DC Fiscal Policy Institute

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THE MIDDLE-CLASS SQUEEZE: DC's Tax System Falls Most Heavily on Moderate-Income Families

Families in the District with incomes of $20,000 to $60,000 pay one-tenth of their incomes in DC property, sales, and income taxes, according to a new study by the Institute on Taxation & Economic Policy.[1] This is much higher than the share of income the city's richest families pay in DC taxes. The study found that families with incomes of $1.5 million or more pay 8 percent of income in DC taxes.

The main reason for the unfairness of DC taxes is the city's reliance on sales and excise taxes. These taxes fall most heavily on lower-income residents, who spend a greater portion of income on goods and services than higher-income families do. DC's property tax also falls more heavily on lower-income residents. DC's income tax is progressive, with rates that get higher as income rises, but not enough to offset the unfair impact of other taxes. (The study found that most state and local tax systems are regressive.)

The new analysis has one important bright spot, finding that the city's poorest families face the lowest combined DC taxes — largely due to a targeted low-income tax benefits. But for all other families, taxes as a share of income get smaller as incomes get larger.

This information is important as the District continues to struggle with a weak economy and falling tax collections. With a projected budget shortfall of $300 million for fiscal year 2011, revenue increases may be considered over the next year. The tax increases adopted earlier this year to address DC's fiscal problems — primarily sales, gasoline, and cigarette taxes — added to the tax rates that DC's lowest income families pay. Given the new findings that tax rates already are highest for DC's moderate-income families, it will be important to consider whether any proposed increases would make DC's tax system more regressive.

Key Findings: DC's Middle-Income Families Face the Highest DC Tax Rates

The new report examines tax payments of DC residents by dividing the DC population into five equal groups by income, and also looked at taxes paid by the richest one percent. It found:

- **Taxes are relatively low for DC's poorest families:** The lowest-income fifth of DC's families — those with incomes under $20,000 — paid 6.2 percent of their income in property, sales, and income taxes in 2007.[2] This combined tax rate was lower than for any other income

[1] Institute on Taxation and Economic Policy, *Who Pays?:A Distributional Analysis of the Tax Systems in All 50 States, 3rd Edition*, November 2009.
[2] The ITEP report reflects permanent tax changes adopted after 2007 and before October 2009.

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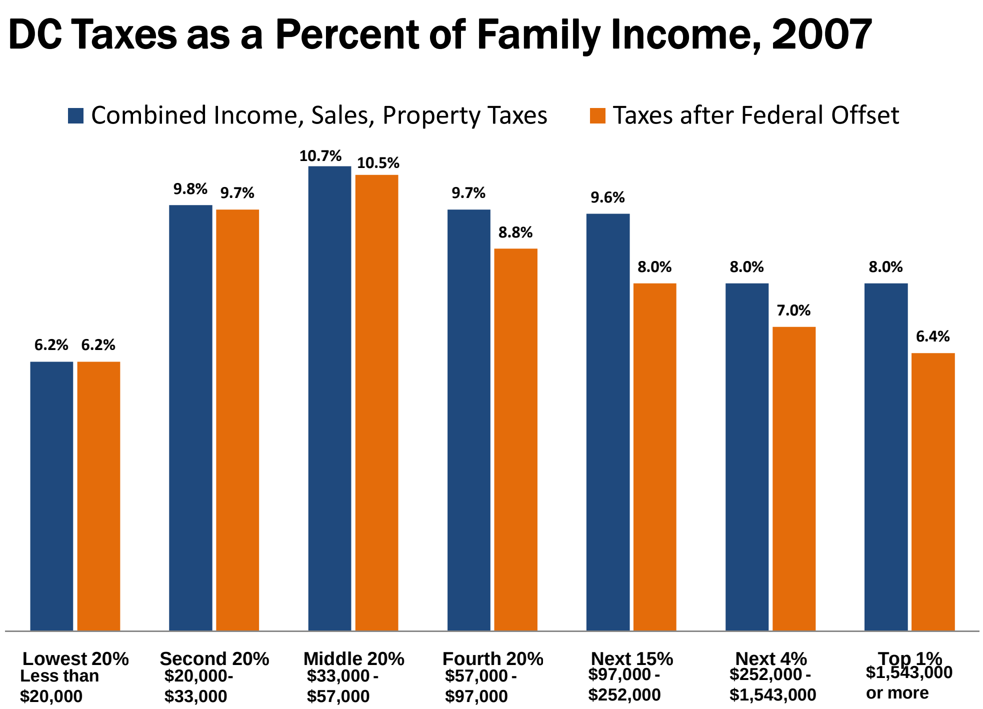
FIGURE 1



Note: These figures take into account the effect of deductibility of DC income and property taxes on Federal tax returns.
Source: Institute on Taxation & Economic Policy, October 2009

group. It largely reflects the impact of DC's Earned Income Tax Credit, a tax benefit for working poor families.

- **DC taxes consume a very high share of income for moderate-income families.** DC taxes equal 9.8 percent of income for families with incomes between $20,000 and $33,000 (the second fifth of families), and 10.7 percent of income for families between $33,000 and $57,000 (the middle fifth of families).

- **DC's richest families pay a smaller share of income in taxes than most other DC families**. The richest one percent of DC households — those with incomes above $1.5 million — paid 8 percent of income in DC taxes in 2007. This is lower than the tax rate for any other income group, other than the poorest families.

- **DC's tax system is more regressive when federal tax offsets are considered.** The state and local income and property taxes families pay are deductible on their federal tax return. This reduces the *net* effect of state and local taxes. Since higher income families are the most likely to itemize deductions, the federal deduction offsets DC taxes more for higher income families than for lower-income families, making DC's net tax system more regressive. When the federal offsets are considered, taxes for DC's middle-fifth of families falls from 10.7 percent to 10.5 percent, while the tax rate for the richest one percent falls from 8 percent to 6.4 percent.

High taxes make it harder for DC's moderate-income families to make ends meet. A single parent family of three needs an income of more than $41,000 after taxes to meet its basic needs, according to self-sufficiency standard developed by Wider Opportunities for Women.[3] The fact that families at this income level pay more than 10 percent of income in DC taxes means DC's tax system pushes many working families even further below self-sufficiency.

The difference in tax rates between middle- and higher-income families in DC is significant. For example, if families in the middle of DC's income distribution paid taxes at the same rate as the richest one percent of families — 6.4 percent versus 10.5 percent — they would pay $1,900 <u>less</u> in taxes each year.[4]

The District's Tax System Has Both Regressive and Progressive Elements

Like most states, the District relies on a mixture of tax sources. For some DC taxes, the highest effective tax rates fall on low and moderate-income families. These are *regressive* taxes. Other DC taxes are *progressive,* with higher-income families paying higher tax rates than lower-income families.

- **Sales and excise taxes are regressive.** The poorest fifth of DC families pay 6.8 percent of income in sales and excise taxes, while these taxes consume just 0.6 percent of income for the richest one percent. The sales tax is regressive because low income residents spend a greater portion of their income on goods and services than higher income residents. Higher-income persons typically do not spend their entire incomes, and the portion that they save is not subject to sales or other consumption taxes.

- **DC's property tax is regressive:** The poorest fifth of DC residents pay 3 percent of income on property taxes, while the wealthiest one percent pay 1.5 percent of income. These figures include estimates of the property taxes that renters indirectly pay through their rent.

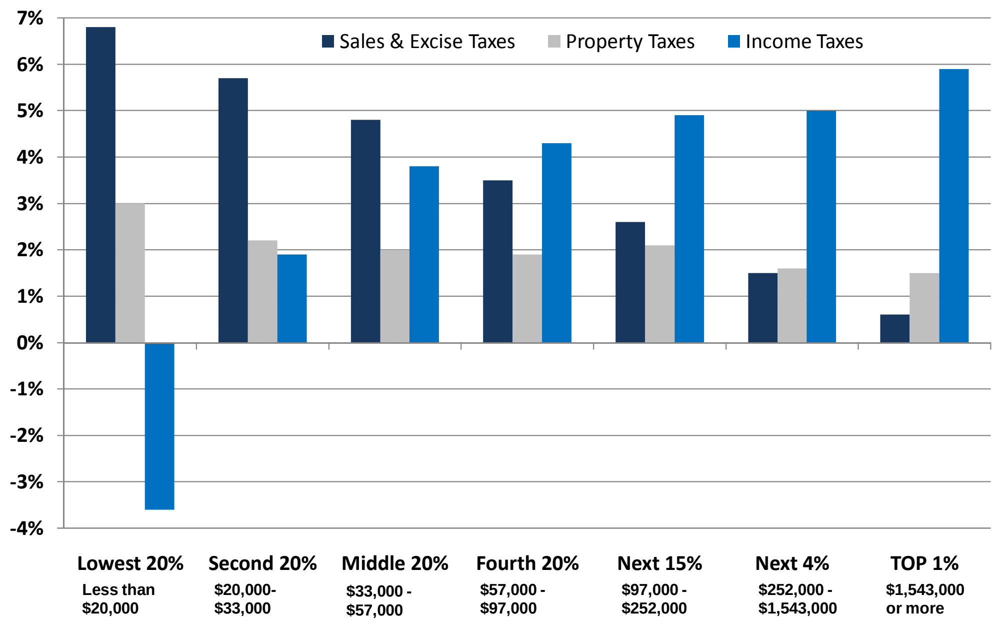
- **DC's income tax is progressive.** The District's income tax uses graduated rates — that is, it has a series of tax rates that increase as income rises. The District's tax system is also made progressive by the Earned Income Tax Credit, a tax credit for low-income workers equal to 40 percent of the federal EITC. The EITC is *refundable,* meaning that families can get a refund if their EITC benefit is higher than their tax bill. For this reason, the income tax rate for the poorest fifth of DC households is *negative* 3.6 percent, meaning that families on average receive income tax refunds equal to 3.6 percent of income. DC's income tax payments rise as income rises. The middle fifth of DC households pay 3.8 percent of income in income taxes, and the richest one percent pay 5.9 percent of income.

[3] Diana Pearce, "The Self-Sufficiency Standard for the Washington, D.C. Metropolitan Area 2005," Wider Opportunities for Women, September, 2005, p. 9.

[4] According to the ITEP study, the middle fifth of DC families have average income of $45,400. The difference in the tax rates these families pay and the richest one percent pay is 4.1 percent. This equals $1,900 for a family earning $45,400.

FIGURE 2

DC Income Tax, Sales Tax, and Property Tax As a Percent of Family Income, 2007



Source: Institute on Taxation & Economic Policy, October 2009

The net effect of DC's tax system — with middle-income families paying the highest tax rates — reflects the fact that at most income levels, the income tax is not sufficiently progressive to offset the regressive effects of the sales and property taxes.

Many Recent Changes to DC's Tax System Have Been Regressive, although Some Progressive Changes Have Been Made

Over the past decade, the District has adopted both tax reductions and tax increases. Many of these changes have made contributed to the problem of lower-income families facing greater tax rates than higher-income families — including tax *cuts* that largely benefited higher-income families and tax *increases* that fell most heavily on low-income families. In particular, when the DC Council adopted $42 million in tax increase in July 2009 to address a budget gap, all of the increases had a greater impact on lower-income families than on higher-income families.

- **Key Progressive Tax Changes:** The District established an Earned Income Tax Credit in 2000, based on the federal EITC. DC's EITC has been several times since then and now is set at 40 percent of the federal credit, making it the largest state-level EITC in the nation.[5] The District also has increased the standard deduction and personal exemption in the income tax,

[5] DC Fiscal Policy Institute, *DC's Earned Income Tax Credit Supports Working Families across the District*, 2008.

and the homestead deduction in the property tax.

- **Key Regressive Tax Changes:** Legislation adopted in 1999 reduced DC's income tax rates at all income levels, but the reductions provided greater tax cuts to higher-income families.[6] Property tax rates for homeowners have been reduced significantly since 2005, and a provision was adopted that limits increases in taxable assessments to 10 percent per year. An analysis by the DC Fiscal Policy Institute showed that DC's property tax cap provides the greatest benefits to owners of the highest-value homes.[7]

- **Regressive Tax Increases in 2009:** The DC Council adopted $42 million in revenue increases in July 2009 to help address a budget shortfall. The package included increases in sales, cigarette, and gasoline taxes, and it eliminated annual inflation adjustments for the standard deduction and personal exemption in the income tax and the homestead deduction in the property tax.[8] While these tax increases helped balance the budget and limit the need for cuts in services, they all have the effect of increasing taxes primarily on low- and moderate-income families. The budget-balancing plan included no progressive revenue provisions that could offset the regressive changes.[9]

Looking Ahead: Making DC's Tax System More Fair

Examining taxes paid by residents at different income levels is an important way to assess a tax system. The new analysis reveals that DC's tax system, like the tax system in many states, results in higher effective tax rates on moderate-income families than on the city's wealthiest families.

This information is important as the District struggles with a projected budget shortfall of $300 million for fiscal year 2011 — and the possibility of raising taxes to help address it. Given that DC's tax system already affects moderate-income families the most — and that tax increases adopted in 2009 fell most heavily on lower-income families — it will be important to consider whether any future proposed increases would make DC's tax system more regressive. While many factors should be taken into account, tax increases that focus more on higher-income families should be given priority consideration. This could include, but is not limited to, establishing new income tax rates for DC's highest-income families.[10]

When the District emerges from its fiscal crisis, these findings also suggest that efforts to reduce taxes should be targeted on the lower-income families that face the highest tax rates.

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[6] See, for example, DC Fiscal Policy Institute, *Meeting DC's Challenges, Maintaining Fiscal Discipline*, 2007.
[7] DC Fiscal Policy Institute, "Property Tax Relief Issues," 2005
[8] The figures on tax rates by income in this report do not reflect many of these tax increases. Other the cigarette and gasoline tax increases, the tax increases adopted this year are temporary, expiring in 2012 or 2013. The ITEP study focused on existing tax law and permanent tax changes that will be implemented in the future. It thus does not reflect the impact of the sales tax increase or elimination of cost-of-living adjustments for various tax benefits.
[9] DC Fiscal Policy Institute, "What's in the Amended FY 2010 Budget? A Summary," October 2009.
[10] DC Fiscal Policy Institute, "Raising Revenue by Creating a New tax Bracket for Top Earners," 2009