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Fixing The Tax Parity Act "Trigger" Changes Are Needed to Ensure Appropriate Suspension of Tax Cuts

Introduction and Summary

In 1999, the District of Columbia Council enacted the Tax Parity Act, which included substantial reductions in income and property taxes for residents and businesses to be phased in through 2004. Some $149 million in tax reductions already have been implemented as a result of this law, and the amount of annual tax relief will rise to $320 million when the act is fully implemented.

When the Tax Parity Act was considered in 1999, some argued that its costs were not affordable over the long-term. Proponents of the tax cuts noted that the gradual phase-in of the tax cuts over several years would allow them to be halted if the District's fiscal conditions worsened. In addition, a "trigger" provision was added to the bill that would suspend the tax cuts automatically when economic or fiscal conditions were weak.

Economic indicators released today show that one of the Tax Parity Act trigger conditions has been met, which means the tax cuts will be suspended temporarily. Suspending tax cuts could prove critical to helping the District maintain a balanced budget in 2002. District officials have projected a $100 million revenue shortfall due to the recession and $173 million in additional "spending pressures," for a total potential deficit of $273 million. The D.C. Chief Financial Officer has developed a plan to address these problems which does not include a suspension of the tax cuts.

The CFO also has acknowledged, however, that this plan requires the District to tap all available revenues, including its budgeted reserves, to meet the budget shortfall as it currently is estimated. If fiscal conditions worsen, as is occurring in many states around the country as revenue collections weaken and residents losing jobs and income require more public programs and services, the District would be hard put to find to resources to offset additional deficits. The triggered suspension of the tax reductions will help ensure a balanced budget even if fiscal conditions continue to worsen through a further decline in revenues or additional spending pressures.

The District is not alone in facing fiscal problems or the necessity of suspending tax cuts. Nearly every state is now facing a budget shortfall as a result of the economic downturn. Six states, including Virginia, already have suspended or reversed tax reductions. In three of those states, a trigger mechanism was responsible for the change. In four other states, including Maryland, the governor has called for suspension of a phasing-in tax cut. A number of other states in which there is no phasing in tax cut have enacted tax increases or are considering doing so.

Implementation of the District's trigger provisions, however, will not be as straightforward as was intended when the legislation was enacted. The trigger mechanism to suspend the Tax Parity Act has several design problems that would lead to unintended results, and it is likely that the Mayor and Council will need to address these problems prior to implementation of the trigger. The

following are the problems inherent in the trigger provision as it currently is written.

- The trigger would lead to a 61 percent increase in real property taxes for landlords. Due to a clear error in drafting the trigger, the property tax rate intended for non-residential businesses ($1.85 per $100 of assessed value) would be applied to residential rental properties (which had a tax rate of $1.15 in 2001).

- The trigger would not only suspend income tax reductions scheduled for 2002, it also would reverse income tax cuts enacted in 2001, thereby increasing taxes for some D.C. households.

- The trigger suspends tax cuts in 2002 but not in 2003, even though District officials acknowledge that the budget shortfall will be at least as serious in 2003 as in 2002. Without modifications to the trigger, the 2003 budget that will be enacted this spring will have to be developed under the assumption that the tax cuts will *not* be suspended.

- The trigger would lead to a sharp re-introduction of tax cuts when the trigger period ends. Rather than returning to a gradual path of tax cuts, all suspended tax cuts would become effective at once when a trigger requirement is no longer met. As a result, several years' worth of reductions could be implemented in one year, making it difficult for the District to manage the transition to tax cuts when the trigger period ends.

Changes to the Tax Parity Act trigger will need to be made soon, because by law the trigger must be implemented by March. Given the intent of the trigger — to suspend tax cuts in periods of fiscal weakness — the following approach to suspending the tax cuts seems appropriate.

- **The trigger should suspend *new* tax reductions but should not reverse tax cuts that already have been implemented.** The trigger should not cause tax increases. If the District's fiscal crisis substantially deepens, the Mayor and the Council may need to consider tax increases. But that should occur through proactive steps by the Mayor and Council, which would allow District leaders to shape the appropriate type and level of tax increases.

- **The trigger should suspend tax cuts for both 2002 and 2003, including individual income, corporate income, and real property taxes.** If the District's economy and fiscal condition rebound sharply during 2002, policy makers could re-consider implementing the 2003 tax cuts later this year.

- **Tax cuts should return to a gradual phase-in when the trigger period ends.** Once the trigger no longer is in effect, the tax reductions should pick up where they left off, with the tax cuts originally scheduled for 2002. Several years' worth of cuts should not be implemented at once.

The tax cuts scheduled for 2002 total $70 million in 2002 and $130 million in 2003. Suspending the tax cuts and avoiding this loss of revenue would help

ensure that the District can maintain a balanced budget, even if fiscal conditions continue to worsen, and help the District maintain public services at a time when economic problems increase the need for government programs and services.

The District Faces a Shaky Budget Outlook

States across the country are experiencing severe fiscal stress. The economic downturn has depressed revenues while also leading to higher spending in certain program areas in which higher unemployment and decreased income of residents tend to increase the need for services, such as Medicaid. As a result, states are facing deficits totaling $40 billion nationwide for the current fiscal year. Revenues in 43 states are below estimates and budget cuts are currently being considered or have already been implemented in at least 36 states.

The District also is facing serious fiscal problems.

- The District's Chief Financial Officer has projected that District revenues will fall $100 million below projected levels in the current year, fiscal year 2002. This figure will be updated in February, when a new revenue forecast will be released.

- The District also is facing some $173 million in "spending pressures," or expenditure needs that were not factored into the 2002 budget. Most of the spending pressures are unrelated to the economic downturn.

The CFO has outlined a potential plan to address the resulting $273 million budget shortfall in 2002. The plan — which has not yet been approved by the Mayor or Council — primarily includes use of existing reserve funds and spending reductions within the public schools.

According to the CFO, these steps would fully address the 2002 budget shortfall as currently estimated, but they also would require tapping all available fund sources, including unspent reserves from prior years and all of the District's 2002 budgeted reserve. The CFO noted on January 9 that if the plan is adopted, "the District will have exhausted its remedies for dealing with financial problems without affecting programs."[(1)] This means that if financial conditions worsen in *any* way — either because revenues fall further or because new spending pressures arise — the District would not be able to maintain a balanced budget without spending cuts or tax increases.

The Chief Financial Officer also has indicated that fiscal problems in 2003 are likely to be serious as well. Revenues are expected to fall below current projections, and many spending pressures identified this year are expected to continue.[(2)] While no estimate of the budget shortfall in 2003 has been released, it is likely to be at least as serious as in 2002.

The "Trigger" to Suspend the Tax Parity Act Has Been Met, Which Will Help the District Maintain a Balanced Budget

In 1999, the D.C. Council enacted the Tax Parity Act, which included multi-year reductions in income and property taxes for both households and businesses. Some $149 million in tax cuts from the Tax Parity Act had been implemented as of fiscal year 2001. The cost of additional, scheduled tax cuts total $70 million in 2002 and $130 million in fiscal year 2003.[(3)] The tax cuts include a reduction in personal income taxes in both 2002 and 2003, a reduction in business property taxes in 2002, and a reduction in the business income ("franchise") tax in 2003.

The budget shortfall projected by the Chief Financial Officer assumes that tax cuts scheduled for 2002 under the Tax Parity Act will be implemented. Yet it now appears that the tax cuts will be suspended in 2002 as a result of a "trigger" mechanism that was designed to suspend the tax cuts in periods of fiscal weakness. Economic indicators released today show that the trigger requirement has now been met. The suspension of the tax cuts as a result of the trigger will avoid revenue losses to the District and therefore help it maintain a balanced budget.

The trigger mechanism was included in the Tax Parity Act as a way to ensure that the sizable tax cuts would not jeopardize the District's financial health. Even proponents of the bill understood that the tax cuts should be implemented each year only if the District's fiscal health were strong enough to allow it.

- For example, the chief sponsors of the bill, Council members Jack Evans and David Catania wrote in a *Washington Times* opinion column in 1999 that "The beauty of phasing the reduction in over a three-year period is that if a recession occurs and revenues decline sharply, we can stop the phase-in and, if necessary, roll back the decrease."[(4)]

- In a 1999 *Washington Post* news article, Evans was quoted as saying that "David [Catania] and I have said all along that if there were any sign of a revenue shortfall, we would stop the tax cut and reverse it if necessary" and that "If a [budget] surplus is not in place to finance a tax cut, I would initiate steps to stop a tax cut."[(5)]

- In testimony before the Council in support of the Tax Parity Act in 1999, some representatives from the business community noted that the tax cuts should be suspended if the District's fiscal health declined. Curtis Etherly, testifying on behalf of the Greater Washington Board of Trade, stated that "A deliberate phased-in set of tax reductions, with clear circuit-breakers, such as pegs to certain and specific revenue targets, however, can help the District...plan effectively for the future while, at the same time, provide aggressive tax relief." Kathy Barnes, then president of the Apartment and Office Building Association, noted that "Because of the approach contained in [the Tax Parity Act], vigilant oversight by the Mayor, the Council, and the Control Board will allow for future adjustments, in the event that the revenue picture should change."[(6)]

The trigger mechanism was included in the Tax Parity Act as such a "circuit-breaker." Specifically, the trigger calls for the suspension of the tax cuts if either of the following conditions is met.

- the District's General Fund balance falls to an amount less than five percent of the locally-supported budget; or

- projected national economic growth is 1.7 percent or less in inflation-adjusted dollars or 3.5 percent or less without adjusting for inflation. This provision relies on the economic projection made by the U.S. Congressional Budget Office in its January report on the budget and the economy.[7]

On January 23, CBO released some of the tables that will be included in its January economic and budget report, which will be published in late January. According to the tables, CBO projects that the nation's GDP will grow 0.8 percent in 2002, after adjusting for inflation, which is lower than the Tax Parity Act trigger threshold.[8] As a result, it now appears that the Tax Parity Act will be suspended in 2002. Under the law, the trigger is implemented when the Chief Financial Officer certifies that a trigger requirement is met, and that must occur within 30 days of the release of the District's annual audit. The audit will be released by February 1, which means the trigger must be implemented by March 3.

As a result of the trigger, the District will join a number of states that have suspended previously enacted tax cuts. In Virginia, the last stage of a reduction in the personal property tax (known more commonly as the "car tax") will be suspended as a result of a trigger. Triggers also caused suspension or reversal of tax cuts recently in California and Oklahoma. Phasing-in tax cuts have been suspended through legislative action in Connecticut, Florida, and Nebraska. Governor Glendening of Maryland has included the suspension of an income tax reduction in his budget proposal, and the governors of Maine, Michigan, and Rhode Island have similarly called for suspensions.

Problems with the Trigger Will Require Modifications

A review of the trigger provision reveals that it has several design problems. If implemented as it is currently designed, the trigger would lead to some results that clearly were unintended and others that may not have been intended. Thus, it appears that District policy makers will need to modify the trigger to ensure appropriate implementation of the intended tax cut suspension.

There are four primary problems with the design of the trigger.

The trigger would result in a 61 percent increase in real property taxes for rental residential properties

Under the Tax Parity Act, the number of real property tax classes was scheduled to be reduced from four in 2001 to two in 2002. The two residential property classes in effect in 2001 — Class 1 (owner-occupied homes) and Class 2 (residential rental) — would have been combined into a new class 1 in 2002. The two commercial property classes in 2001 — class 3 (hotel) and 4 (other commercial) — would have been combined into a new class 2. A separate provision in the Tax Parity Act sets the 2002 tax rates at $0.96 per $100 assessed value for the new class 1, the pre-existing rate for owner-occupied homes, and $1.85 per $100 assessed value for the new class 2, the pre-existing rate for hotels and motels. These changes would reduce real property tax rates for residential rental properties and for commercial properties.

Both the class change provision and the rate change provision include a trigger provision. The trigger provision for the changes in property tax classes includes both the general fund balance component and the GDP component, but the trigger for the rate change provision has only the general fund balance component. The absence of the GDP component in the rate change trigger appears to have been inadvertent.[9] This apparent error is significant because only the GDP trigger requirement has been met, and the general fund balance trigger requirement almost certainly *will not* be met when the District's audit is released in late January or early February.[10] As a result, the real property tax rate changes scheduled for 2002 will *not* be suspended, but the change in real property classes will. This would lead to clearly unintended results.

- As a result of the trigger's suspension of changes in property tax classes, residential rental properties would continue to be classified as class 2 properties, rather than being folded into class 1. But these properties would be taxed at the new class 2 rate of $1.85 per $100 of assessed value, the rate that had been intended for hotels and commercial properties. This rate is 61 percent higher than the property tax rate levied on residential rental properties in 2001, which was $1.15 per $100 assessed value.
- There will be four property tax classes in 2002, but rates will be specified only for classes 1 and 2. This does not pose a serious problem, but it is further indication of design flaws in the trigger. Under D.C. law, if no property tax rates are set for a given year, the rates from the prior year continue. Thus classes 3 and 4 would be taxed at the 2001 rates.

Real Property Tax Changes Scheduled Under the Tax Parity Act			
Real Property Taxes in 2001		Real Property Taxes in 2002 If Tax Parity Act were implemented	
Tax Class	Tax Rate (per $100 assessed value)	Tax Class	Tax Rate (per $100 assessed value)
Class 1(owner-occupied)	$0.96	Class 1	$0.96
Class 2 (rental residential)	$1.15		
Class 3 (hotels)	$1.85	Class 2	$1.85
Class (commercial)	$1.95		

Actual Real Property Tax Classes and Rates in 2002 Under the Trigger If Problem with Trigger is Not Fixed	
Tax Classes (remaining at 2001 definitions)	Tax Rate
Class 1(owner-occupied)	$0.96
Class 2 (rental residential)	$1.85
Class 3 (hotels)	$1.85*
Class (commercial)	$1.95*
*No tax rates are specified for classes 3 and 4 in 2002. Under D.C. law, if property tax rates are not specified in a given year, the rates from the prior year continue to be in effect. The rates shown here for classes 3 and 4 are the 2001 rates.	

The trigger suspends new tax cuts scheduled for 2002 but also reverses tax cuts implemented in 2001

Under the trigger, new tax cuts scheduled for 2002 will not be implemented. In addition, a review of the District tax code suggests that the trigger also would suspend tax reductions that were implemented in 2001, returning tax rates to 2000 levels. In other words, suspension of the Tax Parity Act in 2002 would lead to an increase in taxes for some District households.

This would occur because each Tax Parity Act reduction for 2001 and beyond, as incorporated in the D.C. tax code, includes a provision stating that the reduction will not apply if the trigger requirement is met.[(11)] This means that the Tax Parity Act trigger would not only suspend new tax cuts scheduled for 2002 but also would suspend tax cuts implemented in 2001. It is not clear whether the retroactive suspension of tax cuts was intended when the trigger provision was created.

Reversing the 2001 income tax cuts would not affect lower-income families — such as a family of four with $25,000 in income — since the Tax Parity Act did not include income tax reductions for this group in 2001. A family of four with income of $75,000 would experience a $403 increase in income taxes resulting from a suspension of tax cuts implemented in 2001, while a family of four with an income of $150,000 would face a $541 tax increase.

The trigger is not well connected to the District's budget cycle

As noted earlier, budget officials have indicated that the District will face serious fiscal conditions in FY 2003, which starts October 1, 2002. Despite these problems, the current design of the trigger requires the District to develop its FY 2003 budget under the assumption that $130 million in tax cuts scheduled under the Tax Parity Act will be implemented.

Mayor Williams is expected to submit a proposed FY 2003 budget to the D.C. Council in March 2002, and the Council is expected to enact a final budget in May. Congressional approval of the FY 2003 budget is likely to occur by the end of calendar year 2002. Yet the determination of whether the Tax Parity Act is suspended in FY 2003 will not be made until January 2003, when a new report from the Congressional Budget Office and a new D.C. audit are expected.

This illustrates that the Tax Parity Act trigger is not well connected to the D.C. budget cycle. Policy makers are required to establish a budget before the fiscal year, using the best revenue estimates available at the time. If the revenue estimates indicate that tax cuts would not be affordable without large cuts in programs and services, it would seem appropriate to suspend tax cuts. But the Tax Parity Act trigger determination is not timed to occur before the budget is developed.

The trigger would lead to a sharp re-introduction of tax cuts when the trigger period ends

As noted earlier, the trigger operates by suspending all relevant tax cuts when a trigger requirement has been met. The Tax Parity Act has no special provisions, however, to address how tax cuts would be implemented when the trigger period ends. Instead, it appears that all suspended tax cuts become effective at once when a trigger requirement is no longer met. For example, if the trigger were met in both 2002 and 2003 but not in 2004 then the tax cuts scheduled for 2002, 2003, and 2004 — totaling nearly $200 million — would be implemented in 2004.

This is in conflict with the goal of implementing tax cuts gradually. Implementing several years worth of tax cuts in one year, just as the economy and fiscal conditions are recovering, is likely to prove to be unaffordable and disruptive.

Fixing the Trigger

When the Tax Parity Act was enacted, District policymakers clearly indicated their intention that the tax cuts should be implemented only when the District's health is strong — and that tax cuts should be suspended temporarily in periods of fiscal distress. The District clearly has entered such a period. If the tax cuts are implemented in 2002 and 2003, the District is unlikely to have sufficient revenues to meet ongoing needs, which means it would face a budget shortfall unless reductions in programs or services or offsetting tax increases were enacted.

As indicated above, the Tax Parity Act trigger was intended to suspend tax cuts automatically when fiscal conditions decline. While the trigger has been met for 2002, it cannot be implemented without modification. While it is difficult to determine precisely how policy makers intended the tax cut suspension to occur, the following steps seem consistent with the intent and would be a reasonable approach.

- **New tax cuts should be suspended, but tax cuts already implemented should not be reversed as a result of the trigger.** Some states, such as Oklahoma, have a trigger that reverses tax cuts already implemented. Most commonly, however, only prospective tax cuts are suspended or deferred. At this time, it does not appear that reversing previous tax reductions is needed to maintain a balanced budget.

  This does not mean District policymakers will not have to consider tax increases in the near future. Indeed, the District may face a substantial deficit even if the next phase of tax cuts scheduled under the Tax Parity Act reductions is suspended. If it becomes necessary to take such action to raise taxes, District leaders should shape the appropriate type and level of tax increases.

- **Tax cuts should be suspended for 2002 and 2003.** As noted the District's fiscal problems are likely to be as serious, if not more serious, in 2003 as they are in 2002. It thus would be appropriate to suspend tax cuts for both years. Suspending the 2003 tax cuts at this point is important because the FY 2003 budget will be developed in the spring of 2002. (The table on the next page highlights the impact of suspending tax cuts in 2002 and 2003 on hypothetical businesses and families.) Moreover, if the District's economy and fiscal condition rebound sharply during 2002, policy makers could re-consider implementing the 2003 tax cuts later this year.

- **Tax cuts should return to a gradual phase-in when the trigger period ends.** Once the trigger no longer is in effect, the tax reductions should pick up where they left off. If the tax cuts were suspended for two years and re-introduced in 2004, this would mean implementing the tax cuts originally scheduled for 2002 in 2004.

Conclusion

The Tax Parity Act trigger provision was designed to suspend tax reductions temporarily during periods of economic or fiscal decline. The trigger thus was intended to prevent the tax reductions from exacerbating revenue shortfalls and budget deficits that occur in such times. While the trigger requirement for 2002 has been met, problems with the trigger design will need to be addressed before it can be implemented. Fixing the trigger and suspending tax cuts appropriately could prove critical to the District's fiscal health in the coming years.

Impact of Tax Parity Act on Hypothetical Households and Businesses					
	Tax relief implemented through 2001*	**Tax relief scheduled through 2002***	**Change from 2001**	**Tax relief scheduled through 2003***	**Change from 2001**
Individual Income Tax**					
Household with $25,000 gross earnings	$175	$175	$0	$263	$88
Household with $75,000 gross earnings	$703	$908	$205	$1,038	$335
Household with $150,000 gross earnings	$841	$1,253	$412	$1,905	$1,064
Business Property Tax					
Apartment building worth $1,000,000	$3,500	$5,400	$1,900	$5,400	$1,900
Retail Business worth $1,000,000	$2,000	$3,000	$1,000	$3,000	$1,000
Business Income Tax					
Taxable Income of $250,000	$0	$0		$1,875	$1,875
Taxable Income of $1,000,000	$0	$0		$7,500	$7,500

* This illustrates tax relief compared with tax liability in 1999.
** for family of four with two working adults. This assumes a family with income $25,000 claims the standard deduction, that a family with income of $75,000 has $8,000 in itemized deductions, and that a family with income of $150,000 has $14,000 in itemized deductions.

End notes

1. Statement of Dr. Gandhi at the Annual City Leadership Forum sponsored by DC Agenda, January 9, 2002, p. 6. It is worth noting that the CFO's plan to address the $273 million shortfall does not involve tapping rainy day funds the District has built up in recent years. One of D.C's rainy day funds — the "contingency" fund — can be drawn down when revenues decline substantially. It thus may be possible to tap the contingency fund if D.C.'s fiscal conditions worsen. But the rules governing the fund would require any funds withdrawn in 2002 to be repaid in 2003. Because the 2003 budget situation also appears weak, use of the contingency fund in 2002 would not be particularly beneficial or advisable.

2. Ibid., p. 6.

3. The District's Chief Financial Officer estimated the costs of the 2002 tax cuts in January 2002. A projection made in January 2001 indicated that the 2003 tax cuts would be $60 million larger than the 2002 cuts.

4. Jack Evans and David Catania, "A Taxing System," *Washington Times*, April 19, 1999, page A19. When this was published, the tax cut legislation being considered would have phased reductions in over three years.

5. Rudolph A. Pyatt, Jr., "However You Add it Up, It's Time for D.C. Tax Reform," *Washington Post,* April 29, 1999, page E3.

6. Testimony before the D.C. Council Committee on Finance and Revenue, April 30, 1999.

7. The Tax Parity Act trigger is found in § 47-387.01 of the D.C. Code. Paragraph (2) of the section reads: "If the certification demonstrates that the nominal GDP growth reflected in the CBO winter report published in January of that fiscal year is less than or equal to 3.5% or that the real GDP growth reflected in the same report is less than or equal to 1.7% then the certification shall be published in the D.C. Register along with a notice that any provisions of this title affected by the certification shall be inapplicable."

8. Testimony of Dan Crippen, Director, Congressional Budget Office, before the Senate Budget Committee, January 23, 2002, p.15.

9. The GDP component was added to each of the separate trigger provisions through a series of amendments on the last day that the Council considered the Tax Parity Act. The GDP component was added to every trigger provision in the act other than the real property tax rate change.

10. As noted earlier, the Tax Parity Act would be suspended if the District's general fund balance in the most recently completed fiscal year falls below a level equal to five percent of the locally supported budget. In 2002, that would mean that the fund balance at the end of FY 2001 would have to fall below $180 million. The District's fund balance was $464 million at the end of 2000, and District officials have indicated that the 2001 audit is likely to show a surplus for 2001, which would enhance the general fund balance even further. Thus, it is unlikely that the general fund balance will fall below the trigger threshold.

11. For example, paragraph 4A of §47.1806.03 of the District Code includes the individual income tax reductions for tax year 2001. Paragraph 4B of that section states that "Subparagraph (A) of this paragraph shall not apply if the certification by the Chief Financial Officer required by §47.387.01 [the trigger provision] demonstrates that the accumulated general fund balance for the immediately preceding fiscal year is less than 5% of the general fund operating budget for the fiscal year, the nominal GDP growth is less than or equal to 3.5% or the real GDP growth is less than or equal to 1.7%." Other sections of the D.C. tax code identify that reductions in individual income taxes, business property taxes, and corporate franchise taxes indicate that the reductions "do not apply" if a trigger provision requirement is met. See §47-1806.03(a), paragraphs (5)(B), (6)(B), and 7(B); §47-812, paragraphs (b-4)(2) and (b-5)(2); and §47-1807.02 (a)(3)(B).