

Department of Legislative Services
2017 Session**FISCAL AND POLICY NOTE**
First Reader

House Bill 1042

(Delegate Krebs, *et al.*)

Ways and Means

Income Tax - Personal Exemptions - Inflation Adjustment

This bill indexes, based on the annual change in the Consumer Price Index (CPI), the value of the income tax personal exemption and the additional exemption for elderly or blind individuals.

The bill takes effect July 1, 2017, and applies to tax year 2018 and beyond.

Fiscal Summary

State Effect: General fund revenues decrease by \$2.5 million in FY 2018, reflecting the impact from less than one-half of a tax year. Future year estimates reflect annualization, the projected increase in the CPI, and the number of exemptions claimed. Minimal increase in general fund expenditures beginning in FY 2018 due to computer programming expenses in the Comptroller's Office.

(\$ in millions)	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022
GF Revenue	(\$2.5)	(\$13.2)	(\$30.1)	(\$45.9)	(\$62.7)
GF Expenditure	-	-	-	-	-
Net Effect	(\$2.5)	(\$13.2)	(\$30.1)	(\$45.9)	(\$62.7)

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

Local Effect: Local revenues decrease by \$1.5 million in FY 2018 and by \$37.6 million in FY 2022. Local expenditures are not affected.

Small Business Effect: Minimal.

Analysis

Current Law: **Exhibit 1** shows the current value of the personal exemption by federal adjusted gross income (FAGI).

Exhibit 1
Personal Exemption Values by FAGI and Filing Class
Current Law

	<u>FAGI</u>	<u>Exemption Value</u>
Single Taxpayers	\$100,000 or less	\$3,200
	\$100,001-\$125,000	1,600
	\$125,001-\$150,000	800
	Over \$150,000	0
Joint Taxpayers	\$150,000 or less	\$3,200
	\$150,001-\$175,000	1,600
	\$175,001-\$200,000	800
	Over \$200,000	0

FAGI: federal adjusted gross income

Individuals who are age 65 or older and blind individuals may claim an additional personal exemption of \$1,000.

Background: The CPI is a measure of the average monthly change in the price for goods and services paid by consumers between any two time periods and is the most commonly utilized measure to calculate inflation and deflation. Under the current economic forecast, the CPI is expected to increase by about 2% annually in the next 10 years.

Major components of the federal income tax are indexed for changes in inflation, including federal income tax rate brackets. The Internal Revenue Service issues revenue procedures that set the inflation adjustments for the following tax year. About 40 items are typically adjusted. Indexing tax brackets to the change in inflation prevents “bracket creep,” whereby households pay additional income taxes merely because of inflation and not because the taxpayer’s economic well-being has improved. 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. Since the original legislation lacked indexing, it applied to households of much more limited means than originally intended, leading the U.S. Congress to enact a series of temporary corrective measures until the American Taxpayer Relief Act of 2012 provided permanent relief by indexing the tax.

According to the Federation of Tax Administrators, 18 states, or 43% of all states that impose a broad-based income tax, provided an inflation adjustment in tax year 2016 by indexing their rate brackets, standard deductions, and/or personal exemption to a consumer

price or cost-of-living measure. None of Maryland's surrounding states or the District of Columbia provides for an explicit inflation adjustment of income tax components.

Although the State's income tax brackets are not indexed for inflation, several components of Maryland's income tax system are influenced by inflation, including the State pension exclusion, State earned income tax credit, and poverty level tax 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 tax credit is based on a percentage of the federal earned income tax credit, of which the value of and eligibility standards for are adjusted annually based on the change in the CPI. The poverty level tax credit is based on federal poverty standards, which are adjusted annually based on inflation. Taxpayers can claim either a standard deduction or itemized deductions for State income tax purposes. While the value of the standard deduction does not change based on inflation, the value of itemized deductions is sensitive to inflation because (1) federal income tax phase-out rules based on the 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 other important components of the income tax, such as the 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 improved over time.

State Revenues: The indexing of the personal exemptions proposed by the bill takes effect beginning with tax year 2018. As a result, general fund revenues will decrease by \$2.5 million in fiscal 2018, which reflects the impact of less than one-half of tax year 2018. Future year estimates reflect annualization, projected increases in the CPI, and the number of exemptions claimed. **Exhibit 2** shows the estimated impact of the bill on State and local revenues.

Exhibit 2
State and Local Revenue Impacts
(\$ in Millions)

	<u>FY 2018</u>	<u>FY 2019</u>	<u>FY 2020</u>	<u>FY 2021</u>	<u>FY 2022</u>
State	(\$2.5)	(\$13.2)	(\$30.1)	(\$45.9)	(\$62.7)
Local	(1.5)	(7.9)	(18.1)	(27.6)	(37.6)
Total Revenues	(\$4.0)	(\$21.1)	(\$48.2)	(\$73.5)	(\$100.3)

State Expenditures: General fund expenditures for the Comptroller's Office may increase minimally beginning in fiscal 2018 as a result of issuing new employer withholding tables and altering the personal income tax forms.

Local Revenues: Local income tax revenues will decrease as a result of the increase in exemption amounts specified by the bill. Local revenues will decrease by \$1.5 million in fiscal 2018 and by \$37.6 million in fiscal 2022, as shown in Exhibit 2.

Additional Information

Prior Introductions: SB 301 of 2016 received a hearing in the Senate Budget and Taxation Committee, but no further action was taken. Its cross file, HB 160, received a hearing in the House Ways and Means Committee, but no further action was taken. HB 142 of 2015 received an unfavorable report from the House Ways and Means Committee.

Cross File: SB 236 (Senator Eckardt, *et al.*) - Budget and Taxation.

Information Source(s): Comptroller's Office; Federation of Tax Administrators; Global Insight; Moody's Analytics; Department of Legislative Services

Fiscal Note History: First Reader - February 27, 2017
md/jrb

Analysis by: Robert J. Rehrmann

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