PIONEER OPPORTUNITY

A Timely Tax Cut:

How New Hampshire is Taking Advantage of Massachusetts' Graduated Income Tax Proposal

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WHITE PAPER

No. 238 | October 2021

PIONEER INSTITUTE
PUBLIC POLICY RESEARCH

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Introduction

As Massachusetts voters weigh an amendment to the state constitution to enact a surtax on million-dollar earners, they should be cognizant of how the policies of other states could interact with the tax hike to encourage an exodus of jobs and capital. This is especially true when those policies occur in proximate jurisdictions. New Hampshire is a neighboring state that has already benefited from out-migration from Massachusetts to the tune of over $426 million in taxable income in 2019 alone.[1]

New Hampshire is, by most measures, a low-tax state, increasing its appeal as a destination for domestic migrants.[2] Despite having no tax on personal earned income, it has a 5 percent tax rate on interest and dividends. However, a new budget amendment, passed in July 2021, will eliminate the interest and dividends tax by 2027, contributing to a divergence in tax policy between New Hampshire and many of its neighbors that proponents say would help "attract an increasingly mobile workforce and entrepreneurial base."[3]

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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. The state legislature granted final approval in June 2021, and the proposal 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 COVID-19 may exacerbate these relocation effects, as the pandemic has made telecommuting much more prevalent, at least in the short term.[4]

Diverging Paths on Tax Policy

As New Hampshire's tax cut is implemented, the timing couldn't be worse for Massachusetts, which has already seen increased vulnerability to an exodus of workers and businesses as a result of the work-from-home phenomenon during the COVID-19 pandemic.[5] New Hampshire's tax cut, combined with a mirroring income tax hike in Massachusetts, could accelerate the long-standing trend of income and capital flowing from Massachusetts to less expensive states.[6]

The combination of the graduated income tax and New Hampshire's fiscal belt-tightening seems particularly poised to lure financial services jobs out of the state, given that Massachusetts' surtax would apply to capital gains and New Hampshire's tax cut applies solely to interest and dividends. In turn, the financial services industry is a crucial backer of high-tech startups that have turbo-charged the Bay State's innovation economy in recent years while also creating demand for low-skill service jobs that benefit workers of all stripes.[7]

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This economic misstep is not just theoretical. A divergence in income tax rates between Massachusetts and its competitor states seems to have accelerated the direction of capital flows in recent years. A notable example is Connecticut, whose top marginal income tax rate increased from 4.5 percent in 2003 to 6.99 percent in 2018, even while Massachusetts's top rate decreased from 5.6 to 5.1 percent over the same period.[8] Overall, Connecticut personal income tax hikes have taken effect in 2004, 2009, 2012, and 2016. Massachusetts personal income tax cuts have taken effect in 2004, 2012, 2014, 2016, 2019, and 2020.[9]

At the same time, taxpayers migrating between Connecticut and Massachusetts brought increasing amounts of wealth to the Bay State. As shown in Figure 1, by 2019, households that moved from Connecticut to Massachusetts made nearly $195 million more in adjusted gross income (AGI) than households that moved from Massachusetts to Connecticut that same year. As recently as 2004, interstate migration between Connecticut and its northern neighbor brought more net wealth to Connecticut.

This reversal in fortune for the Constitution State provides a compelling explanation for Connecticut's perennial budget deficits: even as tax rates were increasing, the amount of taxable income was growing slowly due to out-migration. This fact is, in turn, reflected in state coffers: between fiscal years 2008 and 2020, the state budget grew by 63 percent in Massachusetts, and just 22 percent in Connecticut.[10]

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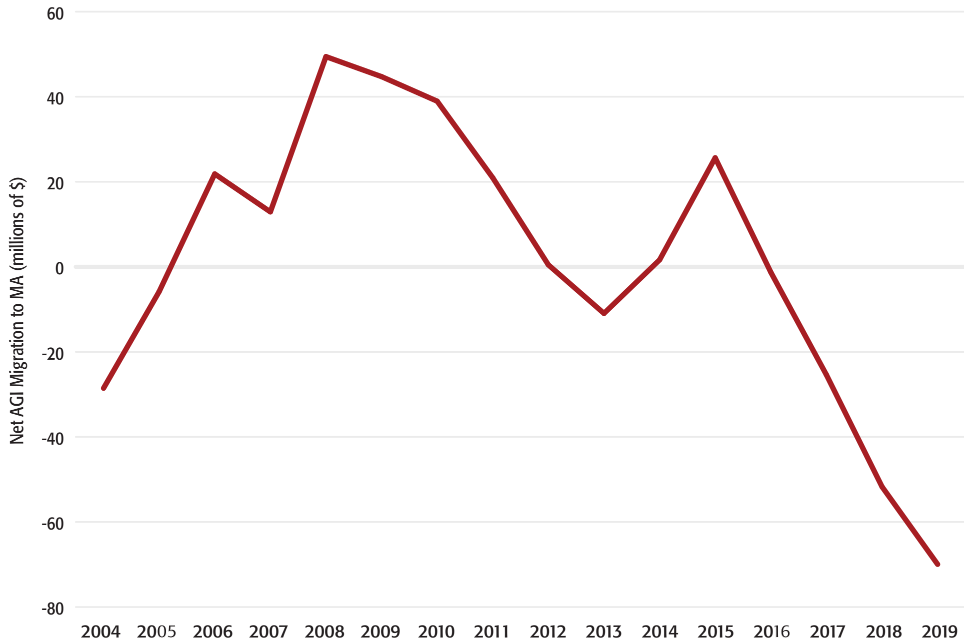
Figure 1: Net AGI migration from Connecticut to Massachusetts, 2004–2019

Unlike Connecticut, Rhode Island provides an example of a state that has cut taxes even more aggressively than Massachusetts over the last 25 years. For most of the 1990s, income tax rates in Rhode Island were determined as a percentage of federal income tax payments, with different brackets paying between 25 and 32.5 percent of federal taxes (or, at a 39.6 percent federal rate, between 9.9 and 12.9 percent of income).[11] These rates gradually converged to 25 percent by 2002.[12] A momentous tax reform in 2011 knocked the 9.9 percent top marginal rate to 5.99 percent, where it remains as of 2021.[13] This makes for a particularly important test for the link between tax policy and wealth migration because, unlike in Massachusetts and Connecticut, the major tax changes were concentrated on one year—2011—rather than occurring incrementally.

Rhode Island provides an example of a state that has cut taxes even more aggressively than Massachusetts over the last 25 years.

Once a mixed picture, Massachusetts now routinely loses more wealth to Rhode Island than The Ocean State does to Massachusetts, and in recent years the gap has grown increasingly wide. In Figure 2, note that the trend was increasingly for migrants to favor Massachusetts over Rhode Island until the Great Recession, and Rhode Island's state assembly first voted to cut the top tax rate to 5.99 percent in 2010. While Rhode Island's top income tax rate is still higher than that of Massachusetts, other factors—such as the cost of living—have likely contributed to Rhode Island's recent edge.

Figure 2: Net AGI migration from Rhode Island to Massachusetts, 2004–2019



Other northeastern states that have raised taxes over the past couple of decades include New York and New Jersey. The Empire State first raised its top personal income tax rate to nearly 9 percent in 2009 before adopting a true "millionaires tax" in 2012.[14] Meanwhile, New Jersey recently doubled down on its 2004 millionaires tax by creating a new tax bracket for those making at least $5 million per year that took effect in 2019. New York and New Jersey display a very similar trend as Connecticut, with increasing amounts of wealth migration to the Bay State in recent years (see Figures 3 and 4).

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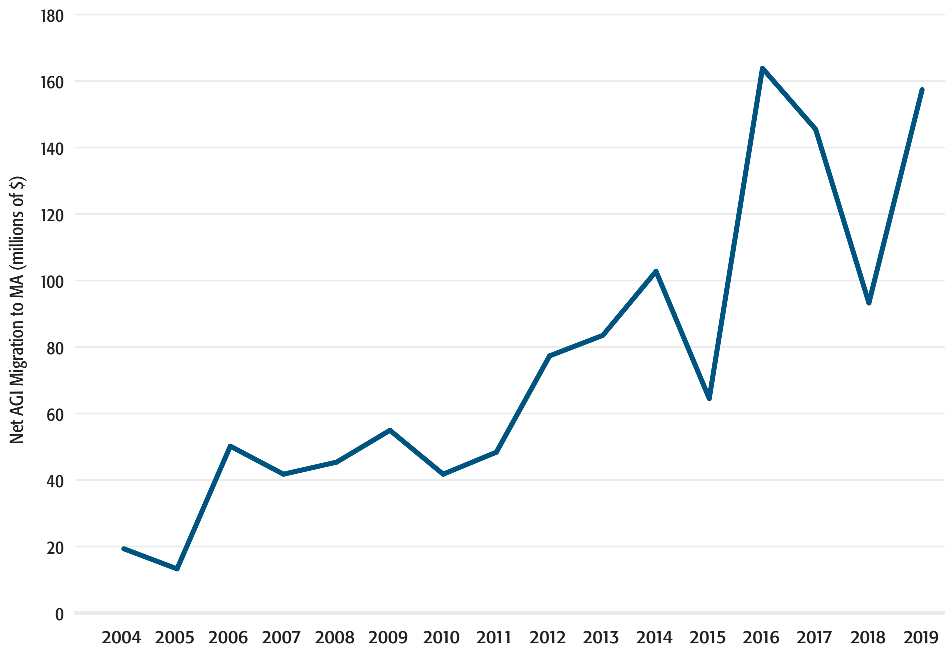
Figure 3: Net AGI migration from New York to Massachusetts, 2004–2019

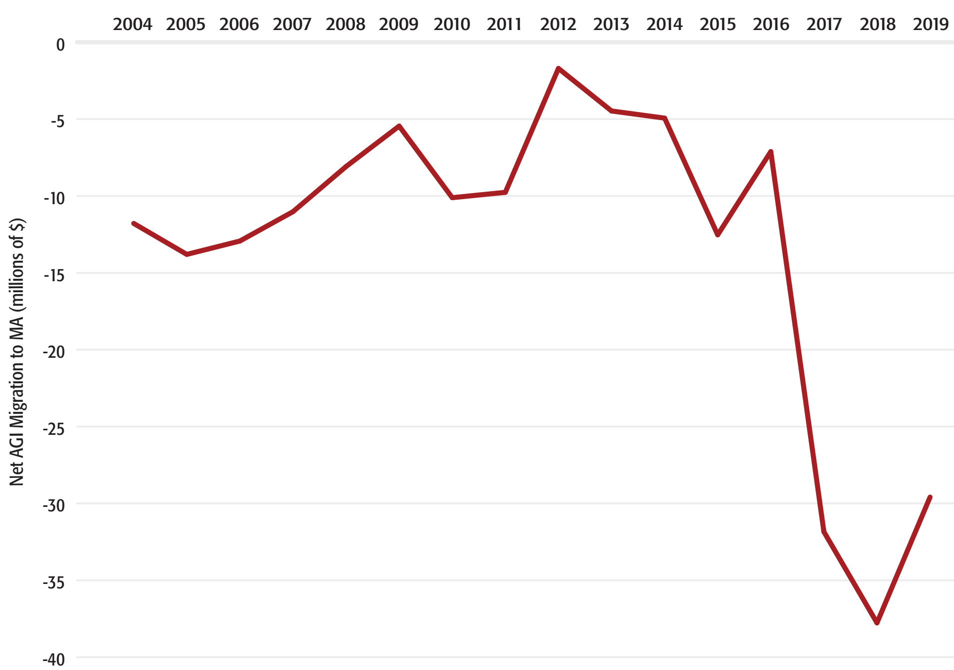
Figure 4: Net AGI migration from New Jersey to Massachusetts, 2004–2019



AGI migration to Massachusetts even from states outside the Northeast closely tracks with tax policy changes. In a situation most immediately comparable to that of New Hampshire, Tennessee phased out their own investment income tax starting in 2016. While migrants' wealth has consistently flowed from Massachusetts to Tennessee over the last 15 years, the magnitude has increased enormously in recent years. Between 2016 and 2017, when Tennessee's governor signed the law to eliminate the tax, net AGI migration from Massachusetts to Tennessee more than quadrupled to over $30 million (see Figure 5), even though Tennessee is hundreds of miles away from the Bay State.[15]

AGI migration to Massachusetts even from states outside the Northeast closely tracks with tax policy changes.

Figure 5: Net AGI migration from Tennessee to Massachusetts, 2004–2019



Meanwhile, much of New Hampshire shares a job market with eastern Massachusetts, making it especially appealing for businesses and individuals to move across state lines if the surtax passes. Recent academic research demonstrates that the wealthy are highly responsive to tax changes, whether via physical migration, "shifting" earned income to unearned income, or otherwise.[16] Further, IRS data shows that, in 2018, Massachusetts taxpayers who would be subject to the surtax reported $1.87 billion in interest and $4.23 billion in dividends.[17] These facts, combined with the continued divergence of tax policy between New Hampshire and Massachusetts, could reduce the Bay State's tax base, as well as deter talented workers and innovative employers from setting down roots here, if the surtax is passed.

Conclusion

If Massachusetts' graduated income tax passes, New Hampshire will have a marginal tax rate of 0 percent on personal income by 2027, while in Massachusetts it would be at least 9 percent (and up to 16 percent for short-term capital gains). This discrepancy could prove dangerous in the long-run as Massachusetts seeks a full recovery from COVID-19, especially in an era of remote work.

In tandem with tax restraint in recent decades, Massachusetts state revenues have grown much faster than those of neighboring states. Our economy has flourished, in part due to competitive advantages over other cold, expensive places like New York and New Jersey. Wealthy residents of these places have increasingly voted with their feet to move to Massachusetts, bringing jobs and tax dollars with them. Before considering the surtax proposal in 2022, Massachusetts voters should heed a version of an old adage: we're already beating high-tax places. Why join them?

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About the Author

Andrew Mikula is a former Economic Research Analyst at Pioneer Institute and current candidate for a Master's in Urban Planning at Harvard University.

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