HB238 Taxpayer Protection Act - State Income Tax CPI Adjustments

My name is Kail Padgitt and I am currently Staff Economist at the Tax Foundation, a non-partisan, non-profit research institution founded in 1937 to analyze tax issues and raise economic awareness among taxpayers, lawmakers, and media. We track tax-related issues at all levels of government, and follow income tax related issues at the federal, state, and local levels.

We appreciate the opportunity to submit this written testimony regarding H.B. 238 to the Ways and Means Committee. The Tax Foundation takes no position on the bill but is eager to provide information about the subject matter. H.B. 238 is designed to index the state’s personal income tax brackets based on the annual change in the Consumer Price Index. Two important results of indexing should be considered: (1) indexing the brackets to inflation preserves the progressive nature of the personal income tax; and (2) indexing will save taxpayers money and reduce government revenue.

The distinction between real and nominal income is key to understanding the time value of money. Nominal income is measured in terms of each year’s current prices. Real income, however, is a measure of income that accounts for general changes in the price level from year to year. For example, in 1970, $50,000 was a high annual salary for a family of four. But in 2010, $50,000 is below the median. In nominal terms, they are the same: $50,000 is $50,000. But in real terms, that $50,000 in 1970 is equal to $279,235.82 in 2010. Real income permits valid comparisons of prices and income over time. The most widely used tool to make those adjustments is the Consumer Price Index as estimated by the Bureau of Labor Statistics in the Department of Labor.

Indexing the brackets of the personal income tax enhances stability within the tax code in terms of economic purchasing power. For example, if a Maryland taxpayer’s annual salary increase matches the inflation rate exactly, he received no real raise because his purchasing power is the same as it was the year before. He definitely received a raise in nominal terms, but inflation wiped it out.

During the 1970s when high inflation was the bane of the U.S. economy, this “fake raise”
problem was rampant. And adding insult to injury, when it came time to pay income
taxes, many workers found themselves pushed up into higher tax brackets because of
inflation, even though their purchasing power had not increased. This happened because
the federal tax brackets were not indexed for inflation. This phenomenon is known as
bracket creep. Starting in 1985, bracket creep was fixed at the federal level with indexing.
Since then, a taxpayer who finds himself in a higher federal tax bracket may not be happy
about it, but at least he knows that it happened because of real growth in his income.

That reform never spread to Maryland, and over time the number of Marylanders paying
in the higher brackets has increased as inflation has raised nominal income. For most of
the past several decades, bracket creep in Maryland has disproportionately affected
lower-income individuals, simply because middle-income Marylanders were already in
the state’s top tax bracket, paying the top rate of 4.75%. There were no higher brackets
for them to be pushed into.

Recently, Maryland enacted four new rates and brackets on high-income people, so going
forward, upper-middle income people who are currently paying in the 4.75% bracket may
be pushed up into higher brackets by inflation unless the code is indexed. So-called
millionaire taxes will eventually apply to people who don’t consider themselves to be
anything like millionaires.

This brings up the second point about indexing to inflation: it saves taxpayers money,
which is another way of saying that the government collects less. Revenue estimates that
the state is currently relying on will all have to be rescored downward to take into
account that inflation will no longer impose a hidden tax increase on Maryland’s
taxpayers each year. When Marylanders’ purchasing power doesn’t rise, neither will tax
revenue.

In some states, unindexed brackets have come to resemble a flat tax due to inflation and
real income growth. For example, the existence of six tax brackets would normally
indicate a steeply progressive system, but in Georgia, the top bracket starts at the
relatively low income level of $7,000. This means all taxable income over $7,000 is
taxed at the top rate. Economically speaking, this can be a good thing. Studies have
shown that when individuals making financial decisions do not have to worry about being
pushed into higher tax brackets, they make better decisions, ones that are based on the
economics instead of on taxes. This is the economic argument for a single-rate system
that implements progressivity with a standard deduction. Out of the 34 states with multi-
rate personal income taxes, 14 index their brackets for inflation. Marylanders currently
have the decision to become the 15th state.

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