Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

October 26, 2007

ADDITIONAL OPTIONS FOR REVENUE IN MARYLAND

By Nicholas Johnson and Michael Mazerov

KEY FINDINGS

- Maryland's governor has proposed a revenue package to avert or minimize budget cuts in education, health care and other areas.
- The governor's package might prove insufficient, or some elements such as legalized slot machines might prove unacceptable to the legislature. If so, there are additional revenue options that would be consistent with the governor's goal of a fairer, more modern and more adequate tax system.
- The options described in this memo would raise over $600 million per year toward financing Maryland public services.

Maryland Governor Martin O'Malley has proposed a set of new revenue options for the state. The additional revenue is needed to close a projected budget deficit and continue to finance education, health care, transportation, and other public service at current-law levels. Without the additional revenue, the state would need to reduce spending by an estimated $1.5 billion to $1.7 billion annually relative to current law and would need to forgo any expansion of services such as health coverage or new school construction. The governor's package would raise revenue from sales taxes, personal and corporate income taxes, cigarette and gasoline taxes, and legalized slot machine gambling.

It is not clear whether all of the elements of the governor's package — such as the gambling revenue — will be acceptable to the legislature or will be enacted at the level proposed. It is also not clear whether the revenue raised by the package will be sufficient to close the entire budget gap over the next four years. (The governor's own numbers suggest that even with the new revenues, spending will slightly exceed revenues in each of the next several years, resulting in a spending-down of the state's general fund balance. If revenue collections are less than projected, a deficit could recur.)

This paper provides some additional revenue options for the governor and legislature to consider. Each of the options recommended here would advance the governor's expressed goals: making Maryland's tax system fairer, more up-to-date, and better able to pay for high-quality education, health care, transportation, and other services. This paper also suggests several changes to the governor's package that could be adopted without undermining the governor's tax policy goals.

Taken together, these measures could add more than *$600 million* in annual revenue to the governor's package. They include:

1. **Expanding the sales tax to include more services**. Tax experts have long questioned the equity and efficiency of levying sales tax on goods but not on most services, as Maryland does. The governor has proposed taxing four services that are currently exempt from sales tax: tanning parlors, health club membership fees, non-medical massage, and property management. Taxing *additional* services such as cable and satellite TV, auto repair, interior decorating, pet grooming, and country club membership, many of which are already taxed by one or more of Maryland's neighbors, could raise an additional **$163 million** or more.

2. **Creating a new Corporate Alternative Minimum Tax.** A corporate AMT, together with the governor's proposal to close tax loopholes, would ensure that corporations doing business in Maryland contribute to the cost of public services. There are a number of ways such a tax could be structured; one recent proposal (SB 728 in 2005) was estimated to raised **$169 million**.

3. **Enacting a corporate "throwback rule."** This would prevent Maryland corporations from creating "nowhere income" that is untaxable by any state. Under this rule, Maryland corporations' profits would be considered taxable by Maryland if they are not taxable in any other state. Some 20 other states have such a rule. The estimated revenue gain would be **$20 million**.

4. **Expanding the governor's progressive income tax proposal.** The governor's proposal to make the income tax more progressive could be altered to reduce the income levels at which families must begin paying at the new income tax rates. If the new top rates were applied to the highest-income 6 percent of Maryland households, the state could raise **$90 million** more than would be raised under the governor's proposal. (The remaining 94 percent of Maryland households would be unaffected by this change.)

5. **Cutting in half the proposed income tax reduction for most Maryland taxpayers**. The governor proposes to cut income taxes for the vast majority of Maryland households by $90 to $150 per household, at a substantial cost to the state. Halving the typical household's tax cut would reduce the overall revenue loss by **$134 million**.

6. **Forgoing the governor's proposal to increase the personal exemption for seniors**. Most of the benefit of this proposal (about 77 percent) would go to seniors with above-average incomes. Without this change, the net revenue yield from the package would increase by **$13 million.**

7. **Forgoing the governor's proposal to create twice-yearly short-term sales tax exemptions for clothing and energy-efficient appliances**. Evidence suggests that such short-term exemptions do not stimulate retail sales over the long run, nor do consumers reap the full benefit of the exemption. There are also administrative and compliance costs associated with such exemptions. Without these the exemptions, the revenue yield from the governor's package would increase by **$13 million**.

8. **Adding a line to the state income tax form for taxpayers to report how much they owe in use tax**. This might generate **$1 million**.

The remainder of this analysis provides more explanation of these options.

1. Expand the sales tax base to encompass additional services primarily purchased by individuals. Potential revenue impact: at least $170 million.

Maryland could expand its sales tax base to encompass additional services that are primarily purchased by individual households, beyond the four categories recommended by Governor O'Malley (tanning parlors, health club membership fees, non-medical massage, and property management). The additional services to be included in the sales tax could include such items as cable and satellite TV, auto repair, interior decorating, pet grooming, and country club membership fees.

It is widely recognized that the sales tax is intended to be a tax on spending or consumption. Taxing goods but failing to tax most services violates the principle of "horizontal equity" — that similarly-situated taxpayers should be taxed alike. For example, it violates the horizontal equity principle for Maryland to tax disposable diapers but not diaper delivery services. Horizontal equity can also be violated by inconsistent taxation of services. For example, fees at commercial driving ranges in Maryland are subject to the county admissions and amusement tax, but country club membership dues are not. There is no reason why someone who likes to watch pay per view movies on television should pay sales tax while his neighbor, who spends an equivalent amount of money each month to watch premium cable channels like HBO, does not. Yet that is currently the state of affairs under Maryland's sales tax.[1]

Moreover, the consumption of services represents a growing share of the U.S. economy, while the consumption of goods represents a declining share of the U.S. economy. Broadening the tax base to include services as well as goods can help ensure that the sales tax base grows with the economy in future years.[2]

Significantly-expanded sales taxation of services is also essential in the long run to ensure that sales tax revenues grow at rates comparable to the costs of the public services that the tax is meant to pay for. Household consumption has shifted slowly but steadily away from purchases of goods toward purchases of services over the past few decades. If the sales tax base is not broadened to encompass such services, either sales tax rates will have to increase or the revenue yield of the tax will erode. Tax rate increases exacerbate the horizontal inequities discussed above and are likely to stimulate more tax avoidance through Internet and cross-border purchasing. Expansion of the sales tax base is the preferable solution.

Maryland has considerable room to expand its sales tax base; according to a survey by the Federation of Tax Administrators, 25 states tax more services than Maryland does.

House Bill 448 from the 2007 session of the General Assembly proposed a significant expansion of the sales tax to encompass more than 30 new categories of services. Many of those were services that almost always are sold from one business to another; economists generally recommend that

---

[1] There can be good reasons to exempt some services from sales taxation. For example, medical care spending generally is not voluntary, and people should not be taxed for getting sick. The list of potentially taxable services in this analysis excludes medical care and other services that are justifiably exempt.

[2] For a thorough discussion of issues involved in the taxation of services, see Michael Mazerov, *Expanding Sales Taxation of Services: Options and Issues*, Center on Budget and Policy Priorities, June 2003, available at http://www.cbpp.org/3-24-03sfp.htm.

states try to avoid taxing such services. Nonetheless, even if such services were set aside, the enactment of the H.B. 448 would (according to the Department of Legislative Services) generate approximately $163 million annually from the expansion of Maryland's sales tax base to encompass the following services: Cable TV, vehicle repair and maintenance, parking, boat docking and landing, storage, shoe repair, exterminating, and interior decorating.

There are a wide variety of additional household services that some other states include under their sales taxes and that Maryland could consider including as well. Encompassing some of these services would also be consistent with the base expansions contained in H.B. 448; for example, if shoe repair is to be taxable there is no reason that garment repair should not be as well. Likewise, if cable television is to be taxed, satellite television and radio subscription services should be taxed, too. The following are additional examples of household services that could be brought into Maryland's sales tax base: pet grooming and boarding, landscaping and lawn care, satellite TV and radio, Internet video and audio downloading and streaming services, limousine services, temporary trailer park and camping site rentals, dry cleaning and laundry services, garment alteration and repair, private club membership fees, carpet and upholstery cleaning, tattooing and body piercing, wrapping/packaging and mailing services, and swimming pool and hot tub cleaning.

2. Require a corporate minimum tax. Potential revenue impact: $169 million.

There are numerous provisions of the Maryland corporate income (profits) tax that make it quite possible for a corporation doing business in the state to pay little or no tax even in a year in which it is profitable. For example, the corporation may be claiming a variety of economic development-related tax credits for which it is eligible that are sufficient to offset all of its tax liability. A Maryland-based manufacturer with most or all most of its customers located out of state will owe little or no corporate tax due to a recent change in the formula in the corporate tax law that determines the share of a multistate manufacturer's nationwide profit that Maryland may tax. In addition, corporations may have implemented a variety of tax shelter mechanisms to reduce their Maryland corporate tax liability, such as transferring income-earning assets to subsidiaries located in foreign tax haven nations.

The basic justification for the corporate income tax is the "benefits received" principle. Corporations benefit from public services provided by the state of Maryland — for example, the roads that enable them to transport their goods to market efficiently and the good schools and universities that attract and educate their employees — and should make at least a minimum contribution every year to the financing of those services. Even when corporations are taking advantage of tax incentives that the legislature clearly intended to offer, it is not necessarily the case that policymakers intended that corporations be able to zero-out their tax liabilities. Moreover, even a corporation that truly is unprofitable in a particular year continues to benefit from state services and can reasonably be asked to make a small financial contribution to support them.

In recognition of this principle, a number of states have enacted various forms of corporate minimum taxes. For example, some states have minimum taxes of a fixed dollar amount levied on every corporation in the state. Other states, such as North Carolina and West Virginia, levy a second general business tax that is based on the business' net worth and is owed in addition to the corporate income tax; in years in which corporate income tax liability is zero, the second tax serves

as a minimum tax. Still others, such as New Hampshire and New York, have a second business tax — calculated on a base other than income or profit — that is explicitly intended as an alternative minimum tax. These taxes are structured in such a way that the corporation effectively pays the higher of the regular corporate income tax or the alternative tax every year.

Maryland has implemented none of these forms of a corporate minimum tax, but it has considered doing so in recent years. Senate Bill 748, introduced in the 2005 legislative session, proposed to enact a minimum tax modeled on those in effect in New Jersey (applicable to out-of-state corporations only) and Kentucky. The minimum tax would have applied to corporations with gross profits from Maryland sources in excess of $1 million annually or gross receipts in excess of $2 million. The maximum tax rate on gross profits would have been 0.8 percent and the maximum rate on gross receipts would have been 0.4 percent; corporations would have made an election to be taxed on either a gross profits (sales minus cost of goods sold) or gross receipts base. For a single corporation, moreover, the highest amount that any corporation could owe under the alternative calculation would have been $5 million. The Department of Legislative Services estimated that S.B. 748 would have yielded approximately $169 million in new annual revenue.

Another option for the state would be to raise an equivalent amount of revenue from an AMT modeled on New Hampshire's Business Enterprise Tax. The base of the BET is the amount of "value-added" within the corporation — equivalent to the corporation's sales minus its purchases from independent firms.

Such a minimum tax would complement Governor O'Malley's recommendation that the state close a variety of corporate income tax loopholes through the mandating of "combined reporting." The corporate income tax will continue to be the basic corporate tax in the state, and it is important that the state first take all appropriate measures to bolster the effectiveness of that tax. Combined reporting cannot, however, close all corporate tax loopholes, nor does it ensure that corporations that have zeroed-out their tax liabilities by claiming tax incentives make a minimal contribution to funding state services. Thus, a minimum tax would serve as an effective and important back-stop to Maryland's traditional corporate income tax.

3. Enact a "Throwback Rule" to improve corporate taxes. Potential revenue impact: $20 million.

Maryland could follow the example of roughly 20 other states with corporate income taxes and enact a "throwback rule." The problem a throwback rule solves is that a corporation in *one* state can sell goods in *another* state without paying tax on the profits from those sales in *either* state. This creates a competitive disadvantage for corporations who are taxed on all their sales. The "throwback rule" eliminates this disadvantage.

The throwback rule eliminates what tax administrators call "nowhere income" — that is, profits that are not subject to any state's corporate income tax. "Nowhere income" exists because of a little-known federal law, Public Law 86-272, which establishes the basic rules under which a corporation can be subjected to corporate income tax on profit earned in any given state. Under Public Law 86-272, states often cannot tax the profits of corporations whose only presence in a state is selling goods (as opposed to operating facilities, for instance).

The throwback rule effectively allows a state in which a corporation produces its wares to tax the profit on any sales made by the corporation into states in which the corporation has insufficient presence to be subjected to a tax on its profit from those sales. (The sales are said to be "thrown-back" for tax purposes from the state in which the purchaser is located to the state in which the seller is located.)

Maryland's lack of a throwback rule allows a significant share of the profits of its resident corporations to be earned somewhere in the United States but not subject to tax by *any* state. For example, if 95 percent of the sales of a Maryland manufacturer are outside the state (as might well occur for a business that is selling specialized subcomponents of another business' products), but the manufacturer is not taxable in those states because of Public Law 86-272, then 95 percent of the manufacturer's profits will not be subject to state corporate income tax in *any* state. The throwback rule eliminates such "nowhere income."

Approximately half the states with corporate income taxes have implemented the throwback rule. Maryland's failure to do so is a loophole in its corporate income tax that is deeply unfair to small businesses and individuals alike. A small, family-owned corporation that sells only to Maryland customers will be subject to tax on 100 percent of its profit. Similarly, an individual that earns income in multiple states — a lawyer practicing in Maryland, Delaware, and Pennsylvania, for example — will also be subject to tax on 100 percent of her income. Only multistate corporations can have "nowhere income" under Maryland law; the small business and the lawyer will be paying income tax at higher-than-necessary tax rates because of the tax that some multistate corporations are escaping.

Senate Bill 392 in the 2003 session of the Maryland General Assembly would have implemented the throwback rule. According to the Department of Legislative Services, its enactment would raise $20 million annually in additional corporate income tax revenue.[3]

4. Expand the new top income tax rate proposed by governor to include more upper-income taxpayers. Potential revenue impact (in addition to revenue from the governor's proposal): $90 million

By making Maryland's income tax more progressive — cutting the tax rate for middle-income Marylanders and adding new top brackets for the highest-income families — the governor proposes to raise a net of $162 million in additional revenue in FY 2009. This amount could be significantly increased by making two changes to the governor's plan: eliminating the modest income tax cut that accrues under the governor's plan to middle-income families, and increasing slightly the number of high-income families that are subject to the two new top income tax rates.

Under the governor's plan, only those with taxable income above $200,000 ($150,000 for single filers) would pay taxes at the new 6 percent rate, and only those with taxable income above $500,000 would pay taxes at the new 6.5 percent rate. Even among tax filers with incomes above $200,000

[3] See Department of Legislative Services, Office of Policy Analysis, "Overview of Maryland's Revenue Structure," presentation to the House Ways and Means Committee, October 2, 2007.

— the highest-income 5 percent of the population — roughly half will avoid the new top rates, because they claim enough exemptions and deductions to keep their taxable income below the $200,000/$150,000 threshold.[4]

The result is that the governor's proposal will raise taxes on very tiny slices of the population. The Comptroller's office estimates that only 2.3 percent of taxpayers would face any tax increase under this proposal. Even in Maryland's highest-income counties, Howard and Montgomery, only 4 percent to 5 percent of tax filers would pay more. The new top rate of 6.5 percent would be even more limited in its impact, affecting less than one percent of tax filers. None of Maryland's neighbors reserves its top income tax rate for such a small slice of the population.

The governor's proposal could be modified so that the new top income tax brackets could take effect at slightly lower income levels. For instance, the 6 percent bracket could be applied to taxable income over $150,000 for married couples ($100,000 for single filers) and the 6.5 percent bracket could be applied to taxable income over $300,000. This tax increase would still affect only a tiny percentage of Maryland taxpayers; some 94 percent of Maryland households would be unaffected. This change would raise an additional $90 million beyond what's in the governor's proposal.

5. Forgo half of the income tax cut proposed for other Marylanders. Potential revenue impact: $134 million.

While raising taxes on a very small number of high-income Marylanders, the governor's plan would also give a modest tax cut to almost all other Maryland tax filers — roughly $70 to $170 depending on income and filing status. It would accomplish this by increasing the income limits for the 3 percent bracket and the 4 percent bracket. The decision to broaden those brackets is, by itself, a $268 million tax cut, according to the Institute on Taxation and Economic Policy. By cutting the bracket-broadening in half, the state could increase revenue by about $134 million compared to the governor's proposal.

6. Forgo the increase in the personal exemption for senior citizens. Estimated revenue: $13 million.

Many seniors, particularly those with low- to middle incomes, would not benefit from the governor's proposed $1,000 increase in the personal exemption for senior citizens. This is because Maryland already has a relatively generous income tax break for senior citizens: a complete exemption for Social Security and other pension income up to $41,400 for married couples and $20,700 for single filers. Combined with other exemptions and deductions, this pension exemption means that many seniors with moderate incomes do not pay income taxes.

---

[4] The estimates in this section were calculated by the nonpartisan Institute on Taxation and Economic Policy, a Washington-based research organization. Details on the computer model used for these estimates are available at www.itepnet.org. The ITEP estimates refer to the impact if the proposals were in effect for 2007, so they are likely to differ slightly from estimates that may be generated by the Department of Legislative Services, but the difference is likely to be relatively slight.

Among those seniors who do benefit, the largest benefits would accrue to those with the highest incomes. Seniors with taxable incomes in the 2 percent tax bracket would receive a $40 tax cut; seniors with incomes in the new 6.5 percent bracket would receive a $65 tax cut. The Institute on Taxation and Economic Policy estimates that only 23 percent of the benefits of this tax cut will go to the bottom 60 percent of the state's population.

7. Forgo new short-term sales tax exemptions for clothes and energy-efficient appliances. Estimated revenue impact: $13 million.

The governor proposes establishing two weeks each year in which clothes and energy-efficient appliances would be exempt from sales tax. There is evidence to suggest that these temporary tax exemptions are not effective ways either to boost retailer sales or to cut costs for consumers. A study in New York found that taxpayers spend more during the exemption periods, but spend less before and after them, so that the overall impact on retail trade is imperceptible. A study in Florida found that retailers on average charge higher pre-tax prices on exempt goods, so that shoppers end up receiving only a portion of the benefit of the tax reduction. There are also compliance costs associated with reprogramming cash registers to identify temporarily exempt goods, and administrative costs to the state associated with promulgating lists of which goods are exempt. [5]

Although a number of other states each year offer such "sales tax holidays" on various items, few of them are permanent; most of them are decided on a year-to-year basis depending on the state's fiscal condition. It would be entirely reasonable to Maryland to wait to see whether, in fact, the proposed revenue package returns the state to fiscal health before enacting such temporary exemptions. John Mikesell, an Indiana University professor and noted expert on state sales tax policy, has written, "Only a state with *extremely strong finances* can legitimately consider a holiday at all, even though total revenue loss will be rather modest" (emphasis added). That does not describe Maryland's current fiscal condition.[6]

By not enacting permanent tax-exempt weeks, the state could save $13 million per year.

8. Add a line to the state personal income tax form for self-remittance of consumer use tax. Estimated revenue impact: $1 million.

Maryland residents, like residents of every other state with a sales tax, are supposed to self-remit "consumer use tax" on any purchases they make from out-of-state Internet and catalog companies, unless the companies themselves collect the sales tax. The same is true of items that Marylanders purchase in Delaware (or any other state without a sales tax) and bring into the state.

Because many of these purchases are relatively small, compliance will never be anywhere near 100 percent. But compliance in Maryland is probably even lower than it needs to be, because Maryland

---

[5] See New York State Department of Taxation and Finance, Office of Tax Policy Analysis, "The Temporary Clothing Exemption: Analysis of the Effects of the Exemption on Clothing Sales in New York State," November 1997; and Richard Harper, "Price Effects Around a Sales Tax Holiday: An Exploratory Study," *Public Budgeting & Finance*, Winter 2003, pp. 108-113.

[6] Mikesell, "State Sales Tax Holidays: The Continuing Triumph of Politics Over Policy," *State Tax Notes*, July 10, 2006.

has made virtually no effort to educate its citizens about their use tax obligations. Moreover, the tax form for calculating and remitting use tax is buried on the Comptroller's web site, and taxpayers are supposed to file quarterly, quite apart from personal income tax filing.

With a few minimal steps, Maryland could raise new revenue by educating citizens about the use tax and making it easier for people who want to meet their legal obligations to do so. A number of other states (including North Carolina) include information about the use tax in the income-tax booklet and a line on the income tax form for reporting the tax that is due on an annual basis. This system relieves taxpayers of the need to write separate checks for income and use tax payments. Maryland could also require paid tax preparers to sign a separate statement on the income tax form that they informed their clients of their use tax payment obligations and inquired whether the client had made any out-of-state purchases during the relevant tax year.

The fiscal impact of a similar recent proposal in California (not enacted) was estimated to raise $6 million in new revenue. Since Maryland's economy is one-sixth the size of California's, it is reasonable to think it might raise $1 million in Maryland.