HB 238

Department of Legislative Services

2010 Session

FISCAL AND POLICY NOTE

House Bill 238 (Delegate Krebs, *et al.*)
Ways and Means

Taxpayer Protection Act - State Income Tax CPI Adjustments

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

The bill takes effect July 1, 2010, and applies to tax year 2016 and beyond.

Fiscal Summary

State Effect: General fund revenues decrease by $33.0 million in FY 2017 and by $67.9 million in FY 2021. Minimal increase in general fund expenditures in FY 2016 due to computer programming expenses at the Comptroller's Office.

($ in millions)	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021
GF Revenue	($33.0)	($40.0)	($48.8)	($61.9)	($67.9)
Expenditure	0	0	0	0	0
Net Effect	($33.0)	($40.0)	($48.8)	($61.9)	($67.9)

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 previously had a highest marginal rate of 4.75%. Chapter 10 of 2008 imposes in tax year 2008 through 2010 an income tax surcharge on taxpayers with net taxable income in excess of $1 million. **Exhibit 1** lists income tax brackets effective through tax year 2010. After tax year 2010, the highest marginal rate will be 5.5%.

Exhibit 1
Maryland State Income Tax Rates

Single, Dependent Filer, Married Filing Separate

Rate	Maryland Taxable Income
2.00%	$1 - $1,000
3.00%	$1,001 - $2,000
4.00%	$2,001 - $3,000
4.75%	$3,001 - $150,000
5.00%	$150,001 - $300,000
5.25%	$300,001 - $500,000
5.50%	$500,001 - $1,000,000
6.25%	Excess of $1 million

Joint, Head of Household, Widower

Rate	Maryland Taxable Income
2.00%	$1 - $1,000
3.00%	$1,001 - $2,000
4.00%	$2,001 - $3,000
4.75%	$3,001 - $200,000
5.00%	$200,001 - $350,000
5.25%	$350,001 - $500,000
5.50%	$500,001 - $1,000,000
6.25%	Excess of $1 million

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 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 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 brackets. The IRS issues revenue procedures which sets the inflation adjustments for the following tax year. In the most recent procedure, about 40 items were adjusted. Indexing tax brackets to the change in inflation prevents "bracket creep," whereby households pay additional income taxes merely because of general price increases and not because the taxpayer's economic well-being has increased. 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. The original legislation lacked indexing; it now applies to households of much more limited means than originally intended, leading Congress to enact a series of temporary corrective measures in the last few years.

Fourteen states provide 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. **Exhibit 2** lists the states that index a component of the income tax.

Exhibit 2
States that Index Some Portion of the Income Tax

State	Tax Brackets	Standard Deduction	Personal Exemption
Alabama	X		
Arizona		X	
Arkansas	X		
California	X	X	X
Idaho	X		
Iowa	X	X	
Kentucky		X	
Maine	X	X	
Michigan			X
Minnesota	X	X	X
Montana	X	X	X
Nebraska		X	
New Mexico		X	X
North Dakota	X	X	X
Ohio			X
Oregon	X	X	X
Rhode Island	X	X	X
South Carolina	X	X	X
Vermont	X	X	X
Wisconsin	X		

Source: CCH, Inc., Tax Foundation

Although the State's income tax brackets are not indexed for inflation 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 CPI. The State earned income credits are based on a percentage of the federal credit, the value of which and eligibility standards of are adjusted annually based on the change in 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 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 some of the more important components such as 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 increased over time.

State Revenues: The bill will index the value of certain State income tax brackets based on the annual change in CPI, beginning in tax year 2016. As a result, general fund revenues will decrease by $33.0 million in fiscal 2017 and by $79.3 million in fiscal 2022, as illustrated in **Exhibit 3**.

Exhibit 3
Estimated Decrease in State Revenues

Fiscal Year	Revenue Decrease ($ in millions)
2017	$33.0
2018	40.0
2019	48.8
2020	61.9
2021	67.9
2022	79.3

State Expenditures: The Comptroller's Office reports that it will incur a one-time expenditure increase in fiscal 2016 to update tax tables.

Additional Information

Prior Introductions: HB 895 of 2009 received a hearing in the House Ways and Means Committee, but no further action was taken.

Cross File: None.

Information Source(s): CCH, Inc., Comptroller's Office, Tax Foundation, Department of Legislative Services

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Analysis by: Robert J. Rehrmann

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