PIONEER OPPORTUNITY

A Grim Distinction

Massachusetts would have top marginal short-term capital gains tax rate in the U.S. under the proposed graduated income tax

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Note: *Pioneer Institute questions the legality of the view held by amendment proponents and the Massachusetts Department of Revenue that the amendment should be interpreted as applying to income from short-term and long-term capital gains. We believe that the proposed amendment is poorly worded and should be revised before any further action is taken. However, in this paper we present an analysis based on DOR's initial interpretation.*

Introduction

The graduated income tax proposal would create a 4 percent surtax on personal annual income over $1 million on top of the current state income tax rate of 5 percent for all filers. For filers who have total income over $1 million and short-term capital gains, the amount representing short-term capital gains in excess of total income would effectively be taxed at 16 percent rather than at the current rate of 12 percent, giving Massachusetts the highest short-term capital gains rate in the country. Meanwhile, Massachusetts' long-term capital gains tax rate would be the highest in New England.[1] This could be especially damaging to the Commonwealth's financial services industry, a major employer in the state and ultimately a driver of economic activity in many other economic sectors.

What is the Graduated Income Tax?

For the past several years, Massachusetts has been considering a state constitutional amendment that would levy a 4 percent surtax on annual personal income over $1 million. The first attempt to do so, filed by initiative petition, failed a Massachusetts Supreme Judicial Court challenge in 2018 before re-emerging as a legislative petition and receiving initial approval at a constitutional convention in 2019. A vote on final approval by the legislature is expected in the spring of 2021. If passed, it will appear on the statewide ballot in the fall of 2022.

Proponents of the amendment, led by the Massachusetts Teachers Association and the Service Employees International Union, together with advocacy and religious groups, call it the "Fair Share Amendment," a nod to their frequent assertions that the measure would require only the very wealthy to pay what proponents believe is their "fair share" of taxes.

Opponents argue that it would endanger the long-term economic well-being of Massachusetts by prompting high-income residents and businesses to relocate to states that have lower income tax rates and discouraging high-income individuals and businesses from coming to Massachusetts in the first place. They believe that COVID-19 may exacerbate these relocation effects, as the pandemic has made telecommuting much more prevalent, at least in the short term.[2]

Curbing Investment, Squandering Opportunity

If approved, the initiative would have an outsized impact on capital gains taxes, hiking the state's top marginal rate on short-term capital gains to the highest in the nation, surpassing California (see Figure 1).

Research shows that higher taxes on capital gains hamper investment, reduce productivity, and ultimately slow down wage growth.[3] A study by Nobel laureate Robert Lucas estimates that if the U.S. eliminated its capital gains and dividend taxes, the capital stock of American plants and equipment would be 50 percent larger.[4] Further, Massachusetts is already considered one of the least appealing states in the country for day trading, as it is the only state that taxes short-term capital gains at a consistently higher rate than long-term capital gains.[5]

The initiative would have an outsized impact on capital gains taxes, hiking the state's top marginal rate on short-term capital gains to the highest in the nation

Ultimately, these impacts to the financial services industry have broad economic consequences. The Massachusetts Technology Collaborative has made it clear that venture capital has been a crucial enabler of the recent growth in small tech and healthcare startups in Massachusetts.[6] In 2018 alone, private equity firms invested over $10.4 billion in innovative Massachusetts companies, constituting almost 2 percent of the state's GDP that year.[7] Research has shown that one new "high-tech" job supports the creation of as many as five others, including low-skill service sector positions.[8] Thus, in hurting the investors underpinning much of the innovation economy, a higher capital gains tax rate in Massachusetts could result in a significantly slower recovery from COVID-19 than in a stable tax scenario.

Unlike capital gains' treatment in the federal tax code, capital gains can push a Massachusetts taxpayer into the higher state tax bracket

Figure 1. Top Marginal short-term Capital Gains Tax Rate by State, 2015[9]

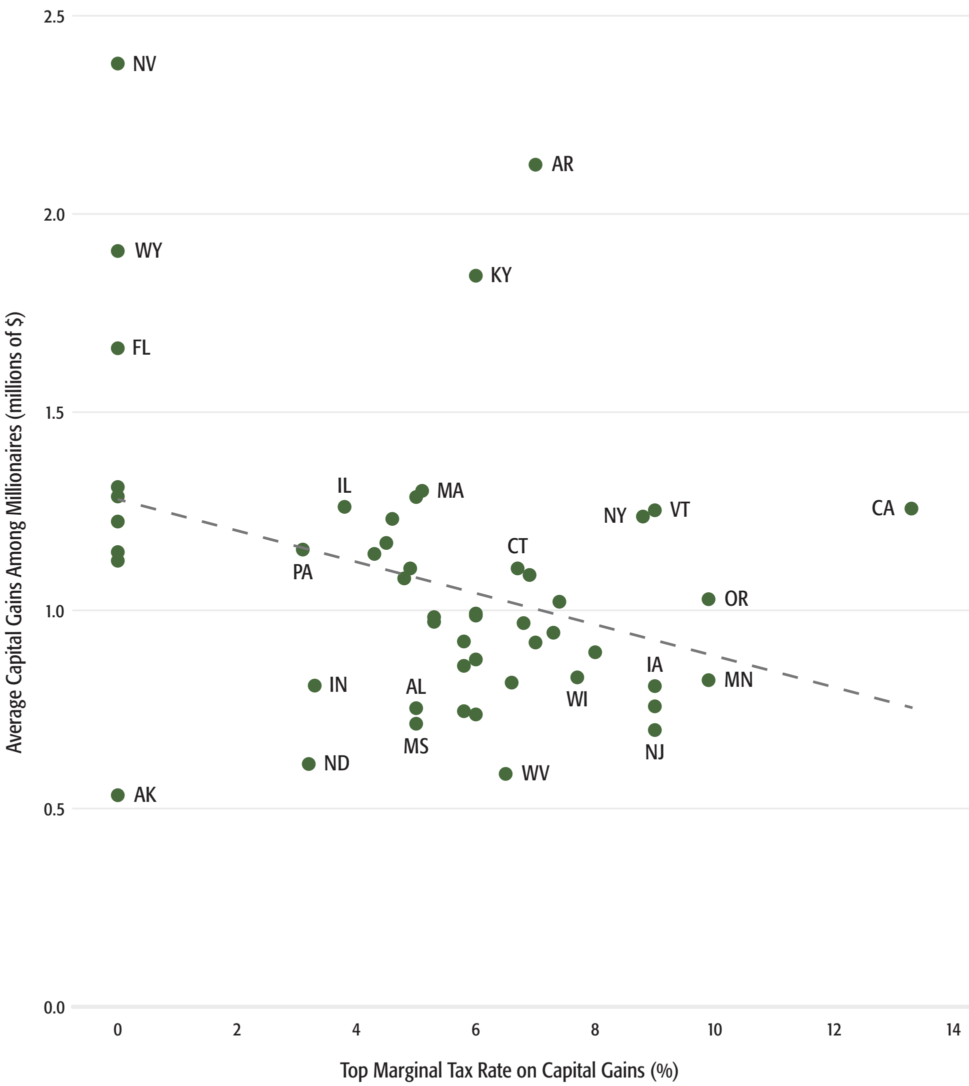
State	State rate	State	State rate
Massachusetts (if GIT passes)	16.0%	Oklahoma	5.3%
California	13.3%	Mississippi	5.0%
Massachusetts (current)	12.0%	Utah	5.0%
New York	8.8%	Montana	6.9%
Oregon	9.9%	Louisiana	6.0%
Minnesota	9.9%	Kansas	4.8%
New Jersey	9.0%	Arkansas	7.0%
Vermont	9.0%	Colorado	4.6%
Washington, D.C.	9.0%	Indiana	3.3%
Maryland	5.8%	Arizona	4.5%
Maine	8.0%	Michigan	4.3%
Iowa	9.0%	Alabama	5.0%
Hawaii	7.3%	South Carolina	7.0%
Idaho	7.4%	Illinois	3.8%
Nebraska	6.8%	Pennsylvania	3.1%
Connecticut	6.7%	New Mexico	4.9%
Delaware	6.6%	North Dakota	3.2%
West Virginia	6.5%	Alaska	0.0%
Rhode Island	6.0%	Florida	0.0%
Georgia	6.0%	Nevada	0.0%
Missouri	6.0%	New Hampshire	0.0%
Kentucky	6.0%	South Dakota	0.0%
Virginia	5.8%	Tennessee	0.0%
North Carolina	5.8%	Texas	0.0%
Ohio	5.3%	Washington	0.0%
Wisconsin	7.7%	Wyoming	0.0%

An important factor in the potential impact of the surtax is its treatment of capital gains on par with earned income. The Internal Revenue Service (IRS) essentially treats capital gains as separate from income taxes in that capital gains income cannot push a taxpayer into a higher income tax bracket. But the graduated income tax would apply a 4 percent surtax to all annual income over $1 million, including income from capital gains. Unlike capital gains' treatment in the federal tax code, capital gains can push a Massachusetts taxpayer into the higher state tax bracket. For venture capitalists and other investors, this fact is a powerful disincentive to invest in startups or other business activity in Massachusetts.

For a tangible example of how higher tax rates make a place less appealing for investors, see the IRS's 2018 SOI (Statistics of Income) database, which include federal capital gains income reported by taxpayers with incomes of $1 million or more.[10] In 2018, eight of the nine states with no personal income tax had higher than average capital gains among millionaires (see Figure 2). Notably, none of the states considered to be national centers of finance, insurance, and industry, like New York, New Jersey, California, Massachusetts, and Connecticut, are in the top tier for capital gains averages. Instead, most of the states with the top capital gains averages among the wealthy, including Nevada, Florida, and Wyoming, have no capital gains taxes. Such evidence seems to make a common-sense case for the argument that taxpayers do in fact take state tax rates into consideration when deciding where to take capital gains income.

Most of the states with the top capital gains averages among the wealthy are not national centers of finance, but instead merely have low capital gains taxes

Figure 2: Correlation Between Average Capital Gains of High Income Earners and Top Marginal Capital Gains Tax Rate by State, 2018[11]



Conclusion

Raising taxes on capital gains via a graduated income tax could devastate the financial services industry in Boston, which has played a key role in fueling the region's innovation economy, as reflected in the numerous tech start-ups in Kendall Square and the Seaport District. Not only does Greater Boston's financial services industry catalyze job creation in other sectors, but it also employs some 147,000 people itself as of 2019, making up 77 percent of total state financial services employment.[12]

Raising taxes on capital gains via a graduated income tax could devastate the financial services industry in Boston

Under a graduated income tax, Massachusetts' top marginal short-term capital gains tax rate would be the highest in the nation, exacerbating a tax and regulatory environment that has made it hard for day traders and other investors to contribute to Massachusetts' economy. By imposing a 4 percent income on all annual income over $1 million, including capital gains, the graduated income tax would penalize the capital formation that is the key to long-term growth and higher living standards for all in the Commonwealth.

Endnotes

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