

Conceptual Framework and Guiding Principles for Judging the District of Columbia Revenue System

The Commission is requested to adopt of binding statement of a set of guiding principles early in its deliberations. A draft of these proposals begins on Page 5 of this document. In drafting these criteria for Commission review the staff has taken into account the wording in the Commission's legislative mandate (Text Box 1). In order to frame this Commission discussion, pages 1 and 2 provide background on the traditional theory of the public budget regarding the assignment of fiscal roles among different types of government (federal, state, local).

While the District of Columbia has experienced strong economic and population growth over the last ten years, it faces serious challenges, generally beyond the control of local policy makers, in the next decade. For example, regardless of the outcome of the 2012 election, the federal government must confront its growing debt. It is likely that there will be significant retrenchments in the federal government over the next decade which will directly impact the economy of the District.

Similarly, the economy of the District is undergoing a transformation from reliance on businesses related to the federal government (e.g., law firms, lobbying activities, etc.) to an increased reliance on education and health care sectors. The nature of the District's employment will change as a result of this trend and tax revenues may decline because the growing sectors tend to be non-profits exempt from taxation. In the context of these evolving trends and looking out over the decade to come, it is appropriate, and necessary, to review of the District's revenue system.

Much has changed in the District since the last tax commission report of 1998. In response to trends over the last decade, there have been many piecemeal changes to the revenue system of the District. Often such changes respond to short term developments without systematic consideration of their long term effects. While this is typically how the policy process works, it is beneficial from time to time to step back and take a broad look the intended and unintended consequences of such actions.

The Commission sees its role as providing goals, directions and recommendations for District of Columbia revenue policy with regard to how these recommendations fit together for a revenue system as a whole and for their short *as well as* long term effects.

The overall theme for the Commission is to structure a revenue system that is responsive to the DC's changing "external" environment of the economic, demographic, institutional and technological that frame, and constrain, the policy options of state and local government. The task of being responsive to this changing "fiscal architecture" is not only of great importance, but also within the control of local policy makers.

Among the most important of the Commission's decisions --some argue it is the single most important -- will be the set of normative goals that the Commission adopts to guide its revenue policy recommendations as the District of Columbia approaches the quarter century mark.

That a Commission agreement on the goals for judging a revenue system is important is true for three reasons. First, as the Commission moves through its examination of the current DC revenue system the members will not only have to sort through, and sort out, many arcane matters, but then having done so, make recommendations as how the city should best fund its flow of public services to its citizens. And, it will often turn out that what "makes sense" for one set of revenue recommendations may conflict with the results or outcomes of another set of recommendations. Thus, early agreement on what the revenue

system should look like will force a discipline on the Commission (as well as on current and future policymakers) on how to recognize and weigh the pros-and cons of policy options for structuring a system that will define revenue policy not only in the next financial plan but also for the several fiscal years ahead.

Second, agreement on a set of principles for policy deliberation serves to further emphasize that in making its recommendations the Commission is considering the revenue *system* as a whole. That is, that Commission recognizes that relationships exist among the many separate tools for funding the public services and that not every component of the system will –nor should it– meet all the goals of a “good” tax, but that what matters is whether the components taken together satisfy the Commission’s guiding principles.

Third, Commission agreement on a normative set of goals makes the statement that however technical, complex and often arcane a revenue system may become in order to match the technical and complex nature of the DC economy, one must never lose sight of the fact that the revenue system is, fundamentally, a statement about the relationship between the citizens and their government and among the citizens themselves.

Conceptual Framework: DC as an Open Economy

The generally accepted analysis of public finance assigns three primary goals for public sector activity: the maintenance of full employment and price level stability (Stabilization), the determination and attainment of an equitable distribution of income and wealth (Distribution), and the avoidance/minimization of the misallocation of society’s scarce resources that results from inefficiencies in the private market system (Allocation).

Clearly, these functions overlap. For example, an expanded public transportation program will not only reallocate resources from public to private uses (allocation), but also redistribute income of property owners living along and at the beginning and end of the transportation improved corridor. Similarly, the method of financing, whether through bonds, fares, and/or taxes and fees, will have its own distributive effects. Further, the project may have local effects on employment and prices, the extent to which is largely a function of regional and national economic conditions (stabilization).

However, despite such overlapping, the standard stabilization-distribution-allocation breakdown provides a useful framework for answering a fundamental question of public budget policy: which type of government, federal, state or local should be charged with the overall performance of the three functions?

The answer to the question is not just an exercise in theory, but, rather, goes to the practical reality of the degree of “openness” of the economy. If DC were a closed economy—that is, an economy isolated from the rest of the world, with no extra- jurisdictional transactions, the benefits of, or costs imposed by, a given policy could be largely limited to the residents of the jurisdiction. That is, the “spillovers” to other jurisdictions would be minimized. Although no economy is completely closed, a national economy with a government that has the authority to restrict the flow of economic resources (such as the US in its entirety) better approximates this structure than does a state or local government. Thus, inter-jurisdictional factor (e.g., labor, capital) and product mobility does not become a major consideration in national budget policy.

However, a critical asymmetry exists for state or local budget policy because of the “open” nature of the jurisdiction. Unlike the federal government, the District of Columbia has no authority to legislate tariff, quota, or import license barriers to restrict the flow of services. Nor can it effectively restrain the movement of factors through migration controls or investment regulations. Nor, can it establish its own

banking system to control the money supply in order to manipulate the local prices or stimulate job creation.

Given this asymmetry, the public budget fundamentals of an open economy are structurally different from that of national budget policies. One implication of this reality is that the achievement of stabilization and distribution goals are primarily a concern of the national (federal) government, but that the most quantitatively important role of “government”—the commandeering of private resources for public sector use—accrues to the state and local sector (and, to note, DC is the only subnational government that performs both state and local fiscal roles).

The Stabilization Function

There are three reasons why the District as a state and local government Columbia cannot effectively carry out stabilization policies. The first has already been mentioned, and that is that it cannot control the supply of money and credit. Second, due to its openness, the District is unable to effectively induce changes in local economic output, employment and price levels through fiscal policy—the discretionary manipulation of the level of tax and expenditure levels. Although changes in DC’s tax and spending policies may be directed toward local residents, the stabilization effect will be greatly dampened by spending leakages across its borders. Thus, for example, money that accrues to a DC resident through a tax reduction package and/or an employment program will be greatly dampened by spending leakages (e.g., the income earned in the DC used to make a the money payment for a Washington Nationals baseball cap may be channeled in various ways such as to the manufacturer in Bangladesh, the wholesale distributor in Baltimore, the retail clerk who lives in Bowie, and the retailer’s lawyer from Cleveland). In the economist’s jargon, the stimulus effect of the “multiplier” is very small.

The third reason for the inherent ineffectiveness of a state or local government’s stabilization policy stems from the labor in-migration effects that would be induced even if there were no spending leakages. For example, if DC were successful improving large scale employment (say on some public works project) there is no legal means to stop current non-resident laborers from moving here, thus frustrating the District’s full employment goal. Again, there is a dampened “multiplier” effect.

Distribution of Income and Wealth

A dominant theme in U. S. social policy holds that overall effective tax progression –that effective tax rates on individuals increase as their income increases -- is a desirable goal. This theme has particular political attraction in large central cities which, ringed by high income suburbs, are home to a disproportionate number of low income families.

But again due to the openness of an economy, caution must be used in the making of local tax and transfer policy. The federal government can tax high income earners with little concern to what happens to the composition of its population; there are relatively few tax expatriates from the U.S. However, were a local government to strenuously undertake redistribution income through its fiscal operations, one would expect an in-migration of low income families and out-migration of high income taxpayers. The point here is not to argue that the “gressivity” issue is either irrelevant or unimportant to a local government, but rather, to note that an attempt by a local government to dramatically redistribute income and wealth through “own” tax and spending will be self-defeating.

Is there a case for tax progressivity in a state/local “open economy”? Yes. There are at least two justifications. The first is that since many state and local taxes are inherently regressive, employing other taxes that are progressive will serve to offset the overall regressivity of the tax system as a whole. Second, if there is general agreement with the ability-to-pay principle of taxation (effective tax rates as

income increases) as it applies to individuals, it follows that there is a policy presumption in favor of some degree of overall progressivity in a tax system. Such a policy has merit as long as it does not create unintended outcomes elsewhere in the economy (further discussion below when one comes to the goals of efficiency and equity).

Allocation of Society's Scarce Private Resources of Land, Labor, Capital & Entrepreneurship

Of the tasks goals of public policy, it is the allocation function—the commandeering of economic resources for public use— that falls largely to a state & local government such as District of Columbia. In general the assignment of these allocation decisions is based on the spatial extent of the benefits of a particular good or service. Thus, the scope of public good that may have nationwide (or regional) benefits will be federally (or regionally) determined; e.g., nationally: defense, customs and international immigration, environmental protection; regionally: inter-local transportation, water supply. There is also an important role for inter-jurisdictional cooperation in the provision of some largely “local” services (e.g. solid waste management)

Conversely, there are public goods and services for which the assignment to local jurisdictions is not only feasible, but from a broad resource allocation perspective, are such that will promote the efficiency and equity goals of public policy (terms and a topic to be examined below in the following list of goals and empirically in subsequent Commission meetings). Examples include benefits that can be largely limited to a local jurisdiction: police and fire protection, street construction and maintenance, education, literacy promotion, skills training, sanitation services, health clinics, and cultural and recreational facilities.

When one adds up the numbers on the expenditure side of the total public budget, it is clear that is just how US society works: the US state and local sector accounts for just over 12 percent of the US GDP. This is one and a half times the size of the federal sector with national defense spending included and four and a half times federal government spending when one considers only federal non-defense spending.

Note that the preceding discussion does not address the question of the appropriate size of government. There are good and bad ways to generate a given agreed-upon level of revenues in a state and local system regardless of one's view of the appropriate role of government on the expenditure side of the budget equation.

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Guiding Principles for Design of the Washington, DC Revenue System

The Commission's *Guiding Principles* for the design of a high quality revenue system for the Washington, DC (District of Columbia) is presented below. In its adoption and application of these principles for making its final recommendations for reforming and restructuring the District of Columbia revenue system as it approaches the quarter century mark, the Commission explicitly notes the advice of Justice Oliver Wendell Holmes (1927) that "Taxes are what we pay for civilized society" and that to enhance that civil society government plays an important role as a "fifth factor" of production" to complement the private factors of land, labor, capital, and entrepreneurship. The Commission also notes that with respect to these *Principles*, the terms "revenue" and "tax" may be used interchangeably.

Certainty

The primary job of a revenue system is to produce revenues that finance an agreed upon flow of public services and, in doing so, balance the tradeoffs between *elastic* revenue sources that tend to expand at least as rapidly as the District's population and economic activity with those that provide revenues that are *stable* whether the level of business activity and income rises or falls.

That getting the right balance of revenue elasticity and stability is important is a recognition that a system that is highly responsive to changes in the District's economic activity may provide prodigious revenues in periods of prosperity and growth; but that in slow growth period revenue may decline faster in percentage terms than a jurisdiction's income. The result may be not only unintended cutbacks in existing public services and safety net programs, but also a high degree of financial uncertainty for its individual and business taxpayers alike. Thus, the commission recognizes the need for a mix of elastic and stable revenue sources for the system as a whole.

~~Recognize the District's Changing Fiscal Architecture~~

~~The Commission recognizes that the revenue system must be designed to capture the fiscal benefits of its fiscal architecture. Global and national trends in economic, demographic, institutional arrangements are occurring that are beyond the control or manipulation of District of Columbia policymakers and administrators. Nevertheless these trends, which taken together define the "fiscal architecture" for its revenue producing potential cannot be ignored since they frame—and constrain—what makes long term fiscal sense so that the revenue system not become disconnected from the underlying foundation of the local economy. If a system becomes obsolete for its times, the inherent structural weaknesses of that revenue system may become intolerable, leading citizens to lose confidence their government.~~

Neutrality (Efficiency)

Neutrality or efficiency in taxation recognizes that revenue should be chosen so as to minimize unintended interference with private economic decisions in otherwise efficient markets. Special emphasis here must be placed on the word "unintended." A revenue-induced distortion of private economic decisions may be justified in the public interest to encourage or discourage a particular activity. Thus the Commission adopts the neutrality principle that any such distortion be deliberate and transparent, but that otherwise private economic decisions should be guided by the market and not by the revenue code.

Competitiveness

The District of Columbia's revenue system should be compared to other places for which it competes for residents and jobs and therefore be evaluated for the effects on the growth of the City's economy and employment and the migration of residents. In adopting this goal of the Commission recognizes that not all competitiveness strategies are revenue related and that when revenue policy does become relevant to local economic development, that policy not be *ad hoc* but rather be made with regard to the system as a whole and as to its long term effects.

Fairness in Apportionment of Revenues (Equity)

Few questions in public finance are more subjective than the question of how to allocate the cost of financing government across the businesses and individuals in a community. Nevertheless, tax equity is a proper concern in economic analysis and must be addressed as objectively as possible. There are two dimensions of equity that will guide the Commission's recommendations. *Horizontal equity* requires that taxpayers in the same economic circumstances pay the same in same amount of tax – "equal treatment of equals". This principle is applicable to individual and business taxpayers alike and, for individuals, incorporates the concept of fairness across generations. "Equal treatment of taxpayers" in similar circumstances can also often be promoted by taxing on the basis of "benefits received" whereby there is a matching between those who benefit from a flow of public service and those though pay the tax cost for those services.

Vertical equity is the principle used to judge the fairness of a revenue system that holds that individual taxpayers in different circumstances should pay different amounts of tax/revenue. Vertical equity implies that the different circumstances of some individuals having a higher of levels of income and wealth have a higher greater ability to pay tax than do others, and thus, should pay a higher effective tax rate.

Transparency and Accountability

Changes in the tax system should be the result of explicit and fully disclosed legislative actions rather than the under a veil of hidden or complex institutional arrangements. To promote such accountability the government should routinely reports to its citizens on the structure and operations of the revenue system with documents that they can understand. In turn, the citizens of the District of Columbia must exercise their responsibilities to monitor tax and spending policy

Simplicity in Taxpayer Compliance and Revenue Administration

The Commission adopts the twin principles of ease of taxpayer compliance and revenue administration. On the matter of compliance, taxes should be designed to minimize the costs borne by taxpayers (individuals and business institutions alike) in keeping records, compiling and filing tax returns, and working through an audit and appeals process. Such revenue simplicity not only enhances citizen understanding of, and control over, their revenue system, but also promotes voluntary compliance and reduces tax evasion. In a similar manner, a system that creates undue complexity for the revenue administrator (i) increases the citizens' cost of running a government agency for which there is no corresponding service benefit and (ii) makes more difficult the accomplishment of the intended outcome of the elected policymakers

As the Commission considers its options for restructuring and reform of the District of Columbia revenue system there will inevitably be tradeoffs among the *Guiding Principles*. For example, a high reliance on a broad base of consumption spending will typically be associated with regressivity –a violation of vertical equity--and yet it also provides a good source of revenue system stability and promotes horizontal tax equity. Thus, just to reach tax proportionality (effective tax rates are the same across all income classes),

compensatory adjustments may have to be made with respect to taxes on wealth (tax base) and income (typically, base and rate adjustments). That such tax system balancing will be required in order to satisfy all six of the goals for the revenue system further indicates that a high quality revenue system will employ a mix of revenue types.

Text Box 1: Consistency of Proposed TRC Guiding Principles With Its *Legislative Mandate*

There is established a Tax Revision with the purpose of preparing comprehensive recommendations to the Council and Mayor [that will]

1. *Modernize, simplify, and increase transparency*—explicitly included below
2. *Broaden the tax base* [comment: base broadening is a strategy to achieve the objectives of a high quality revenue system, but not a goal in itself. Indeed, with respect to cost-recovery and “getting the prices right” for the payment of some specific services, on both equity and efficiency grounds some revenue sources should be narrowly based]
3. *Make the District’s tax policy competitive with surrounding jurisdictions*—included (neutrality/efficiency)
4. *Encourage business job growth and creation* - included (competitiveness, efficiency) 5. *Provide for fairness* in apportionment of taxes –included (equity)

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