Testimony of Kelly Ross, Policy Analyst
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Regarding House Bills 1061 and 1306
March 10, 2004

Thank you Madam Chairwoman and members of the Committee for the opportunity to appear today. My name is Kelly Ross. I am a tax policy analyst with the Institute on Taxation and Economic Policy (ITEP). ITEP's research focuses on federal and state tax policy issues, especially as they affect lower- and middle-income taxpayers.

My testimony today focuses on two revenue-raising tax bills introduced in the Maryland House of Delegates: HB 1061, the "Millionaire's Tax Surcharge," and HB 1306, the "Maryland Progressive Income Tax Reform Act of 2004." In particular, my testimony will discuss the impact of each bill on the fairness of the Maryland tax system, and will also evaluate the impact of these bills on Maryland income tax revenues. Each of these bills would result in a progressive tax increase affecting only a small number of the wealthiest Maryland residents, and would make the overall Maryland tax system more equitable.

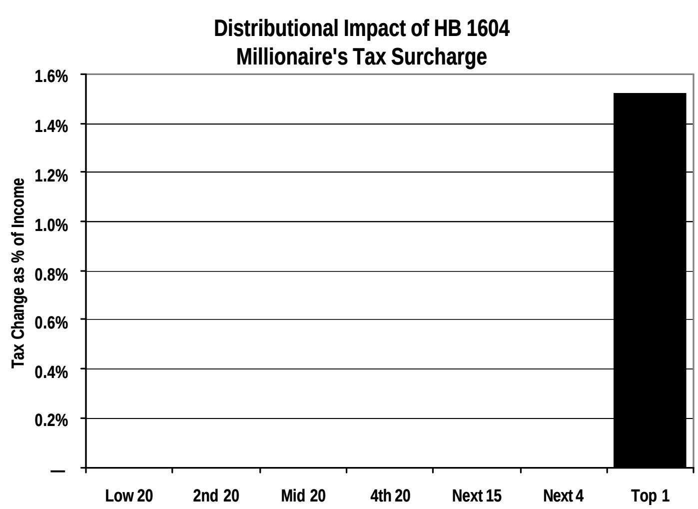
Features of HB 1061 and HB 1306

HB 1061:
Flat 7.75% tax rate for taxpayers with taxable income over $500,000

HB 1306:
Adds two new top brackets:
1) 5.75% for married couples with incomes over $210,000 ($160,000 for singles)
2) 6.75% for all filers with incomes over $301,000
Increases the filing threshold to $19,000 for individuals.

HB 1061: "The Millionaire's Tax Surcharge"

HB 1061 introduces a new top tax rate of 7.75 percent for Marylanders with taxable incomes over $500,000. The 7.75 percent rate would apply not only to income over $500,000 but to all taxable income for these wealthy taxpayers.



If House Bill 1061 were adopted in 2004, ninety-nine percent of Maryland taxpayers would be completely unaffected. The best-off one-percent of Marylanders would see, on average, a state tax increase equal to 1.5 percent of their income, for an average tax hike of $15,912. Because state income taxes can be written off on federal income tax forms by Marylanders who itemize—and because the wealthy Marylanders who would be subject to this tax hike tend to pay at relatively high marginal federal tax rates— almost 35 percent of the tax hikes falling initially on these taxpayers will ultimately be paid for by the federal government in the form of reduced federal income taxes for Maryland itemizers.

HB1061 Revenue Impact In $Millions, Tax Year 2004

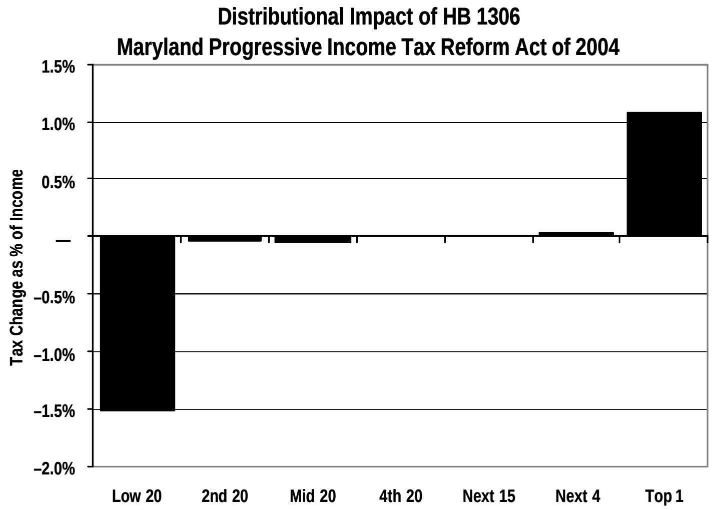
State Tax Increase:	$404
Federal Tax Cut:	-$141
Overall Tax Change	$263

If the personal income tax changes specified in House Bill 1061 were implemented in 2004, the net effect would be to raise state income tax collections by $404 million. The change in the combined federal and state income taxes paid by Maryland taxpayers, however, would be significantly smaller—approximately $263 million in tax year 2004. This is because the state tax hike in HB 1061 would result in a federal tax *cut* of over $141 million in tax year 2004 for Maryland residents who itemize their federal income taxes.

HB 1061 does have two notable, albeit easily fixed defects, however. First of all, it has a huge cliff effect. Someone with $500,000 in taxable income would pay $23,698 in state income. But if that person earns another dollar, his or her income tax would jump to $38,750, an increase of more than $15,000. Second, an unmarried couple earning, say, $500,001 would pay $23,645 in income taxes, while a married couple making the same amount would pay $38,750. That's a huge marriage penalty.

These problems could be easily fixed by applying the proposed new top 7.75% top rate only to taxable income in excess of about $300,000 for couples and $150,000 for unmarried taxpayers. Such an approach would avoid cliffs and marriage penalties while raising the same amount of added revenue as HB 1061 as drafted, and with virtually no change in the distribution of the tax hike.

HB 1306: "The Maryland Progressive Income Tax Reform Act of 2004"



House Bill 1306 differs from HB 1061 in two important ways. First, the bill imposes two new top marginal tax rates, with a 5.75 percent rate over $210,000 for married couples ($160,000 for singles) and a 6.75 percent rate for taxable income over $301,000. Second, the bill provides income tax relief for low income Marylanders by exempting the first $19,000 of federal adjusted gross income from tax.[1]

If HB 1306 were passed in 2004, most income groups would, on average, be virtually unaffected by this bill. As the following chart illustrates, the poorest 20 percent of taxpayers would receive the greatest benefit from this legislation. On average, these taxpayers would receive a tax cut of 1.5 percent of their income or $179.

At the other end of the income spectrum, the wealthiest 1 percent of taxpayers —those with incomes over $339,000 in 2004—would experience an average state income tax hike of just over $11,000. As with HB 1061, however, the deductibility of state income tax increases on federal tax forms means that about a third of this tax increase would be directly offset by lower federal income tax payments.

HB1306 Revenue Impact In $Millions, Tax Year 2004	
State Tax Increase:	$192
Federal Tax Cut:	-$98
Overall Tax Change	$94

ITEP's analysis of the revenue impact of HB 1306 shows that if the bill's income tax changes were implemented in 2004, their net effect would be to raise state income tax collections by $192 million. Because a third of the $287 million tax hike on the wealthiest one percent would be offset by the federal government, while

[1]The language of HB 1306 does not specify whether the exemption for married couples is equal to that for single taxpayers. For purposes of this analysis, we have assumed that the same $19,000 threshold applies to all taxpaying units, regardless of size.

essentially none of the $90 million tax cut on the poor would affect federal taxes, more than half of the net change would be offset by lower federal taxes.

How Income Tax Reform Would Affect Tax Fairness in Maryland

In January 2003 ITEP released a report entitled *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*.[2] This study found that the current Maryland state and local tax structure is regressive, requiring lower- and middle- income taxpayers to pay a larger share of their income in state and local taxes than the wealthiest taxpayers. In particular, the study found that: the effective state and local tax rate on the wealthiest one percent of Maryland families was just 5.1 percent of income after the federal offset is taken into account, substantially less than the 8.8 percent tax burden on Marylanders in the middle of the income distribution and the 9.4 percent effective tax rate on the very poorest 20 percent of Maryland residents.

The study also found that the regressivity of the Maryland tax structure was partially due to the state's relatively flat income tax rate structure. In fact, 4 out of every 5 Maryland taxpayers pay at the highest income tax rate of 4.75% on taxable income over $3,000. 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. So while Maryland taxpayers do not have a tax system whose reliance on sales and excise taxes is not especially high, these taxes are the most unfair taxes. 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.

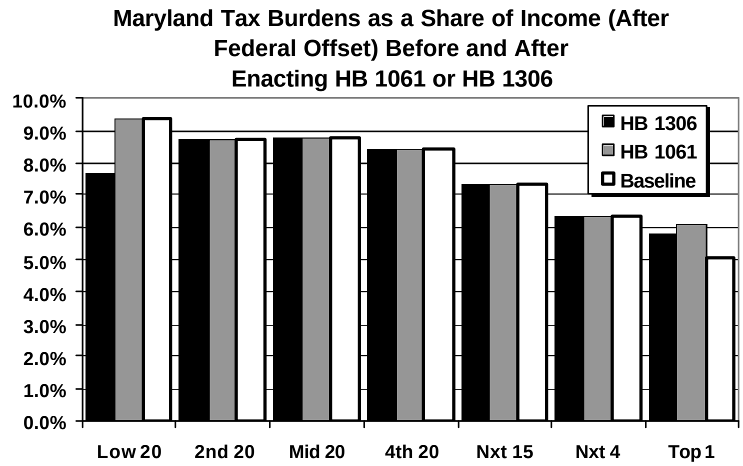
The two bills analyzed here would each take important steps towards adding progressivity to the Maryland income tax—but would these changes be sufficient to eliminate the regressivity in the Maryland tax structure? As the following table shows, Maryland's overall state and local tax system would remain regressive even if one of these proposed tax changes were enacted.

The table and chart show the incidence of Maryland's current state and local tax system in 2000, as published in ITEP's *Who Pays* study, after taking account of the

[2] Institute on Taxation and Economic Policy, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States, 2nd Edition*, January 2003.

benefit of federal itemized deductions. It then shows how enacting either of these bills would affect the distribution of Maryland taxes.

- # HB 1601 would affect only the top 1 percent of taxpayers. This group's total Maryland tax burden after the federal offset would increase—but only to 6.1 percent of income. That would still be far below the tax rate on low- and middle-income Marylanders.



- # HB 1306 would cut taxes on the poorest fifth of Marylanders from 9.4 to 7.7

Impact of HB 1061 and HB 1306 on Maryland's Tax Structure in 2000

	Low 20	2nd 20	Mid 20	4th 20	Nxt 15	Nxt 4	Top 1
Who Pays Net (Baseline) as % of Income	9.4%	8.8%	8.8%	8.4%	7.3%	6.3%	5.1%
Tax Change Under:							
HB 1061	—	—	—	—	—	—	1.1%
HB 1306	–1.7%	–0.0%	–0.0%	–0.0%	—	0.0%	0.7%
New Net Tax as % of Income							
HB 1061	**9.4%**	**8.8%**	**8.8%**	**8.4%**	**7.3%**	**6.3%**	**6.1%**
HB 1306	**7.7%**	**8.7%**	**8.8%**	**8.4%**	**7.3%**	**6.4%**	**5.8%**

percent, and increase taxes on the top one percent increases from 5.1 to 5.8 percent. Nevertheless, the Maryland tax system would remain regressive overall, albeit noticeably less so than now.

Conclusion

These two bills take somewhat different approaches to revenue-raising. HB 1061 imposes a single 7.75 percent tax rate on all taxable income for Marylanders earning over $500,000, while HB 1306 applies two new top marginal rates on high-income earners and provides low-income tax relief by increasing the amount of income the poorest Marylanders can shelter from income tax. While each of these bills would make the Maryland tax system somewhat less regressive, it is important to note that the Maryland tax system would remain regressive overall after implementing either of these changes. However, both of these bills can be considered a step in the right direction for tax adequacy and equity.

Thank you for the opportunity to testify.

Appendix: About ITEP and the ITEP Tax Model

The Institute on Taxation and Economic Policy (ITEP) has engaged in research on tax issues since 1980. Since 1996 ITEP has used a *microsimulation tax model* to conduct research on federal, state, and local tax systems. A microsimulation model uses a large sample of tax returns and other data to estimate the impact of tax systems and tax proposals on actual taxpayers at different income levels. This is the same type of tax model used on the federal level by the U.S. Treasury Department, the Congressional Joint Committee on Taxation, and the Congressional Budget Office, as well as by many state revenue departments. A properly constructed microsimulation model can provide accurate estimates of revenue yield and tax incidence by income group.

ITEP's microsimulation model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to 750,000 records (including 13,832 records for Maryland). This database is based on federal tax returns, with statistically valid samples from every state and the District of Columbia. The database is augmented with a sampling of records from the U.S. Decennial Census "five percent sample" (which contains a random sample of five percent of all census forms received by the Census Bureau); the Census data are statistically matched with the tax return records. The data on these records is then extrapolated to subsequent years using federal tax micro and tabular data, Census Bureau Current Population Survey micro and tabular data, and other widely respected data sources.

These, and other, data are used by the ITEP model's four modules: Personal Income Tax, Property Tax, Consumption Tax and Business Tax. These modules calculate tax liability on a record-by-record basis and sum the results to provide revenue and tax incidence estimates. (A complete description and methodology for the ITEP model is available on request.)

The ITEP model has the unique capability of analyzing all major taxes for every state and the District of Columbia. In 2003, the ITEP model was used to produce the study *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*. This study was released jointly with Citizens for Tax Justice. *Who Pays?* shows the distributional impact, by income level, of all major state and local taxes for each of the 50 states. It has been used by many state revenue departments and legislative fiscal offices since its publication.

The ITEP Model is also unique in its ability to forecast the effect of both federal and state tax changes on taxpayers in a given state. This capability is especially important in analyzing the impact of proposed tax changes that affect people on multiple levels. For example, proposals for federal tax reform often impact state tax collections. Similarly, proposals to change state tax structures, such as the bills under discussion today, can affect the federal taxes paid by a state's residents in ways that can drastically affect the overall incidence of these proposals.

In addition to its fifty-state analyses, ITEP often conducts research in individual states. This work has been primarily funded by private foundations. Recent major foundation-funded state studies include) *Tax Strategies for a Strong Minnesota* (1998) and *Choices for Iowa: Building A Better Tax System* (1998) and *Balancing Act Tax Reform Options For Illinois* (2002).