HB300 Fairness in Taxation for Retirees Act

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 retirement and pension taxation at the federal and state levels.

We appreciate the opportunity to submit this written testimony regarding H.B. 300 to the Ways and Means Committee. The Tax Foundation takes no position on the bill but is eager to provide information about differential treatment of retirement accounts.

This legislation intends to equalize tax treatment of retirement income. Currently, you have two classes of retirees—those with conventional pensions whose income receives generous tax treatment and those whose retirement income is taxed normally if it comes from any of the following retirement vehicles: IRAs, simplified employee plans (SEPs), Keogh Plans or ineligible deferred compensation plans.

HB300 would grant the same generous treatment to all retirement income that is currently granted to pensions. Of course, when a politically motivated loophole has been inserted into the law, such as the pension exclusion, there are always two ways to “level the playing field.” The legislature can repeal the favored treatment, or the legislature can grant the special treatment to everyone. The latter method is the conventional political practice because it can be fairly described as both a principled reform that makes the code fairer and a tax cut. The former method is political suicide because it can be described as punishing pensioners with a tax hike.

Legislatures generally view the tax code as having two purposes. The first and most obvious is to raise the revenue necessary to fund government activities. Secondly, the tax code is a tool to manipulate the economy, a method to reward favored taxpayers with low
tax rates or none at all while shifting the tax burden to everyone else and punishing some taxpayers with increased rates. This is essentially fiscal expenditure through the tax code.

These two attitudes toward the tax code are in direct conflict because the labyrinth of rewards and punishments that result from manipulating the tax code impairs the code’s function as an efficient revenue producer. The Tax Foundation generally favors the clean, revenue-raising approach, following the classic mantra of the tax reformer: broad bases with low rates. That is the most popular type of tax law that will raise the most revenue at the lowest costs, specifically the costs of compliance and excess burden.

Compliance costs are well understood: the time and money spent by taxpayers filing their taxes plus the time and money spent by tax collectors administering the law. More obscure but nevertheless quite real is the “excess burden” of the tax system. People think of what they’ve paid in taxes as the “burden,” which is correct. But when income taxes are high enough to make people work and earn less, or when sales taxes are so high that people buy less, the value of this undone work and unmade purchases is an economic burden that isn't tallied as a tax payment. Economists call it the "excess burden" of the taxes. It is inherently difficult to quantify things that didn't happen, but scholars agree these costs are substantial.¹

An ideal income tax would attempt to tax all forms of income whether they are wages, capital gains, dividends or retirement income. An income tax that covers all sources of income insures that the rate will be as low as possible. Removing certain forms of income from the base requires increases in the rate of other forms of income. These increased rates create excess burdens on the economy. A recent Tax Foundation Special Report by economist Robert Carroll shows that the excess burden of an income tax can be 11 to 15% of the total revenue collected in the state². The excess burden for such high income earners can be shown to be even higher. This is an important consideration for states, like Maryland, which have high rates on high-income earners.

Taxing all sources of income becomes a difficult task if one uses the standard economic definition of income known as Haig-Simons. If all sources of income cannot be taxed, however, it still makes sense to tax all similar forms of income equally.

The question before the Maryland legislature is whether to continue the favored treatment of pension income over other similar sources of income. Among retirees, Maryland is currently a comparatively attractive state for retirement only if individuals draw their income from pensions. Most Marylanders in or nearing retirement do not have conventional pensions, so we imagine this would be a popular tax cut. However, there is a trade-off. Maryland will be narrowing its tax base overall, causing economic inefficiency and placing more pressure on wage income and other tax sources to fund the

state. On the other hand, with the status quo, the preference for pension income causes distortions in the personal financial planning of Maryland residents.