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Fiscal Fact

Maryland Considers Proposal to Extend "Millionaires Tax" to \$100,000 Income Level

By

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Earlier this year, Maryland Governor Martin O'Malley proposed a number of tax proposals, including increasing income taxes,¹ applying the sales tax to gasoline,² raising cigar taxes,³ and doubling the "flush" tax, a septic system levy.⁴

Last month, despite the bevy of options that were suggested, the Maryland General Assembly failed to reach a revenue deal by a matter of minutes before the end of their session. What is traditionally a confetti- and balloon-filled final night celebration was replaced by a stern 1 AM press conference by Governor O'Malley.⁵ Since then, O'Malley has called a special session to begin on May 14 to discuss an income tax hike which could affect all earnings over \$100,000. While specific details are still scarce, we will here review some of the options that were on the table at the end of the regular session and discuss impacts on Maryland's fiscal situation and national competitiveness.

Budget "Cuts" and the Doomsday Fallacy

When the regular session ended without a new revenue deal, many onlookers feverishly decried the austerity of the "doomsday" budget that took effect instead, which would cut \$500 million in expenses over the next year. However, these "doomsday" cuts are actually applied to planned spending *increases*, and even under this "doomsday" scenario the budget will still increase by \$700 million, or 2 percent over last year.

¹ Joseph Henchman, *Maryland Looking to Raise Income Tax on Middle-Earners*, Tax Foundation Tax Policy Blog (Mar. 20, 2012), <http://taxfoundation.org/blog/show/28059.html>.

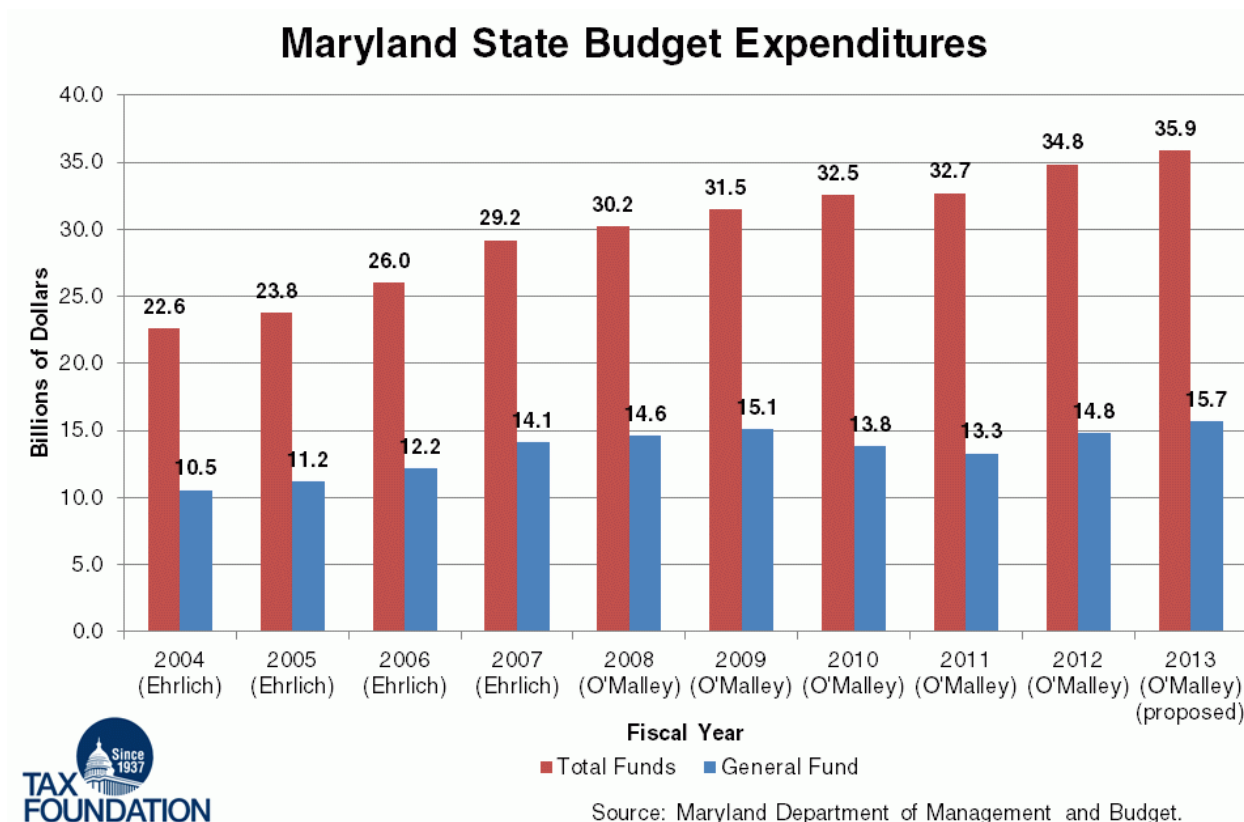
² David Hill, *O'Malley springs sales-tax surprise on assembly*, THE WASHINGTON TIMES, Jan. 11, 2012, <http://www.washingtontimes.com/news/2012/jan/11/omalley-springs-sales-tax-surprise-on-assembly/>.

³ General Assembly of Maryland, Department of Legislative Services, *The 90 Day Report: A Review of the 2012 Legislative Session* (Apr. 13, 2012), at B-13, <http://mlis.state.md.us/2012rs/90-Day-report/The90DayReport.pdf>.

⁴ Joseph Henchman, *Maryland Governor Proposing Increases in Income, Sales, Gasoline, Cigar, and 'Flush' Taxes*, TAX FOUNDATION TAX POLICY BLOG (Jan. 19, 2012), <http://taxfoundation.org/blog/show/27903.html>.

⁵ Aaron C. Davis & John Wagner, *Officials in Md. fail to vote on tax, casino bills*, THE WASHINGTON POST, Apr. 9, 2012, http://www.washingtonpost.com/local/md-politics/md-legislature-scrambles-in-closing-hours-to-finish-major-tax-and-casino-bills/2012/04/09/g1QAKBl66S_story.html.

Figure 1 shows Maryland's budget expenditures, which have grown steadily since 2004.



The editorial board of the *Washington Post* has argued that simply allowing the “doomsday” budget to proceed might be the most appropriate course of action, while a special session is likely to bring more complications than solutions:

The truth is that if lawmakers in the General Assembly were to stay home and skip the special sessions, the effect would be to cancel plans for a tax increase; spare the state a senseless expansion of casino gambling; eliminate some dubious spending programs; and ensure that Maryland's \$35 billion budget still manages to grow by a respectable \$700 million, about 2 percent.⁶

Income Tax Proposal

An income tax proposal was put forward on May 14 which would increase rates for singles earning above \$100,000 and for joint filers earning above \$150,000. This plan also phases out the exemption more aggressively than the current tax system, meaning that more income from high-income filers will be taxed, resulting in higher effective rates. Table 1 shows rates proposed under this plan.

⁶ Editorial Board, *Who's afraid of Maryland's 'doomsday' budget?*, THE WASHINGTON POST, Apr. 27, 2012. http://www.washingtonpost.com/opinions/maryland-lawmakers-should-go-easy-on-the-budget-fixes/2012/04/26/gIQA5HT0jT_story.html.

Table 1: New Rates Under Maryland Proposal

Single Filers			Married Filing Jointly, Head of Household		
Bracket	Current Rate	Proposed Rate	Bracket	Current Rate	Proposed Rate
>\$0	2%	2%	>\$0	2%	2%
>\$1,000	3%	3%	>\$1,000	3%	3%
>\$2,000	4%	4%	>\$2,000	4%	4%
>\$3,000	4.75%	4.75%	>\$3,000	4.75%	4.75%
>\$100,000	4.75%	5%	>\$150,000	4.75%	5%
>\$125,000	4.75%	5.25%	>\$175,000	4.75%	5.25%
>\$150,000	5%	5.50%	>\$200,000	5%	5.5%
>\$250,000	5%	5.75%	>\$225,000	5%	5.75%
>\$300,000	5.25%	5.75%	>\$350,000	5.25%	5.75%
>\$500,000	5.5%	5.75%	>\$500,000	5.5%	5.75%

This proposal, though not a substantial increase from last year, could have palpable effects on the tax bills of high-income Maryland residents and businesses. Table 2 shows back-of-the-envelope calculations for a dual-earner, two child family with \$250,000 in federal adjusted income living in Maryland, the District of Columbia, and Virginia. If enacted, they would pay \$989 more in state income taxes:

Table 2: Two Child Family with \$250,000 in Income

State	Currently	Under Maryland Proposal
Maryland	\$16,786	\$17,775
District of Columbia	\$16,612	\$16,612
Virginia	\$11,651	\$11,651

Before 2007, when Maryland first adopted a “millionaires tax,” the state had a fairly flat income tax system, and this latest episode is just a continuation of a trend where the state is gradually tilting the income tax code to rely more heavily on high-income earners (See Table 3, below).

Table 3: Maryland Individual Income Tax Rates for Single Filers, 2007

Bracket	Rate
>\$0	2%
>\$1,000	3%
>\$2,000	4%
>\$3,000	4.75%

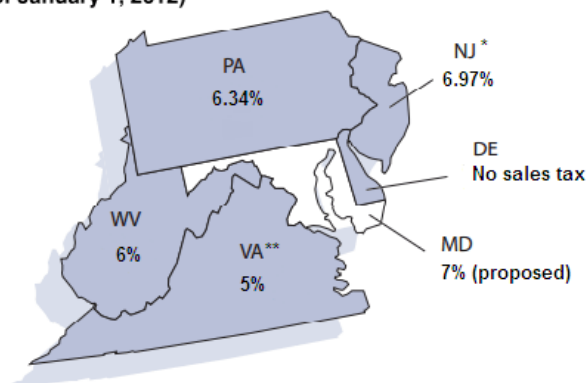
As we have seen at the federal level, progressive tax codes make for volatile revenue collections. High income earners are often businesses, which are especially sensitive to economic expansions and contractions.⁷ Additionally, there is a negative incentive affect associated with high top marginal rates. In the long run, laborers are less likely to gain additional skills and aspire to higher wages if more of that potential income is taken by tax authorities.⁸ So while income tax hikes on the wealthy are often popular with voters, because of the interconnectedness of the economy, the resulting decreases in labor productivity negatively affect everyone.

Sales Tax Proposal

Another potential tax increase proposal that might resurface in the special session is a one percent sales tax increase from 6 percent to 7 percent that was discussed mid-April.⁹ If passed, the sales tax increase would tie Maryland for the second highest statewide sales tax rate in the country. Further, it would move Maryland out of step with its neighbors, particularly Delaware, which has no sales tax. Figure 2 shows sales tax rates around Maryland.

Figure 2

**Combined State and Average Local Sales Taxes Near Maryland
(as of January 1, 2012)**



Note: Rates include population-weighted averages of local rates.

*Salem County, New Jersey is subject to a reduced sales tax rate, and we account for this by reducing their statewide rate of 7 percent according to the population of Salem County.

**Virginia levies a 1 percent mandatory, statewide, local add-on sales tax at the state level.

These disparate sales tax rates would instigate an increase in cross-border shopping, which would have a negative effect on revenue collections and hurt business activity in the state as consumers make purchases in neighboring states.¹⁰

New Jersey, which already has a 7 percent statewide rate, is well aware of this problem. In response to cross-border shopping, the state implicitly acknowledged that their sales tax rate is uncompetitive by halving the state sales tax rate in Salem County (on the Delaware border) from 7 percent to 3.5 percent.

⁷ R. Alison Felix, *The Growth and Volatility of State Tax Revenue Sources in the Tenth District*, FEDERAL RESERVE BANK OF KANSAS CITY ECONOMIC REVIEW (2008), <http://www.kansascityfed.org/Publicat/Econrev/PDF/3q08Felix.pdf>.

⁸ Edward C. Prescott, *Why Do Americans Work So Much More than Europeans?*, 28 FEDERAL RESERVE BANK OF MINNEAPOLIS QUARTERLY REVIEW 2-13 (2004), <http://www.minneapolisfed.org/research/QR/QR2811.pdf>.

⁹ Scott Drenkard, *Maryland Considers Raising Sales Tax Rate, Would Tie Second Highest in Nation*, TAX FOUNDATION'S TAX POLICY BLOG (Apr. 12, 2012), <http://taxfoundation.org/blog/show/28122.html>.

¹⁰ Mehmet Serkan Tosun & Mark Skidmore, *Cross-Border Shopping and the Sales Tax: A Reexamination of Food Purchases in West Virginia* (Working Paper, 2005), <http://www.rri.wvu.edu/pdffiles/Tosunwp2005-7.pdf>. See also Randolph T. Beard, Paula A. Gant, & Richard P. Saba, *Border-Crossing Sales, Tax Avoidance, and State Tax Policies: An Application to Alcohol*, 64 SOUTHERN ECONOMIC JOURNAL 293-306 (1997).

Transparency

One of the problems with using a special session to make major tax and spending decisions is that the process tends to be opaque. Leading up to the special session, there was no formal tax plan that was available in writing. As of press time, a preliminary income tax bill has been released and we have done our best to analyze it here, but given the short time span of the session, it is difficult for citizens and commentators to keep up with the various bills' progress and voice opinions on legislation.

Conclusion

Maryland's latest income tax increase proposal fails to meet the criteria of sound tax policy. By opting to raise taxes on high-income earners, the proposal seeks to raise taxes in a politically expedient way, but one which will have distortive long-term effects. If a sales tax increase re-emerges as proposal, this too will make Maryland less competitive among its neighbors and in the nation.

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