
LOWERING MARYLAND'S STATE PERSONAL INCOME TAXES TO STIMULATE BUSINESS DEVELOPMENT: MYTHS AND REALITIES

MICHAEL BELL

Principal Research Scientist, Johns Hopkins Institute for Policy Studies

and

MURRAY JOHNSTON

Research Assistant

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Baltimore, Maryland 21202

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Executive Summary

Once the facts are presented it becomes clear that Maryland's state personal income tax is *not* out of line with other states and the more serious threat to future economic development may be the ability of state and local governments to provide the level and quality of services necessary to support that development.

Maryland's economy is not healthy. It has been undergoing major restructuring and downsizing for the last ten years, and prospects for the immediate future are not bright. Maryland's manufacturing sector continued to decline in the first half of the 1990s — at twice the rate of manufacturing nationally. Cuts in federal employment ripple through the state's economy and federal research facilities in the state are vulnerable to future federal budget cuts. Firm restructuring and downsizing affects the state's traditionally strong industries such as transportation, utilities, finance, business services, and health services. According to one analyst there has been no real job growth in Maryland for more than a year.

In response to the challenges presented by these trends, Governor Glendening created the Maryland Economic Development Commission to develop a strategy for overcoming the state's anemic economic performance. Their report, *Strategic Directions for Increasing Maryland's Competitiveness*, documents the state's economic problems and proposes a comprehensive strategy to promote job growth in the state. One element of that strategy, reducing the state personal income tax in Maryland, has received substantial attention in the press and the 1997 session of the General Assembly. In short, the report concludes that Maryland's high personal income taxes create a *red flag* that is deterring both existing and out-of-state firms from investing in the state and state personal income taxes should be lowered by 15 percent by 1999 and another 10 percent after that.

The purpose of this paper is to examine these propositions more thoroughly. Once the facts are presented it becomes clear that Maryland's state personal income tax is *not* out of line with other states and the more serious threat to future economic development may be the ability of state and local governments to provide the level and quality of services necessary to support that development. The report discusses in depth the following *Myths* and *Realities*.

Myth: Maryland's state personal income tax is out of line with our neighboring states.

Reality: Maryland's state personal income tax has a maximum marginal rate of 5 percent reached at \$3500 income. Of the 43 states that have personal income taxes, only 5 have a maximum marginal tax rate *lower* than Maryland's. Thus, the reality is that Maryland has one of the lowest top marginal tax rates in the country and one of the least progressive personal income taxes in the nation. Our aggregate personal income tax collections are high relative to other states because local governments depend heavily on the personal income tax as a source of revenue — more than local governments in any other state.

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Myth: Maryland is a high tax state.

Reality: Maryland residents paid \$139 per \$1000 of personal income in 1993 to support state and local governments. This is 9 percent less than in 1981 and is 10 percent below the national average. In fact, only five states — Arkansas, New Hampshire, Virginia, Illinois, Tennessee and Missouri — devote a smaller share of their personal income to supporting state and local governments than Maryland. The reality is that Maryland is a low tax state.

Myth: Growth in state spending is out of control and the major contributor to the structural deficit in the state budget.

Reality: State spending has not increased as fast as personal income in any of the last 10 years. State spending has declined as a share of personal income from 9 percent in 1979 to 7.7 percent in 1994. If state revenue in 1994 accounted for the same share of personal income as they did in 1979, total state revenues would have been \$1.5 billion greater. More troubling is the shift in revenue raising responsibility from the state to local governments in Maryland. Since local governments rely on more regressive revenue sources this involves a shift in financing state and local government to those in society least able to afford it.

Myth: If the state personal income tax is reduced economic development will be stimulated in the State.

Reality: The economic literature reviewed in this report makes it clear that both taxes and the level and quality of government services provided are important influences on the location choices of firms and families. There is no *a priori* reason to suspect, and the empirical evidence does not support the conclusion, that reductions in taxes would automatically stimulate more economic activity — especially if the level and quality of services decline because of inadequate revenues. Given the relatively low effort by citizens in Maryland to support basic governmental services it is more likely that declining service qualities will be an important deterrent to growth in the state than state personal income taxes which are low compared to other states.

There is no *a priori* reason to suspect, and the empirical evidence does not support the conclusion, that reductions in taxes would automatically stimulate more economic activity.

Finally, efforts to evaluate the business tax climate in Maryland that look only at one tax or service at a time can be misleading and are not a strong foundation for policy making. For example, an alternative way to evaluate the business tax climate of a state is to take a representative firm and calculate its overall tax liability in Maryland and other comparison states to see what impact it has on the bottom line of the firm. Since

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different industries respond to different location factors, the analysis should be done for representative firms in different industries.

Such a study has been done by Robert Tannenwald, Senior Economist, Federal Reserve Bank of Boston. Hypothetical firms representative of selected industries are assumed to be located at various sites around the nation. It is assumed that the firms' pre-tax rate of return, asset mix, capital/labor ratio, and non-tax costs are identical at all sites. The only difference across sites, therefore, are state and local tax characteristics. Tannenwald applied this approach by comparing after tax rates of returns across 22 states for 5 different industries — men's clothing, fabricated metals, computers, electronic components, scientific instruments.¹ The results of this comparison of state tax climates are displayed in Table 5. It is important to note that all five industries obtain their second highest after tax rate of return in Maryland, behind only Alabama. Thus, one must conclude, that based on this comprehensive approach to evaluating the business tax climate in a state, at least for these five industries, the business tax climate in Maryland is very favorable relative to the other 21 comparison states.

Policy makers must consider what people actually do, not just what they say. For example, although the Chamber of Commerce has been outspoken in support of the personal income tax cut, there is evidence that the business community values a high level and quality of public services and is willing to tax themselves higher in order to provide better services. Specifically, in downtown Baltimore the business community got together to form a Special Benefits district. The District imposes a higher property tax on the businesses within the district and earmarks the revenues from that tax for improved public services, e.g. street lighting, aesthetics, safety, etc. Similarly, the business community participated in creating a Special Benefits District in Charles Village for basically the same purposes. Finally, there is an economic literature explaining the prices paid for single family homes which also demonstrates unambiguously that families are willing to pay higher prices for housing in local jurisdictions with a higher level and quality of public services. In all of these cases, businesses and families reveal their preferences for paying higher taxes in order to receive a higher level and quality of public services.

In the final analysis, decision makers must consider both sides of the budget when making tax and/or spending decisions. In the current small government environment in Maryland, where the size of state and local government has declined by nearly 9 percent since 1980, one could argue that maintaining the level and quality of services necessary to promote growth and development may be more important at this point in time in Maryland than considering further cuts in taxes, which, in all likelihood, will lead to further reductions in the ability of state and local government to provide the level and quality of services demanded by its citizens and businesses.

¹ Robert Tannenwald, "State Business Tax Climate: How Should It Be Measured and How Important Is It?" New England Economic Review, January/February 1996.

Introduction

The purpose of this paper is to examine more comprehensively and systematically the arguments advanced by those arguing that Maryland's personal income tax needs to be lowered significantly to stimulate private economic activity and critically important related issues.

Maryland's economy is not healthy. It has been undergoing major restructuring and downsizing for the last 10 years, and prospects for the immediate future are not bright. Maryland's manufacturing sector continued to decline in the first half of the 1990s — at twice the rate of manufacturing nationally. Cuts in federal employment ripple through the State's economy and federal research facilities in the state are vulnerable to future federal budget cuts. Firm restructuring and downsizing affects the state's traditionally strong industries such as transportation, utilities, finance, business services, and health services. According to Charles McMillion, President of MBG Information Services, there has been no real job growth in Maryland for the past 12 months.¹

The challenge facing the state is to design and implement a set of effective and complementary policies which will increase the rate of economic growth in Maryland's private sector.² In response to this challenge, Governor Glendening created the Maryland Economic Development Commission to develop a strategy for overcoming the state's current economic problems and stimulating the private sector growth necessary to maintain the State's above average family incomes. Their report, *Strategic Directions for Increasing Maryland's Competitiveness*, documents the state's economic problems and proposes a comprehensive strategy to promote job growth in the state. One element of that strategy is reducing Maryland's state personal income tax. This proposal was the focus of the Joint Select Committee on Competitive Taxes and Economic Development in the Maryland House of Delegates and is the focus of debate in the opening days of Maryland's 1997 Legislative Session. The authors of the report conclude that Maryland's high personal income taxes create a *red flag* that is deterring both existing and out-of-state firms from investing in the State.³

This view recently received added support from a study by the Cato Institute. According to the study authors, Stephen Moore and Dean Stansel, research analysts with the Cato Institute, Maryland's economic growth will fall behind its neighbors — Virginia, Pennsylvania, New Jersey and New York — because they are cutting taxes. Their analysis is based on correlations between tax burdens and family income, new jobs, and population growth for states that increased and states that cut taxes between 1990 and 1995. A similar approach was followed by Mahlon R. Straszheim who correlates employment growth with income tax burdens and reaches the conclusion that Maryland's personal income tax burden is so high that it is deterring growth in the state.⁴

The purpose of this paper is to examine more comprehensively and systematically the arguments advanced by those arguing that Maryland's personal income tax needs to be lowered significantly to stimulate private economic activity and critically important related issues. By examining the facts, we can sort out the myths and preconceived notions from reality and make a more informed policy judgement about how best to promote economic development in the state. The next section briefly reviews the state personal income tax in Maryland and concludes that it is *not* out of line with

other states. The main factor that sets Maryland apart from other states is our high reliance on the personal income tax as a means of funding local government in the state. Thus, if there is concern about the aggregate level of personal income taxes in Maryland, the salient issue is whether or not local governments should continue to rely so heavily on the income tax as a source of local revenues.

That is followed by a brief review of trends in the role of state and local government in Maryland and concludes that a more serious concern for future economic growth in the State, and our continued strong bond rating, is the structural deficit in the State's budget and the impact a major tax cut would have on the level and quality of publicly provided services available in the state. The trend in Maryland of shifting revenue raising responsibility from the State government to local governments is also troubling and must be addressed. In fact, if left unchecked this trend could negate any anticipated positive benefits from lowering state personal income taxes.

That is followed by a brief review of the economic literature that examines the link between economic growth, taxes, and spending. The final section reviews some of the findings of that economic development literature as it relates to state spending on education and infrastructure. The conclusion is that adequate public services are at least as important a factor influencing location decisions as taxes and the decline in the relative size of government in Maryland over the last 15 years raises serious questions about the ability of state and local governments to continue to provide the level and quality of services necessary to support economic development.

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Personal Income Taxes In Maryland

Maryland's maximum personal income tax rate is relatively low.

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The Maryland Economic Development Commission found that "Maryland's personal income taxes are high relative to the benchmark states and create a *red flag* that is deterring both existing and out-of-state firms from investing in the State."⁵ The report concludes that the personal income tax is a defining tax in Maryland and the legislature needs to reduce the tax by 15 percent by 1999 and another 10 percent after that.⁶

A couple of facts are important to consider before proceeding down this tax cut route too far, too quickly. First, based on information in the October 1996 *State Tax Guide*, published by the Commerce Clearing House, seven states have no state personal income tax⁷ and only five states have maximum marginal tax rates for their state personal income taxes that are *lower* than Maryland's 5.0 percent.⁸ Thus, in reality Maryland's state personal income tax rate structure is not out of line with other states. In fact, based on these data, Maryland's maximum personal income tax rate is relatively low, even when compared to the maximum rates for state personal income taxes in our neighboring states — e.g. Virginia, 5.75 percent; North Carolina, 7.75 percent; New Jersey, 6.37 percent; New York, 7.125 percent; and Ohio, 7.0 percent. In addition, as the information in Appendix A indicates, all of these states also have a more progressive rate structure for their state personal income tax than Maryland. Looking only at this information, one would conclude that Maryland's state personal income tax structure should be made more progressive and that there is some room to actually raise the top marginal tax rate some.

A second concern about the personal income tax in Maryland, however, is that local governments in Maryland depend heavily on the personal income tax for their own-source revenues — 20 percent compared with 3 percent for local governments nationally. Unlike virtually all other states, Maryland's personal income tax finances both state and local services. Thus, comparing Maryland's personal income tax burden with the benchmark states like Virginia, North Carolina and New Jersey is comparing apples and oranges and leads to inappropriate policy conclusions. You cannot compare the burden of a single tax across states without considering the role it plays in both state and local finances.

The data in Table 1 illustrate these concerns. For example, in Maryland local income taxes represent fully one-third of all income tax collections in the State. This is higher than any of the comparison states. In addition, three of the six comparison states used by the Maryland Economic Development Commission to make the case Maryland's taxes are high, collect virtually no local income taxes — New Jersey, North Carolina, and Virginia.

Similarly, Maryland relies on the local income tax for nearly 21 percent of local own-source revenues. This is more than 50 percent higher than Ohio which relies on local income taxes for 13.3 percent of local own-source revenues. Three states — New Jersey, North Carolina, and Virginia — generate virtually no local revenues from the income tax. Thus, comparing total personal income tax collections in Maryland to only

state personal income taxes in Virginia, North Carolina, New Jersey and all the other comparison states is a misleading mixing of apples and oranges which gives a distorted picture of the relative burden of financing state and local governments and leads to inappropriate policy conclusions.

TABLE 1

LOCAL INCOME TAX REVENUES AS A SHARE OF TOTAL INCOME TAX REVENUES AND AS A SHARE OF TOTAL LOCAL SOURCE REVENUES, 1993

State	Local Inc. Tax (000s)	State Inc. Tax (000s)	Total Local Own Rev. (000s)	Local Inc. as Share of Total	Local Inc. as Share of Own Rev.
U.S. Average	\$ 11,105,889.00	\$ 112,755,742.00	\$ 374,851,794.00	9.0%	3.0%
Delaware	\$ 27,293.00	\$ 513,138.00	\$ 561,742.00	5.1 %	4.9%
Kentucky	\$ 379,908.00	\$ 1,733,415.00	\$ 2,934,053.00	18.0%	12.9%
MARYLAND	\$ 1,542,659.00	\$ 3,079,664.00	\$ 7,408,786.00	33.4%	20.8%
New Jersey	\$ 23,691.00	\$ 4,350,485.00	\$ 13,789,807.00	0.5%	0.2%
New York	\$ 3,532,541.00	\$ 15,300,000.00	\$ 46,987,776.00	18.8%	7.5%
North Carolina	—	\$ 3,992,016.00	\$ 7,256,411.00	0.0%	0.0%
Ohio	\$ 2,078,507.00	\$ 4,721,854.00	\$ 15,582,246.00	30.6%	13.3%
Pennsylvania	\$ 1,897,653.00	\$ 4,657,926.00	\$ 15,262,987.00	28.9%	12.4%
Virginia	—	\$ 3,584,765.00	\$ 8,236,848.00	0.0%	0.0%

Source: U.S. Census Bureau, Government Finance Division

An alternative perspective on this issue can be gained by simply examining the marginal personal income tax rates for various states. Data collected from the October 1996 *State Tax Guide* indicate that Maryland's marginal tax rates for local income taxes are relatively high. This information, contained in Appendix B, indicates that of the sixteen states that have some authority for local income taxes, only Kentucky, New York, Ohio and Pennsylvania have maximum local tax rates near Maryland's. Thus, if Maryland is different from other states by having relatively high *aggregate* income tax collections, it is because local governments in Maryland rely on the personal income tax for own-source revenues to a greater extent than local governments in any other state. If there is a concern about the aggregate personal income tax burden in Maryland, the issue is not how much to lower the *state* personal income tax, but rather whether

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a rush to cut state personal income taxes seems unnecessary, inappropriate, and perhaps counterproductive — especially in view of recent trends in the role of government in Maryland. We turn to this topic in the next section.

the *local* income tax should continue to be a major source of revenue for local governments in the State.

Finally, Maryland benefits from being located next to Washington D.C. In the other states that allow local governments to tax personal income, virtually all local governments tax personal income at the place of employment, typically through a wage tax. Maryland taxes personal income at the place of residence and Congress has forbidden Washington D.C. from taxing personal income of non-residents. Ordinarily, Maryland residents working in Washington D.C. would pay taxes to Washington D.C. and they would get a credit on their Maryland return for taxes paid. As a result, Maryland personal income tax revenues would be lower than they are now, given the current definition of taxable income and the tax schedules. In other words, tax rates would actually have to be higher to generate the same amount of revenue if D.C. taxed non-resident income. In a sense, Maryland receives a windfall from the personal income tax because Congress prohibits Washington D.C. from taxing income of non-residents, so we are able to generate more revenue for a given tax rate.

In sum, the reality is that Maryland's state personal income tax is *not* out of line with other states. In fact, it is relatively low and not very progressive compared to other states. Maryland does have, however, a high local income tax — higher than any other state in the nation. If the policy concern is with the high level of aggregate personal income taxes in the state, the appropriate policy issue is not how to reduce *state* personal income taxes even further, but rather whether the *local* income tax should continue to play such a critical role in financing local governments in the state. In short, those advocating cuts in the state personal income tax as a means of stimulating business development in the state have the wrong solution to the wrong issue. Finally, all income taxes are deductible from federal income taxes, thereby reducing the net effective rate. Sales taxes are not deductible from federal income taxes. In this context, a rush to cut state personal income taxes seems unnecessary, inappropriate, and perhaps counterproductive — especially in view of recent trends in the role of government in Maryland. We turn to this topic in the next section.



State and Local Revenue Trends in Maryland

One trend that has serious implications for Maryland's service delivery and revenue raising needs, is the shift of these responsibilities from the federal to state and local governments.

Since the founding of the United States, principles of free enterprise have guided the establishment of its institutions and its government. This early focus on the "unalienable rights" of the individual to "Life, Liberty and the Pursuit of Happiness" represents the belief that individuals are the best agents of their own welfare. Individuals know their preferences best and pursue their different interests through the market place. As a general rule, we typically prefer to keep more of our income to spend as we see fit and give less to government to spend.

A competitive market economy, nevertheless, does need government. Some governmental activities are the domain of the federal government (national defense), some state governments (interstate highways) and some local governments (potable water). To meet its obligations and duties, each government must draw upon the resources of the citizens in its jurisdiction to pay for its programs and operations. State and local governments must draw primarily upon the personal income of their residents for the wherewithal to fulfill their obligations in a manner that is consistent with the expectations and wishes of its residents.

One trend that has serious implications for Maryland's service delivery and revenue raising needs, is the shift of these responsibilities from the federal to state and local governments. Current welfare reform initiatives that block grant programs to support the most disadvantaged in society and shift them to state governments is the most recent initiative along these lines. As a result of these policies, the federal share of total own-source government revenues has declined consistently from 65 percent in 1962 to 51 percent in 1993. As these trends continue, by the end of this decade the state and local sector will be the majority partner in our federal system, in terms of raising general own-source revenues.

State and local governments in Maryland have historically provided their residents with a high level of government services. For instance, public education is a high priority in Maryland, and the State has a national reputation for schools and students that are some of the finest in the nation. Similarly, the availability of high quality health care to all citizens in Maryland is another state priority, and Maryland's unique public health system testifies to that widely held value. Finally, Maryland's transportation network is more extensive than neighboring states and is in much better condition than transportation systems nationally.

To maintain these high standards, however, the state and localities must be able to draw on adequate resources to meet the needs and expectations of their citizens. As the State grows in population and wealth, the demand for more and better services also increases. Therefore, as service delivery responsibilities shift from the federal to state and local governments, and as the state's population grows and the economy struggles, *there must be significant growth in revenues if the current level and quality of public services are to be maintained.*

Over the past 15 years, however, this has not been the case. According to the data in Table 2, in 1993 citizens in Maryland paid approximately \$139 per \$1,000 of state

personal income to support state and local governments. This compares with a national average of over \$153 per \$1,000 personal income. State and local governments in Maryland took nearly 10 percent less personal income than state and local governments nationally. In fact, the size of state and local government in Maryland, relative to personal income, ranked 45th in the nation in 1993 — down from 29th in 1981. In 1993, only Arkansas, New Hampshire, Virginia, Illinois, Tennessee and Missouri made a smaller effort to fund state and local government services relative to personal income than Maryland. *In short, the financial support for the activities of our state and local governments by the citizens in Maryland is among the lowest in the nation and it is not accurate to characterize Maryland as a high tax state. In fact, one might be more legitimately concerned whether the level and quality of services is adequate to support greater economic growth.*

According to data in Table 3 it appears these trends have continued at the state level in Maryland into the mid-1990s. Specifically, the growth rate in State spending recommended by the Spending Affordability Committee has been below or equal to the growth in personal income every year of the last decade except in 1995. During that entire 10 year period (1986-96), the actual growth in State spending approved by the legislature never exceeded the growth rate recommended by the Spending Affordability Committee.

State and local governments in Maryland took nearly 10 percent less personal income than state and local governments nationally.

TABLE 2

STATE AND LOCAL OWN-SOURCE REVENUES AS A SHARE OF STATE PERSONAL INCOME, 1981 AND 1993

State	1981	1993	%Change
U.S. Average	\$ 154.01	\$ 153.49	-0.3%
Delaware	\$ 160.52	\$ 157.83	-1.7%
District of Columbia	\$ 170.23	\$ 174.66	2.6%
Kentucky	\$ 138.75	\$ 150.35	8.4%
MARYLAND	\$ 152.17	\$ 138.66	-8.9%
New Jersey	\$ 142.07	\$ 146.02	2.8%
New York	\$ 196.22	\$ 188.78	-3.8%
North Carolina	\$ 137.42	\$ 142.20	3.5%
Ohio	\$ 126.70	\$ 146.71	15.8%
Pennsylvania	\$ 138.87	\$ 142.17	2.4%
Virginia	\$ 134.44	\$ 135.06	0.5%

SOURCE: U.S. Census Bureau, Government Finance Division

TABLE 3
SPENDING AFFORDABILITY COMMITTEE RECOMMENDATIONS
TO THE GOVERNOR AND THE LEGISLATIVE POLICY COMMITTEE

Fiscal Year	Growth Rate	<i>Committee Recommendation</i>	Amount (In Millions)	<i>Legislative Action</i>	Amount (In Millions)
		Basis of Calculation		Growth Rate	
1983	10.18%	90% of growth in personal income	\$431.9	9.62%	\$412.8
1984	9.00%	80% of growth in personal income	\$428.0	5.70%	\$269.8
1985	6.15%	102% of growth in personal income	\$326.7	8.38%	\$402.0
1986	8.00%	120% of growth in personal income	\$407.2	7.93%	\$404.6
1987	7.70%	75% of growth in personal income	\$421.5	7.31%	\$402.2
1988	7.28%	90% of growth in personal income	\$430.2	7.27%	\$429.9
1989	8.58%	3-year avg. of growth in personal income	\$557.5	8.54%	\$552.9
1990	8.79%	100% of growth in personal income	\$618.9	8.78%	\$618.2
1991	9.00%	100% of growth in personal income	\$691.6	8.98%	\$689.7
1992	5.14%	60% of growth in personal income	\$421.8	5.00%	\$410.0
1993		No Recommendation		10.00%	\$823.3
1994	2.50%	85% of growth in personal income	\$216.7	2.48%	\$215.0
1995	5.00%	107.6% of growth in personal income	\$443.2	5.00%	\$443.2
1996	4.50%		\$420.0	4.50%	\$420.0

Source: Department of Fiscal Services, Assessing Affordability: An analysis of the spending affordability process prepared at the request of the Spending Affordability Committee, September 1995.

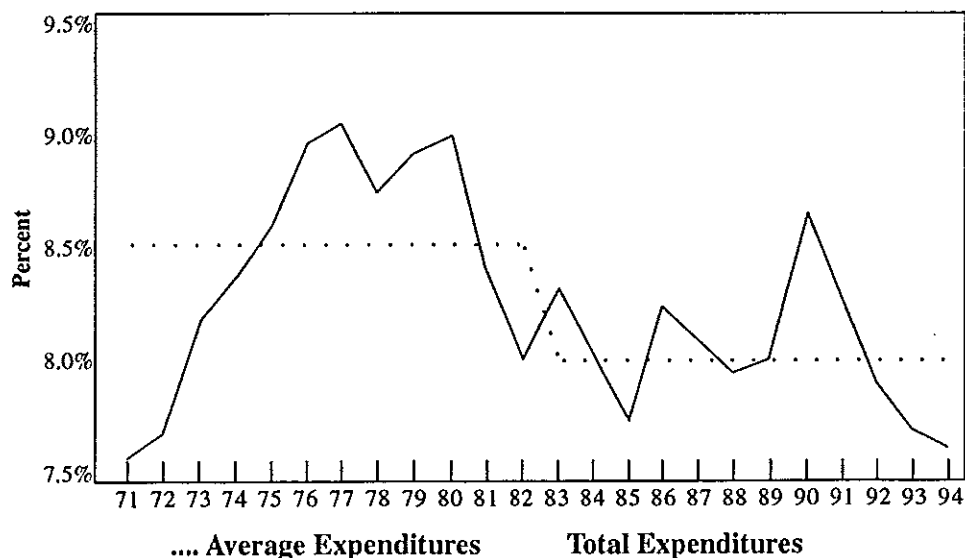
The resulting decline in the size of state government in Maryland, in relation to the economy, is confirmed by data collected by the Department of Fiscal Services.⁹ A report for the Spending Affordability Committee in September 1995 indicates that in 1979 State expenditures were 8.96 percent of State personal income, but fell to 8.10 percent in 1989 and to 7.76 percent in 1994 (see Figure 1). If state expenditures in 1994 accounted for the same share of personal income as they did in 1979, total State spending in 1994 would have been \$1.46 billion greater than actual spending that year. Thus, *ad hoc* annual efforts to balance the budget, and the explicit policy of the Spending Affordability Committee to hold increases in State expenditures below growth in state personal income, have combined to reduce significantly the size of state government in Maryland.

In addition to the shrinking size of state and local government, the discrepancy between growth rates of the state and local sectors' own-source revenues has significant implications for fiscal policy in Maryland. While the state sector has always been larger than the local sector in Maryland, local governments have had to pick up more of

While relative stability characterizes the national trend, there is a clear trend in Maryland to shift increasing revenue raising responsibility to local governments.

Figure 1

STATE SPENDING AS PERCENT OF PERSONAL INCOME



Includes general and special funds. Excludes federal, restricted and state reserve fund contributions.

Source: Department of Fiscal Services, Assessing Affordability: An analysis of the spending affordability process prepared at the request of the Spending Affordability Committee, September 1995.

TABLE 4

**LOCAL OWN-SOURCE REVENUES AS A SHARE OF STATE
OWN-SOURCE REVENUES, 1981 AND 1993**

State	1981	1993	%Change
U.S. Average	77.8%	80.3%	3.2%
Delaware	30.2%	26.9%	-10.9%
Kentucky	37.2%	42.8%	15.1 %
MARYLAND	72.9%	79.9%	9.6%
New Jersey	83.6%	77.1%	-7.8%
New York	121.2%	119.3%	-1.6%
North Carolina	54.4%	62.1%	14.2%
Ohio	92.8%	89.9%	-3.1 %
Pennsylvania	75.9%	69.7%	-8.2%
Virginia	67.9%	74.3%	9.4%

SOURCE: U.S. Census Bureau, Government Finance Division

the slack during this downsizing of state government. U.S. Census data in Table 4 show that in Maryland local own-source revenues, as a percentage of State own-source revenues, grew from 72.9 percent in 1981 to 79.9 percent in 1993. Nationally, local revenues raised from own-sources, relative to state own-source revenues, increased modestly during this period, from 77.8 percent in 1981 to 80.3 percent in 1993. While relative stability characterizes the national trend, there is a clear trend in Maryland to shift increasing revenue raising responsibility to local governments. Is this good/desirable public policy given other changes taking place in our federal system? How would an *ad hoc* cut in the state personal income tax affect this trend?

In fact, the reality is that Maryland has shifted revenue raising responsibility to local governments at a more rapid rate than most other states. As a result, the local share of total state and local revenues in Maryland ranked 26th in 1981, but increased to 15th in 1993 — only 14 states are more dependent on their local governments for revenue raising than Maryland. While the local share of total state and local own-source revenues increased by nearly 10 percent in Maryland from 1981 to 1993, data in Table 4 indicate that is more than all the comparison states except for Kentucky and North Carolina, both of which have relatively centralized state and local systems to begin with. New Jersey, which was more decentralized than Maryland in 1981, has become more centralized and now is below the national average, in terms of the role of local government in raising revenues. Similarly, Ohio has become more centralized

but is still more dependent on local governments for revenue raising than local governments nationally.

At the same time, in Maryland, own-source local revenues increased as a percentage of total local general revenues from 58.0 percent in 1979 to 70.8 percent in 1993. Nationally, the share of local revenues generated from own-sources increased only modestly, from 55 percent in 1979 to 62 percent in 1993. In all years, however, local governments in Maryland were responsible for raising a larger share of their revenues from own-sources than local governments nationally.

The trend to shift funding responsibility for various governmental functions from the state and federal governments to local governments in Maryland leads to a second serious concern: the types of revenue sources available to State government compared to those available for local governments. Local governments in Maryland generate 45 percent of their own-source revenues from the property tax and an additional 16 percent from user charges — both of which are generally regarded as being stable, albeit regressive revenue sources.¹⁰ Local governments receive about 20 percent of their revenues from the personal income tax. Alternatively, the state receives fully one-third of its own-source revenues from the personal income tax and only 13 percent from property taxes and user charges combined.¹¹ Thus, the shifting of government financing from state to local governments means that more regressive taxes will pay for government services and lower income households will be asked to bear more of the tax burden.

In sum, the reality is that Maryland reduced its effort to finance state and local governments by 9 percent from 1981 to 1993, and is now among the five states with the lowest effort to financially support the activities of their state and local governments. During this downsizing of government, revenue raising responsibility shifted from the State to local governments in Maryland. Also, local governments have become more dependent on own-source revenues during this period — more than local governments nationally and more than in 1981. This implies that an increasing share of government revenues in Maryland are being raised by more regressive means thereby shifting the burden of financing government to those least able to pay.

In spite of these facts, there seems to be a myopic focus on cutting state personal income taxes as a means of promoting economic development in the current legislature. However, a number of factors contribute to economic development, albeit two of the most important are taxes and spending on infrastructure and education. While there are other significant factors, these two are among the most prominent. Furthermore, they are related to one another because taxes finance infrastructure investment and public education. The remainder of this paper surveys what is known about economic development with respect to taxes, other public services, and education.

The next section looks at the impact of state and local taxes on economic development. The recent literature on business location decisions shows that taxes generally have a negative impact on economic development. In particular, taxes have a more

In sum, the reality is that Maryland reduced its effort to finance state and local governments by 9 percent from 1981 to 1993, and is now among the five states with the lowest effort to financially support the activities of their state and local governments.

A high tax/high service jurisdiction may be more desirable than a low tax/low service jurisdiction.

pronounced negative impact for locational decisions within a region or metropolitan area than decisions among regions and metropolitan areas.

The following section then considers the impact of public services on business activity. The literature indicates that increases in public services that matter to industry — infrastructure and education in particular — have a positive impact on economic development. A comparable increase in government services can mitigate — if not turn around — the negative impact of higher taxes on business activity. A high tax/high service jurisdiction may be more desirable than a low tax/low service jurisdiction. Local and state government services, therefore, can play as large a role in business activity as that of taxes.

The final section reviews the impact on economic development of public spending on primary and secondary education. In principle, public education can play an important role in the decision of businesses to locate in a region for two reasons. First, good public school systems provide an educated work force that an employer would seek for skilled employees. Second, the business executives who make the decision to move to an area may choose an area with better schools for their own children, all things being equal. The literature indicates a positive impact on business activity where such impacts are measured.

Taxes and Economic Development

Studies on the effect of taxes on business location decisions in the 1950s, 1960s and the early and middle 1970s generally did not find statistically significant negative tax effects on state and local economic growth.

State and local tax rates are a salient issue for the Maryland General Assembly. Traditionally, the Maryland business lobby argues that the state projects the image of levying high taxes. The argument asserts that the perception of onerous taxes leads some businesses to locate in places other than Maryland or leads some Maryland businesses to decide against expanding. This debate over the impact of Maryland's state and local taxes, therefore, requires us to ask what is known about the impact of taxes on business activity.

This issue, and the related issue of how state and local spending is related to economic development, are contentious issues. In the economics literature there are two fundamental approaches to trying to analyze these relationships. Specifically, researchers rely on surveys of businesses which ask questions about the factors that influence their location decisions. In addition, researchers conduct empirical research which analyzes factors that are associated with (sometimes in a causal manner) with economic growth. The survey literature generally finds that taxes are not high on the priority list of factors that influence business location decisions. However, if all other factors are the same, then at the margin taxes can be important in some locations for some industries. Alternatively, the results of the empirical analyses are somewhat mixed, albeit one can make a case that there is a link between taxes and economic growth at the margin for some industries.

Studies on the effect of taxes on business location decisions in the 1950s, 1960s and the early and middle 1970s generally did not find statistically significant negative tax effects on state and local economic growth.¹² This trend, however, has changed. In 1991, researcher Timothy J. Bartik published the results of his comprehensive review of 84 published and unpublished studies done since 1979 which examine the relationship between economic growth, taxes, and public services.¹³ Of the studies that compared business location decisions across different metropolitan areas, 70 percent had at least one statistically significant negative tax effect. Of these inter-metropolitan area studies that sought to keep the level of public services constant for the purposes of comparison, 80 percent had at least one statistically significant negative tax effect; and of these studies that sought to take account for the inherent characteristics of the specific metropolitan communities in question, 92 percent of the studies show at least one statistically significant negative tax effect. For every one percent increase in taxes, business activity decreased by a mean of 0.25 percent, 0.33 percent and 0.44 percent in each set of studies respectively.

It must be emphasized here that these empirical results typically assume that the level and quality of public services are held constant. That is, without a change in the level and quality of services, higher taxes may discourage growth in some places for some industries at the margin. If taxes are decreased, and there is a subsequent decrease in the level and quality of public services provided, the net effect could very easily be an overall negative impact on economic growth and development. Thus, those arguing that a reduction in the personal income tax in Maryland will stimulate

economic development and growth must guarantee that the level and quality of public services provided by state and local governments will not be diminished — otherwise the empirical evidence does not support their case.

For the business location studies that look at decisions among localities within a single metropolitan area, the negative tax effect is greater, albeit fewer studies found such an effect. Fifty-seven percent of these studies had at least one negative tax effect, and 70 percent of intra-metropolitan studies that took into account the characteristics of the individual localities had at least one negative tax effect. These results suggest that taxes do have a negative impact on business activity when the level and quality of services are held constant, and the tax effects are stronger within a metropolitan area than among different metropolitan areas. Bartik attributes this finding to the theory that businesses choose metropolitan areas based on many market conditions of which taxes are a minor, though significant consideration. Within a metropolitan area, however, relative state and local taxes play a more important role in location decisions. Furthermore, when the unobserved state and local characteristics that effect growth are taken into account, the negative tax effects are more consistent and more pronounced.

Some of the studies that Bartik includes in his analysis clearly capture important aspects of this tax effect. Roger W. Schmenner, a business location scholar, found that when a company's managerial sentiment is for low taxes, the final location decisions are consistent with the expressed preference.¹⁴ Tax researchers Michael Wasylenko and Therese McGuire found that higher personal income tax rates or an increase in overall taxation discourages economic growth in the manufacturing industry, but that higher state and local spending on education has a favorable impact on economic development.¹⁵ In addition, business professor Joseph Gyourko found that relatively higher taxes on capital — such as property taxes — tend to increase the labor intensity of the manufacturing industry within the tax jurisdiction. Capital intensive manufacturers, therefore, tend to locate in jurisdictions with low taxes on capital. On the other hand, labor intensive manufacturers tend to locate in high capital tax jurisdictions — such as central cities — even though payroll taxes may be high.¹⁶ Likewise, researcher Robert J. Newman found that the businesses that tended to locate or relocate in the southern part of the United States because of low corporate tax rates were those that were capital intensive.¹⁷

An important characteristic of these studies, and Bartik's analysis, is that manufacturing industries play a prominent role in the analysis, although they are a very small share of the Maryland economy. Thus, **the empirical findings of studies looking only at manufacturing industries cannot be easily applied to non-manufacturing sectors.** Each sector makes its location decisions based on a different set of considerations and the findings for one sector cannot be extended to all other sectors.

Other important studies also identify similar tax effects on economic activity. A study of small business start-ups by Bartik finds that tax cuts have a modest but positive impact on small business starts that can be diminished by a reduction in business-

Capital intensive manufacturers, locate in jurisdictions with low taxes on capital. Labor intensive manufacturers locate in high capital tax jurisdictions — such as central cities.

In the final analysis, the empirical literature on the link between taxes and economic performance is mixed.

related public services.¹⁸ However, personal income and corporate taxes had no significant impact on the number of new business starts.

In the final analysis, the empirical literature on the link between taxes and economic performance is mixed. While there are some general themes that emerge from this literature, the findings are not robust enough — across all taxes, locations and industries — to make any blanket recommendations. The major caveat, however, is that the level and quality of services must be maintained. Therefore, the Legislature must proceed with caution when making policy in this area.

If, as this literature suggests, taxes reduce growth or inhibit development, then presumably no democratic government would collect taxes unless there were offsetting benefits. Accurate estimates of the possible negative effects of taxes require similar estimates of those possible benefits from the public services financed by the taxes.¹⁹ This is the subject of the next section.

Public Services and Economic Development

If the revenues from a tax increase are directed toward public services that industry desires, then businesses are more likely to choose to locate in that jurisdiction. Alternatively, if taxes are cut, and, as a result so are public services that businesses want, some firms may shun the low-tax jurisdiction with declining services.

While the evidence suggests that under some circumstances tax increases may have a negative impact upon economic activity, the purpose to which the tax revenues are applied can be equally as significant in influencing location decisions of both firms and families. Increases in some public services — roads, infrastructure, police and fire service, and education — have a tendency to improve business activity. Thus, if the revenues from a tax increase are directed toward public services that industry desires, then businesses are more likely to choose to locate in that jurisdiction. Alternatively, if taxes are cut, and, as a result so are public services that businesses want, some firms may shun the low-tax jurisdiction with declining services. For example, researcher L. Jay Helms finds that tax increases that do not go into business-related public services “significantly retard economic growth,” but if the revenues are used to fund improved public services such as education, highways, public health and safety, then the favorable impact of these services may more than counterbalance the adverse impacts of the tax increases.²⁰

Bartik’s 1991 analysis of the economic impact of taxes also surveys 30 studies of the effect of public services on business location decisions. Of these inter-metropolitan studies, 60 percent find at least one type of public service having a positive and statistically significant impact on business location decisions. In particular, infrastructure and education “have the most consistently positive relationship to local business activity.”²¹ On the other hand, Bartik also observes that 7 of 12 studies that looked at the economic impact of increased welfare spending have at least one negative and statistically significant impact. Thus, there is some empirical evidence that suggests public spending does promote economic development, but how that spending is allocated can indicate the direction of the net impact of the tax increase necessary to pay for it.

One of the most important studies that Bartik includes in his survey of public service impacts on economic development is by Alicia H. Munnell, who at the time of the study directed research for the Federal Reserve Bank of Boston. Munnell’s study looks at the statistical relationship between expenditures on public capital and employment growth within the various states. She found that the differentials in public capital spending correspond to differentials in economic growth, and she observes that public investment in infrastructure “had a significant positive impact on that state’s private employment growth.”²² This leads her to conclude — in light of the benefits from public investment that do not flow from private investment — that the economy of this country is under performing because of under investment in the public sector.

Using an analytical model based on Munnell’s work but with different data, Bartik elaborates upon the analysis to look at the long-run effects of increases in state and local public spending on manufacturing productivity and output.²³ As previously explained, Bartik looks at the manufacturing sector because of the existence and quality of the data that are available. Furthermore, the manufacturing sector fills a role in the regional economy with relatively clear and uncomplicated causal relationships as compared to other sectors of the economy. Bartik’s research estimated the long-run effect

(cumulative effect after 11 years) on manufacturing output of an increase of one percent of state personal income for a variety of expenditure and revenue categories. The results are listed in the following table.²⁴

Fiscal Variables	Long-Run Effect on Manufacturing Output
Elementary and Secondary Education	12.69
Higher Education	19.22
Health	23.96
Highways	7.47
Other Public Spending	16.12
Property Taxes	-10.95
Other Taxes	-17.46
Fees	-13.19
Intergovernmental Revenue	-7.59
Deficit	-16.39

Results of analysis indicate that increases in public investment do increase economic activity in the manufacturing sector, but the means of generating the revenue for the increased expenditure can have a significant impact of its own right.

The results of Bartik's analysis indicate that increases in public investment do increase economic activity in the manufacturing sector, but the means of generating the revenue for the increased expenditure can have a significant impact of its own right. Therefore, increased investment and revenues can generate a net economic gain, if the right combinations are used to raise funds and the funds are used in a productive manner. Clearly, this is not a clarion call for more government spending across the board. It is, however, evidence that a carefully considered tax system and a judicious selection of public service expenditures can promote economic development.

Primary and Secondary Education and Economic Development

While the relationship between educational funding and outcomes remains contentious, empirical evidence consistently indicates a positive relationship between higher education funding and improved economic development.

While many of the previously mentioned articles indicate that increased spending on primary and secondary education has positive impacts upon the business location or manufacturing output, the relationship between educational spending and educational outcomes is complicated. Higher education expenditures, in and of themselves, do not necessarily result in better educational outcomes. The landmark 1966 report *Equality of Educational Opportunity* — also known as the Coleman report — and a more recent article “The Economics of Schooling: Production and Efficiency in the Public Schools”²⁵ both found little relationship between educational inputs (i.e. class size, length of school day, teacher experience, teacher pay) and educational outcome as measured by scores on standardized tests. Further analysis of the data evaluated in the second study, however, consistently concludes that class size and teacher experience and skill do effect student performance.²⁶ More educational funding can permit higher salaries that attract and retain more and better teachers. The implication of this research is that additional educational funding which has the effect of (1) reducing class size through the hiring of more teachers and of (2) increasing teacher pay that attracts the more skilled and retains experienced teachers will lead to better academic performances by the students.

The issue of equality of educational opportunity also draws attention to education funding levels. State court rulings on state constitutions across the nation have required states to provide equal educational opportunities to all its students. This has led to efforts to make sure that all students have similar opportunities through schools that have access to adequate resources. The measure of the equality of opportunity has generally come down to the level of a school’s expenditure per pupil. For these reasons, educational spending in principle can and does have an impact on educational outcomes.

While the relationship between educational funding and outcomes remains contentious, empirical evidence consistently indicates a positive relationship between higher education funding and improved economic development. International statistical analyses show a robust finding that the initial average level of school contributes positively to growth.²⁷ It is important to note, however, that increases in the level of schooling do not have a similar positive impact on economic growth, and economist Zvi Griliches believes this is because, on the international level, the highly educated tend to concentrate in the public sector where their productivity is more difficult to measure.²⁸ This leads us to conclude that higher education can improve economic growth, but how the increases in education are utilized has implications for economic development.

In the United States, similar positive impacts have been identified. Tax researcher Michael Wasylenko evaluated the Minnesota state tax system as part of a group of researchers at the request of the state’s political and economic leaders. His analysis finds that “higher expenditure on education relative to income has positive effects on overall employment growth.” Therefore, proposals to reform the tax system by reducing expenditures to education would be counterproductive.²⁹

Likewise, Bartik's statistical analysis of the impact of public fiscal actions on economic development also identified an increase in business activity associated with increases in spending for primary and secondary education. Drawing on the data in the previous table, an increase of one percent of state personal income for expenditures on primary and secondary education would result in a 12.69 percent long-run increase in manufacturing output.³⁰ For an increase of one percent of state personal income in property taxes over the same time period, the long-run decrease in manufacturing output is estimated to be 10.95 percent. Thus there would be a net increase in manufacturing output. It is important to note that an increase of one percent of state personal income of all taxes other than property taxes is estimated to decrease manufacturing output by 17.46 percent which would create a net loss. Primary and secondary education, nevertheless, are generally funded by property taxes, so the net gain scenario is the more appropriate one. These results seem to indicate that a tax increase to fund an improvement in public education generates a net gain. It must be said that the net outcome depends on the source of revenue and how the additional resources are used.

Furthermore, a statistical analysis of business location decisions by William F. Fox and Matthew N. Murray finds that the median years of education (as a rough guide of long-run education policies) has a statistically significant impact on the decision of businesses to locate in a jurisdiction.³¹

This pattern of empirical evidence showing that education expenses have a positive impact on economic development can be clearly observed in Bartik's survey of the literature examining the effect of public service provision on business location decisions. Some of the studies mentioned above find a positive impact for increased local education spending, including Bartik's analysis of small business location decisions,³² Helms' statistical analysis of economic growth³³ and Wasylenko and McGuire's study of the impact of business climate on states' employment growth rates.³⁴ In Bartik's survey, he categorizes the observed effects according to whether in effect was positive or negative and whether the effects were statistically significant. Of the 13 studies that sought to measure the impact of primary and secondary education expenditure on business location decisions, five identified a statistically significant positive effect, six had positive effects that were not significant, two had negative effects that were not significant, two had negative effects that were statistically significant and two studies had insignificant findings or findings of unclear significance. Some studies measured more than one effect and only one study identified a positive and a negative effect, though both were not statistically significant.³⁵

Education scholars may argue about the relationship between increased educational spending and educational outcomes. Nevertheless, experience shows a consistent finding that primary and secondary education spending has a positive impact on economic development and business location. Education is a public service that businesses desire and seem to react to favorably. Other public services have a positive impact on economic development also, in particular, public investments in infrastructure.

results seem to indicate that a tax increase to fund an improvement in public education generates a net gain.

Conclusion

the more serious threat to future economic development may be the ability of state and local governments to provide the level and quality of services necessary to support that development.

As the General Assembly convenes in Annapolis for the 1997 session, the defining issue of this legislative session seems to be determining how to reduce the state's personal income tax. The Chamber of Commerce, the Governor, the Speaker of the House of Delegates and others have all put forward initiatives to reduce personal income taxes in Maryland. The facts reviewed in this report, however, suggest that such a policy is the wrong response to the wrong problem and may actually have adverse effects on economic growth in the state.

The purpose of this paper is to examine more thoroughly the notion that state personal income taxes must be reduced and to consider other related issues. The facts presented indicate that Maryland's state personal income tax is *not* out of line with other states and the more serious threat to future economic development may be the ability of state and local governments to provide the level and quality of services necessary to support that development. Based on the information presented above, the following *Myths* and *Realities* emerge.

Myth: Maryland's state personal income tax is out of line with our neighboring states.

Reality: Maryland's state personal income tax has a maximum marginal rate of 5 percent reached at \$3500 income. Of the 43 states that have personal income taxes, only 5 have a maximum marginal tax rate *lower* than Maryland's. Thus, the reality is that Maryland has one of the lowest top marginal tax rates in the country and one of the least progressive personal income taxes in the nation. Our aggregate personal income tax collections are high relative to other states because local governments depend heavily on the personal income tax as a source of revenue — more than local governments in any other state.

Myth: Maryland is a high tax state.

Reality: Maryland residents paid \$139 per \$1000 of personal income in 1993 to support state and local governments. This is 9 percent less than in 1981 and is 10 percent below the national average. In fact, only five states — Arkansas, New Hampshire, Virginia, Illinois, Tennessee and Missouri — devote a smaller share of their personal income to supporting state and local governments than Maryland. The reality is that Maryland is a low tax state.

Myth: Growth in state spending is out of control and the major contributor to the structural deficit in the state budget.

Reality: State spending has not increased as fast as personal income in any of the last 10 years. State spending has declined as a share of personal income from 9 percent in 1979 to 7.7 percent in 1994. If State expenditures in 1994 ac-

counted for the same share of personal income as they did in 1979, total State revenues would have been \$1.5 billion greater. More troubling is the shift in revenue raising responsibility from the state to local governments in Maryland. Since local governments rely on more regressive revenue sources this involves a shift in financing state and local government to those in society least able to afford it.

There is no *a priori* reason to assume that a high tax/high service jurisdiction will be less desirable than a low tax/low service jurisdiction.

Myth: If the state personal income tax is reduced economic development will be stimulated in the State.

Reality: The economic literature reviewed in this report makes it clear that both taxes and the level and quality of government services provided are important influences on the location choices of firms and families. There is no *a priori* reason to suspect, and the empirical evidence does not support the conclusion, that reductions in taxes would automatically stimulate more economic activity — especially if the level and quality of services declines because of inadequate revenues. Given the relatively low effort by citizens in Maryland to support basic governmental services it is more likely that declining service qualities will be an important deterrent to growth in the State than state personal income taxes which are low compared to other states.

Two final points. The empirical analyses reviewed here indicate that both sides of the state and local budget are important in influencing location decisions of both families and firms. Both taxes and expenditures are important. There is no *a priori* reason to assume that a high tax/high service jurisdiction will be less desirable than a low tax/low service jurisdiction. In fact, there is evidence in Maryland that both families and businesses are willing to tax themselves more for a higher level of public service. This is consistent with the overall set of recommendations of the Maryland Economic Development Commission that also expressed serious concerns about the overall quality of life in Maryland — where quality of life is determined in large part by how effectively government acts to protect the environment, provide high quality education and transportation.

Second, efforts to evaluate the business tax climate in Maryland that look only at one tax or service at a time can be misleading and are not a strong foundation for policy making. For example, an alternative way to evaluate the business tax climate of a state is to take a representative firm and calculate its overall tax liability in Maryland and other comparison states to see what impact it has on the bottom line of the firm. Since different industries respond to different location factors, the analysis should be done for representative firms in different industries.

Such a study has been done by Robert Tannenwald, Senior Economist, Federal Reserve Bank of Boston. Hypothetical firms representative of selected industries are

one must conclude, that the business tax climate in Maryland is very favorable relative to the other 21 comparison states.

assumed to be located at various sites around the nation. It is assumed that the firms' pre-tax rate of return, asset mix, capital/labor ratio, and non-tax costs are identical at all sites. The only difference across sites, therefore, are state and local tax characteristics. Tannenwald applied this approach by comparing after tax rates of returns across 22 states for 5 different industries — men's clothing, fabricated metals, computers, electronic components, scientific instruments.³⁶ The results of this comparison of state tax climates are displayed in Table 5. It is important to note that all five industries obtain their second highest after tax rate of return in Maryland, behind only Alabama. Thus, one must conclude, that based on this comprehensive approach to evaluating the business tax climate in a state, at least for these five industries, the business tax climate in Maryland is very favorable relative to the other 21 comparison states.

Table 5

After Tax Rate of Return for Selected Manufacturing Industries, 1991

State	5-Industry Average		Men's Clothing		Fabricated Metals		Computers		Electronic Components		Scientific Instruments	
	Return	Rank	Return	Rank	Return	Rank	Return	Rank	Return	Rank	Return	Rank
AL	16.0	1	15.5	1	16.0	1	16.1	1	16.1	1	16.0	1
MD	15.7	2	15.4	2	15.7	2	15.7	2	15.7	2	15.7	2
SC	15.5	3	15.3	3	15.6	3	15.5	5	15.7	2	15.6	3
FL	15.5	3	15.2	4	15.6	3	15.6	3	15.7	2	15.6	3
NY	15.4	5	15.0	5	15.5	5	15.6	3	15.6	5	15.4	5
IL	15.3	6	14.9	7	15.4	6	15.4	6	15.5	6	15.3	6
NH	15.3	6	15.0	5	15.3	7	15.3	7	15.4	8	15.3	6
TN	15.3	6	14.9	7	15.3	7	15.2	9	15.5	6	15.3	6
MA	15.2	9	14.8	10	15.3	7	15.3	7	15.4	8	15.3	6
TX	15.2	9	14.6	13	15.2	10	15.2	9	15.4	8	15.3	6
ME	15.1	11	14.9	7	15.2	10	15.1	12	15.3	11	15.2	11
RI	15.1	11	14.5	16	15.2	10	15.2	9	15.3	11	15.1	13
GA	15.0	13	14.6	13	15.1	13	15.1	12	15.2	15	15.2	11
NC	15.0	13	14.6	13	15.1	13	15.1	12	15.2	15	15.1	13
CA	15.0	13	14.7	11	15.0	17	15.0	18	15.2	15	15.1	13
NJ	15.0	13	14.3	18	15.1	13	15.1	12	15.3	11	15.1	13
WI	15.0	13	14.3	18	15.1	13	15.1	12	15.3	11	15.0	18
VT	14.9	18	14.7	11	15.1	17	14.0	19	15.1	19	15.0	18
OH	14.9	18	14.3	18	15.0	17	15.1	12	15.1	19	15.0	18
WA	14.8	20	14.0	22	14.7	20	14.9	19	15.2	15	15.1	13
PA	14.6	21	14.2	21	14.7	20	14.7	21	14.9	21	14.7	21
CT	14.5	22	14.5	16	14.5	22	14.5	22	14.7	22	14.6	22

Policy makers must consider what people actually do, not just what they say. For example, although the Chamber of Commerce has been outspoken in support of the personal income tax cut, there is evidence that the business community values a high level and quality of public services and is willing to tax themselves higher in order to provide better services. Specifically, in downtown Baltimore the business community got together to form a Special Benefits District. The District imposes a higher property tax on the businesses within the district and earmarks the revenues from that tax for improved public services, e.g. street lighting, aesthetics, safety, etc. Similarly, the business community participated in creating a Special Benefits District in Charles Village for basically the same purposes. Finally, there is an economic literature explaining the prices paid for single family homes which also demonstrates unambiguously that families are willing to pay higher prices for housing in local jurisdictions with a higher level and quality of public services. In all of these cases, businesses and families reveal their preferences for paying higher taxes in order to receive a higher level and quality of public services.

In the final analysis, decision makers must consider both sides of the budget when making tax and/or spending decisions. In the current small government environment in Maryland, where the size of state and local government has declined by nearly 9 percent since 1980, one could argue that maintaining the level and quality of services necessary to promote growth and development may be more important at this point in time in Maryland than considering further cuts in taxes, which, in all likelihood, will lead to further reductions in the ability of state and local government to provide the level and quality of services demanded by its citizens and businesses.

maintaining the level and quality of services necessary to promote growth and development may be more important at this point in time in Maryland than considering further cuts in taxes

Appendix A:

State Individual Income Taxes: Rates, 1996

Source: State Tax Guide October, 1996 Commerce Clearing House, Inc.

Rates for Single Individuals or Married Filing Separately

State	Income Subject to Tax	Mariginal Rate (percent)
Alabama	First \$500	2.0
	501-3000	4.0
	Over 3000	5.0
Alaska	No tax	
Arizona	First \$10,000	3.0
	10,001 - 25,000	3.5
	25,001 - 50,000	4.2
	50,001 - 150,000	5.2
	Over 150,000	5.6
Arkansas	First \$2999	1.0
	3000 - 5999	2.5
	6000 - 8999	3.5
	9000 - 14,999	4.5
	15,000 - 24,999	6.0
	Over 24,999	7.0
California	First \$4908	1.0
	4909 - 11,632	2.0
	11,633 - 18,357	4.0
	18,358 - 25,484	6.0
	25,485 - 32,207	8.0
	32,208 - 111,695	9.3
	111,696 - 223,390	10.0
	Over 223,390	11.0
Colorado	Modified federal taxable income	5.0
Connecticut	First \$2250	3.0
	Over 2250	4.5

State	Income Subject to Tax	Mariginal Rate (percent)
Delaware	First \$2000	0.0
	2001 - 5000	3.2
	5001 - 10,000	5.0
	10,001 - 20,000	6.0
	20,001 - 25,000	6.35
	25,001 - 30,000	6.65
	Over 30,000	7.1
D.C.	First \$10,000	6.0
	10,001 - 20,000	8.0
	Over 20,000	9.5
Florida	No tax	
Georgia	First \$750	1.0
	751 - 2250	2.0
	2251 - 3750	3.0
	3751 - 5250	4.0
	5251 - 7000	5.0
	Over 7000	6.0
Hawaii	First \$1500	2.0
	1501 - 2500	4.0
	2501 - 3500	6.0
	3501 - 5500	7.25
	5501 - 10,500	8.0
	10,501 - 15,500	8.75
	15,501 - 20,500	9.5
	Over 25,000	10.0
Idaho	First \$1000	2.0
	1001 - 2000	4.0
	2001 - 3000	4.5
	3001 - 4000	5.5
	4001 - 5000	6.5
	5001 - 7500	7.5
	7501 - 20,000	7.8
	Over 20,000	8.2

State	Income Subject to Tax	Mariginal Rate (percent)
Illinois	Taxable net income	3.0
Indiana	Modified fed. AGI	3.4
Iowa	First \$1081	0.4
	1082 - 2162	0.8
	2163 - 4324	2.7
	4325 - 9729	5.0
	9730 - 16,215	6.8
	16,216 - 21,620	7.2
	21,621 - 32,430	7.55
	32,431 - 48,645	8.8
	Over 48,645	9.98
Kansas	First \$20,000	4.4
	20,001 - 30,000	7.5
	Over 30,000	7-75
Kentucky	First \$3000	2.0
	3001 - 4000	3.0
	4001 - 5000	4.0
	5001 - 8000	5.0
	Over 8000	6.0
Louisiana	First \$10,000	2.0
	10,001 - 50,000	4.0
	Over 50,000	6.0
Maine	First \$4149	2.0
	4150 - 8249	4.5
	8250 - 16,499	7.0
	Over 16,499	8.5
Maryland	First \$1000	2.0
	1001 - 2000	3.0
	2001 - 3000	4.0
	Over 3000	5.0

State	Income Subject to Tax	Mariginal Rate (percent)
Mass.	Interest, dividends, capital gains	12.0
	5 Classes of capital gain income	0.0 to 5.0
	All other income	5.95
Michigan	Taxable Income	4.4
Minnesota	First \$16,070	6.0
	16,071 - 52,790	8.0
	Over 52,790	8.5
Mississippi	First \$5000	3.0
	5001 - 10,000	4.0
	Over 10,000	5.0
Missouri	First \$1000	1.5
	1001 - 2000	2.0
	2001 - 3000	2.5
	3001 - 4000	3.0
	4001 - 5000	3.5
	5001 - 6000	4.0
	6001 - 7000	4.5
	7001 - 8000	5.0
	8001 - 9000	5.5
	Over 9000	6.0
Montana	First \$1899	2.0
	1900 - 3799	3.0 less \$19
	3800 - 7599	4.0 less \$57
	7600 - 11,399	5.0 less \$133
	11,400 - 15,199	6.0 less \$247
	15,200 - 18,999	7.0 less \$399
	19,000 - 26,499	8.0 less \$589
	26,500 - 37,899	9.0 less \$854
	37,900 - 66,399	10.0 less \$1233
	Over 66,399	11.0 less \$1897

State	Income Subject to Tax	Mariginal Rate (percent)
Nebraska	First \$2400	2.62
	2401 - 17,000	3.65
	17,001 - 26,500	5.24
	Over 26,500	6.99
Nevada	No tax	
N.H.	Interest and dividends only	5.0
New Jersey	First \$20,000	1.4
	20,001 - 35,000	1.75
	35,001 - 40,000	3.5
	40,001 - 75,000	5.525
	Over 75,000	6.37
New Mexico	First \$5500	1.7
	5501 - 11,000	3.2
	11,001 - 16,000	4.7
	16,001 - 26,000	6.0
	26,001 - 42,000	7.1
	42,001 - 65,000	7.9
	Over 65,000	8.5
New York	First \$5500	4.0
	5501 - 8000	5.0
	8001 - 11,000	6.0
	11,001 - 13,000	7.0
	Over 13,000	7.125
N.C.	First \$12,750	6.0
	12,751 - 60,000	7.0
	Over 60,000	7.75

State	Income Subject to Tax	Marginal Rate (percent)
N.D.	First \$3000	2.67
	3001 - 5000	4.0
	5001 - 8000	5.33
	8001 - 15,000	6.67
	15,001 - 25,000	8.0
	25,001 - 35,000	9.33
	35,001 - 50,000	10.67
	Over 50,000	12.0
	or individuals, estates and trusts may choose to calculate their state income tax liability another way	
	adjusted federal income tax liability	14.0
Ohio	First \$5000	0.693
	5001 - 10,000	1.387
	10,001 - 15,000	2.775
	15,001 - 20,000	3.469
	20,001 - 40,000	4.162
	40,001 - 80,000	4.857
	80,001 - 100,000	5.550
	100,001 - 200,000	6.444
	Over 200,000	7.004
Oklahoma	First \$1000	0.5
	1001 - 2500	1.0
	2501 - 3750	2.0
	3751 - 4900	3.0
	4901 - 6200	4.0
	6201 - 7700	5.0
	7701 - 10,000	6.0
	Over 10,000	7.0
Oregon	First \$2200	5.0
	2201 - 5550	7.0
	Over 5550	9.0
Penn.	Penn. taxable income	2.8

State	Income Subject to Tax	Mariginal Rate (percent)
R.I.	Fed. income tax liability	27.5
S.C.	First \$2250	2.5
	2251 - 4500	3.0
	4501 - 6750	4.0
	6751 - 9000	5.0
	9001 - 11,250	6.0
	Over 11,250	7.0
S.D.	No tax	
Tennessee	Interest and dividends	6.0
Texas	No tax	
Utah	First \$750	2.55
	751 - 1500	3.5
	1501 - 2250	4.4
	2251 - 3000	5.35
	3001 - 3750	6.0
	Over 3750	7.0
Vermont	Federal income tax liability	25.0
Virginia	First \$3000	2.0
	3001 - 5000	3.0
	5001 - 17,000	5.0
	Over 17,000	5.75
Washington	No tax	
W.V.	First \$10,000	3.0
	10,001 - 25,000	4.0
	25,001 - 40,000	4.5
	40,001 - 60,000	6.0
	Over 60,000	6.5

State	Income Subject to Tax	Mariginal Rate (percent)
Wisconsin	First \$7500	4.9
	7501 - 15,000	6.55
	Over 15,000	6.93
Wyoming	No tax	

Appendix B:

Local Income Taxes: Rate, Selected Cities and Counties, 1996 Source: State Tax Guide October, 1996 Commerce Clearing House, Inc.

State City (County)	City Tax Rate		County Tax Rate		Income Tax Based on
	Res.	Non-Res.	Res.	Non-Res.	

Alabama

Birmingham	1.0	1.0			gross receipts and compensation from bus. transactions in city
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Arkansas No cities currently levy income taxes

California

Los Angeles	0.825				payroll expense for certain businesses in city
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San Fransico	1.0 to 1.5				payroll expense for certain businesses in city and county
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Delaware

Wilmington	1.25	1.25			wages, salaries, net profits and commissions
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Georgia No cities or counties currently levy income taxes

Indiana

Bloomington (Monroe)			1.0	0.25	County adjusted gross income
Evansville (Vanderburgh)			1.0	0.25	
Fort Wayne (Allen)			0.8	0.35	
Indianapolis (Marion)			0.7	0.175	
Muncie (Delaware)			0.8	0.35	

Most Indiana counties have residential tax rates around 1.0 or 1.25 percent while the non-residential rate is typically between 0.25 to 0.5 percent. Perry County had a residential rate of 9.5 percent, but that may be a typo.

<u>State</u> City (County)	<u>City Tax Rate</u>		<u>County Tax Rate</u>		<u>Income Tax Based on</u>
	Res.	Non-Res.	Res.	Non-Res.	

Iowa

School Districts: For 1995, approximately 400 school districts levied income surtaxes at rates ranging from 1 percent to 20 percent.

School district income surtaxes are based on state income tax liability

Kentucky

Lexington (Fayette)

2.75* 2.75*

Louisville (Jefferson)

2.2* 1.45

2.2* 1.45

*Rate includes county school levy of 0.58 in Fayette and 0.75E in Jefferson. Lexington-Fayette County is a consolidated government.

Maryland

Allegany County	60.0
Anne Arundel County	50.0
Baltimore City	50.0
Baltimore County	55.0
Calvert County	50.0
Caroline County	50.0
Carroll County	50.0
Cecil County	50.0
Charles County	50.0
Dorchester County	50.0
Frederick County	50.0
Garrett County	50.0
Harford County	50.0
Howard County	50.0
Kent County	50.0
Montgomery County	60.0
Prince George's County	58.0
Queen Anne's County	55.0
St. Mary's County	60.0
Somerset County	60.0
Talbot County	60.0

All counties and Baltimore City impose local income taxes at 30E to 60% of the state income tax liability.

<u>State</u>	<u>City Tax Rate</u>		<u>County Tax Rate</u>		<u>Income Tax Based on</u>
City (County)	Res.	Non-Res.	Res.	Non-Res.	
<hr/>					
Washington County			50.0		
Wicomico County			60.0		
Worcester County			30.0		
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Michigan					
Detroit	3.0	1.5			All earned and unearned income.
Flint	1.0	0.5			
Grand Rapids	1.0	0.5			
Highland Park	2.0	1.0			
Lansing	1.0	0.5			
Pontiac	1.0	0.5			
Saginaw	1.5	0.75			
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Missouri					
Kansas City	1.0	1.0			Salaries, wages, commissions and other earned compensation
St. Louis	1.0	1.0			
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New Jersey					
Newark	1.0				Employer payroll tax
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New York					
New York City	2.6	0.45			Salaries, wages, commissions and other earned compensation
	to	to			
	3.4	0.65			
Yonkers (Westchester)					Yonkers has a surtax on state income tax
	15.0	0.5			

<u>State</u> <u>City (County)</u>	<u>City Tax Rate</u>		<u>County Tax Rate</u>		<u>Income Tax Based on</u>
	Res.	Non-Res.	Res.	Non-Res.	
Ohio					
Akron	2.0	2.0			Compensation and net profits
Cincinnati	2.1	2.1			
Cleveland	2.0	2.0			
Columbus	2.0	2.0			
Dayton	2.25	2.25			
Toledo	2.25	2.25			
Youngstown	2.0	2.0			
Oregon					
Tri-County Metro- 0.6179					Employer payroll tax
politan Transit Districts*					*Includes Washington, Clackamas and Multnomah Counties and the City of Portland.
Lane County Mass 0.56					
Transit District					
Pennsylvania					
Philadelphia	3.34	4.2082			Wages, salaries, commissions and other earned income
Pittsburgh	2.87	5 1.0			

Footnotes

- ¹ See Michelle Singletary, "Area Job Growth Slow, But Unemployment Falls," Washington Post, December 6, 1996, p. B11. There is some recent evidence that the state's economy may be starting to turn around. See Michael Conte, Regional Economic Studies Institute, Towson State University, "Taxation, Site Selection and Economic Development," testimony presented before the Joint Select House Committee on Competitive Taxation and Economic Development, Annapolis, Maryland, December 11, 1996.
- ² Strategic Directions for Increasing Maryland's Competitiveness: A Report to Governor Parris N. Glendening by the Maryland Economic Development Commission through the Department of Business and Economic Development, February 1996.
- ³ Strategic Directions, op. cit., Chapter 2, p. 11. Emphasis added.
- ⁴ Dr. Mahlon R. Straszheim, Department of Economics, University of Maryland at College Park, Testimony before the Special Joint House Committee on Competitive Taxation and Economic Development, Maryland House of Delegates, December 11, 1996.
- ⁵ Strategic Directions, op. cit., Chapter 2, p. 11. Emphasis added.
- ⁶ Ibid., Chapter III, p. 9.
- ⁷ Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming.
- ⁸ Connecticut (4.5%), Illinois (3.0%), Indiana (3.0%), Michigan (4.4%), and Pennsylvania (2.8%).
- ⁹ Department of Fiscal Services, "Assessing Affordability: An Analysis of the Spending Affordability Process Prepared at the Request of the Spending Affordability Committee," Maryland General Assembly, September 1995, Annapolis, Maryland, p. 39.
- ¹⁰ The property tax in Maryland was found to be generally regressive, especially for families with incomes above \$10,000. See Robert M. Schwab, The Incidence of Maryland Property, Income and Sales Taxes, in Technical Supplement to the Report of the Maryland Commission on State Taxes and Tax Structure, Volume 1, December 1990.
- ¹¹ The personal income tax in Maryland was found to be generally progressive up to \$30,000 income, declining somewhat to \$50,000 and then increasing again. The sales tax in Maryland was found to be generally regressive across all income classes. See Robert M. Schwab, The Incidence of Maryland Property, Income and Sales Taxes, ibid.
- ¹² Bartik, Timothy J. 1991. Who Benefits from State and Local Economic Development Policies? Kalamazoo, Michigan: W.E. Upjohn Institute for Employment Research. p. 39
- ¹³ Bartik, 1991. p. 38 - 43, 216 - 247

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- ¹⁴ Schmenner, Roger W., Joel C. Huber, and Randall L. Cook. 1987. "Geographic Differences and the Location of New Manufacturing Facilities" *Journal of Urban Economics*. 21: 83-104. p. 97, 100.
- ¹⁵ Wasylenko, Michael and Therese J. McGuire. 1985. "Jobs and Taxes: The Effect of Business Climate on States' Employment Growth Rates" *National Tax Journal*. 38, 4 (December): 497-512. p. 497, 509.
- ¹⁶ Gyourko, Joseph. 1987. "Effects of Local Tax Structures on the Factor Intensity Composition of Manufacturing Activity across Cities" *Journal of Urban Economics*. 22: 151-164. p. 161.
- ¹⁷ Newman, Robert J. 1983. "Industry Migration and Growth in the South" *Review of Economics and Statistics*. 65: 76-86. p. 85.
- ¹⁸ Bartik, Timothy J. 1989. "Small Business Start-Ups in the United States: Estimates of the Effects of Characteristics of States" *Southern Economic Journal*. 55, 4 (April): 1004-1018.
- ¹⁹ Ronald C. Fisher, *The Effects of State and Local Public Services on Economic Development*, a paper prepared for presentation at a symposium on **The Effects of State and Local Public Policies on Economic Development**, Federal Reserve Bank of Boston, November 8, 1996.
- ²⁰ Helms, L. Jay. 1985. "The Effect of State and Local Taxes on Economic Growth: A Time Series-Cross Section Approach" *Review of Economics and Statistics*. 67 (February): 574-582.
- ²¹ Bartik, 1991. p. 46 - 48, 248 - 253, 46.
- ²² Munnell, Alicia H. with the assistance of Leah M. Cook. 1990. "How Does Public Infrastructure Affect Regional Economic Performance?" *New England Economic Review*. Sept./Oct.: 11-32. p. 26
- ²³ Bartik, 1996.
- ²⁴ Bartik, 1996. p. 52, Table A-10.
- ²⁵ Eric Hanushek. 1986. "The Economics of Schooling: Production and Efficiency in the Public Schools" *Journal of Economic Literature*. 24 (September): 1162.
- ²⁶ National Education Association by the Corporation for Enterprise Development (CFED). 1995. *How Education Spending Matters to Economic Development*. National Education Association, Research Division. Washington, DC: NEA. p. 22-27.
- ²⁷ Griliches, Zvi. 1996. *Education, Human Capital, and Growth: A Personal Perspective*. National Bureau of Economic Research Working Paper 5426 (January). Cambridge, Massachusetts: NBER. p. 10.
- ²⁸ Griliches, 1996. p. 11.

²⁹ Wasylenko, Michael. 1986. "The Effect of Business Climate on Employment Growth" in Robert D. Ebel and Therese J. McGuire, eds., *Final Report of the Minnesota Tax Study Commission: Volume 2, Staff Papers*. St. Paul, Minnesota: Butterworths. p. 70.

³⁰ Bartik, 1996. p. 52.

³¹ Fox, William F. and Matthew N. Murray. 1991. "The Effects of Local Government Public Policies on the Location of Business Activity" in Henry W. Herzog, Jr. and Alan M. Schlottmann, eds., *Industry Location and Public Policy*. Knoxville, Tennessee: The University of Tennessee Press. p. 106-7.

³² Bartik, 1989. p. 1012.

³³ Helms, 1985. p. 579.

³⁴ Wasylenko and McGuire, 1985. p. 507-9.

³⁵ Bartik, 1991. p. 248 - 253.

³⁶ Robert Tannenwald, "State Business Tax Climate: How Should It Be Measured and How Important Is It?" New England Economic Review, January/February 1996.

Michael Bell is a Principal Research Scientist at The Institute for Policy Studies, Johns Hopkins University. He has had a variety of research, policy analysis and management positions. Prior to joining the Institute, Dr. Bell was Deputy Executive Director of the National Council on Public Works Improvement, a Congressionally created Council to evaluate the state of the nation's infrastructure. Responsibilities included managing the day-to-day operations of the Council's staff (12), structuring the Council's budget (\$5.0 million over 28 months), serving as study manager and as an expert public finance economist.

In addition, Dr. Bell served on the staffs of the District of Columbia and Minnesota State Tax Study Commissions and was responsible for evaluating research proposals, negotiating contracts, monitoring and evaluating staff and consultant research progress, summarizing and presenting research findings and recommendations to the Commission and writing the final reports.

In addition to these management responsibilities, Dr. Bell served on the staff of the Office of the Chief Economist, U.S. Department of Commerce and was responsible for designing, drafting and implementing research initiatives, monitoring and evaluating on-going research, synthesizing research findings and formulating policy recommendations on state and local finance, federalism and urban and rural development issues. Also, he represented the Office and when appropriate the Under Secretary for Economic Affairs on Interagency and interdepartmental groups, with other federal agencies, and with representatives of business, labor, state and local governments and various public interest groups.

Finally, Dr. Bell served on the staff of or as a consultant to a variety of groups including the Urban Affairs, U.S. House of Representatives; the Advisory Commission on Intergovernmental Relations; the Office of State and Local Affairs, U.S. Department of Treasury; and the Greater Washington Research Center researching and writing on a variety of state and local finance and intergovernmental issues.

Murray L. Johnston, III received a B.A. in liberal arts with special honors from the University of Texas at Austin in 1990 and a Master of Arts in Policy Studies from the Institute for Policy Studies at The Johns Hopkins University in 1996. Mr. Johnston has worked as a press aide to the Clayton Williams for Governor campaign in 1990 and from 1991 to 1994 he worked in the Washington, DC office of U.S. Senator Phil Gramm.

