Narrowing Income Inequality Through the Tax Code

By Marlana Wallace and Ed Lazere

DC's tax system stands out in two key ways, according to a new analysis on how state tax policies affect families at different income levels. First, taxes on DC families living on very low incomes–below about $24,000 a year–are lower than in any state in the U.S. That good news is due primarily to income and property tax credits targeted to help residents working hard to make ends meet. But the analysis shows that families with incomes just above that level pay the same share of their income in DC taxes (income, sales, and property taxes) as the District's wealthiest residents. At a time when the income of the top fifth of DC households is 34 times larger than the bottom fifth ($320,000 compared with $9,000)—and a time of growing income gaps between Black and white residents—the District should be asking its wealthiest residents to pay more to address the city's inequities.

Beyond changes in actual policy, the District can do more to help families by making sure they get all the tax benefits they are eligible for. DC has a substantial Earned Income Tax Credit (EITC) for working households with low incomes, for example, but almost one-third of eligible families don't claim it. More outreach is needed.

These findings are based on a new report, Who Pays? A Distributional Analysis of the Tax Systems in All 50 States, by the Institute on Taxation and Economic Policy.

How DC's Tax Code Does—And Does Not—Reduce Income Inequity

The District's local tax choices can improve—or worsen—the vast income inequity that threatens the future of our city.

DC's income tax is a "progressive" tax, meaning it asks for greater contributions from those who can most afford to pay *(Figure 1).* But residents pay taxes other than income taxes, too. And the picture looks very different when those other taxes are considered. In particular, sales taxes affect people living on low incomes far more than high-income households. Families living pay-check to pay-check spend most of their earnings, unlike wealthier families who can afford to save. As a result, sales taxes—which cover things like utilities, clothing and phone bills amount to a higher share of a server's wages than a financial manager's earnings, for example. Property taxes affect lower-earners more as well, since landlords typically pass the costs of property taxes on to their renters. When property, sales *and* income taxes are all accounted for, the progressive impact of DC's local income tax is profoundly muted.

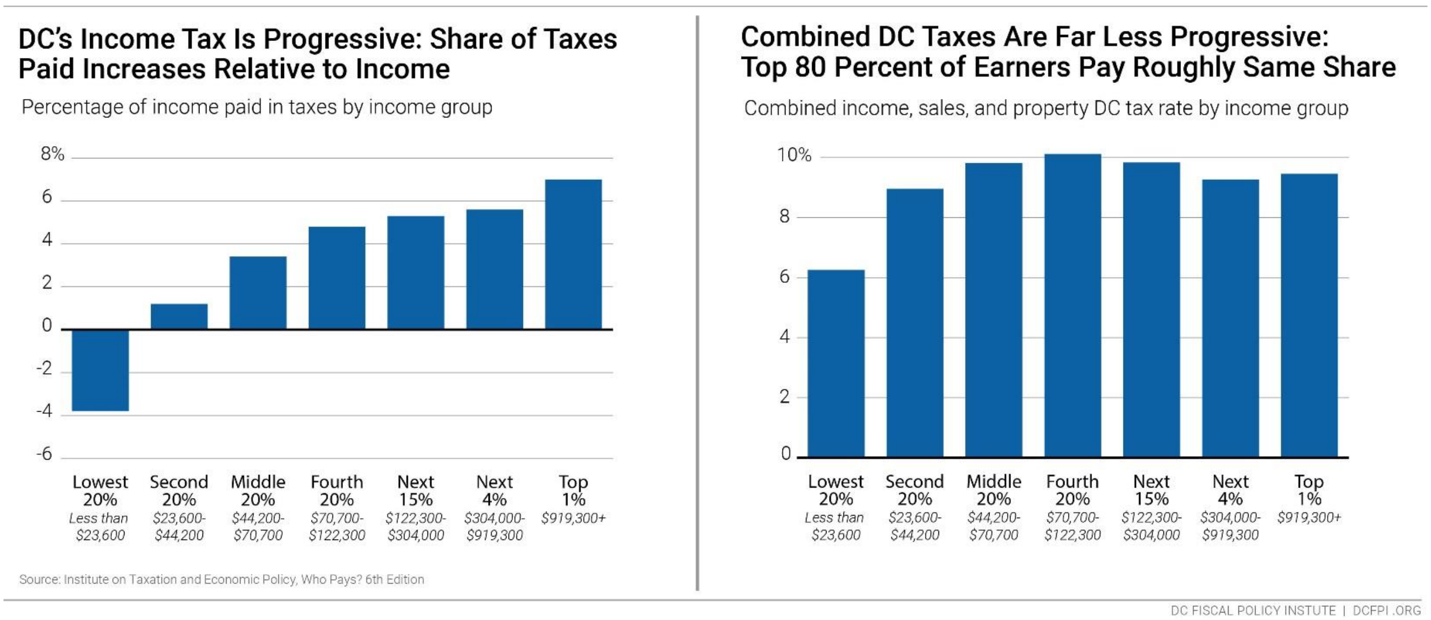
Two things are worth noting about DC's tax code:

- First, combined taxes are low on DC's families with the smallest incomes– in fact, the rate is lower than in any state (about 6 percent). That's because DC has substantial tax benefits targeted specifically on these households, like the EITC. (See below for more on the EITC and how to make it even better.)

- Second, for families at all income levels above that, DC's tax system tells a different story *(Figure 1)*. District workers earning any amount greater than $23,600—from the full-time minimum wage worker to the law firm partner—are all effectively paying between 9 percent and 10 percent of their income in combined DC taxes.

These findings show that by not asking the wealthiest residents to pay their fair share, DC leaders are forgoing an opportunity to leverage the enormous wealth in our city towards investments in education and housing that benefit everyone. One way to do this is to strengthen the progressivity of DC's local income tax further by raising the top rates on our highest-income households—many of whom just got [a big *federal* tax cut]—thereby offsetting some of the regressive impacts of sales and property taxes.

Figure 1.



More Outreach is Needed to Ensure District Residents Benefit From the Earned Income Tax Credit

DC's [Earned Income Tax Credit] (EITC), in combination with the federal EITC, assists residents who work but have low earnings through an income tax credit that puts money back in the pockets of those who need it most. The EITC is "refundable" meaning that it provides a refund even when families owe little or nothing in income taxes. The EITC is a proven, effective anti-poverty tool that lifts thousands of families out of poverty. Families largely use the credit to pay for necessities, like groceries, transportation and child expenses, or to pay down past-due bills and debt.[1] [Research shows] that when families get the added financial stability provided by the EITC, their children do better in school and earn more as adults.

For working families with three or more children, combined local and federal earned income tax credits can have a maximum value of $9,003.[2] For adults without children in the home, combined local and federal earned income tax credits can have a maximum value of $1,038. (The federal EITC for those without children is much lower than for those with children.)

Unfortunately, many DC families who should be claiming the EITC do not. That's because many do not file a federal tax return since they do not owe income taxes. Yet by not filing taxes, eligible families miss out on a valuable income-support, especially DC workers without children in the home. Nationally, an estimated 79 percent of eligible families benefited from the EITC in 2014. But in DC that figure was only 72 percent—the lowest in the country.[3]

DC leaders should invest more to ensure that the low-income workers are benefitting from the local tax policies designed to enhance their economic security. And, they should also take additional steps to make our tax code more progressive by asking DC's wealthiest residents to pay their fair share.

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[1] For a summary of the research, see: "EITC and Child Tax Credit Promote Work, Reduce Poverty, and Support Children's Development, Research Finds," Center on Budget and Policy Priorities, 2015. Available at https://www.cbpp.org/research/federal-tax/eitc-and-child-tax-credit-promote-work-reduce-poverty-and-support-childrens?fa=view&id=3793

[2] For families with children, the DC EITC is 40 percent of the federal credit. For families without children in the home, the DC EITC is 100 percent of the federal credit. For maximum credit values, see: https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/eitc-income-limits-maximum-credit-amounts-next-year

[3] https://www.eitc.irs.gov/eitc-central/participation-rate/eitc-participation-rate-by-states