ITEP

INSTITUTE ON TAXATION AND ECONOMIC POLICY

1616 P Street, NW Washington, DC 20036
(202) 299-1066

WRITTEN TESTIMONY SUBMITTED TO
THE MARYLAND HOUSE WAYS AND MEANS COMMITTEE
REGARDING HOUSE BILL 1177
MARCH 11, 2010

Thank you for the opportunity to submit written testimony. My name is Matthew Gardner. I am the Executive Director of the Institute on Taxation and Economic Policy (ITEP), a nonprofit research group based in Washington, DC. ITEP's research focuses on federal and state tax policy issues, especially as they affect lower- and middle-income taxpayers.

My testimony today focuses on House Bill 1177, which would make permanent a temporary "millionaire's tax" that is scheduled to expire at the end of 2010. The testimony emphasizes that the "millionaire's tax" makes Maryland's tax system at least somewhat less unfair than it otherwise would be; that claims about the negative impact of the tax are unfounded; and that allowing the tax to expire would result in a substantial federal tax increase for upper-income Marylanders.

MAKING AN UNFAIR TAX SYSTEM SLIGHTLY LESS UNFAIR

Maryland's tax system currently falls most heavily on low- and middle-income families—and allows the very best-off taxpayers to pay substantially less of their income in tax than any other income group must pay. According to a November 2009 ITEP analysis, which looks at the permanent features of the tax system and does NOT include the impact of the millionaire's tax:

- ➢ The poorest twenty percent of Maryland families paid 9.9 percent of their income in state and local taxes (including the offsetting impact of federal taxes), on average.
- ➢ Middle-income Marylanders paid 9.8 percent of their income in state and local taxes, by the same measure, on average.
- ➢ The very best-off 1 percent of Marylanders (a group with average incomes well over $1.5 million), paid just 6.2 percent of their income in state and local taxes after accounting for the interaction with federal income taxes—about a third less than what low- and middle-income families have to pay.
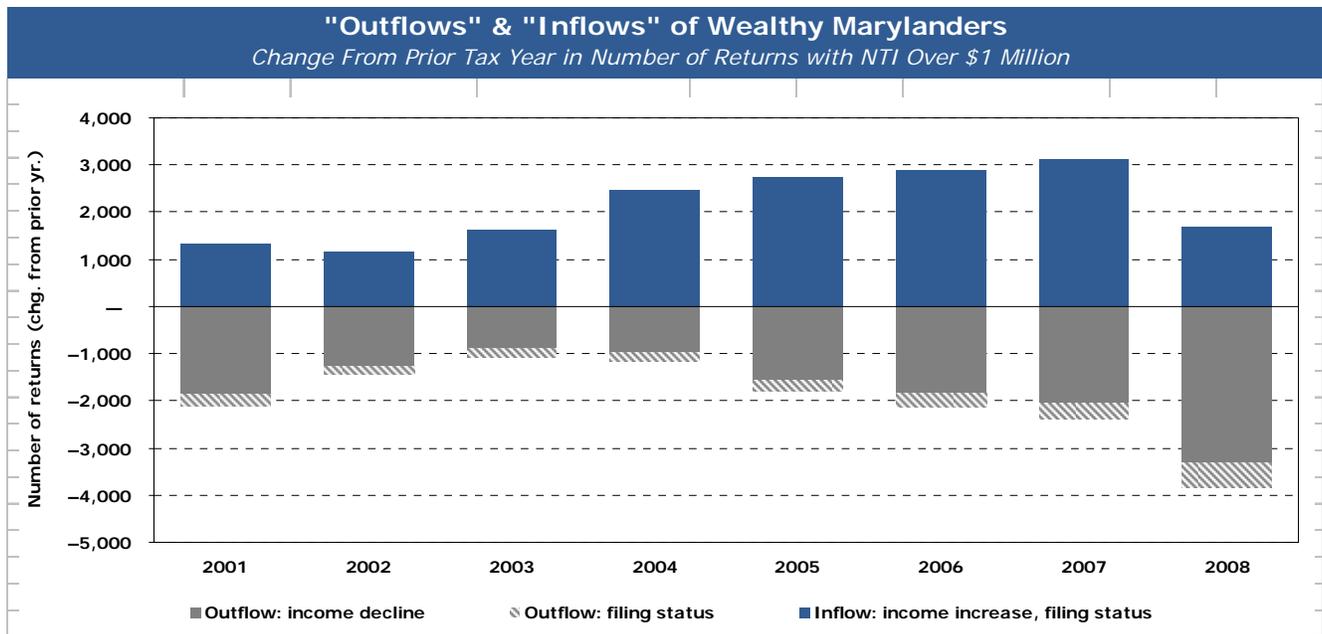
Including the impact of the millionaire's tax changes this picture only slightly: the effective tax rate on the best-off Marylanders increases from 6.2 percent to 6.4 percent. In other words, the millionaire's tax helps ensure that the large gap between what the best-off 1 percent pay and what

everyone else pays gets a little bit smaller, moving the tax system a bit closer towards achieving the minimal standard of tax fairness that most people would find acceptable. But, with or without the millionaire's tax, the reality is that the taxpayers who would be subject to the millionaire's tax are exactly the ones who are currently paying the lowest effective tax rate of anyone in the state.

THE "MISSING MILLIONAIRES" MYSTERY

In the wake of enacting the "millionaire's tax," the Maryland Comptroller's Office released data on the income tax filing patterns of the upper-income taxpayers who were subject to the tax. Unfortunately, the results of the Comptroller's analysis were misconstrued by some observers to imply that a third of the state's millionaires had left the state in response to the income tax increase.

However, as a January 2010 ITEP report notes, a more accurate way of describing what happened to Maryland's millionaires between 2007 and 2008 is to note that they didn't leave—they just stopped being millionaires. As the following chart shows, the most obvious factor governing the change in the number of Maryland millionaires between 2007 and 2008 is the sharp growth in the number of millionaires whose taxable income fell below $1 million.

"Outflows" & "Inflows" of Wealthy Marylanders
Change From Prior Tax Year in Number of Returns with NTI Over $1 Million

This information might be more helpful if there were similar information available from other states: after all, if the recession is to blame for the sharp drop in the number of Maryland millionaires, one would expect to see a similar pattern in other states. Unfortunately, we are aware of only one other state in which strictly comparable data is available. Utah's State Tax Commission publishes similar data every year. What their most recent data show is that the number of Utah millionaires fell by 60 percent—twice as much as what Maryland experienced—between 2007 and 2008. Notably, no one in Utah is blaming this trend on the income tax, because at just the same time that Maryland was hiking their income tax, Utah was cutting theirs, enacting a substantial income tax cut in which the very best off taxpayers were the biggest beneficiaries. In fact, the sensible consensus in Utah is that

the economic slowdown of the past two years explains the sharp decline in the number of Utah millionaires. This explanation seems just as plausible in Maryland.

OFFSETTING FEDERAL TAX CHANGES

Progressive state income tax changes, such as Maryland's "millionaire's tax," always have an impact on the amount of federal income taxes paid by affected groups. This is because state income taxes can be claimed as an itemized deduction on federal income tax returns. Under current law, the top federal marginal tax rate for most Maryland millionaires in 2011 will be 39.6 percent. This means that, for whatever tax hikes these taxpayers see under the Maryland millionaire's tax, as much as 39.6 percent of that tax hike would be offset directly by federal tax cuts. The flip side of this, of course, is that whatever tax cut lawmakers think they're giving the best-off millionaires by repealing this tax, close to 40 percent of it could never see the inside of a Marylander's wallet, and would go instead directly to the federal government.

This impact is muted somewhat because some of the very best-off Marylanders pay the federal Alternative Minimum Tax, which can partially or, in some cases, completely eliminate this offsetting federal tax change. However, the most recent data show that nationally, more than 70 percent of taxpayers with AGI over $1 million don't owe any AMT liability at all. For these taxpayers, this "federal offset" has a very real impact on reducing state income tax liability.

CONCLUSION

Any feature of Maryland's tax system can (and should) be evaluated based on a number of potentially competing objectives. The most obvious objective of the state's tax system is to raise sufficient revenues to pay for the public investments Marylanders demand, and the Maryland millionaire's tax has clearly accomplished that. The tax has also helped, at least on the margin, to make an unfair tax system at least somewhat less unfair. Of course, it's also important to evaluate the impact of tax changes on a state's economic development climate—but there is simply no evidence that the Maryland millionaire's tax has prompted an exodus of upper-income families from the state.

Thank you for the opportunity to submit this testimony.

BACKGROUND ON ITEP

The Institute on Taxation and Economic Policy (ITEP) has engaged in research on tax issues since 1980. Since 1996 ITEP has used a *microsimulation tax model* to conduct research on federal, state, and local tax systems. A microsimulation model uses a large sample of tax returns and other data to estimate the impact of tax systems and tax proposals on actual taxpayers at different income levels. This is the same type of tax model used on the federal level by the U.S. Treasury Department, the Congressional Joint Committee on Taxation, and the Congressional Budget Office, as well as by many state revenue departments. A properly constructed microsimulation model can provide accurate estimates of revenue yield and tax incidence by income group.

ITEP's microsimulation model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to 750,000 records. This database is based on federal tax returns, with statistically valid samples from every state and the District of Columbia. The database is augmented with a sampling of records from the U.S. Decennial Census "five percent sample" (which contains a random sample of five percent of all census forms received by the Census Bureau); the Census data are statistically matched with the tax return records. The data on these records is then extrapolated to subsequent years using federal tax micro and tabular data, Census Bureau Current Population Survey micro and tabular data, and other widely respected data sources.

These, and other, data are used by the ITEP model's four modules: Personal Income Tax, Property Tax, Consumption Tax and Business Tax. These modules calculate tax liability on a record-by-record basis and sum the results to provide revenue and tax incidence estimates. (A complete description and methodology for the ITEP model is available on request.)

The ITEP model has the unique capability of analyzing all major taxes for every state and the District of Columbia. In 2009, the ITEP model was used to produce the study *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*. This study shows the distributional impact, by income level, of all major state and local taxes for each of the 50 states. It has been used by many state revenue departments and legislative fiscal offices since its publication.

The ITEP Model is also unique in its ability to forecast the effect of both federal and state tax changes on taxpayers in a given state. This capability is especially important in analyzing the impact of proposed tax changes that affect people on multiple levels. For example, proposals for federal tax reform often impact state tax collections. Similarly, proposals to change state tax structures, such as the bills under discussion today, can affect the federal taxes paid by a state's residents in ways that can drastically affect the overall incidence of these proposals.

In addition to its fifty-state analyses, ITEP often conducts research in individual states. This work has been primarily funded by private foundations. ITEP's full body of research is available at www.itepnet.org.