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Exempting Pass-through Income from Taxation Would Harm Maryland's Economy

Position Statement Opposing House Bill 1250
Given before the House Ways and Means Committee

Implementing a tax cut for one category of businesses would significantly reduce resources that Maryland relies on to fund education, roads, hospitals and other public assets that make the state an attractive place to work and live. At the same time, it won't provide financial relief to residents who truly need it. For these reasons, the Maryland Center on Economic Policy opposes House Bill 1250.

Contrary to claims that House Bill 1250 would benefit small businesses, the bill would provide a tax break for tens of thousands of wealthy individuals at the expense of the public services that are essential to a thriving economy. The proposed tax break would apply to individuals such as doctors, real estate brokers, or lawyers who operate their own practices or firms and who have annual incomes as high as $199,999.[1] The proposal would cost the state, at a minimum, $375 million over five years, according to estimates provided to the Maryland Economic Development and Business Climate Commission.[2]

This proposal is poorly targeted, misguided and untimely. Lawmakers are considering its passage at a time when Maryland needs more resources for schools, transportation, public safety and other priorities that would create a better foundation for future economic growth.

As currently constructed, HB 1250 would allow for approximately 75,000 business owners who have income in excess of $100,000 to take advantage of this tax break.[3] A tax cut that exempts some well-off business owners from having to pay their fair share would not create job growth in Maryland.

In order to boost the economy, a tax subsidy must target businesses that are likely to create jobs, and HB 1250 fails to do so. For one thing, a large share of pass-through entities aren't businesses in any economically meaningful sense or don't have significant job-creation potential. In many cases, these business structures are used to establish an individual as a self-employed contractor to a single firm with no intention to hire anyone else.

A study by the nonpartisan research staff of the U.S. Department of Treasury found that 88 percent of the owners of sole proprietorships and pass-through entities – which include partnerships, limited liability companies, business trusts, and S corporations – own businesses that spend less than $10,000 per year on payroll or contract labor.

Over the past three decades, the number of businesses choosing to structure themselves as pass-through entities has steadily increased. In 1980, pass-through entities accounted for 20.7 percent of U.S. business profits. By 2011, this figure rose to over half (54.2 percent) of business profits, according to a recent study by academic and U.S. Treasury Department economists.[4] Today, more than 90 percent of U.S. businesses are structured as pass-through entities, according to the Tax Policy Center.[5]

Maryland also now receives more income tax payments from pass-through entities (about $1.1 billion in 2014) than from corporations, because of the large number of businesses structured this way. It is clear that reducing the tax liability for the more than 91 percent of those businesses that qualify for this tax break would take away much-needed resources that support state services—amounting to a reduction of $75 million per year.[2]

Maryland should learn from the experiences of Ohio and Kansas and other states, which have had to reduce essential state services after lowering or eliminating taxes for certain categories of businesses. Such actions won't drive job creation in Maryland and could actually set the state's economy back if we have to cut services such as schools, transportation and public safety,[6] which support a healthy, thriving economy.

Taxes are among several factors that influence economic development in a state. The range of services that a state provides to businesses — including education and training for workers and infrastructure vital to a good transportation network — is also important. So is the overall quality of life in the state.

Tax cuts accompanied by service cuts are unlikely to improve the economy and could become a drag on growth. Maryland cannot afford to cut taxes without cutting services, therefore lawmakers should focus on making larger public investments in schools, transportation, and safe communities, which are at the heart of what makes Maryland a good place to live and do business.

For these reasons, the Maryland Center on Economic Policy respectfully requests that the House Ways and Means Committee give a favorable report to House Bill 1250.

Endnotes:

1 The Department of Legislative Services. House Bill 1250. 2016. http://mgaleg.maryland.gov/2016RS/bills/hb/hb1250F.pdf

2 The Department of Legislative Services. Report of the Maryland Economic Development and Business Climate Commission. Phase 2: Taxes. January 2016. http://mgaleg.maryland.gov/Pubs/CommTFWorkgrp/2016-MEDBCC-Report-Phase-II.pdf

3 The Comptroller of Maryland. Personal Income Tax Statistics, Tax Year 2012.December 2014. http://finances.marylandtaxes.com/static_files/revenue/statisticsofincome/individual/2012_Personal_SOI.pdf

4 Cooper, Michael, et al. National Bureau of Economic Research. Business in the United States: Who Owns it and How Much Tax Do They Pay. October 2015. http://conference.nber.org/confer/2015/TPE15/Cooper_McClelland_Pearce_Prisinzano_Sullivan_Yagan_Zwick_Zidar.pdf

5 Rosenberg, Joseph. Tax Policy Center. Flow-Through Business Income as a Share of AGI. September 2014. http://www.taxpolicycenter.org/UploadedPDF/1001750-flow-through-business-income.pdf

6 Maryland Center on Economic Policy. Cutting Business Taxes Won't Help Maryland's Economy. 2015 http://www.mdeconomy.org/cutting-business-taxes-wont-help-marylands-economy/