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## Testimony on Maryland's Tax Climate before the Maryland Economic Development and Business Climate Commission

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TESTIMONY AS PREPARED

Chairman Augustine and members of the Maryland Economic Development and Business Climate Commission, thank you for the opportunity to testify before you today regarding Maryland's tax climate. My name is Jared Walczak and I'm a policy analyst with the Tax Foundation, a nonpartisan tax policy organization based in Washington, D.C.

### ***Three Ways of Evaluating State Tax Systems***

At the Tax Foundation, we maintain three major studies looking at taxes in the fifty states: the *State Business Tax Climate Index*, our *State and Local Tax Burdens* report, and *Location Matters*. Each helps to quantify different aspects of state tax systems and, we hope, provide a blueprint for positive tax reform.

Each study represents a different way of looking at state taxes. The *Index* measures tax structure; it takes rates into account, but more than that, it reviews the neutrality, transparency, simplicity, and stability of each state's tax structure across more than one hundred variables. The *Index* is probably our best known publication, and is responsible for the rankings you often hear cited in the media—that a state's business climate ranks as such, or that it does this well (or poorly) for, say, the property tax component. We provide an overall ranking as well as rankings on five sub-indices: corporate, individual, sales, unemployment insurance, and property taxes.

But while we hope these rankings can help drive an important conversation about tax reform, they are the beginning, not the end, of the conversation the *Index* is intended to facilitate, because the *Index* enables state by state comparisons across a wide range of factors: whether a state imposes a franchise tax, or employs a throwback rule, or implements loan and interest repayment UI taxes, caps carryforwards, indexes brackets for inflation, and so on and so forth. And that, I think, is the real value of the *Index* for policymakers: it's a roadmap. It contributes to the tax reform discussion by allowing legislators to see how their state's tax structure compares to other states across a large range of variables. I'll return to how Maryland does momentarily.

We also have our *Burdens* study, which looks at the total tax costs incurred by a state's residents, paid both in and out-of-state. Determining how much, in aggregate or on average, residents pay to their own state is a rather simple matter, answered by spending a couple of minutes with Census data or state revenue reports. This, however, is only part of the picture from a taxpayer's perspective, as differences in state economies and state tax structures can lead to significant differences in liability across state lines. *Burdens* seeks to fill that gap.

Finally, we have *Location Matters*, which we just released in its second edition. *Location Matters* is unique in the field: it's the only study out there that helps answer the bottom-line question asked by business executives: "How much will my company pay in taxes?" It is also intended to serve as a tool for policymakers, helping to illustrate the effects of a given tax structure on a range of firm types. The study takes seven model firms, largely representing those most sought after by state economic development agencies, and then runs their taxes in all fifty states, first as mature firms—thus ineligible for most incentives—and then again as new firms, able to take advantage of a range of tax incentives.

This allows us to see how not only tax rates, but also apportionment formulas, sourcing rules, throwback rules, and other structural aspects of the tax code impact effective tax rates for different types of firms, and also to get a better idea of *which* taxes are most significant for businesses, and how neutral—or more often, non-neutral—the tax system is across firm types.

### ***State Business Tax Climate Index***

Maryland ranks 40th overall on the 2015 *State Business Tax Climate Index*. By comparison, Delaware ranks 14th, Pennsylvania 34th, Virginia 27th, and West Virginia 21st. On the sub-indices, Maryland ranks 16th for corporate taxes, 45th for individual income taxes, 8th for sales taxes, 21st for unemployment insurance taxes, and 41st for property taxes.

Maryland's tax climate is at best uneven, combining a moderate sales tax burden with a high but fairly well structured corporate income tax and some of the higher individual income and property tax burdens in the nation.

Maryland's corporate income tax rate is, of course, 8.25 percent, which compares favorably to Pennsylvania's 9.99 percent rate but unfavorably to the rates of most other regional and national competitors. Structurally, Maryland does a better than average job at avoiding the incentives game, which often results in a race to the bottom and incentivizes some firms—those in targeted industries, or those newly established—at the expense of those in less advantaged industries, or which have been in the state longer.

Since states should most hope to attract firms with long time horizons and long-term commitments, relying heavily on incentives often proves counterproductive. Although

Maryland offers a modest job creation credit, it avoids creating the patchwork evident in many other states. This helps the state substantially on our *Index*, which heavily weights structural elements of the tax code, and more importantly, it helps job creators here in Maryland.

Nevertheless, the corporate tax rate remains quite high, and can be a disincentive for many firms, particularly those structured in such a way as to experience significant exposure to corporate income taxes. Every year, legislation is introduced to reduce corporate income taxes—which account for 2.9 percent of state and local income taxes—and such a move could certainly make Maryland significantly more attractive to many businesses.

Maryland's individual income tax has eight brackets, and a taxpayer is already in the fifth bracket if she earns \$3,001. Significantly, the state does not index brackets to inflation, leading to bracket creep over time, where incomes which are lower in real terms are subjected to higher brackets. Thirty-two states either index their tax brackets, impose a single-rate income tax, or forego an individual income tax altogether. Maryland is one of the eighteen states imposing unindexed progressive income taxes. Indexing the brackets would be a simple but meaningful step toward ensuring that the tax burden does not increase, in a regressive manner, over time.

Local income taxes, meanwhile, result in high effective tax rates despite a middle-of-the-pack state income tax. Local income taxes range between 1.25 and 3.20 percent, yielding a top rate of 8.95 percent in the City of Baltimore and five counties, and in excess of 8 percent throughout most of the state. In Baltimore City, it only takes \$3,001 in taxable income to hit an 8.2 percent combined state and local income tax bracket.

The state also imposes a marriage penalty by failing to double bracket widths for two-income families in the fifth to eighth brackets. Eliminating the marriage penalty would be a welcome step toward greater neutrality in the state tax code. These structural shortcomings, along with the high state and local combined rate, are responsible for Maryland's 45th place showing on the individual income tax component of our *Index*.

Maryland's property taxes extend to equipment and, in some cases, to inventory as well, and rather unusually, taxes on capital are higher than taxes on land and improvements—typically more than twice as high. Baltimore City, for instance, assesses \$2.248 per \$100 on real property and \$5.62 per \$100 on tangible personal property (equipment, office furniture and fixtures, supplies, etc.), including business inventory.

Although the majority of states still tax tangible personal property, Baltimore's rate is easily twice that of most other major cities, and its overall property tax burden is several times higher than those imposed in most major cities. Similar patterns hold true across

the state. Extending property taxes to business tangible personal property, and taxing it at high rates, yields a 41st place results on the property tax component of our *Index*.

Maryland's best performance on one of our *Index* subcomponents is on the sales tax, where the state exempts most business inputs. The state also extends the sales tax to services by default, though many services are specifically exempted. Ideally, a well-structured sales tax would extend to all final consumer transactions, both goods and services, while exempting business inputs, where the tax will tend to pyramid. Although Maryland's tax structure falls well short of this ideal, it comes closer than many states. Combined with the state's fairly average 6.0 percent rate, the result is a strong 8th place performance on the sales tax subcomponent of our index. The state's UI structure and burdens, meanwhile, are very much middle of the pack.

### ***State and Local Tax Burdens***

Maryland ranks 7th for overall state and local tax burden, with Marylanders making tax payments of \$4,077 per capita to Maryland and \$1,520 to other states, for a per capita state and local tax burden of \$5,598, or 10.6 percent of state income.

Among state and local tax collections, 38.0 percent of collections are attributable to individual income taxes, 26.7 percent of collections are derived from property taxes, 13.5 percent from sales and excise taxes, 2.9 percent from corporate income taxes, and 18.9 percent from a range of other taxes.

### ***Location Matters***

Finally, I'd like to take a few minutes to review the Maryland findings of our just-released *Location Matters* study. As noted previously, we take seven model firms—a corporate headquarters, a research and development facility, a large retail store, a call center, a distribution center, and both a capital-intensive and a labor-intensive manufacturer—and, partnering with the international accounting firm KPMG, we run their taxes in all fifty states, first as a mature corporation, and then again as a new company eligible for more tax incentives.

Three of the firms—the corporate headquarters, R&D facility, and retail store—are located in a large city in each state, in this case Baltimore. The other four firms are located in or around a smaller city, in this case Salisbury. In running the firms' taxes, we look at everything. So, for instance, Maryland benefits from not permitting local gross receipts taxes, but is disadvantaged by local income taxes and property taxes on equipment. Our calculations yield an effective state and local tax rate on a company's net income.

*Location Matters* helps to explain why some firms experience moderate tax burdens in a state with an 8.25 percent corporate income tax, while others struggle.

By largely foregoing job creation and investment credits, Maryland is among a small number of states actually offering lower effective rates for mature, rather than new, firms. These mature firms are helped by the lack of a throwback rule and benefits sourcing. Furthermore, although the state generally employs a double-weighted sales factor apportionment formula, it offers single sales factor apportionment to manufacturing operations.

Maryland's tax structure falls disproportionately on activities and investments associated with new firms. For instance, Maryland imposes the highest tax burden in the nation for new capital-intensive manufacturing operations despite low income, unemployment insurance, and sales tax burdens for the firm type. The chief factor is the highest property tax of its type in the nation—nearly four times the national average—partially attributable to the imposition of the country's third highest rate on equipment. Since newer firms tend to have a greater share of assets tied up in undepreciated equipment, they can experience heavier tax burdens in an environment like Maryland's. The state's property tax on equipment substantially disadvantages all of the newly established firms in the study.

The mature corporate headquarters ranks 17th, the R&D facility 10th, the retail store 32nd, capital- and labor-intensive manufacturers 24th and 4th respectively, call centers 9th, and distribution centers 14th. In each case, the tax costs are higher—often much higher—for new firms, making it difficult for companies to take root or to expand in Maryland.

All of this speaks to the issue of tax neutrality as well as above-average tax incidence. Some of this is due to different firm profiles: a call center is very labor-intensive, with much of its expenditures tied up in employee compensation, and thus unemployment insurance taxes play an unusually large role. Similarly, distribution centers are property-heavy, and thus property taxes outstrip everything else. Other times, some of the variance can be chalked up to tax incentives that may be available to some firms but not others. Most significantly, the state's heavy property tax burdens fall more substantially on some firms than on others, and particularly on new operations. No matter what the cause in any given case, though, the end result is that some types of businesses experience much heavier tax burdens than others.

### ***Conclusion***

My colleagues and I at the Tax Foundation would be more than happy to work with this committee, and with any interested legislators, to identify possible avenues for tax reform, or to provide research and analysis as these discussions continue. Maryland faces challenges but also an opportunity—the opportunity to reform the state's tax structure with an eye to the principle that, as best as possible, taxes should be simple, transparent, neutral, and stable, with broad bases and low rates.