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ScienceDirect
Journal of Urban Economics 63 (2008) 920–937
JOURNAL OF Urban Economics
www.elsevier.com/locate/jue

Income taxes and the destination of movers to multistate MSAs

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Received 3 January 2007; revised 26 July 2007
Available online 21 August 2007

Abstract

We examine how differences in state income tax rates, as well as other state and local taxes and public service expenditures, influence the choice of state of residence for households (federal tax filers) moving into multistate metropolitan areas (MSAs) using data from the IRS on the migration of taxpayers. MSAs that are on borders provide a spatial discontinuity—discrete differences in state tax rates within a single labor market. These MSAs allow residents to live in one state and work in another state. We find that differences in state income tax rates have a significant impact on the relative rate of migration to the states within an MSA. However, contrary to what would be expected, this impact is only significant in MSAs in which the filing state is based on employment (states without reciprocity) and not for those states in which the filing state is the state of residence (states with reciprocity). In MSAs where states do not have reciprocity agreements, a difference of ten percent in tax rates leads to a 4.1 percent difference in the relative rate of incoming taxpayers. Analogously, we find that a ten percent difference in state tax rates in these MSAs results in a 3.3 percent difference in the rate of tax base inflow (AGI). Our results suggest that one reason that differences in state income taxes appear to have more impact in multistate MSAs without reciprocity is that only relatively large differences in state income tax rates have any impact on migration and these differences are much more pronounced in MSAs without reciprocity.

JEL classification: H73; H71; J61

1. Introduction

Elected state officials and lobbying groups often make the argument that reductions in state tax rates will 'pay for themselves' through the tax revenues generated from new economic activity induced by the lower rates.[1] Reducing the top state tax rate on individual income will make the state more attractive to entrepreneurs and other forms of human capital, increasing the tax base and tax revenues through the resulting economic development. Reducing the state tax on pension income will cause more retirees to move to the state, bringing with them more than offsetting property and

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[1] For example, in 2005 Kentucky's governor, Ernie Fletcher, unveiled a 'tax modernization plan' to reduce the state's top individual and corporate income tax rates, and to repeal the state's corporate license tax. Other tax rates were raised, such as on cigarettes, satellite television, and hotel rooms. The plan was designed to be revenue neutral in the first year. State economists estimated that within five years the plan would create a net of 8000 new jobs and an additional $18 million in new state revenues annually.

0094-1190/$ – see front matter
doi:10.1016/j.jue.2007.07.007

sales tax receipts. While the impacts of tax cuts on state revenues is a concern of politicians and policymakers, increases in the tax base through increases in taxpaying units (households) also provides increased employment and economic stimulus.

The literature suggests that state taxes matter to the location of economic activity and assets, though there is little evidence about the magnitude of the effects for different types of taxes. And, in part due to issues of data availability, much of the empirical literature concerns the movement of older taxpayers. For example, Bakija and Slemrod (2004) examine the effect of state estate and inheritance taxes on the migration of wealthy elderly taxpayers and find a statistically significant but modest negative impact of high state taxes. Conway and Houtenville (1998) find that states with high property, income and sales taxes experience greater out-migration. Conway and Houtenville (2001) find that the elderly tend to migrate to states that have low personal income and death taxes, and which exempt food from sales taxes. Conway and Rork (2006) further examine this issue, suggesting that states may modify tax policy as a *result* of migration rather than the converse. Here we address a similar issue: how differences in state individual income tax rates affect the migration of households (and their incomes) from state to state. In particular, we take advantage of the natural experiment that occurs inside multistate metropolitan areas, to learn how arriving households sort themselves when presented with a choice among more than one state income tax schedule.

The opportunities for substitution are particularly great in multistate metropolitan areas, where households can readily choose among different taxing jurisdictions as they decide where to live, work, and shop. For example, if a state government substantially raised its income tax rate, households could relocate to a lower income tax state without leaving regular contact with their family and friends, or the advantages of the metropolitan labor market and most of the area's urban amenities.[2]

Jurisdiction shopping and border jumping in multistate metropolitan areas are mitigated to a degree by reciprocity agreements, or more precisely the lack thereof, between state governments. Without a reciprocity agreement, people working in a state may be required to pay that state's individual income tax even if they reside in another state, thus removing the fiscal incentive to live in the state with the lower income tax rate. Seventeen states have reciprocity agreements between one to seven other states. The agreements allow someone to pay state income taxes to the state of residence even though their income was earned in another state, and possibly earned in a state with a higher tax rate. In fact, we find that even when the states in a multistate MSA do not have reciprocity agreements, differences in income tax among the states in the MSA do have significant impacts on where incoming households locate.

In this study, we investigate whether movers to multistate MSAs respond to differential state income tax rates. We expect that the portion of the MSA located in the state with the lowest individual income tax rate would receive a disproportionate number of the new residents, after controlling for other economic and fiscal factors that influence location decisions. Households moving to a MSA have less jurisdictional friction than existing residents, since, by definition, they are already moving somewhere and therefore are incurring the relevant transaction costs, like selling a house, finding a job, choosing schools, and leaving neighbors and communities. We further restrict the analysis to people moving to multistate MSAs from other states, to screen out people who are simply moving to a metropolitan area from somewhere else in the same state, often from an adjacent exurban county as these people are likely to have more affiliation to their state than out-of-state residents moving to the MSA.

Economists have long exploited the natural experiments that take place along political borders to learn about the economic effects of government policies. Mikesell (1970, 1971) found that a high municipal sales tax rate has a negative effect on retail sales along borders. Fox (1986) examined the effects of differential tax rates in three multistate MSAs containing Tennessee counties and found that sales tax differentials exerted a "modest influence on the location of economic activity along state's borders." Similarly, Walsh and Jones (1988) measured the growth in grocery store sales along the state border as West Virginia phased out its sales tax on groceries over three years. Holmes and Thomas (1998) found that manufacturing employment rises sharply in counties governed by state right-to-work laws when they are bordering states without right-to-work laws. Mark et al. (2000) examine activity over nine jurisdictions in two states and DC and find that jurisdictions within the Washington DC metropolitan area that have high sales and personal property taxes see a re-

[2] We acknowledge the possibility of endogenous state tax policies, where State *A* might keep its tax rates 'competitive' with State *B* if much of its population and tax base lies along their common border. States, like Texas or Florida, where most of the tax base is far from its border with other states are theoretically able to set tax policy based more on other considerations.