DC Fiscal Policy Institute

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RAISING REVENUE BY CREATING A NEW TAX BRACKET FOR TOP EARNERS: A PROGRESSIVE APPROACH TO ADDRESSING DC'S BUDGET SHORTFALL

By Elissa Silverman

A DC Councilmember has proposed raising the income tax rate on the District's wealthiest residents as a way to generate money for next year's budget. The idea has been met with some skepticism, including the belief that this will push the well-off to leave the city.

Yet for several reasons, this bill should be taken seriously. A number of states have recently raised taxes on high earners, and about 10 states are now considering such a measure. In fact, the proposed new rate in DC would remain below the top rate in the Maryland suburbs. The **increase** would not only generate needed revenue, but also shift the District in the direction of a more progressive tax system. A progressive tax system, much like President Obama's plans to undo some of the 2001 tax cuts given to the wealthy, is considered more equitable because those who make more pay more as a share of their income and those who make less pay less.

This proposal stands in contrast with several revenue provisions in the FY 2010 proposed budget, which would make DC's tax system more regressive. In particular, proposals to eliminate the cost-of-living increase for the standard income tax deduction and homestead deduction as well as charging a $51 a year "streetlight maintenance" fee—would hit low-income and working families in the District the hardest.

Beyond these factors, economists have indicated that raising income taxes on higher-income households is a sensible approach to addressing budget shortfalls because it has only a limited effect on the economy. Other research shows that increasing income taxes on the wealthy is unlikely to lead such families to change their residence.

The Equitable Income Tax Act of 2009: How it Would Work and Why It Is a Reasonable Approach to DC's Budget Shortfall

The Equitable Income Tax Act of 2009, introduced by Ward 1 Councilmember Jim Graham, is a progressive alternative. The bill would create a new bracket of 8.9 percent for taxable income above $500,000. Currently, D.C.'s top rate is 8.5 percent. Under the new proposal, a household with taxable income of $600,000 would pay approximately $400 more than they currently owe.

For several reasons, this proposal represents a reasonable way to raise revenues and address DC's severe budget problems.

DC is not alone in asking top earners to contribute more to pay for vital government services. California, New York, New Jersey, and Maryland have raised their top tax rates recently.

Similar plans are currently being considered in other states, including Oregon, Delaware, Connecticut and Illinois. New Jersey is considering boosting its rate for the second time in five years, to 10.25 percent.

Even with the proposed new rate, DC's top income tax would remain lower than in neighboring Montgomery and Prince George's counties. As a result of state income tax increases adopted last year, affluent residents in Montgomery County pay a combined state and local income tax rate of 9.45 percent if they have taxable income above $1 million, while residents in Prince George's County face a top rate of 9.35 percent. And for residents who have taxable income between $500,000 and $1 million, the rates are 8.7 percent in Montgomery and 8.6 percent in Prince George's, which is close to the proposed new DC rate.

What about Northern Virginia? Though the state's top income tax rate is 5.75 percent, the Virginia suburbs have far higher property taxes, including the annual car tax. A September 2006 study by the DC Fiscal Policy Institute found that when both income and property taxes are added up, DC residents at many income levels pay the lowest overall taxes in the region. For example, income and property taxes for a married couple with two children and income of $100,000 is $1,300 lower in DC than in Fairfax County and $1,100 lower than in Arlington County.

The bill would make the District's tax system more progressive, allowing the D.C. Council to reverse some of Mayor Fenty's more regressive proposals. A progressive tax system is structured according to income. Those who earn more pay a higher share of income in taxes, while those who earn less pay a lower share. Currently, DC's tax system is regressive because of its reliance on the sales tax —like most state and local tax systems. DC's low-income families pay a higher share of their income in DC taxes than higher-income families do.[1]

The Equitable Income Tax Act would raise revenues to address DC's budget shortfall in a progressive way — with no impact on low- and moderate-income families. This stands in contrast to several tax and fee proposals in the proposed FY 2010 budget, which would fall heavily on low-income residents. Though $51 for streetlight maintenance may be a minor amount for some families, it is not incidental to District families who live paycheck to paycheck. For example, $51 out of the paycheck of someone who earns $15,000 a year is more burdensome than for someone who earns $150,000. That is regressive, because the tax has a more severe impact on lower-income households. And the fee would be on top of a 10 percent tax on utilities District residents already pay.

Another regressive measure in the proposed budget would be to eliminate the cost-of-living adjustment for the standard deduction, the personal exemption, and the homestead deduction. Most filers who take the standard deduction are lower-income because they do not own homes and itemize their taxes.

There is no evidence supporting the idea that a new tax bracket would lead to "rich flight" from the District. Critics often respond that top earners would simply move to a place with lower income taxes. Yet they offer no data to support their claim, and a Princeton University researcher has found that this effect is minimal. Douglas S. Massey, a demographer at Princeton and

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[1] See, for example, DC Fiscal Policy Institute, *Bridging the Gaps in DC: Strategies to Help Low-Income Working Families*, November 2008, page 5.

President of the American Academy of Political and Social Science, published a report last September analyzing the impact of a 2.6 percentage point tax hike in New Jersey on those making more than $500,000 a year. Massey estimated the tax increase cost New Jersey less than 1 percent of the "half-millionaire" households in the state, and that it resulted in a substantial increase in tax revenue.

Leading economists endorse this approach to addressing state budget deficits. Peter Orzag (now head of the U.S. Office of Management and Budget) and Nobel Prize-winner Joseph Stiglitz have noted that "tax increases on higher-income families are the least damaging mechanism for closing state fiscal deficits in the short run."[2] They note that cuts in government programs can be damaging to local economies. Tax increases on higher-income families have a more limited effect because these families spend and invest much of their income outside of the local area and because modest tax increases are unlikely to affect their consumption.

Conclusion

Revenue from a higher tax bracket for top earners could be put toward monies for much-needed programs, help reverse some of the more regressive measures in this year's budget, or a combination of both. According to estimates released to the council from the Office of the Chief Financial Officer, the tax would generate approximately $11 million in revenue in fiscal year 2010 and $16 million in fiscal year 2011.

Some of those monies might be put toward affordable housing, which has taken a particularly big hit in the proposed budget. The Local Rent Supplement Program, which provides housing vouchers for low-income families to keep a roof over their heads, and Housing Production Trust Fund, which is a major source of money for affordable housing development, will see significantly lower funding in fiscal year 2010. The need for these programs only becomes greater during a recession.

Because it would raise revenues progressively, without adversely affecting low-income residents, the Equitable Income Tax Act is a reasonable approach to boosting revenue in this challenging budget year.

[2] Peter Orszag and Joseph Stiglitz, "Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive than the Other During a Recession?" Center on Budget and Policy Priorities, revised November 6, 2001.