THE CASE FOR HIGHLY GRADUATED RATES IN
STATE INCOME TAXES

ROBERT I. KELLER*

INTRODUCTION

There exists today in the United States a major but rarely men-
tioned indirect program of general revenue sharing¹ between the federal
government and the state and local governments. This program, which
should not be confused with the program of direct general revenue
sharing enacted by the State and Local Fiscal Assistance Act of 1972,² is
administered by the United States Treasury Department. The
amount of federal tax receipts disbursed under the program to any
given state or local government is, however, entirely within the control
of the state or local government itself. This is because the amount dis-
tributed is determined solely by two factors: (1) the total amount of
tax revenue that the state or local government can collect; and, (2) the
federal marginal tax brackets of the taxpayers from whom such
revenue is collected.³

* Associate Professor of Law, University of Maryland. B.S., 1963, University
of Pennsylvania; LL.B., 1966, Harvard University.

1. The concept of revenue sharing has been described as:
[a strategy under which] . . . a portion of federal tax receipts are disbursed by
means of a predetermined formula to state and local governments, with few
strings attached. Washington's role is that of collecting taxes and distributing
the receipts to lower levels of government; it is not involved in designing, ad-
ministering, or regulating the specific public services on which the money is
spent. . . .

Two types of revenue sharing may be encompassed by this strategy: general
revenue sharing, under which the recipient units of government are free to use
their grants as they see fit, and special revenue sharing, or block grants, under
which the recipients must spend their grants on programs in a broad functional
area, such as education or urban development.

E. FRIED, A. RIVLIN, C. SCHULTZE & N. TEETERS, SETTING NATIONAL PRIORITIES


3. The funds allocated to state and local governments under the State and Local
Fiscal Assistance Act of 1972 are disbursed using a multiple factor approach:
The money is first allocated among the states. Each state as an area is allotted
the amount available to it under either the original Senate version or the original
House version of the general revenue sharing plan, whichever is greater. Under
the Senate's distribution formula the revenue is divided among the states according
to their total populations, relative incomes, and tax efforts (that is, the ratio of
total taxes collected to personal income); the House version of the formula
includes, in addition, urbanized population and state income tax collections. One-
The program is identified in the Tax Expenditure Budget of the United States as the "deductibility of nonbusiness State and local taxes (other than on owner-occupied homes and gasoline)," and is listed in that budget under the appropriate heading: "[r]evenue sharing and general purpose fiscal assistance." The estimated cost to the federal

third of each state's allotment is given to the state government to use as it sees fit. The remaining two-thirds is divided among the county areas of the state on the basis of each county's population, tax effort, and relative income. E. FRIED, A. RIVLIN, C. SCHULTZE & N. TEETERS, supra note 1, at 279-80 (emphasis added).

For purposes of this article, it is important to note that the House formula relies in part on "state income tax collections." If, as suggested herein, a state moves to an increased reliance on the income tax as a source of revenue, that state will effectively be increasing its share of both the indirect revenue sharing grants under the federal tax system and the direct revenue sharing grants under the State and Local Fiscal Assistance Act of 1972.

4. OFFICE OF MANAGEMENT AND BUDGET, SPECIAL ANALYSES, BUDGET OF THE UNITED STATES GOVERNMENT FISCAL YEAR 1976, at 101-17 (1975) [hereinafter cited as SPECIAL ANALYSES].

The phrase "tax expenditures" was first used in a 1967 speech by Professor Stanley S. Surrey, then Assistant Secretary for Tax Policy in the Treasury Department.

The speech pointed out that those provisions of the federal income tax containing special exemptions, exclusions, deductions, and other tax benefits were really methods of providing governmental financial assistance. These special provisions were not part of the structure required for the income tax itself, but were instead Government expenditures made through the tax system. They were similar in purpose, therefore, to the direct expenditures listed in the regular budget. But since they provided their assistance through the route of tax reduction rather than direct aid, . . . [they were called] "tax expenditures."

S. SURREY, PATHWAYS TO TAX REFORM vii (1973). The "Tax Expenditure Budget" identifies and quantifies the existing tax expenditures. The Congressional Budget and Impoundment Control Act of 1974, 31 U.S.C. §§ 1301-53 (Supp. IV, 1974), requires that a listing of tax expenditures be included in the regular budget document of the United States. Section 3(a)(3) of the act defines "tax expenditures" as "those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provides a special credit, a preferential rate of tax, or a deferral of tax liability." 1 S. SURREY, W. WARREN, P. McDaniel & H. AULT, FEDERAL INCOME TAXATION CASES AND MATERIALS 113 n.6d (Supp. 1975).

5. SPECIAL ANALYSES, supra note 4, at 109. The SPECIAL ANALYSES further explains this item as follows:

The deductibility of nonbusiness State and local taxes provides indirect assistance to these governments. The deductibility of property taxes on owner-occupied homes and excise taxes on gasoline are classified elsewhere. The estimates . . . are primarily for the deductibility of State and local income and sales taxes.

Id. at 114.

6. Id. at 109. The Tax Expenditure Budget also lists under this heading: "Exclusion of interest on State and local debt," and "Exclusion of income earned in U.S. possessions." Id.
government of this revenue sharing program for the fiscal year 1976 is $9.95 billion.\textsuperscript{7}

The nature of the general revenue sharing program brought about by the deductibility of nonbusiness state and local taxes is easily observed. When, for example, a state imposes a $100 tax on a person in the 50 percent federal income tax bracket, only $50 of the $100 tax is actually borne by the taxpayer; the remainder is borne by the federal government. Mechanically, of course, the taxpayer remits the full $100 to the state, but in so doing he is, to the extent of $50, acting as a mere conduit to pay federal dollars into the state treasury. By deducting the $100 state tax on his federal income tax return, the state taxpayer reduces his federal income taxes by $50, and is thus reimbursed to that extent by the federal government. \textit{In effect, then, the state has imposed a “net tax burden” of $50 on the 50 percent bracket taxpayer, and has received a federal matching grant of $50.}

In direct expenditure terms,\textsuperscript{9} the assistance furnished by the federal government to state and local governments through the itemized de-

\textsuperscript{7} \textit{Id.} The equivalent figures for the years 1968, 1971, and 1974 were $2.8 billion, $5.6 billion, and $6.96 billion, respectively. 1 S. Surrey, W. Warren, P. McDaniel & H. Ault, Federal Income Taxation Cases and Materials 244 (1972); Special Analyses, supra note 4, at 109. By comparison, the direct program of general revenue sharing established by the State and Local Fiscal Assistance Act of 1972 will have distributed about $30.2 billion to state and local governments between January, 1972, and December, 1976, when the program is scheduled for termination. This amounts to annual disbursements of slightly over $6 billion. 2 National Science Foundation Research Applied to National Needs, General Revenue Sharing; Research Utilization Project 1 (1975).

\textsuperscript{8} The term “net tax burden” or “net state tax burden” will be used throughout this article to mean that figure arrived at by deducting from the amount of taxes actually remitted by a taxpayer to a state or local government, the amount of federal tax savings achieved by deducting such state and local tax payments at the taxpayer’s marginal federal income tax bracket.

\textsuperscript{9} Every tax expenditure program can be translated into direct expenditure terms and analyzed as if it were a direct expenditure program. See generally S. Surrey, Pathways to Tax Reform (1973). The analysis in the text views the deductibility of nonbusiness state and local taxes as a system of indirect revenue sharing grants from the federal government to state and local governments. However, the direct expenditure program brought about by the federal deductibility of state and local taxes can also be analyzed from the vantage point of the aid it gives to individual taxpayers. Viewed in this manner, the direct assistance program to state and local taxpayers would appear as follows:

1. If a married couple had more than $200,000 of taxable income, the federal government would, for each $100 of state and local taxes imposed on the couple, pay $70 to the state or local government, leaving the couple to pay $30;

2. If a married couple had $10,000 of taxable income, the federal government would, for each $100 of state and local taxes imposed on the couple, pay $22 to the state or local government, leaving the couple to pay $78; or;

3. If a married couple were too poor to pay any income tax, the federal government would pay no part of any tax imposed on the couple by the state and local government.
duction for nonbusiness state and local taxes can be seen as a program of matching grants from the federal government to the state and local governments distributed on the following terms:

1. If a state or local government imposes a $30 net tax burden on a person in the 70 percent federal tax bracket, the federal government pays the state or local government a matching sum of $70;\textsuperscript{10}

2. If a state or local government imposes a $30 net tax burden on a person in the 50 percent federal tax bracket, the federal government pays the state or local government a matching sum of $30;\textsuperscript{11}

3. If a state or local government imposes a $30 net tax burden on a person in the 14 percent federal tax bracket, the federal government pays the state or local government a matching sum of approximately $5;\textsuperscript{12}

4. If a state or local government imposes a $30 net tax burden on a person who is either a nontaxpayer for federal income tax purposes, or who, although a taxpayer, elects the federal optional standard deduction, the federal government pays nothing to the state or local government.\textsuperscript{13}

No attempt will be made here to discuss the propriety, from a federal viewpoint, of using the deduction mechanism to provide aid to state and local governments.\textsuperscript{14} Rather, the purpose of this article is

\textsuperscript{10} To achieve the same result indirectly through the tax system, a state imposes a $100 tax on the 70 percent bracket taxpayer. The taxpayer initially remits the full $100 to the state, but is reimbursed for $70 of his cost by a $70 reduction in his federal income taxes.

\textsuperscript{11} To achieve the same result indirectly through the tax system, a state imposes a $60 tax on the 50 percent bracket taxpayer. The taxpayer initially remits the full $60 to the state, but is reimbursed for $30 of his cost by a $30 reduction in his federal income taxes.

\textsuperscript{12} To achieve the same result indirectly through the tax system, a state imposes a tax of approximately $35 on the 14 percent bracket taxpayer. The taxpayer initially remits the full $35 to the state, but is reimbursed for approximately $5 of his cost by a $5 reduction in his federal income taxes.

\textsuperscript{13} The standard deduction is itself a tax expenditure item. See note 4 supra. The imposition of an additional state tax burden on the user of a standard deduction, however, neither increases federal tax expenditures nor decreases the taxpayer's federal income tax liability (unless the additional state or local tax paid gives the taxpayer itemized deductions in excess of the maximum standard deduction). Therefore, the additional $30 tax imposed by a state or local government on a taxpayer electing the optional standard deduction is paid entirely out of the pocket of that taxpayer, and the federal government makes no additional contribution to the state or local government.

\textsuperscript{14} There have been numerous proposals offered either to substitute a federal credit for the current deduction for state and local income taxes, or to buttress the deduction with such a credit. E.g., W. Heller, Deductions and Credits for State
to show how a state, through the use of an income tax with highly
graduated rates, can best take advantage of the open-ended revenue
sharing possibilities inherent in the federal deductibility of state and
local taxes, while at the same time creating for itself a tax system

INCOME TAXES, TAX REVISION COMPENDIUM 1 HOUSE COMM. ON WAYS & MEANS,
86th CONG., 1st Sess., 419 (Comm. Print 1959); ADVISORY COMMISSION ON INTER-
gOVERNMENTAL RELATIONS, II JOINT ECONOMIC COMM. 90th CONG., 1st Sess.,
REVENUE SHARING AND ITS ALTERNATIVES: WHAT FUTURE FOR FISCAL FEDERALISM
1137-40 (Comm. Print 1967) [hereinafter referred to as 1965 ACIR]; G. BREAK,
INTERGOVERNMENTAL FISCAL RELATIONS IN THE UNITED STATES 39-45 (1967); H.R.
8193, 92nd CONG., 1st Sess. (1971) and accompanying explanation at 117 CONG. REC.
14197 (1971) (remarks of Representative Byrne). A federal tax credit for state and
local income taxes (whether enacted as a substitute for, or in addition to the current
deduction) would provide a reduction in federal taxes to taxpayers who now use the
federal optional standard deduction or low-income allowance and who, therefore,
obtain no advantage from the existing personal deduction.

However, if a fixed percentage credit (e.g., 30 percent of the state and local
taxes paid) were substituted for the current deduction for state and local income
taxes, high bracket taxpayers would find their net state tax burden increased. It
would, therefore, be politically more difficult for a state to move to highly graduated
rates. See text accompanying notes 52-54 infra. Moreover, because a fixed credit
would not have the same regressive effect on net state tax burdens as does the present
deduction system (i.e., all taxpayers would have their nominal tax burdens reduced by
the same percentage credit), there would be less need for a highly graduated state
income tax to insure an equitable distribution of the state tax burden. See notes
33-46 and accompanying text infra. Finally, under a fixed credit system, the imposition
of a given amount of state tax on a high bracket taxpayer would bring forth
no greater federal revenue sharing to the state than would the imposition of the
same tax on a lower bracket taxpayer. This effect would also undermine a major
argument in favor of highly graduated state income taxes. See notes 27-32 and
accompanying text infra.

Other commentators have favored eliminating the deduction for all state
taxes, including the income tax, and substituting direct federal subsidies. See, e.g.,
H. BRAZER, THE DEDUCTIBILITY OF STATE AND LOCAL TAXES UNDER THE INDIVIDUAL
INCOME TAX, 1 HOUSE COMM. ON WAYS AND MEANS, 86th CONG., 1st Sess., TAX
REVISION COMPENDIUM 407 (Comm. Print 1959). Professor Brazer criticizes the federal deductibility of nonbusiness state and local taxes as being inequitable to in-
dividual taxpayers, and irrational and inefficient as a mechanism for providing aid
to state and local governments. "If Federal subsidies are desirable they should be
direct, subject to the scrutiny provided by the operation of the budgetary process, and
specifically tailored to meet the objectives being sought." Id. at 418.

15. Note that the reference in the text is to a state's use of an income tax
with highly graduated rates. This article does not advocate the proliferation of in-
dependent income taxes at local levels. Rather the proposal contained herein for
the use of highly graduated rates is intended to fall within the broader recommendations
of the Advisory Commission on Intergovernmental Relations that the taxation of
personal income be either by the state or, if also by local governments, "in the form
of a supplement ("piggyback") to be administered with the State tax." 1965 ACIR,
supra note 14, at 1153 (emphasis in original). For an excellent work fully analyzing
both the positive and the negative aspects of local income taxes, see R. SMITH, LOCAL
INCOME TAXES: ECONOMIC EFFECTS AND EQUITY (1972). As of 1972 Maryland was
the only state in which local income taxes were levied as supplements to the state
tax. Id. at 14-15.
which more equitably distributes the tax burden among its citizens and which is more responsive to economic growth and inflation. The State of Maryland, whose existing personal income tax structure is very mildly graduated, will be used as a model. 16 The discussion, however, is equally relevant to any state that does not raise a major portion of its revenue through an income tax with highly graduated rates. 17

THE CURRENT MARYLAND PERSONAL INCOME TAX STRUCTURE

The current Maryland personal income tax structure taxes the first $1,000 of taxable income at a rate of 2 percent, the second $1,000 at 3 percent, the third $1,000 at 4 percent and all taxable income in excess of $3,000 at 5 percent. 18 In addition, Baltimore City and nearly all of the counties of Maryland impose a local income tax (normally referred to as the local piggyback tax) at a rate of 50 percent of that of the state. 19 Therefore, the combined state and local rates in Mary-

16. For a similar analysis using Massachusetts as a model, see Moscovitch, State Graduated Income Taxes — A State-Initiated Form of Federal Revenue Sharing, 25 Nat’l Tax J. 53 (1972) [hereinafter cited as MOSCOVITZ]. Minnesota was used as a model in W. HELLER, supra note 14.

17. The only states today that have income taxes with highly graduated rate structures (defined somewhat arbitrarily here as those with maximum marginal rates of 10 percent or more and with marginal brackets that graduate up to at least $30,000 of taxable income) are: Alaska (14.5 percent on taxable income over $400,000); Delaware (19.8 percent on taxable income over $100,000); Hawaii (11 percent on taxable income over $30,000); Iowa (13 percent on taxable income over $75,000); Montana (11 percent on taxable income over $35,000); Rhode Island (17 percent of federal income tax liability which is equivalent to 11.9 percent on taxable income over $200,000); Vermont (25 percent of federal income tax liability which is equivalent to 17.5 percent of taxable income over $200,000). Jurisdictions whose highest marginal rate of tax is ten percent or more but whose highest bracket is under $30,000 include California (11 percent on taxable income over $15,500); Minnesota (15 percent on taxable income over $20,000); New York (15 percent on taxable income over $25,000); North Dakota (10 percent on taxable income over $8,000); Oregon (10 percent on taxable income over $5,000); Wisconsin (11.4 percent on taxable income over $14,000); and the District of Columbia (10 percent on taxable income over $25,000). Colorado’s tax is only 8 percent of taxable income over $10,000, but there is a 2 percent surtax on intangible income over $5,000. New Jersey has no broad-based income tax of its own, but imposes a tax on New York commuters equal to the New York income tax. 1 CCH STATE TAX GUIDE 1531–34 (1975). A bill has recently been introduced in California (S.B. No. 540) (1975) to increase the marginal rates in its personal income tax to 23 percent on taxable income over $127,500.


19. Md. Ann. Code art. 81, § 283(a) (1975) authorizes each county and Baltimore City to impose a local income tax upon its residents equal to a percentage (to a maximum of 50 percent) of such residents’ state income tax liability. See note 15 supra.
land graduate from 3 percent on the first $1,000 of taxable income to 7.5 percent on all taxable income in excess of $3,000.\footnote{20}

Maryland adjusted gross income is essentially the same concept as "adjusted gross income" under the federal income tax.\footnote{21} To arrive at Maryland taxable income, taxpayers\footnote{22} deduct from adjusted gross income personal and dependency exemptions and either itemized personal deductions or a standard deduction. Maryland grants a deduction of $800 for each personal and dependency exemption, and allows a standard deduction (which must be used if the optional standard deduction is elected for federal purposes) of 10 percent of

\footnote{20. A State Tax Reform Study Committee of the Maryland General Assembly has recently recommended further graduating the income tax rates so that the highest marginal tax rate would be 8 percent (12 percent including the 50 percent local piggyback tax) on all taxable income in excess of $40,000. \textit{State Tax Reform Study Committee, 1975 Report of the State Tax Reform Study Committee 14-15} [February 1976] [hereinafter cited as 1975 Report].

A recent report of the Maryland Commission on the Functions of Government clearly recognizes Maryland's need for additional revenues and concludes that "such additional revenue should be generated through a restructured state income tax and/or the state retail sales tax." \textit{II Report of the Maryland Commission on the Functions of Government 13} (1975) [hereinafter referred to as the \textit{Searby Report}]. The Commission recommended that if the personal income tax is to be used to raise the additional revenues, the tax should be made "meaningfully progressive." \textit{Id.} at 19, and it set forth five possible new rate schedules for the personal income tax, the highest of which had marginal rates (including the piggyback tax) graduating up to 18 percent. \textit{Id.} at 10.


22. Unlike the federal income tax, Maryland's income tax currently has only one rate schedule in effect for both single and married taxpayers. A Maryland husband and wife who file jointly for federal tax purposes, however, have the option of filing either a joint or a separate return in Maryland. The latter is known in Maryland as a combined-separate return. \textit{Md. Ann. Code} art. 81, \$ 280(d) (1975). The combined-separate filing status will be advantageous to married taxpayers so long as each spouse has separate income in excess of $800 (the Maryland personal exemption). By filing a combined-separate return, each spouse takes advantage of the lower brackets applicable to his or her first $3,000 of taxable income, and each is entitled to a separate standard deduction of 10 percent of adjusted gross income up to a maximum of $500. The State Tax Reform Study Committee has estimated that permitting married persons to elect the combined-separate filing option results in a loss of state revenue of approximately $14.5 million annually (a loss of combined state-local revenue of approximately $21.75 million annually). \textit{1975 Report, supra} note 20, at 10. The Committee has recommended the elimination of the combined-separate filing status. \textit{Id.} at 21. For simplicity, all computations of Maryland tax in this paper, whether under the existing or the proposed rates, have been made as if the combined-separate filing status did not exist. It has been assumed that there is but one rate schedule applicable to all taxpayers, married or single, and that married taxpayers must file jointly. \textit{See Tables 1-4 infra}.}
Maryland adjusted gross income, up to a maximum deduction of $500.\textsuperscript{23} Itemized deductions for Maryland purposes are essentially the same as for federal purposes, except that no deduction for state income taxes paid is permitted on the Maryland return.\textsuperscript{24}

This paper compares the current Maryland personal income tax system with a proposed system identical to it in all respects except that the proposed system substitutes the following highly graduated rate schedule for the existing one:\textsuperscript{25}

\begin{tabular}{|c|c|}
\hline
\textit{Maryland Taxable Income} & \textit{The Combined state and local tax is:} \\
\hline
$0 to $999 & 1.5\% of the taxable income \\
$1,000 to $1,999 & $15 plus 3\% of excess over $1,000 \\
$2,000 to $3,999 & $45 plus 4.5\% of excess over $2,000 \\
$4,000 to $7,999 & $135 plus 6\% of excess over $4,000 \\
$8,000 to $11,999 & $375 plus 7.5\% of excess over $8,000 \\
$12,000 to $15,999 & $675 plus 9\% of excess over $12,000 \\
$16,000 to $19,999 & $1,035 plus 10.5\% of excess over $16,000 \\
$20,000 to $23,999 & $1,455 plus 12\% of excess over $20,000 \\
$24,000 to $27,999 & $1,935 plus 13.5\% of excess over $24,000 \\
$28,000 to $31,999 & $2,475 plus 15\% of excess over $28,000 \\
$32,000 to $39,999 & $3,075 plus 16.5\% of excess over $32,000 \\
$40,000 to $49,999 & $4,395 plus 18\% of excess over $40,000 \\
$50,000 to $99,999 & $6,195 plus 19.5\% of excess over $50,000 \\
$100,000 and over & $15,495 plus 21\% of excess over $100,000 \\
\hline
\end{tabular}

There is nothing sacrosanct about the particular rate schedule chosen. It was selected because it would have raised virtually the same amount of revenue for Maryland in 1973 (the last year for which an accurate statistical breakdown on individual income tax returns filed in Maryland was available) that the existing personal income tax actually raised in that year.\textsuperscript{26}

\begin{itemize}
\item 23. The Maryland personal income tax has no provision that is equivalent to the federal low income allowance, Int. Rev. Code of 1954, § 141(c). The Maryland Tax Reform Study Committee has recommended that Maryland's percentage standard deduction be increased to 10 percent of adjusted gross income up to a maximum deduction of $1,500, with a minimum deduction of $500. 1975 Report, supra note 20, at 16-17.
\item 24. There are other minor differences between allowable federal and allowable Maryland itemized deductions. Md. Ann. Code art. 81, § 281 (1975).
\item 25. The proposed rate schedule would be applicable to all single and married Maryland taxpayers. See note 22 supra.
\item 26. See Table 1, Columns 2 and 6 infra.
\end{itemize}
Graduated Rates and State-Initiated Revenue Sharing or How to Reduce Taxes Without Reducing Revenues

The first advantage of highly graduated state income tax rates is that such rates enable a state to shift a substantial part of the burden of financing state governmental operations from state taxpayers onto the federal government. The mechanics by which this shift of burdens takes place is best illustrated by assuming a situation in which a state wants to keep its revenue constant, but desires to shift tax burdens from low to higher income taxpayers in order to make its tax system more equitable. To accomplish this result, the state decides to amend its personal income tax in a manner that would decrease the tax revenue collected from taxpayers electing the standard deduction (for federal and state purposes) by a total of $100X (e.g., by increasing the allowable standard deduction), but would increase the tax revenue collected from taxpayers in the federal 70 percent tax bracket by the same $100X (e.g., by increasing the marginal state rates at that income level). The results of this shift in tax burdens for the state, state taxpayers, and the federal government are as follows:

1. The state's revenue from its personal income tax remains the same. The $100X that the state previously collected from the taxpayers using the standard deduction is now collected from the 70 percent bracket taxpayers.

2. The taxpayers using the standard deduction are relieved of a net state tax burden in the amount of $100X.

3. The 70 percent bracket taxpayers have their net state tax burden increased by $30X (i.e., the $100X paid to the state less the $70X saved by the federal deduction).

4. The federal government, in effect, makes an additional contribution to the state treasury of $70X (i.e., the $70X value of the federal deduction to the 70 percent bracket taxpayers).

The state is, thus, receiving $70X from the federal government that it formerly collected from state taxpayers. It is this ability of a state, by its own fiscal policies, to bring about additional federal grants, and thus shift tax burdens from state taxpayers onto the federal government.

27. This term was first used by Moscovitch, supra note 15.

28. It is not being suggested here that an increased standard deduction could realistically be funded by increasing taxes on the few state taxpayers in the highest 70 percent federal tax bracket. Rather, the shift in tax burdens from users of the standard deduction to 70 percent bracket taxpayers is being assumed in order to simply illustrate the concept referred to herein as "state-initiated revenue sharing."
government, which has been referred to as "state-initiated revenue sharing." It is a politician's dream: reduced taxes without reduced revenues — that is, a reduction of the total tax burden borne by the taxpayers of the state, without a reduction in the revenue received by the state.

Table 1 illustrates "state-initiated revenue sharing" on a larger scale. It shows the additional federal grants that Maryland could have initiated had it shifted, in 1973, from its existing rate schedule to the proposed highly graduated one. While both rate schedules would have raised virtually the same revenue for Maryland in 1973, the proposed highly graduated rate schedule would have done so at a significantly lower cost to Maryland taxpayers. More specifically, Maryland taxpayers with adjusted gross income (AGI) under $30,000 would, as a class, have been relieved of a net state tax burden of approximately $100 million. $50 million of that burden would have been shifted to Maryland taxpayers with AGI above $30,000, while the remaining $50

29. Moscovitch explained "state-initiated revenue sharing" in the following terms: [A] graduated tax allows the state to shift a large part of the tax burden onto the Federal Government. Since all major state and local taxes are deductible for Federal income-tax purposes, the Federal Government in effect bears part of the burden of state taxes. By shifting state taxes onto those taxpayers in the highest Federal tax brackets, the adoption of graduated rates increases the total amount of Federal tax savings, and thereby reduces the total burden of a state income-tax. In effect, adoption of graduated rates offers an opportunity for the state to participate in a form of state-initiated revenue-sharing. Moscovitch, supra note 16, at 53.

30. In the calendar year 1973, Maryland actually recorded revenue from the state tax of $532,288,403 and from the local tax of $265,232,224, for a total of $797,520,627. State of Maryland, Comptroller of the Treasury, Income Tax Division, Summary Report, Individual Income Tax Returns Filed for the Year 1973, at 9 (1975). The difference between that figure and the $822,372,000 shown in Table 1 is explained mainly by the fact that the latter figure was computed on the assumption that married taxpayers could not file a combined-separate return. See note 22 supra. In addition, the revenue figure in Table 1, unlike the actual revenue figure, is not reduced for foreign state and personal property tax credits. Md. Ann. Code art. 81, §§ 290 (Supp. 1975) & 291 (1975).

31. Table 1 adopts the adjusted gross income classifications used by the Maryland Income Tax Division in its annual report on individual income tax returns. State of Maryland, Comptroller of the Treasury, Income Tax Division, Summary Report, Individual Income Tax Returns Filed for the Year 1973 (1975). While taxpayers with AGI between $20,000 and $30,000 will, as a class, find their state tax burdens decreased under the proposed rates, many taxpayers within that class will find their taxes increased. A taxpayer with taxable income of $18,500 will pay the same state tax under either the proposed or the existing rate schedule. Consequently, in terms of AGI, the breakeven point for a family of four with itemized deductions (other than the state and local income tax) equal to 16 percent of AGI is approximately $26,000. The breakeven point for a family of four (in which only one spouse has income) that elects the optional standard deduction is $22,000.
Table 1
PROPORTION OF MARYLAND INCOME TAX(i) OFFSET BY DEDUCTIBILITY UNDER FEDERAL INCOME TAX—
EXISTING AND PROPOSED RATES (AS OF 1973)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) $ 0 to $ 999</td>
<td>(2) $ 42</td>
<td>(3) ---</td>
<td>(4) ---</td>
<td>(5) $ 42</td>
<td>(6) $ 21</td>
</tr>
<tr>
<td>(6)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$ 1,000 to $ 1,999</td>
<td>$ 294</td>
<td>---</td>
<td>---</td>
<td>$ 294</td>
<td>147</td>
</tr>
<tr>
<td>$ 2,000 to $ 2,999</td>
<td>$ 3,290</td>
<td>---</td>
<td>---</td>
<td>$ 3,290</td>
<td>1,832</td>
</tr>
<tr>
<td>$ 3,000 to $ 3,999</td>
<td>$ 5,508</td>
<td>---</td>
<td>---</td>
<td>$ 5,508</td>
<td>3,296</td>
</tr>
<tr>
<td>$ 4,000 to $ 4,999</td>
<td>$ 8,799</td>
<td>---</td>
<td>---</td>
<td>$ 8,799</td>
<td>5,708</td>
</tr>
<tr>
<td>$ 5,000 to $ 5,999</td>
<td>$ 12,221</td>
<td>---</td>
<td>---</td>
<td>$ 12,221</td>
<td>8,028</td>
</tr>
<tr>
<td>$ 6,000 to $ 6,999</td>
<td>$ 16,475</td>
<td>---</td>
<td>---</td>
<td>$ 16,475</td>
<td>10,665</td>
</tr>
<tr>
<td>$ 7,000 to $ 7,999</td>
<td>$ 19,745</td>
<td>---</td>
<td>---</td>
<td>$ 19,745</td>
<td>13,142</td>
</tr>
<tr>
<td>$ 8,000 to $ 8,999</td>
<td>$ 22,831</td>
<td>---</td>
<td>---</td>
<td>$ 22,831</td>
<td>15,971</td>
</tr>
<tr>
<td>$ 9,000 to $ 9,999</td>
<td>$ 25,130</td>
<td>---</td>
<td>---</td>
<td>$ 25,130</td>
<td>17,927</td>
</tr>
<tr>
<td>$ 10,000 to $ 14,999</td>
<td>$ 156,616</td>
<td>---</td>
<td>---</td>
<td>$ 156,616</td>
<td>117,011</td>
</tr>
<tr>
<td>$ 15,000 to $ 19,999</td>
<td>$ 159,039</td>
<td>---</td>
<td>---</td>
<td>$ 159,039</td>
<td>133,337</td>
</tr>
<tr>
<td>$ 20,000 to $ 29,999</td>
<td>$ 197,238</td>
<td>---</td>
<td>---</td>
<td>$ 197,238</td>
<td>193,518</td>
</tr>
<tr>
<td>$ 30,000 to $ 39,999</td>
<td>$ 81,746</td>
<td>---</td>
<td>---</td>
<td>$ 81,746</td>
<td>98,168</td>
</tr>
<tr>
<td>$ 40,000 to $ 49,999</td>
<td>$ 34,243</td>
<td>---</td>
<td>---</td>
<td>$ 34,243</td>
<td>49,037</td>
</tr>
<tr>
<td>$ 50,000 to $ 74,999</td>
<td>$ 35,242</td>
<td>---</td>
<td>---</td>
<td>$ 35,242</td>
<td>59,952</td>
</tr>
<tr>
<td>$ 75,000 to $ 99,999</td>
<td>$ 15,416</td>
<td>---</td>
<td>---</td>
<td>$ 15,416</td>
<td>19,626</td>
</tr>
<tr>
<td>$ 100,000 to $ 149,999</td>
<td>$ 12,551</td>
<td>---</td>
<td>---</td>
<td>$ 12,551</td>
<td>26,997</td>
</tr>
<tr>
<td>$ 150,000 to $ 199,999</td>
<td>$ 5,173</td>
<td>---</td>
<td>---</td>
<td>$ 5,173</td>
<td>12,167</td>
</tr>
<tr>
<td>$ 200,000 and over</td>
<td>$ 10,211</td>
<td>---</td>
<td>---</td>
<td>$ 10,211</td>
<td>18,471</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>$ 822,372</strong></td>
<td><strong>$ 174,582</strong></td>
<td><strong>$ 647,790</strong></td>
<td><strong>$ 824,007</strong></td>
<td><strong>$ 222,267</strong></td>
</tr>
</tbody>
</table>

(i) All references in this table to the Maryland income tax or the state income tax include the 50 percent local piggyback tax.

(iii) Assumes combined separate filing status unavailable for married taxpayers; no reduction is made for foreign State and personal property tax credits.

Computation: (a) The average adjusted gross income for the returns in each adjusted gross income class were computed. (b) Taxpayers in each adjusted gross income class were divided between single and married taxpayers, and were further divided between itemizers and standard deductors; all taxpayers with adjusted gross income above $50,000 were assumed to itemize their personal deductions, and all taxpayers with adjusted gross income below $50,000 were assumed to elect the optional standard deduction or low-income allowance. (c) The gross federal income tax for all persons in each class was computed assuming no deductibility for the State income tax. The gross federal income tax for all persons in each class was then recomputed assuming that itemizing taxpayers in the group deducted the State income tax. The difference between these latter two computations represents the figures shown in Column 3 & 6. In making this computation the possible effects of the federal maximum tax on earned income have been ignored.

million would have been effectively shifted from Maryland taxpayers onto the federal government\textsuperscript{32} (Table 1, Column 7 minus Column 3).

**Equity of Highly Graduated Rates in State Income Taxes**

Just as it is the federal deductibility of state and local taxes that makes possible the state-initiated revenue sharing described above, so too is it the federal deductibility that makes the use of highly graduated rates in state income taxes essential from an equity viewpoint. Traditionally, taxes or tax systems have been classified as progressive, proportional or regressive depending on whether they take from high-income persons a larger percentage of their income, the same percentage of their income, or a smaller percentage of their income than they take from low-income persons.\textsuperscript{33} However, before these three classifications can be used to describe accurately the true impact of state and local taxes, they must be redefined to mean progressive, proportional or regressive after taking into account the federal deductibility of the state and local taxes. Using that definition, state and local taxes which are regressive on their face\textsuperscript{34} become more regressive in their actual

\textsuperscript{32} In Table 1, the amount of state tax estimated to be offset by deductibility under the federal tax was computed without taking into account the possible effects of the federal 50 percent maximum rate on earned income. INT. REV. CODE OF 1954, § 1348. In fact, the effects of section 1348 would be minimal. If, for example, one-third of the state tax deducted by taxpayers with AGI above $50,000 were deducted from a federal marginal 50 percent bracket — rather than the higher brackets indicated in Table 1 — the results would be as follows:

1. Under existing rates, the state taxes offset by federal deductibility would decrease from $174,582 to $172,604; and,

2. Under the proposed rates, the state taxes offset by federal deductibility would decrease from $222,267 to $218,271.

The assumption that one-third of the state tax deducted by taxpayers with AGI above $50,000 would be deducted against the maximum 50 percent federal bracket probably overstates the actual impact of section 1348. See Appendix infra.

\textsuperscript{33} While academicians continue their never-ending debate about the theoretical justification for progressive taxes, politicians and the general public have long accepted them, at least in principal, as more equitable than taxes that are either proportional or regressive. The classic work on the subject is W. BLUM & H. KALVEN, JR., THE UNEASY CASE FOR PROGRESSIVE TAXATION (1953); see also C. GALVIN & B. BITTKE, THE INCOME TAX: HOW PROGRESSIVE SHOULD IT BE? (1969).

\textsuperscript{34} Because low income people spend a greater fraction of their income than do high income persons, a tax on consumer purchases is on its face inherently regressive. While exemption of food makes the sales tax basically proportional, such an exemption results in a substantial loss of revenue. A number of states have, therefore, enacted legislation to permit sales tax credits against the income tax in order to lessen the regressivity without significantly reducing revenue. ADVISORY COMMISSION ON INTER-GOVERNMENTAL RELATIONS, FEDERAL-STATE-LOCAL FINANCES: SIGNIFICANT FEATURES OF FISCAL FEDERALISM 3 (1973–74 ed. 1974) [hereinafter referred to as 1973–74 ACIR]. For a description of state and local sales taxes now in effect see id. at 238–51.
impact; state and local taxes which are proportional on their face become effectively regressive in their impact; and state and local taxes which are mildly progressive on their face become effectively proportional and regressive over a wide range of income. It is only the state income tax with rates highly graduated over a wide range of income that avoids having its upper income end relentlessly bent into regressive form by the effects of federal deductibility.\textsuperscript{85}

Consider, for example, the impact on state taxpayers of a state income tax which imposes a flat rate of 5 percent of AGI, and makes no allowance for personal exemptions or personal deductions. In appearance, that tax imposes a proportional 5 percent burden on the income of all state taxpayers. That appearance, however, is entirely deceptive. In fact, it is only the state taxpayer who elects the federal optional standard deduction or low-income allowance who actually bears the full nominal 5 percent rate. All others (\textit{i.e.}, itemizers) receive federal help in paying their state tax, and the amount of federal help they receive increases as their federal marginal income tax bracket increases. That is, of course, the way it is with all deductions. A $100 deduction saves a 70 percent bracket taxpayer $70, a 50 percent bracket taxpayer $50, and a 14 percent bracket taxpayer only $14. So, for example, the taxpayer in the 50 percent marginal federal tax bracket will initially remit the full 5 percent tax to the state, but he will then deduct that state tax paid on his federal income tax return, and thus be reimbursed by the federal government for 50 percent of the state tax. The state taxpayer will effectively bear only a 2.5 percent tax himself.

After federal deductibility, then, the nominal 5 percent proportional tax is actually borne by state taxpayers in the following manner:

1. 5 percent by taxpayers using the standard deduction;
2. 4.3 percent by itemizers in the 14 percent federal marginal tax bracket;
3. 3.4 percent by itemizers in the 32 percent federal marginal tax bracket;
4. 2.5 percent by itemizers in the 50 percent federal marginal tax bracket; and

\textsuperscript{85} See W. Heller, \textit{supra} note 14, at 422. Three states (Nebraska, Rhode Island, and Vermont) insure effective progressivity throughout the income scale by making their state income taxes a flat percentage of a taxpayer's federal income tax liability. From an administrative viewpoint this approach is the simplest for both the taxpayer and the tax administering agency. Most states, however, have been unwilling to effectively relinquish control of their income tax systems to the federal government in this way. For an analysis of the "percent of federal tax" approach see Moscovitch, \textit{supra} note 16, at 60–64.
5. 1.5 percent by itemizers in the 70 percent federal marginal tax bracket.

What on its face appeared to be a proportional tax is actually borne by state taxpayers in an entirely regressive fashion, with the richest paying 1.5 percent of their income, and the poorest paying 5 percent.

Unlike the tax just considered, the Maryland personal income tax is not on its face, proportional; rather, it has rates (including the local piggyback tax) which graduate from 3 percent on the first $1,000 of taxable income to 7.5 percent on all taxable income over $3,000. Maryland's income tax, therefore, appears mildly progressive at all income levels; but again the appearance is deceptive. Part I of Table 2 illustrates the actual (after federal deductibility) impact of the existing Maryland personal income tax on a hypothetical family of four at various income levels. Each family is assumed (for both state and federal income tax purposes) to have itemized deductions (not including the state income tax paid) equal to 16 percent of AGI. 36 Table 2 (Part I, Column 6) indicates that, despite the regressive effect federal deductibility has on net state tax burdens, the current Maryland personal income tax remains very slightly progressive for itemizing taxpayers up to $25,000 of AGI. At that level of income, the average itemizing family of four is bearing a net state tax burden equal to 3.6 percent of its AGI; however, federal deductibility thereafter bends the state tax into entirely regressive form. For example, the family with $50,000 of AGI bears a net state tax burden of 3.1 percent of its AGI, the family with $100,000 a net state tax burden of 2.5 percent of its AGI, and the family with $500,000 a net state tax burden equal to a miniscule 1.9 percent of its AGI. 37

By reducing the tax burden on itemizing families with AGI of $25,000 and below, and increasing the burden on families with AGI above that level, 38 the proposed rate schedule makes the Maryland personal income tax effectively (after federal deductibility) progressive for itemizing families of four up to an AGI level of $100,000 (Table 2,

36. Table 2 assumes that the federal 50 percent maximum rate on earned income, INT. REV. CODE OF 1954, § 1348, is not applicable to the hypothetical taxpayers. To the extent that the 50 percent maximum rate on earned income applies to the taxpayer with $100,000, $200,000 or $500,000 of AGI, that taxpayer's effective (i.e., after federal deductibility) state tax burden will increase somewhat, because he will then be deducting part of his state tax from a 50 percent marginal tax bracket rather than the higher marginal tax bracket set forth in the applicable federal rate schedule. See Appendix infra.

37. See note 36 supra.

38. The actual breakeven point for a family of four with itemized deductions (other than the state and local income tax) equal to 16 percent of AGI is approximately $26,000. See note 31 supra.
Table 2
THE ESTIMATED BURDEN OF THE EXISTING AND PROPOSED MARYLAND PERSONAL INCOME TAX FOR A HYPOTHETICAL FAMILY OF FOUR AT VARIOUS INCOME LEVELS

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
<td>(5)</td>
<td>(6)</td>
<td></td>
</tr>
<tr>
<td>$ 5,000</td>
<td>$30</td>
<td>.6</td>
<td>15%</td>
<td>$26</td>
<td>.5</td>
<td></td>
</tr>
<tr>
<td>10,000</td>
<td>$300</td>
<td>3.0</td>
<td>19%</td>
<td>243</td>
<td>2.4</td>
<td></td>
</tr>
<tr>
<td>15,000</td>
<td>615</td>
<td>4.1</td>
<td>22%</td>
<td>480</td>
<td>3.2</td>
<td></td>
</tr>
<tr>
<td>20,000</td>
<td>930</td>
<td>4.7</td>
<td>25%</td>
<td>698</td>
<td>3.5</td>
<td></td>
</tr>
<tr>
<td>25,000</td>
<td>1,245</td>
<td>5.0</td>
<td>28%</td>
<td>896</td>
<td>3.6</td>
<td></td>
</tr>
<tr>
<td>30,000</td>
<td>1,560</td>
<td>5.2</td>
<td>32%</td>
<td>1,061</td>
<td>3.3</td>
<td></td>
</tr>
<tr>
<td>50,000</td>
<td>2,820</td>
<td>5.6</td>
<td>45%</td>
<td>1,551</td>
<td>3.1</td>
<td></td>
</tr>
<tr>
<td>100,000</td>
<td>5,970</td>
<td>6.0</td>
<td>55-58%</td>
<td>2,537</td>
<td>2.5</td>
<td></td>
</tr>
<tr>
<td>200,000</td>
<td>12,270</td>
<td>6.1</td>
<td>66-68%</td>
<td>4,072</td>
<td>2.0</td>
<td></td>
</tr>
<tr>
<td>500,000</td>
<td>31,170</td>
<td>6.2</td>
<td>70%</td>
<td>9,351</td>
<td>1.9</td>
<td></td>
</tr>
</tbody>
</table>

**PART I (EXISTING RATES)**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 5,000</td>
<td>$15</td>
<td>.3</td>
<td>15%</td>
<td>$13</td>
<td>.3</td>
<td></td>
</tr>
<tr>
<td>10,000</td>
<td>207</td>
<td>2.1</td>
<td>19%</td>
<td>168</td>
<td>1.7</td>
<td></td>
</tr>
<tr>
<td>15,000</td>
<td>480</td>
<td>3.2</td>
<td>22%</td>
<td>374</td>
<td>2.5</td>
<td></td>
</tr>
<tr>
<td>20,000</td>
<td>819</td>
<td>4.1</td>
<td>25%</td>
<td>614</td>
<td>3.1</td>
<td></td>
</tr>
<tr>
<td>25,000</td>
<td>1,224</td>
<td>4.9</td>
<td>28%</td>
<td>881</td>
<td>3.5</td>
<td></td>
</tr>
<tr>
<td>30,000</td>
<td>1,695</td>
<td>5.7</td>
<td>32%</td>
<td>1,153</td>
<td>3.8</td>
<td></td>
</tr>
<tr>
<td>50,000</td>
<td>4,197</td>
<td>8.4</td>
<td>42-45%</td>
<td>2,344</td>
<td>4.7</td>
<td></td>
</tr>
<tr>
<td>100,000</td>
<td>12,201</td>
<td>12.2</td>
<td>55-58%</td>
<td>5,340</td>
<td>5.3</td>
<td></td>
</tr>
<tr>
<td>200,000</td>
<td>29,103</td>
<td>14.6</td>
<td>64-66-68%</td>
<td>9,877</td>
<td>4.9</td>
<td></td>
</tr>
<tr>
<td>500,000</td>
<td>82,023</td>
<td>16.4</td>
<td>70%</td>
<td>24,607</td>
<td>4.9</td>
<td></td>
</tr>
</tbody>
</table>

**PART II (PROPOSED RATES)**

**Note:** In computing both the state tax paid (which includes the 50% local piggyback tax), and the federal marginal tax brackets from which the state tax was to be deducted, it was assumed (i) that all taxpayers had itemized deductions of 16% of adjusted gross income without taking into account the state tax paid; (ii) that all income was earned by one spouse; (iii) that the federal 50% maximum tax on earned income was inapplicable; and (iv) that all income was includible income and all itemized deductions (other than the state income tax) were allowable deductions for both federal and state tax purposes.
Part II, Column 6). Between $100,000 and $200,000 of AGI the
net state tax burden again dips slightly: at the level of income, the
nominal state rates have stopped graduating while the federal rates
continue to graduate.39

In terms of equity, however, things are really worse in Maryland
than Table 2 indicates. Table 2 deals only with taxpayers who itemize
their personal deductions, and tells nothing of the plight of the majority
of low- and middle-income taxpayers who elect either the federal op-
tional percentage standard deduction or low-income allowance.40 These
taxpayers are doubly disadvantaged in Maryland: first, they receive no
federal help in paying their state tax; and second, they are entitled to
no low-income allowance, and a percentage standard deduction of only
10 percent of AGI up to a maximum deduction of $500.41 The combi-
nation of these effects leads to dramatic and perverse differences
between the tax burdens borne in Maryland by high-income itemizers
and those borne by low- and middle-income taxpayers electing the
optional percentage standard deduction or low income allowance.
Column 3 of Table 3 (Part I) reveals, for example, that under the
existing Maryland personal income tax, a family of four with $20,000
of adjusted gross income that elects the federal optional standard
deduction bears an effective state tax burden (5.7 percent) that is
3 times that borne by a family with $500,000 of adjusted gross income
(1.9 percent).42 The family with $15,000 of adjusted gross income
that elects the federal optional standard deduction bears an effective
state tax burden (5.1 percent) that is 2.7 times as great as that borne
by the $500,000 income family.43 The proposed rates, while reducing
taxes on all low- and middle-income taxpayers, still leave taxpayers
using the optional standard deduction or low income allowance in a most
disadvantaged position (see Table 3, Part II, Columns 2 and 3).44

39. For the possible effects of the 50 percent federal maximum rate on earned
income, Int. Rev. Code of 1954, § 1348, on the overall progressivity of the existing
and proposed Maryland personal income tax see Appendix infra.

40. For 1975, the federal optional standard deduction is an amount equal to sixteen
percent of an individual taxpayer's adjusted gross income. The maximum deduction
amounts are $2,300 for a single taxpayer, $2,600 for a married taxpayer filing jointly,
and $4,300 for a married taxpayer filing separately. The federal low income allow-
ance during 1975 is $1,600 for a single taxpayer, $1,900 for a married taxpayer
filing jointly, and $950 for a married taxpayer filing separately.

41. See note 23 supra.

42. See note 36 supra.

43. Id.

44. As noted in the text, the high state tax burden borne by Maryland taxpayers
who use the standard deduction is attributable both to their inability to subtract state
income taxes paid in computing their federal income tax and to the very low standard
deduction allowed in Maryland. To alleviate this discrimination, Maryland might
consider the adoption of a highly graduated rate schedule which, by increasing the
Table 3
THE ESTIMATED BURDEN OF THE EXISTING AND PROPOSED MARYLAND INCOME TAX FOR A HYPOTHETICAL FAMILY OF FOUR AT VARIOUS INCOME LEVELS: FAMILIES WITH AGI OF $20,000 OR LESS ASSUMED TO ELECT OPTIONAL STANDARD DEDUCTION OR LOW-INCOME ALLOWANCE FOR FEDERAL INCOME TAX PURPOSES

<table>
<thead>
<tr>
<th>Adjusted Gross Income</th>
<th>Net State Tax Burden After Federal Deductibility</th>
<th>Net State Tax Burden as Percentage of Adjusted Gross Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>5,000</td>
<td>$ 43</td>
<td>.9</td>
</tr>
<tr>
<td>10,000</td>
<td>383</td>
<td>3.8</td>
</tr>
<tr>
<td>15,000</td>
<td>758</td>
<td>5.1</td>
</tr>
<tr>
<td>20,000</td>
<td>1,133</td>
<td>5.7</td>
</tr>
<tr>
<td>25,000</td>
<td>896</td>
<td>3.6</td>
</tr>
<tr>
<td>30,000</td>
<td>1,061</td>
<td>3.5</td>
</tr>
<tr>
<td>50,000</td>
<td>1,551</td>
<td>3.1</td>
</tr>
<tr>
<td>100,000</td>
<td>2,537</td>
<td>2.5</td>
</tr>
<tr>
<td>200,000</td>
<td>4,072</td>
<td>2.0</td>
</tr>
<tr>
<td>500,000</td>
<td>9,351</td>
<td>1.9</td>
</tr>
</tbody>
</table>

**PART I (EXISTING RATES)**

<table>
<thead>
<tr>
<th>Adjusted Gross Income</th>
<th>Net State Tax Burden After Federal Deductibility</th>
<th>Net State Tax Burden as Percentage of Adjusted Gross Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>5,000</td>
<td>$ 24</td>
<td>.5</td>
</tr>
<tr>
<td>10,000</td>
<td>273</td>
<td>2.7</td>
</tr>
<tr>
<td>15,000</td>
<td>623</td>
<td>4.2</td>
</tr>
<tr>
<td>20,000</td>
<td>1,067</td>
<td>5.3</td>
</tr>
<tr>
<td>25,000</td>
<td>881</td>
<td>3.5</td>
</tr>
<tr>
<td>30,000</td>
<td>1,153</td>
<td>3.8</td>
</tr>
<tr>
<td>50,000</td>
<td>2,344</td>
<td>4.7</td>
</tr>
<tr>
<td>100,000</td>
<td>5,340</td>
<td>5.3</td>
</tr>
<tr>
<td>200,000</td>
<td>9,877</td>
<td>4.9</td>
</tr>
<tr>
<td>500,000</td>
<td>24,607</td>
<td>4.9</td>
</tr>
</tbody>
</table>

**PART II (PROPOSED RATES)**

Note: For taxpayers with AGI of $25,000 and over, Columns 2 and 3 of this Table are identical to Columns 5 and 6 of Table 2. In this Table, however, all taxpayers with AGI of $20,000 or less are assumed to elect the optional standard deduction or low income allowance for federal income tax purposes, and are therefore required to use the optional standard deduction for Maryland income tax purposes as well.
From the perspective of equity, the case for highly graduated rates is, thus, quite formidable. The adoption by Maryland of the proposed rate schedule will provide significant tax relief to most low-and middle-income state taxpayers, without unduly burdening the state's more wealthy. The nominally very high marginal rates that the proposed rate schedule imposes on the state's high-income taxpayers will, in the end, be borne in large part by the federal government. Part II of Table 2 indicates that under the highly graduated proposed rates, no Maryland taxpayer would bear a net state tax burden (after federal deductibility) much higher than 5 percent of his AGI.

ECONOMIC RESPONSIVENESS OF HIGHLY GRADUATED RATES

State and local governments are faced today with an ever increasing need for tax revenue. If this need is to be met without

tax rates for itemizing Maryland taxpayers with AGI below $25,000, gives less relief than does the proposed rate schedule to taxpayers in those brackets, (see Table 3 supra), but which, by increasing the optional standard deduction and introducing a low income allowance, directs more relief to low and middle income taxpayers who do not itemize their personal deductions. See note 23 supra. For purposes of clarity in illustrating the effects of a highly graduated state tax rate, this article assumes no change was made in the allowable Maryland standard deduction.

45. With marginal federal tax brackets that graduate up to 70 percent on unearned income, and state rates that graduate up to 21 percent, it might appear that a high bracket taxpayer's last dollar of income is being taxed at an almost confiscatory combined federal-state rate. But, of course, the combined federal-state rate is not nearly as high as it would first appear. When a 21 percent marginal state rate is added to a 70 percent marginal federal rate, the combined marginal rate is 76.3 percent and not 91 percent. The 21 percent state tax is deducted from the federal marginal 70 percent tax bracket, resulting in a net tax increase caused by the state tax of only 6.3 percent.

46. To the extent that the federal maximum 50 percent rate on earned income, INT. REV. CODE of 1954, § 1348, applies to a high bracket taxpayer, his net state tax burden would rise above 5 percent, see Appendix infra. His net combined federal-state tax, however, will decrease.

47. The future needs of the State of Maryland for additional revenue were discussed in the SHERBOW REPORT:

Even in times of economic stability and growth, the financing of governmental operations through the existing system of taxation in Maryland has been criticized by the tax paying public. Inflation and the increasing complexity of economic, social, environmental, energy, and other problems will cause the costs of government in the years ahead to increase. To provide essentially the same service today at levels comparable to a year ago requires a higher cash outlay; in a period of moderate economic growth, the increase in the tax base fills this gap, but a recession in the midst of inflation dictates either a reduction in services or an increase in tax rates or new sources of revenues.

SHERBOW REPORT, supra note 20, at 5.

While major increases in direct federal grants to the state and local governments might provide the needed additional revenue, there is no current expectation that any such increases will be forthcoming. In fact, there are even indications that
frequent increases in tax rates, a state must create a tax source which is capable of keeping up with economic growth and inflation. Only the highly graduated state income tax will adequately serve this function.\(^{48}\)

It does this because,

As personal income in a state rises, the average family moves to a higher income-tax bracket. Under a graduated tax, the per cent of its income a family pays in taxes also rises. With a given increase in personal income in a state, then, a graduated income tax will produce a bigger revenue increase than a flat tax. Thus, a state could meet its fiscal needs . . . with less frequent increases in tax rates.\(^{49}\)

The economic responsiveness of highly graduated rates is illustrated by Table 4. While the proposed highly graduated rates would have produced virtually the same revenue in 1973 as did the existing rates, Table 4 estimates that, by 1977, the proposed rates would be out-producing the existing rates by more than $120 million (Column 6 minus Column 2),\(^{50}\) and because of the effects of federal deductibility, the additional $120 million of state revenue would be paid for almost entirely by the federal government (Column 7 minus Column 3).\(^{51}\) This

---

President Ford’s proposal to extend the direct revenue sharing program (see note 3 supra) beyond its 1976 expiration date may be in trouble. Washington Post, Dec. 2, 1975, § A, at 2, col. 3. A recent study of the 1972 direct revenue sharing program indicates that without such increased federal grants, state and local governments will experience rapidly expanding revenue expenditure gaps during the remainder of the 1970’s even “if prices continue to rise at even moderate rates.” D. GREYTAK & B. JUMP, THE IMPACT OF INFLATION ON THE EXPENDITURES AND REVENUES OF SIX LOCAL GOVERNMENTS, 1971-1979, 2 GENERAL REVENUE SHARING-RESEARCH UTILIZATION PROJECT 49, 55 (1975).

48. In 1965, the Advisory Commission on Intergovernmental Relations concluded that:

The overriding fiscal need of State governments (including their local governments) is more tax revenue, particularly a tax source with a strong revenue growth potential in a growing economy. This immediately focuses attention on the personal income tax because, in a majority of the States, it is either the least effectively used major tax source or not used at all, and because it responds to economic growth more than any other tax.

1965 ACIR, supra note 14, at 1127. Almost ten years later the same group again recommended that “[t]he personal income tax should stand out as the single most important revenue instrument in the State tax system,” specifically noting the importance of the use of graduated rates in increasing “the responsiveness of income tax collections to economic growth.” 1973-74 ACIR, supra note 34, at 1, 3.

49. MOSCOWITZ, supra note 16, at 54.

50. The 1977 figures were estimated by computing the annual percentage increase/decrease in the number of Maryland taxpayers in each adjusted gross income class between 1971 and 1973, and assuming the same percentage changes continued annually from 1973-77.

51. In Table 4, as in Table 1, the amount of state tax estimated to be offset by deductibility under the federal tax was computed without taking into account the
## Table 4

PROPORTION OF MARYLAND INCOME TAX OFFSET BY DEDUCTIBILITY UNDER FEDERAL INCOME TAX — EXISTING AND PROPOSED RATES (AS OF 1977)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Column 2 minus Column 3</td>
<td>Column 5</td>
<td>Column 6 minus Column 8</td>
<td></td>
<td>Column 7</td>
<td>Column 9</td>
</tr>
<tr>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
<td>(5)</td>
<td>(6)</td>
<td>(7)</td>
</tr>
<tr>
<td>$ 0 to $ 999</td>
<td>$ 42</td>
<td>$ ...</td>
<td>$ 42</td>
<td>$ 21</td>
<td>$ ...</td>
<td>$ 21</td>
</tr>
<tr>
<td>$ 1,000 to $ 1,999</td>
<td>$ 48</td>
<td>$ ...</td>
<td>$ 48</td>
<td>$ 24</td>
<td>$ ...</td>
<td>$ 24</td>
</tr>
<tr>
<td>$ 2,000 to $ 2,999</td>
<td>$ 2,597</td>
<td>$ ...</td>
<td>$ 2,577</td>
<td>$ 1,435</td>
<td>$ ...</td>
<td>$ 1,435</td>
</tr>
<tr>
<td>$ 3,000 to $ 3,999</td>
<td>$ 5,246</td>
<td>$ ...</td>
<td>$ 5,246</td>
<td>$ 3,148</td>
<td>$ ...</td>
<td>$ 3,148</td>
</tr>
<tr>
<td>$ 4,000 to $ 4,999</td>
<td>$ 8,670</td>
<td>$ ...</td>
<td>$ 8,670</td>
<td>$ 5,624</td>
<td>$ ...</td>
<td>$ 5,624</td>
</tr>
<tr>
<td>$ 5,000 to $ 5,999</td>
<td>$ 11,121</td>
<td>$ 99</td>
<td>$ 11,022</td>
<td>$ 7,305</td>
<td>$ 63</td>
<td>$ .9</td>
</tr>
<tr>
<td>$ 6,000 to $ 6,999</td>
<td>$ 15,383</td>
<td>$ 211</td>
<td>$ 15,172</td>
<td>$ 9,958</td>
<td>$ 146</td>
<td>$ 1.5</td>
</tr>
<tr>
<td>$ 7,000 to $ 7,999</td>
<td>$ 17,531</td>
<td>$ 438</td>
<td>$ 17,093</td>
<td>$ 11,908</td>
<td>$ 313</td>
<td>$ 2.6</td>
</tr>
<tr>
<td>$ 8,000 to $ 8,999</td>
<td>$ 19,905</td>
<td>$ 838</td>
<td>$ 19,067</td>
<td>$ 13,924</td>
<td>$ 606</td>
<td>$ 4.4</td>
</tr>
<tr>
<td>$ 9,000 to $ 9,999</td>
<td>$ 20,955</td>
<td>$ 1,056</td>
<td>$ 19,899</td>
<td>$ 14,949</td>
<td>$ 755</td>
<td>$ 5.1</td>
</tr>
<tr>
<td>$ 10,000 to $ 14,999</td>
<td>$ 164,462</td>
<td>$ 12,844</td>
<td>$ 151,618</td>
<td>$ 122,873</td>
<td>$ 9,358</td>
<td>$ 7.6</td>
</tr>
<tr>
<td>$ 15,000 to $ 19,999</td>
<td>$ 248,467</td>
<td>$ 36,525</td>
<td>$ 211,942</td>
<td>$ 208,312</td>
<td>$ 30,120</td>
<td>$ 14.5</td>
</tr>
<tr>
<td>$ 20,000 to $ 29,999</td>
<td>$ 455,127</td>
<td>$ 108,684</td>
<td>$ 346,443</td>
<td>$ 446,543</td>
<td>$ 106,152</td>
<td>$ 23.8</td>
</tr>
<tr>
<td>$ 30,000 to $ 39,999</td>
<td>$ 226,297</td>
<td>$ 82,041</td>
<td>$ 144,256</td>
<td>$ 271,758</td>
<td>$ 98,518</td>
<td>$ 36.3</td>
</tr>
<tr>
<td>$ 40,000 to $ 49,999</td>
<td>$ 88,483</td>
<td>$ 37,400</td>
<td>$ 51,083</td>
<td>$ 126,047</td>
<td>$ 53,165</td>
<td>$ 42.2</td>
</tr>
<tr>
<td>$ 50,000 to $ 74,999</td>
<td>$ 73,254</td>
<td>$ 37,082</td>
<td>$ 36,226</td>
<td>$ 123,279</td>
<td>$ 62,183</td>
<td>$ 50.4</td>
</tr>
<tr>
<td>$ 75,000 to $ 99,999</td>
<td>$ 35,944</td>
<td>$ 20,066</td>
<td>$ 15,878</td>
<td>$ 70,941</td>
<td>$ 39,460</td>
<td>$ 55.6</td>
</tr>
<tr>
<td>$100,000 to $149,999</td>
<td>$ 25,033</td>
<td>$ 14,901</td>
<td>$ 10,132</td>
<td>$ 53,846</td>
<td>$ 31,994</td>
<td>$ 59.4</td>
</tr>
<tr>
<td>$150,000 to $199,999</td>
<td>$ 11,642</td>
<td>$ 7,667</td>
<td>$ 3,975</td>
<td>$ 27,382</td>
<td>$ 17,885</td>
<td>$ 65.3</td>
</tr>
<tr>
<td>$200,000 and over...</td>
<td>$ 19,754</td>
<td>$ 13,828</td>
<td>$ 5,926</td>
<td>$ 51,048</td>
<td>$ 35,734</td>
<td>$ 70.0</td>
</tr>
</tbody>
</table>

**Totals**: $1,449,941 $373,626 25.8 $1,076,315 $1,570,304 $486,452 31.0 $1,083,852

**Note**: The 1977 figures were estimated by computing the average percentage increase/decrease in the number of Maryland taxpayers in each adjusted gross income class between 1971 and 1973. The percentages so computed were then used to estimate the Maryland tax liability, and the federal tax savings resulting from deductibility for each adjusted gross income class for the year 1977. The estimated breakdown in each adjusted gross income class between single and married and standard deduction and itemizer was assumed to remain constant between 1973 and 1977. Since there have been increases in the allowable standard deduction since 1973, this assumption presumably understates the number of standard deductors in 1977. (See Table 2 for 1973 computations).
revenue gap between the proposed and existing rates would, of course, widen in each succeeding year.

The same additional $120 million revenue would, of course, be produced for the state in 1977 by the proposed rates were those rates first instituted in 1977, rather than in 1973 as hypothesized. There are political advantages, however, in the earlier move to highly graduated rates. In the present economy where high inflation steadily pushes up average personal incomes, the longer a state holds off adopting highly graduated rates, the more difficult doing so becomes politically. Each year more and more persons move into higher tax brackets and are therefore adversely affected by the same shift to a given graduated rate schedule. For example, in 1973, only about 7.5 percent of all Maryland taxpayers would have had their state taxes increased by the introduction of the proposed highly graduated rates. By 1977, however, it is estimated that approximately 16.5 percent of all Maryland taxpayers would find their state taxes increased by the introduction of these same rates.

**Problem of Interstate Tax Competition**

Given the striking advantages of a state's use of an income tax with highly graduated rates, it is difficult to understand why so few states today have such a tax. The answer presumably lies in the traditional fear among state and local politicians and voters of interstate tax competition. They believe, whether justifiably or not, that interstate possible effects of the federal 50 percent maximum rate on earned income. Int. Rev. Code of 1954, § 1348. See note 32 supra. If, for example, one-third of the state tax deducted by taxpayers with AGI above $50,000 were deducted from a federal marginal 50 percent bracket rather than the higher brackets indicated in Table 4, the results would be as follows: (1) Under existing rates, the state taxes offset by federal deductibility would decrease from $373,626 to $369,881; (2) Under the proposed rates, the state taxes offset by federal deductibility would decrease from $486,452 to $478,208. See Appendix infra.

52. Of course, it may be argued that responding to inflation by grading rates is unfair to taxpayers because, while inflation may bring about an increase in a taxpayer's nominal taxable income, it does not increase his ability to pay. Therefore, if higher rates are applied to the nominally higher taxable income, it will bring about an increased real tax burden on a fixed real income. For a response to this argument, see Beer & Walther, Inflation and the Progressivity of the Federal Individual Income Tax, 10 Cal. W.L. Rev. 537 (1974).

53. It was assumed that 29 percent of Maryland taxpayers in the AGI classification of $20-$30,000 had AGI above $25,000 and 71 percent had AGI below $25,000. This division was based on average U.S. figures. U.S. Department of Treasury, Statistics of Income — 1972 Individual Income Tax Returns 9, Table 1.2 (1973).

54. See notes 50 and 53 supra.

55. For general discussions of the problem of interstate tax competition, see O. Oldman & F. Schettel, State and Local Taxes and Finance, Text, Problems and Cases 100-04 (1974), Advisory Commission on Intergovernmental Relations,
tax differentials significantly affect taxpayers' decisions regarding place of residence and place of work. This fear is particularly great when the tax being considered is the highly visible state income tax. It has been alleged, for example, that personal income tax rate differentials for salary income not only encourage citizens from locating in a high income tax state, but also discourage business firms from doing the same "because of the difficulty of attracting executive talent to such States."56

Available evidence, while inconclusive, tends to indicate that interstate personal tax differentials play but a minor role in the decisions of citizens and businesses regarding residence and business location.57 Nevertheless, this factor cannot be ignored by those attempting to influence legislative decisions in the tax field:

[W]hether or not empirical studies can isolate tax influences on location, policy makers clearly fear the potential effects, and these effects are therefore a real factor in tax policy at the state and local level, even if their fear is not justified by the evidence. . . . It is of little use for students of public finance to dismiss this as nonrational behavior.58

Not only should students of public finance not ignore the fear that policy makers have of interstate tax competition, but they should affirmatively attempt to mitigate that fear.

First of all, potential reformers should explain to the policy makers that the federal deductibility of state and local taxes has a greatly moderating effect on interstate tax differentials.59 For if tax differentials do, in fact, affect any groups' decisions as to residence, it is probably only the decisions of high-income taxpayers, and they are the ones for whom the moderating effect of federal deductibility is most significant. Moreover, they are also the ones most likely to be aware of this moderating effect. The moderating effect of federal deductibility on interstate tax differentials can be observed by comparing the net state income tax burden under existing law of a family of four

---

56. BRIDGES, supra note 55, at 10 n.18.
57. One study suggests that even high income individuals are almost totally insensitive to local tax differentials. R. BARLOW, H. BRAZER & J. MORGAN, ECONOMIC BEHAVIOR OF THE AFFLUENT 169-70 (1966). See also OLDMAN & SCHOEFTLE, supra note 55; and BRIDGES, supra note 55.
59. For a discussion of the effects of the federal deductibility of state and local taxes on interstate tax differentials, see BRIDGES, supra note 55.
with $100,000 of AGI with that of a similarly situated family under the proposed highly graduated rates. While the taxes actually remitted by the family to the state will increase under the proposed rates by $6,231 (from $5,970 to $12,201), an increase of 6.2 percent of AGI, the family's net state tax burden (after federal deductibility) will increase by only $2,803 (from $2,537 to $5,340), an increase of only 2.8 percent of AGI (see Table 2). Secondly, potential reformers should emphasize to policy makers that, even if the imposition of high state income tax rates does lead to the exodus of some individuals (or even businesses) from their state, the revenues lost by such exodus will be easily recouped by the higher additional revenues raised by the higher rates.

Finally, state policy makers should not be allowed to lose sight of the consistent trend throughout the nation toward higher rates in state income taxes. The continuation of this trend — and there is no reason to believe that the trend will not continue — will inevitably result in their being no low-tax jurisdictions to which a high-income taxpayer can flee. Since 1967, income taxes have been introduced into five states that previously had no income tax (leaving only ten states without broad-based personal income taxes), and rates have been increased at least once in twenty-one other state income taxes. During 1975 alone there were across-the-board rate increases in state income taxes in four states, and moves in two others toward the imposition of new broad-based income taxes. Today, the highest marginal tax bracket equals or exceeds 10 percent in fourteen states. By comparison, in 1967, there were but seven states imposing taxes with marginal rates that high.

60. Since Maryland's neighboring state of Virginia has income tax rates similar to those now existing in Maryland, [Va. Code Ann. § 58-151.011 (1974)] this comparison will approximate the interstate tax differentials that would exist between Maryland and Virginia were Maryland to adopt the highly graduated proposed rates.
61. Illinois, Maine, Ohio, Pennsylvania and Rhode Island.
62. Connecticut, Florida, Nevada, New Hampshire, New Jersey, South Dakota, Tennessee, Texas, Washington and Wyoming. New Hampshire, Tennessee. New Jersey (as of 1973), and Connecticut tax capital gains and dividends. New Jersey also has a broad-based income tax applicable only to New York residents working in New Jersey. During 1975, efforts were made in New Jersey and South Dakota to initiate a broad-based income tax, but the efforts failed.
63. These figures were compiled by the author from CCH State Tax Guide, 1531-34 and Advisory Commission on Intergovernmental Relations, Tax Overlapping in the United States Selected Tables Updated, A Supplement to Report M-23, 23-31, Table 53 (1967).
64. Michigan, Nebraska, Rhode Island and Utah.
65. New Jersey and South Dakota. The efforts failed.
66. See note 17 supra.
Maryland's neighboring State of Delaware, for example, currently imposes an income tax with rates graduating as high as 19.8 percent.\textsuperscript{68} The current maximum rates in the income taxes of neighboring Virginia and the District of Columbia are 5.75 percent\textsuperscript{69} and 10 percent,\textsuperscript{70} respectively and likely to move higher soon.\textsuperscript{71} The same forces that are pushing Maryland toward the use of a more highly graduated income tax (\textit{i.e.}, its growing need for more tax revenue and particularly a tax source with a strong revenue growth potential, as well as the demands of its citizenry for a more equitable state and local tax system) will presumably also force its neighboring states to follow suit.

\textbf{Summary}

The case for highly graduated rates in state income taxes may be summarized as follows: (1) The highly graduated state income tax most effectively takes advantage of the indirect program of federal revenue sharing resulting from the deductibility of state and local taxes for federal income tax purposes; (2) It is only the highly graduated state income tax which imposes a greater net state tax burden on high-income taxpayers than on low-income taxpayers; and, (3) It is only the highly graduated state income tax which, because of its greater responsiveness to changes in personal income, is capable of financing the rapidly increasing cost of state and local governmental operations. Just as the states' needs for additional revenue overcame the historical opposition to the very use by states of income taxes,\textsuperscript{72} their current needs for expanding revenue sources are beginning to erode opposition to highly graduated state income tax rates. As more states move toward the adoption of highly graduated state income tax rates, fears of interstate tax competition (already greatly mitigated by the effects of federal deductibility) will be effectively laid to rest.

\textsuperscript{70} \textit{D.C. Code Ann.} § 47-1567(b)(a) (1973).
\textsuperscript{71} According to a recent editorial in the \textit{Washington Post}:

\begin{quote}
[T]he fiscal news emanating from Richmond is not good. In fact, each time Gov. Mills E. Godwin discusses the state's financial shape, it is worse . . .

Certainly it has been difficult for all governments to anticipate the pressures of the economy on their budgets and programs . . . [This pressure] will require a recognition by Gov. Godwin and the General Assembly that the answer cannot be merely to reduce services. . . . \textit{New sources of revenue must be proposed, lobbied for and approved.}
\end{quote}

\textit{Washington Post}, Dec. 4, 1975, § A, at 18, col. 1 (emphasis added). There are also indications that the District of Columbia is considering a 4 to 5 percent increase in its personal income tax (which now has a maximum marginal rate of 10 percent).


\textsuperscript{72} \textit{J. Pechman}, \textit{supra} note 55, at 221.
APPENDIX

The body of this article ignored the possible effects on the net (i.e., after federal deductibility) state tax burden of high-income taxpayers caused by the federal 50 percent maximum rate on earned income. This Appendix is designed to illustrate those effects, and to demonstrate that they do not significantly detract from the equitable arguments set forth herein in favor of highly graduated state income taxes. The federal maximum tax on earned income is:

in effect, an alternative tax computation for earned income under which earned income in taxable income brackets where the tax rate

73. INT. REV. CODE of 1954, § 1348. In 1969, “Congress concluded that extremely high rates of tax, particularly in the case of earned income, are unrealistic and tend to create distortions in our tax system.” JOINT COMMITTEE ON INTERNAL REVENUE, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969, at 224 (1970) [hereinafter cited as GENERAL EXPLANATION]. Congress therefore enacted a 50 percent maximum marginal rate on earned income to help reduce the “disincentive effect of high tax rates in the case of earned income.” Id. at 224. For purposes of section 1348:

Earned income generally includes wages, salaries, professional fees or compensation for personal services, including royalty payments to authors and inventors and, in the case of a taxpayer engaged in a trade or business where both personal services and capital are a material income-producing factor, a reasonable amount but not more than 30 percent of his share of the net profits of the business.

Id. at 226.

In 1972, 88,000 tax returns filed in the United States reported income subject to the 50 percent maximum rate on earned income. U.S. DEPARTMENT OF TREASURY, STATISTICS OF INCOME — 1972 INDIVIDUAL INCOME TAX RETURNS 145, Table 3A (1973). These 88,000 returns were divided among taxpayers in the following AGI classes:

<table>
<thead>
<tr>
<th>AGI Class</th>
<th>Number of tax returns in AGI class reporting income subject to 50 percent maximum rate</th>
<th>Percentage of tax returns in AGI class reporting income subject to 50 percent maximum rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$50,000–$100,000</td>
<td>46,000</td>
<td>9.5%</td>
</tr>
<tr>
<td>$100,000–$200,000</td>
<td>35,000</td>
<td>38.0%</td>
</tr>
<tr>
<td>$200,000–$500,000</td>
<td>6,000</td>
<td>31.2%</td>
</tr>
<tr>
<td>Over $500,000</td>
<td>1,000</td>
<td>27.0%</td>
</tr>
<tr>
<td></td>
<td>88,000</td>
<td></td>
</tr>
</tbody>
</table>

Id. at 6 and 145, Table 1.1 and Table 3A (1973).

74. See notes 33–46 and accompanying text supra.

75. The possible effects of the maximum tax on earned income on state initiated revenue sharing was considered in notes 32 and 51 supra and were found to be minimal. The maximum tax rate, of course, has no effect on the economic responsiveness argument advanced in favor of a highly graduated state tax system. See notes 47–54 and accompanying text supra.
would otherwise be greater than 50 percent is subject to a flat 50 percent rate.\textsuperscript{76}

Because the net state tax burden borne by a taxpayer depends on the federal tax bracket or brackets from which he deducts his state taxes, the relationship between the federal maximum 50 percent tax rate on earned income and a taxpayer's net state tax burden is obvious. To the extent that the application of the maximum tax on earned income results in a taxpayer's deducting his state and local taxes at a 50 percent, rather than, \textit{e.g.}, a 60 or 70 percent marginal federal tax bracket, his net (\textit{i.e.}, after federal deductibility) state tax burden will increase.

The following two examples (the first a situation in which all of the taxpayer's AGI is earned income, and the second a situation in which only part of the taxpayer AGI is earned income) illustrate the mechanics of computing the federal tax under the 50 percent maximum rate on earned income, and the effect of this computation on the net state tax burden of high income taxpayers.

\textit{Example 1}

A Maryland family of four has $100,000 of adjusted gross income, all consisting of earned net income.\textsuperscript{77} Personal deductions (other than

\begin{itemize}
\item \textbf{76. General Explanation, supra note 73, at 225.} The mechanics by which this alternative tax operates is further explained by Professor Chommie as follows:
\end{itemize}

The application of the 50% maximum rate requires that earned income be first reduced to "earned net income" (the deduction of the section 62 adjusted gross income deductions allocable to the earned income), and then to "earned taxable income." The determination of the latter can be expressed in terms of a formula which is designed to reduce the benefits of section 1348 when the taxpayer has untaxed preference income in excess of $30,000 and to take into account the taxpayer's non-earned income. This is the formula:

\begin{align*}
A &= \text{Earned net income} \\
B &= \text{Adjusted Gross Income} \\
C &= \text{Taxable Income} \\
D &= \text{Total preference Income} \\
\text{Earned taxable income} &= \frac{A}{B \times C} - [D - 30,000]
\end{align*}

Once earned income is determined, section 1348(a) prescribes a three-step process for the determination of tax liability. The first step requires a computation of the amount of taxable income at or below the 50% bracket ($52,000 on a joint return; $38,000 for heads of households and unmarried individuals). The second step consists of multiplying the amount of earned income which exceeds the taxable income in the first step by the maximum 50% rate. The third and final step requires the determination of the tax on the balance of taxable income by computing total tax liability without section 1348 and subtracting the tax on earned taxable income without using section 1348. The sum of the three steps constitutes total tax liability.

The foregoing process, it should be noted, subjects the top amounts of unearned income to tax at the marginal rate which would be applicable if section 1348 did not apply.


77. "Earned income" is defined in note 73 supra, and "earned net income" is defined in note 76 supra. It is assumed in this example that the taxpayer does not
the deduction for state and local income taxes paid) equal $16,000. The existing rate schedule is in effect in Maryland, so that the family owes state and local income taxes to Maryland of $5,970.\textsuperscript{78}

A. \textit{Section 1348 is Inapplicable}

If Section 1348 were not in the Internal Revenue Code, the family’s federal income tax liability and net state income tax burden would be computed as follows:

1. Adjusted Gross Income (AGI) \hspace{2cm} $100,000
2. Exemptions \hspace{2cm} 3,000
3. Personal deductions (other than for state and local income taxes paid) \hspace{2cm} 16,000
4. Taxable income (without deduction for state and local income taxes paid) \hspace{2cm} 81,000
5. Federal tax if no state or local income taxes paid \hspace{2cm} 33,920
6. Federal tax bracket(s) from which $5,970 of state and local income taxes are deducted \hspace{2cm} 58 \& 55%
7. Actual federal tax paid (\textit{i.e.} based on $75,030 of taxable income) \hspace{2cm} 30,487
8. Reduction in federal tax caused by deduction for state and local income taxes (line 5 less line 7) \hspace{2cm} 3,433
9. Net state tax burden ($5,970 [state and local tax paid] less $3,433) \hspace{2cm} 2,537
10. Net state tax burden as percentage of AGI (line 9 divided by line 1) \hspace{2cm} 2.5%

B. \textit{Section 1348 is Applicable}

Application of the federal maximum 50 percent rate on earned income will reduce the family’s actual federal income tax paid from $30,487 to $29,575, but will increase the net state tax burden from $2,537 to $2,985, have preference income in excess of $30,000. \textit{See} note 76 \textit{supra}. For a full discussion of the effects of preference income on the maximum tax on earned income, see Sunley, \textit{The Maximum Tax on Earned Income}, 27 \textit{Natl. Tax J.} 543 (1974).

78. \textit{See} Table 2, Column 2 \textit{supra}.
and the net state tax burden as a percentage of AGI from 2.5 to 3 percent. These figures are computed as follows:

1. Adjusted gross income (AGI) (all earned income) — $100,000

2. Exemptions ____________________________ 3,000

3. Personal deductions (other than for state and local income taxes paid) ____________________________ 16,000

4. Taxable income and earned taxable income (without deduction for state and local income taxes paid) — 81,000

5. Federal tax if no state or local income taxes paid ($18,060 on first $52,000 of taxable income plus 50 percent of excess over $52,000: i.e., $18,060 plus ½ [$81,000 less $52,000]) ____________________________ 32,560

6. Federal tax bracket(s) from which $5,970 state and local income taxes are deducted ____________________________ 50%

7. Actual federal tax paid ($18,060 on first $52,000 of taxable income plus 50 percent of excess over $52,000: i.e., $18,060 plus ½ [$75,030 less $52,000]) ____________________________ 29,575

8. Reduction in federal tax caused by deduction for state and local income taxes (line 5 less line 7) — 2,985


10. Net state tax burden as percentage of AGI (line 9 divided by line 1) ____________________________ 3%

Example II

A Maryland family of four has $200,000 of adjusted gross income. $100,000 of that income is earned net income and $100,000 is dividend income. Personal deductions (other than the deduction for state and local income taxes paid) equal $32,000. The proposed rate schedule is in effect in Maryland, so that the family owes state and local income taxes to Maryland of $29,103.

79. "Earned income" is defined in note 73 supra, and "earned net income" is defined in note 76 supra. It is assumed in this example that the taxpayer does not have preference income in excess of $30,000. See note 77 supra. The $100 exclusion for dividends received is ignored.

80. See Table 2, Column 2 supra.
A. Section 1348 is Inapplicable

If section 1348 were not in the Internal Revenue Code, the family's federal income tax liability and net state income tax burden would be computed as follows:

1. Adjusted gross income (AGI) $200,000
2. Exemptions 3,000
3. Personal deductions (other than for state and local income taxes paid) 32,000
4. Taxable income (without deduction for state and local income taxes paid) 165,000
5. Federal tax if no state or local income taxes paid 86,980
6. Federal tax bracket(s) from which $29,103 of state and local income taxes are deducted 68%, 66% & 64%
7. Actual federal tax paid (i.e., based on $135,897 of taxable income) 67,754
8. Reduction in federal income tax caused by deduction for state and local income taxes (line 5 less line 7) 19,226
9. Net state income tax burden ($29,103 [state and local tax paid] less $19,226) 9,877
10. Net state tax burden as percentage of AGI (line 9 divided by line 1) 4.9%

B. Section 1348 is Applicable

Application of the federal maximum 50 percent rate on earned income will reduce the family's actual federal income tax paid from $67,754 to $67,197, but will increase the net state tax burden from $9,877 to $10,800, and the net state tax burden as a percentage of AGI from 4.9 to 5.4 percent. These figures are computed as follows:

1. Adjusted gross income (AGI) $200,000
   Dividends $100,000
   Earned net income $100,000
2. Exemptions 3,000
3. Personal deductions (other than for state and local income taxes paid) 32,000
4. Taxable income (without deduction for state and local income taxes paid) ........................................ 165,000

5. Percent earned net income is of AGI ($100,000/ $200,000) .......................................................... 50%

6. Federal tax if no state or local income taxes paid (tax based on $82,500 of earned taxable income and $82,500 of other taxable income) .............................................. 85,500

7. Federal tax bracket(s) from which $29,103 of state and local income taxes are deducted .......................... N/A

81. Line 6 was computed as follows:

6a. Earned taxable income without deduction for state and local income taxes paid (50% of $165,000) .................. $82,500

6b. Regular tax on taxable income if no state and local income taxes paid (tax on $165,000) ............................ 86,980

6c. Regular tax on earned taxable income if no state and local income taxes paid (tax on $82,500) .................. 34,790

6d. Tax on income not eligible for the 50% limit, if no state and local income taxes paid (Line 6b less line 6c) ........... 52,190

6e. Tax under 50% limit on earned taxable income (without deduction for state and local income taxes paid):

   (i) Tax on taxable income on which the tax rate does not exceed 50% (i.e., tax on $52,000) .................. $18,060

   (ii) 50% of earned taxable income (without deduction for state and local income taxes paid) in excess of $52,000 ($82,500 less $52,000 equals $30,500) .................. 15,250

                     33,310

6. Federal income tax if no state or local income taxes paid (Line 6d plus line 6e) ........................................ $85,500

82. When either the 50 percent maximum tax is not applicable, or the 50 percent maximum tax is applicable but AGI consists only of earned net income, it is possible to set forth the marginal tax bracket or brackets from which state and local taxes paid will be deducted. However, where AGI consists of both earned net income and other income, the effect of any additional personal deductions on federal tax liability can only be understood by observing the effect of that deduction on the three-step process of computing tax under section 1348. See note 76 supra. For example, consider the situation of a married couple with taxable income of $220,000 (without considering a $20,000 deduction for state and local income taxes paid), made up $110,000 of earned taxable income and $110,000 of other taxable income. It might appear that an additional $20,000 personal deduction would be subtracted from a net 60 percent marginal tax bracket: i.e., $10,000 would be deducted from the maximum 50 percent marginal tax bracket applicable to earned income, and $10,000 would be deducted from the top 70 percent bracket applicable to the other taxable income. In
8. Actual federal tax paid (i.e., based on $135,897 of taxable income, half of which [$67,949] is earned taxable income and half of which [$67,949] is other taxable income) 67,197 $83

fact, however, federal income tax will be reduced by $12,800, or 64 percent of the $20,000 additional deduction, as illustrated below:

<table>
<thead>
<tr>
<th>Taxable Income Without Deduction for $20,000 state and local income tax</th>
<th>Taxable Income After Deduction for $20,000 state and local income tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Step 1 Tax $18,060</td>
<td>Step 1 Tax $18,060</td>
</tr>
<tr>
<td>[Tax on first $52,000 of taxable income]</td>
<td>[Tax on first $52,000 of taxable income]</td>
</tr>
<tr>
<td>Step 2 Tax 29,000</td>
<td>Step 2 Tax 24,000</td>
</tr>
<tr>
<td>[50% of excess of earned taxable income over $52,000]</td>
<td>[50% of excess of earned taxable income over $52,000]</td>
</tr>
<tr>
<td>($110,000 less $52,000)</td>
<td>($100,000 less $52,000)</td>
</tr>
<tr>
<td>Step 3 Tax 73,600</td>
<td>Step 3 Tax 65,800</td>
</tr>
<tr>
<td>[Tax on income not eligible for 50% maximum limit — i.e., tax on marginal income from $110,000 to $220,000]</td>
<td>[Tax on income not eligible for 50% maximum limit — i.e., tax on marginal income from $100,000 to $200,000]</td>
</tr>
<tr>
<td>Total Tax $120,660</td>
<td>Total Tax $107,860</td>
</tr>
</tbody>
</table>

The $10,000 of the state and local income tax deduction applicable to Step 2 reduces the Step 2 tax by $5,000 (from $29,000 to $24,000) or 50 percent of the $10,000 deduction. The $10,000 of the state and local income tax deduction applicable to Step 3, however, reduces the Step 3 tax by $7,800 (from $73,600 to $65,800) or 78 percent of the $10,000 deduction. The net result is a federal tax reduction of $12,800 (from $120,660 to $107,860) which is 64 percent of the additional $20,000 deduction.

83. Line 8 was computed as follows:

- 8a. Earned taxable income (50% of $135,897) $67,949
- 8b. Regular tax on taxable income (tax on $135,897) 67,754
- 8c. Regular tax on earned taxable income (tax on $67,949) 26,592
- 8d. Tax on income not eligible for 50% limit (Line 8b less line 8c) 41,162
- 8e. Tax under 50% limit on earned taxable income 26,035
  (i) Tax on taxable income on which the tax rate does not exceed 50% (i.e., tax on $52,000) 18,060
  (ii) 50% of earned taxable income in excess of $52,000 ($67,949 less $52,000 equals $15,949) 7,975
- 8. Actual federal income tax paid (Line 8d plus line 8e) $67,197

Even though one-half of the additional deduction for state and local income taxes will be allocable to earned income, and therefore, deducted from a maximum 50
9. Reduction in federal income tax caused by deduction for state and local income taxes (line 6 less line 8) ____________ 18,303

10. Net state tax burden ($29,103 [state and local tax paid] less $18,303) ________________________________ 10,800

11. Net state tax burden as percentage of AGI (line 10 divided by line 1) ________________________________ 5.4%

The following table illustrates the net state tax burden (under both the existing and proposed Maryland rate schedules) borne by hypothetical families of four with $100,000, $200,000 and $500,000 of AGI, with varying amounts of such AGI constituting earned net income. Each taxpayer is assumed to have personal deductions (without taking into account state and local income taxes paid) equal to 16 percent of AGI.84

<table>
<thead>
<tr>
<th>Taxable Income Without Deduction for $29,103 state and local income tax</th>
<th>Taxable Income After Deduction for $29,103 state and local income tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Step 1 Tax ____________ $18,060</td>
<td>Step 1 Tax ____________ $18,060</td>
</tr>
<tr>
<td>[Tax on first $52,000 of taxable income]</td>
<td>[Tax on first $52,000 of taxable income]</td>
</tr>
<tr>
<td>Step 2 Tax ____________ 15,250</td>
<td>Step 2 Tax ____________ 7,975</td>
</tr>
<tr>
<td>[50% of excess of earned taxable income over $52,000 — 50% of $30,500 ($82,500 less $52,000)]</td>
<td>[50% of excess of earned taxable income over $52,000 — 50% of $15,949 ($67,949 less $52,000)]</td>
</tr>
<tr>
<td>Step 3 Tax ____________ 52,190</td>
<td>Step 3 Tax ____________ 41,162</td>
</tr>
<tr>
<td>[Tax on income not eligible for 50% maximum limit — i.e., tax on marginal income from $82,500 to $165,000]</td>
<td>[Tax on income not eligible for 50% maximum limit — i.e., tax on marginal income from $67,949 to $135,897]</td>
</tr>
<tr>
<td>Total Tax ____________ $85,500</td>
<td>Total Tax ____________ $67,197</td>
</tr>
</tbody>
</table>

The $14,551 (50 percent of $29,103) of the state and local income tax deduction applicable to Step 2 reduces the Step 2 tax by $7,273 (from $15,250 to $7,975) or 50 percent of the $14,551 deduction. The $14,551 of the state and local income tax deduction applicable to Step 3, however, reduces the Step 3 tax by $11,028 (from $52,190 to $41,162) or 73.8 percent of the $14,551 deduction. The net result is the federal tax reduction of $18,303 (from $85,500 to $67,197), which is 62.9 percent of the additional $29,103 deduction.

84. It is assumed in Appendix Table 1 that the taxpayers do not have preference income in excess of $30,000. See note 76 supra.
APPENDIX TABLE I

<table>
<thead>
<tr>
<th>AGI (1)</th>
<th>No part of income is subject to fifty percent maximum rate on earned income (2)</th>
<th>AGI represents $100,000 of earned net income (3)</th>
<th>Lower of $200,000 or AGI represents earned net income (4)</th>
<th>Lower of $300,000 or AGI represents earned net income (5)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100,000</td>
<td>2.5</td>
<td>3.0</td>
<td>3.0</td>
<td>3.0</td>
</tr>
<tr>
<td>200,000</td>
<td>2.0</td>
<td>2.4</td>
<td>3.1</td>
<td>3.1</td>
</tr>
<tr>
<td>500,000</td>
<td>1.9</td>
<td>2.0</td>
<td>2.3</td>
<td>2.6</td>
</tr>
</tbody>
</table>

Part I (Existing Rates) (Percent)

Part II (Proposed Rates) (Percent)

$100,000   | 5.3     | 6.1   | 6.1   | 6.1   |
200,000    | 4.9     | 5.4   | 7.3   | 7.3   |
500,000    | 4.9     | 5.1   | 6.0   | 6.9   |

Note: In computing both the state tax paid (which includes the fifty percent local piggyback tax), and the reduction in federal tax paid caused by the state income tax deduction, it was assumed that: (1) all taxpayers had itemized deductions of 16 percent of AGI without taking into account the state tax paid; (2) all income was earned by one spouse; (3) the taxpayers did not have tax preference items in excess of $30,000; and (4) all income and itemized deductions (other than the state income tax) were includible income and allowable deductions for both federal and state tax purposes.

CONCLUSION

Effect of Maximum Tax Under Existing Maryland Rates

The federal maximum 50 percent rate on earned income has minimal effect on the net state tax burden borne by a high income taxpayer under the existing Maryland rates. Appendix Table I (Part I) indicates that, under existing rates, the net state tax burden on high income persons does not rise much higher than 3 percent, even when the federal maximum tax on earned income is considered. This 3 percent net state tax burden remains significantly lower than that borne by many lower income itemizers and users of the standard deduction.

Effect of Maximum Tax Under Proposed Highly Graduated Rates

The federal maximum tax on earned income would have a more significant effect on the net state tax burdens of high-bracket taxpayers (and therefore on the overall progressivity of the state tax system)
were the highly graduated proposed rate schedule adopted in Maryland. Appendix Table I (Part II) shows, however, that even under the proposed rates, the net state tax burden of a high-income taxpayer would not be significantly affected by the maximum tax unless that taxpayer had not only a high AGI (above $100,000), but also an AGI which consisted mainly of earned net income. Finally, because only about one-third of all taxpayers with AGI above $100,000 report any income subject to the 50 percent maximum rate,\(^85\) the net state tax burdens of two-thirds of all high-bracket taxpayers remain entirely unaffected by the 50 percent maximum tax.

\(^85\) See note 73 supra.