Department of Legislative Services

Maryland General Assembly
1999 Session

FISCAL NOTE

House Bill 55 (Delegate Rosenberg)
Ways and Means

Income Tax - Subtraction Modification for Federal Insurance Contribution Act Tax and Federal Self-Employment Income Tax - Tobacco Tax

This bill increases the tobacco tax rate for a standard 20-cigarette pack by $1.00 and increases the tax rate for other pack sizes by a comparable amount. The wholesaler discount is also reduced from 1.36% to 0.36% of the purchase price of tax stamps.

In addition, the bill creates a subtraction modification from income for: (1) the Federal Insurance Contribution Act (FICA) taxes; or (2) 50% of self-employment taxes. The subtraction is allowed for each taxpayer and is the lesser of: (1) the amount of the FICA or self-employment tax; or (2) $2,700.

The bill takes effect July 1, 1999. The subtraction modification applies to all tax years beginning after December 31, 1998.

Fiscal Summary

State Effect: General fund revenues would increase by $232.1 million in FY 2000 and $217.5 million in FY 2001 from the increased tobacco tax rate. General fund revenues would decrease by $336.2 million in FY 2000 and $231.7 million in FY 2001 from the FICA tax subtraction. The net effect is a loss in general fund revenues of $104.1 million in FY 2000 and $18.8 million in FY 2001. Future year general fund revenue decreases reflect declining cigarette consumption and rising wage income. Expenditures would not be affected.

(in millions)	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004
GF Revenues	($104.1)	($18.8)	($32.8)	($43.5)	($52.5)
GF Expenditures	0	0	0	0	0
Net Effect	($104.1)	($18.8)	($32.8)	($43.5)	($52.5)

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

Local Effect: Local piggyback revenues would decrease by $190.6 million in FY 2000 and $134.7 million in FY 2001. Future year revenue losses increase by about 3% annually.

Small Business Effect: Minimal.

Fiscal Analysis

State Effect:

Increasing the Tobacco Tax Rate

Increasing the tobacco tax rate by $1.00 for a standard 20-cigarette pack will increase general fund revenues by $232.1 million in fiscal 2000 and $217.5 million in fiscal 2001. The estimates are based on the following assumptions:

- a federal excise tax increase of $.10 in fiscal 2000 and another $.05 increase in fiscal 2001 under current federal law;
- a manufacturer's price increase of $.50 in fiscal 1999, $.20 in fiscal 2000, and another $.10 in fiscal 2001 as a result of the recent tobacco settlement between the tobacco companies and the states, and the proposed farmer's settlement;
- there is a price elasticity of -0.4% for cigarette sales (that is, for every 10% increase in price, there is a 4% reduction in sales);
- inflation will increase the price of cigarettes by 3% each year, thereby reducing the consumption of cigarettes over time (as explained above);
- an estimated 2.5% decrease in sales as a result of cross-border sales for each $.50 increase in the tobacco excise tax (reflecting 5% of the smoking population located in border counties purchasing in another state). Currently, there is an incentive for Maryland residents to travel to Delaware, Virginia, Pennsylvania, or West Virginia because of the lower tax rates in these states. Increasing the tobacco tax will further increase this incentive; and
- the estimated base price per pack of cigarettes will be $2.70 for fiscal 2000 (before

the tobacco tax rate increase), which includes all excise taxes.

Future year general fund revenue increases decline by about 10% annually due to the decrease in cigarette consumption.

Allowing a FICA Subtraction

The Federal Insurance Contribution Act (FICA) tax, also known as "payroll tax", is paid on wage and salary income. The FICA tax rate is 7.65%, which includes 6.2% for Old Age and Survivors Disability Insurance (OASDI) and 1.45% for Medicare. Employees pay the 7.65% while employers contribute an additional 7.65%. The OASDI tax is applied to the first $68,400 of income for 1998 while the Medicare tax applies to all earnings. Self-employed individuals pay a self-employment tax which is simply twice the FICA tax rate, or 15.3%.

This bill would allow a FICA subtraction of 7.65% of wages, subject to a maximum subtraction of $2,700 (which corresponds to about $35,000 in annual wage income). As a result, general fund revenues will decrease by $220.3 million in tax year 1999 and $231.7 million in tax year 2000. Although the increased subtraction is allowed for tax year 1999, it is assumed that most taxpayers will not adjust their estimated payments to reflect the increased subtraction until after July 1, 1999. Consequently, general fund revenues are estimated to decrease by $336.2 million in fiscal 2000, reflecting the impact of tax year 1999 and half of tax year 2000.

The above estimates are based on 1996 Maryland Statistics of Income data and the Board of Revenue Estimates' forecasted wage and salary growth. It assumes that half of the joint returns are two wage-earner households and both individuals claim the FICA subtraction, and the number of returns grow by 1% annually. Future year estimates increase by about 3% annually.

Net General Fund Effect

The net effect of increasing the tobacco tax rate in July 1999 and allowing a FICA subtraction for all of tax year 1999 is a decrease in general fund revenues of $104.1 million in fiscal 2000 and $18.8 million in fiscal 2001. General fund revenue losses increase over time due to declining cigarette consumption and rising wage income.

The Office of the Comptroller currently employs nine tax agents to enforce anti-smuggling regulations and advises that it will require 12 additional alcohol and tobacco agents with necessary equipment (vehicles, guns, cell phones, etc.) at a cost of $620,400 in fiscal 2000 to help control the anticipated increase in smuggling as a result of this bill.

The Department of Legislative Services advises that because there is only limited experience with a tobacco tax increase of this size, the extent to which smuggling will become a problem is unknown. However, if organized or large scale smuggling does become a problem in the future, additional tax agents may be required, perhaps on the scale envisioned by the Comptroller's office. It should be noted that a loss from the additional cross-border sales has been incorporated in the revenue estimates.

Local Revenues: Local piggyback revenues would decrease as a result of the FICA subtraction. Revenues are estimated to decrease by $190.6 million in fiscal 2000 and $134.7 million in fiscal 2001. Future year revenue losses grow by about 3% annually.

Information Source(s): Comptroller of the Treasury (Bureau of Revenue Estimates), Department of Legislative Services

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