Testimony of Matthew Gardner, State Tax Policy Director
Institute on Taxation and Economic Policy
Regarding Bill 16-35
March 14, 2005

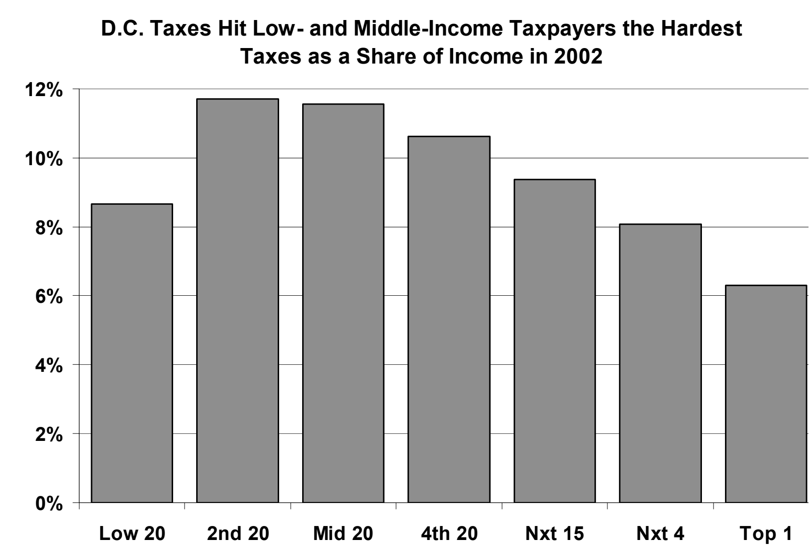
Thank you for the opportunity to discuss the changes in the District of Columbia's personal income tax proposed in Bill 16-35. I am Matthew Gardner, State Tax Policy Director for the Institute on Taxation and Economic Policy (ITEP). Founded in 1980, ITEP is a nonprofit tax policy research group focusing on federal and state tax policy issues, with an emphasis on tax fairness and adequacy.

ITEP's analysis of Bill 16-35 shows that it would impact the District's tax system in two important ways. First, the bill would make the District's tax system less unfair by reducing the income tax on low- and middle-income D.C. residents. Second, it would reduce the revenues available to fund public services by about $86 million if implemented in 2004. I will discuss each of these findings in turn.

The D.C. Tax System is Regressive

The District of Columbia's tax system is *regressive*. That is, when we measure the impact of all income, property, sales and excise taxes on individual D.C. residents at different income levels, we find that D.C. taxes take more of the income of low- and middle-income taxpayers than from the wealthiest D.C. residents.

As the following chart shows, in 2002 the poorest twenty percent of D.C. paid on average of 8.7 percent of their income in D.C. taxes, while middle-income D.C. residents paid 11.6 percent of their income and the very wealthiest 1 percent of D.C. residents paid just 6.3 percent of their income in D.C. taxes.



This inequity reflects the interaction of the many different taxes that D.C. residents pay. Sales taxes and excise taxes hit low-income taxpayers especially hard. Property taxes are also regressive. Only the personal income tax can tax wealthier D.C. residents at higher rates. When the impact of this one progressive tax and a host of other regressive taxes are folded together, we see a tax system that is regressive overall. Of course, no lawmaker would ever propose an income tax that applies higher tax rates to low-income workers and much lower tax rates to the wealthiest taxpayers. Yet that is essentially what D.C. lawmakers have enacted by allowing sales taxes, excise taxes and property taxes to play an important role in the tax system.

The remedy for this basic unfairness in the D.C. tax system is clear—lawmakers can either reduce the role of regressive sales and property taxes in funding D.C. services, while increasing the role of progressive income taxes, or they can make the income tax more progressive, either by reducing the income taxes paid by low-income families, or by increasing the income taxes paid by the wealthiest D.C. residents.

Bill 16-35 Would Make the D.C. Tax System Less Regressive

Like most state income taxes, the D.C. personal income tax allows families to shelter some basic amount of their income from tax through the use of exemptions and deductions. Exemptions provide bigger tax cuts for larger families, while the standard deduction does not vary with family size. But the exemptions and deductions allowed by the District are different from those used by the federal government and other states in two important respects: they're smaller, and they're not indexed for inflation. The low exemption means that low-income working families in D.C. are less effectively sheltered from paying tax than are families in many other states. The lack of indexing means that these exemptions and deductions are worth a little bit less to D.C. families every year.

Bill 16-35 would resolve both of these problems by increasing the District of Columbia exemptions and deductions to equal the federal amounts. Because these features of the federal tax system are indexed for inflation, this move would ensure that low-income D.C. residents would not face a hidden tax hike from this change each year.

This change would have a progressive impact on D.C. taxes if enacted in 2004, providing the largest tax cuts, as a share of income, for the poorest D.C. residents.

In particular, D.C. residents in the poorest twenty percent of the income distribution would see an average tax cut of $191 if this plan were enacted in tax year 2004. This would mean a tax cut equal to 1.5 percent of income for the average taxpayer in this group.

Taxpayers in the middle of the income distribution would see a larger tax cut in dollar terms, with an average tax break of $405 in 2004. But as a share of income, the tax cut would be somewhat smaller for this group than for lower-income taxpayers.

Distributional Impact of Bill 16-35

All D.C. Taxpayers, 2004

2004 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than $19,000	$19,000 – $35,000	$35,000 – $49,000	$49,000 – $78,000	$78,000 – $178,000	$178,000 – $405,000	$405,000 – Or More
Average Income in Group	$13,000	$27,000	$41,000	$62,000	$113,000	$260,000	$1,789,000
Tax Change as a % of Income	–1.5%	–1.3%	–1.0%	–0.6%	–0.3%	–0.1%	+0.0%
$ Average Tax Change	$ –191	$ –355	$ –405	$ –363	$ –331	$ –204	$ +297
Share of Total Tax Change	12%	22%	25%	22%	16%	3%	–1%

Source: ITEP Microsimulation Tax Model, March 2005

Bill 16-35 Would Reduce D.C. Tax Collections Substantially

Increasing personal exemptions and standard deductions is a progressive idea—but it is also a costly one. ITEP estimates that fully implementing bill 16-35 in tax year 2004 would cost about $86 million annually.

This relatively large cost reflects the design of exemptions and deductions. As previously noted, these tax breaks are available to taxpayers at all income levels, from the poorest wage earner to the wealthiest executive. A more targeted tax cut, such as an expanded property tax "circuit breaker" credit or an increased Earned Income Tax Credit, could provide low- and middle-income tax relief at a lower cost.

In thinking about the $86 million price tag of this proposal, it is important also to remember that not all of the city's revenue loss from this change would go to D.C. residents. Because state and local income taxes can be written off on federal taxes for those who itemize their federal 1040's, any policy change that reduces the D.C. income taxes paid by wealthier taxpayers will *increase* the federal income taxes paid by these same taxpayers. As a result of this interaction, about 5 percent of the city's revenue loss from this proposal would never see the inside of D.C. taxpayers' wallets at all, but would go directly to the federal government in the form of higher federal income taxes for D.C. itemizers.

This interactive effect means that D.C. policymakers have a basic policy question to answer in designing income tax cuts: how much of this tax cut should go to D.C. taxpayers? If the answer is "all of it," then the best way to achieve this is to enact a tax cut that targets its benefits only to the low- and middle-income taxpayers who are hit hardest by the D.C. tax system. If you give income tax cuts to D.C. residents who don't itemize their federal income taxes, you'll have achieved this objective. If, on the other hand, you give income tax cuts to wealthier taxpayers who do itemize their federal income taxes, some of that tax cut will be lost to the federal government. From an economic development perspective, in other words, the greatest "bang for the buck" can be gotten by targeting tax breaks to low-income taxpayers.

Conclusion

The provisions of Bill 16-35 achieve greater tax fairness, but at the cost of reduced city tax revenues. The Council is to be commended for recognizing the inequity of the city's taxes. The larger question, of course, is whether such a tax cut is affordable at this time. Area governments are already confronting the legacy of previous tax cuts, enacted in the late 1990s, that some argue were unaffordable. Virginia's legislation to repeal the car tax and the food tax have dramatically constrained the state's ability to fund services in the recent economic downturn. Previously enacted income tax cuts in Maryland and the District have arguably had the same effect. Before enacting tax cuts of this magnitude, it is important to ask whether the city's public services are being adequately funded not just for fiscal year 2006, but for the next five years and in the long run. Permanent tax cuts can hamper the city's ability to provide the services we would like our government to provide.

Thank you for the opportunity to testify.