MDCEP
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A Prudently Designed Sales Tax Base Expansion Can More Maryland Forward

Letter of Information Regarding House Bill 1628

Given before the House Ways and Means Committee

Maryland's economy has changed in important ways during the last half century, but our revenue system has not always kept up. Operating a 20th century tax code in a 21st century economy has caused Maryland's revenue growth to stagnate, falling further behind on meeting Marylanders' needs. We should comprehensively reform our tax code to close corporate loopholes, end ineffective tax breaks, and modernize outdated policies. As one part of that effort, expanding our sales tax base to include consumer services would bring our tax code more in line with today's economy. The effectiveness and equity of this reform depend on how it is designed. **Experts across the ideological spectrum agree that the sales tax should focus on household consumption, not business inputs such as business-to-business services.**

Household consumption has shifted significantly during the last half century, with consumption of generally taxable tangible goods declining and consumption of generally untaxed services increasing. Only about 30 percent of consumer sales nationwide are subject to sales taxes today, down from about 40 percent throughout the 1970s.[i] This shift is a major contributor to slow revenue growth that makes Maryland's sales tax a less effective part of our revenue system than it was in the past. As we consider Marylanders' growing needs—for world-class public schools, high-quality health care, and modern transportation infrastructure—it is smart to incorporate a large and growing share of household consumption into the sales tax base.

A well-designed sales tax base expansion should include services that are primarily consumed by households, while exempting services that primarily serve as business inputs:

- Unlike taxes on profits, businesses are able to pass taxes on inputs along to consumers in the form of higher prices. From a business's perspective, a tax on inputs is equivalent to an increase in those inputs' prices—just as for consumers, the retail sales tax is equivalent to paying a higher price. Businesses would respond to this increase in costs in the way they respond to any increase in costs—by raising prices.
- Any consumer good that has a multi-step supply chain would include multiple levels of taxes on the same product. This has the potential to significantly increase retail prices in a way that is opaque to the consumer.
- Taxing business inputs increases the ultimate price of essentially all products, including those that are exempt from retail sales taxes. This means that consumers would newly pay hidden sales taxes on necessities such as groceries.
- Because the exemption for necessities in our current sales tax is intended to make it more equitable by reducing the taxes low-income families pay, taxing business services would likely make Maryland's sales tax more lopsided, not less.
- Experts across the ideological spectrum agree that sales taxes should exempt business inputs. For example,

experts at the Institute on Taxation and Economic Policy,[ii] the Center on Budget and Policy Priorities,[iii] Ernst & Young in a report commissioned by the Council on State Taxation,[iv] and the Mercatus Center have all written in support of this exemption.[v]

If lawmakers removed business inputs from House Bill 1628 while maintaining the rate reduction, the bill would reduce sales tax revenue on net. Removing business inputs as well as the rate reduction would result in a smaller, but still substantial revenue gain:

- The Department of Legislative Services advises that business services, professional services, and information services primarily serve as business inputs rather than household consumption. Together, these services account for $3.1 billion of the base expansion's $3.7 billion gross revenue gain in fiscal year 2025.
- Exempting these three categories of services would leave a gross revenue gain of $647 million. After the $827 million loss in current revenue caused by the rate reduction, this would result in a net loss of $181 million in fiscal year 2025.
- Exempting business services while keeping the current 6 percent tax rate would raise approximately $776 million in fiscal year 2025—a smaller, but still substantial revenue gain. Together with other tax reforms, this could be part of a package that pays for the Kirwan Commission's education reforms while preventing cuts to other essential services.

Reforming Maryland's sales tax to include household services is smart policy, if designed correctly. If House Bill 1628 exempted business services and kept the state's current 6 percent sales tax rate, it would make our revenue system more modern and more effective.

Equity Impact Analysis: House Bill 1628

Bill summary

House Bill 1628 would expand Maryland's sales tax base to include nearly all services, including services that primarily serve as business inputs.

Background

Maryland's sales tax is based primarily on the tangible goods that dominated our economy throughout the 20th century. As our economy has transitioned toward services, sales tax revenues increasingly lag economic growth and Marylanders' needs for public investments such as education and health care.

Equity Implications

Our growing underinvestment in essential services like education, health care, and transportation harms all Marylanders, and at the same time has outsized impacts on people who face economic roadblocks because of low income or the ongoing legacy of racist policy. Reforming Maryland's tax code to raise adequate revenue would strengthen our ability to invest in the foundations of our economy and reduce barriers that hold back too many Marylanders.

Taxing business inputs would likely make Maryland's tax code more lopsided than it currently is, because this policy choice would place hidden tax responsibilities on low-income families purchasing groceries and other necessities—and would also increase sales tax revenues overall, which are known to place the greatest responsibilities on working families.

Exempting business inputs while keeping the state's current 6 percent sales tax rate would generate a smaller, but still substantial revenue gain. This would strengthen Maryland's ability to invest in essential services than increase opportunities for families who currently face economic obstacles, while making the reform less lopsided and more effective.

Even with these changes, any sales tax expansion would likely increase working families' tax responsibilities the most. Policymakers can mitigate these effects by pairing sales tax reform with other tax reforms that ask the most of large corporations and wealthy families, and by including working family tax credits such as an Earned Income Tax Credit expansion or creation of a state-level Child Tax Credit.

Impact

The equity impact of expanding the sales tax base to include services **depends heavily on policy design choices**.

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[i] Michael Leachman and Michael Mazerov, "Four Steps to Moving State Sales Taxes into the 21st Century," Center on Budget and Policy Priorities, 2013, https://www.cbpp.org/research/state-budget-and-tax/four-steps-to-moving-state-sales-taxes-into-the-21st-century

[ii] "Chapter Three: Sales and Excise Taxes" in *The ITEP Guide to Fair State and Local Taxes*, Institute on Taxation and Economic Policy, 2011, https://itep.org/wp-content/uploads/guide3.pdf

[iii] Michael Mazerov, "Expanding Sales Taxation of Services: Options and Issues," Center on Budget and Policy Priorities, 2009, https://www.cbpp.org/research/state-budget-and-tax/expanding-sales-taxation-of-services-options-and-issues

[iv] Andrew Phillips and Muath Ibaid, "The Impact of Imposing Sales Taxes on Business Inputs," Ernst & Young for the Council on State Taxation, 2019, https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/1903-3073001_cost-ey-sales-tax-on-business-inputs-study_final-5-16.pdf

[v] Justin Ross, *A Primer on State and Local Tax Policy*, Mercatus Center at George Mason University, 2014, https://www.mercatus.org/system/files/Ross_PrimerTaxPolicy_v2.pdf