Testimony of Matthew Gardner
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Before the Maryland General Assembly
Regarding the Sales Tax Legislation in the Tax Reform Act of 2007
November 1, 2007

Thank you for the opportunity to testify before you this afternoon. My name is Matthew Gardner. I am the Executive Director of 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 the sales tax legislation included in the Tax Reform Act of 2007. In particular, my testimony will discuss the impact of the bill's expansion of the sales tax base to include more services. The proposed changes are an important first step toward a more sustainable Maryland tax system. But, because these changes increase the importance of Maryland's most regressive major revenue source, expanding the sales tax base will make it even more important to provide some form of low-income tax offset to mitigate the impact on Maryland's poorest families.

The Issue: Maryland's Tax System is Regressive

In January 2003 ITEP released a report entitled *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*.[1] This study found that Maryland's state and local tax system is regressive, requiring lower- and middle- income taxpayers to pay a more of their income in state and local taxes than the wealthiest taxpayers must pay. 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, substantially less than the effective rate of 8.8 percent on Marylanders in the middle of the income distribution and the 9.4 percent effective tax rate on the very poorest 20 percent of Marylanders.

The study also found that the regressivity of the Maryland tax structure was partially due to regressive sales taxes. These consumption taxes are inherently regressive because low-income families spend more of their income on purchases of items subject to sales and excise taxes than do wealthier taxpayers. The study found that

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

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.

Maryland's Incredible Shrinking Sales Tax

The yield of Maryland's general sales tax has steadily fallen over the past two decades. According to the Census Bureau, in fiscal year 2005, Maryland general sales taxes amounted to 1.3 percent of personal income – 44th highest in the nation. By this measure, Maryland sales and excise taxes have fallen from 1.7 percent in 1978 to 1.3 percent in 2005. One important reason for this decline is that the Maryland sales tax base is narrow—and shrinking by the day.

Taxing Goods; Exempting Services

Maryland's sales tax applies primarily to tangible goods (such as furniture or books), but exempts most services. The omission of services from the tax base is not the result of conscious policy choices, but a historical accident: when Maryland enacted its sales tax in 1947, services were a relatively small part of consumer spending. In recent years, however, spending on services has skyrocketed: in 2003, services represented almost 60 percent of personal consumption nationally.

A 2004 study by the Federation of Tax Administrators (FTA) found that of the 168 potentially taxable services, less than half were taxed by most states. The FTA study found that Maryland currently taxes just 39 of these 168 potentially taxable services. The challenge facing Maryland is to modernize the sales tax base by including at least some sales of personal or professional services in the tax base. The Governor's proposed reform would take an important first step toward this goal by broadening the sales tax base to include more services including services obtained at a tanning salon or massage facility, gym memberships and property management services.

The Case for Broadening the Sales Tax Base

Economists generally argue that base-broadening is the best means of ensuring the long-term vitality of a tax—and this is especially true of the general sales tax. Narrow-based taxes tend to fluctuate more because changes in particular economic sectors can affect the overall yield of the tax, while broader-based taxes are less sensitive to these changes. In the long run, taxing services pays long-term dividends: as consumers spend more of their income on services, sales tax revenues will keep pace with income growth. Taxing services will also make the sales tax less regressive because many of these services are consumed by wealthier taxpayers.

However, it is important to recognize that taxing services will not eliminate the inherent unfairness of the sales tax. No expansion of the tax base is likely to change the basic relationship between consumption and income: low-income taxpayers simply spend more of their income just to get by than do wealthier taxpayers. For this reason, it is vital that any effort to expand the sales tax base should be accompanied by some form of low-income tax credit designed to mitigate the impact on the poor Marylanders who are hit hardest by the current tax system. Laudably, the Governor's plan includes a sales tax credit designed to achieve this goal.

Further expansion of the sales tax base to include more services than those proposed should be a priority, but within limits. While the potential revenue yield of taxing business consumption may be tempting, taxing these services would distort the economic behavior of businesses. For example, a company that finds itself taxed four times in the process of producing a single good (three times on the purchase of intermediate goods and once on the sale of the final product) will face an incentive to escape taxation by "vertically integrating" – that is producing intermediate goods itself. Also, taxing "business to business" transitions will make the sales tax even more unfair because "business to business" sales taxes are ultimately passed through to consumers in the form of higher prices. These passed-through taxes are invisible to the consumer and have unpredictable effects on fairness (since the amount passed through depends on the number of stages of production that were taxed). By contrast, a clear-cut case can be made for extending the sales tax base to include personal retail services consumed by individuals like those proposed here.

Conclusion

As currently structured, Maryland's general sales tax is both unfair and unsustainable. The Governor's proposed reforms would take important steps towards repairing each of these problems. But it is vital that any effort to expand the base should include some form of targeted low-income tax credit.