



The Maryland Public Policy Institute

IMPROVING
MARYLAND'S
ECONOMIC
COMPETITIVENESS

*Policy Reforms to Promote
Economic Prosperity*

IMPROVING
MARYLAND'S
ECONOMIC
COMPETITIVENESS

*Policy Reforms to Promote
Economic Prosperity*



The Maryland Public Policy Institute

Published by
The Maryland Public Policy Institute
One Research Court, Suite 450
Rockville, Maryland 20850
240.686.3510
mdpolicy.org

Copyright © 2009

*Nothing written here is to be construed as the official opinion of the Maryland Public Policy Institute
or as an attempt to aid or hinder the passage of any bill before the Maryland General Assembly.*

IMPROVING MARYLAND'S ECONOMIC COMPETITIVENESS

Policy Reforms to Promote Economic Prosperity

DONNA ARDUIN AND WAYNE H. WINEGARDEN, PH.D.

INTRODUCTION

STATES FIERCELY COMPETE WITH ONE ANOTHER: they compete for jobs, they compete for businesses, and they compete for people. There is no finish line in the inter-state economic competition. This never-ending struggle requires states to consistently maintain an advantageous economic environment vis-à-vis other states.

Many factors impact a state's competitive environment. A number of these factors—such as climate, natural resources, or in Maryland's case, proximity to Washington, D.C.—do not change. State economic policies (i.e. tax, expenditure, and regulatory policies) vary across states and across time within a state and have significant implications for a state's economic prospects. For this reason, state economic policies are crucial economic competitive metrics. And, the results of this economic competition have real implications for future state economic performance. The states that establish and maintain the most pro-growth economic environment will have flourishing economies while states with weak competitive environments will have struggling economies.

Maryland now clearly falls into the latter category. Due to the tax increases implemented in 2008, Maryland's competitiveness is falling significantly behind the country's economic leaders. The rationale for these tax increases—the impending structural deficit—will continue to erode Maryland's economic competitiveness further in the future if left unchecked.

In the near-term, the struggling Maryland economy and resulting decline in tax revenues are creating even greater pressure for more tax increases in order to maintain state spending commitments. However, if the state is finding it more difficult to afford its desired spending commitments, Maryland's citizens are finding it equally hard. While raising taxes anytime is difficult, raising taxes during difficult economic times is especially problematic. No phrase should be more important for Maryland to adhere to than *primum non nocere* (first, do no harm). Maryland should not balance the government's budget by unbalancing its citizens' budgets.

Maryland's should focus on creating a more competitive economic environment that encourages greater work, savings, and investment in the state and aligns the state's expenditure commitments with its ability to afford them. This paper provides a blueprint to address Maryland's declining economic competitiveness. This blueprint provides policy guidance that will help Maryland increase

its economic competitiveness, raise its sustainable long-run economic growth rate, and accelerate income and jobs growth in the state.

In the first section, we review the relationship between state tax and regulatory policies and economic growth, and illustrate why Maryland's potential economic growth rate will be enhanced by pro-growth tax reforms, and worsened by progressive tax reforms. With this theory established, the second section reviews Maryland's current economic state. The third section illustrates that Maryland's current expenditure growth is inconsistent with a vibrant and growing economic environment. The fourth section documents the relative decline in Maryland's economic competitiveness due to the tax increases that were "necessary" to fund the structural deficit.

Ideally, Maryland needs structural tax reform; but at a minimum, the state needs to repeal the recently enacted tax increases. Doing so requires the state to reduce its long-term spending commitments: instead of doing "more with less" the state must do "less with less." The fifth section reviews Maryland's structural deficit and suggests measures to reduce long-term spending commitments in order to align future expenditures with long-term revenues that are consistent with a vibrant and growing state economy. The final section offers some concluding thoughts.

SECTION I: THE THEORY BEHIND LOW- BROAD-BASED TAXES – WHY CUT SPENDING?

Excessive taxation is detrimental to labor and capital, poor and rich, men and women, and old and young. Excessive taxation is an equal opportunity tormentor. In the short run, higher taxes on labor or capital lower after-tax earnings. In the longer run, mobile factors "vote with their feet" and leave the state, leaving immobile factors (such as low-wage workers, and property) to suffer the tax burden. The principals of Arduin, Laffer & Moore Econometrics (ALME) have produced decades of research demonstrating that states where taxes are high and/or increasing relative to the national norm experience relative income and population declines, rising relative unemployment, and declines in housing values. Progressive tax structures are particularly problematic. The high marginal income tax rate discourages wealth creation but the progressive tax structure fails to address the equity.

The mode of taxation is as important as the amount of taxation, as noted by 19th century American economist Henry George:

The mode of taxation is, in fact, quite as important as the amount. As a small burden badly placed may distress a horse that could carry with ease a much larger one properly adjusted, so a people may be impoverished and their power of producing wealth destroyed by taxation, which, if levied in any other way, could be borne with ease.¹

While the world is dynamic and many of its ups and downs are outside the control of state government, there are a number of criteria for judging the efficacy of a state's tax system. Henry George summarized these well:

The best tax by which public revenues can be raised is evidently that which will closest conform to the following conditions:

1. That it bear as lightly as possible upon production—so as least to check the increase of the general fund from which taxes must be paid and the community maintained.
2. That it be easily and cheaply collected, and fall as directly as may be upon the ultimate payers—so as to take from the people as little as possible in addition to what it yields the government.
3. That it be certain—so as to give the least opportunity for tyranny or corruption on the part of officials, and the least temptation to lawbreaking and evasion on the part of the taxpayers.
4. That it bear equally—so as to give no citizen an advantage or put any at a disadvantage, as compared with others.²

The theory of incentives provides the basis for establishing an optimal tax policy. Changes to marginal tax rates are critical for growth because they change incentives to demand and supply la-

bor and capital. Firms base their decisions to employ workers, in part, on the workers' total cost to the firm. Holding all else equal, the greater the cost to the firm of employing each additional worker, the fewer workers the firm will employ. Conversely, the lower the marginal cost per worker, the more workers the firm will hire. For the firm, the decision to employ is based upon gross wages paid, a concept that encompasses all costs borne by the firm.

Workers, on the other hand, care little about the cost to the firm of employing them. Of concern from a worker's standpoint is how much the worker receives for providing work effort, net all deductions and taxes. Workers concentrate on net wages received. The greater net wages received, the more willing a worker is to work. If wages received fall, workers find work less attractive and they will do less of it. The difference between what it costs a firm to employ a worker and what that worker receives net is the tax wedge.

The concept of incentives, and what drives both employers and employees to work, save, and invest are key when evaluating potential economic growth in a state. According to the theory of incentives, states with policies that excessively reduce the return to working, saving, and investing should grow less, while states with policies that encourage working, saving, and investing should grow more.

Tax Policy Matters for Economic Growth The empirical evidence supports the conclusions from the theory of incentives. Economic growth in the states with the highest tax burdens consistently lags economic growth in the states with the lowest tax burdens. Table 1 summarizes the latest results. Economic growth in the 10 states with the lowest tax burdens, defined as total state and local taxes as a percentage of personal income, exceeds the economic growth in the 10 states with the highest tax burdens. Overall economic growth as measured by residents' total personal income has been significantly higher in the low-tax states. Not surprisingly, stronger economic growth has led to more jobs and higher population growth in the low-tax states as more and more people choose to relocate to the lower-taxed states.

Similar to the experience of the low tax states, economic growth in the states with no personal income tax exceeds economic growth in the states

with the highest personal income tax burdens. Table 2 illustrates this relationship.

“Voting With Their Feet” Each state within the U.S. is analogous to a country with open borders. Just as the U.S. competes with other countries for the location of economic activity, states compete with each other for the location of factories, offices, and jobs within the U.S. This competition is seen through tax-cutting battles between neighboring states and targeted tax incentives to encourage corporate relocation. As states seek to hold companies and workers within their borders and attract new ones, the winners and the losers will be separated by their ability to understand the competitive environment where they exist and take steps to enhance their own state's appeal. Since monetary policy and federal fiscal policy are basically the same for all of the states, and inherent state advantages and disadvantages (such as climate, natural resources, distances to desirable areas, et cetera) remain fairly constant over time, state and local fiscal policies are far and away the most important factors that determine changes in the competitiveness and, hence, relative economic growth rates among the states.

The overall level of taxation in a state is also critical: Overtaxed states per se restrain growth, while states that—even if they currently are not overtaxed—raise taxes inhibit growth. A reduction in tax rates reduces the cost of doing business in a state. This increases demand for the now less-expensive goods and services produced within the state. The higher demand for the state's goods and services will result in an increased profitability for businesses located within the state. Business failures will decrease in states with declining relative tax burdens and the formation of new businesses will rise. If all else remains the same, a reduction in tax rates increases the return to capital and labor costs, leading to increases in the supplies of capital and labor within the state.

Symmetrically, every state that raises its relative tax burden will find it difficult to retain existing facilities and attract new businesses and workers. In tax-raising states, new business startups will decline and business failures will increase.

Competition among the many states results, in large part, from the ability of mobile factors of production to “vote with their feet” and relocate to political jurisdictions pursuing more favorable

**TABLE 1 STATE AND LOCAL TAX BURDEN VS. 10-YEAR ECONOMIC PERFORMANCE
(2007 STATE & LOCAL TAX BURDEN VS. ECONOMIC PERFORMANCE BETWEEN 1997 AND 2007,
UNLESS OTHERWISE NOTED)**

	2006 S&L TAX BURDEN	PERSONAL INCOME GROWTH	POPULATION GROWTH	NET DOMESTIC IN-MIGRATION ASA % OF POPULATION	NON-FARM PAYROLL EMPLOYMENT GROWTH	UNEM- PLOYMENT RATE
SOUTH DAKOTA	\$87.40	76.0%	5.2%	-1.8%	14.5%	3.2%
TENNESSEE	\$88.99	63.6%	11.9%	4.3%	9.6%	5.2%
ALABAMA	\$90.44	61.6%	6.1%	0.8%	8.0%	3.5%
NEW HAMPSHIRE	\$90.51	73.0%	13.2%	6.0%	15.9%	3.4%
COLORADO	\$94.00	88.5%	21.9%	5.1%	19.5%	4.4%
MISSOURI	\$98.48	56.6%	7.8%	1.3%	7.3%	4.8%
TEXAS	\$99.49	87.2%	20.6%	2.1%	20.8%	5.0%
OKLAHOMA	\$100.21	70.1%	7.2%	0.1%	13.8%	3.9%
OREGON	\$101.10	65.0%	14.3%	4.7%	16.0%	5.4%
GEORGIA	\$102.50	78.1%	23.8%	6.4%	15.7%	4.7%
10 STATES WITH LOWEST TAX BURDEN	\$95.31	72.0%	13.2%	2.9%	14.1%	4.4%
CONNECTICUT	\$119.41	61.6%	5.6%	-3.1%	5.6%	4.3%
WISCONSIN	\$121.73	59.8%	6.8%	0.6%	10.3%	4.7%
WEST VIRGINIA	\$123.38	46.3%	-0.4%	-0.5%	8.2%	4.8%
RHODE ISLAND	\$125.32	60.5%	5.8%	-1.9%	11.8%	5.3%
ALASKA	\$131.39	52.6%	9.8%	-3.9%	19.4%	6.8%
HAWAII	\$133.05	46.9%	6.5%	-6.5%	16.5%	2.6%
MAINE	\$134.56	62.6%	6.3%	3.7%	13.1%	4.6%
WYOMING	\$140.43	86.0%	5.0%	-2.0%	23.9%	3.2%
VERMONT	\$143.29	64.9%	5.8%	1.0%	11.9%	3.5%
NEW YORK	\$150.52	53.8%	3.9%	-10.1%	8.3%	4.5%
10 STATES WITH HIGHEST TAX BURDEN	\$132.31	59.5%	5.5%	-2.3%	12.9%	4.4%

economic policies. Changes in tax rates have the greatest impact on the supplies of factors of production that are highly mobile. For example, a worker who is prepared to relocate to achieve a higher standard of living will be extremely sensitive to a change in his state's tax rates.

By contrast, tax rate changes will only slightly affect the supplies of immobile factors of production and/or real estate. For example, capital in the form of a new manufacturing plant, as in the case of the example below, is highly immobile. Its operating level initially will be relatively unaffected by an increase in a state's tax rates. The major impact of state tax rate changes will be on the plant's after-tax profits and, ultimately, whether to close down or to remain open. The implication of this analysis is that taxes levied on

mobile factors will be passed on to the immobile factors located within the state. Thus, the burden of state and local taxes may very well differ from its initial incidence.

Consider two hypothetical manufacturing companies with production plants located within just miles of each other. One is located in Maryland, and the other, virtually identical, is located just across the border in Virginia. Since we assume both companies sell virtually identical products in the U.S. market, competition will force them to sell their products at approximately the same price. Because each company's plant is separated by just a thin and invisible state line, both have to pay the same interest cost on borrowings, the same after-tax wages to their employees, and the same prices to their suppliers.

TABLE 2 TOP MARGINAL PERSONAL INCOME TAX RATE (STATE & LOCAL) VS. 10-YEAR ECONOMIC PERFORMANCE 2007

	TOP PIT RATE	PERSONAL INCOME GROWTH	POPULATION GROWTH	NET DOMESTIC IN-MIGRATION AS A % OF POPULATION	NON-FARM PAYROLL EMPLOYMENT GROWTH	UNEMPLOYMENT RATE
ALASKA	0.00%	52.6%	9.8%	-3.9%	19.4%	6.8%
FLORIDA	0.00%	83.9%	22.4%	8.9%	30.4%	3.2%
NEVADA	0.00%	120.1%	52.7%	20.5%	52.9%	4.1%
NEW HAMPSHIRE	0.00%	73.0%	13.2%	6.0%	15.9%	3.4%
SOUTH DAKOTA	0.00%	76.0%	5.2%	-1.8%	14.5%	3.2%
TENNESSEE	0.00%	63.6%	11.9%	4.3%	9.6%	5.2%
TEXAS	0.00%	87.2%	20.6%	2.1%	20.8%	5.0%
WASHINGTON	0.00%	70.6%	14.7%	3.1%	18.6%	5.0%
WYOMING	0.00%	86.0%	5.0%	-2.0%	23.9%	3.2%
9 STATES WITH NO PIT	0.00%	79.2%	17.3%	4.1%	22.9%	4.3%
KENTUCKY	8.20%	61.0%	7.4%	1.7%	10.4%	5.8%
HAWAII	8.25%	46.9%	6.5%	-6.5%	16.5%	2.6%
MAINE	8.50%	62.6%	6.3%	3.7%	13.1%	4.6%
OHIO	8.87%	45.0%	2.3%	-2.8%	3.0%	5.4%
NEW JERSEY	8.97%	63.3%	7.9%	-4.2%	12.1%	4.8%
OREGON	9.00%	65.0%	14.3%	4.7%	16.0%	5.4%
VERMONT	9.50%	64.9%	5.8%	1.0%	11.9%	3.5%
CALIFORNIA	10.30%	74.1%	14.0%	-3.5%	17.7%	4.8%
NEWYORK	10.50%	53.8%	3.9%	-10.1%	8.3%	4.5%
9 STATES WITH HIGHEST MARGINAL PIT RATE	9.12%	59.6%	7.6%	-1.8%	12.1%	4.6%

Now, consider what would happen if Maryland were to put through a large corporate income tax increase, while Virginia held constant or lowered its income tax rate. Because the market for the companies' product is highly competitive, the company in Maryland would not be able to pass the tax hike forward to its customers in the form of higher prices. Likewise, the company in Maryland would not be able to pass the tax hike backward onto its suppliers or employees. The Maryland firm would have to absorb the tax increase through lower after-tax profits. This drop in profits would be reflected by a fall in the stock price for the company in Maryland. Clearly, the identical competitor in Virginia would benefit.

As time horizons lengthen following our hypothetical tax increase in Maryland, mobile labor and capital begin to move out of Maryland and into Virginia. This migration of factors of production will benefit Virginia to the detriment of Maryland.

Such an example is not simply hypothetical either. Several major tax changes have occurred at the state and federal levels. Each one of these case studies illustrates the positive economic impact of a pro-growth tax reform.

California's Proposition 13 In 1978, a force that had been building strength for several years finally brought a huge and dramatic change to the California economy. The public's frustration with high and rising state and local (particularly property) taxes found expression in the passage of Proposition 13—an initiative to limit state and local spending and taxation. In June 1978, Proposition 13 rolled the entrenched political establishment. Proposition 13 was a constitutional amendment that (1) set property taxes not to exceed 1 percent of a property's value (down from the 3.5 percent rate that existed at the time), (2) rolled assessed property tax val-

ues back to their 1976 levels, (3) allowed the base value to grow no more than 2 percent per year unless the property changed hands, and (4) required that all new or increased taxes be voted in by a supermajority of the electorate. Proposition 13 won in a landslide.

Following on Proposition 13's heels was an elimination of the state's inheritance tax, an indexing of the state's income tax, and an elimination of the state's business inventory tax. In 1979, Proposition 4 passed, locking the tax gains into place by requiring (1) spending to grow no faster than the sum of population growth and inflation and (2) all surplus revenues to be returned to the taxpayers.

Prior to the passage of Proposition 13 in March of 1978, Arthur Laffer wrote an economic analysis that was used by the United Organization of Taxpayers, detailing support for the passage of Proposition 13. This analysis included forecasts of what the initiative's effects would be, and almost all were spot-on. In the aftermath of this tax revolt, previously chronically depressed California enjoyed a remarkable economic resurgence, outperforming the nation in nearly every conceivable measure. Naturally, the state's high tax burden fell like a stone, from \$124.57 to \$95.19 just one year later.

In 1977, California per capita personal income was 15 percent above the national average. Three years later, it was 18 percent above the national average. California's unemployment rate was 1.2 percentage points higher than the U.S. rate in 1977; in 1980 the California rate was lower than the national rate by 0.4 percentage points. Between 1978 and 1988 the number of jobs in California increased by 32 percent, twice the 16 percent increase in jobs nationwide. The population in California increased 24 percent from 1978 to 1988, over twice the national increase of 10.7 percent.

And housing prices in the state soared. There is perhaps no better barometer for changes in the after-tax rate of return on assets than the price of the ultimate immobile factor: housing. In the second quarter of 1978, right before Proposition 13's passage, the median home price in California was \$70,677, which was 7.4 times per capita personal income in the state and 21 percent more expensive relative to the U.S. Over the decade of the 1980s, absolute and relative housing prices in California took off and never looked back. In the third quarter of 1981, the median home price in California was \$108,455, or 8.1 times per capita

personal income and 42 percent more expensive relative to the U.S. By the end of the decade, per capita personal income-adjusted housing prices in California were nearly double those for the U.S.

Proposition 13 did what it was advertised to do. The historical record also shows that Proposition 13 did not have any long-term deleterious effect on the finances of the state's various levels of government. The Great California Tax Revolt more than paid for itself.

The private sector of the economy fared beautifully in the aftermath of Proposition 13, but opponents questioned whether this private sector success might have come at the expense of the public sector. They feared that post-Proposition 13 revenues would be absolutely gutted, forcing expenditure cuts well beyond the elimination of wasteful spending. Vital services, they said, would suffer; schools would have to close; fire and police protection would no longer be adequate. But citizens' fears about maintaining adequate levels of state and local government services were allayed very soon after the changes were enacted.

First looking at revenues, Proposition 13 passed on June 6, 1978, one month prior to the end of FY 1978. State and local property tax revenues fell \$5.0 billion, from \$11.0 billion in FY 1978 to \$6.0 billion in FY 1979, far short of the static revenue loss forecasts of \$7 billion. In addition, higher revenues in every other major tax category offset this drop. Total state and local revenues fell by only \$1.1 billion that first year.

Looking at the bigger picture, the combined state and local tax burden per \$1,000 of personal income fell from \$124.57 in FY 1978 to \$94.93 in FY 1982, a 24 percent reduction. Yet in spite of the precipitous fall in the state's average tax rate, state and local revenues did not fall proportionately. In fact, total tax revenue grew by 19 percent from \$27.4 billion in FY 1978 to \$32.5 billion in FY 1982. The tax base expanded more than enough to offset the reduction in tax rates. Even after adjusting for inflation, which can distort economic data during this high inflationary period, tax revenues fell much less than the reduction in the state and local tax burden.

Economic expansion and higher property values led to healthy property tax growth over the following years, and by FY 1985 property tax collections were back to their FY 1978 \$11.0 billion level. The disruptive shortage of funds so widely anticipated never materialized.

Turning our attention to spending, total state and local direct general expenditures were not slashed between FY 1978 and FY 1979 as skeptics had predicted; in fact, expenditures increased 1.6 percent from \$36.9 billion to \$37.5 billion over this period. The tax reduction that had invigorated the state's economy so profoundly did not impose any significant reduction in government services.

The state's balanced budgets during this period reflect the remarkable success of combining lower tax rates and increased output, employment and production with restrained spending. California's experience following Proposition 13 exemplifies the types of pro-growth dynamics that follow sound tax reform. These effects have also been experienced at the federal level.

The Harding/Coolidge Tax Cuts In 1913, the federal progressive income tax was put into place with a top marginal rate of 7 percent. Thanks in part to World War I, this tax rate was quickly increased significantly and peaked at 77 percent in 1918. Then, through a series of tax-rate reductions, the Harding/Coolidge tax cuts dropped the top personal marginal income tax rate to 25 percent in 1925.

While tax collection data for the National Income and Product Accounts (from the U.S. Bureau of Economic Analysis) do not exist for the 1920s, we do have total federal receipts from the U.S. budget tables. During the four years prior to 1925 (the year the tax cut was fully enacted), inflation-adjusted revenues declined by an average of 9.2 percent per year. Over the four years following the tax-rate cuts, revenues remained volatile but averaged an inflation-adjusted gain of 0.1 percent per year. The economy responded strongly to the tax cuts, with output nearly doubling and unemployment falling sharply.

Perhaps most illustrative of the power of the Harding/Coolidge tax cuts was the increase in GDP, the fall in unemployment, and the improvement in the average American's quality of life over this decade. Table 3 demonstrates the remarkable increase in American quality of life, as reflected by the percentage of Americans owning items in 1930 that previously only the wealthy owned (or no one owned).

The Kennedy Tax Cuts During the Depression and World War II the top marginal income tax rate

TABLE 3 PERCENTAGE OF AMERICANS OWNING SELECTED ITEMS

ITEM	1920	1930
AUTOS	26%	60%
RADIOS	0%	46%
ELECTRIC LIGHTING	35%	68%
WASHING MACHINES	8%	24%
VACUUM CLEANERS	9%	30%
FLUSH TOILETS	20%	51%

Source: Stanley Lebergott, *Pursuing Happiness: American Consumers in the Twentieth Century*.³

rose steadily, peaking at an incredible 94 percent in 1944 and 1945. The rate remained above 90 percent well into President John F. Kennedy's term in office, which began in 1961. Kennedy's fiscal policy stance made it clear he was a believer in pro-growth, supply-side tax measures. Said Kennedy in January 1963, in the Economic Report of the President:

Tax reduction thus sets off a process that can bring gains for everyone, gains won by marshalling resources that would otherwise stand idle—workers without jobs and farm and factory capacity without markets. Yet many taxpayers seemed prepared to deny the nation the fruits of tax reduction because they question the financial soundness of reducing taxes when the federal budget is already in deficit. Let me make clear why, in today's economy, fiscal prudence and responsibility call for tax reduction even if it temporarily enlarged the federal deficit—why reducing taxes is the best way open to us to increase revenues.⁴

Kennedy further reiterated his beliefs in his Tax Message to Congress:

In short, this tax program will increase our wealth far more than it increases our public debt. The actual burden of that debt—as measured in relation to our total output—will decline. To continue to increase our debt as a result of inadequate earnings is a sign of weakness. But to borrow prudently in order to invest in a tax revision that will greatly increase our earning power can be a source of strength.⁵

President Kennedy proposed massive tax-rate reductions that passed Congress and went into law after he was assassinated. The 1964 tax cut reduced the top marginal personal income tax rate from 91 percent to 70 percent by 1965. The cut reduced lower-bracket rates as well. In the four years prior to the 1965 tax-rate cuts, federal government income tax revenue, adjusted for inflation, had increased at an average annual rate of 2.1 percent, while total government income tax revenue (federal plus state and local) had increased 2.6 percent per year. In the four years following the tax cut these two measures of revenue growth rose to 8.6 percent and 9.0 percent, respectively. Government income tax revenue not only increased in the years following the tax cut, it increased at a much faster rate.

The Kennedy tax cut set the example that Reagan would follow some 17 years later. By increasing incentives to work, produce and invest, real GDP growth increased in the years following the tax cuts, more people worked, and the tax base expanded. The expenditure side of the budget benefited as well because the unemployment rate was significantly reduced.

Testifying before Congress in 1977, Walter Heller, President Kennedy's Chairman of the Council of Economic Advisors, stated:

What happened to the tax cut in 1965 is difficult to pin down, but insofar as we are able to isolate it, it did seem to have a tremendously stimulative effect, a multiplied effect on the economy. It was the major factor that led to our running a \$3 billion surplus by the middle of 1965 before escalation in Vietnam struck us. It was a \$12 billion tax cut, which would be about \$33 or \$34 billion in today's terms, and within one year the revenues into the Federal Treasury were already above what they had been before the tax cut.

Did the tax cut pay for itself in increased revenues? I think the evidence is very strong that it did.⁶

The Reagan Tax Cuts In August 1981, Ronald Reagan signed into law the Economic Recovery Tax Act (ERTA, also known as Kemp-Roth). ERTA slashed marginal earned income tax rates by 25 percent across-the-board over a three-year pe-

riod. The highest marginal tax rate on unearned income dropped to 50 percent from 70 percent immediately (the Broadhead Amendment) and the tax rate on capital gains also fell immediately from 28 percent to 20 percent. Five percentage points of the 25 percent cut went into effect on October 1, 1981. An additional 10 percentage points of the cut then went into effect on July 1, 1982, and the final 10 percentage points of the cut began on July 1, 1983.

Looking at the cumulative effects of ERTA in terms of tax (calendar) years, the tax cut provided a reduction in tax rates of 1.25 percent through the entirety of 1981, 10 percent through 1982, 20 percent through 1983, and the full 25 percent through 1984. As a provision of ERTA, Reagan also saw to it that the tax brackets were indexed for inflation beginning in 1985.

To properly discern the effects of the tax-rate cuts on the economy, we use the starting date of January 1, 1983, given that the bulk of the cuts were in place on that date. However, a case could be made for a start date of January 1, 1984, the date the full cut was in effect.

These across-the-board marginal tax-rate cuts resulted in higher incentives to work, produce, and invest, and the economy responded. Between 1978 and 1982 the economy grew at a 0.9 percent rate in real terms, but from 1983 to 1986 this growth rate increased to 4.8 percent.

Prior to the tax cut the economy was choking on high inflation, high interest rates, and high unemployment. All three of these economic bellwethers dropped sharply after the tax cuts. The unemployment rate, which had peaked at 9.7 percent in 1982, began a steady decline, reaching 7.0 percent by 1986 and 5.3 percent when Reagan left office in January 1989.

Inflation-adjusted revenue growth dramatically improved. Over the four years prior to 1983, federal income tax revenue declined at an average rate of 2.8 percent per year, and total government income tax revenue declined at an annual rate of 2.6 percent. Between 1983 and 1986 these figures were a positive 2.7 percent and 3.5 percent, respectively.

The most controversial portion of Reagan's tax revolution was the big drop in the highest marginal income tax rate from 70 percent when he took office to 28 percent in 1988. However, Internal Revenue Service data reveal that tax collections from the

wealthy, as measured by personal income taxes paid by top percentile earners, increased between 1980 and 1988 despite significantly lower tax rates.

Lessons for Maryland and Future Tax Policy Changes The real world experiences of California's Proposition 13 or the Harding/Coolidge, Kennedy, and Reagan tax cuts/reforms at the federal level illustrates the power of reducing marginal income tax rates. In Maryland, recent tax reforms have moved in the opposite direction—not heeding the lessons from these major tax reforms.

All tax changes create two primary economic effects. Economists call these the income effect and the substitution effect. The income effect examines the changed behavior that directly arises from changes in income or wealth. For example, people will tend to increase the amount of consumption in response to an increase in income. The substitution effect examines the changed behavior that arises from changes in the relative costs of different goods or activities. For example, a switch in tax policy that reduces the costs of one good compared to another will provide incentives for people to consume more of the former at the expense of the latter.

Any proposed tax reform, will have both income and substitution effects. Tax reform should reduce the penalty from additional work, savings, and investment and subsequently encourage increased:

- Work effort
- Work demand (and subsequently wages)
- Savings
- Investment and subsequently, greater capital accumulation

For any economic decision (i.e., work effort, saving, or investing) the marginal tax rate on the next dollar earned is crucial. To see why the marginal tax rate matters, imagine the work or investing incentives a person would face if the marginal tax rate on the next dollar earned was 100.0 percent. Under this scenario, every extra dollar a person earns would go straight to the government. Regardless if the tax rate on the previous dollar earned was zero, there is very little incentive for anyone to work, save, or invest under such a punitive tax rate. Now imagine the work or investing incentives a person would face if the marginal tax rate on the next dollar earned was zero. Under this

scenario, the investor or worker would get to keep the full value of the income or return that they earn. Obviously, the second scenario is more favorable to the worker or investor than the first.

Pro-growth tax environments maximize the after-tax income for the next dollar earned, raising the reward to work, and thereby increase the cost of leisure—the cost of leisure can be measured by the amount of other consumption goods that people could purchase (e.g., sending the kids to a better school or purchasing a high-definition TV), with the extra work effort. This opportunity cost to leisure increases following a decrease in the marginal income tax rate. Whenever a good's cost increases, rational people will economize on its use. These incentives are encapsulated by the aforementioned substitution effect that induces people to work more. Because the substitution effect captures the trade-off between work and leisure, it is the marginal tax rate (the amount of extra consumption that a person must give up by not working) that is the appropriate incentive driver.

Government revenues are not immune from the incentive drivers either. Tax collections are a game of cat and mouse: the individual wants to maximize his return on labor (after-tax income) and the government wants to maximize revenues it receives from the working individual. It is clear that the government will raise no revenue by levying a zero percent tax on income; the government takes none of the income earned so government revenues are zero. Similarly, the government can expect to raise no revenue by levying a 100.0 percent tax on income; there is no incentive for anyone to work so taking 100 percent of nothing is still nothing. This effect (i.e. the Laffer Curve Effect) incorporates the economy's dynamic realities and importantly illustrates that government revenues are not always raised when the marginal tax rate is increased, See Figure 1.

Government revenues can be significantly enhanced when tax reforms lead to positive growth-enhancing incentives that grow the tax base. The government will, consequently, share in the beneficial growth impacts. The resulting growth in the economy and consequently the consumption base will lead to a larger tax base and lead to even larger revenues over the aforementioned static estimates.

Pro-Growth Fiscal Policy Criteria The following economic policy “checklist” contains gen-

FIGURE 1 THE LAFFER CURVE

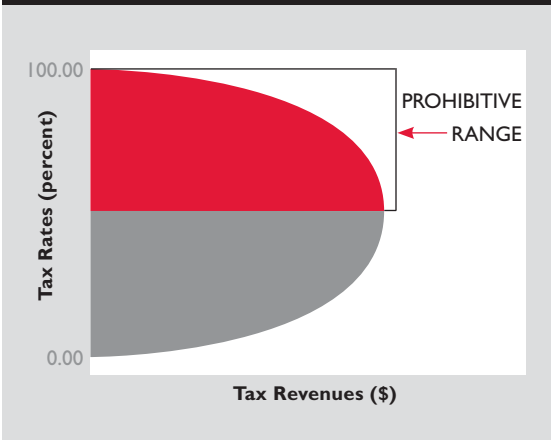
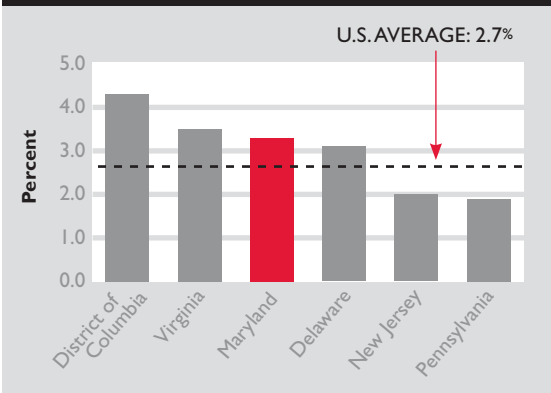


FIGURE 2 AVERAGE GROWTH IN STATE GDP: MARYLAND COMPARED TO U.S. AND NEIGHBORS 1998 – 2007⁸



eral rules that summarize the lessons from the historical experiences that guide the following recommendations:

- During prosperous times, life is relatively easy in the state legislatures, as high levels of economic activity result in abundant tax revenues and spending that often grows unrestrained with few consequences; during the bad times, flaws are exposed. Bad times expose fiscal flaws, spending flaws, pension flaws, and yes, flaws in the tax codes.
- There is truly never a good time to raise taxes, but raising taxes during difficult times is especially bad. Tax increases only worsen economic downturns. By raising taxes during depressed economic conditions, employers and employees face additional impediments just to keep from moving backwards. It makes

no sense to raise taxes on the last three people working. People do not work to pay taxes, and nor do businesses locate their plant facilities as a matter of social conscience. People work to earn what they can after paying all taxes. During tough times, after-tax earnings are depressed naturally, which is why unemployment rates are so high. Piling on more taxes only exacerbates the problem. Businesses locate their plant facilities to make after-tax returns for their owners. During depressed times, businesses are often desperate to reduce costs because of a shortfall in revenues. Increased taxes in one location can be the final straw leading to businesses relocating to more tax-friendly locations or to make the ultimate decision to close down operations.

- Raising tax revenues is far from cost free. Obviously, when tax rates on an activity are raised, the volume of that activity shrinks, leading to a revenue offset. There are also substantial collection costs to both the government and the taxpayer from raising taxes, which result in less money being collected than paid. To the extent taxpayers seek to avoid, evade, or otherwise shelter and hide their taxable income, the amount of additional revenues is also greatly reduced and can, in fact, end up costing the government money directly as a consequence of raising taxes. Capital flight and labor flight, along with companies going out of business, are classic responses to increased taxation at the state and local levels. In many of these cases the state and local governments actually lose revenues when they raise taxes.
- If raising taxes actually were to improve a state's fiscal circumstances, the state would do so by worsening the fiscal circumstances of those it governs. No phrase is more important for government to follow than *primum non nocere* (First, do no harm). Balancing the government's budget by unbalancing its citizens' budgets contradicts tax policy goals of promoting growth, fairness, and liberty.
- Almost without exception, states underestimate revenues during good times and overestimate revenues during bad times. As a result of overestimating revenues during bad times, politicians believe their fiscal circumstances are less severe than they actually are, leading to spending

above and beyond revenues or delays in implementing spending cuts when they are desperately needed. Then, when deficits later appear, state legislators often turn to higher taxes, which in turn result in deeper declines in the economy, revenues again falling short of expectations, and a continuation of the spend-and-tax cycle.

- Raising tax rates, especially during difficult times when tax increases are most frequently considered, virtually always deludes politicians into believing that more revenues will materialize than actually do. Cutting tax rates does the opposite. Static revenue estimates always assume that no one's behavior will change, and therefore a 10 percent tax increase will increase tax revenues 10 percent. In fact, this is never true. The dynamic effects of slower growth, reduced profitability, higher unemployment (and its associated costs), and tax evasion and avoidance, just to name a few, combine to ensure that actual revenues fall short of forecasted revenues.
- A tax system—such as a flat single rate tax system without deductions—that avoids excessive revenues during good times will not tempt politicians to build up expensive spending programs that in turn will be unaffordable during tough times. Spending volatility—whereby spending actually is cut during bad times,—causes so much hardship among those most vulnerable. A flat tax with modest rainy day provisions may well be one of the most moral tax structures as well as one of the most productive tax structures.

It is important to keep these points in mind. An understanding of the relationship between state policies, economic performance, and asset values is vital toward creating an economically competitive tax system.

SECTION II: MARYLAND'S CURRENT ECONOMIC STATE

As illustrated in Figure 2, overall real economic activity (state GDP) in Maryland has been growing 3.3 percent a year between 1998 and 2007. This growth rate exceeds the national average of 2.7 percent and is slightly above average among Maryland's neighbors. The historically above average economic performance also holds true if economic performance is measured by income growth of residents (personal income), See Figure 3.

FIGURE 3 AVERAGE GROWTH IN STATE PERSONAL INCOME: MARYLAND COMPARED TO U.S. AND NEIGHBORS 1998 – 2007⁹

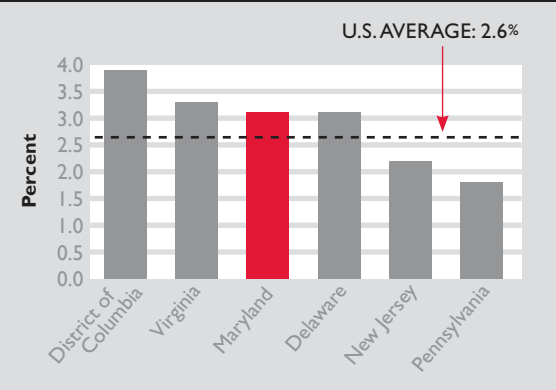
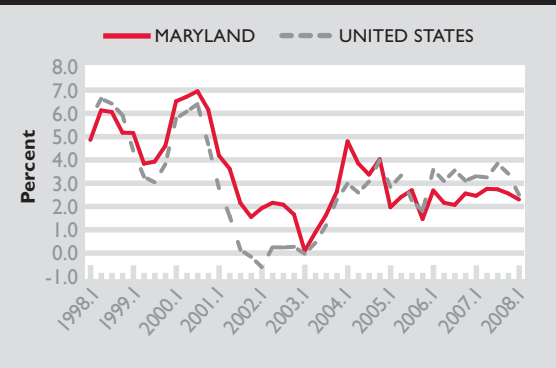


FIGURE 4 AVERAGE GROWTH IN QUARTERLY STATE PERSONAL INCOME: MARYLAND COMPARED TO U.S. AND NEIGHBORS 1998 – 2008¹⁰



Maryland, particularly the D.C. area, is experiencing a significant decline in housing values. As such, Maryland's economy should be growing slower than average. This is exactly what is happening; the current economic downturn is having a disproportionately large impact on Maryland's economy. The most recent quarterly personal income growth data illustrates that Maryland's historical growth premium began to disappear in 2005. See Figure 4. Figure 4 also illustrates that the personal income growth deficit narrowed substantially in the first quarter of 2008.

A similar pattern holds with respect to jobs (growth in non-farm employment) in Maryland. Maryland's relative performance exceeded national employment growth, but this premium eroded in 2005. Beginning in the first quarter of 2008, the latest employment data

FIGURE 5 AVERAGE GROWTH IN STATE EMPLOYMENT: MARYLAND COMPARED TO U.S. 1998 – 2007¹¹

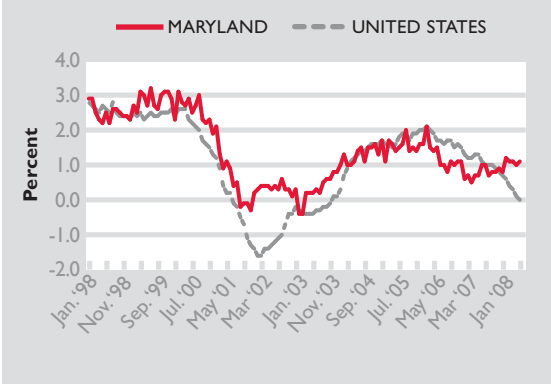


FIGURE 6 GROWTH IN STATE SPENDING PER CAPITA: DIFFERENCE BETWEEN MARYLAND AND U.S. GROWTH RATE 1981 – 2006¹³

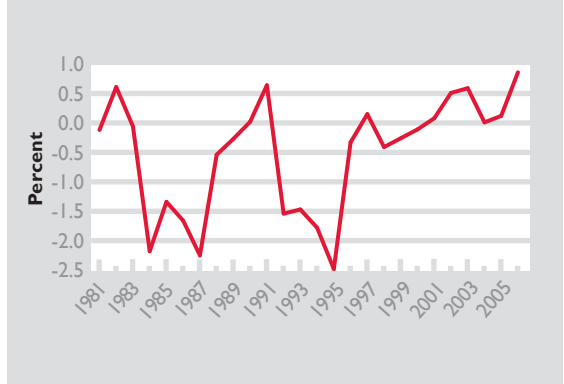
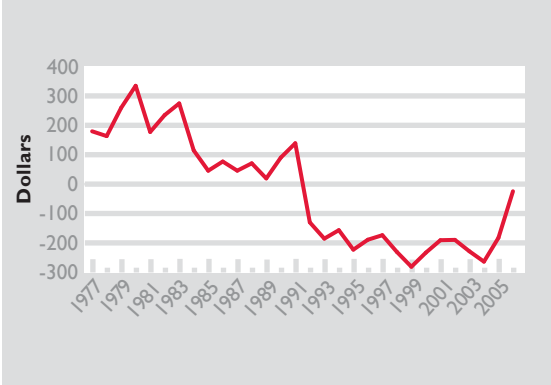


FIGURE 7 DIFFERENCE BETWEEN STATE SPENDING PER CAPITA IN MARYLAND COMPARED TO U.S. 1981 – 2006¹⁴



shows that the employment growth premium in Maryland compared to the nation has returned. See Figure 5.

SECTION III: MARYLAND'S ERODING SPENDING DISCIPLINE

Maryland's economic landscape has been traditionally slightly below average, and the implications from this are discussed more fully below. It is important to note here that the recent tax increases have changed this trend. Maryland's economic landscape now creates a large disincentive to work, produce, and save in Maryland. The justification for worsening Maryland's economic landscape has been the "structural deficit." Because future spending commitments are being used to justify the more confiscatory tax structure, it is useful to discuss the spending side of the ledger prior to the revenue side.

Until recently, fiscal discipline in Maryland compared to the national average has been competitive. To illustrate Maryland's historic fiscal discipline, we calculate the average growth rate over successive 5-year periods in order to obtain a long-term view of relative spending growth in Maryland compared to other states.¹² Figure 6 traces out the difference between the average per capita state expenditures growth in Maryland compared to the average per capita state expenditures growth for the state's overall.

As Figure 6 shows, except for 3 years, the 5-year average growth in per capita spending in Maryland between 1981 and 2000 was below the 5-year average state growth in expenditures per capita for the states as a whole. As a result, Maryland's total expenditures per capita, which adjusted for inflation was over \$330 higher than the average state per capita expenditures in 1981, was \$281 below the national average in 1999, see Figure 7.

Beginning in 2000, Maryland's historic spending discipline began to weaken – especially between 2004 and 2006, see Figure 6. Figure 7 shows the results of the excessive growth in expenditures in Maryland—whereas expenditures per capita in Maryland had been below the national average by around \$200 per capita since 1992, Maryland state expenditures per capita in 2006 were nearly equal to the U.S. average.

Returning to Maryland's relative growth rate, Figure 8 compares Maryland's real economic growth rate (dotted black line) to changes in real per capita state spending (solid red line). Figure

8 illustrates the generally negative relationship between Maryland's real per capita spending growth and Maryland's real per capita income growth. When the growth in real per capita spending declines (solid red line goes down), the growth in real per capita income tends to increase (dotted black line goes up). The reverse is true when growth in real per capita spending increases. Simply put, each dollar of additional spending comes with a cost in terms of lost potential economic growth.

The U.S. Census data, which puts state expenditure data on a comparable basis, is only current through 2006. However, state spending in Maryland has continued to grow, especially in FY 2007, see Figure 9. Figure 9 shows that spending growth has slowed, but is still growing at a 3.9 percent rate, which is equal to the average overall state expenditure growth in the U.S. between 2001 and 2006.

Future spending plans under current policies would continue the trend of higher spending growth in Maryland compared to the rest of the country. Paramount among the future obligations is the future education spending commitments due to the Thornton Act. Passed in 2002, the Thornton Act commits Maryland to an additional \$1.3 billion in K-12 education expenditures by FY 2008. Back in 2002, Maryland spent \$1,266 per capita on education, which was 93.5 percent of the national average. A \$1.3 billion increase implied that per capita education spending would be \$1,505 or 111 percent of the national average expenditures in 2002. By 2006, total per capita education expenditures were \$1,585 or 98 percent of the national average expenditures in 2006. Since 2006, the accelerated growth in education expenditures has continued and Maryland's education expenditures can no longer be considered inadequate compared to the average state's per capita education expenditures.

Looking forward, the budget situation is difficult. The Department of Legislative Services, Office of Policy Analysis and the Maryland Budget and Tax Policy Institute estimate that current planned expenditures will exceed current planned revenues: "Maryland faces a structural deficit."¹⁷ Because planned expenditures exceed planned revenues, the solution implemented during the 2008 Special Session was to increase revenues. This solution is the opposite of what Maryland should have done. As we illustrate below, Maryland's economic competitiveness has been histori-

FIGURE 8 GROWTH IN REAL PER CAPITA INCOME COMPARED TO REAL STATE SPENDING IN MARYLAND 1981 – 2007¹⁵

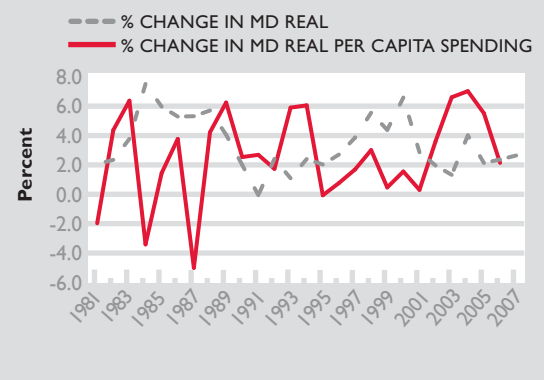
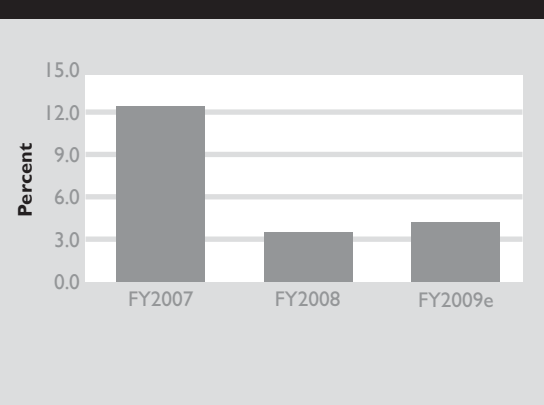


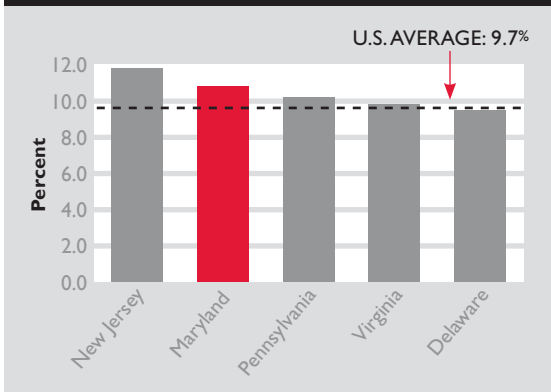
FIGURE 9 GROWTH IN STATE SPENDING IN MARYLAND 2007 – 2009e¹⁶



cally slightly below average—but low per capita spending has been a bright spot. Between 1981 and 2006, the income of Maryland residents has been, on average, nearly 16 percent larger than the country's over this time period. But, when spending per capita in Maryland has grown faster (on a per capita basis) than the average state, Maryland's income premium tends to decline. The reverse has been true when Maryland's per capita spending has grown slower than the average state.

Balancing the structural deficit by increasing taxes is an attempt to solidify the higher spending levels in Maryland. But, Maryland's experience shows that such policies will diminish Maryland's income premium vis-à-vis the rest of the country. The existence of the structural deficit should have been addressed on the spending side of the ledger,

FIGURE 10 TOTAL TAX BURDEN AS A PERCENTAGE OF PERSONAL INCOME: MARYLAND COMPARED TO U.S. AND NEIGHBORS 2008



not the tax side. Once future spending commitments were aligned with future tax revenues, tax policy changes should have then been used as an opportunity to improve Maryland's competitiveness, economic growth, and subsequently tax revenue growth in the future.

The results from FY 2008 support this spending discipline approach to solving the structural deficit problem. For FY 2008, total tax revenues missed forecasts by \$73.8 million despite massive tax increases that have eroded Maryland's economic competitiveness, and FY 2009 revenues are now \$431.9 million below previous the previous projections.¹⁸ Tax increases oftentimes miss their revenue targets due to a lack of appreciation of the dynamic consequences from tax increases discussed in Section I.

Estimating what will be as a consequence of a tax increase is precarious to say the least. But, failing to estimate the dynamic consequences of tax changes will always be wrong. While Maryland's FY 2008 revenue underperformance results in part from the slowing national economy (as claimed by the revenue authorities), taking more money away from Maryland's residents during difficult economic times worsens the overall economic environment, reduces the welfare of Marylanders, and ultimately leads to lower government revenues compared to projections. With incredible clarity, John Maynard Keynes described these difficulties:

...to create wealth will increase the national income and that a large proportion

of any increase in the national income will accrue to an Exchequer, amongst whose largest outgoings is the payment of incomes to those who are unemployed and whose receipts are a proportion of the incomes of those who are occupied. . . whether or not he thinks himself competent to criticize the argument in detail, that the answer is . . . it agrees with the instinctive promptings of his common sense. Nor should the argument seem strange that taxation may be so high as to defeat its object, and that, given sufficient time to gather the fruits, a reduction of taxation will run a better chance than an increase of balancing the budget. For to take the opposite view today is to resemble a manufacturer who, running at a loss, decides to raise his price, and when his declining sales increase the loss, wrapping himself in the rectitude of plain arithmetic, decides that prudence requires him to raise the price still more—and who, when at last his account is balanced with nought on both sides, is still found righteously declaring that it would have been the act of a gambler to reduce the price when you were already making a loss.

Maryland cannot solve its structural deficit based on "the rectitude of plain arithmetic." The higher taxes and fiscal crises that will accompany the growing expenditures will lead to declining economic performance in Maryland. Maryland's overall economic competitiveness and fiscal health can only be enhanced by implementing increased spending control that arrests the recent growth in state spending. Spending commitments should be subsequently aligned with a pro-growth tax environment that will increase economic incentives in Maryland, leading to greater economic growth, employment growth, and subsequently tax revenue growth.

SECTION IV: THE NEGATIVE IMPACTS FROM MARYLAND'S 2008 TAX INCREASES

Before we suggest specific spending discipline proposals, it is useful to gain a fuller understanding of what is at stake. In Section I, we describe the benefits that accrue to states that implement pro-growth tax policies and the costs that befall states that implement anti-growth tax policies. Maryland's 2008 tax

increase is an example of the latter. It is therefore useful to document the negative incentives the 2008 tax increases created.

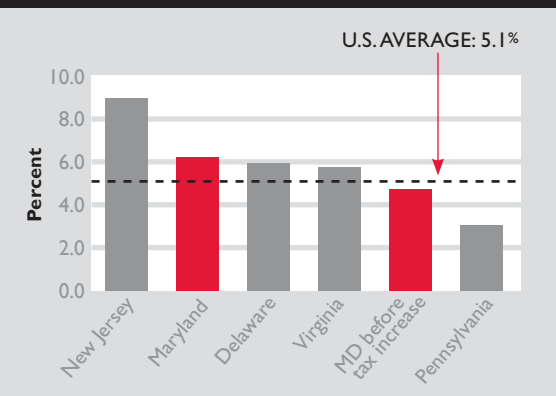
We monitor the changing incentives in Maryland's economy by tracking the impact from government tax policies on the economy's production process. For instance, someone has to exert effort to create all of the goods and services in our economy. Economists generally classify this effort as the "labor input" into production. The other inputs into production are classified as capital, or the tools and machines people use (which come from savings and investments), and technology, or the know-how/skills needed to create the things we need and want. Government policies matter because government taxes, expenditures, and regulations impact the inputs into production. These impacts either discourage the use of labor, capital, and technology, or encourage their use. Due to the importance of labor and capital in the economic process, it is useful to track tax policy impacts based on its impact on labor and capital in addition to the tax burden on consumption and the overall tax burden in the state.

Maryland recently enacted several ill-advised tax increases that significantly expanded the tax on labor and capital. To highlight the negative impact of these tax changes, we review the state of Maryland's economic competitiveness both before and after the tax increase.

Starting with overall tax burdens, according to the Tax Foundation, total state and local taxes comprised 10.8 percent of total personal income in 2008, which is above the national average of 9.7 percent (Figure 10).¹⁹ Maryland's overall tax burden is the fourth highest tax burden in the nation, and second highest in its region—New Jersey has the highest state and local tax burden in the nation.²⁰

The Tax Burden on Labor People do not work to pay taxes. People work to earn the highest wages, after taxes. High (or rising) taxes on labor reduce workers' after-tax wages, reducing the incentive to work. Because workers can receive a higher (or rising) after-tax wage for the same gross wage if they moved to a state with a lower (falling) tax burden, the economic climate of other states are critical. People have an incentive to leave a state with high (or rising) taxes on labor income and relocate to a state where the taxes on labor income is lower (falling). As people respond to these incen-

FIGURE 11 TOP MARGINAL PERSONAL INCOME TAX RATE: MARYLAND COMPARED TO U.S. AND NEIGHBORS 2007



tives, income growth, employment growth, and overall economic growth suffer in the state with high or rising taxes.

Top Marginal Personal Income Tax Rate Maryland's top marginal income tax rate is now 6.25 percent. Compared to Maryland's neighbors, three states (Delaware, Virginia, and Pennsylvania) have lower top marginal income tax rates, and only one state (New Jersey) has a higher top marginal income tax rate. Prior to recent tax increases, the only neighbor with a lower top marginal personal income tax rate was Pennsylvania. Maryland has, consequently, lost this competitive advantage vis-à-vis most of its neighbors due to the tax increase. Maryland's top marginal income tax rate also went from being below the average top marginal income tax rate in the nation by 35 basis points or \$3.50 in lower taxes for every \$1,000 earned, to above the average top marginal income tax rate in the nation by 115 basis points, or \$11.50 in higher taxes for every \$1,000 earned.

However, Maryland's competitive position is even worse than this comparison of state income tax rates indicates. Localities in Maryland impose a relatively large local income tax burden. Including the average local income tax, Maryland's top personal income tax rate had been higher than both the U.S. average and most of its neighbors. Due to the recent tax increases, Maryland's combined average state and local income tax rate is the highest compared to all of its neighbors. See Figure 12.²¹ Because people do not care whether the state or locality imposes the tax, from a labor

FIGURE 12 TOP STATE AND LOCAL MARGINAL PERSONAL INCOME TAX RATE: MARYLAND COMPARED TO U.S. AND NEIGHBORS 2007

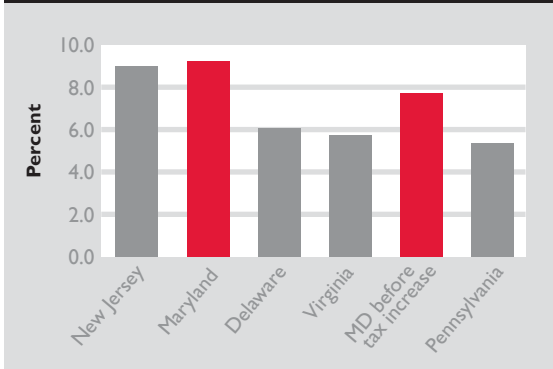
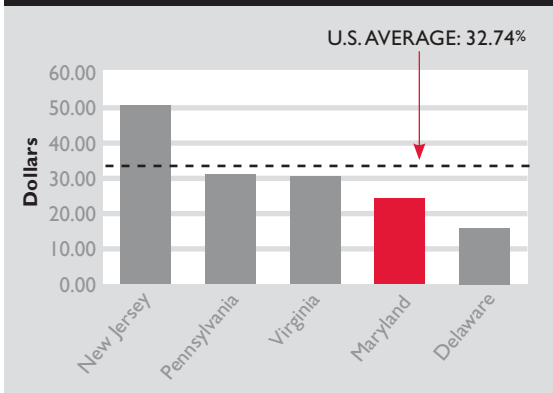


FIGURE 13 PROPERTY TAX BURDEN PER \$1,000 OF PERSONAL INCOME: MARYLAND COMPARED TO U.S. AND NEIGHBORS 2007



tax perspective, Maryland is now at a significant competitive disadvantage.

Top marginal income tax rates are not necessarily comparable, however. For instance, California's top rate does not apply until an income of \$1 million, while Virginia's top marginal income tax rate of 5.75 percent becomes effective at \$17,000, and Maryland's top marginal income tax rate becomes effective at \$1 million. The median top bracket becomes effective once an income of \$25,000 is reached.

The top bracket is an important indicator, however. The top marginal tax rate determines the incentive to innovate. Maryland now offers the least accommodating environment for aspiring entrepreneurs and small businesses compared to all of its neighbors, save New Jersey, which has one of the worst environments in the country. A success-

ful business in Baltimore County that faces the top bracket can save \$40.10 in state and local income taxes for every \$1,000 it earns just by moving north up Route 95 into Pennsylvania. The same business in Montgomery County can save \$37.00 in income taxes for every \$1,000 it earns by moving around the Capital Beltway into Virginia. Given that after-tax corporate profits, on average, are approximately \$70 for every \$1,000 of income, this implies a 53 percent to 57 percent increase in profitability by simply leaving Maryland.²²

Tax Progressivity Ideally, states will tax the largest possible tax base at the lowest possible tax rate. Personal income tax codes often fall far short of this economic ideal. Although both might generate a similar revenue stream, the tax structure of a state that imposes a low flat-rate tax on a broad range of personal income provides greater economic efficiency and growth incentives, and subsequently experiences greater economic performance than the tax structure of a state with a narrow, highly progressive personal income tax.

On this measure, Maryland's tax system is average. We define and measure tax progressivity as the difference in the average tax liability per \$1,000 of income for gross incomes of \$50,000 and \$150,000. Included in our calculation of tax liability are all appropriate adjustments for the standard deduction, personal exemptions and/or credits, deductibility of federal income taxes, local personal income taxes, et cetera. Based on this definition, the difference in tax liability was \$5.28 per \$1,000 of income, which ranked as the 21st (out of 50) most progressive state income tax system in the country. The tax increases raised this figure to \$5.84, which would still rank 21st.

From the perspective of taxes on labor effort, Maryland went from a state with a slightly better than average environment to a state that is slightly worse than average. This reduction in competitiveness creates greater headwinds for Maryland's economy.

The Tax Burden on Capital Similar to the tax burden on labor, Maryland's tax burden on capital is also punitive. Documenting taxes on capital income is more complicated than documenting taxes on labor income. State governments do not treat all forms of capital equally. Often, states (and

TABLE 4 TAXATION OF CAPITAL IN MARYLAND AND ITS NEIGHBORS

	MARYLAND		VA	PA	NJ	DE
	BEFORE	AFTER				
PROPERTY TAX BURDEN <i>(per \$1,000 of personal income)</i>	\$24.30	\$24.30	\$30.56	\$31.12	50.71	15.91
ESTATE/INHERITANCE TAX LEVIED	YES	YES	NO	YES	YES	NO
TOP MARGINAL STATE RATE: INCOME, DIVIDENDS, AND CAP. GAINS	4.75%	6.25%	5.75%	3.07%	8.97%	5.95%
TOP MARGINAL CORPORATE TAX RATE	7.00%	8.25%	6.00%	9.99%	9.00%	8.70%

the federal government) double or even triple tax capital income. All factories, equipment, land, et cetera used to produce goods and services are considered capital from an economic perspective.²³ Purchases of capital require an investment by businesses or individuals. Businesses do not invest as a matter of social conscience. They invest to earn the highest possible rate of return on their investments. Businesses and other investors will only purchase capital if the expected return to the capital exceeds all costs—including all tax costs.

Taxing the return to capital is synonymous with taxing saving and investment. High taxes on savings and investment lowers the after-tax rate of return from saving and investing, diminishing the incentives to invest. Lower investment translates into a smaller and less productive capital stock. Income, employment, and economic growth are all subsequently reduced.

Returns to saving and investment are taxed in many ways. First, corporations earn profits, which are the returns to the investors or the owners of the “capital.” These profits are subject to corporate income taxes, or in the case of some firms, personal income taxes. If the profits are then distributed to investors as a taxable dividend, the income is taxed again through dividend taxes. Should the owner of the company, or any income generating asset, decide to sell his ownership rights to the capital, any increase in the value of the stream of payments from the capital (capital gains) will be taxed. Similarly, the interest income from savings or bond investments faces income taxes. Finally, states will tax the value of some assets in addition to the income stream generated from these assets (another instance of states taxing the same income multiple times) by taxing property and imposing estate and gift taxes. Table 4 summarizes the tax burden on capital imposed in Maryland and its neighbors.

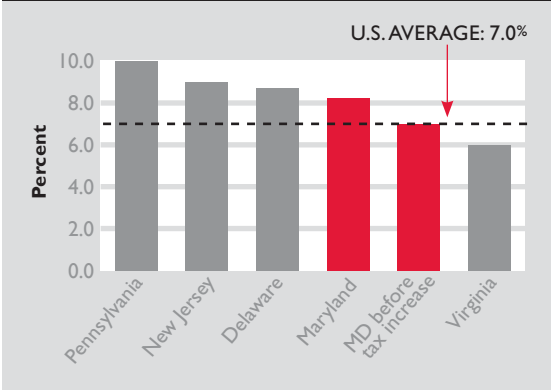
Property Tax Burden As of 2006, Maryland’s property tax burden is \$24.30 per \$1,000 of personal income. Compared to Maryland’s neighbors and the nation as a whole, this is below the national average burden of \$32.74—the only neighbor with a smaller property tax burden is Delaware. As Figure 13 illustrates, Maryland’s property tax burden provides an important competitive advantage for the state.

Estate Taxes Unlike Virginia and Delaware, Maryland imposes a death tax—inheritances are taxed at a rate of 10 percent of the value of the property that passes to the descendant. The death tax is fundamentally flawed from a sound economic perspective.

The death-tax represents double, or even triple, taxation. When income is earned in Maryland, appropriate Maryland (and federal) income taxes are paid on the money. If a person does not spend this money in his or her lifetime, then this money is once again subject to tax—the death tax. Currently in Maryland, a person could pay up to 44.35 percent in federal, state, and local income taxes when he or she earns the money, yet pay taxes again on the same money if it is passed on in his or her estate. Hence, after all taxes have been paid on income, the income is taxed once again when someone dies.

The first non-wartime estate tax was instituted in 1916 as part of the federal income tax. It was explicitly designed to help break up large concentrations of wealth—of the Vanderbilts, the Rockefellers and other so-called “robber baron” families—and to make sure heirs paid some tax on their inheritances. Nineteenth century political theorist Jeremy Bentham and economist John Stuart Mill were two of the most prominent advocates of an inheritance tax system. They argued that the estate tax was an ideal tax—a supply-sider’s dream. Why? Because,

FIGURE 14 TOP MARGINAL CORPORATE INCOME TAX RATE: MARYLAND COMPARED TO U.S. AND NEIGHBORS 2008



they argued, it is a tax collected from the dead, and the dead can't change their behavior. It seemed like a win-win because money would be raised for the government with no adverse effects on the incentives to work and save.

Nothing could be further from the truth. The death tax puts Maryland at a significant competitive disadvantage and does significant harm to Maryland's economy, yet this punitive tax raises very little revenues for the state, and fails to achieve its objective of curtailing the transmission of wealth from one generation to the next. It is arguably the most counterproductive tax in the entire internal revenue code.

The core economic problem with the death tax is that the confiscatory rates imposed by the federal and state governments penalize saving and investment and unjustly force the break-up of thousands of closely held family-owned businesses, farms, ranches, and other properties.

The death tax also causes the misallocation of tens of billions of dollars a year away from the highest wealth-producing investments into entirely unproductive tax shelters (and into the hands of estate planners, tax accountants, and life insurance salesmen). Less than half of estates that must go through the burden of complying with the paperwork and reporting requirements of the estate tax actually pay even a nickel of the tax. These small-sized estates sometimes are forced to spend tens of thousands of dollars to comply with a tax they do not even owe.

The compliance costs relative to the dollars raised are enormous. For example, the National

Federation of Independent Business documents that nearly 60 percent of business owners would expand jobs if the estate tax were repealed.²⁴ The U.S. Joint Economic Committee estimates that the death tax has reduced U.S. wealth creation by \$500 billion because the tax raises the cost of capital and thus dramatically reduces the savings rate of seniors and reduces reinvestment in family businesses.²⁵

Because of the high economic and compliance costs of the death tax studies have shown tremendous positive impacts on the economy and government revenues from its repeal. In a study on the death tax, economist Richard E. Wagner, Ph.D. of George Mason University calculated that eight years following the repeal of the death tax, the U.S. economy would:

- Be \$80 billion wealthier
- Create 250,000 additional jobs
- Invest in more capital by an additional \$640 billion²⁶

The same effects impact state death taxes—except that a state death tax can be avoided by simply moving across an invisible state line. Due to all of these inefficiencies with estate taxes, Maryland's estate tax creates a significant competitive disadvantage for the state.

Corporate Income Tax Rate and Burden As discussed above, the marginal tax rate a business or individual faces determines the incentives to engage in productive economic activity. To see the impacts from these taxes on incentives to acquire capital (i.e., save and invest), we incorporate the impact of all of the relevant capital taxes and simply follow the money.

Maryland's corporate income tax rate is uncompetitive from a national perspective (Figure 14). Prior to the latest tax increases, Maryland's top marginal corporate tax rate on businesses was 7.0 percent, equal to the national average. Following the tax increase, Maryland's corporate income tax rate is 125 basis points above the national average and closes in on the high tax rates of several of its neighbors. Compared to this region, corporations have a greater incentive to locate in Virginia where the top tax rate is 6.0 percent, saving \$2.25 for every \$100 in lower taxes.

To further illustrate this point, imagine several representative companies facing the highest marginal income tax brackets and earning an ad-

TABLE 5 TAXATION OF CORPORATE INCOME

	MARYLAND		VA	PA	NJ	DE
	BEFORE	AFTER				
ADDITIONAL NET INCOME	\$1,000.00	\$1,000.00	\$1,000.00	\$1,000.00	\$1,000.00	\$1,000.00
FEDERAL INCOME TAX LIABILITY						
<i>Corporate Income tax (weighted)</i>	13.7%	13.7%	13.7%	13.7%	13.7%	13.7%
<i>Personal Income tax (weighted)</i>	21.3%	21.3%	21.3%	21.3%	21.3%	21.3%
STATE INCOME TAX LIABILITY						
<i>Corporate Income tax (weighted)</i>	4.7%	5.6%	3.5%	3.3%	5.5%	3.7%
<i>Personal Income tax (weighted)</i>	2.7%	3.2%	2.3%	3.9%	3.5%	3.4%
ADDITIONAL NET INCOME AFTER TAXES	\$601.69	\$592.57	\$611.99	\$603.46	\$591.62	\$603.91

ditional \$1,000 in profits. One firm operates in Maryland and one operates in each one of Maryland's neighbors we have been tracking. Each representative company faces a federal income tax liability. Depending on the company's structure, the tax liability could be either the top marginal corporate income tax rate or top marginal personal income tax rate. In this example, the representative companies pay a weighted share of the corporate and personal income tax rates. The weights represent the share of total net income subject to the corporate income tax and the share of total net income subject to the personal income tax. The weights are calculated based on the share of total net corporate income subject to corporate taxes as reported by the Internal Revenue Service Statistics On Income data.²⁷

With respect to federal income tax rates, the division is irrelevant as the top corporate and personal income tax rates are both 35 percent. The distinction for state income taxes is relevant – for instance, in Maryland the top corporate income tax rate is 8.25 percent while the top personal income tax rate is 9.2 percent (including local income taxes). Table 5 summarizes this information for Maryland (both before and after the 2008 tax increases) and its neighbors.

The final line of Table 5 calculates the additional after tax net income to each one of these companies if they were located in Maryland versus its neighbors, and takes into account the deductibility of state income taxes. As Table 5 clearly shows, the recently enacted tax increases reduced companies' marginal net incomes by \$9.11 per \$1,000 in net income. Additionally, Maryland companies can increase their net income by locating to Pennsylvania (+\$10.88 per \$1,000 in net income), Delaware

(+\$11.34 per \$1,000 in net income), or Virginia (+\$19.42 per \$1,000 in net income). Table 5 clearly illustrates Maryland's disadvantaged and declining competitiveness with respect to attracting corporations to operate within the state.

Taxes on Dividends, Capital Gains and Interest Earnings Maryland's competitive disadvantage grows even more, because the tax burden imposed on capital is not finished. The owners of a corporation (individuals) face another round of taxation on this income when the company pays a dividend or the asset is sold for a capital gain.

Using national payout-ratios based on the Bureau of Economic Analysis's National Income and Product Account (NIPA) tables, and the ratio of companies that are dividend-payable, we can estimate the percentage of net income that is subject to dividends taxes. These figures are summarized in Table 6.

Table 6 shows that if both a company and the individual owning the company are located in Maryland, the recently enacted tax increases reduced their combined marginal net incomes by \$10.43 per \$1,000. Additionally, both the company and individual owner can increase their net income by locating to Pennsylvania (+\$14.07 per \$1,000 in net income), Delaware (+\$11.17 per \$1,000 in net income), or Virginia (+\$19.11 per \$1,000 in net income). Table 6 clearly illustrates Maryland's disadvantaged and declining competitiveness with respect to attracting corporations to operate within the state.

There are still more taxes on capital. Most states and the federal government also tax interest income and capital gains income. Maryland taxes capital gains at 6.25 percent, which is the same as ordinary income (Figure 15). Compared to Maryland's neighbors, the state's capital gains taxes are

TABLE 6 CORPORATE INCOME SUBJECT TO DIVIDEND TAXES

	MARYLAND		VA	PA	NJ	DE
	BEFORE	AFTER				
ADDITIONAL NET INCOME AFTER TAXES	\$601.69	\$592.57	\$611.99	\$603.46	\$591.62	\$603.91
<i>Earnings Paid Out</i>	\$509.44	\$501.72	\$518.16	\$510.94	\$500.92	\$511.33
<i>Earnings Paid Out Subject to Dividend Tax</i>	\$136.16	\$134.10	\$138.49	\$136.56	\$133.88	\$136.66
INDIVIDUAL DIVIDEND TAX						
<i>Federal</i>	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%
<i>State</i>	4.75%	6.25%	5.75%	3.07%	8.97%	5.95%
TOTAL AFTER-TAX INCOME (INCL. RETAINED EARNINGS)	\$575.77	\$565.34	\$584.45	\$579.41	\$561.33	\$576.50

FIGURE 15 CAPITAL GAINS TAX RATES: MARYLAND COMPARED TO U.S. AND NEIGHBORS 2008

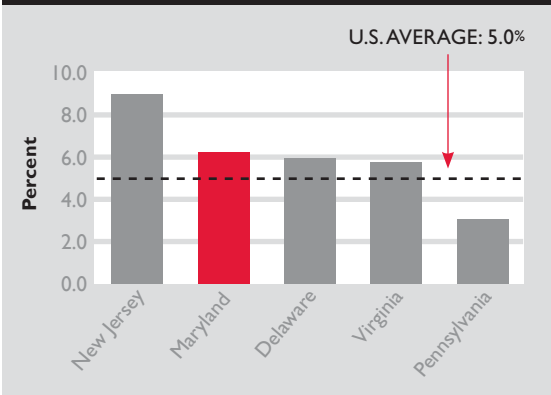
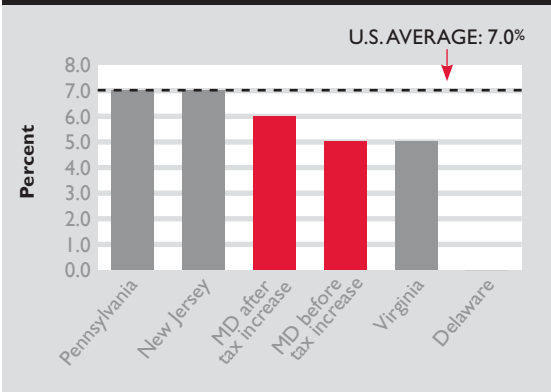


FIGURE 16 STATE AND MAXIMUM LOCAL SALES TAX RATES: MARYLAND COMPARED TO U.S. AND NEIGHBORS 2008



uncompetitive, and nationally, Maryland's capital gains taxes are 125 basis points above than the average state capital gains tax.

Capital gains taxes discourage investment; and due to their volatility, capital gains taxes create sig-

nificant revenue swings. Using a similar methodology as Tables 5 and 6, we track \$1,000 of interest and capital gains income if it were earned by an individual living in Maryland compared to that same income if it were earned by an individual living in Maryland's neighbors. The results are summarized in Table 7.

Table 7 illustrates that the after-tax return to both interest income and capital gains income fell significantly due to the recent tax increases—the return to interest income fell \$9.75 per \$1,000 of interest income (a 1.6 percent decline in after-tax returns). Interest income returns went from being higher than most of Maryland's neighbors to being below all of its neighbors except New Jersey.

The story is the same for capital gains income. Maryland's return for capital gains income fell \$12.52 per \$1,000 of capital gains income. The return for a \$1,000 investment is up to 3.4 percent higher in Maryland's neighbors (Pennsylvania) than in Maryland for the exact same investment.

The results from this analysis are clear: the recent tax increases have put Maryland at a significant disadvantage compared to its neighbors (and the country overall) with respect to corporate income, interest income, and capital gains income. This disadvantage creates obstacles for Maryland in attracting businesses and investors. Entrepreneurs, as opposed to locating in Maryland, could settle in Virginia or Pennsylvania where the marginal tax rates are significantly less than the tax rates they would face in Maryland. The comparison indicates that Maryland should at a bare minimum repeal the additional costs created by the recent tax increases in order to induce more businesses and economic activity into the state.

TABLE 7 TAXATION OF INTEREST AND CAPITAL GAINS INCOME

	MARYLAND		VA	PA	NJ	DE
	BEFORE	AFTER				
INDIVIDUAL INTEREST INCOME	\$1,000.00	\$1,000.00	\$1,000.00	\$1,000.00	\$1,000.00	\$1,000.00
<i>Federal Interest income Taxes</i>	35.00%	35.00%	35.00%	35.00%	35.00%	35.00%
<i>State Interest Income Taxes</i>	4.75%	6.25%	5.75%	3.07%	8.97%	5.95%
INDIVIDUAL INTEREST INCOME (AFTERTAX)	\$619.13	\$609.38	\$612.63	\$630.05	\$591.70	\$611.33
CAPITAL GAINS INCOME	\$1,000.00	\$1,000.00	\$1,000.00	\$1,000.00	\$1,000.00	\$1,000.00
FEDERAL INCOME TAX LIABILITY						
<i>Capital Gains taxes (Long-term)</i>	15.00%	15.00%	15.00%	15.00%	15.00%	15.00%
<i>Capital Gains taxes (Short-term)</i>	35.00%	35.00%	35.00%	35.00%	35.00%	35.00%
STATE INCOME TAX LIABILITY						
<i>Capital Gains taxes</i>	4.75%	6.25%	5.75%	3.07%	8.97%	5.95%
CAPITAL GAINS INCOME (AFTER TAX)	\$795.22	\$782.69	\$786.87	\$809.24	\$759.99	\$785.20

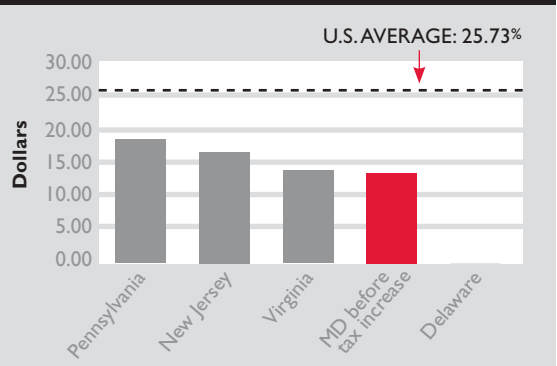
The Consumption Tax Burden Due to the differences in state sales tax bases and the complexity that local sales taxes add, we compare Maryland's sales tax burden using two different measures: state and local sales tax rates and state and local sales tax revenues per \$1,000 of personal income. Figure 16 compares Maryland's state and local sales tax rate to its neighbors based on the state and maximum local sales tax rates.

When comparing those localities with the highest state and local sales tax rates, Maryland looks average compared to its neighbors, but low compared to the country overall. Total sales tax revenue per \$1,000 of personal income provides a measure of the pervasiveness of the state and local sales tax rates. Figure 17 compares the sales tax burden per \$1,000 of personal income in Maryland to its neighbors as well as the U.S. average.

Figure 17 illustrates that Maryland and its neighbors impose relatively low sales tax burdens compared to the country as a whole; and Maryland imposed the lowest sales tax burden of all its neighbors, except for Delaware, prior to the latest tax increase. Based on a static analysis of the recent state sales tax increase to 6.0 percent, Maryland's sales tax burden increases to \$16.54 per \$1,000 of personal income, replacing Virginia as the third highest sales tax rate among all of Maryland's neighbors, see Figure 18.

Overall, consumption taxes in Maryland are relatively competitive compared to both its neighbors and the U.S. overall, whether measured by the tax rate levied or the actual burden imposed.

FIGURE 17 STATE AND LOCAL SALES TAX BURDEN PER \$1,000 OF PERSONAL INCOME: MARYLAND COMPARED TO U.S. AND NEIGHBORS 2006



SECTION V: MARYLAND'S FISCAL ENVIRONMENT: WHERE DO WE GO FROM HERE?

The recent tax increases has significantly degraded Maryland's economic landscape. Workers, investors and firms all have strong incentives to locate in other states rather than Maryland. Specific trouble spots in Maryland's economic landscape include:

- Maryland's overall tax burden (total taxes collected relative to state income) is too high;
- Maryland's top state and local tax rate on personal income, including capital gains and interest income, are among the highest in the country; and
- Maryland's corporate income tax rate has gone from average, to significantly above the average state's corporate income tax rate.

FIGURE 18 STATE AND LOCAL SALES TAX BURDEN PER \$1,000 OF PERSONAL INCOME: MARYLAND BEFORE AND AFTER TAX INCREASE COMPARED TO U.S. AND NEIGHBORS 2006

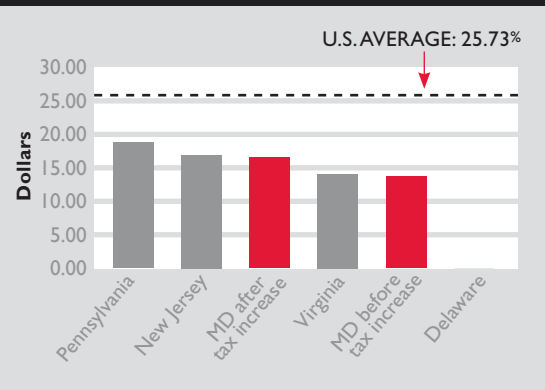


FIGURE 19 TOTAL GENERAL EXPENDITURES PER CAPITA



Because the recent tax changes have reduced Maryland's economic competitiveness so dramatically, one tax reform option is to simply repeal the offending tax increases. This approach has its merits; however, Maryland's tax system prior to the tax increases was not ideal. Maryland can use the tax repeal opportunity to reform its overall tax system—preferably to a low flat rate tax.

A flat tax eliminates much of the inefficiency in a convoluted tax system by broadening the tax base and sharply reducing marginal tax rates. Many of the distortions that exist with the current tax system are minimized. A flat rate tax reduces the collection cost per dollar of tax revenues and eliminates much of the bureaucracy necessary to monitor and enforce numerous state taxes. Its adoption leads to a surge in growth and creates a more competitive economy.

A marginal tax rate cut—ideally to a flat rate—has two types of effects. Because the decrease in marginal tax rates lowers the cost to the employer in the form of lower wages paid, firms will employ more workers. On the supply side, a reduction in marginal tax rates raises net wages received. Again, more work effort will be supplied. Therefore, tax cuts increase the demand for, and the supply of, factors of production. In dynamic formulations, as tax rates fall, output growth increases and vice versa.

Under a flat rate tax, average tax rates will remain approximately constant for a given level of income or output. However, the rewards for incremental work by labor, the employment of additional capital, and the more efficient combination of the two will all be higher with the flat tax. As a result, more employment, output and production is expected. Economic growth rates will accelerate until these effects are fully incorporated into the workings of the economy.

There is an important caveat. Maryland is on an unsustainable spending path.

A Fiscal Agenda Placing Maryland on a sustainable spending path requires a review of the state's spending priorities. By definition, responsible budgeting requires trade-offs. Responsible households adjust their daily expenditures (perhaps eating at fewer restaurants) to meet the family's longer-term goals (perhaps taking a desired vacation or saving for the kids college education). The same is true for state budgeting.

The Maryland Office of Policy Analysis has stated that Maryland's long-term revenues were insufficient to meet long-term expenditure plans—a structural deficit problem.²⁸ The Governor's plan, which was implemented by the state, assumed that the structural deficit problem was that planned expenditures exceeded expected revenues because revenues are insufficient. Just as families all across Maryland are now tightening their belts, realizing they cannot continue to afford all the expenditures they may wish, the problem with the state of Maryland is that expenditures are excessive.

The per capita expenditures for the average state, as well as for several of Maryland's key neighbors, provide evidence that Maryland can reduce overall expenditures and still deliver the necessary state services. Figure 19 compares the per

TABLE 8 PER CAPITA SAVINGS IN MARYLAND IF SPENDING IS REDUCED TO AVERAGE U.S. STATE SPENDING LEVEL OR MARYLAND'S LOW SPENDING NEIGHBORS

	AVERAGE U.S. STATE	PENNSYLVANIA	VIRGINIA
HEALTH	-\$135.97	-\$169.40	-\$203.08
CORRECTION	-\$69.29	-\$85.90	-\$32.32
HIGHWAYS	-\$50.77	----	-\$36.87
GOVERNMENT ADMINISTRATION	-\$44.47	-\$20.15	-\$67.65
POLICE PROTECTION	-\$28.38	-\$15.82	----
PARKS AND RECREATION	-\$8.90	-\$9.40	-\$11.87
NATURAL RESOURCES	-\$5.50	-\$25.94	-\$45.10

capita expenditures in Maryland to the per capita expenditures in the average state and Maryland's neighbors. Figure 19 illustrates that while Maryland's per capita expenditures are significantly below high-spending New Jersey (the state with the 17th highest per capita expenditures) and Delaware (the state with the 2nd highest per capita expenditures), it spends more on a per capita basis than the average U.S. state as well as neighboring Virginia and Pennsylvania.

There are several specific budget areas where Maryland spends significantly more than the average U.S. state, as well as Pennsylvania and Virginia. Table 8 details those areas by documenting the per capita savings Maryland could achieve if the per capita spending level in Maryland were reduced to these lower levels.

Reducing Maryland's per capita expenditure level requires budget prioritization: while some choices may be easier than others, there are no easy choices. But, it is not unreasonable to expect Maryland to run its state government operations (government administration) as efficiently as neighboring Virginia—which faces similar geographic, social, and demographic realities. Similarly, during difficult budget and economic times it is not unreasonable to expect the parks and recreations and natural resources services to either increase their efficiencies, or consider doing less with less. Just increasing the per capita spending efficiency of these three program areas (government administration, parks and recreations, and natural resources) saves Maryland nearly \$700 million in annual expenditures.

Overall, if Maryland adjusted its state expenditures to match the per capita expenditure level in the average U.S. state or in lower-spending neighbors Pennsylvania and Virginia, then Maryland could accrue significant budgetary savings. If

Maryland reduced its spending level to the average states per capita expenditures, the state would save \$461.3 million. Matching the expenditure levels of its low-spending neighbors could save Maryland between \$624.1 million (Pennsylvania) and \$2.4 billion (Virginia).

CONCLUSION

Tax policy matters because Maryland must compete with other states for tomorrow's growth industries. Economists in general acknowledge that reduced tax rates and a competitive economic landscape improve economic incentives, thereby creating long-run benefits to a state. However, they tend to underestimate how quickly the economy responds to the economic incentives. Ignoring the incentive effects is perilous and leads to incorrect forecasts.

Economic growth that follows the implementation of pro-growth economic landscapes often exceeds the most optimistic projections due to the dynamic impacts they generate. The longer a pro-growth economic landscape is in place, the greater these gains and the more prosperous a state's economy becomes. During prosperous times, when economic growth is greater, there is the added benefit of falling demand for government social spending programs (e.g., unemployment and welfare) that further benefits a state's budget.

Maryland's tax system has become significantly less pro-growth, however, jeopardizing the state's relative prosperity. Maryland's lack of competitiveness is also evident compared to its neighbors—and Maryland does not live in a very competitive neighborhood. For instance, Maryland imposes a larger overall tax burden and more punitive tax rate on personal and corporate income than most of its neighbors. The pro-growth environment in neighbors such as Virginia, let alone in some of

the most competitive states in the country such as Texas and Nevada, significantly compromises Maryland's growth prospects.

As the review of Maryland's tax policies shows, there are many areas for improvement. Ideally, Maryland should impose a flat rate tax—which can be either based on consumption or income—that will increase the pro-growth environment in the state. If a flat rate tax were implemented, then overall economic growth in Maryland will accelerate, personal income for residents of Maryland will increase, and growth in the total number of jobs created in the state will increase. Short of implementing a comprehensive pro-growth tax reform, repealing the recently enacted state tax increases is a good start toward improving Maryland's economic competitiveness.

The recent surge in government spending is the primary obstacle blocking Maryland's ability to improve its overall economic competitive-

ness. This growth trend is a troubling sign if it is not reversed through sound fiscal reform. Implementing successful tax reform depends upon reining in the recent acceleration in the growth of government in Maryland. Bringing Maryland's spending commitments, on a per capita basis, in line with just the average state per capita expenditures provides significant savings to the state. Implementing an expenditure cap on this level can help solidify these gains, providing a fertile environment to improve Maryland's economic landscape.

Implementing both the spending and tax reforms represents a significant opportunity for Maryland to break from its past and address the current weaknesses in Maryland's tax system. Such reforms will make Maryland significantly more competitive than all of its neighbors and ensure Maryland's relative economic prosperity will endure.

DONNA ARDUIN, *President, Arduin, Laffer & Moore Econometrics, served as California Governor Arnold Schwarzenegger's Director of Finance from November 2003 until October 2004; Governor Jeb Bush's Director of the Florida Office of Policy and Budget from 1999 – 2003; Governor George Pataki's First Deputy Budget Director throughout his first term; and, Governor John Engler's Chief Deputy Director of the Michigan Department of Management and Budget for three years during his first term. Ms. Arduin's Governors have consistently received high marks on the Cato Institute's fiscal report cards during her tenure with their administrations. A graduate of Duke University, Arduin graduated magna cum laude with honors in economics and public policy. She worked as an analyst in New York and Tokyo in the private financial markets for Morgan Stanley and Long-Term Credit Bank of Japan.*

WAYNE H. WINEGARDEN, PH.D., *Partner, Arduin, Laffer & Moore Econometrics, is responsible for analyzing and writing the firm's industry-based policy studies. Previously, Dr. Winegarden worked as an economist for Altria Companies Inc. in Hong Kong and New York City; was a Senior Analyst/Earhart Fellow for Citizens for a Sound Economy; and an Economics Instructor at Marymount University and George Mason University. Dr. Winegarden is currently a columnist for Townhall.com, and is interviewed and quoted in such media as Bloomberg Radio and CNN/jn. Dr. Winegarden received his B.A., M.A. and Ph.D. in Economics from George Mason University.*

1. Henry George, *Progress and Poverty*, 1879.
2. *Ibid.*
3. (Princeton: Princeton University Press, 1993), pp. 102, 113, 130, 137.
4. Kennedy, John F., "Annual message to the Congress: The Economic Report of the President," January 21, 1963.
5. Kennedy, John F., "Special Message to the Congress on Tax Reduction and Reform," January 24, 1963.
6. Walter Heller, "Testimony before the Joint Economic Committee, U.S. Congress, 1977," quoted in Bruce Bartlett, *The National Review*, October 27, 1978. [p. # available?]
7. According to the Case-Shiller Home Price Index, property values in the Washington, D.C. Metropolitan Statistical Area (MSA) are down 21.4 percent compared to the peak, which is larger than the average decline of 18.8 percent.
8. Bureau of Economic Analysis, <http://www.bea.gov/regional/gsp>.
9. Bureau of Economic Analysis, <http://www.bea.gov/regional/spi/>.
10. Bureau of Economic Analysis, <http://www.bea.gov/regional/sqip/>.
11. Bureau of Labor Statistics, www.bls.gov/sae/
12. Average spending growth is the compound annual growth rate. The average growth rate for 1981 is the compound annual growth rate between 1977 and 1981; for 1982, the average growth rate is the compound annual growth rate between 1978 and 1982, and so on.
13. When comparing state expenditures across states, U.S. Census data, which adjusts state data to ensure comparability across the states, is used, www.census.gov/govs/www/index.html.
14. U.S. Census data: www.census.gov/govs/www/index.html
15. Government expenditure data is from the U.S. Census: www.census.gov/govs/www/index.html; and real per capita personal income is from the U.S. Bureau of Economic Analysis: www.bea.gov/regional/spi/
16. State spending is total state expenditures as reported in successive fiscal digests of Maryland: <http://dbm.maryland.gov> [exact link please].
17. See "Maryland's Fiscal Structure and the Deficit Within: Presentation to the Senate Budget and Taxation Committee, House Committee on Appropriations, and House Committee on Ways and Means," Department of Legislative Services, Office of Policy Analysis, June 27, 2007; and "Budget Brief: Maryland's Budget to Increase 10 Percent," Maryland Budget and Tax Policy Institute, April 7, 2006.
18. See Brian White, "'Md. comptroller says revenue \$73.5 million below forecast in 2008, 'more bad news' on way," Associated Press, August 29, 2008; and Peter Franchot, "Letter to Governor Martin O'Malley," State of Maryland Board of Revenue Estimates, September 9, 2008.
19. Tax Foundation, <http://www.taxfoundation.org/taxdata/>.
20. *Ibid.*
21. The average local tax rate weights each locality's tax rate by the population of the locality yielding an average tax rate that is weighted by the number of people in the state subject to a certain local income tax rate.
22. Average after tax corporate profits is based on data from 1998 – 2007; see the Bureau of Economic Analysis, www.bea.gov. After-tax corporate profits are annual after-tax corporate profits: Table 6.1.D.; and total income is based on Gross Domestic Product: Table 1.1.5
23. Human capital, often the most important input to production, is impacted by the tax burden on labor; not the tax burden on capital as it is defined here.
24. "Permanent Repeal of the Death Tax," National Federation of Independent Businesses: Talking Points, www.nfib.com.
25. "The Economics of the Estate Tax," Joint Economic Committee, December 1998.
26. Richard Wagner, "Federal Transfer Taxation: A Study in Social Cost," The Center for the Study of Taxation, 1993 .
27. Tom Petska, Michael Parisi, Kelly Luttrell, Lucy Davitian, and Matt Scoffice, "An Analysis of Business Organizational Structure and Activity from Tax Data," IRS SOI, 2005. <http://www.irs.gov/pub/irs-soi/05petska.pdf>
28. Office of Policy Analysis, "Maryland's Fiscal Structure and the Deficit Within," Department of Legislative Services, June 27, 2007.

ABOUT THE MARYLAND PUBLIC POLICY INSTITUTE

Founded in 2001, the Maryland Public Policy Institute is a nonpartisan public policy research and education organization that focuses on state policy issues. Our goal is to provide accurate and timely research analysis of Maryland policy issues and market these findings to key primary audiences.

The mission of the Maryland Public Policy Institute is to formulate and promote public policies at all levels of government based on principles of free enterprise, limited government, and civil society.

In order to maintain objectivity and independence, the Institute accepts no government funding and does not perform contract research. The Maryland Public Policy Institute is recognized as a 501 (C) (3) research and education organization under the Internal Revenue Code.

The Maryland Public Policy Institute

One Research Court | Suite 450 | Rockville, MD 20850 | mdpolicy.org