Testimony of Matthew Gardner
Institute on Taxation and Economic Policy
Before the Maryland General Assembly
Regarding Governor O'Malley's Income Tax Restructuring Legislation
November 1, 2007

Thank you for the opportunity to testify before you this afternoon. My name is Matthew Gardner and I am the Executive Director of the Institute on Taxation and Economic Policy (ITEP). Founded in 1980, ITEP is a nonprofit tax policy research group focusing on federal and state tax policy issues, with an emphasis on tax fairness and adequacy.

My testimony today focuses on the proposed changes to Maryland's personal income tax put forward by Governor O'Malley and the impact that those changes would have on Marylanders at different income levels. Before I present the substance of my analysis of the Governor's proposal, however, I would like to describe three important contexts for you and your colleagues to consider: the manner in which taxes in Maryland are currently distributed; the other elements of the Governor's "Tax Reform Act of 2007" and the effect they would have on tax fairness; and the impact of the federal tax cuts enacted since 2001 on Marylanders. When one considers these contexts, it becomes clear that progressive personal income tax reform is an essential component of Maryland's ongoing tax reform effort. The changes proposed by the Governor represent a laudable step in that direction. But further steps could be taken to enhance tax equity and to generate additional revenue to address the state's projected budget deficit. I will conclude my testimony with a brief discussion of those further steps.

Three Important Contexts

First, Maryland's current state and local tax system is regressive, as it requires low- and middle-income taxpayers to pay a much larger share of their incomes in taxes than upper-income ones. In January 2003, ITEP released *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*. This study found that the effective state and local tax rate for the wealthiest one percent of Maryland taxpayers was just 5.1 percent, substantially less than both the effective rate of 8.8 percent for middle-income Marylanders and the effective rate of 9.4 percent for low-income taxpayers in the state. (These figures account for the interaction between the federal tax code and Maryland's tax system, commonly referred to as the "federal offset".) Although the personal income tax constitutes a sizable fraction of total revenue in Maryland, it does not do nearly enough to offset regressive sales, excise, and property taxes, in large part because of its very flat bracket structure, a feature I will examine a greater length later in my testimony.

Second, this situation would only be made worse if the other elements of Governor O'Malley's Tax Reform Act were enacted without accompanying improvements in the personal income tax. In particular, the increases in the sales tax rate and in the cigarette excise envisioned under the Governor's plan would be quite regressive. These changes would impose much heavier burdens on poor taxpayers than on rich ones because the former must dedicate a significantly larger share of their overall incomes to consumption than the latter.

Third, the federal tax cuts adopted since President Bush took office have overwhelmingly benefited the wealthiest taxpayers in Maryland, further exacerbating the already unequal distribution of incomes in the state. According to Citizens for Tax Justice, in 2007 alone, the wealthiest 1 percent of Maryland taxpayers is expected to receive an average federal tax cut of $45,981. That's more than 80 times the average tax cut received by the bottom 60 percent of Maryland taxpayers combined. Consequently, even if the Governor's Tax Reform Act – or other, still more progressive changes in law – were enacted, affluent Marylanders would still enjoy an enormous net federal-state tax cut.

In short, while Maryland does depend on its personal income tax more than most states, it still has a tax system that, on the whole, is regressive. Because the other elements of the Governor's tax proposal would simply make that situation worse, it is critical that improvements in the personal income tax be included in any reform package the Assembly chooses to adopt. While such improvements would undeniably have a disproportionate impact on upper-income taxpayers, those taxpayers have, over the last six years, enjoyed a substantial windfall in the form of federal tax cuts.

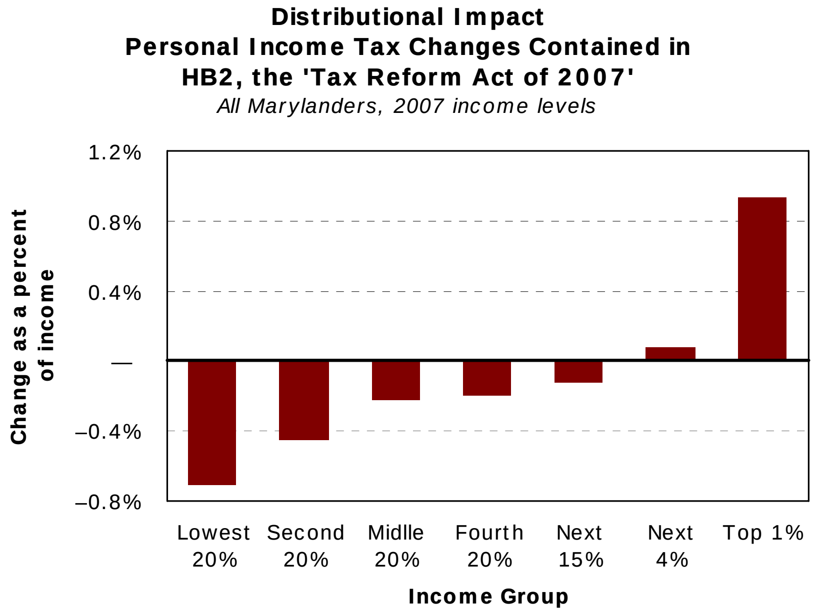
Governor O'Malley's Proposed Changes

With these contexts in mind, allow me to turn to the Governor's proposed personal income tax changes and the impact that they would have on tax fairness in Maryland. As you know, the Governor has proposed four major changes to the state income tax:

- A restructuring of tax brackets and rates, with an expansion of tax brackets for low-income taxpayers and the addition of two new tax brackets for upper-income filers;
- The creation of a refundable tax credit of $50 for all taxpayers with federal adjusted gross incomes of less than $30,000, intended to offset a portion of each taxpayer's sales tax liability;
- An increase in the refundable portion of Maryland's "two-tier" earned income tax credit (EITC) from 20 percent of the federal EITC to 25 percent, and;
- An increase in the exemption for blind and elderly taxpayers from its present level of $1,000 to $2,000.

The first three of these changes, if enacted, would make Maryland's personal income tax substantially more progressive. The bracket changes proposed by the Governor – most notably, increasing the income threshold for the 4.75 percent tax bracket for married couples and heads of households from $3,000 to $22,500 and adding two brackets with rates of 6.0 percent and 6.5 percent starting at $200,000 and $500,000 for those filers – would help to address one of the main shortcomings of the existing income tax – its extremely flat rate structure. In addition, the creation of a new refundable tax credit and the expansion of another would help to offset the regressive nature of most of the other taxes levied in

Maryland. Unfortunately, while elderly taxpayers do face some challenges that other taxpayers do not have to confront, the last of the Governor's proposed changes would not enhance tax equity, but would instead principally benefit upper-income seniors. The 30 percent of Maryland seniors with incomes under $20,000 in 2007 would collectively enjoy less than 1 percent of the benefit from increasing the elderly exemption.



The combined effect of these changes is still noteworthy. The poorest fifth of Marylanders would see their personal income taxes fall by $89 on average – an amount equal to roughly 0.7 percent of income. Taxpayers in the middle of the income distribution in Maryland would receive an average tax cut of $109 – the equivalent of 0.2 percent of income. In contrast, the wealthiest 1 percent of Marylanders – taxpayers whose average income is expected to be $1.5 million in 2007 – would experience a tax increase of approximately 0.9 percent of income. Their average tax increase would be about $14,700, but, as noted earlier, these same taxpayers will receive an average federal tax cut of over $45,000 in 2007, meaning that they would still experience a net tax cut of roughly $30,000 – more than many Marylanders earn in a single year.

Overall, under the personal income tax provisions of the Governor's plan, only three percent of taxpayers – all with incomes in excess of $150,000 – would experience a tax increase, while 93 percent of taxpayers would receive a tax cut.

Of course, for those Marylanders who would experience a personal income tax increase under the Governor's plan, that increase would be mitigated by a reduction in federal income taxes owed. That is, many upper-income taxpayers choose to use itemized deductions, among which are state and local income taxes, instead of the standard deduction on their federal returns; thus, any state personal income tax increase generally leads to federal income tax reduction. For some Marylanders, this "federal offset" could be close to 30 percent of their state tax increase.

Further steps

If the personal income tax changes proposed by the Governor were enacted in 2007, they would yield roughly $90 million in new state revenue. In light of some of the other approaches the Governor has outlined for closing Maryland's anticipated budget gap – such as relying on regressive taxes, revenue from casino gambling that may not be realized, or cuts to essential public services – it's worth examining options for modifying the Governor's plan in ways that could yield more revenue while still achieving a fairer tax system overall.

There are broadly two ways in which these dual goals could be achieved. First, more could be asked of wealthy Marylanders – those families who have benefited inordinately not only from broad economic trends such as the unequal growth in incomes, but also from the federal tax policies of the last six years. Only 3 percent of Marylanders would pay higher income taxes under the Governor's plan. If the starting point for the Governor's new 6.0 percent tax rate were lowered – from $200,000 to $150,000 for married couples and from $150,000 to $100,000 for singles– and the starting point for the proposed 6.5 percent rate were likewise reduced – from $500,000 for all filers to $300,000 – only about 6 percent of Marylanders would pay higher taxes, but the state would take in another $90 million (relative to the Governor's plan). Another option would be to lower those starting points further and to introduce a third new bracket with a rate of 6.25 percent; that approach would generate $245 million more than Governor O'Malley's plan, but would still impose a personal income tax increase on only 15 percent of Maryland taxpayers.

The second way in which additional revenue could be realized while still achieving greater tax fairness would be to alter the Governor's Tax Reform Act so that it provides a more targeted tax cut to low- and moderate-income Marylanders. For example, taken in isolation, the bracket expansions envisioned by the Governor would reduce income taxes by $268 million if instituted in 2007. If those bracket expansions were removed from the Governor's plan, about half of that $268 million in revenue could be used to achieve comparable income tax cuts for the poorest 40 percent of Marylanders – whether through more modest bracket expansions, through a more generous sales tax credit than the one proposed by the Governor, or through additional refinements in Maryland's refundable EITC. (For example, Maryland is one of only two states with Earned Income Tax Credits that do not make the EITC available to childless workers. Extending the EITC to childless workers would provide targeted low-income tax cuts at a low cost.) The remainder of that $268 million could then be used in place of some spending cuts or other tax increases.

In sum, the need for progressive changes to Maryland's personal income tax is clear. Governor O'Malley's Tax Reform Act, if approved by the Assembly, would help to meet that need. Given the other choices before you and your colleagues however – including the greater use of regressive forms of taxation, the introduction of casino gaming, or cuts in the services that Marylanders rely on each and every day – changes in the personal income tax beyond those recommended by the Governor may be desirable.