Department of Legislative Services
Maryland General Assembly
2008 Session

FISCAL AND POLICY NOTE

House Bill 455 (Delegate Olszewski, *et al.*)
Ways and Means Budget and Taxation

Income Tax - Brackets - Inflation Adjustment

This bill would index the State income tax brackets based on the annual change in the Consumer Price Index.

The bill takes effect July 1, 2008 and applies to tax year 2011 and beyond.

Fiscal Summary

State Effect: General fund revenues could decrease by $2.5 million in FY 2011, which represents the impact of one-half a tax year. Future years reflect annualization, estimated growth in exemptions claimed, and estimated change in the CPI. Expenditures would not be affected.

($ in millions)	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013
GF Revenue	$0	$0	($2.5)	($5.2)	($5.3)
Expenditure	$0	$0	$0	$0	$0
Net Effect	$0	$0	($2.5)	($5.2)	($5.3)

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

Local Effect: None.

Small Business Effect: Minimal.

Analysis

Current Law: Chapter 3 of the 2007 special session established new State income tax brackets, which had previously had a top rate of 4.75%. **Exhibit 1** lists income tax brackets effective tax year 2008.

Exhibit 1
Maryland State Income Tax Rates

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 - $150,000	4.75%	$3,001 - $200,000
5.00%	$150,001 - $300,000	5.00%	$200,001 - $350,000
5.25%	$300,001 - $500,000	5.25%	$350,001 - $500,000
5.50%	Excess of $500,000	5.50%	Excess of $500,000

Background: The 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 a market basket of 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 also commonly used to measure the cost-of-living, and is used to increase wages in an attempt to maintain a constant standard-of-living given rising costs. The CPI has increased by an average of 2.6% annually in the last 10 years, and is expected to increase by a similar amount in the next few years.

In tax year 2007, 13 states provided an inflation adjustment by indexing their income tax 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. Five states index their personal exemption or standard deduction to adjust for inflation. Another eight states implicitly adjust their personal exemption or standard deduction amounts for inflation by using federal amounts to determine the state amount. **Exhibit 2** lists the states that index some component of their income tax.

Exhibit 2
States that Index Some Portion of the Income Tax

State	Tax Brackets	Standard Deduction	Personal Exemption
Arkansas	X		
California	X	X	
Idaho	X		
Iowa	X		
Maine	X		
Massachusetts			X
Michigan			X
Minnesota	X		
Montana	X		
Nebraska		X	X
North Dakota	X		
Ohio	X		X
Oregon	X		
South Carolina	X		
Vermont	X		
Wisconsin	X		

Several components of Maryland income tax system are influenced by inflation, including the State pension exclusion, State earned income credits, and poverty level 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 the CPI. The State earned income credits are based on a percentage of the federal credit that is adjusted in value and income eligibility annually based on the CPI. The poverty level 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. 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 the CPI flow through for State income tax purposes; and (2) the amount that taxpayers itemize is influenced by rising prices in the economy, particularly increases in home prices.

The lack of indexation can cause individuals to pay more taxes merely because prices increase, even if the taxpayer's economic well-being has not changed. The most salient example is the Alternative Minimum Tax, originally enacted in 1969 to ensure that high-income taxpayers were not able to avoid income taxes. The lack of indexing in the original legislation has caused it to ensnare individuals of much more limited means than originally intended, leading Congress to enact a series of temporary corrective measures in the last few years.

State Revenues: The bill would index the value of the State income tax brackets based on the annual change in the CPI, beginning in tax year 2011. As a result, general fund revenues would decrease by $2.5 million in fiscal 2011, which represents the impact of one-half a tax year. State revenues would decrease by $5.2 million in fiscal 2012 and $5.3 million in fiscal 2013.

Additional Information

Prior Introductions: None.

Cross File: SB 518 (Senator Stone) – Budget and Taxation.

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

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