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Maryland's Tax Rates Dismiss Regional Tax Competition

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Hearing on H.B. 1286
Before the Maryland House Ways & Means Committee

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Chair and members of the Committee:

My name is Rob Shrum and I am currently Manager of State Affairs 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 property tax issues on the state and local levels.

We appreciate the opportunity to submit this written testimony regarding H.B. 1286 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.1286 would reduce the rate of the sales and use tax from 6% to 5%, reduce the maximum rate of local gross receipts taxes on admissions and amusements tax that a county or municipal corporation from 11% to 10%, and alter the percentage of gross receipts from vending machine sales to which the sales and use tax rate applies from 94.5% to 95.25% The most prominent feature of this bill, which I will focus primarily on in this testimony, is the reduction in Maryland's sales tax from 6% to 5%.

In 2008, Maryland raised the sales tax rate to 6% from 5%, the corporate income tax rate to 8.25% from 7%, and the cigarette excise tax to $2.00 from $1.00 per pack. Maryland also created four

Key Findings

- From a regional vantage point, it seems that Maryland is dismissing the possible effect of tax competition. With the sales tax rate of 6% Maryland is currently tied with Pennsylvania, West Virginia, and Washington, D.C. in having the highest sales tax in the region; coming in higher than Virginia (5%) and Delaware (0%).
- Sales taxes not only impact consumers, but they can also have a detrimental effect on businesses - The seller and the consumer both bear a portion of the costs of the sales tax, the consumer through a higher price with tax included and the producer through a lower list price.
- The Comptroller's office has estimated that revenue from the 2008 tax increases ran 44% under projection, suggesting negative economic impacts from the tax increase. Sales tax receipts were projected to fall 3.5% in FY 2009 after adjusting for the rate increase and other law changes, with all major components of the sales tax declining except for receipts from utilities.
- A sales tax reduction would be a positive first step toward improving the state's business tax climate. The 20% reduction in the rate (from 6% to 5%) would result in a rise in Maryland's State Business Tax Climate Index from 45th to 43rd.

new income tax brackets, raising taxes on filers earning more than $150,000 per year. The state's top personal income tax rate is now 6.25% (up from 4.75%); that's on top of county income taxes that average 2.98%. With these increases, Maryland dropped from 24th to 45th in the Tax Foundation's *State Business Tax Climate Index* and firmly planted itself in the ranks of the highest-tax states. Maryland's state-local tax burden is higher than any of its neighboring states and the state lags behind in the region in nearly every major form of taxation. From a regional vantage point, it seems that Maryland is dismissing the possible effect of tax competition.

With the sales tax rate of 6% Maryland is currently tied with Pennsylvania, West Virginia, and Washington, D.C. in having the highest sales tax in the region; coming in higher than Virginia (5%) and Delaware (0%). Certainly this uncompetitive rate does nothing to encourage consumers in the surrounding states to come to Maryland to make purchases. The rate encourages Marylanders who live closer to bordering states with lower sales tax rates to at least consider shopping across state lines rather than make their purchases and be faced with the 6% rate.

In 2008, the state Comptroller's office estimated that increasing the sales tax by one percentage point would add an additional $377 million, adding higher state income tax brackets would raise $504 million in Fiscal Year 2009, and the $1 hike in cigarette taxes would net an additional $74 million. All told, the state expected $976 million more for its budget.[1]

At the end of the year the Comptroller's office revised its estimate for fiscal year 2009, revealing a $415 million shortfall and a $1.9 billion shortfall next year for fiscal year 2010, assuming spending grows at 0.7%. Most alarmingly, revenue from the 2008 tax increases ran 44% under projection, suggesting a loss of economic activity from the increases.[2] Specifically in regards to the sales tax, the State Comptroller Peter Franchot noted in the estimate:

> In fiscal year 2009, sales tax receipts are projected to fall 3.5% after adjusting for the rate increase from 5% to 6% and other law changes, with all major components of the sales tax declining except for receipts from utilities. Baseline revenues are projected to decline 0.1% in fiscal year 2010.[3]

A myth we often hear is that sales taxes have no effect on business because they are paid at the point of sale by consumers. The same logic is used in reverse to argue that consumers are unaffected by corporate income tax increases because they aren't legally involved in the payment. In reality, the economic burden of taxation rarely falls only on the party that has the legal obligation to remit the tax payment. Instead, the burden spreads to other parties with a financial stake. For example, when sales taxes are collected and remitted by stores, part of the burden is borne by the customers, part by the storeowners, and part by employees in the form of lower wages or fewer jobs.

The sales tax acts a wedge between the price the consumer pays (list price + tax) and the price the seller receives (list price only). The seller and the consumer both bear a portion of the costs of the sales tax, the consumer through a higher price with tax included and the producer through a lower list price. So in truth, sales taxes not only impact consumers, but also have a detrimental effect on businesses.

Just look at the Maryland-Delaware border and try to say with a straight face that the sales tax isn't hurting Maryland's retailers and retail employees!

While the Maryland Department of Legislative Services' (DLS) estimated last year that a sales tax reduction would decrease sales tax revenues by $620.5 million in FY 2010 and by $793.5 million in FY 2014, it did not account for a rise in lost sales to lower-tax jurisdictions. Economizing is never pleasant, but Maryland should identify structural changes to spending that would result in ongoing savings to the State General Fund.[4]

In Maryland's case, a reduction in sales tax can serve as a possible first step toward improving the state's business tax climate. Repealing the 20% tax hike (from 5% to 6%) as we come out of the recession would result in a rise in Maryland's *State*

Business Tax Climate Index score from 45th to 43rd and probably lose less revenue than expected.

Tax rates, including sales tax rates, matter enough on a business level to make new and expanding businesses think long and hard before locating or expanding in a high-tax jurisdiction. With Maryland being a high-tax state surrounded by moderate-tax states, the state has had to rely on offering incoming or expanding businesses generous tax breaks to make up for the high rates. Such practices are often ineffective at sustained economic development, and often earn the rightful ire of resident businesses who resent seeing the state's economic development office roll out the red carpet of tax exemptions for newcomers. [5]

A sales tax reduction would signal that Maryland recognizes the impacts of regional competition and is seeking to steer the state back in the right direction. To become fully competitive in the region, Maryland will need to build upon that step and consider reforming its income and corporate income taxes and create a healthy business tax climate that is welcoming to small business owners and entrepreneurs.

Notes

[1] Joseph Henchman, "Maryland Revenue Falls Short Despite (or Because of?) Huge Tax Hikes," Tax Foundation Tax Policy Blog (Sept. 2008) http://www.taxfoundation.org/blog/show/23613.html

[2] Joseph Henchman, "State Budgets: Maryland Tax Increases Can't Keep Up With Spending Increases," Tax Foundation Tax Policy Blog (Dec. 2008) http://www.taxfoundation.org/blog/show/24123.html

[3] State Comptroller Peter Franchot, "Report of the Maryland Board of Revenue Estimates on Estimated Maryland Revenues: Fiscal Years Ending June 30, 2009 and June 30, 2010" (Dec. 16, 2008) http://www.marylandtaxes.com/publications/fiscalrprts/2009_BRE_REPORT.pdf

[4] Delegate J.B. Jennings, "O'Malley Must 'Redress These Economic Atrocities That He Has Placed On Every Maryland Taxpayer'" *The Dagger* (Feb. 28, 2010) http://www.daggerpress.com/2010/02/28/del-jennings-omalley-must-redress-these-economic-atrocities-that-he-has-placed-on-every-maryland-taxpayer/

[5] Bill Ahern, "Maryland Flouts Regional Tax Competition with Historic Tax Hike," *Tax Foundation Fiscal Fact No. 124 (April 2008)* http://www.taxfoundation.org/research/show/23101.html

About the Tax Foundation

The Tax Foundation is a non-partisan, non-profit research institution founded in 1937 to educate taxpayers on tax policy. Based in Washington, D.C., the Foundation's economic and policy analysis is guided by the principles of sound tax policy: simplicity, neutrality, transparency, and stability. The Tax Foundation seeks to make information about government finance more understandable, such as with the annual calculation of "Tax Freedom Day," the day of the year when taxpayers have earned enough to pay for the nation's tax burden and begin earning for themselves.

About the Center for State Fiscal Policy at the Tax Foundation

The Tax Foundation's Center for State Fiscal Policy produces timely, high-quality, and user-friendly data and analysis for elected officials, national groups, state-based groups, grassroots activists, the media, business groups, students, and the public, thereby shaping the state policy debate toward simple, neutral, transparent, stable, and pro-growth tax policies.