DC Fiscal Policy Institute

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TAX AND REVENUE ISSUES IN THE FY 2010 BUDGET

Summary of Tax Issues in the Mayor's Proposed Budget: Mayor Fenty's proposed FY 2010 budget includes $122 million in new revenues to help address the city's sharp drop in revenue collections — which helped limit the budget cuts needed to create a balanced budget. The Mayor's budget also included a small amount of revenue reductions — including tax abatements adopted last year and the impact of some tax changes in the federal stimulus law on DC revenues.

The revenue increases include $20 million from enhanced compliance, $73 million in additional fees and fines, $17 million in tax increases and $11 million in other measures.

Summary of the Full Council Vote, May 12: The Council eliminated the proposed streetlight maintenance fee and the proposed increase in the 911 tax. The Council also restored the cost of living adjustment to the standard deduction and personal exemption. The Council identified funds to restore the cost of living adjustment for the homestead deduction, but not until FY 2011. The Committee on Public Works and Transportation identified $17million in additional revenues through enhanced parking enforcement. An additional $7 million would come from installing parking enforcement cameras on street sweepers, and $3 million from enhance enforcement of litter laws.

Summary of Amended FY2010 Budget Vote, July 31: As a result of a $150 million revenue shortfall for FY2010 announced in June 2009, Mayor Fenty submitted an amended FY 2010 budget on July 17, and the Council adopted an amended budget on July 31. The amended budget included $41 million in new taxes, including an increase in the general sales tax to 6 percent, an increase in cigarette and gasoline taxes, and elimination of cost-of-living adjustments through 2013 for the standard deduction, personal exemption, and homestead deduction. With these changes, revenue increases in the FY 2010 budget total $165 million. (See Table 1 on the next page.)

SUMMARY

MAYOR'S BUDGET PROPOSAL

- The proposed FY 2010 budget included $122 million in new revenues.
- Some increases reflected policy improvements, such as elimination of a corporate tax shelter. Other changes, however, would increase taxes and fees with a disproportionate effect on low-income residents. This includes eliminating cost of living adjustments (COLA) for the standard deduction, personal exemption, and homestead deduction; a new streetlight maintenance fee; and an increase in the 911 fee.

COUNCIL COMMITTEE MARK-UP

- The DC Council restored the COLA for the standard deduction, eliminated the streetlight maintenance fee, and cancelled the increase in the 911 tax. The Council adopted $28 in additional fees, primarily from parking enforcement.

FINAL BUDGET VOTE, MAY 12

- The Council restored the COLA for the personal exemption for FY 2010. The COLA for the homestead deduction was restored, but not until 2011.

AMENDED FY 2010 BUDGET, JULY 31

- To help address a new revenue shortfall, the amended budget included $41 million in new revenues, primarily from increasing sales, gas, and cigarette taxes, and by eliminating COLAs for the three tax deductions described above.

While some of the revenue increases reflect policy improvements, such as elimination of corporate tax shelters, several of the tax increases will make the DC revenue system more regressive by disproportionately increasing taxes and fees on low-income residents. This includes elimination of cost of living adjustments for the standard deduction and personal exemption in the income tax and the property tax homestead deduction, as well as the increase in sales, cigarette and gasoline taxes. While some of the increases have other rationales — for example, the sales tax is paid in part by non-residents, and increasing cigarette taxes leads to reduced cigarette use — the FY 2010 package includes no provisions to offset the regressive impact. The revenue package also includes no increases that target higher-income residents.

More Detail on Tax Provisions in the FY 2010 Budget

The revenue increases in the FY 2010 budget are discussed in more detail below.

Enhanced Tax Compliance

The budget would raise $20 million through a tax amnesty program. Individuals and corporations that owe taxes prior to 2009 would not have to pay penalties if the taxes are paid.

This provision was not changed by the Council in its May 12 vote or in the July 31 amended FY 2010 budget vote.

Fees and Fines

The proposed budget included $73 million in revenues from new or increased fees and fines. This includes $36 million from enhanced traffic law enforcement; $15 million from raising parking meter fees (a part of the fee increase was adopted last year by the DC Council); $12 million from a new "streetlight maintenance fee" that would add $51 to the annual electricity bills for each DC household; $7 million from increasing the fee placed on phone bills that helps cover the costs of emergency and non-emergency response services; and $3 million increases in other various fees.

Council Committee Mark-up and Full Council Action, May 12: The Council eliminated $19 million in fees from the Mayor's proposed budget, including the streetlight maintenance fee and the proposed increase in the 911 tax. The Council added $28 million in new fees and fines. The Committee on Public Works and Transportation identified $17million in additional revenues through enhanced parking enforcement. An additional $7 million would come from installing parking enforcement cameras on street sweepers, and $3 million from enhance enforcement of litter laws. The Council adopted other fee increases totaling $1 million.

Amended FY 2010 Budget Vote, July 31: There were no changes to fees and fines in the amended FY 2010 budget.

TABLE 1 REVENUE INCREASES IN THE FY 2010 BUDGET (FIGURES IN MILLIONS	Mayor's Proposal	Full Council Vote, May 12	Amended Budget, July 31
Tax Amnesty	$20	$20	$20
Increase Parking meter rates	$15	$15	$15
Enhanced Traffic Enforcement	$36	$36	$36
Enhanced Parking Enforcement	$0	$24	$24
Enhanced Public Littering Enforcement	$0	$3	$3
Establish Streetlight Maintenance Fee	$12	$0	$0
E911 Fee Increase	$7	$0	$0
Other Fees	$3	$4	$4
Close Delaware Holding Company Tax Shelter	$10	$10	$10
Eliminate Sales Tax Holiday	$1	$1	$1
Eliminate Cost of Living Adjustment to Standard Deduction	$2	$0	$2
Eliminate Cost of Living Adjustment to Personal Exemption	$3	$0	$3
Eliminate Cost of Living Adjustment to Homestead Deduction	$2	$0	$2
Establish Floor for Homeowner Taxable Assessments	$5	$5	$5
Apply Economic Interest Tax to Co-op Sales	$5	$5	$5
Increase Sales Tax rate from 5.75% to 6%	$0	$0	$21
Increase gasoline tax from 20 cents to 23.5 cents/gallon	$0	$0	$4
Increase cigarette taxes from $2 to $2.50/pack	$0	$0	$10
TOTAL	$122	$123	$165

Closing Corporate Tax Loopholes

The budget would raise $10 million by eliminating a "Delaware holding company" deduction in DC's corporate income tax. Under current law, corporations are able can shift profits from DC to Delaware— which has no corporate income tax — by transferring income to a subsidiary company in Delaware that is created only for this purpose.

When the income is transferred to the Delaware holding company, it is deducted from taxable income in DC. The District attempted to eliminate this deduction in 2004, but legislation proposed in the FY 2010 budget is needed to fully close this tax shelter.[1]

Council Committee Mark-up and Full Council Action, May 12: The Council did not change this provision.

Amended FY 2010 Budget Vote, July 31: This provision was not changed in the amended FY 2010 budget vote. However, the DC Council took further steps to improve corporate tax collections, by adopting a "combined reporting" requirement starting in 2011. Combined reporting eliminates tax-avoidance strategies of large multistate corporations by treating the parent and most subsidiaries as one corporation for District income tax purposes. Under combined reporting,

[1] For a further description of the Delaware Holding Company tax shelter, see Center on Budget and Policy Priorities, *Growing Number of States Are Considering a Key Corporate Tax Reform*, September 2007.

corporations would be required to combine their nationwide profits, including profits from all subsidiary companies, and the District would then tax a share of that combined income using the appropriate apportionment formula.

Eliminate Sales Tax Holidays

The proposed budget would raise $1.3 million by eliminating the District's two sales tax holidays, one in August and one after Thanksgiving. During the sales tax holidays, no sales tax is charged on schools supplies and clothing purchases under $100. Research has shown that sales tax holidays do not provide an economic boost as intended. They tend to shift *when* families and individuals make purchases, but they do not appear to increase overall sales each year. For example, an analysis of New York state's sales tax holiday found that retail sales increased during the week of the sales tax holiday, but they found that sales in the calendar quarter that included the sales tax holiday were not higher than in the prior year. [2]

This provision was not changed by the Council in its May 12 vote or in the July 31 amended FY 2010 budget vote.

Eliminate Cost of Living Adjustments to Several Tax Benefits

Mayor Fenty's proposed FY 2010 budget would eliminate cost of living adjustments to three tax deductions — the homestead deduction in the property tax, the standard deduction in the income tax, and the personal exemption in the income tax. By freezing these deductions and exemptions at current levels, rather than allowing them to increase each year, DC residents will pay higher income and property taxes than they otherwise would. The impact of eliminating cost-of-living adjustments increases over time, as the deductions fall further behind an inflation-adjusted value with each passing year. The proposal would increase taxes by $7 million in 2010 and $17 million by 2013.

As discussed below, these deductions are progressive, because they provide a greater benefit to lower-income residents than to higher-income residents. Eliminating the cost of living adjustments thus will have a disproportionate impact on low-income DC residents.

Council Committee Action: During committee mark-ups, the Committee on Public Works and Transportation identified additional revenues to restore the cost-of living adjustment to the standard deduction. The Committee of the Whole identified funds to restore cost of living adjustments for the personal exemption. The full Council also restored the COLA for the homestead deduction, but not until FY 2011.

Amended FY 2010 Budget Vote, July 31: The DC Council voted to eliminate COLAs for all three deductions through 2013.

Applying Economic Interest Tax to Sales of Co-op Units

When a residential or commercial property is sold in the District, the city levies deed recordation and deed transfer taxes, each of which is set at 1.45 percent of the property's sale price. When a portion of a property's value is sold — typically this occurs only with commercial properties — an

[2] See the Tax Foundation, "Sales Tax Holidays: Politically Expedient but Poor Tax Policy," August 2006.

"economic interest" tax of 2.9 percent applies, which matches the combined amount of deed recordation and deed transfer taxes. Neither of these taxes currently applies, however, when the owner of a residential co-op unit sells his or her share in the co-op. The proposed budget would apply the economic interest tax to such sales, generating $5 million in additional revenue.

This provision was not changed by the Council in its May 12 vote or in the July 31 amended FY 2010 budget vote.

Set Floor on Taxable Assessments

Under DC's property taxes, homeowners qualify for several tax relief provisions on their primary home, including a homestead deduction and a 10 percent cap on the amount by which their taxable assessment can increase each year. As a result of these provisions, the taxable assessment for many homes — the assessment to which the tax rate is applied — is well below the full assessed value.[3] The 10 percent cap provisions also can result in two homes of similar values having very different tax bills, if the homes were bought in different years. The proposed change would require that taxable assessments equal at least 40 percent of the home's full assessed value. This would eliminate some of the unintended consequences of DC's property tax provisions, and it would help reduce the wide disparities in taxes paid by owners of homes of similar value. It would raise $5 million per year.

This provision was not changed by the Council in its May 12 vote or in the July 31 amended FY 2010 budget vote.

Increase General Sales Tax Rate

The amended FY 2010 budget adopted by the DC Council increased DC's general sales tax rate from 5.75 percent of purchases to 6 percent. This will go into effect in November 2009.

Increase Gas Tax Rate

The amended FY 2010 budget adopted by the DC Council increased DC's gas tax from 20 cents per gallon to 23.5 cents. This will bring DC's gas tax in line with the Maryland gas tax.

Increase Cigarette Tax

The amended FY 2010 budget adopted by the DC Council increased DC's cigarette tax from $2 per pack to $2.50 per pack.

Many Tax Increases in the FY 2010 Budget Are Regressive

The amended FY 2010 budget approved on July 31 includes several provisions that are regressive, which means that the impact of the tax increases will fall most heavily on lower-income families. The regressive tax increases total $42 million. Meanwhile, the amended FY 2010 includes no tax increases that target higher-income residents — who are more able to afford a tax increase.

[3] Some homes, in fact, have a taxable assessment of zero, and because taxable assessments can rise by only 10 percent each year, the taxable assessments of these homes will remain at zero as long as the current owner lives there.

It is worth noting that the DC Council rejected two regressive tax changes from the Mayor's proposed budget. The proposed budget would have created a new streetlight maintenance fee that would have added $51 dollar to annual electricity bills for all DC households. It also would have increased a fee that supports 911 services, adding roughly $10 a year to phone bills. While these fees may be manageable for middle and higher-income families, they would have placed a burden on low-income families, many of whom struggle to pay utility bills and sometimes face utility shut-offs as a result of non-payment. Because the fee increases would be the same dollar amount for all households, the impact would be regressive — that is, they would consume a greater share of income for low-income households.

The regressive tax increases that remain in the FY 2010 budget include the following:

The Sales Tax

Sales taxes absorb a greater share of the income of lower-income taxpayers than of higher-income taxpayers. This is largely because higher-income persons do not consume their entire incomes; the portion of their incomes that they save is not subject to sales or other consumption taxes. For this reason, the sales tax is one of the more regressive state-level.

The Cigarette Tax

The cigarette tax has a regressive impact because lower-income residents are more likely to smoker. Even if smoking rates were the same at all income levels, the cigarette tax would consume a larger share of income for low-income households than for high-income households. Increasing the cigarette tax has been popular in many states because higher taxes appear to lead to reduced cigarette consumption. While there is an important public health argument for increasing cigarette taxes, the regressive impact remains. One option to address this is to provide offsetting tax relief targeted generally toward low-income residents. For example, a portion of the incremental revenue from the cigarette tax — or from other taxes that might be raised at the same time — could be used to institute or increase a state Earned Income Tax Credit, a state sales tax credit, or a property tax/rent credit for low-income families.[4]

Standard Deduction, Personal Exemption, and Homestead Deduction

Legislation passed in 2007 required these DC tax benefits to be adjusted upward for inflation each year, so that their real value will not drop over time. They were adopted because each of these deductions had not been adjusted for many years and had lost ground to inflation. Eliminating the annual inflation adjustments in these tax benefits would increase the taxes DC residents pay, with a disproportionate affect on low-income residents.

The Standard Deduction: The standard deduction is an amount — $4,000 in most cases — that households are allowed to deduct from their income if they are not claiming itemized deductions. In the District, three-fifths of tax filers claim the standard deduction, and nearly all households that

[4] See Center on Budget and Policy Priorities, "Cigarette Taxes: Cautions and Considerations," July 2002 (http://www.cbpp.org/7-3-02sfp.pdf)

claim it have incomes under $50,000. The standard deduction is especially important to renters, since most do not have enough deductions that would allow them to itemize deductions.

The District's standard deduction was set at $2,000 from 1987 to 2006. During that time, the value of the standard deduction lost substantial ground to inflation. The standard deduction was increased in both 2006 and 2007 — to $4,000 — and an annual inflation adjustment was adopted. The Mayor's budget would freeze the standard deduction at this level.

The Personal Exemption: Under DC's personal exemption, households are allowed to deduct $1,675 from their income for each person included on their tax return. While this deduction applies to all taxpayers, the value is greater as a share of income for lower-income families. For example, a married couple with two children can claim personal exemptions totaling $6,700 this year. This amount would offset more than one-quarter of the income of a family earning $25,000 but less than seven percent of the income of a family earning $100,000.

DC's personal exemption was frozen at $1,370 from 1991 through 2006. The personal exemption was increased in 2006 and 2007 —to $1,675 — and an inflation adjustment was added. The Mayor's budget would freeze the personal exemption at this level.

The Property Tax Homestead Deduction: The homestead deduction is an amount that DC homeowners are allowed to deduct from their home's assessed value before the tax rate is applied. For 2009, the Homestead Deduction equals $67,500.

The homestead deduction is progressive because it offsets a higher share of a home's value for owners of lower-value homes than for owners of higher value homes. For example, the homestead offsets more than 20 percent of the value of a home worth $300,000, but only 11 percent of a home assessed at $600,000.

The Homestead Deduction was set at $30,000 in 1991 and remained that level until 2003. It has been increased several times in recent years, reaching $64,000 in 2007. The most recent increase also included an annual cost of living adjustment. The Mayor's budget would eliminate the cost of living adjustment by freezing the Homestead Deduction at $67,500.

It is worth noting that this change will not immediately affect all homeowners, as would elimination of inflation adjustments in the standard deduction and personal exemption. This is because DC homeowners also qualify for a 10 percent cap on the annual increase in their home's taxable assessment. Each year, the home's taxable assessment — the assessment level to which the tax rate is applied — is determined as the lower of two calculations:

- Last year's taxable assessment plus 10 percent (1.1 times the prior year taxable assessment); or
- The full assessed value minus the homestead deduction.

For many homeowners in the District, the taxable assessment is lower when computed as last year's taxable assessment plus 10 percent. For these homeowners, a change in the value of the homestead deduction will not have an immediate effect. Freezing the value of the homestead deduction will have the greatest effect on new homeowners, since they do not qualify for the 10 percent cap in the first year that they own their home. Some other homeowners also will be affected, if their full assessed value minus the homestead deduction is lower than their capped taxable assessment.

Tax Reductions in the FY 2010 Budget

The Mayor's FY 2010 proposed budget also includes a small number of tax reductions, primarily to implement a variety of tax abatements adopted in 2008 and to reflect the impact that two federal tax reductions will have on DC's tax collections. The DC Council maintained each of these provisions during its budget mark-ups.

The FY 2010 budget would implement tax abatements that were adopted in 2008 for six projects. These include tax abatements for National Public Radio the Urban Institute, the Pew Charitable Trust, the Southwest Waterfront Development, the Georgia Commons Development, and the O Street Market project. The costs of these abatements in FY 2010 will total just $1.6 million, but will rise to $9 million by 2013.

The FY 2010 budget also reflects the impact of two federal tax changes included in the federal stimulus law. That law temporarily exempts income from unemployment compensation from taxation, and it would temporarily expand the federal Earned Income Tax Credit. The FY 2010 DC budget would allow unemployment benefits also to be exempt from DC income tax, a reduction of $4 million in revenues. Because DC has an earned income tax tied to the federal credit — residents can claim a DC EITC equal to 40 percent of the federal EITC — the expansion of the federal credit also result in greater DC EITC benefits. The DC EITC benefit expansion will total $1.8 million.