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**FINANCE COMMITTEE TAX CUT PROPOSALS
WOULD MAINLY BENEFIT HIGH-INCOME RESIDENTS
More Progressive Alternatives Are Not Being Considered**
By Ed Lazere

Friday, May 4, the Committee on Finance and Revenue approved two tax relief measures that primarily would benefit high-income DC residents — a cut in the estate tax, and a reduction in the 10 percent property tax cap for homeowners to a five percent cap. These tax cuts would total \$27 million. These tax cuts now will be considered by the full Council when it votes on the FY 2008 budget on May 15.

The Committee did not, however, consider any tax cut proposals that target relief on low- and moderate-income residents, such as a bill introduced earlier this year that would raise the standard deduction and personal exemption in the income tax, and the property tax Homestead Deduction. In addition to being progressive, this other pending legislation that is not being considered would target relief on renters, who have not benefited from the substantial property tax cuts of recent years

A review of the proposals likely to be considered by the Finance and Revenue Committee indicates that there is little public policy rationale to support them.

- **DC's homeowner property taxes already are the lowest in the region:** For example, the average 2006 property tax bill on a DC home worth \$600,000 was \$900 lower than in Montgomery County and \$2,000 lower than in Fairfax County.
- **The proposed property tax relief overwhelmingly would benefit owners of high-value homes in high-income neighborhoods.** More than half of the proposed relief would go to homes worth \$750,000 or more, even though they represent just 21 percent of all DC homes. Households living east of the Anacostia River would receive just six percent of the benefits, while homeowners in Wards 2 and 3 would receive 52 percent.
- **A five percent cap is uncommon in the DC area.** Virginia counties have no cap on annual property tax increases, and the cap in Montgomery County is 10 percent. Prince George's County has a lower cap, but it also has the highest property taxes in the region.
- **The estate tax already is limited to a very small share of estates.** DC currently applies the estate tax to estates over \$1 million. The Finance and Revenue Committee proposal would raise the threshold to \$3.5 million. National figures show that under a \$1 million threshold, fewer than two percent of all estates are taxed. In the District, a household with a \$1.5 million estate currently pays taxes of about 4.5 percent of the estate.
- **There is little evidence that wealthy residents move from one state to another because of the estate tax.** Half the states have some form of inheritance tax, and the other half do not.

Recent research finds, however, that these taxes have little or no effect on decisions of elderly residents to move.

The budget proposed by Mayor Fenty for FY 2008 includes a reduction in the residential property tax rate. It is not clear if the District can afford any further tax relief while also balancing the budget, since the mayor's proposal would not result in a surplus for FY 2008. If any forms of tax relief are considered, however, these findings suggest that an increase in the standard deduction and personal exemption would be better targeted on households in need of relief than the proposed cuts in the estate tax and the property tax cap. These issues are discussed in more detail below.

Why a Five Percent Property Tax Cap Is Unwarranted

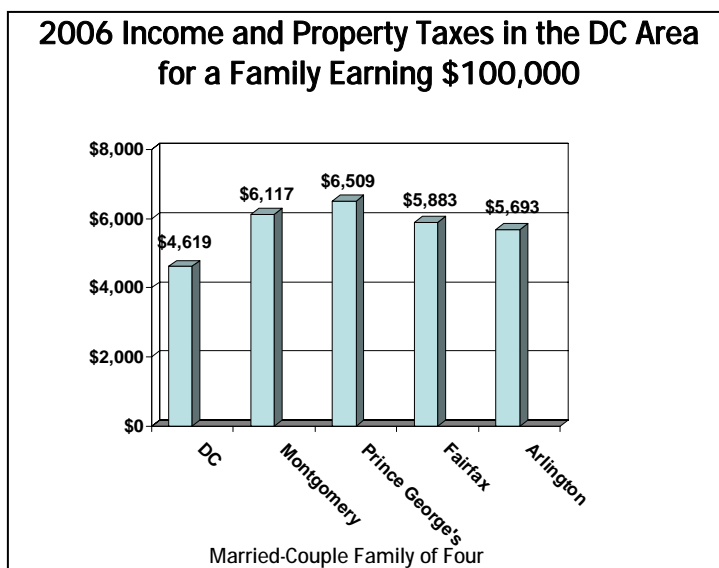
Several factors call into question the need for a five percent property tax cap. First, the District has adopted substantial tax relief in recent years, making DC's taxes the lowest in the region. Moreover, the five percent cap is not well targeted on families most in need of tax relief, with most of the benefits going to owners of expensive homes in DC's most affluent neighborhoods. Finally, the District already protects elderly and low-income households through several targeted property tax relief measures — including a five percent annual cap for low-income, long-time homeowners.

DC's Homeowner Property Taxes Are the Lowest in the Region

The District has taken a series of steps in recent years to address the impact of rapidly rising home assessments on DC homeowners. This includes raising the Homestead Deduction, reducing the property tax rate, and setting a cap on annual increases in a property's taxable assessment. (Mayor Fenty has proposed a further rate cut for 2008.) The cap is now set at 10 percent per year, which means that a homeowner's tax liability can grow no more than 10 percent, regardless of the increase in their home's value. As a result:

- **DC's property taxes on homeowners are the lowest in the region.** For homes worth \$600,000, the average 2006 property tax in DC was \$2,900, compared with \$3,800 in Montgomery County, \$4,700 in Prince George's County, \$4,900 in Fairfax County, and \$4,500 in Arlington County.

- **Combined income and property taxes on DC families are now the lowest in the region.** As a result of recent cuts, the income and property taxes paid by DC households are lower in most cases than taxes in suburban Maryland or Virginia. A DC family of four earning \$100,000 pays about \$1,000 less than similar families in Northern



Virginia and over \$1,500 less than families in the Maryland suburbs. This is driven largely by DC's lowest-in-the-region property taxes.¹

- **With Mayor Fenty's proposed rate cut, property tax bills in 2008 will be lower than 2005 tax bills for many DC homeowners.** For nearly half of DC homeowners, 2008 property tax bills will be lower than 2005 property tax bills, an amazing accomplishment given the substantial assessment increases since 2005. For an additional 38 percent of homeowners, taxes in 2008 will have grown by less than five percent per year since 2005.

A Five Percent Cap Mostly Benefits Higher-Income Homeowners

Under current law, the taxable assessment for a DC homeowner — that is, the assessment to which the property tax is applied — can grow no more than 10 percent a year. This means that even if a home's true market value jumps dramatically, its taxable assessment and the homeowner's tax bill can increase no more than 10 percent.

The cap is a broad form of relief that benefits homeowners at all income levels. An analysis of the impact of lowering the cap to five percent, however, shows that it provides substantial benefits to owners of DC's most valuable homes.

Assessed Value	Share of DC Homes	Share of Benefit from 5% cap
Under \$250,000	12%	7%
\$250,000 to \$500,000	47%	22%
\$500,000 to \$750,000	19%	18%
\$750,000 or More	21%	53%
Total	100%	100%

- Homes assessed at \$750,000 or more receive 53 percent of the benefits of the five percent cap, although they represent just 21 percent of DC homes.
- The 59 percent of homes assessed at \$500,000 or less receive just 29 percent of the benefits.³

The benefits of the proposed five percent cap also would flow largely to residents of DC's higher income neighborhoods. This reflects the fact that high-income residents are more likely to own their home than low- and moderate-income residents, and that the homes owned by high-income household typically are worth more than the homes owned by moderate-income households. As a result:

Ward 1	9%
Ward 2	18%
Ward 3	33%
Ward 4	15%
Ward 5	6%
Ward 6	13%
Ward 7	4%
Ward 8	2%

- Over half (52 percent) of the benefits of the proposed five percent cap would go to residents in Ward 2 and Ward 3.
- Residents in Ward 7 and Ward 8, by contrast, would get just six percent of the relief from the five percent cap.

¹ See DC Fiscal Policy Institute, *Taxes on DC Families Are Now the Lowest in the Region*, 2006 (<http://www.dcfpi.org/?p=155>)

² Does not include increase in homestead deduction to \$60,000.

³ These figures reflect the benefits provided by reducing the tax cap from 10 percent to five percent.

Mayor Fenty's Proposal to Eliminate the Property Tax "Calculated Rate" Makes Sense

The FY 2008 budget proposed by Mayor Fenty would reduce the property tax rate for homeowners, from 88 cents per \$100 of assessed value to 86 cents. The Mayor's proposal also would eliminate a provision adopted in 2005 — called the "calculated rate" — that automatically reduces the residential property tax rate each year under certain conditions. The calculated rate resulted in a \$17 million reduction in residential property taxes in 2007.

Eliminating the calculated rate provision makes sense for two reasons. First, as noted, the District has adopted substantial residential property tax relief in recent years, leaving DC homeowners with lower average property tax bills than in any suburban jurisdiction. Given that, it is not clear that this should be the top tax relief priority.

Second, the automatic nature of the calculated rate mechanism raises concerns over both fairness and affordability.

- **The calculated rate makes it harder to consider other forms of tax relief.** This year, for example, the Council is likely to consider some form of relief for small businesses facing very large assessment increases. The revenue loss associated with the calculated rate, however, puts homeowner tax relief ahead of these other forms of tax relief and thus makes it hard to adopt other forms of relief.
- **The calculated rate may lead to tax cuts in times of budget shortfalls:** Under the calculated rate, the residential property tax rate is reduced automatically if total property tax revenues are expected to rise more than a specified amount. There may be times, however, when the city faces fiscal constraints even if property taxes are rising. In 2002, for example, total tax collections for the District fell, as a result of falling sales and income tax revenues, while property tax collections grew at the rapid rate of 14 percent.

- Residents in Ward 4 would gain 15 of the benefits, and Ward 6 residents would receive 13 percent. Residents in Wards 1 and 5 would each receive less than 10 percent of the relief.

DC Has Significant Property Tax Protections for Elderly and Low-Income Homeowners

The District's property tax includes several provisions to protect selected groups from potentially high burdens. These targeted measures suggest that a five percent cap applied to all households is not needed to protect vulnerable populations from rising property taxes.

- Homeowners aged 60 or older with incomes below \$100,000 qualify for a 50 percent property tax break. As a result, the typical property tax bill for elderly DC homeowners is just \$549 this year. Under the current 10 percent cap, the typical tax bill will increase no more than \$55 per year, or less than \$5 per month.
- The District offers a tax credit to long-term low-income homeowners. It applies to those with incomes under 50 percent of the Area Median Income — about \$31,500 for a single person and

\$36,000 for a couple — who have lived in their homes for seven years or more.⁴

- The "Schedule H" property tax credit provides up to \$750 to homeowners with incomes under \$20,000. One option for improving targeted property tax relief would be to raise the eligibility threshold, which has not been adjusted for 30 years. The Finance and Revenue Committee is not expected, however, to consider such a change at its budget mark-up.

Reducing the DC Estate Tax Would Benefit Affluent Estates

The Finance Committee has announced plans to mark up a bill introduced earlier this year to raise DC's \$1 million threshold for filing estate taxes to \$3.5 million over the next few years. This proposal would match an increase in the filing threshold for federal estate taxes, which is being implemented as part of legislation pushed by conservative federal lawmakers to phase out the federal estate tax.

The estate tax is an important revenue source at both the federal and state level and is a very progressive tax. For this reason, Congressional Democrats are likely to take steps to preserve the estate tax rather than allow it to expire, and 23 states and DC have some form of inheritance tax. Locally, Maryland has an estate tax with a \$1 million threshold, as the District does, while Virginia has eliminated its estate tax. At both the federal and state level, estate taxes do not apply when assets are bequeathed to a spouse or to charity.

There are several reasons to preserve DC's estate tax with the existing \$1 million threshold.

- **The estate tax already is limited to a very small share of estates.** When the federal estate tax threshold was \$1 million, only two percent of estates nationally were subject to the estate tax. A national study found that 90 percent of individuals with taxable estates had income of \$200,000 or more in the year before they died.
- **The estate tax generates substantial revenue:** Over the past 10 years, DC's estate tax revenues have averaged more than \$40 million per year. The proposal to raise the threshold to \$3.5 million would cost \$10 million per year.
- **The effective rate of DC's estate tax is relatively low.** For an estate worth \$1.5 million, the DC tax equals about 4.5 percent of the estate's value.

Some argue that maintaining an estate tax could hurt the District's finances by encouraging wealthy residents, particularly elderly residents, to move out of the District or otherwise change their official state of residence. This is a concern that has been raised in many states and is worth exploring. Recent research to address this question has found, however, that the effect of estate taxes on migration is modest at best. Moreover, any revenue savings that an estate tax cut might generate – by keeping some seniors from moving out of the District— would be far outweighed by the revenue losses from scaling back the estate tax.

⁴Eligible residents can claim a credit on their DC income tax return that equals the amount by which their property tax bill exceeds their prior-year tax bill plus five percent.

- A paper published in 2006 by academics from the University of New Hampshire and Vassar College studied the effects of state estate and inheritance taxes on elderly migration rates using census data from 1970 to 2000. The study authors concluded that “Our research casts doubt on the view that the elderly react to state EIG [estate, inheritance and gift] tax policies in making their migration decisions.”⁵
- A 2004 study by researchers from Williams College and the University of Michigan Business School found that high state estate and inheritance taxes do have a statistically significant, but small, negative effect on the number of elderly in a state. The authors explored the possibility that maintaining a state-level estate tax could reduce state revenues by causing elderly residents to leave, which would reduce state income taxes and other taxes. According to the study, that result is unlikely to occur: “... our results imply that in the case of a decoupled estate tax, revenue losses and deadweight losses from these particular forms of behavioral response [tax-induced migration and related avoidance activities] are unlikely to be large relative to revenues collected.” Their finding is a reflection of the modest impact of state estate taxes on elderly migration.⁶
- Some states that have examined this question using Census data also concluded that elderly migration patterns are not affected significantly by taxes. A report by the Wisconsin Department of Revenue concluded that “Comparison of elderly migration patterns provides little evidence that tax treatment has a significant impact on residence decisions by the elderly.”

Some may argue that there are administrative advantages to matching the federal estate tax filing threshold, since then households would only file a DC estate tax return if they are filing a federal return. Yet DC and 11 of the 16 states with an estate tax have thresholds that are lower than the federal estate tax threshold, and there is no indication that this has created notable administrative problems.

Progressive Tax Cut Alternatives that Should Be Considered

Other tax cuts proposals have been introduced this year that would target relief on low- and moderate-income residents, most notably Bill 17-87. This bill would:

- Increase the standard deduction in DC’s income tax from \$2,500 to \$4,000
- Increase the personal exemption in the income tax from \$1,500 to \$2,400
- Increase the property tax Homestead Deduction from \$60,000 to \$64,000

The bill also would create an annual inflation adjustment for all of these measures.

The standard deduction and personal exemption exempt a specified amount of earnings from taxation and, if set at sufficient levels, they can eliminate income tax liability entirely for many low-income households. The standard deduction is particularly important for low- and moderate-

⁵ Conway, Karen Smith and Jonathan C. Rork, “State ‘Death’ Taxes and Elderly Migration — The Chicken or the Egg?” National Tax Journal, Volume LIX, No. 1, March 2006 available at http://pubpages.unh.edu/~ksconway/NTJ_Conway_Rork_Finalv.pdf

⁶ Bakija, Jon and Joel Slemrod, “Do the Rich Flee from High State Taxes? Evidence from Federal Estate Tax Returns”, Abstract, NBER Working Paper No. 10645, July 2004

income households. In DC, three-fifths of taxpayers claim the standard deduction, and more than 90 percent of them have adjusted gross income under \$50,000. The standard deduction is especially helpful to *renters*, since most do not itemize. Renters have not benefited from the wave of property tax relief in recent years.

At the federal level, the combined standard deduction and personal exemption for a married couple with two children is \$23,500. (This stems from a \$10,300 standard deduction and a \$3,300 personal exemption for each of the four household members.) Households with incomes below this level pay no federal income tax. Under the DC income tax, by contrast, the standard deduction and personal exemptions for a family of four total just \$8,500, because DC's standard deduction is \$2,500 and the personal exemption is \$1,500. Partly as a result of these small deductions, taxes on some lower-income DC households are relatively high. A family of four with income of \$30,000, for example, pays more in income tax in DC than in all but 10 states.

The increases in the standard deduction and personal exemption in Bill 17-87 would provide relief to households at all income levels, but the greatest benefits as a percentage of income would go to low-income households.

For families below \$25,000, the tax reduction would be more than one percent of income, while the relief would equal 0.2 percent of income. (A bill introduced in the DC Council in previous years, which was not adopted, would have raised the personal exemption and

Household income*	Tax Relief Under Standard Deduction/ Personal Exemption Under Bill 17-87	Tax Relief As a Percent of Income
\$15,000	\$204	1.4%
\$25,000	\$306	1.2%
\$50,000	\$343	0.7%
\$100,000*	\$306	0.3%
\$150,000*	\$306	0.2%
* assumes these households use itemized deductions		

standard deduction to match the federal levels, as some states do. This would have provided greater relief to households than this year's bill, while still targeting relief on lower-income households.)

The Homestead Deduction is an amount that all homeowners are allowed to deduct from their home's assessed value before the property tax rate is applied. The deduction was set at \$30,000 from 1990 to 2004, when it was increased to \$38,000. In FY 2006 budget, it was raised again to \$60,000. The Homestead Deduction provides broad property tax relief, but the relief is greatest as a percentage of a household's tax bill for owners of lower-value homes. For a home with a taxable assessment of \$300,000, for example, the current homestead deduction provides a 20 percent tax reduction. The relief totals 10 percent of the tax bill for a home with a taxable assessment of \$600,000

Bill 17-87 would increase the Homestead Deduction to \$64,000 and then adjust it for inflation every year after 2008. The relief in 2008 would be relatively modest— about \$35 — but the annual inflation adjustment is important because it would ensure that the Homestead Deduction would not decline in value over time.

Conclusion

Most tax cuts provide relief to select groups of residents or businesses. By benefiting some more than others, tax cuts create shifts in who is responsible for paying for public services. For these reasons, decisions over tax relief should consider the type of relief that is most appropriate at any given time, as well as the effect of tax relief on the ability to provide services and balance the budget.

The proposals to reduce the estate tax and lower the homeowner property tax cap would provide substantial benefits to higher-income DC residents, while not meeting any clear policy needs. If any tax relief is affordable this year, it would be more reasonable to target tax relief on low- and moderate-income households, particularly renters who have not benefited from the property tax cuts of recent years. Legislation to provide progressive tax relief has been introduced in the DC Council this year. As the Finance Committee ponders tax relief options, this legislation should be considered as a top priority.