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**HIDING THE COSTS OF BUSINESS TAX CUTS
Bill 17-20 Could Lead to Substantial Tax Cuts,
But Was Designed to Appear to Have No Effect on DC Finances**

On December 11, the DC Council adopted a bill on first reading that will provide \$11 million in small business property tax relief. The funds for this tax cut had been set aside in the city's fiscal year 2008 budget. The bill faces a second and final reading in January 2008.

The bill, however, also includes additional provisions that would put in place a contingent tax cut — based on a trigger — that could reduce the commercial property tax rate in FY 2009 and every single year after that. The contingent tax cut would be set to occur whether or not the District could afford the revenue loss in that year, and whether or not the commercial property tax cut is or should be the highest priority use of funds in that future year.

While a proposal to reduce the commercial property tax rate is a reasonable policy to consider, the structure of the tax cut provision in this bill is flawed and irresponsible. Because it is designed as a contingent tax cut, it is been estimated to have no effect on the city's future finances — clearly an erroneous method of looking at future finances. As a result, it is a hidden tax cut. For this and other reasons, this tax provision should not be adopted.

How the Bill Works

Bill 17-20, The Small Business Commercial Property Tax Relief Act of 2007, would trigger an automatic cut in the business property tax rate (known as Class 2 properties) if commercial property tax collections in fiscal year 2009 are higher than the most recent projection for collections that year. That projection was made in December 2007. Every dollar in revenues collected in excess of the current projection would be used to reduce the commercial property tax rate. The tax cut would be tied to the first \$3 million of property value for all businesses. This provision helps all businesses, but it targets a greater share of the tax reductions on smaller properties than if the tax cut were spread over the full value of all business property.

In each year after fiscal year 2009, the bill would trigger a similar automatic cut in the commercial property tax rate if commercial property tax collections are projected to grow more than 10 percent. Again, the additional revenues would be used to reduce the tax rate on the first \$3 million of commercial property value. The bill sets a limit on how low the rate can fall.

Problems with the Bill

As noted, it is reasonable for the District to consider commercial property tax reductions as a use of city revenues. The particular structure of this tax cut, however, places business tax cuts as the

first priority for the FY 2009 budget well before the budget is even drafted. More importantly, bill 17-20 was designed in a way that hides the cost of the tax cuts, which is not fiscally responsible.

There are four key problems with the bill.

Problem 1: This bill makes business property tax cuts the top priority for the fiscal year 2009 budget and beyond, placing it ahead of other needs. Currently, commercial property taxes are deposited in the city's general fund and used for all general services — education, public safety, health and welfare, etc. Bill 17-20 would dedicate a portion of those taxes to reduce the commercial property tax rate if commercial property tax collections exceed a specified amount. The tax cut would be automatic and would preclude discussions of other uses of the funds, such as investments in education or reductions in other taxes.

This is in essence a “contingent” funding requirement. It dictates how unforeseen revenues would be used in future fiscal years. A better approach would be for the Mayor and Council to decide how to use the additional funds when they materialize, since there may be a different set of priorities at that time. In recent years, the Mayor and Council have rejected the notion of contingent funding, on the premise that decisions over the use of additional funds should be made when the funds become available.

Problem 2: The bill taps funds that are not “surplus” funds. The premise behind bill 17-20 seems to be that any commercial property tax collections in FY 2009 that exceed the *current* projection should be considered surplus funds. Yet this is not the case. The current revenue estimates are simply projections at one point in time. The projected growth rate in real property tax revenue will change as revised revenue estimates are made. In fact, there will be two more revenue forecasts prepared before the fiscal year 2009 budget is finalized. This further suggests that bill 17-20 effectively is making decisions for the FY 2009 budget well before the Mayor has submitted a proposed FY 2009 budget.

The impact of this provision on DC revenues could be significant. If the commercial property tax collections in FY 2009 are just five percent higher than the current estimate, bill 17-20 would trigger an automatic tax cut of \$65 million. If these revenues turn out to be 10 percent more than currently projected, the tax cut would total \$130 million.

It also is important to note that revenue growth projections made for future years tend to be somewhat conservative. For example, while total property tax collections (from both homes and businesses) rose 23.5 percent in FY 2007 and are projected to grow 13.5 percent in FY 2008, the projected growth rates for FY 2009 and beyond are seven percent or less. If the actual growth in tax collections in FY 2009 is closer to the recent trend, rather than the current conservative projection, a substantial tax cut could be triggered.

Problem 3: The bill hides the costs of possible business tax cuts. If the Council were to adopt a simple reduction in the commercial property tax rate, an official fiscal impact statement from the Chief Financial Officer would show that the tax cut has a cost in terms of lost revenue. It is likely that the CFO would conclude that funds are not sufficient to implement it. In fact, the CFO's fiscal impact statement for the original version of this bill — which assumed a 10 percent cap on how much a business property's taxable assessment could grow each year — concluded that it would have a substantial negative fiscal impact.

The current bill is similar to a 10 percent cap, in that it would limit growth in total commercial property tax revenues to no more than 10 percent per year, although it is limited to the first \$3 million of any business property. This suggests that the revised bill still should show that it has a negative fiscal impact (i.e., that it reduces revenues). Yet the Finance and Revenue Committee report on the more recent version of the bill indicates that it would have *no* impact on the city's finances, even though the bill could lead to automatic tax cuts year after year. This is because the tax cuts are pegged to current revenue forecasts and would only go into effect if actual revenue collections are higher than currently projected.

This means that bill 17-20 can be adopted without identifying a way to pay for the tax cuts. This is not a fiscally responsible way to provide commercial property tax reductions, and it sets a dangerous precedent for future tax-cut proposals. If the Mayor and Council agree that such tax cuts are a priority, the costs of the tax cuts should be accounted for fully and should be funded only if necessary funds can be found in the existing budget at the time the tax cuts are made.

Problem 4: This bill could lead to automatic business tax cuts in the midst of a fiscal crisis:

There can be times when one revenue source — such as property taxes — is growing well, while overall revenue growth is weak due to problems with other sources. Between FY 2002 and FY2003, for example, total tax collections for the District dropped by \$50 million as a result of falling sales and income tax revenues. Yet property tax collections grew at a rate of 14 percent that year. This bill would have triggered a tax cut at a time when total city revenues were already weak.

An Illustrative Example

Consider the following example to illustrate the problems with bill 17-20. In 2005, the CFO projected that total property tax collections would reach \$1.4 billion in fiscal year 2008. Today, the current forecast is that property tax collections will be over \$1.6 billion. If the Council had adopted a bill in 2005 to use “additional” property tax collections in FY 2008 for tax cuts — that is, any collections above the estimate made in 2005 — it would have led to \$200 million in automatic tax cuts this year. Such a bill would have been treated in 2005 as having no impact on the city's future finances, because it would have been tied to revenues that exceeded projections made at that time. Yet clearly \$200 million in tax reductions this year would make it hard to fund important initiatives in education, affordable housing, public safety, and other areas.

Conclusion

The automatic business tax cuts included in Bill 17-20 should be eliminated. This does not mean, however, that the District cannot consider business property tax reductions. Rather than allowing the rate to drop automatically, policymakers could consider the need for business property tax reductions in light of the city's overall budget situation and other budget priorities each year, and then adopt business property tax cuts as part of the budget. Adopting more straightforward tax cuts — with clear costs and clear ways to pay for them — will help ensure that tax cuts fit into the DC budget in a fiscally responsible way.