

Maryland Tax Options in 2003

**Citizens for Tax Justice
February 2003**

In recent months, Maryland lawmakers have sought to eliminate a current-year budget shortfall of \$600 million. Even worse, current projections suggest a \$1.2 billion budget deficit for the fiscal year beginning in July of 2003. In the 2003 legislative session, lawmakers will be forced to make tough choices between spending cuts and tax increases.

In taking the politically difficult but necessary steps to address the state's revenue shortfall, Maryland lawmakers have an opportunity to reverse the regressive trend in Maryland's tax system and restore a more equitable balance between individuals and corporations.

This report describes Maryland's current regressive tax environment, and shows how some kinds of revenue-raising options will improve tax fairness in Maryland, while others will make the Maryland tax laws even more unfair.

Specifically, to avoid making Maryland's tax system even more unfair, Maryland should reject increases in regressive sales taxes. Instead, Maryland should look to the personal income tax as a way to both raise needed revenues and move toward a more progressive tax system. An added advantage of income taxes is that they are deductible by itemizers in computing their federal income taxes, thus creating an offset that substantially reduces their effective burden on Maryland's economy and its taxpayers.

Lawmakers should also note that the corporate share of Maryland's overall taxes has been declining for a number of years. This is part of a trend in states and at the federal level that needs to be halted. This analysis presents several loophole-closing measures that could help revitalize the Maryland corporate income tax.

Maryland's Current Tax Situation

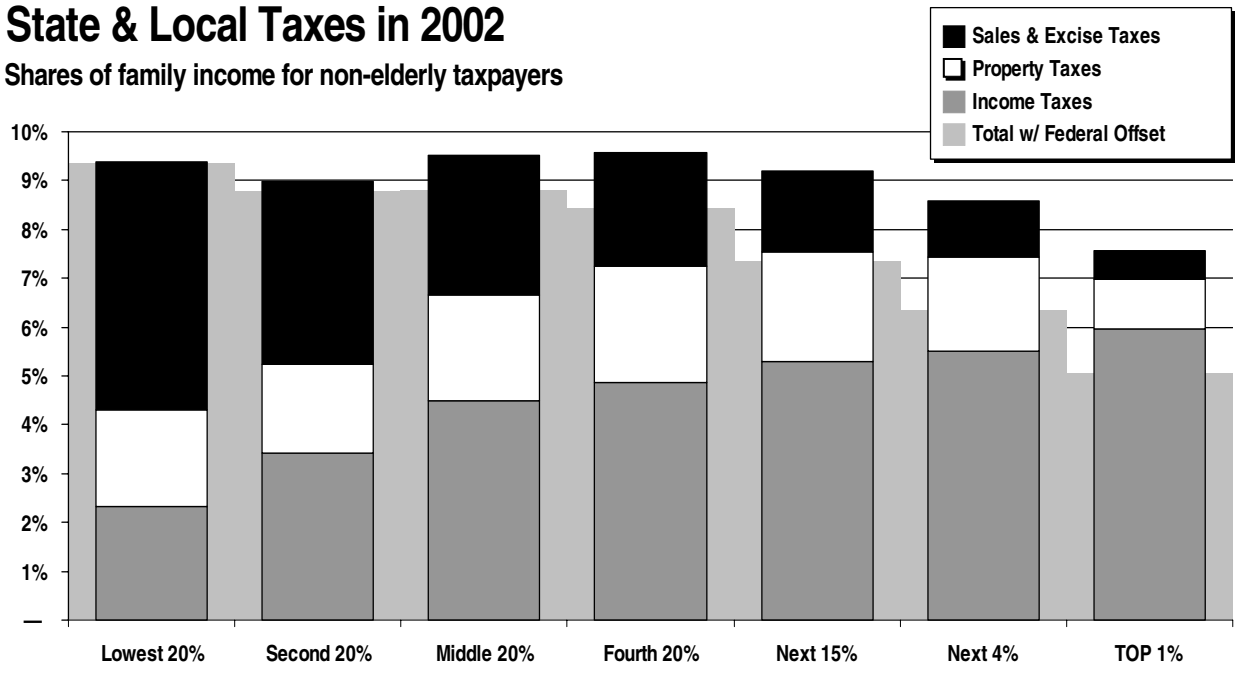
The current Maryland state and local tax structure is *regressive*—that is, it requires low- and middle-income Marylanders to pay higher shares of their incomes in taxes than the wealthiest taxpayers have to pay. In other words, Maryland's tax laws actually redistribute income away from ordinary families and toward the richest Marylanders. A recent analysis by the Institute on Taxation and Economic Policy¹ found that:

- The effective state and local tax rate on the wealthiest one percent of Maryland families—with average incomes of \$1.1 million—is 7.6 percent before accounting for the tax savings from federal itemized deductions. After the federal offset, the effective tax rate is just 5.1 percent.
- The average tax rate on families in the middle of the income distribution—those earning between \$33,000 and \$51,000—is 9.5 percent. After the federal offset, the rate is 8.8 percent, more than half again greater than what the richest pay.
- The tax rate on the poorest Maryland families—those earning less than \$19,000—is 9.4 percent, with essentially no federal offset. That's also more than half again as much as the effective rate on the wealthiest Marylanders.

¹Institute on Taxation and Economic Policy, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States, 2nd Edition*, January 2003. In this March Maryland report, the figures were computed using the ITEP Tax Model.

State & Local Taxes in 2002

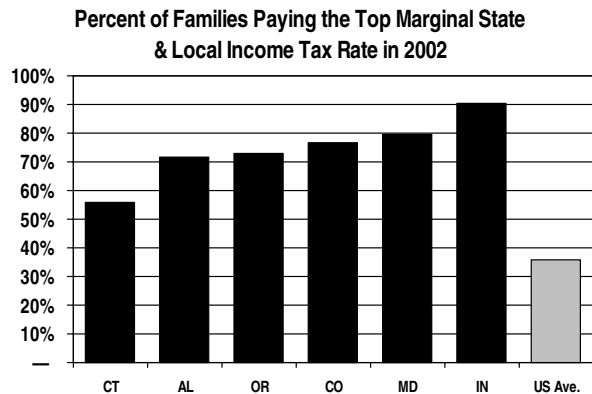
Shares of family income for non-elderly taxpayers



Regressive Elements of Maryland's Current Tax System

Virtually Flat Income Tax Rate

State income taxes are almost always somewhat progressive, but flat-rate income taxes are much less progressive than those with graduated rates. Unfortunately, Maryland's income tax rates are graduated in name only. The top rate kicks in at \$3,000 of taxable income for all taxpayers, resulting in four out of five Marylanders paying the top income tax rate. Because of this essentially flat-rate structure, Maryland's income tax does little to offset the inherent regressivity of the state's sales, excise and property taxes.



Lack of Income Tax Indexing

Indexing tax brackets and exemptions is an important feature of a well-designed progressive income tax. Indexing helps to prevent "bracket creep," which pushes taxpayers into higher brackets even though their real incomes have not risen. Maryland's income tax lacks indexing. If, for example, Maryland had indexed its tax brackets starting in 1989, the top tax bracket would currently start at \$4,166 rather than \$3,000. Failure to index has been a regressive, stealth tax hike on Maryland taxpayers equal to some \$40 million this year compared to 1989 and much more compared to 1967, the last time Maryland adjusted the size of its income tax brackets.

Low Corporate Income Taxes

The Maryland corporate income tax burden is much lower than the national average, and is lower than that of any neighboring state except Virginia. This is partially due to the lower tax rate Maryland applies to corporate taxable income; among neighboring states, only Virginia has a lower corporate tax rate. It also reflects tax provisions such as the “double-weighting” of in-state sales in determining Maryland corporate taxable income.

In the past two decades, the share of Maryland tax revenues derived from the corporate income tax has declined, partially due to the nationwide wave of corporate tax sheltering in recent years. The share of Maryland income taxes paid by corporations has fallen from 9 percent in 1977 to 6 percent in fiscal year 2000—resulting in an offsetting hike in the share of income taxes paid by individual taxpayers.

Corporate Income Tax Burdens in 1999: Two Measures

	% of		% of Total		
	GSP	Rank	Taxes	Rank	Tax Rate
Delaware	0.7%	4	9.4%	2	8.7%
Maryland	0.2%	38	2.4%	41	7%
New Jersey	0.4%	17	4.2%	19	9%
North Carolina	0.4%	20	4.5%	14	7.75%
Pennsylvania	0.4%	16	4.4%	18	9.99%
Virginia	0.2%	45	2.1%	44	6%
West Virginia	0.7%	5	6.1%	8	9%
ALL STATES	0.4%		4.2%		

MD as a % of National Average

63.7% 58.8%

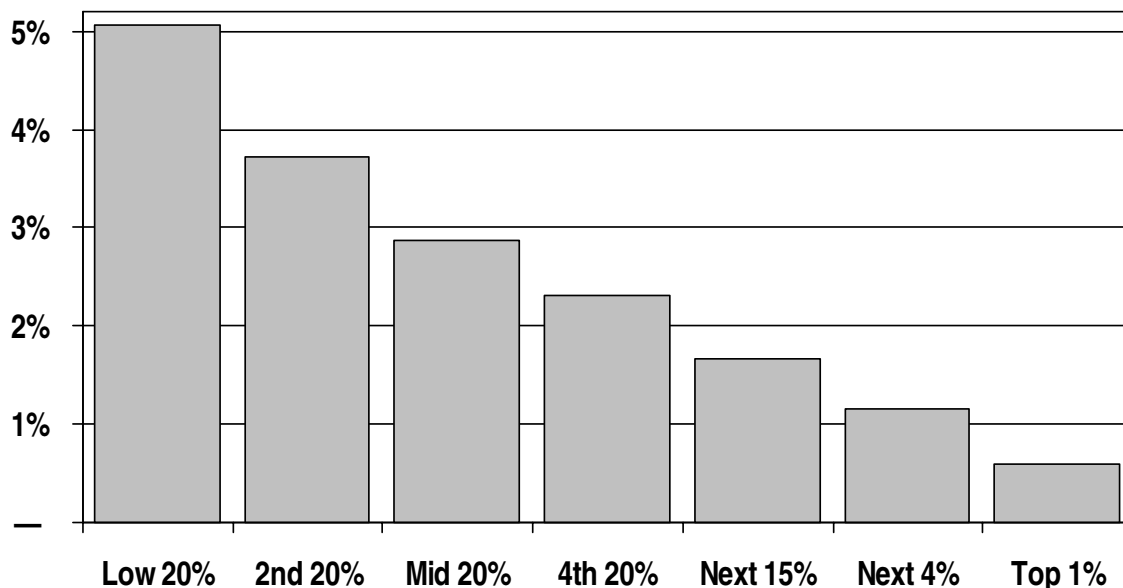
SOURCE: Bureau of Economic Analysis; Bureau of the Census

Sales and Excise Taxes

Although Marylanders are blessed with a tax system whose reliance on sales and excise taxes is not especially high, these taxes are the most unfair taxes imposed by state and local government. Inherently regressive sales and excise taxes take 5.1 percent of income from the poorest Marylanders but just 0.6 percent of income from the wealthiest—effectively imposing a tax rate eight times higher on the poorest Maryland taxpayers than on the rich.

Sales & Excise Taxes in Maryland

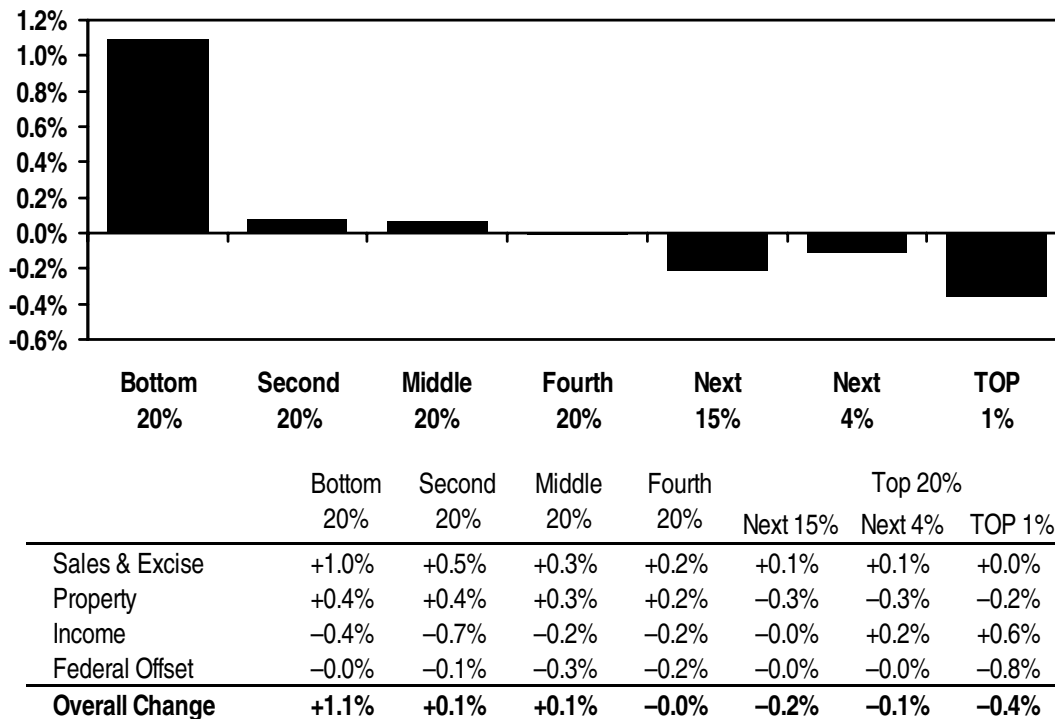
As Shares of Income



How Did Maryland Get Here?

Over the past ten years, Maryland has made many changes to the tax system. Low-income tax credits made the income tax more progressive over the decade, while Maryland's other taxes became more regressive. Overall, Maryland's tax system is more regressive today than it was in 1989.

Changes in Taxes as Shares of Income, 1989 – 2002



Progressive changes to Maryland's income tax have included a partially refundable earned-income tax credit (EITC) equal to 50 percent of the federal EITC. High-income taxpayers saw their effective income tax rate rise with the elimination of the state's 40 percent exclusion for capital gains. These changes added needed progressivity to the state's virtually flat-rate income tax. Unfortunately, regressive changes—such as increases in the cigarette and gasoline excise taxes—outweighed these progressive income tax changes.

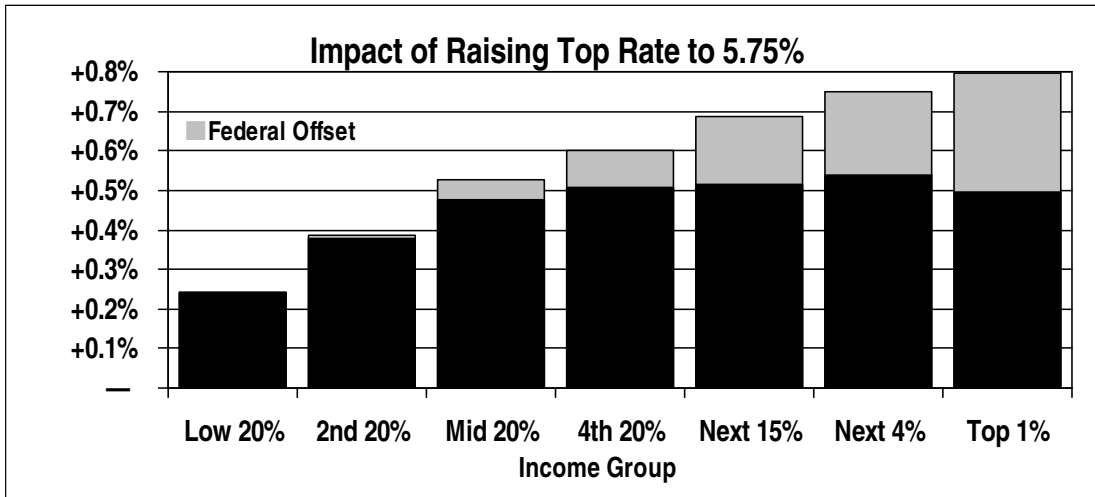
Where to Go from Here: Revenue-raising Options

There are many revenue-raising options available to address the state's budget crisis and meet the needs of the citizens of Maryland. Among the choices, there are some that will reduce the regressivity of the overall tax system. There are other revenue options, however, that would make Maryland's tax system even more unfair.

For each option presented below, we provide an estimate of the revenue yield and the effects on Maryland taxpayers at different income levels. The charts show the tax changes as shares of income by income group, and when relevant, the portion of the tax increase that would be offset by the federal deduction for state income taxes.

Option 1. Increase the existing top income tax rate (add 1 percent). The top rate would rise from 4.75 percent to 5.75 percent on incomes over \$3,000.

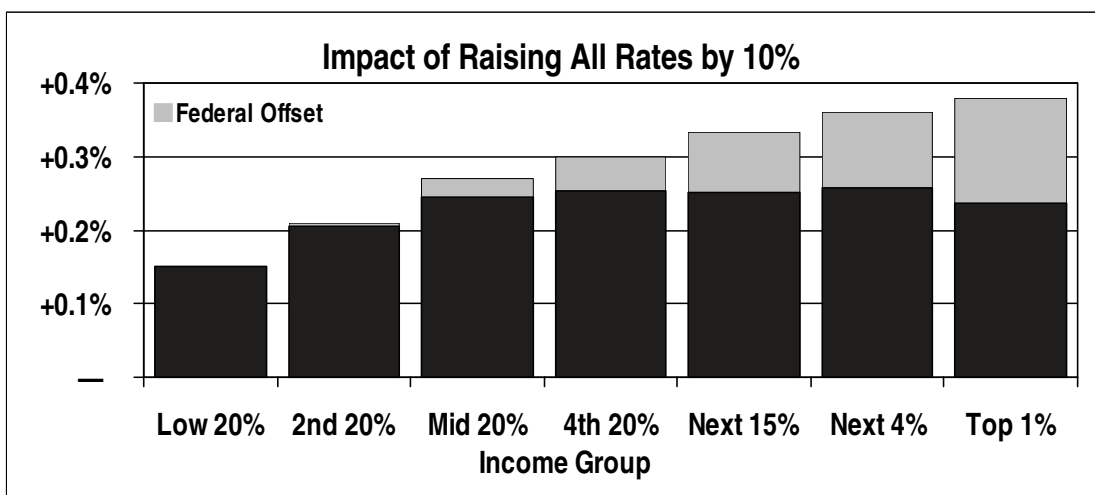
This change would increase the progressivity of the overall Maryland tax system. Because the top marginal rate starts at a comparatively low \$3,000, most Marylanders would be affected by this proposal. More than 23 percent of the state tax hike would be paid for directly by the federal government in the form of federal income tax cuts for Maryland itemizers.



Additional Revenue: \$1.03 billion (\$238 million exported)

Option 2. Increase all income tax rates by 10%. Income tax rates would increase to 2.2%, 3.3%, 4.4% and 5.225%.

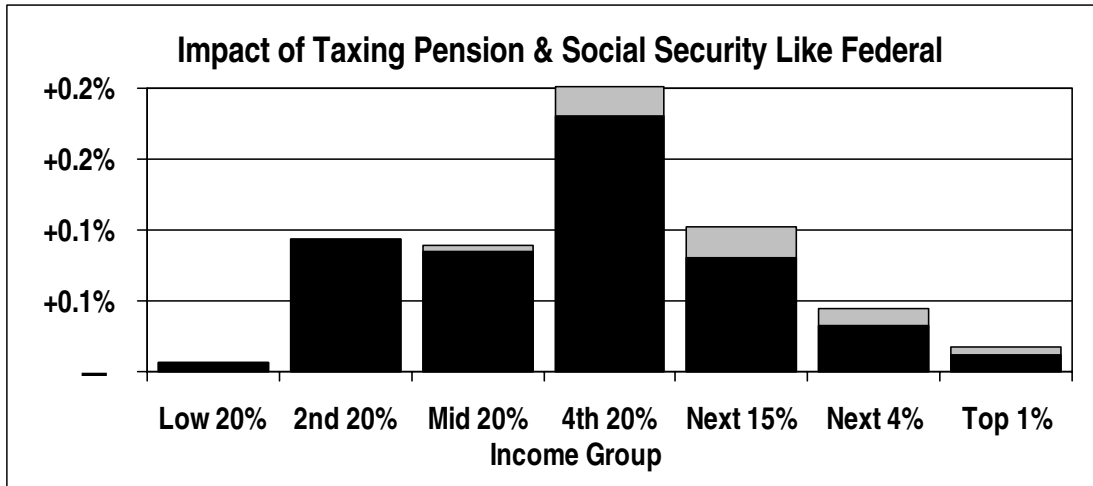
This change would increase the progressivity of the overall Maryland tax system, but would result in a tax hike for all income-tax payers. More than twenty percent of the state tax hike would be paid for directly by the federal government in the form of federal income tax cuts for Maryland itemizers.



Additional Revenue: \$508 million (\$115 million exported)

Option 3. Tax pension and social security income according to federal rules.

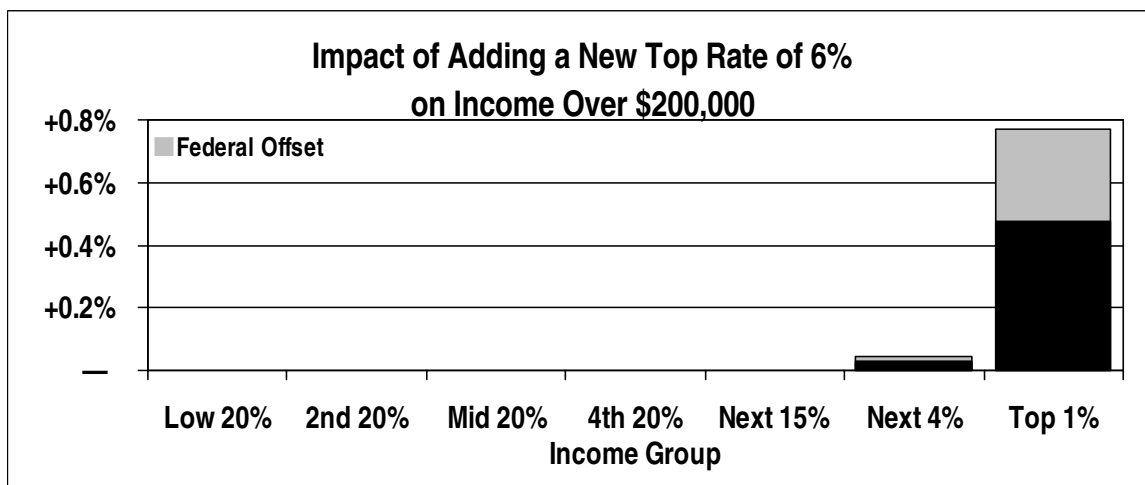
This proposal increases the yield of the personal income tax by removing two poorly targeted—and expensive—exemptions for retirement income. Because the wealthier taxpayers predominantly affected by this option are more likely to itemize on their federal forms, federal income taxes paid by Marylanders would decline by \$21 million under this option.



Additional Revenue: \$154 million (\$21 million exported)

Option 4. Add a new 6 percent top income tax rate at \$200,000.

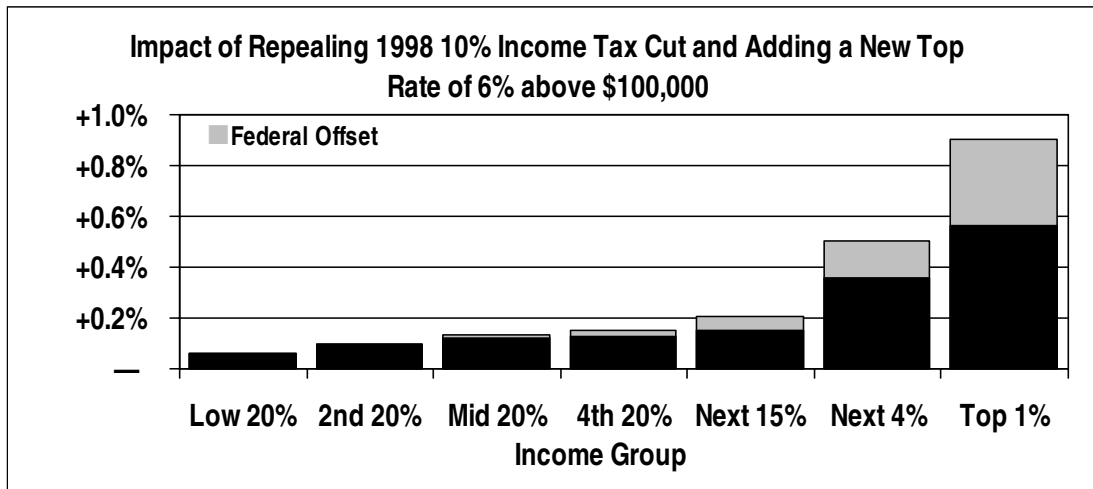
This change would affect only the best-off five percent of Marylanders and would generate significant revenue. More than 38 percent of the state tax hike from this option would be offset by lower federal income tax payments for Maryland itemizers.



Additional Revenue: \$212 million (\$80 million exported)

Option 5. Repeal the 1998 10-percent income tax cut and add a new 6-percent bracket above \$100,000.

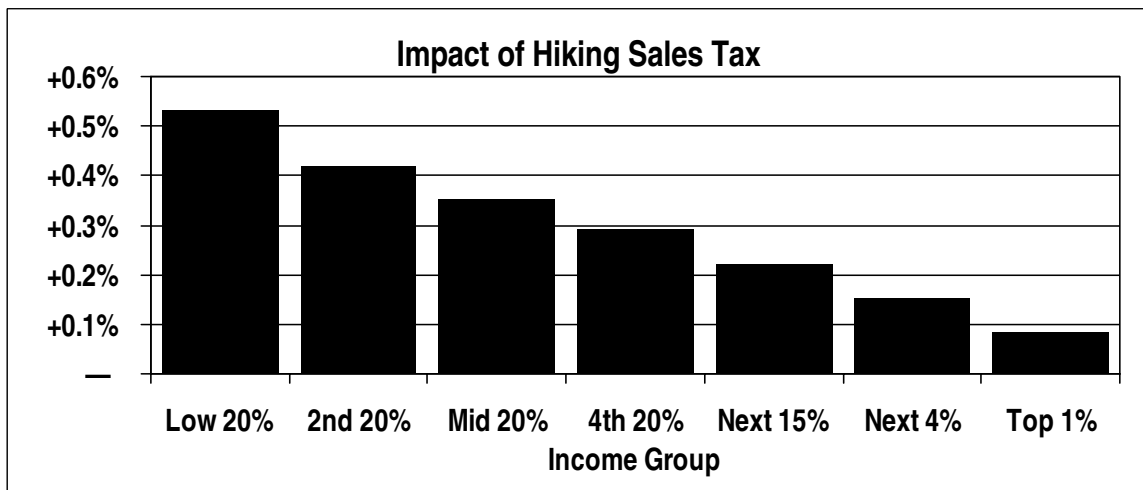
This change would increase the progressivity of the overall Maryland tax system, but would result in a tax hike for all income-tax payers. Almost 30 percent of the state tax hike would be offset by federal tax cuts for Maryland itemizers.



Additional Revenue: \$525 million (\$154 million exported)

Option 6. Raise the sales tax rate from 5 percent to 6 percent.

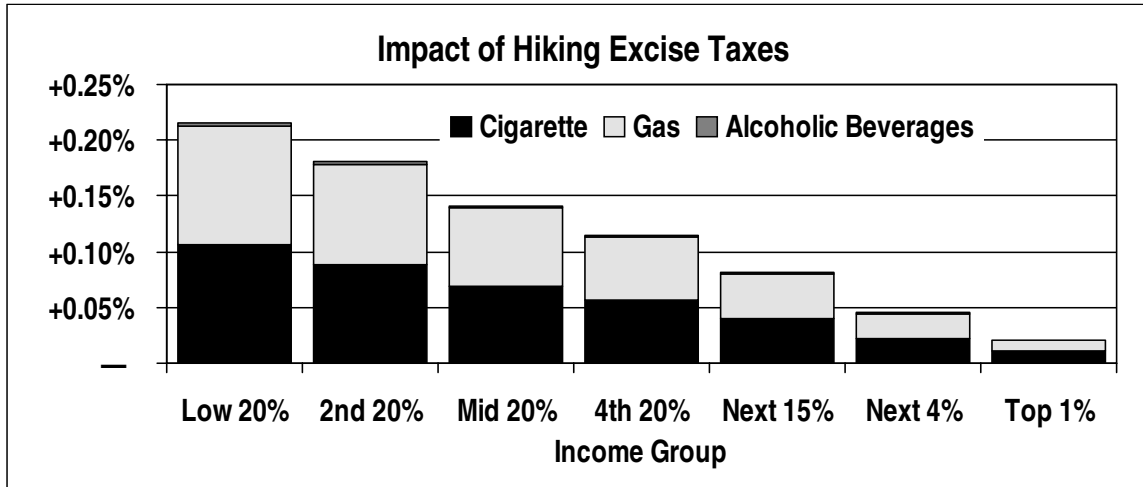
Increasing the sales tax would make Maryland's tax system even more regressive. Because sales taxes are not deductible on federal income tax forms, none of the added sales tax burden would be offset by federal tax cuts. Perhaps most important, the yield of this revenue-raiser would decline over time, as spending by Marylanders continues to shift toward currently-untaxed items.



Additional Revenue: \$520 million

Option 7. Increase Excise Taxes. Raise the cigarette tax from \$1.00 to \$1.36 per pack, the gas tax by 5 cents a gallon, and excise taxes on alcoholic beverages by 10 percent.

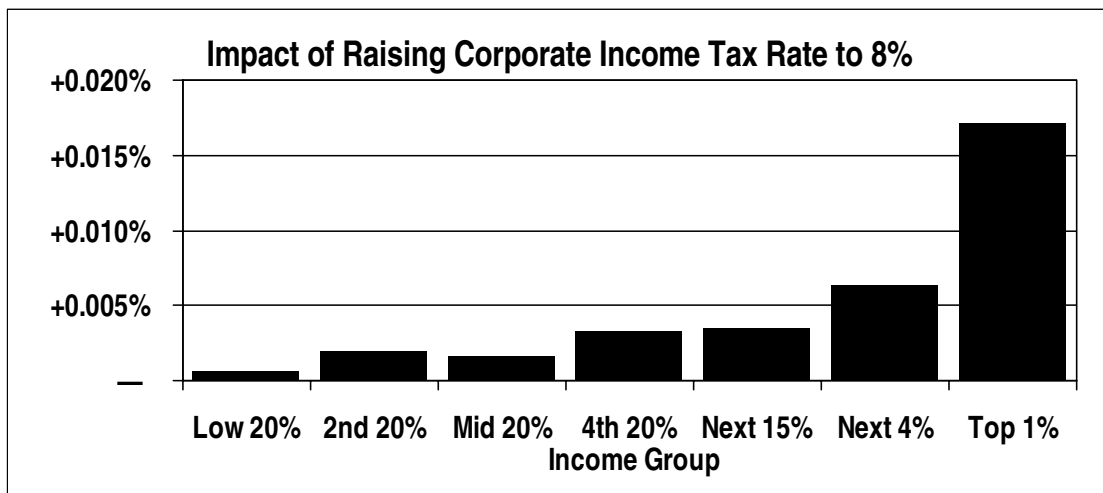
This would make the tax system more regressive and fail to provide sustainable revenue over the long term. Because Maryland's excise taxes on cigarettes, gasoline and alcohol are levied on a per-unit basis, not as a percentage of the price, revenues grow only when consumption grows. Since consumption of cigarettes in particular may actually be falling, these taxes are a poor choice for long-term financing of state and local services.



Additional Revenue: \$277 million

Option 8. Increase corporate tax rate from 7 percent to 8 percent.

Maryland has one of the lowest corporate income tax rates in the region. This change would increase the rate to the regional average. Increases in the corporate income tax are progressive, and are mostly exported to out-of-state shareholders.



Additional Revenue: \$70 million (\$56 million exported to out-of-state shareholders)

Option 9. Close corporate loopholes and shelters.

Other states are taking a hard look at how accounting firms have helped big multistate corporations artificially shift profits into states that don't tax them. Last year, New Jersey passed legislation curbing more than \$1 billion a year in such corporate tax sheltering. At the urging of its new Republican governor, Ohio is now considering a similar path. The following are some of the progressive corporate reforms that Maryland should consider:

Adopt unified reporting to tax the income of "passive investment corporations."

Corporations often set up subsidiaries, sometimes referred to as passive investment corporations (PICs), that own the rights to the copyrights, trademarks and patents of the parent corporation. Banks also set up similar subsidiaries to hold investment assets (bonds, stocks and CDs) that are not needed for working capital. These PICs create a tax shelter through their ownership of the rights to the trademarks and patents of a corporation that are rented back to subsidiaries in states that levy a corporate income tax. Payments for these rights are a deduction in Maryland, while the passive income of the PICs is not taxed where it is domiciled. Likewise, banks earn investment income not subject to Maryland tax. These bank subsidiaries sometimes also make loans to their Maryland parent banks, which become a deduction for the Maryland bank, shifting taxable profits out of Maryland to a state where the passive income is not taxed.

A unified or combined reporting system would allow corporations and banks to continue these passive investment vehicles for non-tax reasons, but Maryland would no longer exempt their passive and investment income from tax. Short of creating a unified reporting system, the State Comptroller should at least have the authority to ensure that these transactions are at arms length and not shams.

Enact a "throwback rule" to tax corporations who move to states without a corporate income tax. The "throwback rule" applies to income that cannot be taxed in Maryland if it is taxed elsewhere but *can* be taxed if it is *not* taxed elsewhere. In other words, if the income is not taxed by another state, the income can be taxed as Maryland income.

Tax sales of controlling interests in real property like sales of real property. Sales of controlling interests in real property is another evasion whereby a corporation sets up a shell company to own a piece of real property—e.g, a plant or building—and sells the company to another corporation. Since ownership of the property did not change, neither the buyer nor the seller owes the state of Maryland nor the locality where the real property exists any recording or transfer taxes.

Scrap Maryland's sales-only and double-weighted sales formulas for apportioning corporate taxable income. Maryland's formula for apportioning corporate profits allows substantial taxable income to be shifted out of the state. Returning to the traditional three-factor formula, based on sales, payroll and property, would help insure that companies benefitting from Maryland public services pay taxes more commensurate with those benefits.

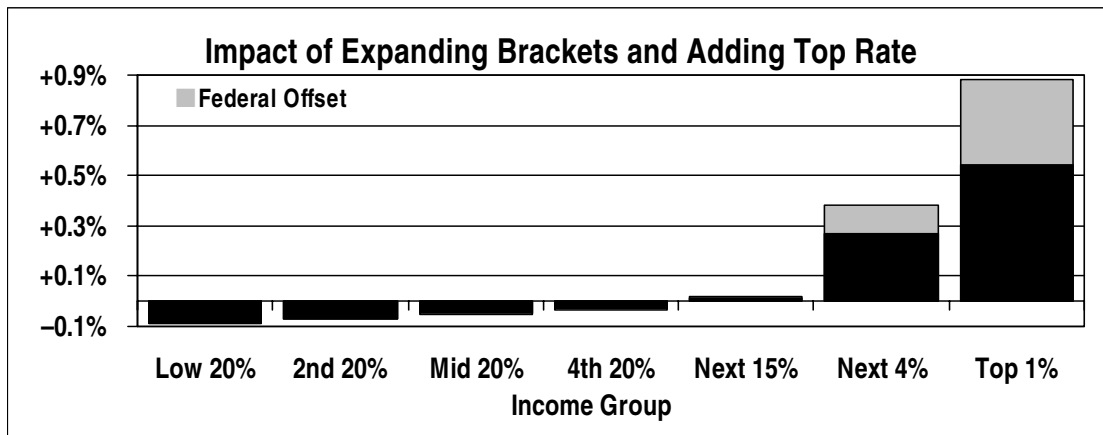
Additional Revenue: Just the first three items on the list would raise \$150 to \$200 million according to the Maryland Budget & Tax Policy Institute; 80 percent of this added tax burden would be exported to residents of other states.

Progressive, Revenue-Raising Combinations of Tax Hikes & Cuts:

These combinations would raise revenue while protecting middle- and lower-income Maryland families.

Combination 1. Widen income tax brackets and adopt a new top income tax rate on income over \$100,000.

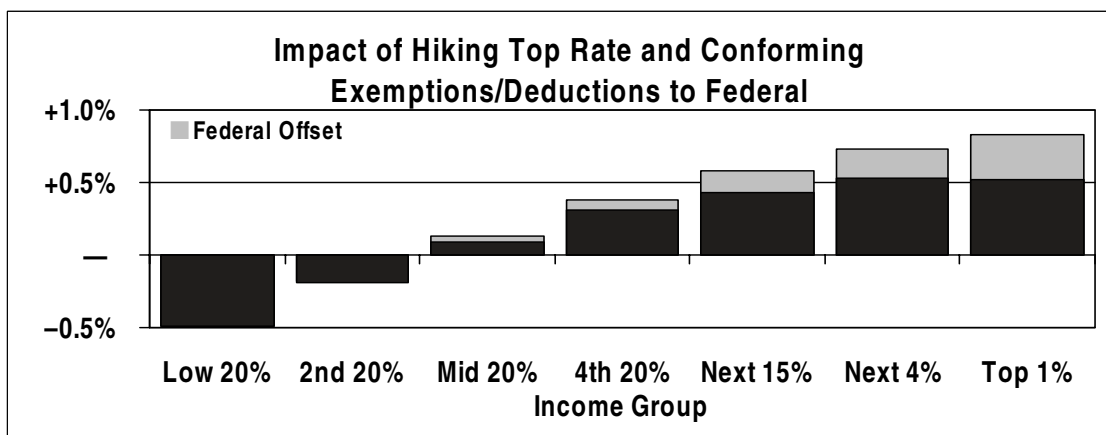
Tax brackets would be expanded to offset the impact of inflation since 1989. A new top tax rate of 6 percent would apply to taxable income in excess of \$100,000 on all taxpayers. This plan would reduce Maryland taxes, on average, for 80 percent of Maryland taxpayers. Almost 40 percent of the added state tax revenue from this plan would be paid for directly by the federal government in the form of lower federal income taxes for Maryland itemizers.



Additional Revenue: \$287 million (\$112 million exported)

Combination 2. Higher top income tax rate, conform exemptions to federal.

This option would increase the top income tax rate to 5.75 percent and increase the personal exemption and standard deduction to conform with the federal tax code. These changes would cut Maryland taxes, on average, for the lowest-income 40 percent of Maryland taxpayers, and would increase the progressivity of the state tax system.



Additional Revenue: \$727 million (\$223 million exported)

Conclusion:

For too many years, Maryland's tax system has redistributed income in favor of those at the top of the income scale and at the expense of low- and middle-income Marylanders. In addressing the current revenue shortfall, Maryland lawmakers can choose to continue this regressive approach, or they can finally decide to move toward a fairer tax system that better serves the needs of the vast majority of Marylanders.

On the one hand, lawmakers can adopt reforms that add a measure of progressivity to the state's income tax and curb corporate tax abuses. In doing so, Maryland would ask those with the highest incomes—and the most ability to pay taxes—to contribute to the support of public services more commensurate with their ability to do so. Or instead, Maryland could raise regressive consumption taxes that would further burden those with the least ability to pay and make the state's tax system even more regressive.

We hope this report will help inform these important decisions.