Department of Legislative Services
2013 Session

FISCAL AND POLICY NOTE

House Bill 308 (Delegate Krebs, *et al.*)
Ways and Means

Taxpayer Protection Act - State Income Tax - Consumer Price Index Adjustments

This bill indexes specified State income tax rate brackets based on the annual change in the Consumer Price Index (CPI).

The bill takes effect July 1, 2013, and applies to tax year 2013 and beyond.

Fiscal Summary

State Effect: General fund revenues decrease by $0.5 million in FY 2015 and by $4.1 million in FY 2018. Minimal increase in general fund expenditures beginning in FY 2015 due to computer programming expenses in the Comptroller's Office.

($ in millions)	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018
GF Revenue	$0	($0.5)	($1.4)	($2.7)	($4.1)
GF Expenditure	$0	-	-	-	-
Net Effect	$.0	($0.5)	($1.4)	($2.7)	($4.1)

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect

Local Effect: Montgomery County expenditures for its earned income credit program may increase minimally beginning in FY 2016. No effect on revenues.

Small Business Effect: Minimal.

Analysis

Current Law: Chapter 2 of the first special session of 2012 (SB 1302) contained numerous provisions that increased State and local tax revenues. About 90% of the estimated increase in fiscal 2014 revenues included in that legislation will be generated from the enactment of increased State income tax rates and a reduction of the personal exemption amounts for certain higher-income taxpayers. These changes are effective beginning in tax year 2012. **Exhibit 1** shows the State income tax rates under current law.

Exhibit 1
Maryland State Income Tax Rates
Current Law

Single, Dependent Filer, Married Filing Separate		Joint, Head of Household, Widower	
Rate	**Maryland Taxable Income**	**Rate**	**Maryland Taxable Income**
2.00%	$1-$1,000	2.00%	$1-$1,000
3.00%	$1,001-$2,000	3.00%	$1,001-$2,000
4.00%	$2,001-$3,000	4.00%	$2,001-$3,000
4.75%	$3,001-$100,000	4.75%	$3,001-$150,000
5.00%	$100,001-$125,000	5.00%	$150,001-$175,000
5.25%	$125,001-$150,000	5.25%	$175,001-$225,000
5.50%	$150,001-$250,000	5.50%	$225,001-$300,000
5.75%	Excess of $250,000	5.75%	Excess of $300,000

Background: CPI is the most commonly used measure of the change in prices over time (inflation). The index tracks the average change in prices paid by urban consumers for various consumer goods and services. It is used to compare the relative value of money and goods over time, given price fluctuations. Though not a perfect measure, it is commonly used to measure the cost of living, and is also used to increase wages in an attempt to maintain a constant standard of living given rising costs. Although the increase in CPI in the last year has slowed due to the economic recession, CPI has typically increased by about 2.5% annually in the last 10 years.

Major components of the federal income tax are indexed for changes in inflation, including federal income tax rate brackets. The federal Internal Revenue Service (IRS) issues revenue procedures which set the inflation adjustments for the following tax year. About 40 items are typically adjusted. Indexing tax brackets to the change in inflation prevents “bracket creep,” whereby households pay additional income taxes merely because of inflation and not because the taxpayer’s economic well-being has improved. The most salient example of bracket creep is the federal alternative minimum tax, originally enacted in 1969 to prevent high-income taxpayers from avoiding income taxes. Since the original legislation lacked indexing, it applied to households of much more limited means than originally intended, leading Congress to enact a series of temporary corrective measures until the American Taxpayer Relief Act of 2012 provided permanent relief by indexing the tax.

According to the Tax Foundation, 14 states provided an inflation adjustment in tax year 2011 by indexing their income tax rate brackets to a consumer price or cost-of-living measure. Various states provide an implicit adjustment by taxing income at a percentage of the taxpayer's federal tax liability. In addition, some states index the value of either the standard deduction or the personal exemption.

Although the State's income tax brackets are not indexed for inflation, several components of Maryland's income tax system are influenced by inflation, including the State pension exclusion, State earned income tax credit, and poverty level tax credit. The maximum value of the State pension exclusion increases every year based on the maximum annual benefit payable under the Social Security Act, which is indexed to CPI. The State earned income tax credit is based on a percentage of the federal earned income tax credit, of which the value of and eligibility standards for are adjusted annually based on the change in the CPI. The poverty level tax credit is based on federal poverty standards, which are adjusted annually based on inflation. Taxpayers can claim either a standard deduction or itemized deduction for State income tax purposes. While the value of the standard deduction does not change based on inflation, the value of itemized deductions are sensitive to inflation because (1) federal income tax phase-out rules based on CPI, when applicable, flow through for State income tax purposes and (2) the amount that taxpayers itemize is influenced by price fluctuations in the economy, particularly changes in home prices.

Income tax brackets and other important components of the income tax, such as the personal exemption and standard deduction, are not adjusted for inflation. As a result, some Maryland businesses and households pay more State income taxes over time due to inflation, even though their economic well-being may not have improved over time.

State Revenues: The bill will index the value of certain State income tax rate brackets based on the rate of inflation. In each tax year, the specified brackets will increase based on the difference in the prior year's CPI compared with the CPI in calendar 2013. It is assumed that the bill impacts withholdings or estimated payments. Based on the brackets specified by the bill and the current inflation forecast, it is estimated that general fund revenues will decrease by a little more than $500,000 in fiscal 2015. Future revenue losses increase and total $4.1 million in fiscal 2018.

State Expenditures: The Comptroller's Office reports that it will incur minimal expenditure increases beginning in fiscal 2015 to update tax and withholding tables.

Local Expenditures: Montgomery County's earned income credit program acts as a grant program by matching the State refundable earned income credit claimed by a taxpayer. Under the program, eligible taxpayers receive a check from the Comptroller, but the grants are paid for by Montgomery County. Under the bill, certain taxpayers will claim a greater refundable earned income credit beginning in tax year 2015. Due to the limited increase in the refund and number of impacted individuals, any increase in expenditures is expected to be minimal.

Additional Information

Prior Introductions: HB 383 of 2012 received a hearing in the House Ways and Means Committee, but no further action was taken.

Cross File: None.

Information Source(s): Comptroller's Office, Internal Revenue Service, Moody's.com, Tax Foundation, Department of Legislative Services

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Analysis by: Robert J. Rehrmann

Direct Inquiries to:
(410) 946-5510
(301) 970-5510