Governor O'Malley's Tax Plan Puts Maryland at Risk in Regional Tax Competition

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Official Data Showing Surpluses Casts Doubt on "Structural Deficit" Claims

Introduction

Maryland Governor Martin O'Malley's new fiscal plan would raise five taxes and cut one. The net result would be a tax increase of almost $2 billion according to the governor's own figures.[1] The current level of tax revenue is $14.6 billion according to the Census Bureau, so in percentage terms, the governor is proposing an almost 14% tax hike.

This brief analysis will use two Tax Foundation rankings to examine the Maryland tax package's potential impact on tax competition in Maryland's region. The first metric is a state-by-state ranking of business tax climate, the *State Business Tax Climate Index*, which compares the rates and brackets and various rules of state income, sales and property taxes. The goal is to measure the efficiency of each state's tax system without regard to how much is collected.

To rank tax burdens, we measure taxes as a percentage of income in each state without regard to specific tax laws. In other words, no matter which taxes are high or low in a state, we tally the collections and compare them to income, which yields a percentage. Adjustments are made for taxes paid by non-residents.

The O'Malley Plan

In brief, Gov. O'Malley proposes six straightforward changes and one mixed bag:

- Raise the general sales tax rate from 5% to 6%.
- Raise the gas tax each year by the amount of inflation.
- Raise the corporate income tax rate from 7% to 8%.
- Approve video lottery terminals that resemble slot machines at various state locations, intending to bring in $500 million annually.
- Raise the cigarette tax rate from $1 to $2.

- Lower the state-level tax on owner-occupied homes from 0.11% to 0.08%. (This is unrelated to local property taxes, which are generally between 10 and 30 times higher, and which constitute the bulk of homeowners' property tax.)
- Raise and lower the tax on wages. At the very low end of the income range, on most income below $15,000 for singles and $22,500 for couples, he would lower the rate from 4.75% to 4.0%. For a vast stretch of income above that, he would keep the current rate: singles would continue to pay the 4.75% rate on income between $15,000 and $150,000. Couples would continue to pay the current 4.75% rate on income between $22,500 and $200,000. Above those income levels, new higher rates would apply, either 6% or 6.5%. On net, the tax hikes at the top end will far outweigh the cuts at the low end.

Maryland's Business Tax Climate Would Suffer

Maryland's business tax climate currently ranks as 24th best nationally in the 2008 *State Business Tax Climate Index*. This makes Maryland third best in a six-state region, behind 9th ranked Delaware and 14th ranked Virginia. However, if the proposed tax increases had been enacted in full at the beginning of the 2008 fiscal year, on July 1, 2007, Maryland's overall rank would be a dismal 43rd best in the nation and second worst in the region. New Jersey would be the only state in the region with a more inhospitable tax climate (see Table 1).

Table 1
With Proposed Tax Hikes, Maryland's Business Tax Climate Would Have Ranked Next-to-Last in Region

	Tax Climate Ranking in FY 2008	
State	**National**	**Regional**
Delaware	9	1
Virginia	14	2
Pennsylvania	27	3
West Virginia	37	4
Maryland	43 *	5
New Jersey	49	6

* Assumes Gov. O'Malley's proposed taxes were fully in effect on July 1, 2007. Maryland's current rank in the FY 2008 Index is 24th best nationally and 3rd best in the six-state region.

Source: *Tax Foundation Background Paper,* No. 57, "State Business Tax Climate Index," October 2007.

Maryland's overall ranking in the *State Business Tax Climate Index* drops so markedly because three of the five components of the *Index* are changed significantly by the governor's proposed tax hikes.

The Corporate Tax Index

Maryland's rank on the Corporate Tax Index is currently excellent, 7th best in the nation. The statutory tax rate is only one component of the Corporate Tax Index, but an important one, and

Maryland would have fallen 7 places to 14th best if its corporate income tax had been 8% instead of 7% on July 1.[2]

Maryland's neighbors generally have higher rates, except for Virginia where the rate is 6%, so Maryland's increase would not have changed its regional standing in this sub-index. Nationally, though, Maryland would fall behind eight more states by raising its corporate tax rate from 7 to 8% (see Table 2).

Table 2
With the New Corporate Tax Rate Hike, Maryland's Regional Ranking Would Not Change, Though National Ranking Would Rise

State	Top Corporate Tax Rate	Ranking	
		National	Regional
Pennsylvania	9.99%	2	1
New Jersey	9.36%	6	2
West Virginia	9.00%	7	3
Delaware	8.70%	12	4
Maryland	8.00%*	15*	5
Virginia	6.00%	35	6
* Assumes O'Malley's proposed 8% rate. Current 7% rate ranks 24th highest nationally, fifth in the six-state region. Source: State tax forms.			

The Individual Income Tax Index
The *State Business Tax Climate Index* tallies individual income taxes because wage taxes on workers affect businesses. Also, many partnerships, S-Corps and other businesses pay their taxes on the individual side of the code. Maryland already scores poorly in this component of the *Index*, 37th best, and if the current plan had been passed and in effect on July 1, 2007, the rank would have dropped to 49th.

Keeping Local Tax Rates in Mind
The current low ranking of 37th can be attributed largely to Maryland's unusually high local income taxes (see Table 3). The further drop to 49th would occur because the tax hike adds two brackets with higher rates and a much larger marriage penalty.

Table 3
Maryland Counties Levy High Local Income Tax Rates

County	Local Rate		County	Local Rate
Howard	3.20%		Kent	2.85%
Montgomery	3.20%		Queen Anne's	2.85%
Prince George's	3.20%		Baltimore	2.83%
Somerset	3.15%		Calvert	2.80%
Wicomico	3.10%		Cecil	2.80%
Harford	3.06%		Washington	2.80%
Baltimore City	3.05%		Garrett	2.65%
Carroll	3.05%		Caroline	2.63%
St. Mary's	3.00%		Dorchester	2.62%
Frederick	2.96%		Anne Arundel	2.56%
Allegany	2.93%		Talbot	2.25%
Charles	2.90%		Worcester	1.25%
Source: Comptroller of Maryland (http://individuals.marylandtaxes.com/incometax/localtax.asp)				

Only 14 states even allow their local governments to levy income taxes, and none do so at such a high rate as Maryland (see Table 4).

Table 4
Maryland has the Highest Average Local Income Tax Rate in the Country

State	Average Local Income Tax Rate	Rank
Maryland	2.73%	1
Ohio	1.81%	2
Pennsylvania	1.28%	3
Indiana	0.98%	4
Kentucky	0.91%	5
Michigan	0.88%	6
Delaware	0.87%	7
New York	0.67%	8
Oregon	0.36%	9
Iowa	0.25%	10
Alabama	0.19%	11
Missouri	0.12%	12
New Jersey	0.09%	13
Arkansas	0.06%	14
Note: County and city rates are weighted by the amount of income earned there before averaging.		

Source: Tax Foundation, from state and local government web sites and state tax forms

Combining these high local rates with Maryland's potentially higher state-level rates from Governor O'Malley's plan would make Maryland's tax on wages the 4th highest nationally and the highest regionally (see Table 5).

Table 5
With New Tax Hike, Maryland Would Have Region's Highest Tax Rate on Wages

State	Top Wage Tax Rate Including Local Taxes	Ranking of Top Wage Tax Rate	
		National	Regional
Maryland	9.48%*	4	1
New Jersey	9.06%	7	2
Delaware	6.82%	21	3
West Virginia	6.50%	23	4
Virginia	5.75%	29	5
Pennsylvania	4.35%	40	6

* Under current law, Maryland's average top rate is 7.48%, ranking 14th highest nationally and second-highest in the six-state region.

Source: Tax Foundation, based on state and local tax forms

Taxpayers in Montgomery County, Prince George's County and Baltimore City pay 3.2% locally. If the governor's plan were enacted, high earners in these three locales would pay 9.7% on income over $500,000. Rhode Island is the only place in the country where these taxpayers would face a higher marginal rate.[3]

Marriage Penalty
For single filers, the new 6% state-level rate would kick in at $150,000 and the 6.5% rate at $500,000. For married filers, the 6% rate starts on taxable income over $200,000 and the 6.5% rate at $500,000. That's a significant marriage penalty compared to states that simply double the bracket widths for married filers.

Small Tax Cuts for Many Filers
Wage tax cuts at the bottom of the income scale would save $90 each for singles with $15,000 in taxable income and $274.50 each for couples with $22,500 in taxable income.

Sales Tax Index
The *State Business Tax Climate Index* includes a comparison of all sales taxes, the general rate and the selective taxes on particular products, because they all affect how much consumers can buy and where they shop. Maryland's rank on the Sales Tax Index is currently excellent, 7th best in the nation in the 2008 *Index*. If the governor's plans to raise the general sales tax rate from 5% to 6%, index the gas tax for inflation and raise the cigarette tax from $1 to $2 had all been passed into law on July 1, 2007, Maryland would have fallen 6 places to 13th best in the Sales Tax Index.

Within the Sales Tax Index, the general sales tax rate is the most heavily weighted item. Maryland consumers already have a powerful incentive to shift purchases across the border to Delaware where they can already save 5% because of Delaware's zero rate. Raising Maryland's rate will exacerbate that problem and not only at the Delaware border (see Table 6).

Table 6
With Proposed Sales Tax Hike, Maryland's Rate Would Rank 3rd Highest Regionally Instead of 4th

State	General Sales Tax Rate	Ranking	
		National	Regional
New Jersey	7.0%	11	1
Pennsylvania**	6.22%	27	2
Maryland	6.0%*	29	3
West Virginia	6.0%	29	3
Virginia**	5.0%	40	5
Delaware	zero	50	6

* Maryland's current 5% rate ranks 39th nationally and 4th highest in the six-state region.

** Pennsylvania's rate includes a state-wide average local sales tax rate of 0.22% and Virginia's rate includes the state-wide 1.0% local add-on.

Source: Tax Foundation

Governor O'Malley also proposes to institute a sales tax holiday each year that could save Maryland taxpayers $13 million off the new higher rate. Sales tax holidays are popular with politicians and taxpayers, but they are poor tax policy nonetheless. They make the tax code more complicated, less stable and less neutral between goods. They also give an advantage to larger, more computerized retailers over smaller retailers.[4]

Cigarette Taxes
Smokers are a politically unpopular group, so raising their taxes is easier. However, raising cigarette taxes can lead to increased border shopping and crime as smokers, who are overwhelmingly low-income, try to evade the tax.[5] Governor O'Malley's plan calls for a doubling of the cigarette tax from $1.00 to $2.00, which would rank as the 4th highest tax on smokers in the country.

With a $2 rate, a cross-border shopper could drive from Maryland to Virginia and save $17 on just one carton. With the current $1 rate, only the Virginia and West Virginia borders pose this problem, but with the new rate, every border would present an opportunity to evade Maryland's tax (see Table 7). While some businesses and individuals may consider moving out of Maryland due to higher taxes, smugglers will certainly be bringing their peculiar brand of business in.

Table 7
With Proposed Cigarette Tax Hike, Maryland's Rate Would Be 4th Highest Nationally, 2nd Highest Regionally

State	Cigarette Tax Per Pack	Ranking	
		National	Regional
New Jersey	$2.575	1	1
Maryland	$2.00*	4	2
Pennsylvania	$1.35	19	3
Delaware	$1.15	22	4
West Virginia	$0.55	39	5
Virginia	$0.30	46	6

*Maryland's current cigarette tax is $1 per pack, which ranks 23rd highest nationally and fourth highest in the six-state region.

Source: Tax Foundation, from state tax forms

Gasoline Taxes
The gas tax in Maryland currently stands at 23.5 cents per gallon, which the governor proposes to index for inflation. If the revenue raised from the gas tax is used to fund roads exclusively, the increase in the rate and revenue each year will approximately mirror the rising costs of its roads, in a user-fee framework. While it is not possible at this time to know how much the rate will increase if indexing takes place, Maryland's gas tax is currently above average at 19th highest nationally. Regionally, Maryland's tax is the third highest (see Table 8).

Table 8
Maryland's Gas Tax Currently Middle of the Pack

State	Gas Tax Rate (Cents Per Gallon)	Ranking	
		National	Regional
Pennsylvania	32.3	4	1
West Virginia	31.5	5	2
Maryland	23.5	19	3
Delaware	23.0	21	4
Virginia	17.5	41	5
New Jersey	14.5	47	6

Note: The tax increase from a plan to index the rate for inflation can't be quantified until inflation is known.

Source: Tax Foundation

Property Tax Index
Maryland's score on the Property Tax Index component of the *State Business Tax Climate Index* will remain unchanged. Maryland will collect in the neighborhood of $7.0 billion in property taxes at the state and local level in 2007. Although a positive step, the $54 million cut proposed for fiscal year

2009 by Governor O'Malley is too small to change the ranking. Instead of paying the state 11 cents per $100 of home value, homeowners would pay 8 cents, and most would save less than $100 annually.

Maryland's Middle-of-the-Road Tax Burden Would Approach Top Ten
Instead of comparing rates and brackets, the Tax Foundation's long-published comparison of state-local tax burdens ignores all the statutes and focuses on the total tax figures, compared to income.

Maryland's 2007 tax burden is currently 10.8% of all the income earned in the state. That ranks 23rd highest.[6] If Governor O'Malley's plan had been in place during 2007, Maryland's state-local tax burden would have been 11.5% of income, and that would have ranked 11th highest nationally (see Table 9).

Regionally, Maryland's tax burden is currently third highest in a six-state region, but it would have been second highest with the new taxes, leaving only a scant 0.07 percentage points between Maryland and perennially high-tax New Jersey. Surpassing New Jersey would put Maryland into the top ten nationwide.

Table 9
With Proposed Tax Hike, Maryland's Tax Burden Would Have Ranked Second Highest in Region

State	2007 Tax Burden	Ranking	
		National	Regional
New Jersey	11.6%	10	1
Maryland	11.5%*	11	2
West Virginia	10.9%	21	4
Pennsylvania	10.8%	24	3
Virginia	10.2%	33	5
Delaware	8.8%	47	6

*Assumes Governor O'Malley's plan had been in effect since January 1, 2007, and would have collected $1.97 billion in extra tax revenue, which reflects the governor's estimate of increased tax revenue for FY 2009, and assuming video lottery terminals are fully operational. Actual 2007 combined state-local burden was 10.8%, ranking 23rd highest nationally and 3rd highest in the six-state region.

Source: *Tax Foundation Special Report*, No. 153, "State and Local Tax Burden Hits 25-Year High," April 2007

Video Lottery Terminals Impact Maryland's Tax Burden
Governor O'Malley's plan includes introducing slot machines, or video lottery terminals (VLTs), to the state's horse racing tracks and possibly other locations in an effort to recapture "lost" gaming revenue from Delaware and Pennsylvania, where slots are already established. The governor anticipates the VLTs will raise $500 million for the state when fully in place and are a major portion of his plan to raise an additional $2 billion.

It is difficult at this time to determine whether the VLT revenue will be included as tax collections or another form of revenue to the state, but no matter what the tax collectors call the money, it will be money out of Marylanders' pockets. The Census Bureau will make a determination once the VLTs are up and running.

If the revenue from the VLTs were excluded from Maryland's tax collections, the Tax Foundation estimate of Maryland's tax burden would be 11.4% and ranked 13th.

Rationale for Raising Taxes: The Structural Deficit

Governor O'Malley's far-ranging tax increase plan will increase the tax burden on Maryland's taxpayers and make the state's business tax climate less competitive. But the governor pushes the plan forward to address what he calls a structural deficit.

In January 2007, the governor came into office and almost immediately declared the state to be in a structural deficit. His first figure was $400 million. It rose quickly to $1.3 billion, and the latest structural deficit figure is $1.7 billion. That is the one O'Malley is asking the legislature to count on, although the current plan raises far more revenue than even this latest figure.[7]

It is hard to discern any sort of deficit from official publications about Maryland's revenue. According to the latest figures from the National Association of State Budget Officers (NASBO), Maryland ran a $1.4 billion *surplus* between July 2005 and June 2006 (FY'06).

Have tax collections dropped off suddenly during the 15 months since June 30, 2006? Not according to the nonpartisan Rockefeller Institute. The Rockefeller Institute reports that total Maryland tax collections grew 9.2% between the second quarter of 2006 and the second quarter of 2007. That's 3.1 percentage points faster than the national average.

The "structural deficit" is an estimate for some future year and presumes that all current surpluses will have been spent and more. Of course, that is possible, and to support this contention, some have blamed a 1996 court order to raise education spending by $1.3 billion annually.[8] The legislature started complying with the judicial mandate in 2002, and although it never enacted specific tax increases, it has been able to greatly increase education spending.

Conclusion

The governor and legislature might be better served looking to cut spending or moving more cautiously on the revenue side, considering the doubt that surrounds the deficit estimate.

The governor's plan will lower Maryland's competitiveness 19 places from 24th to 43rd on the *State Business Tax Climate Index*. Analysis of population data from the Census Bureau and income and output data from the Bureau of Economic Analysis show that the top ten states in the *State Business Tax Climate Index* are growing much more rapidly than states in the bottom ten in all three key areas of economic growth.

In fact, between 2000 and 2006, income in the top ten states in the *State Business Tax Climate Index* grew 12 percentage points faster than it did in the bottom ten states. Population in the top ten states is growing seven percentage points faster and output 17 percentage points faster.

If Maryland enacts this tax plan, it will be joining this slow-growing group of states in the bottom ten.

Notes

1. http://www.gov.state.md.us/pressreleases/DeficitPowerpoint.pdf (Page 19).

2. All U.S. states face a serious competitive disadvantage in a worldwide comparison of corporate income tax rates because of the federal government's 35% rate. See Chris Atkins and Scott Hodge, *Tax Foundation Fiscal Fact,* No. 96, "U.S. Still Lagging Behind OECD Corporate Tax Trends," July 24, 2007.

3. Taxpayers with more than $1,000,000 in taxable income pay 10.3% in California.

4. Curtis Dubay et al., "Sales Tax Holidays: Politically Expedient but Poor Tax Policy," *Tax Foundation Fiscal Fact* No. 63, August 3, 2006.

5. Patrick Fleenor, "How Excise Tax Differentials Affect Interstate Smuggling and Cross-Border Sales of Cigarettes in the United States," *Tax Foundation Background Paper*, No. 26, October 1996.

6. Curtis Dubay, "State and Local Tax Burden Hits 25-Year High," *Tax Foundation Special Report*, No. 153, April 2007.

7. John Wagner, "O'Malley Summons Special Session," *Washington Post* On-line, October 16, 2007, http://www.washingtonpost.com/wp-dyn/content/article/2007/10/15/AR2007101500766.html.

8. Chris Atkins, "Appropriation by Litigation: Estimating the Cost of Judicial Mandates for State and Local Education Spending," *Tax Foundation Background Paper*, No. 55, July 2007.

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