment is a false promise. The authors of S.B. 5 want voters to believe that, under the amendment, state funding of education and transportation will increase by the amount of revenue raised by the tax. The complaint asserts there is no guarantee of that outcome.

The reason is that the legislature would retain ultimate discretion over spending choices. Because the proposed amendment does not require otherwise, the legislature could choose to reduce funding in specified budget categories from other sources and replace it with the new surtax revenue. The amendment

[5] 192nd General Court of the Commonwealth of Massachusetts, "Proposal for Constitutional Amendment S.5," https://malegislature.gov/Bills/192/S5, (Accessed March 29, 2022).

guarantees only that the total spending in these combined categories will not fall below the revenue generated by the surtax.

S.B. 5 is the successor to an earlier, similar measure advanced as a citizen's initiative petition and slated to appear on the 2018 ballot. However, this measure failed when the Massachusetts Supreme Judicial Court ruled that it violated a feature of the citizens' initiative process that requires ballot questions to include only subjects that are "related" or "mutually dependent." The inclusion of two unrelated spending provisions – one on schools and the other on transportation – proved fatal.

While it is unlikely that education and transportation spending will fall to the bare minimum, voters need to know what to expect under the amendment. Our purpose is to show what the evidence says about how the amendment would affect education and transportation spending. Will it bring about a rise in that spending or not?

THE BENEFITS THEORY OF TAXATION

The benefits theory of taxation (or the benefits principle) holds that people should pay for their benefits from government services just as they pay for the benefits from private services.[6] Payment for government services can, for example, take the form of a gas tax, which people pay to maintain the roads on which they drive. This is akin to what they pay for gasoline so they can drive. In contrast, a tax on income does not impinge on driving at all, so it cannot be seen as a user fee for road usage – even if it is earmarked for transportation.

[6] Ira K. Lindsay, 'Benefits Theories of Tax Fairness," in *Studies in Tax Law History* 9, Peter Harris & Dominic de Cogan, eds., (Hart Publishing, 2019), https://ssrn.com/abstract=3548057

THE CASE OF THE TOBACCO TAX

In 1992, Massachusetts passed a ballot initiative that imposed an additional excise tax of 25 cents on a pack of cigarettes.[7] The Act established by the passage of the ballot initiative also created the Health Protection Fund. According to Section 2T of the Act,

> there shall be credited to said Fund all amounts collected pursuant to section seven of chapter sixty-four C, together with any penalties, forfeitures, interest, costs of suits and fines collected in connection therewith, less all amounts refunded or abated in connection therewith, all as determined by the commissioner of revenue according to his best information and belief; any appropriation, grant, gift, or other contribution explicitly made to said Fund; and any income derived from the investment of amounts credited to said Fund.

The Health Protection Fund would then be applied to several health-related purposes. These include:

(1) School health education programs;

(2) Smoking prevention and cessation programs;

(3) Support for prenatal and maternal care programs at community health centers; and

(4) Ongoing activities related to morbidity and mortality resulting from cancer and tobacco-related illnesses.

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[7] Secretary of State, Commonwealth of Massachusetts, *Public Document 43, Massachusetts Election Statistics 1992*, https://archive.org/details/massachusettsele1992mass/page/516/mode/2up?view=theater, (Accessed March 29, 2022).

However, in 2003, Section 2T, which maintained that the funds deriving from the tobacco tax be directed towards the Health Protection Fund, was repealed.[8] Therefore, the funds have not been used as the 1992 ballot initiative promised. The repeal of Section 2T demonstrates the ease with which an earmarked tax can be diverted from its intended purpose.

BHI compiled annual data from the Massachusetts final state budget on spending allocated for smoking prevention and cessation from FY 2012 to FY 2021.[9] See Table 1, column (B). We also collected data on annual tobacco tax revenues from the Massachusetts Department of Revenue over the same period (column C).[10] We then estimated the amount of tobacco tax revenue that should have been dedicated to the Health Protection Fund under the original ballot initiative (column D). Finally, we estimated the revenue budgeted for smoking prevention and cessation programs as a fraction of the revenue that should have gone to the Health Protection Fund (column E = column B/column D).

[8] Massachusetts General Laws, Chapter 29, Section 2T, https://malegislature.gov/Laws/GeneralLaws/PartI/TitleIII/Chapter29/Section2T, (Accessed March 29, 2022).
[9] 192nd General Court of the Commonwealth of Massachusetts, "Final Budget," https://malegislature.gov/Budget/FinalBudget, (Accessed March 29, 2022).
[10] Massachusetts Department of Revenue, Blue Book Reports, https://www.mass.gov/lists/blue-book-reports-department-of-revenue, (Accessed March 29, 2022).

Table 1: Ratio of Budgeted Funds for Smoking Prevention and Cessation to Cigarette Tax Revenue

(A) Fiscal Year (FY)	(B) Budgeted Funds ($, millions)	(C) Cigarette Tax Revenue ($, millions)	(D) Estimated Revenue Allocated for the Health Protection Fund ($, millions)	(E) % Of Budgeted Funds to Estimated Revenue (B/D)
FY 2012	4.15	451.00	32.12	12.92%
FY 2013	4.15	440.08	31.34	13.25%
FY 2014	3.97	520.67	37.08	10.71%
FY 2015	3.87	510.27	36.34	10.64%
FY 2016	3.87	505.56	36.01	10.74%
FY 2017	3.87	490.31	34.92	11.07%
FY 2018	3.72	471.25	33.56	11.08%
FY 2019	4.22	439.82	31.33	13.47%
FY 2020	4.62	416.26	29.65	15.58%
FY 2021	5.12	315.85	22.50	22.75%

In FY 2012, budgeted funds for smoking prevention and cessation in the Massachusetts final budget totaled $4.15 million. BHI estimates that funds dedicated to the Health Protection Fund should have been $32.12 million in FY 2012, as promised by the ballot initiative. Budgeted funds for smoking prevention and cessation were thus only 12.92 percent of the funds owed to the Health Protection Fund. In FY 2021, budgeted funds for smoking prevention and cessation totaled $5.12 million, while cigarette tax revenue totaled $315.85 million. BHI estimates that funds dedicated to the Health Protection Fund should have been $22.50 million in FY 2021. Budgeted funds for smoking prevention and cessation thus came to only 22.75 percent of the funds promised by the ballot initiative. Funds allocated to smoking prevention and cessation have fallen far short of the funds pledged for that purpose.

Wendy A. Ritch and Michael E. Begay reviewed the appropriations process on the Question 1 ballot initiative, which enacted a 25 cents per pack tax.[11] The authors found that only 23 percent of the funds were spent on tobacco education, prevention, and cessation services. Moreover, they also found that earmarked funds were used to supplant funding for pre-existing programs, contrary to voter intent. Ritch and Begay note "that politics did not end after Question 1 was adopted."[12]

Despite the overwhelming momentum for earmarking revenues, advocates of Question 1 in 1993 failed to prevent the legislature from allocating resources to other programs, some loosely related to public health but clearly beyond the scope of the ballot initiative. These include programs for law enforcement, drug abuse prevention, and programs associated with AIDS and breast cancer, none of which were specified by the initiative nor related to tobacco control. Advocates for social and health care spending also saw opportunities to link their interests to tobacco control. At the time, Senator Henri Rauschenbach was reportedly convinced by activists of a link between smoking and HIV infection.[13]

In the end, supporters of the initiative found they had to remind the legislature that opponents of Question 1, namely the tobacco industry, attempted to warn

[11] Wendy A. Ritch and Michael E. Begay, "Smoke and mirrors: how Massachusetts diverted millions in tobacco tax revenues," *Journal of Epidemiology and Community Health* 56, no. 7 (July 2002): 522-528.
[12] Ibid, 11.
[13] Ibid, 11.

voters that "money would not be spent for anti-smoking programs, it could be used for other things." Nonetheless, revenue from Question 1 had hardly any association with tobacco and has been directed toward "non-tobacco related health programs such as indigent health-care, prenatal services, and hospital emergency room support." Ironically, the tobacco industry made sure to drill home a point in which they failed to sway voters.[14]

The prerogatives of the legislature remained tantamount. "The fact that the legislature supplanted, not supplemented, General funds with Question 1 funds for non-initiative programs did not appear to concern most legislators or the directors of most recipient programs.

Ritch and Begay note that approximately $80 million of Question 1 funds were appropriated for non-initiative programs in the first year of its existence. Another $60 million collected were used to "supplant General funds for pre-existing programs, which was prohibited by the language of the initiative."[15]

PAST RESEARCH ON EARMARKS

Because earmarking is an essential feature of government finance, economists have attempted to show how earmarks affect spending on targeted activities.

George R. Crowley and Adam J. Hoffer set out to determine how education and transportation spending responds to earmarked taxes.[16] The study estimates how

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[14] Ibid, 11.

[15] Ibid, 11.

[16] George R. Crowley, Adam J. Hoffer, "Earmarking Tax Revenues: Leviathan's Secret Weapon?" (January 3, 2018). Excerpt from Adam J. Hoffer and Todd Nesbit, eds., *For Your Own Good: Taxes, Paternalism, and Fiscal Discrimination in the Twenty-First Century*. Arlington, VA: Mercatus Center at George Mason University, 2018., Mercatus Research Paper, Available at SSRN: https://ssrn.com/abstract=3171202.

a dollar of revenue raised by sales taxes, personal income taxes, and corporate income taxes affects education spending. The authors find that a dollar of sales tax revenue earmarked for education does not increase education spending. Instead, it offers a strong positive effect on non-education spending — which supports the Leviathan hypothesis. Corporate income tax revenue earmarked for education has a strong negative impact on education spending. On the other hand, a dollar of earmarked personal income tax revenue increases education spending by $.56 to $.76 per capita.   The conclusion is that, under the proposed surtax, at most, $.76 of every dollar of new revenue appropriated for education would go to education, and the rest will go to other purposes.

Spending of surtax revenues on highways is harder to predict. We have noted the importance of user fees like the gasoline tax to highway financing.

Richard F. Dye and Therese J. McGuire examined the impact of earmarked revenues on the level and composition of state spending.[17] Specifically, they looked at the effect of earmarked revenues on elementary and secondary education expenditures, highway expenditures, and non-school local government expenditures. Dye and McGuire found that "an extra dollar of earmarked revenues results in either no change in expenditures or in increases in expenditures that are much smaller than a dollar." In addition, they found that a "greater reliance" on the share of earmarked expenditures leads to no change and sometimes even lower spending.

[17] Richard F. Dye, Therese J. McGuire, "The Effect of Earmarked Revenues on the Level and Composition of Expenditures", *Public Finance Quarterly* 20, no. 4 (October 1, 1992). https://journals.sagepub.com/doi/abs/10.1177/109114219202000410.

Calvin Blackwell, John C. Crotts, Stephen W. Litvin, and Alan K. Styles examined local government spending of accommodations tax revenues in South Carolina.[18] The authors found that local governments engaged in illegal fiscal substitution. The classification of expenditures as "tourism related" allowed local governments to use the "accommodations tax special fund" to free up finances in the general fund for other spending. The authors found significant levels of non-compliance with earmarks for approximately 70.1 percent of the investigated items. In South Carolina, the state legislature dictates the rules on how earmarked taxes are spent while the local governments distribute the money. Since the preferences of the two different-level governments did not coincide, taxes were not spent as intended.

Thomas P. Lauth and Mark D. Robbins studied the use of lottery proceeds for funding public education in Georgia, focusing on the state's effort to safeguard against the fungibility of lottery funds.[19] The authors used several measures when investigating the substitution of lottery revenues for other revenue sources: (1) gross spending in the target areas, (2) the percentage of state expenditures in the target areas, (3) the post-lottery expenditure share index excluding lottery revenue, and (4) the post-lottery expenditure share index including lottery revenue.

After comparing the spending before and after the lottery was put into effect, they concluded that the lottery stimulated additional spending in the target

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[18] Calvin Blackwell, John C, Crotts, Stephen W. Litvin, Alan K. Styles, "Local Government Compliance with Earmarked Tax," *Public Finance Review* 34, no. 2, (March 2006): 212-228, https://doi.org/10.1177/1091142105284213.

[19] Thomas P. Lauth, Mark D. Robbins, "The Georgia Lottery and State Appropriations for Education: Substitution or Additional Funding?" *Public Budgeting & Finance* 22, no. 3, (January 2002): 89-100.

areas. According to Lauth and Robbins, budget fungibility in Georgia has been constrained by the transparency of the budget and appropriations process.

William N. Evans and Ping Zhang analyzed the impact of lottery revenue on K-12 educational spending.[20] They showed, with high probability, that one dollar of earmarked lottery funds generated more spending on K-12 schools than the spending generated from a dollar of lottery profits directed into the general fund. They found that around 50-70 percent of the earmarked lottery profits are allocated to local school districts at the state level and that 80 percent of the distributed profits are spent on public schools.

However, they found that a significant fraction of the lottery revenues earmarked for K–12 education is fungible. They found, with a high probability, that a dollar of earmarked lottery revenues generates less than a dollar of spending on K–12 education.

In a policy brief from 2015, the Minnesota House of Representatives outlined several disadvantages of earmarking taxes.[21] The first argument against earmarking tax revenues is related to budgetary inflexibility. For example, even if the legislature decided that less should be spent on a program, the Minnesota Constitution requires that expenditures cannot be less than earmarked revenues. Second, earmarking revenues can lead to both manipulation and compliance issues. For example, in 1989, the Minnesota state legislature diverted lottery revenues allocated for the environment and natural resources trust fund to the

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[20] William N. Evans and Ping Zhang, "The Impact of Earmarked Lottery Revenue on K–12 Educational Expenditures," *Education Finance and Policy* 2, no. 1, (December 2007): 40-73, https://doi.org/10.1162/edfp.2007.2.1.40

[21] Joel Michael, Minnesota House of Representatives, Research Department, "Earmarking State Tax Revenues," Policy Brief, (August 2015), https://www.house.leg.state.mn.us/hrd/pubs/earmarking.pdf.

general fund. The brief also found that the legislature, at any time, could redefine tax bases, substitute taxes, or make changes in tax law to avoid or minimize the effectiveness of earmarks. Third, the brief found that earmarking revenues can complicate tax policy changes. Earmarking taxes could "make it more difficult (or easier) to "reform a tax by expanding or contracting the tax base and/or changing the rates." Finally, the brief found that earmarking taxes leads to an increase in tax administration and compliance costs. Earmarking requires the tracking and accounting of expenditures and revenues, thereby creating an additional cost. The brief found that earmarked taxes can also create additional tax compliance costs for private taxpayers.

Phuong Nguyen-Hoang evaluated the volatility of earmarked revenues and state highway expenditures in the United States.[22] The author found that earmarked highway revenues and highway expenditures are highly sensitive to economic downturns: A one percent decrease in earmarked revenues is associated with a .24 to .32 percent decrease in state highway expenditures. According to the author, "an increase in positive earmarked revenue deviation from trend is not associated with a rise in highway expenditures." The author attributed this finding to the fungibility of highway funds diverted to other uses.

CONCLUSION

Should voters support the surtax amendment with the expectation of additional spending on transportation and education, they must be aware that the spending promised by the ballot initiative may not be forthcoming. The cigarette tax in

[22] Phuong Nguyen-Hoang. Volatile Earmarked Revenues and State Highway Expenditures in the United States," *Transportation* 42, no. 2, (December 2015): 237-256.

Massachusetts is an example where the state has failed to deliver on the promises made by the ballot initiative. The original intent was to use cigarette tax funds for the purpose of financing programs that provided education on smoking prevention and cessation. However, funds from the cigarette tax have only minimally gone to their intended purpose. It is a crucial example of how earmarked spending for a designated purpose can fail to meet voters' wishes.

The earmarking of revenues from an income tax risks the potential of underfunding programs, especially during an economic downturn. Earmarking revenues from state income taxes through a Constitutional amendment is not a reliable path to increased spending on education and transportation.

Voters must understand the downside of designated spending from income tax funds when voting on the millionaires' tax. The evidence outlined in this study suggests that spending on education and transportation may not rise with the revenue raised by the millionaires' tax.

* The authors would like to thank Dinmukhamed Alchinbayev and Manal Mounji for their assistance.

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