



Analysis of state policy choices with particular attention to their impacts on low- and moderate-income Marylanders

SPECIAL REPORT

A BALANCED APPROACH TO MEET MARYLAND'S NEEDS

State tax revenues have fallen the past year and half by historic proportions. They are nowhere near the level needed to maintain services for Maryland residents. This year's budget got a boost from over \$750 million in one-time transfers and \$2 billion in federal stimulus aid that will run out.

Cuts in spending also played a major role in balancing this year's budget. But relying too heavily on cuts will not meet today's needs in the Maryland and will hurt the state's ability to position itself for future growth.

Maryland has within its reach a number of reasonable revenue options that would be a productive part of the balanced approach needed to preserve public investments in education, health, public safety, a good quality of life and a decent standard of living for all Marylanders.

This report suggests up to \$1.7 billion in revenue options for fiscal year 2011 alone. The Governor and Legislature should put these options on the table. It is important to educate young people, provide health services, keep communities safe, maintain our transportation network, and provide for families who need a safety net. To keep doing those things, Maryland needs a balanced approach to balancing the budget.

Special Report
October 22, 2009

**Maryland Budget & Tax
Policy Institute**
190 W. Ostend Street
Suite 201
Baltimore, MD 21230

410-727-6367
fax 410-727-1914
www.marylandpolicy.org

*a project of the
Maryland Association of
Nonprofit Organizations*

all rights reserved ©

A BALANCED APPROACH TO MEET MARYLAND'S NEEDS

Neil Bergsman

STATE NOT OUT OF THE WOODS YET

Many respected economists are now predicting that the crushing national recession may be at an end. This is certainly good news. But when it comes to Maryland and other states meeting the growing demand for public services, it's not as good as you might think. Not yet, anyway.

To economists, the "end" of a recession means production has stopped falling. But the "end" of the recession does not mean the economy has resumed growth, or that production has reached the point it was at when the recession began. It does not mean unemployment is falling. All that is in the future -- possibly years in the future.

Traditionally, state finances tend to lag a national recovery by at least two years. A primary reason is that unemployment is one of the last economic indicators to improve – and only when it eases sufficiently do state sales and income taxes approach pre-recession levels.

In the meantime, state tax revenues – which have fallen the past year and half by historic proportions – are nowhere near the level needed to maintain services for Maryland residents. In other words, the state's budget is still in trouble and will be for a while: current revenues do not support current spending at a time when struggling families need those services more than ever. And, this year's budget got a boost from over \$750 million in one-time transfers and \$2 billion in federal stimulus aid that will run out.

CUTS-ONLY APPROACH IS DANGEROUS

Cuts in spending also played a major role in balancing this year's budget. But relying too heavily on cuts can be counterproductive both in terms of failing to meet today's needs and hurting the state's ability to position itself for future growth. Some examples from cuts made in August by the Board of Public Works make that point:

- \$4.8 million cut in programs assisting 14,000 developmentally disabled individuals and their families, many of them on the waiting list for regular services.
- \$20.1 million cut in aid to local health departments; these are the agencies charged with responding to swine flu threats.
- Elimination of private career school student grants awarded to 502 students in 2009. This type of assistance with job training is especially important in today's weak economy.
- \$926,000 cut in respite care for families caring for disabled adults.
- \$7.5 million cut in cancer research funding to University of Maryland and Johns Hopkins.

After each round of spending cuts, the range of available options narrows. The next layer will only be worse, with another \$300 million in cuts to the current budget expected in November. Then the state must address a projected \$2 billion budget gap for fiscal year 2011, which begins July 1, 2010.

Another problem with relying too heavily on cuts in spending is the damage it can do to an already fragile economy. Every dollar state government spends goes back into the economy in the form of salaries, payments for purchases and contracts or various assistance programs. Big reductions create a ripple effect throughout the economy. The layoff of state workers, for example, hurts the owners and employees of businesses where the workers shop. Government spending is an economic stimulus; pulling it back too far can make a recession worse and delay recovery.

BALANCED APPROACH MAKES SENSE

For all of these reasons, Maryland needs to meet this crisis with a balanced approach that includes revenues, not just cuts in spending.

That is what most states are doing. Since January 1, 35 states have raised taxes, according to the Center on Budget and Policy Priorities. It was not an either-or proposition; each of these states also cut spending considerably. But they recognized that no single approach can solve a problem this big. Most states have employed a combination of steps that also involves drawing down reserve funds, maximizing the use of federal dollars and raising taxes. A number of prominent economists, including Nobel Prize winner Joseph Stiglitz, have observed that tax increases can do less harm than spending cuts to the economy, especially when they are focused on upper-income households. That's because tax increases on the wealthiest are likely to come in part from their savings rather than money that would have helped the economy by being spent. Stiglitz and others point out that it is good policy to use well-structured tax increases to fill a substantial portion of deficits that exceed the amount that can be closed with reserves or federal funds.

History shows that raising taxes in a recession is a common response by states. During the recession of the early 1990s, 44 states raised taxes by a significant margin (at least 1 percent). In the recession of 2001, 30 states did so. These actions increased annual revenue collections by tens of billions of dollars. Then, as now, tax increases came in states led by Democrats and states run by Republicans.

REASONABLE REVENUE OPTIONS

Maryland has within its reach a number of reasonable revenue options that would be a productive part of the balanced approach needed to preserve public investments in education, health, public safety, a good quality of life and a decent standard of living for all Marylanders not just next year, but well beyond.

Attached to each proposal is a preliminary estimate of the potential revenue gain.

Income Tax:

- **Leave the Current Millionaire Tax in Place**

In 2008, the legislature enacted a three-year temporary increase on the highest income households. The rate on income above \$1 million a year for married and single filers became 6.25%. The 5.5% rate that had applied to all income over \$500,000 still applies to income between \$500,000 and \$1 million.

The measure was part of a package of revenues, spending cuts and fund transfers to offset the money lost from repeal of the politically unpopular sales tax on computer services. The million dollar tax bracket brings in an average of about \$100 million a year. Without further legislative action, this revenue source automatically lapses at the end of calendar year 2010. Because of the overlap between calendar years and state fiscal years, the termination of the millionaire tax occurs six months into fiscal year 2011.

Revenue Gain: \$50 million in Fiscal Year 2011; \$100 million a year after that

(Source of estimate: Department of Legislative Services Fiscal Note to SB 46 of 2008)

Alcoholic Beverages:

- **Increase Tax Rates**

Maryland has among the lowest taxes on alcoholic beverages of any state. The tax on liquor of \$1.50 a gallon – about 30 cents for a .75 liter bottle -- has not changed since 1955. The median among all states is \$3.75 per gallon.

The tax on beer and wine was last increased in 1972. Wine is taxed at 40 cents per gallon --about a dime for a one liter bottle -- and beer at nine cents per gallon -- about a nickel on a six-pack. The national medians are 69 cents for wine and 18 cents for beer.

Overall, Maryland's alcohol tax rates are one half to one seventh the national median. Delaware's rates, for example, are 77% to 240% above Maryland's. A \$6 per gallon tax for liquor, \$1.60 for wine and 36 cents for beer would raise needed revenue. Maryland's tax rates would still be less than the top rates among states.

Revenue Gain: \$84 million a year

(Source of estimate: Department of Legislative Services' fiscal note on HB 791 of 2009)

Corporation Tax:

- **Restrict Companies' Ability to Hide Profits**

It is common practice for large, multi-state corporations to use subsidiaries and affiliated companies in ways that reduce their state tax obligations. In effect, companies can move profits from one state to another on paper to take advantage of states with lower corporate tax rates. Increasingly, states are combating this by adopting what is called "combined reporting," which requires such companies to add together the profits of these various entities and then pay taxes accordingly.

A recent report by the Maryland Bureau of Revenue Estimates concluded that if combined reporting had been in effect in 2006, the state corporate income tax would have produced an additional \$109 million to \$170 million.

With the recent enactment of combined reporting legislation in Wisconsin, 23 of the 45 states with corporate income or similar business taxes have implemented this method. Calling on multi-state corporations to pay their fair share of taxes does more than raise needed revenue. It also adds equity to the system because businesses that are located entirely in a single state and lack the opportunities or resources to engage in interstate income-shifting today end up paying higher taxes than necessary to make up for revenue lost through other companies' avoidance.

Governor O'Malley proposed combined reporting as part of his budget-balancing plan in 2007. The legislature dropped the provision but created a commission to study business taxes and report its recommendation in December 2010.

The Bureau of Revenue Estimates' projection equates to between 12.5% and 19.5% of Maryland's corporate income tax revenues. The Bureau's study is the most thorough and comprehensive look at combined reporting's effects undertaken by any state. However, it is only a simulation, based on companies' self-reported data for a single year. The report's authors emphasize that the estimated revenue from enacting combined reporting now would be different for several reasons.

Clearly, combined reporting would provide a basis for taxing corporations that better reflects economic realities than the current system, and would be less prone to a range of manipulative practices used by some businesses to shelter income from Maryland taxes.

Revenue Gain: \$100 million a year

(Source of estimate: Maryland Budget and Tax Policy Institute, based on 19% of anticipated FY 2011 corporate income tax general funds)

Fuel Tax:

- **Dime a Gallon Increase and More Revenue to General Fund**

The fuel tax is one of Maryland's main sources for funding the state's transportation infrastructure. At 23.5 cents per gallon, it is slightly below the national average and was last increased in 1992. Since then, 43 of the 50 states have increased their fuel taxes.

In its 2007 special session, the legislature voted not to increase the fuel tax, and instead directed that a portion of the state sales tax be diverted from the state's general fund to the transportation fund.

A 10-cent per gallon would provide crucial revenue and still leave Maryland's fuel tax competitive with neighboring states. In 2011, this would restore approximately \$220 million to the general fund and add \$100 million in transportation revenues.

Revenue gain: \$320 million per year

(Source of estimate: Department of Legislative Services fiscal note to HB 746 of 2009)

Sales Tax:

- **Modernize to Reflect Today's Economy**

Maryland's 6% sales tax applies principally to purchases of tangible goods. Only a few services are subject to the state sales tax. According to the Federation of Tax Administrators, Maryland taxes 39 of 168 services included in FTA's survey of all states. This is less than the nationwide median of 47 services subject to tax. Maryland should make its sales tax more productive and equitable by expanding the purchases taxed to cover more services.

When Maryland's sales tax was enacted in 1947, households spent more money per year on goods than services. But that balance has shifted tremendously over the past 40 years. Today, services account for 45% of the typical household's spending while goods make up 32%. In 1970 it was the other way around: taxable goods were 39% of a household's purchases and services were 31%. Many of today's major service

purchases, like cable TV, did not exist when the sales tax law was written. The revenue loss from an outdated sales tax is significant.

Aligning the sales tax to today's purchasing patterns could be accomplished without jeopardizing businesses or low-income households and still cover a broad range of consumer services. It would exclude predominantly business-to-business services (like freight transportation, payroll processing and advertising), and basic services which consume a large share of low-income households' spending (like medical, housing and child care expenses). Taxation of business-to-business services significantly distorts economic decisions, and may be more expensive to households, as taxes become invisibly embedded in final prices. Taxation of basic household services would disproportionately burden low-income households.

There are two approaches to updating the sales tax. The better choice would be a comprehensive plan that applies the sales tax broadly to services, and enumerates specific exceptions. The other is an incremental approach that specifies particular services that would become subject to the tax. The estimates assume the taxes would take effect January 1, 2011, and so apply to only one half of fiscal year 2011.

Revenue Gain:

- **Comprehensive Alternative:** **\$983 million in FY 2011, \$1.97 billion a year after that**

This alternative applies the sales tax to all services purchased by households other than health care, housing, education, legal, banking, public transit, insurance and funeral services.

(Source of Estimate; Mazerov, Expanding Sales taxation of Services: Options and Issues, Center on Budget and Policy Priorities Jul-09, adjusted for current state sales tax rate and for services already taxed)

- **Incremental Alternative:** **\$118 million in FY 2011, \$245 million a year after that**

This alternative covers 26 specified services, including cable TV, vehicle repair, barber and beauty and Interior decorating.

(Source of Estimate: Department of Legislative Services' fiscal note to House Bill 11, Special Session of 2007, less business services, adjusted for current tax rates).

State Reserve Fund:

- **Use Half to Build Financial Bridge leaving 2.5% of revenues in reserve**

Though they have the potential to help fund areas important to Maryland's future, many of the revenue-raising ideas available to the state would not fully phase in until fiscal year 2012. In addition, proceeds from video lottery terminals will not reach sizable amounts until fiscal year 2012 or 2013. So, in order to build a financial bridge to avoid unnecessary disruptions in services, the state should access half of its existing reserve fund in fiscal year 2011. Credit rating agencies expect states to use their reserve funds when needed to maintain balanced budgets. However, they also expect states to have a plan for bringing their budgets back into balance in the long term and replenishing their reserve funds. Maryland is in position to do both.

Maryland's reserve fund equals 5% of state general fund revenues and stands at about \$650 million. The Governor is authorized by law to propose using part of the fund to balance the annual budget. If the transfer reduces the fund's level to below 5% of revenues, legislative approval is required in a measure separate from the budget bill. If the reserve fund's balance falls to less than 3% of total general fund revenues, the Governor must include \$100 million in the budget to replenish the fund. If it's between 3% and 7-1/2% of revenues, the Governor must include up to \$50 million. When the state budget runs a surplus in the general fund, any amount over \$10 million has to be appropriated to the reserve fund the next year.

Revenue gain: \$325 million in FY 2011

Payback: \$100 million in FY 2012, \$50 million per year for next four years, then \$25 million FY 2017

CONCLUSION

State spending is principally used for education, health, transportation, public safety and a social safety net. These are all things Maryland needs to prosper this year and in the future.

An all-cuts budget solution would sacrifice too many of the things that make Maryland such a great state. This report suggests up to \$1.7 billion in revenue options for fiscal year 2011 alone. The Governor and Legislature should put these options on the table. It is important to educate young people, provide health services, keep communities safe, maintain our transportation network, and provide for families who need a safety net. To keep doing those things, Maryland needs a balanced approach to balancing the budget.

Sources

Board of Public Works, Supplement B, Department of Budget and management Action Agenda, BPW 8/26/09 Item 76B.
<http://dbm.maryland.gov/agencies/operbudget/Documents/2010/BPWAgendaItemfinal082609.pdf>

Bureau of Revenue Estimates, Analysis of Tax year 2006 Maryland Corporation Information Reports, Comptroller of Maryland, 2009.

Department of Legislative Services. Fiscal and Policy Notes on proposed legislation. <http://mlis.state.md.us/>

Federation of Tax Administrators. FTA Survey of Services Taxation – Update. 2008.
<http://www.taxadmin.org/fta/pub/services/btn/0708.html>

[Johnson](#), Nicholas, [Nicholas](#) Andrew and Pennington, Steven. Tax Measures Help Balance State Budgets A Common and Reasonable Response to Shortfalls. Center on Budget and Policy Priorities. July 2009.
<http://www.cbpp.org/cms/index.cfm?fa=view&id=2815>

Maryland General Assembly, Maryland’s Revenue Structure (Legislative Handbook Series Volume III), 2006.

Mazerov, Michael. Expanding Sales Taxation of Services: Options and Issues. Center on Budget and Policy Priorities, July 2009.
<http://www.cbpp.org/cms/index.cfm?fa=view&id=2888>

Mazerov, Michael. A Majority of States Have Now Adopted a Key Corporate Tax Reform — “Combined Reporting,” Center on Budget and Policy Priorities, 2009. <http://www.cbpp.org/cms/index.cfm?fa=view&id=246>

O’Malley, Governor Martin, Budget Reductions for the Board of Public Works, August 26, 2009.
<http://www.governor.maryland.gov/documents/090826BPWpowerpoint.pdf>

About the Maryland Budget & Tax Policy Institute

The Maryland Budget and Tax Policy Institute is a nonpartisan research organization that provides timely, accurate and accessible analysis of state budget and tax issues. In addition to general budget and tax research and analysis, the Institute examines issues affecting low-income Marylanders and other vulnerable populations and the important community programs that serve them. For additional information, to be added to our e-mail list, or to make a tax-deductible contribution, please visit our website at www.marylandpolicy.org.

The Maryland Budget and Tax Policy Institute gratefully acknowledges the Ford Foundation, which provides financial support for the Institute under its State Fiscal Analysis Initiative. Additional general support for the Maryland Budget and Tax Policy Institute is provided by the Moriah Fund, the Eugene and Agnes E. Meyer Foundation, the Fund for Change, the Open Society Institute-Baltimore, and generous individual donors.

The Institute is a project of Maryland Nonprofits, www.mdnonprofits.org.