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**WRITTEN TESTIMONY SUBMITTED TO
THE MARYLAND SENATE BUDGET AND TAX COMMITTEE
REGARDING SENATE BILL 249
FEBRUARY 29, 2012**

Thank you for the opportunity to testify on Senate Bill 249. My name is Carl Davis. I am a Senior Analyst with the Institute on Taxation and Economic Policy (ITEP), a nonprofit research group based in Washington, DC. ITEP's research focuses on federal and state tax policy issues, with particular emphasis on the issues of fairness, adequacy, and sound economic policy.

SB 249 would permanently reinstate the "millionaires' tax" that expired at the end of 2010. This testimony emphasizes that the "millionaires' tax" makes Maryland's tax system at least somewhat less unfair than it otherwise would be; that reinstating the tax would result in a substantial federal tax cut for upper-income Marylanders; and that claims about the negative economic impact of the tax are unfounded.

MAKING AN UNFAIR TAX SYSTEM SLIGHTLY LESS UNFAIR

Maryland's tax system currently falls most heavily on low- and middle-income families—and allows the very best-off taxpayers to pay substantially less of their income in tax than any other income group. According to a November 2009 ITEP analysis, which looked at the permanent features of Maryland's tax system and thus did NOT include the impact of the millionaires' tax:

- The poorest twenty percent of Maryland families pay 9.9 percent of their income in state and local taxes (including the offsetting impact of federal taxes), on average.
- Middle-income Marylanders pay 9.8 percent of their income in state and local taxes, by the same measure, on average.
- The very best-off 1 percent of Marylanders (a group with average incomes well over \$1.5 million), pay just 6.2 percent of their income in state and local taxes after accounting for the interaction with federal income taxes. This is about a third less than what low- and middle-income families have to pay.

Including the impact of the millionaires' tax changes this picture only slightly: the effective tax rate on the best-off Marylanders increases from 6.2 percent to 6.4 percent. In other words, the millionaires' tax helps to modestly reduce the large gap between what the best-off 1 percent pay and what everyone else pays—thereby moving the state's tax system a bit closer to achieving the minimal standard of tax fairness that most people would find acceptable. With or without the millionaires' tax, however, the reality is that

those taxpayers who would be subject to the millionaires' tax will continue to pay lower effective tax rates than anyone else in the state.

CUTTING MARYLANDERS' FEDERAL TAX BILLS

Progressive state income tax changes, such as Maryland's "millionaires' tax," always have an impact on the amount of federal income taxes paid by affected groups. This is because state income taxes can be claimed as an itemized deduction on federal income tax returns. The top federal marginal tax rate for most Maryland millionaires in 2012 is 35 percent. This means that, for whatever tax hikes these taxpayers see under the Maryland millionaires' tax, as much as 35 percent of that tax hike will be offset directly by federal tax cuts. Put another way, the federal government will effectively pay for as much as 35 percent of the higher tax bills due by Maryland millionaires under this law.

This impact is muted somewhat because some of the very best-off Marylanders pay the federal Alternative Minimum Tax, which can partially or, in some cases, completely eliminate this offsetting federal tax change. However, the most recent data show that nationally, nearly 80 percent of taxpayers with AGI over \$1 million don't owe any AMT liability at all. For these taxpayers, this "federal offset" has a very significant impact on reducing state income tax liability.

THE "MISSING MILLIONAIRES" MYTH

In the wake of enacting the "millionaires' tax," the Maryland Comptroller's Office released data on the income tax filing patterns of the upper-income taxpayers who were subject to the tax. Unfortunately, the results of the Comptroller's analysis were misconstrued by some observers to imply that a third of the state's millionaires had left the state in response to the income tax increase.

However, as ITEP showed in a series of reports, Maryland's millionaires didn't really leave the state after 2007—they just stopped being millionaires because the Great Recession lowered their incomes. More detailed data from the Comptroller's office revealed that the vast majority of millionaires that originally seemed to have "disappeared" after 2007 actually just moved to a lower tax bracket.

Interestingly, Maryland wasn't the only state where this predictable impact of the recession was mistakenly described as tax-induced flight. Some observers argued that similar declines in New York and Oregon's millionaire populations must also have been due to those states' recent tax increases on high-income taxpayers.

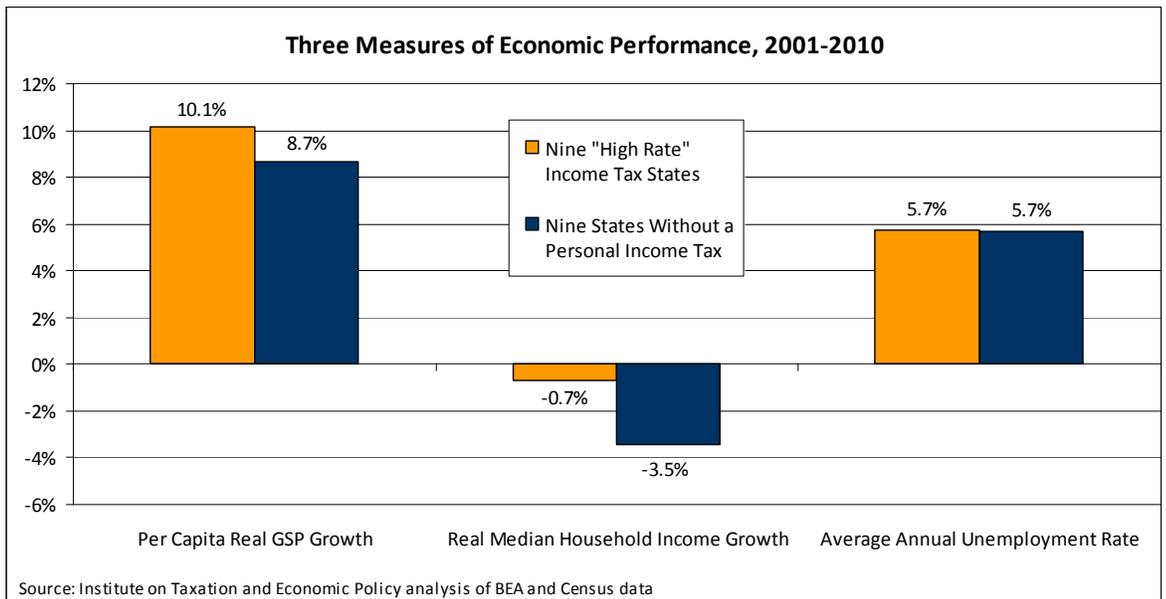
But with new federal tax data finally available for the period covering the Great Recession, the influence of this talking point seems to be on the decline. IRS data shows that the number of taxpayers with federal AGI over \$1 million declined by 40 percent nationwide between 2007 and 2009. And while directly comparable data is not available for Maryland specifically, similar data provided by the Comptroller's office suggests that the decline in Maryland's millionaire population (roughly 43 percent) was little more than the local manifestation of this nationwide trend.

INCOME TAXES AND ECONOMIC PERFORMANCE

The millionaire migration myth is just one component of the more common argument that income taxes—and in particular the top tax rates levied on the wealthiest taxpayers—are generally harmful to states' economies. A look at some of the most important and well-known measures of states' economic well-being, however, provides good reason to be skeptical of this claim.

Over the last decade, economic output per person has grown significantly faster in the nine states with the highest top income tax rates than in the nine states without an income tax at all. And while “real” (inflation adjusted) median income levels have declined in most states, the drop has been much smaller in “high rate” states than in no-tax states. To top things off, unemployment rates have been virtually identical across both types of states.

Maryland's position among these states is also informative. Maryland outperformed seven of nine no-tax states in terms of economic growth per capita, five of nine in terms of changes in median income, and six of nine in terms of lowest unemployment—all despite the supposed disadvantage of levying the millionaires' tax during the last three years covered by this analysis. In this light, there is little reason for Maryland to use low- or no-income tax states as models in deciding how to craft its own tax policy.



CONCLUSION

Any feature of Maryland's tax system can (and should) be evaluated based on a number of potentially competing objectives. The first and most obvious objective of the state's tax system is to raise sufficient revenues to pay for the public investments that Marylanders demand—the millionaires' tax has clearly contributed to achieving this goal in the past, and can continue to do so in the future. A second objective is to improve upon the level of fairness in Maryland's current tax code—the millionaires' can also help, at least on the margin, to make an unfair tax system somewhat less unfair. Third and finally, it's also important to evaluate the impact of tax changes on a state's economic climate—and despite well-publicized claims to the contrary, the available evidence provides no support for the assertion that the Maryland millionaires' tax has prompted an exodus of upper-income families from the state or harmed the state's economy more generally.

Thank you for the opportunity to submit this testimony.

BACKGROUND ON ITEP

The Institute on Taxation and Economic Policy (ITEP) has engaged in research on tax issues since 1980. Since 1996 ITEP has used a *microsimulation tax model* to conduct research on federal, state, and local tax systems. A microsimulation model uses a large sample of tax returns and other data to estimate the impact of tax systems and tax proposals on actual taxpayers at different income levels. This is the same type of tax model used on the federal level by the U.S. Treasury Department, the Congressional Joint Committee on Taxation, and the Congressional Budget Office, as well as by many state revenue departments. A properly constructed microsimulation model can provide accurate estimates of revenue yield and tax incidence by income group.

ITEP's microsimulation model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to 750,000 records. This database is based on federal tax returns, with statistically valid samples from every state and the District of Columbia. The database is augmented with a sampling of records from the U.S. Decennial Census "five percent sample" (which contains a random sample of five percent of all census forms received by the Census Bureau); the Census data are statistically matched with the tax return records. The data on these records is then extrapolated to subsequent years using federal tax micro and tabular data, Census Bureau Current Population Survey micro and tabular data, and other widely respected data sources.

These, and other, data are used by the ITEP model's four modules: Personal Income Tax, Property Tax, Consumption Tax and Business Tax. These modules calculate tax liability on a record-by-record basis and sum the results to provide revenue and tax incidence estimates. (A complete description and methodology for the ITEP model is available on request.)

The ITEP model has the unique capability of analyzing all major taxes for every state and the District of Columbia. In 2009, the ITEP model was used to produce the study *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*. This study shows the distributional impact, by income level, of all major state and local taxes for each of the 50 states. It has been used by many state revenue departments and legislative fiscal offices since its publication.

The ITEP Model is also unique in its ability to forecast the effect of both federal and state tax changes on taxpayers in a given state. This capability is especially important in analyzing the impact of proposed tax changes that affect people on multiple levels. For example, proposals for federal tax reform often impact state tax collections. Similarly, proposals to change state tax structures, such as the bills under discussion today, can affect the federal taxes paid by a state's residents in ways that can drastically affect the overall incidence of these proposals.

In addition to its fifty-state analyses, ITEP often conducts research in individual states. This work has been primarily funded by private foundations. ITEP's full body of research is available at www.itepnet.org.