

Department of Legislative Services
 Maryland General Assembly
 2004 Session

FISCAL AND POLICY NOTE

House Bill 1373 (Delegate Healey, *et al.*)
 Ways and Means

Income Tax and Sales and Use Tax Reform

This bill increases the general sales and use tax rate from 5% to 6%. The bill also increases the standard deduction amount allowed under the Maryland income tax.

The bill takes effect July 1, 2004 and the change in the standard deduction amount applies to all taxable years beginning after December 31, 2003.

Fiscal Summary

State Effect: Net general fund revenue increase of approximately \$391.4 million in FY 2005, reflecting increased sales tax revenues of approximately \$547.7 million and decreased income tax revenues of approximately \$156.3 million. Future years reflect annualization, projected sales tax growth, a projected 1% decline in taxable sales attributable to the higher rate, and larger income tax reductions.

(in dollars)	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009
GF Revenue	\$391,400,000	\$407,000,000	\$424,200,000	\$439,200,000	\$454,800,000
Expenditure	\$0	\$0	\$0	\$0	\$0
Net Effect	\$391,400,000	\$407,000,000	\$424,200,000	\$439,200,000	\$454,800,000

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

Local Effect: Local revenue decrease of approximately \$93.8 million in FY 2005 and escalating to \$105 million by FY 2009 as a result of increasing the standard deduction amount.

Small Business Effect: Meaningful.

Analysis

Bill Summary: The changes in the standard deduction amount are shown in **Exhibit 1**.

Current Law: The general sales and use tax rate is 5%. Revenues go to the general fund. (There is a separate sales tax rate for short-term vehicle rentals that is not affected by the bill.)

The standard deduction is calculated as 15% of Maryland Adjusted Gross Income (AGI) with minimum and maximum amounts as shown in Exhibit 1.

Exhibit 1 Current and Proposed Standard Deduction Amounts

<u>Filing Status</u>	<u>Current Minimum</u>	<u>Current Maximum</u>	<u>HB 1373</u>
Single	\$1,500	\$2,000	\$4,750
Married, filing jointly	\$3,000	\$4,000	\$9,500
Married, filing separately	\$1,500	\$2,000	\$4,750
Head of Household	\$3,000	\$4,000	\$7,000
Qualifying widow(er)	\$3,000	\$4,000	\$7,000
Dependent	\$1,500	\$2,000	\$4,750

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.

State Fiscal Effect: There is likely to be a net general fund revenue increase of approximately \$391.4 million in fiscal 2005 as a result of the two components of the bill, as discussed below.

Sale Tax Increase

Increasing the sales tax by one percentage point would generate \$547.7 million in additional general fund 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. **Exhibit 2** shows increased sales tax revenues for fiscal 2005 through 2009.

Exhibit 2
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>	<u>FY 2008</u>	<u>FY 2009</u>
General Fund Sales Tax Revenue (less vehicle rentals)	\$2,913.4	\$3,021.6	\$3,140.1	\$3,247.6	\$3,358.7
Implied Taxable Sales at 5% Rate	58,268.0	60,432.0	62,802.0	64,952.0	67,174.0
Implied Taxable Sales with 1% Decline	57,685.3	59,827.7	62,174.0	64,302.5	66,502.3
Sales Tax Revenue at 6% Rate	3,461.1	3,589.7	3,730.4	3,858.1	3,990.1
Increased Sales Tax Revenue	\$547.7	\$568.1	\$590.3	\$610.5	\$631.4

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.

Increase Standard Deduction

Based on prior year income tax return data, it is estimated that increasing the standard deduction to the amounts proposed by the bill would result in a general fund revenue decrease of approximately \$156.3 million in fiscal 2005. The decrease in revenues is expected to grow by 3% annually, based on projected underlying income tax revenue growth.

Net Revenue Effect

Exhibit 3 shows the net effect of the bill.

Exhibit 3
Net Effect of HB 1373
(\$ in millions)

	<u>FY 2005</u>	<u>FY 2006</u>	<u>FY 2007</u>	<u>FY 2008</u>	<u>FY 2009</u>
Sale Tax Revenue Increase	\$547.7	\$568.1	\$590.3	\$610.5	\$631.4
Income Tax Revenue Decrease	(156.3)	(161.1)	(166.1)	(171.3)	(176.6)
Net Effect	\$391.4	\$407.0	\$424.2	\$439.2	\$454.8

Local Fiscal Effect: Local government revenues would decrease by approximately \$93.8 million in fiscal 2005. The reduction is due to the fact that changes in Maryland AGI, such as altering the standard deduction amount, flow through to the calculation of the local income tax. It is estimated that local government revenues would decrease by approximately 60% of the State revenue loss associated with the increase in the standard deduction amount. The decrease in revenues is expected to grow by 3% annually and reach approximately \$105 million by fiscal 2009.

Small Business Effect: Increasing the sales tax in Maryland may result in a decline in consumer purchases in the State. Some residents may make more purchases in neighboring states that have a lower tax rate or on the Internet. As sales are shifted out of State or to the Internet, Maryland retailers, many of whom are small businesses, could be negatively impacted. 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. Small businesses may also experience minimal additional costs to program their cash registers.

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: None.

Cross File: None.

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

Fiscal Note History: First Reader - March 8, 2004
mh/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