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Problems with the "Positive Tax Trigger"

by Ed Lazere

In 1999, the DC Council enacted the Tax Parity Act to reduce income and property taxes for both businesses and households over a five-year period. As of today, roughly half of the cuts scheduled under that law, the Tax Parity Act, have been implemented.

Further reductions in personal income taxes scheduled under the Tax Parity Act were suspended this year due to the District's poor fiscal conditions, and Mayor Williams has proposed continuing the suspension in future years because the tax cuts no longer appear affordable. Smaller cuts in corporate income taxes scheduled under the Tax Parity Act are being implemented as scheduled.

Several DC Council members have raised concerns about the proposal to suspend income tax cuts and have argued that continued implementation is important. To address these concerns, the mayor's proposed budget includes a "positive tax trigger" that would implement the income tax reductions in future years if certain fiscal conditions are met.

The provision effectively ties a budget surplus of a specified amount in one year to implementation of a tax cut two years later. For example, a sufficient surplus in 2002 would trigger a tax cut in 2004. While the notion behind the positive tax trigger — that tax cuts should not be implemented unless they are affordable — is a sound one, the design of the trigger has several flaws, and it should be modified.

- **The positive tax trigger could lead to implementation of tax cuts that are not affordable.** A budget surplus in one year provides no guarantee that future fiscal conditions will be strong enough to afford a tax cut. It is unwise to implement new initiatives that have ongoing costs — such as a tax cut — based on a budget surplus, which essentially represents a one-time revenue source. Instead, ongoing commitments of resources should be based on long-term projections of available funds.

- **The trigger would place implementation of tax relief ahead of other budget priorities through FY 2006**. By giving preference to income tax cuts, which primarily would benefit upper-income residents, the trigger would limit the ability of the District to pursue other budget initiatives for several years. In particular, the trigger would make it difficult to restore substantial program reductions — including cuts in health, housing, and human services programs — that, along with the suspension of income tax cuts, are part of the mayor's 2003 budget.

- **The trigger is based on the false notion that DC's household taxes are high when compared with neighboring jurisdictions.** A new DCFPI analysis shows that the tax burden on DC households is close in line with taxes paid by suburban Maryland and Virginia residents — and thus that the goal of "tax parity" largely has been achieved already. This means that additional tax relief scheduled under the Tax Parity Act is not needed to make the District more competitive with its neighbors.

A more appropriate trigger provision would tie implementation of tax relief to the District's five-year financial plan, which includes five-year projections of revenues and expenditures. Tax relief should be triggered only if projected revenues would be sufficient to meet both existing spending needs and tax relief for the full five-year period. Moreover, the baseline for future expenditure needs should assume that the largest spending reductions cuts included in the 2003 budget are restored. In particular, expenditure projections should assume return of tobacco settlement funds to their intended use and full funding of the Housing Production Trust Fund. Designed this way, the positive tax trigger would be fiscally sound and would not require service reductions in order to support tax relief.

The Positive Tax Trigger is Unsound Fiscal Policy

The positive tax trigger is included in legislation that accompanied the mayor's budget — known as the Budget Support Act.(1) The provision effectively would allow remaining income tax cuts under the Tax Parity Act to be implemented if the District generates budget surpluses over the next three years. (See the box on page three for a more thorough explanation of the trigger.)

- If the District has a surplus of at least $45 million in FY 2002, income tax cuts that had been scheduled for 2002 under the Tax Parity Act would be implemented in 2004;
- If the District has a surplus of at least $99 million in FY 2003, income tax cuts that had been scheduled for 2003 would be implemented in 2005; and
- If the District has a surplus of at least $139 million in FY 2004, income tax cuts that had been scheduled for 2004 — the last stage of scheduled income tax cuts in the Tax Parity Act — would be implemented in 2006.(2)

More Detail on How the Positive Tax Trigger Would Work

The positive tax trigger provision in the Budget Support Act actually has two elements. Both must be met to trigger implementation of a tax cut.

- First, actual revenues in a given year must exceed the revenue level that had been projected for that year when the budget was enacted. For example, revenues in 2002 must be at least $45 million higher than the revenue projection upon which the 2002 budget was based.
- Second, the District's general fund balance must have a specified amount of unrestricted funds. For example, the general fund balance must have at least $45 million in unrestricted funds at the end of 2002. The general fund balance essentially represents the accumulation of budget surpluses (or deficits) over time. The positive tax trigger would require that the general fund balance include the specified amount of funds that are not otherwise restricted for specific purposes, such as the District's emergency and contingency reserve funds.

The first requirement — revenues in excess of initial projections — is not meaningful. Just as revenues may exceed initial projections in a given year, so may expenditures. Thus, an increase in revenues above projected amounts does not necessarily mean that the District has revenues that exceed its needs.

The second requirement — unrestricted fund balance — is more meaningful. This is because an increase in the general fund balance can occur only if the District has a budget surplus, that is, an excess of revenues over spending. In addition, resources in the fund balance can be tapped only if they are not restricted for other uses. Thus, this element of the positive trigger essentially requires that the District have a surplus and that the surplus funds be available for use.

As noted in this analysis, however, neither provision is sufficient to guarantee that tax cuts can be afforded in the long-term, since a surplus represents a one-time revenue source while tax cuts have on-going, year-after-year, costs.

The surplus targets appear to be linked to the cost of the tax relief that would be implemented under the trigger. The positive tax trigger thus appears to be intended to allow tax cuts to be implemented only if there are sufficient revenues to pay for them. Yet for two key reasons, the provision would not guarantee that resulting tax cuts would be affordable when implemented.

- **A one-year budget surplus is not sufficient to fund on-going tax relief.** A budget surplus — an excess of revenues over spending — can occur in a given year for several reasons, and it may or may not be a sign of healthy fiscal conditions. The District's 2001 budget surplus, for example, partly resulted from an unusually large increase in corporate income taxes that is not expected to occur in future years. For these reasons, it would not be sound fiscal policy to adopt new initiatives with ongoing costs every year — such as a tax cut — based on a one-year budget surplus.

- **A budget surplus in one year does not guarantee that fiscal conditions will be healthy two years later**. Fiscal conditions can change significantly from year to year. A decline in the economy or an increase in certain program costs could push a budget that had been in surplus in one year out of balance in the next. It is particularly inappropriate to justify a tax cut in a given year based on a surplus *two* years before, because fiscal conditions can change dramatically over a two-year period.

The Positive Tax Trigger Places Tax Cuts Before Other Budget Priorities

By establishing an automatic mechanism for implementation of new tax relief, the positive tax trigger effectively establishes tax reductions as the top budget priority for several years — through FY 2006. Other priorities could be addressed only if funds were available after the tax cuts were funded.

This strong preference for tax cuts is problematic for two reasons. First, the District's current fiscal problems led Mayor Williams to submit a budget that included substantial spending reductions. The positive tax trigger would make restoration of those cuts difficult or impossible.

- The mayor's proposed 2003 budget includes $91 million in spending cuts, half of which would be borne by programs providing critical services to low-income families. For example, it would cut $13 million from health programs, including Medicaid and the Healthcare Alliance for uninsured

DC residents. The budget also reduces funding by 50 percent ($11 million) for the Housing Production Trust Fund, which supports development of affordable housing. Legislation to enhance the housing trust fund was enacted with near-unanimous support just three months ago. In addition, the Interim Disability Assistance program providing temporary cash benefits to 1,100 disabled residents would be eliminated under the mayor's budget.[(3)]

- The mayor's budget would divert $51 million in tobacco settlement funds to address the budget shortfall in FY 2003 and an additional $55 million in FY 2004. Prior legislation called for using half of the tobacco funds for new health, education, and human service initiatives and for saving the remaining half for future health needs. Thus, the diversion results in foregone health services and education programs compared with what would have been available if fiscal problems had not made the diversion necessary.

If the District's fiscal conditions rebound notably in the near future, it would seem appropriate to restore the budget cuts and to return the tobacco settlement funds to their intended use. Yet the District probably will not have sufficient funds to do so if substantial tax relief must be funded first.

Second, the additional tax relief scheduled under the Tax Parity Act primarily would benefit upper-income District residents. (See Table 1.) This means that the positive tax trigger would place implementation of tax relief for upper-income residents ahead of restoring reductions in services for low-income residents.

- A family of four earning $25,000, would receive an additional $175 if remaining tax cuts were implemented;
- A family with income of $75,000, would receive an additional $850 in tax relief; and
- A family with income of $150,000 would receive nearly $1,900 in additional tax cuts.

Tax Cuts Are Not Needed to Make DC Competitive with Suburban Jurisdictions

The support for further income tax cuts stems in large part from the notion that DC's tax burden on families is excessively high and deters families from moving into the District. Yet a recent analysis from the DC Fiscal Policy Institute finds that the goal of "tax parity" with suburban Maryland and Virginia jurisdictions largely has been achieved already.[(4)]

Table I
Income Tax Relief Scheduled under the Tax Parity Act

Household Income*	Tax Relief Implemented to Date	Additional Relief If Remaining Cuts Are Implemented	Total Tax Relief
$25,000	$175	$175	$350

$75,000	703	850	1,553
$150,000	841	1,864	2,705
* for family of four with two working adults. This assumes a family with income of $25,000 claims the standard deduction, that a family with income of $75,000 has $8,000 in itemized deductions, and that a family with income of $150,000 has $14,000 in itemized deductions.			

Claims of high taxes in the District typically are based on a comparison of income tax rates. When only income taxes are compared, the District's tax burden does look high, especially when compared with Virginia. DC's top income tax rate is 9.3 percent, while the top Virginia rate is 5.75 percent. This comparison is incomplete, however, because it fails to take into account other taxes that residents pay based on where they live, particularly property taxes. This omission is significant because the District's property tax rate is the lowest in the metro area. When the District's higher income taxes are considered along with its lower property taxes, regional tax burdens appear much more similar. The DCFPI analysis found that:

- For a family of four earning $50,000, the District's tax burden is *lower* than in all of the jurisdictions except Arlington, where the tax burden is essentially the same as in DC.

- At an income of $100,000, the DC tax burden is *lower* than in Montgomery or Prince George's counties. A District family at this income level would pay just $340 more than a family in Fairfax County, and $710 more than a family in Arlington County.

- Even at $150,000, the taxes paid by a DC family of four are *lower* than or essentially *equal* to those paid by suburban Maryland families. The DC tax burden at this income is $900 more than in Fairfax County and $1,500 more than in Arlington County. While these differences are not insignificant, they are no more than one percent of household income.

These findings call into question the need to place tax cuts before all other budget priorities.

A Better Alternative

The positive tax trigger was designed to implement tax relief in future years if it can be afforded. Unfortunately, significant design flaws in the trigger could lead to implementation of tax relief even when it is not affordable. Beyond that, the positive tax trigger places tax relief ahead of all other budget priorities. Given the substantial costs of the intended tax cuts, it is likely that few other budget initiatives could be addressed for several years if the trigger becomes law. Efforts to restore spending cuts that are being made to address the current budget shortfall, as well as other initiatives to enhance the quality of life in the District, would be delayed. Considering the fact that the District largely has achieved "tax parity" with its neighbors already, this direction seems particularly unwarranted.

A more appropriate approach would be to allow District policymakers to consider tax cuts and spending priorities on an even footing as DC finances recover from the current downturn. The positive tax trigger could be modified so that tax cuts would be implemented only when they would be affordable in the long term and would not require deep spending cuts. This could be accomplished by tying new tax relief to the financial plan developed each year, which includes five-year projections of spending and revenues. Such a provision could allow tax cuts to be implemented if projected revenues would be sufficient to both maintain existing services and to implement the tax relief for the five-year period of the financial plan. It also would be reasonable to develop expenditure projections based on the assumption that some or all of the spending reductions cuts included in the 2003 budget are restored. In particular, expenditure projections should assume return of tobacco settlement funds to their intended use and full funding of the Housing Production Trust Fund.

This design would help ensure that tax cuts are implemented in a fiscally sound way without jeopardizing funding for current programs and services.

End Notes:

1. The "positive tax trigger" is included in Title XI of the Fiscal Year 2003 Budget Support Act of 2002.

2. There are several other aspects of the provision that are worth noting. First, the provision indicates that even if the surpluses are met, tax cuts would not be implemented in a given year if national economic growth is projected to be weak in that year. Second, the provision specifies that if the trigger requirement is not met in one year but is met in a subsequent year, the District would not implement two years' worth of cuts at once, but instead would implement the cuts that had been scheduled for the prior year. If, for example, the District does not have a sufficient surplus in 2002 to meet the trigger but then has a sufficient surplus in 2003, only the tax cut scheduled for 2002 would be implemented.

3. See "Cuts in Mayor's Budget Would Fall Heavily on Low-Income Residents," DC Fiscal Policy Institute, April 15, 2002 (http://www.dcfpi.org/4-12-02bud.htm).

4. DC Fiscal Policy Institute, "DC's Excessively High Taxes: Just Another Urban Legend," April 11, 2002 (http://www.dcfpi.org/4-11-02tax.htm).