

Department of Legislative Services
 Maryland General Assembly
 2004 Session

FISCAL AND POLICY NOTE

House Bill 103 (Delegate Simmons)
 Ways and Means

Sales and Use Tax - Rate - Education Trust Fund

This bill raises the general sales and use tax rate from 5% to 6%. The bill also alters the distribution of sales and use tax revenues by requiring that 16.67% of the revenues, after certain deductions, be deposited in an Education Trust Fund (ETF). The ETF is established as a special, continuing, nonlapsing fund for the purpose of providing State aid to local school systems pursuant to the Bridge to Excellence in Public Schools Act of 2002.

The bill takes effect July 1, 2004.

Fiscal Summary

State Effect: Sales tax revenues could increase by \$547.7 million in FY 2005, increasing in the out-years based on projected sales tax growth and a projected 1% decline in taxable sales attributable to the higher rate. Expenditures would not be affected.

(\$ in millions)	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009
GF Revenue	(\$29.2)	(\$30.3)	(\$31.5)	(\$32.6)	(\$33.7)
SF Revenue	577.0	598.4	621.9	643.2	665.2
GF Expenditure	(577.0)	(598.4)	(621.9)	(643.2)	(665.2)
SF Expenditure	577.0	598.4	621.9	643.2	665.2
Net Effect	\$547.8	\$568.1	\$590.4	\$610.6	\$631.5

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

Local Effect: State aid to local school systems would not be affected.

Small Business Effect: Meaningful. To the extent that the additional sales tax rate encourages consumers to shift purchases to out-of-state or remote sellers and away from Maryland retailers that are small businesses, these small businesses could experience a meaningful negative impact. Small businesses may also experience minimal additional costs to reprogram their cash registers.

Analysis

Current Law: Maryland imposes a 5% sales and use tax. After an allowance for refunds and administrative costs, the revenues are distributed to the State's general fund. Revenues from the sales tax on short-term vehicle rentals, which are not affected by this bill, are distributed to the general fund (55%) and to the Transportation Trust Fund (TTF) (45%).

Background: The sales tax rates for neighboring states are as follows: District of Columbia (5.75%), West Virginia (6%), Pennsylvania (6%, plus local 1% sales tax in certain local jurisdictions; no sales tax on clothing), Delaware (none, but a gross receipts tax on retailers), and Virginia (4.5%, includes 1% for local governments). **Appendix 1** sets forth the sales tax rates for all states.

Sales Tax Incidence

Tax incidence studies are often used to estimate the amount of tax paid by individuals or households. During the 2003 interim, the Department of Legislative Services examined the amount of sales tax paid by Maryland households at various income levels, based on the Bureau of Labor Statistics 2001 *Consumer Expenditure Survey*, the 2000 United States Census, and the *Income Tax Summary Report* for tax year 2002. **Exhibits 1 and 2** show the distribution of households among income classes, the average income (MD AGI), sales tax paid by household, sales tax as a percent of income, and sales tax as a percent of total sales tax at both the current 5% rate and the proposed 6% rate.

Exhibit 1 Sales Tax Incidence at 5% Rate

	<u>Household Distribution</u>	<u>Average Income</u>	<u>Sales Tax by Household</u>	<u>Sales Tax as % of Income</u>	<u>Percent of Total Sales Tax**</u>
Under \$5,000*	1.9%	\$2,636	\$329	12.5%	0.9%
\$5,000-\$9,999	4.0%	8,077	223	2.8%	1.3%
\$10,000-\$14,999	4.3%	12,495	277	2.2%	1.7%
\$15,000-\$19,999	4.5%	17,454	339	1.9%	2.2%
\$20,000-\$29,999	10.3%	24,801	363	1.5%	5.4%
\$30,000-\$39,999	11.0%	34,744	462	1.3%	7.4%
\$40,000-\$49,999	10.2%	44,699	544	1.2%	8.1%
\$50,000-\$69,999	18.0%	59,475	690	1.2%	18.1%
Over \$70,000	35.8%	127,954	1,053	0.8%	54.9%

* May include individuals who are part of other households or other data anomalies.

** Represents percent of total sales tax paid by Maryland households. Does not include sales tax paid by businesses or out-of-state purchasers.

Exhibit 2
Sales Tax Incidence at 6% Rate

	<u>Household Distribution</u>	<u>Average Income</u>	<u>Sales Tax by Household</u>	<u>Sales Tax as % of Income</u>	<u>Percent of Total Sales Tax*</u>
Under \$5,000	1.9%	\$2,636	\$395	15.0%	0.9%
\$5,000-\$9,999	4.0%	\$8,077	268	3.3%	1.3%
\$10,000-\$14,999	4.3%	12,495	332	2.7%	1.7%
\$15,000-\$19,999	4.5%	17,454	407	2.3%	2.2%
\$20,000-\$29,999	10.3%	24,801	436	1.8%	5.4%
\$30,000-\$39,999	11.0%	34,744	555	1.6%	7.4%
\$40,000-\$49,999	10.2%	44,699	652	1.5%	8.1%
\$50,000-\$69,999	18.0%	59,474	828	1.4%	18.1%
Over \$70,000	35.8%	127,954	1,264	1.0%	54.9%

*Represents percent of total sales tax paid by Maryland households. Does not include sales tax paid by businesses or out-of-state purchasers.

Exhibit 3 shows the increase in sales tax paid by household resulting from the proposed 6% rate.

Exhibit 3
Sales Tax Increase by Household Resulting from a 6% Rate

Less than \$5,000	\$66
\$5,000-\$9,999	45
\$10,000-\$14,999	55
\$15,000-\$19,999	68
\$20,000-\$29,999	73
\$30,000-\$39,999	92
\$40,000-\$49,999	109
\$50,000-\$69,999	138
Over \$70,000	211

Bridge to Excellence in Public Schools Act

Chapter 288 of 2002, the Bridge to Excellence in Public Schools Act, altered the State's public school finance system by phasing out or eliminating 27 State education aid programs in order to simplify the structure while significantly increasing overall State

financial support for public schools. Under the legislation, it is estimated that the State will provide \$1.3 billion in new funding for public schools by fiscal 2008.

The proposed fiscal 2005 State budget includes an additional \$324.5 million in funding for public schools, representing a 9.8% increase over fiscal 2004. From fiscal 2005 to 2008, State aid for public schools is expected to increase by 9% to 10% annually.

State Fiscal Effect: Increasing the sales tax by one percentage point would generate \$547.7 million in additional revenues in fiscal 2005 and \$568.1 million in fiscal 2006. This estimate reflects currently projected sales tax growth and a 1% decline in taxable sales due to the higher sales tax. Pursuant to the legislation, \$577 million would go to the ETF in fiscal 2005. The general fund would realize a net decrease of \$29.2 million in fiscal 2005. **Exhibit 4** shows the distribution of the increased sales tax revenues for fiscal 2005 through 2007.

Exhibit 4
Projected Increase in Sales and Use Tax Revenues
(\$ in Millions)

<u>Current Estimates</u>	<u>FY 2005</u>	<u>FY 2006</u>	<u>FY 2007</u>
General Fund Sales Tax Revenue (less vehicle rentals)	\$2,913.4	\$3,021.6	\$3,140.1
Implied Taxable Sales at 5% Rate	58,268.0	60,432.0	62,802.0
Implied Taxable Sales with 1% Decline	57,685.3	59,827.7	62,174.0
Sales Tax Revenue at 6% Rate	3,461.1	3,589.7	3,730.4
Increased Sales Tax Revenue	547.7	568.1	590.3
ETF @ 16.67% of Revenues	577.0	598.4	621.9
General Fund Revenues – HB 103	2,884.2	2,991.3	3,108.6
General Fund Revenues – Current Law	2,913.4	3,021.6	3,140.1
Net Effect General Fund	(29.2)	(30.3)	(31.5)
Total Revenue Increase – All Funds	\$547.7	\$568.1	\$590.3

The 1% decline in taxable sales reflects sales that no longer are subject to Maryland sales tax for three reasons: (1) the sale does not take place at all because the marginal cost dissuades the purchaser (minimal); (2) the sale is diverted to a neighboring state where the sales tax rate is lower; or (3) the sale is diverted to a remote seller, such as an Internet or mail order retailer. To the extent that sales decline more or less than projected as a result of the tax increase, sales tax revenues would change correspondingly.

Education Trust Fund

The total amount of State aid to local school systems would not be affected by this legislation, as discussed below. Dedicating a portion of the sales tax to the newly established ETF provides an additional funding source for the Bridge to Excellence in Public Schools Act. When compared to fiscal 2004, State aid to public schools will increase by \$324.5 million in fiscal 2005 and by \$1.6 billion in fiscal 2009. The increased sales tax revenues dedicated to the ETF would cover 178% of the projected aid increase in fiscal 2005, 86% in fiscal 2006, and 59% in fiscal 2007. **Exhibit 5** shows the percentage of the increase in education aid funded by the ETF.

Exhibit 5
Percent of Education Aid Increases Funded by Trust Fund
(\$ in Millions)

	<u>FY 2005</u>	<u>FY 2006</u>	<u>FY 2007</u>	<u>FY 2008</u>	<u>FY 2009</u>
Education Aid Increase	\$3,644.9	\$4,014.8	\$4,376.8	\$4,806.4	\$4,933.2
Increase over FY 2004	\$324.5	\$694.5	\$1,056.4	\$1,486.0	\$1,612.8
Education Trust Fund	\$577.0	\$598.4	\$621.9	\$643.2	\$665.2
% of Increase	178%	86%	59%	43%	41%

Currently all State education aid is funded with general fund revenues. Each year it is assumed that the entire ETF balance would be spent on education aid required by the Bridge to Excellence in Public Schools Act, resulting in a corresponding decrease in general fund support for education aid.

General Fund

The general fund would realize a \$29.2 million decrease in sales tax revenues in fiscal 2005, a \$30.3 million decrease in fiscal 2006, and a \$31.5 million decrease in fiscal 2007.

Small Business Effect: Increasing the sales tax in Maryland may result in a decline in consumer purchases in the State. Residents may make more purchases in neighboring states that have a lower tax rate or on the Internet. Based on annual taxable sales of approximately \$60 billion, a 1% decline in sales would result in a decline of \$600 million in gross sales.

Additional Comments: The bill, like Maryland's current sales tax law, is in conflict with the terms of the Streamlined Sales Tax Agreement, which requires mathematical rounding for sales tax calculations.

Additional Information

Prior Introductions: HB 1094 of 2003, a similar bill that would have increased the sales tax to fund the education initiative, was not reported from the House Ways and Means Committee.

Cross File: None.

Information Source(s): Comptroller's Office, Department of Legislative Services

Fiscal Note History: First Reader - February 16, 2004
ncs/mdr

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Appendix 1
Major Features of State Sales Taxes
Comparison with Other States
(as of January 1, 2004)

<u>State</u>	<u>States Exempting</u>			<u>State</u>	<u>States Exempting</u>		
	<u>% Tax Rate</u>	<u>Food</u>	<u>Prescr. Drugs</u>		<u>% Tax Rate</u>	<u>Food</u>	<u>Prescr. Drugs</u>
Alabama	4		E	Montana	No State Sales Tax		
Alaska	No State Sales Tax			Nebraska	5.5	E	E
Arizona	5.6	E	E	Nevada	6.5	E	E
Arkansas	5.125		E	New Hampshire	No State Sales Tax		
California	7.25 ¹	E	E	New Jersey	6	E	E
Colorado	2.9	E	E	New Mexico*	5		E
Connecticut*	6	E	E	New York	4.25	E	E
Delaware	No State Sales Tax			North Carolina	4.5	E ⁴	E
D.C.*	5.75	E ³	E	North Dakota	5	E	E
Florida	6	E	E	Ohio	6	E	E
Georgia	4	E	E	Oklahoma	4.5		E
Hawaii	4		E	Oregon	No State Sales Tax		
Idaho	6		E	Pennsylvania	6	E	E
Illinois	6.25	1%	1%	Rhode Island*	7	E	E
Indiana*	6	E	E	South Carolina	5		E
Iowa	5	E	E	South Dakota	4		E
Kansas	5.3		E	Tennessee	7	6%	E
Kentucky	6	E	E	Texas	6.25	E	E
Louisiana	4	E	E	Utah	4.75		E
Maine*	5	E	E	Vermont	6	E	E
Maryland*	5	E	E	Virginia	4.5 ¹	**	E
Massachusetts*	5	E	E	Washington	6.5	E	E
Michigan*	6	E	E	West Virginia*	6		E
Minnesota	6.5	E	E	Wisconsin	5	E	E
Mississippi*	7		E	Wyoming	4		E
Missouri	4.225 ²	1.225%	E	U.S.		28	45

* Local sales/use taxes not authorized or imposed.

**Rate decreased to 3.5% on April 1, 2003.

E - Exempt from sales tax.

¹ Includes statewide local tax and 1.25% in California and 1.0% in Virginia.

² Rate decreases to 4.125% on November 8, 2008.

³ Snack foods excluded from exemption.

⁴ Food sales are subject to local sales taxes.

Source: Federation of Tax Administrators