Testimony to the Revenue Committee on Proposed Constitutional Amendment 15-17

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Thank you for the opportunity to testify on the proposed constitutional amendment to create a graduated income tax for Massachusetts. The Beacon Hill Institute has a long history of providing analysis of state tax policy issues, not just for Massachusetts but for most other states as well. We are pleased to report the results of our analysis of this measure.

The amendment would add four percentage points to the tax rate applicable to filers whose taxable income is $1,000,000 or more. It would go in effect on January 1, 2019 and would be indexed for inflation. Applied to 2015 tax returns, it would have raised the tax on these filers from 5.15 percent to 9.15 percent. The amendment specifies that the revenue it raises will be applied to "quality education and affordable universities, and for the repair and maintenance of roads, bridges and public transportation."

Our analysis argues against adoption of the amendment. We find that the amendment would cause the loss of 9,500 private sector jobs and $1 billion annually in personal disposable income. It will raise about $1.5 billion in new revenue, far less than the approximately $2 billion predicted by some proponents. Furthermore, it will set the stage for future, even more damaging tax increases and resulting economic losses. Perhaps most troublesome is the fact that, as written, the amendment attempts to perpetrate a fraud: Because tax revenues are fungible, it is impossible to honor a promise that the new revenues raised by this measure will be spent for any set of enumerated purposes.

Let me offer a few comments about the general task of applying economic analysis to tax-rate changes. Whatever you hear on this matter from my fellow academics testifying here, it is important for you to know that *every* textbook on tax policy, from Econ 101 to the most advanced PhD courses, recognizes that tax-rate increases have negative effects on economic activity. The question is not whether they will have negative effects but how big those effects will be. The reason is that any rise in a statutory tax rate will raise the marginal tax rate paid by the person being taxed, that is the tax he or she pays on the next dollar of income. This proposal almost doubles the tax on the next dollar of income above $1 million.

Proponents of tax increases would have you hear none of this. It will be all about making the filthy rich Tom Bradys of the world pay their fair share (though one of my students has suggested that, out of gratitude, the government should cut Tom Brady's taxes to zero). But anecdotes are no substitute for hard analysis.

In the case of the personal income tax, the negative effects stemming from a rate increase flow through three channels. First, the higher tax causes a rise in the cost of labor and thus a reduction in the amount of labor firms want to hire and the post-tax wages they are willing to pay. Second, because it falls on business profits as well as labor income, the tax reduces the funds available to a business for expanding plant and equipment, with further negative effects on wages and employment. Third, the higher rate creates an incentive to move business capital to lower-tax states.

Consider the decision by General Electric to move its headquarters from Connecticut to Massachusetts. Had that move taken place last year, a GE executive who had $2 million in taxable income (married, filing jointly) would have had to pay $9,000 more in state income taxes by moving his residence from Connecticut to Massachusetts – an amount that would have made the move to Massachusetts look less attractive.

And what about small business? Proprietors and recipients of partnership income and S-Corp distributions pay personal taxes on their profits and dividends. Business income is not used just to pay for country club memberships and purchases at Tiffany's, but also provides the source of financial capital from which new investments are made. Fifteen percent of all Massachusetts filers reported business income on their 2013 federal tax returns. Sixty-two percent of S-Corp. and partnership income was received by filers with $1 million or more in income. These business have less to invest as their income taxes rise. A business could plan to put its entire $2,000,000 in profits back into its Massachusetts based firm. This measure will leave it with $40,000 less in funds to use for that purpose. Also, a graduated tax punishes businesses that are willing to go for years making low profits only to find themselves in a higher tax bracket when they finally do become more profitable.

Not long ago, the state of Maryland, in its own "soak-the-rich" plan, raised its top tax rate to 6.25 percent from 4.75 percent. The governor said the plan would raise $106 million. It did no such thing. Rather, the number of tax returns filed by millionaires fell sharply to 5,529 from 7,898, a decline of 30 percent, resulting in a loss of $257 million in revenue. No doubt some of this was due to deaths and the recession, but it's also clear that a number of filers simply moved away. Millionaires have a way of going mobile. New Hampshire is just a short drive up Interstate 93.

Is this amendment a solution to the problem of income inequality? Apparently not. According to the Tax Foundation, "Inequality varies little between states, and states with highly progressive income taxes are actually associated with higher inequality."

Massachusetts can avoid raising taxes by cutting costs. It can eliminate the film tax credit and other corporate subsidies. If it wants to improve infrastructure, it can eliminate the prevailing wage as it applies to state projects and stop entering into project labor agreements. It can repeal the Pacheco Law.

Massachusetts came to be labeled Taxachusetts when, at an earlier time, it became undisciplined about raising taxes. Then it redeemed itself with a series of tax cuts, culminating in the 2000 ballot measure to cut the income tax to 5 percent. It is only now approaching that target after having halted progress in 2002.

Some will argue that it is no big deal to tax more heavily the handful of taxpayers whose annual income exceeds $1 million. But this is facile thinking. Once the tax code becomes divided between two brackets, there will be a clamor for creating new brackets and making the code more and more progressive. After all, there are twice as many taxpayers who make between $500,000 and $1 million as there are who make more than a million. And almost 40 times as many who make between $100,000 and $200,000. What's to stop the forces at work here from chipping away at those income groups once the state constitution is amended?

My advice to the legislature is to walk away from this idea. Send a message that Taxachusetts exists no more and that the legislature intends to keep it that way.