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OPTIONS FOR PROTECTING MARYLAND'S LOW- AND MODERATE-INCOME FAMILIES FROM REGRESSIVE TAX INCREASES

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Executive Summary

Maryland faces large budget deficits in the coming fiscal year and for the foreseeable future. Putting the state on secure fiscal footing will almost certainly require significant tax increases. Many of the tax increases currently under consideration would impose a disproportionate cost on Maryland's low- and moderate-income families.

Maryland should seek to mitigate these tax increases on low- and moderate-income families for the following reasons:

- A broad package of tax increases is likely to cost the typical low-income family several hundred dollars per year. This represents a significant amount of money to a family struggling to make ends meet.

- Low- and moderate-income families in Maryland already face high state and local taxes — higher, relative to their income, than high-income Marylanders.

- Growing income inequality has left these families with a smaller share of the pie.

- These families have benefited far less than higher-income Marylanders from recent federal and state income taxes.

KEY FINDINGS

- Tax increases being considered to balance Maryland's budget will have a disproportionate impact on low-income families.

- A typical low-income family in Maryland is likely to face a tax increase of a few hundred dollars — a significant amount for a family struggling to get by.

- To mitigate these tax increases, Maryland could do one or more of the following (with varying degrees of effectiveness):

    - Increase and expand Maryland's refundable Earned Income Credit.

    - Create a new refundable sales tax credit.

    - Increase and reform Maryland's standard deduction; and/or

    - Expand the property tax circuit breaker for homeowners and renters.

This paper describes four options for mitigating tax increases on-low families:

- Increase Maryland's refundable Earned Income Credit from 20 percent to 25 of the federal credit and revoke the exclusion of workers without children living at home;

- Create a new refundable sales tax credit;

- Expand the property tax circuit breaker for homeowners and renters; and

- Increase and reform Maryland's standard deduction.

Because these option are to varying degrees targeted on low- and moderate-income families — roughly the poorest 20 percent to 40 percent of the state's population — they can provide significant assistance to each family at a reasonable fiscal cost.

Background

Maryland faces a General Fund deficit of about $1.7 billion — or 10 percent of the General Fund — in the coming fiscal year, with no improvement foreseen in future years. To address this shortfall in keeping with Maryland's balanced budget requirement, a number of proposals have been advanced. The most prominent proposal is Governor O'Malley's, which calls for a combination of spending cuts, tax changes, and new revenue from expanded gambling. The tax increases included in the governor's plan — including increases in the sales tax, tobacco tax, and car titling tax — would be quite regressive, meaning that low-income families would pay a higher share of their income to cover them than would wealthier families. Likewise, gambling is generally thought to be a regressive revenue source, because on average lower-income households spend a higher proportion of their incomes on gambling than do higher-income households.

The Case for Mitigating Regressive Tax Increases

The goal of mitigating tax increases on low-income families with corresponding tax relief is appropriate for a number of reasons:

- A tax increase of few hundred dollars, as might befall a low-income family under a broad package of tax increases, represents a significant amount of money to a family struggling to make ends meet. A few hundred dollars might cover a month's rent, or two months of groceries, or six months of home heating.

- Low- and moderate-income families in Maryland already face very high state and local taxes, and pay more, relative to their income, than their high-income neighbors. According to the Institute on Taxation and Economic Policy (ITEP), in 2006 the 40 percent of Maryland families with the lowest incomes paid roughly 9.3 percent of their income in state and local taxes, while the top one percent paid only 6.8 percent of their income towards these taxes. This suggests that a typical family of four with income of $20,000 — approximately the federal poverty line

— already pays some $1,900 per year in state and local taxes, which is a large expense for such a poor family.

- Low-income families in Maryland for the most part have not benefited from the present economic expansion. Over the last five years, even as the state's median income has risen, the number of poor families has grown as well, according to the Census Bureau. To add new, regressive tax increases to the economic challenges facing low-income families without mitigating them in some way would be inappropriate.

- Low-income families in Maryland have benefited far less than wealthy Marylanders from recent changes in federal and state income taxes. In 2007 alone, the wealthiest 1 percent of Maryland taxpayers is expected to receive an average federal tax cut of $45,981 from the tax cuts enacted since 2001, according to ITEP. That's more than 80 times the average tax cut received by the bottom 60 percent of Maryland taxpayers. The Maryland income cut passed under Governor Glendenning also helped low-income Marylanders less than it did wealthy ones.

In addition, since the proposals described below are targeted on low- and moderate-income families — roughly the poorest 20 percent to 40 percent of the state's population — they can provide significant assistance to each family at a reasonable fiscal cost. It should be noted that a targeted approach is preferable to more broad-based tax cuts such as across-the-board personal exemption increases or income tax bracket broadenings, which would assist many middle- and upper-income families but at such high cost that the overall revenue-raising impact of the package would be impaired.[1]

How much assistance will low-income families need to meet the proposed tax increases?

A number of the tax increases included in Governor O'Malley's package and likely to be enacted are quite regressive. For example, ITEP data suggest that a one-cent increase in the sales tax rate might cost a typical low-or moderate-income Maryland household $80 to $140 a year — more for larger families. Expanding the sales tax to more services might add another $10 to $20. A one-dollar-per-pack cigarette tax increase might cost the average low- to moderate-income family between $40 and $50 per year. A car titling tax increase would run these families $20 to $30. Another option that may be advanced, a 10-cent gasoline tax increase, would cost these families another $30 to $55. Other tax increases are also being considered.

Depending on what taxes are included in a package, tax increases could easily add up to $300 for low- to moderate-income families, and much more for families with more than two children, rural families that drive a lot, and families that include smokers. Appropriate tax measures could be designed to reflect, roughly, this total.

Another way to assess whether low-income tax relief is adequate is to compare it to the overall revenue from a regressive tax increase. According to ITEP, the poorest 20 percent of taxpayers

[1] However, a personal exemption increase – for all taxpayers or just for seniors — could be designed in such a way that it phases out as a family's income rises. The federal personal exemption and a number of states' income taxes have similar phase-outs; if designed correctly, such a personal exemption change could be part of a package of low-income tax relief.

would pay roughly 7 percent of a sales tax increase or a similar share of a gasoline tax increase (a proportion that far exceeds those taxpayers' share of the state's income). The poorest 40 percent of taxpayers would pay roughly 21 percent of a consumption tax increase. Therefore, a sound strategy would be to dedicate between 7 percent and 21 percent of revenues raised from regressive tax increases to low-income tax relief.

Options for Mitigating Regressive Tax Increases

Option I. Improve Maryland's Refundable Earned Income Tax Credit.

Maryland, like the federal government and 22 other states (counting the District of Columbia as a state), offers an EITC to support low-income working families with children. The EITC has been recognized as one of the nation's most effective anti-poverty tools. Uniquely, Maryland offers *both* a refundable EITC equal to 20 percent of the federal EITC *and* a separate non-refundable EITC equal to 50 percent of the federal credit; they interact in such a way as to complement each other. (A refundable credit is one that can benefit families even if their incomes are too low to have any income tax liability, because the credit can be paid to the family. A nonrefundable credit benefits only families with income tax liability.)

There are two changes to the EITC that would benefit low- and moderate-income working families.

- ***Increase the refundable EITC from its current level of 20 percent of the federal credit to 25 percent or 30 percent of the federal credit.*** An increase in the refundable credit will benefit well over 200,000 Maryland working families with children, particularly those working families whose incomes are too low to have any Maryland income tax liability. Increasing the refundable credit from 20 percent to 25 percent of the federal EITC would provide the average eligible family with between \$100 and \$200 in additional tax relief or income supplement, depending on family structure. This proposal is included in Governor O'Malley's plan. It was also contained in Senate Bill 526 (2007), whose fiscal note estimated its cost at \$33 million.[2] An increase to 30 percent would provide greater tax relief (and carry a larger fiscal note).

- ***Let taxpayers without qualifying children claim the refundable EITC.*** The federal EITC, as well as 21 state credits based on it, offer small benefits to single and married low-income, non-elderly, working adults without qualifying children living in their homes.[3] Maryland is one of just two states that exclude these workers from its refundable EITC.[4] Making these workers eligible for the refundable EITC would provide them as much as \$85 per year (\$107 if the refundable credit were increased to 25 percent of the federal EITC). Implementing this measure would be extremely simple and also would simplify Maryland's tax instructions. This

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[2] See http://mlis.state.md.us/2007RS/billfile/ sb0526.htm.

[3] In general, only a child who lives with the taxpayer counts as a qualifying child for purposes of the EITC. So the federal EITC recipients whom Maryland now excludes from the state refundable EITC may include noncustodial parents.

[4] The other state that excludes workers without qualifying children is Wisconsin. New Jersey and Illinois passed legislation in 2007 making such families eligible for their refundable EITCs.

change would cost less than $4 million.[5]

For more information about Maryland's EITC, see CBPP's legislative testimony on the subject, available at http://www.cbpp.org/mdtestimony.pdf.

Option II. Enact a New Maryland Sales Tax Credit

A number of states have experimented with sales tax credits — direct payments or rebates to all low- and moderate-income families — to help families meet the cost of sales taxes. (The largest, most long-standing such credit is New Mexico's Low Income Comprehensive Tax Rebate, which provides up to $310 to a family of four.) In Maryland, such a credit could also have the function of mitigating increased gasoline taxes or other regressive taxes. A credit's value is sometimes set based on the incremental costs from increases in consumption taxes: perhaps $50 per family member for families with incomes below the poverty line, with lesser amounts for families with incomes just above the poverty line and no credit for middle- or upper-income families. Governor O'Malley's plan, by contrast, includes a flat $50 per family credit for families earning under $30,000 per year.

For taxpayers who are filing income tax forms, the credit could be administered through the income tax system. A separate one-page form could be made available to families that are eligible for the credit but do not file income taxes.

The great challenge with sales tax credits is that many families may not claim the credits for which they are eligible. Both the limited data on the subject and anecdotal evidence indicate that the participation rate for small refundable credits tends to be well below 50 percent. In Kansas, for example, a credit worth up to $130 and intended to balance out the state's sales tax on food was estimated to reach only 33 percent of eligible families in 1995.[6] This problem is particularly acute with taxpayers who do not file income tax forms — a group that includes many of the state's poorest taxpayers. And it is further exacerbated when the credit is a small amount of money, as it would be likely in Maryland.

For these reasons, if such a sales tax credit were enacted, it should be accompanied by a substantial outreach and publicity effort, and it should be large enough to create a strong incentive to claim it.

Even so, it would be reasonable to expect a fairly low participation rate, particularly among those who wouldn't file tax returns. This would reduce the efficacy of such a credit, but, on the other hand, it would make the credit more affordable to the state. Indeed, the Governor's estimate of $10 million for his proposed credit is likely too high, as it appears to be based on the assumption of full participation.

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[5] For additional information on this option, see "A Simple, Inexpensive Way for Maryland to Protect Certain Low-Income Workers from Tax Increases," Center on Budget and Policy Priorities, October 25, 2007.

[6] Steven D. Gold and David S. Liebschutz, *State Tax Relief for the Poor, 2nd Ed.* (Albany: The Nelson A. Rockefeller Institute of Government, 1996), pg. 106.

Option III. Improve the Homeowners' Property Tax Credit and Renters' Tax Credit (Also Known as "Circuitbreakers")

The Homeowners' Property Tax Credit and the Renters' Tax Credit are administered by the Department of Assessments and Taxation. They reduce property tax liability for Marylanders with high property taxes relative to their incomes. (For renters, it is assumed that a certain portion of their rent goes toward property taxes.) High housing costs can be a major factor in making it difficult for families to make ends meet, and property taxes are a contributor to housing costs.

Some 48,000 Maryland homeowners and 10,600 Maryland renters received the credits in FY 2005. The credits are available to homeowners with incomes up to $60,000, renters who are senior citizens or disabled with incomes up to $30,000, and non-senior/non-disabled renters with incomes up to the poverty line (e.g. about $16,000 for a family of three in 2006). To claim the credit, taxpayers must submit a special application each year to the Department of Assessments and Taxation; renters get a rebate check and homeowners get a credit against their property taxes.

The credits could be improved for low- and moderate-income families in the following ways:

- **Make the credits larger**. The formulas for determining the amount of the credits could be adjusted so that the credits equal a larger share of tax liability. Under current law, a homeowner with income of $16,000 and property tax liability of $500 receives a credit worth just $80. A homeowner with income of $20,000 and a $750 property tax bill receives no credit at all. The credit for renters is even less generous.[7] The amount of the credits could be increased and they could be expanded to more homeowners and renters. A modest reform adjusting the formula to increase the homeowners' credit by about $100 for most families would provide up to $6 million to current recipients of the credits, in addition to making more families eligible.

- **Increase participation rates**. The Department of Assessments and Taxation already conducts a limited outreach campaign; additional funding could be allocated to such a campaign, potentially with the assistance of the Comptroller's office, county tax offices, nonprofit organizations, professional tax preparers, senior organizations, media outlets, mortgage companies, landlords, and others. A line should be added to the state income tax form on which taxpayers (especially renters) can claim the credit, rather than requiring submission of an entirely separate form. The increased credit size described above also could make eligible families more likely to try to claim the credit. The Department of Assessments and Taxation has not estimated how many families now fail to receive the credits for which they are eligible. Therefore, it is hard to know what the overall benefit from an increased outreach campaign could be. But it could be substantial.

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[7] Specifically, the current formula for homeowners allows a credit equal to the amount of property tax paid, to the extent that the tax exceeds the following amounts: 0 percent of the first $8,000 of the combined household income, plus 4 percent of the next $4,000 of income, plus 6.5 percent of the next $4,000 of income, plus 9 percent of all income above $16,000. The credit is further limited as follows: the amount of property tax that can be counted in this formula is limited to the property tax levied on home with an assessment of $300,000. Households with net worth exceeding $200,000 are excluded. The exact amounts are shown in the application form at http://www.dat.state.md.us/sdatweb/HTC-60.pdf. The current formula for renters is similar, but results in slightly lower credit amounts; the formulae for renters and homeowners could be made consistent as part of an expansion.

Option IV. Increasing and Reforming Maryland's Standard Deduction

Maryland's standard deduction — which is currently $3,000 to $4,000 (depending on income) for heads of household and married couples, and $1,500 to $3,000 for single filers — has not been adjusted for changes in the cost of living since the late 1980s. Its value has eroded 38 percent since 1990. Maryland's standard deduction is also unusual among states in that it is smaller for taxpayers with low incomes (e.g., married couples with incomes below $26,000) than for higher-income families. Most states have a flat-rate standard deduction. The federal standard deduction for a married couple is a flat $10,000. Increasing the standard deduction would benefit mostly moderate-income individuals and families, because upper-income filers itemize at much higher rates. Of the roughly 1 million Marylanders who claimed the standard deduction in 2005, more than three-fourths had income below $40,000.[8]

Maryland could increase the standard deduction and set it at a flat rate. HB 1373 in 2004 included such a proposal, increasing the standard deduction to $9,500. The estimated fiscal impact at that time was $156 million (plus an additional impact on local income tax collections). The cost of such an increase would be larger for 2008 but a smaller standard deduction increase would, of course, have a smaller cost. The revenue impact, both for the state and for localities, could be further limited by phasing down the standard deduction for higher-income taxpayers, as at least one other state (Alabama) has recently done.

Each $1,000 increase in the standard deduction would reduce state income tax for affected families by up to $47.50 at current tax rates (plus potentially up to $30 in local income tax).

Conclusion: Using multiple approaches

Each of the approaches described above would assist tens of thousands or hundreds of thousands of low- and moderate-income Maryland families meet the increased costs associated with consumption tax increases. But they are not identical in the specific taxpayers that would be assisted. The Earned Income Tax Credit benefits only taxpayers with earnings, so some low-income taxpayers — including low-income retirees[9] — would not benefit from increases in the credit. Increases in the standard deduction generally would leave out families with incomes too low to have income tax liability under current law (the exception would be some of the current recipients of the refundable EITC, whose credit would be increased due to its interaction with the standard deduction). Improvements in the homeowners' and renters' credits would leave out low-income families with relatively low housing costs. And sales tax credits would leave out many low-income families, particularly those who do not file state income tax returns, due to expected low participation rates.

A sound approach, therefore, could be to include more than one of the proposals above. Such a package would assist a wide range of low- and moderate-income families who will face increased costs as a result of regressive tax increases.

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[8] These figures include only "taxable returns," that is, those that have positive net taxable income after exemptions and deductions.

[9] Seniors who are working and raising children in the home, however, can receive the EITC.