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Suspending the Tax Parity Act in 2003 Is Vital to Helping the District Maintain a Balanced Budget and Fiscal Stability

by Ed Lazere

On January 23, a "trigger" that was designed to suspend the Tax Parity Act in periods of economic and fiscal weakness was activated. The trigger will suspend tax reductions in 2002 and will help the District address a substantial budget shortfall. Ten other states, including Maryland and Virginia, have either suspended tax reductions or have proposed such a suspension to avoid further revenue losses in the midst of the economic downturn.

Unfortunately, the trigger in the Tax Parity Act has several design problems, and it will need to be modified before it can be implemented.[(1)] Some District leaders, including some Council members and the Chief Financial Officer, have proposed a partial suspension — suspending income tax reductions in 2002 but allowing scheduled business property tax reductions to go through. Moreover, because the trigger suspends taxes for only one year at a time, the District's current financial plans appear to assume that all tax cuts scheduled for 2003 will be implemented.

These plans seem to be based on an overly optimistic view of the District's fiscal conditions. Recently released information shows that the District faces serious budget problems and that the plan to partially suspend the Tax Parity Act would leave the budget out of balance in both fiscal year 2002 and fiscal year 2003. To maintain fiscal stability in the near future, it appears that the District will need to suspend all tax cuts in 2002 — and to continue the suspension through 2003.

- The District faces a 2002 budget shortfall of $240 million, assuming a partial suspension of tax reductions. The CFO has identified steps that would address $215 million of the shortfall. Although this plan would require tapping all available resources, including all reserve funds, it would not close the budget gap fully.

- Suspending all tax cuts in 2002 — that is, suspending property tax reductions in addition to income tax reductions — would provide an additional $35 million in revenues. This would be sufficient to address the remainder of the District's 2002 budget shortfall.

In 2003, the District and most states expect to face large budget shortfalls even though the economy is expected to begin to recover. This reflects the fact that recoveries in state and local fiscal conditions typically lag recoveries in economic conditions.

- The CFO's unofficial estimate of the 2003 shortfall is $230 million, including an assumption that all tax cuts scheduled for 2003 will be implemented. Although this is roughly the same as the 2002 shortfall, the resources available to address the budget gap will be far smaller in 2003 than in 2002. While roughly $215 million in revenues and program savings have been identified in 2002, only $70 million is clearly available to address the 2003 shortfall.

- Suspending tax cuts in 2003 as well — that is, keeping tax rates at 2001 levels in both 2002 and 2003 — would avoid a revenue loss of about $130 million in 2003. This would increase resources available to close the budget gap from $70 million to $200 million. Because the budget gap in 2003 is $230 million, even this will not address the District's budget problems fully, and further steps would be needed to balance the budget. (The tax cuts that would be suspended are described in the Appendix.)

The District already has taken steps to suspend income tax reductions in 2002 as a result of the Tax Parity Act trigger, but it has not prepared for a suspension of property tax cuts. Because DC law requires property tax bills for FY 2002 to be mailed by March 1, District leaders need to take action very soon to ensure proper implementation of the tax cut suspension. It is important to note unless the property tax cuts are suspended in 2002, they cannot be suspended in 2003, because 2002 represents the final phase of scheduled property tax cuts.

District officials also need to act soon to suspend tax cuts in 2003. The 2003 budget will be submitted by the Mayor in March and enacted by the Council in May. If tax cuts will be suspended in 2003, the budget should be developed using a revenue forecast that takes the suspension into account.

Some policymakers have expressed a concern that a suspension of tax reductions in 2002 and 2003 may not be needed because economic and budget conditions may improve in the near future. There is, of course, no way of knowing how soon the economy will recover. Given this uncertainty, a more prudent approach would be to suspend all tax cuts now for both years. The tax cuts always can be implemented later if conditions improve. For example, if the District has a surplus at the end of fiscal year 2002 or fiscal year 2003, it could implement some or all of the tax cuts at that time, in the form of a refund.

These issues are discussed in more detail below.

The 2002 Budget Will Be Out of Balance If Property Tax Cuts Are Implemented

The District faces a serious budget shortfall this year, both because of declining revenues and because of increasing spending needs.

- According to the CFO, The District faces $201 million in "spending pressures," or expenditure needs that were not factored into the 2002 budget. The spending pressures, which largely are unrelated to the economic downturn, include spending on schools, Medicaid, public safety, and employee compensation costs, among others.

The level of spending pressures in 2002 actually is somewhat smaller than in previous years. Early in 2001, for example, the Chief Financial Officer identified roughly $250 million to $280 million in spending pressures. Late in the fiscal year, substantial overspending in the DC Public Schools and Medicaid was identified, adding more than $100 million to the earlier identified spending pressures.

Nevertheless, the recently released audit for FY 2001 shows that the District budget had a $78 million surplus. This occurred primarily because revenue growth was much stronger than anticipated. Tax revenues in 2001 totaled $3.2 billion, which was $291 million, or 10 percent higher than the $2.9 billion in revenues that had been budgeted. In addition to strong revenue growth, the 2001 budget was aided by a $150 million reserve for unforeseen problems. (Much of that reserve was used to facilitate the transition from the Public Benefit Corporation to the new Health Care Alliance.)

In 2002, by contrast, the District cannot expect to address its spending pressures with strong revenue growth. Instead, tax revenues in 2002 will *be lower* than the amount upon which the budget was based, because of the economic slowdown.

- The District's Chief Financial Officer has projected that District revenues will fall $73 million below the level projected when the budget was enacted in 2002, as a result of the economic downturn. Suspending income tax reductions scheduled for 2002 as a result of the Tax Parity Act trigger will increase revenues by $34 million and will lower the shortfall to $39 million.

- While the 2002 budget assumed tax revenues of $3,241 million, the current revenue estimate is $3,202 million, assuming suspension of the Tax Parity Act income tax reductions. This amount is slightly lower than total tax revenues in 2001.

The combination of spending pressures and declining revenues has created a budget gap in 2002 of $240 million. The CFO has outlined a plan to address about $215 million of this shortfall.[(2)] According to the CFO, these steps — which have not yet been approved by the Mayor, the Council, or the Congress — would require "using all of the District's uncommitted funds."[(3)] As shown in Table I, the plan would use all of the reserves set aside last year that were not spent ($36 million), as well as all of the reserves included in the FY2002 budget ($138 million).[(4)] The plan also would require the DC Public Schools to implement spending reductions of $35 million to partly offset an estimated $62 million in overspending.[(5)]

Table 1
Resources Available to Address Budget Shortfalls
In FY 2002 and FY 2003

	FY 2002	FY2003
Budgeted reserve	$138 million	$70 million
Carryover reserve	$36 million	$0
DCPS program reductions	$35 million	$0*
Other	$5 million**	NA
Total	$214 million	$70 million

* It is likely that the 2003 budget gap is based on the assumption that DCPS spending cuts in 2002 will be continued in 2003.
** According to CFO documents, this reflects a "citywide NPS recoupment." It is not clear whether the 2003 budget gap is based on an assumption that these savings will occur in 2003 as well.

Thus, the District's 2002 budget remains $25 million out of balance. If fiscal conditions worsen in any way during the remaining eight months of fiscal year 2002 — that is, if revenues decline further or if new spending pressures arise — the shortfall would be even larger.

Fully Suspending Tax Cuts in 2002 Would Close the Budget Gap

As noted, the District has suspended income tax cuts scheduled for 2002 as a result of the Tax Parity Act trigger, saving $35 million, but steps have not been taken to suspend property tax cuts. Suspending property tax reductions in 2002 would free up an additional $35 million in revenues, which would be sufficient to close the 2002 budget gap as it is now estimated. If fiscal conditions worsen in the remainder of the year, additional steps may be needed to maintain a balanced budget.

Can the District's Unrestricted Fund Balance Be Used to Address Budget Problems?

The audit of DC finances in fiscal year 2001 revealed that the District has a general fund balance of $562 million. The size of the fund balance, which in many ways acts as the District's savings account, reflects the accumulation of annual budget surpluses and deficits over time. When the District has a surplus in a given year, the fund balance increases by the amount of the surplus.

In releasing the audit findings, the CFO noted that some $91 million of the fund balance is unrestricted. The remaining $471 million is restricted for a variety of uses, such as the rainy day fund and funds set aside to guarantee payment of bond obligations.

The announcement of unrestricted funds within the fund balance raises the question of whether those funds can be used to address the budget gap in 2002 or 2003. Unfortunately, it does not appear that this is the case, for at least two reasons. First, the District generally does not have the authority to use resources in its fund balance without explicit permission from the U.S. Congress, and it is not clear whether congressional approval for such an action would be given. Second, and perhaps more important, the District's CFO has indicated that he intends to add nearly $150 million to the District's rainy day fund this year and that the $91 million uncommitted funds in the general fund would contribute to that effort.

If property tax cuts are to be suspended in 2002, District leaders will need to act soon. By law, property tax bills are mailed in March and September of each fiscal year.

The first property tax bills for FY 2002 thus are expected to be mailed in less than a month. District officials must decide well before the beginning of March whether property taxes will remain at rates and classes used in 2001 or whether the scheduled reductions in rates will be implemented, so that the appropriate bills can be sent. Dr. Gandhi has indicated that it would be difficult to amend the property tax bills even if a suspension is enacted very soon. It thus may be necessary for the Mayor and Council to consider delaying slightly the mailing date for the bills or taking other steps that would allow the CFO to prepare appropriate tax bills.

As discussed below, District leaders should consider suspending property tax cuts in 2003 as well. Yet unless the property tax cuts are suspended in 2002, they cannot be suspended in 2003, because 2002 represents the final phase of property tax cuts scheduled under the Tax Parity Act. In other words, there are no new property tax reductions to be implemented in 2003, and the only way to preserve revenues through suspending tax reductions is to suspend the 2002 tax reductions and to continue that suspension in 2003. This increases the importance of suspending property tax reductions in 2002.

Suspending Tax Cuts in 2003 Is Critical to Maintaining Fiscal and Service Stability

Although the economy is expected to begin rebounding in 2002, most states and the District expect to face budget shortfalls in 2003, reflecting the fact that recoveries in fiscal conditions typically lag recoveries in economic conditions.

Early in February, the District's Chief Financial Officer released a preliminary estimate showing that the budget shortfall in 2003 is $230 million. This estimate compares projected revenues with "baseline" spending needs, or the amount needed to maintain programs and services at 2002 levels. It appears to be based on an assumption that tax cuts scheduled for 2003 under the Tax Parity Act will be implemented.

While this budget shortfall is roughly the same as the 2002 shortfall, it actually presents a far more serious problem. This is because the resources available to address the shortfall will be much smaller in 2003 than in 2002. As table I shows, the CFO has identified some $215 million in actions that could be taken to address the 2002 budget shortfall. Yet only $70 million will be free to address the shortfall in 2003.

- In 2002, the CFO plans to use all of the $36 million in funds that were not spent from the FY 2001 budgeted reserve. It is unlikely that there will be any carryover of reserve funds into 2003, because all reserve funds available in 2002 will be needed to address that year's shortfall.
- The 2002 budget effectively includes $138 million in budgeted reserves.[(6)] In 2003, the budgeted reserve will be only $70 million as a result of changes included in the recent DC Appropriations Act.
- The District will address $62 million in school spending pressures through $35 million in school spending cuts in 2002. It is likely that the estimate of spending needs for 2003 assumes that the 2002 school spending reductions will be continued in 2003. In other words, the $230 million spending gap in 2003 already takes those spending cuts into account.

Suspending Tax Cuts in 2003 Would Address a Large Share of the Budget Gap

Given the large budget shortfall expected in 2003 and the limited resources to address it, District leaders should take steps to suspend the Tax Parity Act in 2003 as well as 2002. This would be consistent with the intent of the trigger — and of the key supporters of the Tax Parity Act — to halt implementation of tax reductions when the District's fiscal conditions become weak. For example, Council member Jack Evans was quoted in a 1999 *Washington Post* news article 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."[(7)]

Suspending all tax cuts in 2003 as well as 2002 — which would mean allowing tax rates to remain at 2001 levels for this period — would avoid a revenue loss of $130 million in 2003.[(8)] When combined with the $70 million budgeted reserve in 2003, the District would have $200 million to address the projected $230 million budget shortfall. While this would not eliminate the need for other budget-balancing actions, it would limit the need to make deep reductions in District programs and services.

If the tax cuts are to be suspended in 2003, District policymakers will need to take steps to do so soon and should not wait for 2003 trigger determination to occur. The Tax Parity Act trigger suspends tax cuts one year at a time, because the trigger is based on economic and fiscal measures that are issued annually. This means that the trigger that was activated in January 2002 will suspend tax cuts in 2002 but not in 2003, and that the trigger determination for 2003 will not be made until January 2003, several months after the 2003 budget is completed. If the tax cuts are to be suspended in 2003, it would be more appropriate to enact the suspension now, so that the 2003 budget can be developed this spring with a clear indication of the amount of revenues that will be available.

Tax Cuts Could Be Implemented Through Refunds if District Finances Rebound Rapidly

Some policy makers have expressed a concern that the District may not need to suspend the property tax cuts in 2002 or any of the tax cuts in 2003 because economic and fiscal conditions may recover much more rapidly than expected. If that were to occur, suspending tax cuts could contribute to a surplus rather than simply helping the District maintain a balanced budget.

It is not clear at this time how rapidly the District's revenues will recover, nor whether new spending pressures may yet arise. As a result, it would be more appropriate to suspend tax reductions now and implement them at a later date if fiscal conditions rebound sharply and revenues are sufficient. For example, if the District ultimately has a budget surplus in 2002, and the budget appears to be in balance for 2003, some or all of the 2002 tax cuts could be implemented retroactively through a special refund payment or through an adjustment to future tax bills.

A decision to implement tax cuts should not be made, however, until the fiscal year has ended and it is clear that a refund could be afforded. This is because new budget problems could arise late in the fiscal year that would affect the ability to institute the tax reductions. In 2001, for example, serious budget shortfalls in the DC Public Schools and in Medicaid were not identified until close to the end of the fiscal year.

Conclusion

District policymakers must soon address problems in the Tax Parity Act trigger to ensure that the suspension of tax cuts occurs in appropriate fashion. Although the trigger was intended to suspend all taxes when economic conditions worsen, some policymakers wish to implement a partial suspension, by halting income tax cuts but allowing property tax reductions to go through. Unfortunately, this approach would lessen the ability of the District to address its serious budget problems in 2002 and 2003. A more appropriate approach would be to suspend all tax reductions in 2002 and 2003 and to determine at a later date whether some or all of the tax cuts can be afforded.

Appendix

The Tax Parity Act called for reduction of a variety of District taxes between 2000 and 2004. As of 2001, some $149 million of tax reductions already have been implemented as a result of the act. Suspension of tax cuts in 2002 and 2003 would temporarily halt reductions in individual income and business property taxes, both of which were reduced in 2000 and 2001. It also would delay implementation of a reduction in the corporate income tax rate, which has not yet been reduced as a result of the Tax Parity Act. The table below highlights the impact of the suspension on hypothetical businesses and families.

Impact of Tax Parity Act on Hypothetical Households and Businesses

	Tax relief implemented through 2001*	Additional Tax relief scheduled for 2002 & 2003
Individual Income Tax**		
Household with $25,000 gross earnings	$175	$88
Household with $75,000 gross earnings	$703	$335
Household with $150,000 gross earnings	$841	$1,064
Business Property Tax		
Apartment building worth $1,000,000	$3,500	$1,900
Retail Business worth $1,000,000	$2,000	$1,000
Business Income Tax		
Taxable Income of $250,000	$0	$1,875
Taxable Income of $1,000,000	$0	$7,500

* This illustrates tax relief compared with tax liability in 1999.
** This assumes a family with income of $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 (for a family of four with two working adults).

End Notes

1. See "Fixing the Tax Parity Act Trigger: Changes Are Needed To Ensure Appropriate Suspension of Tax Cuts," DC Fiscal Policy Institute, January 23, 2002.

2. Unpublished documents from the Chief Financial Officer, February 2002.

3. Remarks of Natwar Gandhi, Chief Financial Officer of the District of Columbia, at the "Council Briefing and Press Conference on the District of Columbia's FY 2001 Comprehensive Annual Financial Report (CAFR)," January 28, 2002, page 3.

4. An additional $5 million in budget savings would be achieved through a "citywide NPS [non-personal services] recoupment." Non-personal services reflect expenditures for things other than salaries and benefits for District employees, such as supplies or direct benefit payments to residents. It is not clear from available documents what the nature of this recoupment is.

5. The CFO's plan to close the budget gap would not involve tapping the District's rainy day fund, known as the emergency and contingency reserves. Some of these funds can be used only in response to natural disasters and related emergencies. The remainder of the rainy day fund can be used only in cases of substantial revenue declines. Although District revenue growth is weak, the requirements for using the rainy day funds are unlikely to be met. Moreover, the rules governing the fund require that any funds withdrawn in one year must be replenished fully in the next year. Because it is not clear when DC finances will rebound strongly, use of the rainy day fund at this time would not be particularly beneficial or advisable.

6. The FY 2002 reserve amount equaled $150 million in the budget prepared by the Mayor and Council and submitted to U.S. Congress in June 2001. At the request of the District officials, Congress approved a plan to reduce the reserve to $120 million in 2002 (and $70 million in 2003). Reducing the reserve from $150 million to $120 million freed up $30 million. Of that amount, Congress directed the District to provide $12 million to the DC Public Schools, leaving $18 million for other purposes. The net result is that the District has $138 million in 2002 that can be used to address unforeseen budget needs — $120 million in the basic reserve and $18 million remaining from lowering the reserve from $150 million to $120 million.

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

8. In January 2002, the CFO estimated that tax cuts scheduled for 2002 total $70 million. An earlier estimate from the CFO indicated that the 2003 tax reductions represented an additional $60 million.