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PRINCIPLES TO GUIDE EFFORTS TO ADDRESS DC'S NEW REVENUE SHORTFALL

A June 2009 revenue forecast shows that the District of Columbia's budget is once again out of balance, as a weak economy continues to depress our resources. Less than a month after adoption of the budget for fiscal year 2010, the new forecast revealed a $190 million shortfall for the remainder of fiscal year 2009 — which ends in just three months — and a $150 million shortfall in FY 2010. The new shortfall will require Mayor Fenty and the DC Council to make difficult budget choices, despite adoption of $800 million in budget-balancing measures in the 2010 budget.

The following steps can help balance the District's budget while limiting the impact on DC residents. In particular, the Mayor and Council should pursue approaches to replace a portion of the revenues that have been lost due to the weak economy, which total $950 million in fiscal year 2010. This would be consistent with the actions taken in other states, most of which have tapped rainy day funds, adopted revenue increases this year, or have done both.

- **Use the Rainy Day Fund and Fix Its Restrictive Rules:** The District has $330 million in reserves intended to address budget crises. Some 27 states have tapped their reserves recently, but the District has not. Using half of the rainy day reserves would cover roughly half of the $340 million shortfall for FY 2009 and FY 2010, while leaving some reserves for future years. The Mayor and Council also should start working now with Congress to eliminate numerous federal rules that make DC's reserve far more restrictive than the rainy day funds in nearly every state, including a requirement to repay withdrawals in a very short time frame — two years.

- **Tap Other Resources:** The District has a number of special-purpose funds that are financed by fees and other revenues collected by the government. Some of these accounts have surpluses that can be used to close the budget shortfall. The District should scour aggressively for extra funds, including the Ballpark Revenue fund that supports the baseball stadium and the Convention Center fund.

- **Raise Revenue:** The District's budget shortfall stems almost entirely from falling revenue collections. Some 25 states have enacted revenue increases this year, with 12 more considering increases. The District has raised revenues only modestly, covering $100 million of an $800 million budget gap for FY 2010, and most of the additional revenues come from enhanced traffic and parking enforcement. Options to raise additional revenues include measures such as eliminating the CAPCO tax credit program (a job creation program which has proven to be an expensive failure), expanding the sales tax base, and raising the minimum corporate franchise tax. Revenue-raising options also should be progressive — by targeting those most able to pay additional taxes. This could include a new top income tax rate or by eliminating the tax exemption for interest on out-of-state bonds.

- **Spread Budget Cuts Broadly:** DC agencies already have been asked to cut their budgets considerably to address previous revenue shortfalls. The new budget shortfall will require increasingly difficult decisions over service reductions. Future budget cuts should be spread across agencies to minimize the impact in any one area. Possible programmatic cuts include postponing lower-priority transportation projects and delaying an expansion of the police force.

- **Preserve Safety Net Programs:** Local funding for DC's health and human service programs has grown more slowly than any other part of the budget over the past five years. With DC's unemployment rate at the highest level in 25 years and demand for public assistance benefits rising dramatically, the District should avoid cutting services that help with basic needs like housing, healthcare, and food assistance.

These issues are discussed in more detail below.

It's Raining, So It's Time to Use DC's Rainy Day Fund

The District, like most states, has a rainy day fund that it can use to address a major economic crisis or other factors that throw its budget out of balance, such as a natural disaster.

Some 27 states have tapped their rainy day funds to close budget gaps in 2009 or 2010, but the District has not.[1] Yet the decline in the District's economy and finances indicate that it is raining heavily now — that is, now is an appropriate time to use the rainy day reserves. Projected revenues for fiscal year 2010 have fallen by nearly $1 billion, and unemployment in the city has hit a 25-year high. The District's Chief Financial Officer has certified that that District has met conditions needed to tap its rainy day fund.

The District should consider using its rainy day fund now, especially to address the FY 2009 shortfall.

- **Using half of the rainy day fund would reduce DC's 2009-2010 budget gap by one-half or more.** If the District were to use half of the rainy day funds now — $165 million — that would cover nearly half of the revenue shortfall for FY 2009 and FY 2010, leaving additional reserve funds for use in the future if needed.

- **Rainy day reserves limit the need to cut services or raise revenues during an economic downturn**. Spending rainy day reserves provides a stimulus to the local economy that can help offset the effects of a recession.

- **Rainy day funds are fiscally responsible.** When states have rainy day reserves, they set aside funds when fiscal conditions are strong — rather than spending all of the growing revenues. They can then use those funds when fiscal conditions weaken.

Use of the rainy day fund would not fully eliminate the budget gap (and it would be unwise to fully use the reserve now). Even if the District taps its rainy day fund, it will need to find ongoing budget savings to balance the budget in FY 2010 and beyond. In this way, using the reserve does

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[1] National Association of State Budget Officers, *Fiscal Survey of the States: Spring 2009*, tables A-5a and A-5b (http://www.nasbo.org/publications.php#fss2007)

not delay budget-balancing efforts, although it does make them easier.

Federal Restrictions on DC's Rainy Day Fund Need to Be Addressed

Although it makes sense to use DC's rainy day fund now, there are federal restrictions on these reserves that need to be addressed. The federal requirement that the District establish a reserve – adopted in 2000 — was a positive step. Unfortunately, Congress imposed several rules governing the fund, even though it is made up solely of local funds, which are far stricter than the rules most states place on their rainy day reserves.

The District's leaders should work with the federal government to give the District the same kind of flexibility over its rainy day fund that other states have.

Eliminate the Rule that Requires DC to Repay its Rainy Day Fund While It Is Still Raining. Under federal rules, DC must repay half of a rainy day fund withdrawal within one year and the remaining half within two years. This means that the District would be forced to repay a withdrawal before the recession is over and its finances have recovered. Some 39 of 46 states with a rainy day fund have no time-specific replenishment rule. Instead, most states (31) wait to re-build their rainy day funds until their budgets return to surplus; others wait until revenues start growing faster than a specified rate. This process seems to work. State rainy day fund balances fell from $29 billion nationally in 2000 to $7 billion in 2002, in the midst of the last recession. State rainy day fund balances grew to $35 billion in 2008 as states replenished their reserves.

Among DC and the six states that require repayment in a certain time frame, only DC and Rhode Island require repayment within two years.[2]

Allow DC's Rainy Day Fund to be Used Flexibly to Meet Emerging Needs. DC's rainy day reserves are split into two parts: Some $230 million can be used to address falling revenues. The remaining $100 million is restricted for use in a natural disaster or a declared state of emergency. No other state restricts a portion of their rainy day fund for natural disasters. Instead, most states have full access to their reserves for *either* a natural disaster or economic downturn.[3]

Allow DC's Rainy Day Fund to be Used Whenever Falling Revenues Push the Budget Out of Balance. Currently, the fund cannot be used unless a revenue shortfall is greater than five percent of the budget or roughly $250 million. While the District met that threshold in FY 2009, it has not met the threshold for FY 2010, even though projected revenues are $150 million lower than the amount assumed in the approved budget. In 39 states, the rainy day fund can be used whenever revenue collections drop below expected levels by any amount.[4]

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[2] This information is drawn from Center on Budget and Policy Priorities, *Rainy Day Funds: Opportunities for Reform*, April 2007 (http://www.cbpp.org/files/4-16-07sfp.pdf).
[3] DC Fiscal Policy Institute, *Fixing DC's Rainy Day Fund*, April 2003, page 6 (http://dcfpi.org/?p=73)
[4] DC Fiscal Policy Institute, *Fixing DC's Rainy Day Fund*, April 2003, page 6 (http://dcfpi.org/?p=73)

Tapping Other DC Funds

As noted, the DC budget includes a number of "special-purpose" funds, which are financed by fees, fines, assessments, or reimbursements, and the use of these funds is restricted to certain specified purposes. Examples include the Crime Victim's Assistance Fund and the Home Purchase Assistance Program (HPAP) Fund, which provides low- and no-interest loans to help low-income first-time homebuyers. The HPAP fund is financed through the repayments of the loans granted by the program.

Overall, the FY 2010 DC budget includes 230 approved special purpose funds that are expected to collect $459 million.

Each year, some special purpose accounts build up surpluses, and these surpluses have been used in the past to cover revenue shortfalls in other parts of the budget. It is likely that the Mayor and Council will consider this approach again, which generally is a sound approach in the current economic climate. (If dedicated funds for a given account are not being used, it is worth exploring whether this is because the purpose of the fund is not being met or whether the revenues dedicated to the fund are more than needed to meet the purpose.)

The District should scour aggressively for extra funds this year, given the severity of the budget crisis. In particular, the District should explore using the following:

- **Ballpark Revenue fund:** This fund was established to cover the costs associating with financing the construction of the Nationals' baseball stadium. In recent years, the fund has collected more than needed to meet these costs. In 2008, a proposal was floated to use these surplus funds to help pay for a new soccer stadium. That proposal was never adopted, but it suggests that surpluses in the Ballpark Fund might be available for other purposes, including covering the budget shortfall.

- **Washington Convention Center Fund**: This fund receives a portion of restaurant and hotel sales taxes and is used to operate the convention center and to pay the convention center bonds. The Mayor and Council could use any of its surplus funds, at least temporarily, for the budget shortfall. This could be accomplished either by removing funds from the account, or by changing DC law to reduce the dedicated taxes that go into the fund.

- **Baseball Community Benefit Fund.** This fund was established in 2004 as part of the legislation to publicly finance a baseball stadium. It was intended to address concerns that the stadium would divert funding from other community priorities. No expenditures from the fund have been made yet, although Mayor Fenty has proposed using $23 million in 2009 to cover costs of the Summer Youth Employment Program. If that occurs, the Community Benefit Fund still would leave roughly $25 million available from this fund in FY 2009 and FY 2010. While it would be desirable to use the fund for new programs as intended, it may be better at this point to use it to prevent cuts to services that meet the fund's intended purposes.

Raising Additional Revenues

As DC's revenue conditions worsen, it will be harder to preserve critical services without raising additional revenues. Many states across the country face the same situation, and many of them have adopted revenue increases to help balance their budgets without slashing services. Some 25 states have adopted revenue increases this year, and another 12 states are considering them.[5]

To date, the District has addressed its revenue shortfall largely through budget savings, relying on revenue increases to cover only a small share of the budget gap. The FY 2010 budget, for example, included roughly $100 million in new revenues to address an $800 million budget gap. Most of the revenue increases come from enhanced traffic and parking enforcement and other fees ($75 million), with only $10 million in tax increases.[6]

The following are options that the District should consider to raise revenues. These changes would raise revenues in ways that strengthen DC's tax system or make DC taxes more progressive — i.e., revenue increases that would target residents according to their ability to pay.

- **Eliminate the CAPCO tax credit program**: In 2004, the District adopted the CAPCO program, which provides generous tax credits that are intended to incentivize creation of jobs for DC residents. The legislation set aside $50 million in tax credits for the program. Yet across the country, CAPCO programs have proven to be both expensive and ineffective.[7] A 2009 report from the DC Auditor found that DC's program resulted in just 31 new jobs.[8] The District should eliminate the CAPCO tax credit program.

- **Apply the Sales Tax to Tickets for All Entertainment Venues:** The District applies the sales tax to some ticket sales, but not to others. The DC sales tax applies to tickets at the Verizon Center and the Nationals stadium, at rate of 10 percent. Movie tickets are taxed at the basic sales tax rate of 5.75 percent. Yet live performances — plays, musicals, opera, dance, etc. — are not subject to any sales tax in the District. The District could extend the sales tax — at either the 5.75 percent rate or 10 percent rate — to tickets for live performances. Extending the sales tax to live performances would improve the equity of the sales tax, and the additional tax payments would fall to a significant extent on non-residents.

- **Expand the Sales Tax to Cover Selected Services:** The DC sales tax, like most state sales taxes, was created years ago when most retail sales were in the form of goods. Increasingly, however, our economy is becoming service-oriented, and services are a growing share of retail sales (such as grocery delivery and health clubs). DC has expanded its sales tax to cover some services, like labor costs for car repairs, but many services remain uncovered by the city's sales tax. DC could raise additional revenue by applying the sales tax to selected services that currently are not taxed, including pet grooming, security firms, and test preparation services.

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[5] Center on Budget and Policy Priorities, *Tax Measures Help Balance State Budgets*, June 2009 (http://www.cbpp.org/cms/index.cfm?fa=view&id=2815)

[6] The budget raises $5 million by setting a minimum level for homeowner property taxes and an additional $5 million by applying the economic interest tax (equivalent to deed recordation and transfer taxes) to the sale of residential co-op units.

[7] For example, see testimony of Rutgers professor Julia Sass Rubin before the Dc Council on April 3, 2009 (http://oct.dc.gov/services/on_demand_video/channel13/april2009/04_03_09_PUBSVRC_1.asx)

[8] DC Auditor, *Certified Capital Companies Program*, 2009 (http://www.dcauditor.org/DCA/Reports/DCA052009.pdf)

Expanding the sales tax to more services has other advantages. It improves the fairness of the tax system to have all consumer purchases covered by the sales tax — it is not fair for example that buying a bottle of pet shampoo is taxed but having a business wash a pet is not.

- **Increase the Minimum Corporate Franchise Tax:** DC's minimum franchise tax is just $100, and it has not been adjusted for 25 years. Roughly 60 percent of businesses in the city pay the minimum tax, because they claim deductions, credits, and other tax benefits to reduce their tax liability to the minimum level.

- **Increase the Cigarette Tax.** The District's cigarette tax is currently $2 per pack. While this is higher than in most states, raising the cigarette tax has been shown to reduce smoking. Because the District's health programs incur substantial expenses costs for smoking-related illnesses, the increase also can be justified as a way to reduce health expenditures.

- **Eliminate Income Tax Exemption for Interest on Out-of-State Bonds:** The District is one of just two states that allow residents to claim an income tax exemption for the interest they receive on state and local bonds issued in other cities and states. Every state with an income tax offers such exemption for interest from in-state bonds, which provides an incentive to support the state's infrastructure projects. But only DC and Indiana allow this exemption for interest on out-of-state bonds because it effectively represents a tax incentive to invest in other states' infrastructure.

  In 2008, the U.S. Supreme Court upheld a state's right to allow a tax exemption for interest on in-state bonds but not for interest on out-of-state bonds. Numerous state organizations — including the National Governors' Association and the U.S. Conference of Mayors — submitted briefs in support of this practice. The state groups argued that offering an exemption only for interest earned on in-state bonds helps limit the cost of the exemption while also encouraging residents to purchase their state's bonds.

  The DC residents who invest in tax-exempt bonds tend to be high-income. In 2005, some 70 percent of the tax-exempt interest received in DC went to residents with incomes of $200,000 or more. Even if DC eliminates this local tax exemption, residents who invest in out-of-state bonds would continue to qualify for a federal income tax exemption on the interest they receive.

- **Create a New Top Income Tax Rate:** In recent years, a number of states, including Maryland, New York, New Jersey, Hawaii, and California have established a new income tax bracket for families above a certain income level, like $500,000. The Maryland changes, for example, created a series of new tax brackets for residents with incomes above $200,000 for a married couple, with a top rate for those making over $1 million.

  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."[9] They note that cuts in government

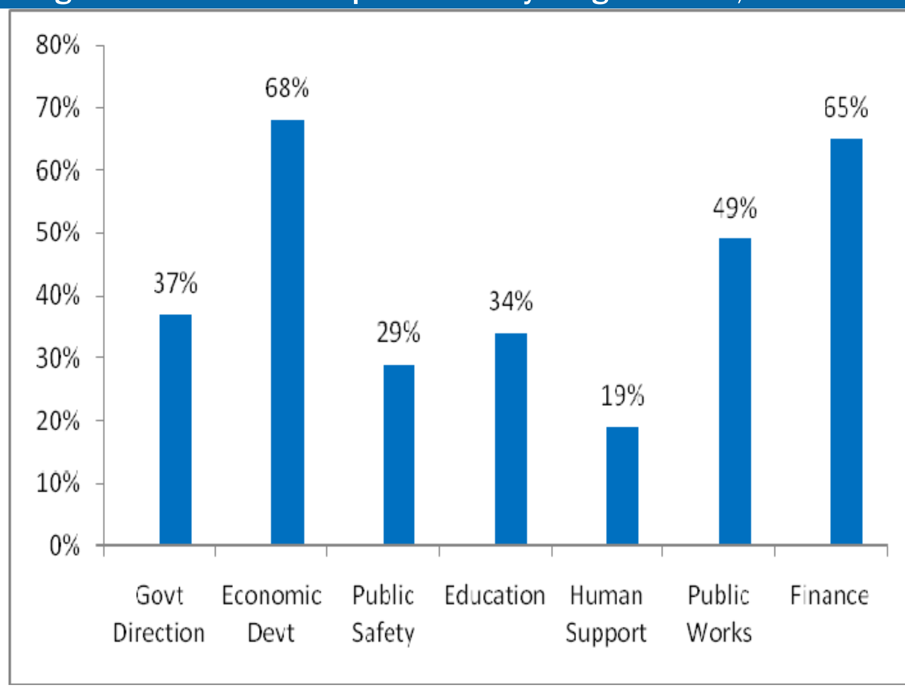
[9] Peter Orszag and Joseph Stiglitz, "Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive than the Other During a Recession?" Center on Budget and Policy Priorities, revised November 6, 2001.

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.

A bill introduced in the DC Council this year, The Equitable Income Tax Act of 2009, 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. This would leave DC's top tax rate lower than in Montgomery County (9.45 percent) or Prince George's County. While DC's top income tax rate would be higher than in Virginia (the top rate there is 5.75 percent), tax liabilities are lower for many DC residents than in Northern Virginia when both income and property taxes are considered.[10]

In addition to Maryland, a number of other states — including New Jersey, Rhode Island, and Vermont — have an income tax bracket for higher-income households that is above DC's top tax rate.

FIGURE 1
Change in General Fund Expenditures by Program Area, 2005 – 2010



Source: DCFPI analysis of DC budget information.

Spreading the Burden of Budget Cuts Broadly

The District has reduced the budget of nearly every agency in response to the sharp decline in revenues over the past year. The new budget shortfall resulting from the latest revenue forecast undoubtedly will require additional budget savings, even if the rainy day fund is used and if revenue-raising measures are adopted.

The new budget shortfall will require increasingly difficult decisions over service reductions. Two broad principles should guide these decisions.

- **Budget Cuts Should be Spread Across Agencies to Minimize the Impact in Any One Area.** It is worth noting that in recent years, as rising revenues allowed the DC budget to

[10] DC Fiscal Policy Institute, "Raising Revenue by Creating a New Tax Bracket for Top Earners: A Progressive Approach to Addressing DC's Budget Shortfall," April 2009 (http://dcfpi.org/?p=417)

expand, the budget increases were spread across all areas of the budget. Figure 1 compares the FY 2010 budget for each program area with expenditures in FY 2005. It shows that the total budget grew 35 percent during this period. The budgets for the Public Safety, Education, and "Government Direction" functions grew at roughly this rate. The budgets for Economic Development, Public Works, and Financing functions all grew faster than the overall budget, while the budget for "Human Support Services" grew slower than the overall budget.[11]

- **Safety Net Programs Should Be Preserved:** Given the current economic downturn and DC's high unemployment rate — now at the highest level since 1983 — the District should avoid cutting services that help with basic needs like housing, healthcare, and food assistance. Demand for the District's safety net programs has risen over the past year; the Temporary Assistance for Needy Families (TANF) caseload has risen by 9 percent, while Food Stamp/SNAP participation has increased by 14 percent. DC's Food Stamp enrollment is currently at the highest level in 20 years. As noted, Human Support programs have grown slower than the rest of the DC budget over the past five years.

[11] These budget growth numbers reflect adjustments by the DC Fiscal Policy Institute to make the FY 2005 and FY 2010 figures comparable. For example, roughly $70 million of transportation funds were shifted from the capital budget to the operating budget in FY 2008. Because these funds are reflected in the FY 2010 Department of Transportation's operating budget but not in its FY 2005 budget, this exaggerates the increase during this period. This analysis adjusts the FY 2005 DOT budget upwards to reflect the shifted funds. In another example, these figures make upward adjustments to the budgets for DC Public Schools and the Department of Health Care Finance to reflect federal stimulus funds these agencies will receive in FY 2010, since the federal funds will allow the District to reduce local spending on these agencies without reducing services.