INSTITUTE ON TAXATION AND ECONOMIC POLICY

Personal Income Tax Reform: Improving the Fairness of Taxes in the District of Columbia

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Chairman Williams and members of the commission, thank you for the opportunity to submit this testimony. My comments will focus on reforming the District of Columbia's personal income tax, with an aim toward improving the overall fairness of DC's tax system.

This January, my organization released the fourth edition of our *Who Pays?* report, analyzing the distribution of state and local taxes in all fifty states, as well as in the District of Columbia.[1] In that report we found that middle-income DC residents devote significantly more of their income to paying DC taxes than their upper-income neighbors. While the top 1 percent of earners pay 6.3 percent of their incomes in DC taxes, and the top 5 percent of earners pay 7.1 percent, middle-income taxpayers pay a much higher effective tax rate ranging from 9.4 to 11.0 percent.

This means that for all but the poorest taxpayers, DC's tax system is markedly regressive. This is driven largely by the regressive impact of the city's sales, excise, and property taxes. The personal income tax is the only effective tool that DC has available for offsetting this regressivity. In the comments below I discuss four options for fine-tuning DC's income tax to lessen its impact on moderate- and middle-income taxpayers. I also describe four options for funding those tax cuts with policies that would increase upper-income taxpayers' effective tax rates to be more in line with those paid by their less affluent neighbors.

Cutting Taxes for Middle-Income Residents

The District's moderate and middle-income families face a fairly high effective tax rate when compared to that levied by other states. Four options for bringing down the tax rates faced by these groups are discussed below.

[1] http://www.itep.org/

1. **Standard Deduction:** Increasing the District of Columbia's standard deduction is among the best options available for providing targeted relief to moderate income residents. Roughly 60 percent of DC tax returns claim the standard deduction, including 75 percent of returns with incomes under $75,000.[2] Unlike boosting the personal exemption or cutting the rates applied to lower levels of income, a standard deduction increase would benefit very few high-income taxpayers. Instead of claiming the standard deduction, upper-income taxpayers tend to itemize because they have significant amounts of mortgage interest, charitable deductions, and other deductible expenses. Increasing the standard deduction could also simplify the tax filing process for taxpayers who find that the higher standard deduction amount exceeds their itemized deductions, and therefore allows them to forego the additional effort needed to document and claim itemized deductions.

2. **Personal Exemption:** Most states with broad-based personal income taxes offer a personal exemption that is larger than DC's $1,675 exemption. Increasing this exemption would primarily benefit the District's lower- and middle-income families, though even the most affluent residents would benefit unless the exemption is phased-out at higher income levels, as is done at the federal level and in many states (see bullet #2 in the next section).

3. **Tax Rates and Brackets:** While the District of Columbia's personal income tax rate structure is more in line with the "ability to pay" principle than many states', there is still room for improvement. Currently, DC residents' 40,001st dollar of taxable income is taxed at the same rate as their 350,000th, despite the very different financial circumstances of different residents found throughout this income range. Changing the rate structure in a manner similar to Policy Option #7 would therefore improve the equity of DC's personal income tax, though the options' focus on cutting rates, without any offsetting increases, would pose a challenge for DC's budget. Moreover, from a fairness perspective, this option is not as well targeted as increasing the standard deduction or personal exemption. ITEP estimates that 21 percent of the benefits of this option would flow to the most affluent 5 percent of DC residents. In other words, out of the roughly $55 million price tag that the Office of Revenue has attached to this policy option, at least $11.5 million would not actually go to the "middle-income taxpayers" that this reform is designed to benefit.

4. **Earned Income Tax Credit:** The District of Columbia's Earned Income Tax Credit (EITC) is fairly generous, but not for workers without children. While a family with one child can claim up to $1,300 in DC EITC benefits in 2013, low-income residents without children receive $195, or less, from DC's EITC. Given the EITC's proven track record of encouraging work and lifting families out of poverty, expanding the District's meager EITC benefit for childless residents is a wise policy choice. Moreover, doing so would significantly improve the distribution of DC's overall tax system. While ITEP estimates that the District's poorest residents face a fairly low effective tax rate overall (6.6 percent), this finding masks a significantly higher effective rate being paid among poor families without children who see little, if any, of their sales, excise, and property tax bills offset by the EITC.

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[2] http://cfo.dc.gov/node/217262 and http://media.wix.com/ugd/ddda66_9597deffad39e7d35ae18a79ef609786.pdf

Funding Middle-Income Tax Cuts

Middle-income tax cuts would come at a significant cost to DC's budget. The Office of Revenue Analysis estimates that raising DC's standard deduction and personal exemption to match the federal amounts, for example, would cost nearly $109 million per year. Cutting the state's middle-income tax brackets as described in Policy Option #7 would cost an additional $55 million.[3] Since revenue reductions of this size would require a significant reduction in the quality of public investments like education and infrastructure, it is important that the Commission also consider tax policy options for funding any middle-income tax relief. My comments below focus on four revenue-raising options that would primarily affect the District's high-income residents—the group who, as described above, currently faces a much lower effective tax rate than the middle-class.

1. **Itemized Deduction Phase-Out:** Starting in Tax Year 2011, the District of Columbia began phasing-out itemized deductions for taxpayers earning over $200,000 per year. This policy limits the steep regressivity of itemized deductions—an issue that an increasing number of states, and the federal government, have recently addressed with similar limits on itemized deductions. Two reform options and one additional issue are discussed below.

    a. **Increasing the phase-out rate:** DC itemized deduction phase-out reduces a taxpayer's deductions by 5 cents for every dollar by which their income exceeds the phase-out starting point. This means that for a taxpayer with $40,000 in itemized deductions, they continue to at least partially benefit from those deductions until their income reaches $1 million per year. Speeding up the phase-out to 7 cents per dollar, for example, would prevent that same taxpayer from claiming any itemized deductions if their income exceeds roughly $572,000.

    b. **Capping deductions:** Hawaii and Maine have itemized deduction phase-outs that are very similar to DC's, though each of these states also pairs their phase-out with a strict cap on the maximum itemized deduction that a taxpayer can claim. Capping deductions ensures that itemizers' tax benefits are not too far out of line with those received by taxpayers claiming the standard deduction. Maine's $27,500 cap effectively limits taxpayer's maximum itemized deduction to 3.7 times the value of its standard deduction, while Hawaii's $50,000 cap limits itemizers to roughly 11.4 times the benefit that standard deduction claimants receive.[4]

    c. **Decoupling from the federal "Pease" limitation:** With the return of the federal government's own itemized deduction limitation (known as "Pease") as of January 1, 2013, some have expressed concerns that the District may soon be applying two sets of phase-out rules to its itemized deductions. While this issue is of concern, resolving it is straightforward. The federal government's itemized deduction limitation takes effect at a higher level of income than DC's, and phases out itemized deductions more slowly. For these reasons, replacing the District's limitation with

[3] Note that the combined cost of these two reforms would be slightly different than the simple sum of their revenue estimates, as a result of interaction effects between the District's tax rates and exemptions/deductions. *See* http://media.wix.com/ugd/ddda66_9597deffad39e7d35ae18a79ef609786.pdf and http://media.wix.com/ugd/ddda66_bd7d79a42982824a59788b5582eb0796.pdf.

[4] Hawaii's standard deduction is $2,200 for singles and $4,400 for married couples, compared to a maximum itemized deduction of $25,000 for singles and $50,000 for couples. Maine's $27,500 cap does not vary by filing status and is worth 3.7 times the state's $10,150 standard deduction for couples or 5.4 times its $5,075 standard deduction for singles.

the federal Pease provision would result in a sizeable tax cut exclusively for taxpayers with over $200,000 per year in taxable income. Given that District residents at this level of income currently face a lower effective tax rate than any other group, and given that the Commission appears most interested in cutting taxes for *middle*-income families, the District should opt to keep its own limitation rather than replace it with Pease. Doing so would simply involve decoupling from this portion of federal law, and would not require adding even one line to the District's income tax return (see footnote).[5] Maintaining the District's current phase-out obviously will not "raise" revenue to fund middle-income tax cuts, though it would avoid a reduction in revenue for the District.

2. **Personal Exemption Phase Out:** The federal government and over half a dozen states, including Maryland, phase-out the value of their personal exemptions for high-income taxpayers. This kind of phase-out better targets the exemption to those taxpayers with less ability to afford their tax bills. And attaching a personal exemption phase-out to any increase in the size of the personal exemption could significantly lower the cost of such an increase. If DC decides to conform its personal exemption amounts to match the federal exemption, the federal phase-out should become a part of DC law as well, unless lawmakers specifically act to decouple from that portion of federal law. But an exemption phase-out is a policy option regardless of whether DC conforms to federal law. Maryland's phase-out is a stand-alone provision beginning at incomes of $100,000 for singles and $150,000 for married couples, while the federal exemption phase-out begins at $250,000 for singles and $300,000 for married couples.

3. **Tax Rates and Brackets:** While few observers would argue for raising the District's 8.5 percent tax rate on taxable incomes of $40,000, the fairness and yield of DC's income tax could be improved by raising the tax rates applied at higher levels of income. Making permanent the 8.95 percent rate on incomes over $350,000 is an important first step in this regard, though even with this temporary bracket the top 1 percent of DC earners currently pay a lower effective tax rate than any of their lower-income neighbors. Additional, higher rate brackets on incomes over $500,000 (as described in Policy Option 8) could further improve the distribution of DC taxes. Lawmakers could also consider revisiting the current 8.95 percent bracket so that it applies at a slightly lower level of income—similar to the $250,000 top bracket in place in Maryland.[6] Another option would be to adopt a tax rate "recapture" provision similar to those in place in Connecticut, Nebraska, and New York. These recapture laws prevent high-income taxpayers from benefiting from the lower rates levied on the first portion of their income.

4. **Out-of-State Municipal Bonds:** The District of Columbia's unusual tax break for interest collected on out-of-state bonds overwhelmingly benefits the District's most affluent taxpayers. According to the Office of Tax and Revenue, three out of every four dollars of tax exempt

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[5] DC residents currently begin calculating their DC itemized deductions (in Calculation F of the D-40 Instruction Booklet) by subtracting their state income tax and sales tax deduction from their "Total Itemized Deductions from Form 1040." In order to avoid applying the federal Pease limitation to the District's itemized deductions, DC's tax forms would simply need to be changed to require that the taxpayer subtract those same income and sales tax deductions from "the total of the amounts from federal Schedule A, lines 4, 9, 15, 19, 20, 27, and 28." Prior to the elimination of Pease in 2010, this is the exact same calculation that taxpayers subject to Pease performed on Line 1 of their Itemized Deduction Worksheet (federal 1040 Instructions, 2009).

[6] Maryland's top bracket applies to singles and married taxpayers filing separately who earn $250,000 or more, and to heads of household and married couples filing jointly that earn $300,000 or more.

interest income flow to DC taxpayers with over $200,000 in annual income.[7] Just 5.7 percent of this income flows to the much larger group of taxpayers with incomes under $50,000. No state in the country offers this kind of comprehensive tax break on bonds issued by other states. Eliminating the exemption for bonds purchased in the future, while retaining the exemption for bonds that have already been issued, could generate significant revenue for middle-income tax cuts without disrupting the cash flow of retirees who already purchased bonds that they anticipated would be exempt from DC taxes. Grandfathering-in the exemption for previously issued bonds, however, would significantly reduce the yield of this reform in the short-term, and may require gradually phasing-in any middle-income tax cuts enacted alongside it.

Conclusion

The District of Columbia's tax system has a fairness problem. Low-income and middle-income families pay more of their incomes in local taxes than the best-off families must pay. I have outlined several sensible strategies for mitigating this unfairness by reducing taxes on middle- and low-income families. But in a challenging fiscal environment, these tax cuts must be paid for, and the city has a number of straightforward revenue-raising options that would help fund middle-income tax cuts by increasing income taxes on the best-off taxpayers.

Thank you for the opportunity to testify.

[7] http://www.dcfpi.org/dcs-millionaire-tax-shelter-out-of-state-bonds