To: Council of the District of Columbia

From: Richard Auxier

Date: December 6, 2021

Re: Best Practices in Local Revenue Recovery to Inform an Equitable COVID-19 Recovery

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This memo was prepared at the request of and with funding from the DC Council to inform efforts to promote an equitable recovery following the COVID-19 pandemic. We are grateful to the DC Council and to all our funders, who make it possible for Urban to advance its mission. The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders. Funders do not determine research findings or the insights and recommendations of Urban experts. Further information on the Urban Institute's funding principles is available at urban.org/fundingprinciples.

Introduction

The COVID-19 pandemic created unprecedented revenue volatility in the District of Columbia (DC) and most other state and local governments. Across the country, state and local tax collections rapidly collapsed following "shutdown" orders in the spring of 2020 but then recovered—far faster than was anticipated—following both congressional pandemic relief legislation and unforeseen economic shifts.

As DC continues its local revenue recovery, it will confront many of the same challenges facing other states and large cities, including fiscal planning during a period of great uncertainty, navigating fast-changing federal policies, and promoting an equitable recovery. However, unlike other jurisdictions, DC's government uniquely functions and taxes as both a state and a local government, creating responsibilities and opportunities.

This memo highlights lessons to be learned—good and bad—from other state and local governments. But it also stresses that the pandemic's effect on state and local revenue varies significantly depending on both the configuration of a jurisdiction's revenue system and its economic mix of industries.

Finally, on matters of equity, although work remains to be done, policymakers should appreciate that DC is widely regarded as a leader. DC's policy work on equity, whether new (baby bonds) or old (property tax relief), sets DC apart from most jurisdictions. Nonetheless, additional, achievable reforms could make DC's revenue system fairer and more just.

Background: The Pandemic's Unexpected and Unequal Effect on State and Local Revenue

In July 2020, a Tax Policy Center analysis of state revenue forecasts showed that total tax revenue for all 50 states would fall roughly $75 billion below pre-pandemic forecasts in fiscal year 2020 and $125 billion short in fiscal year 2021.[1] A private analysis done by Moody's Analytics in September 2020 projected a combined $450 billion shortfall for state and local governments in fiscal years 2021, 2022, and 2023.[2]

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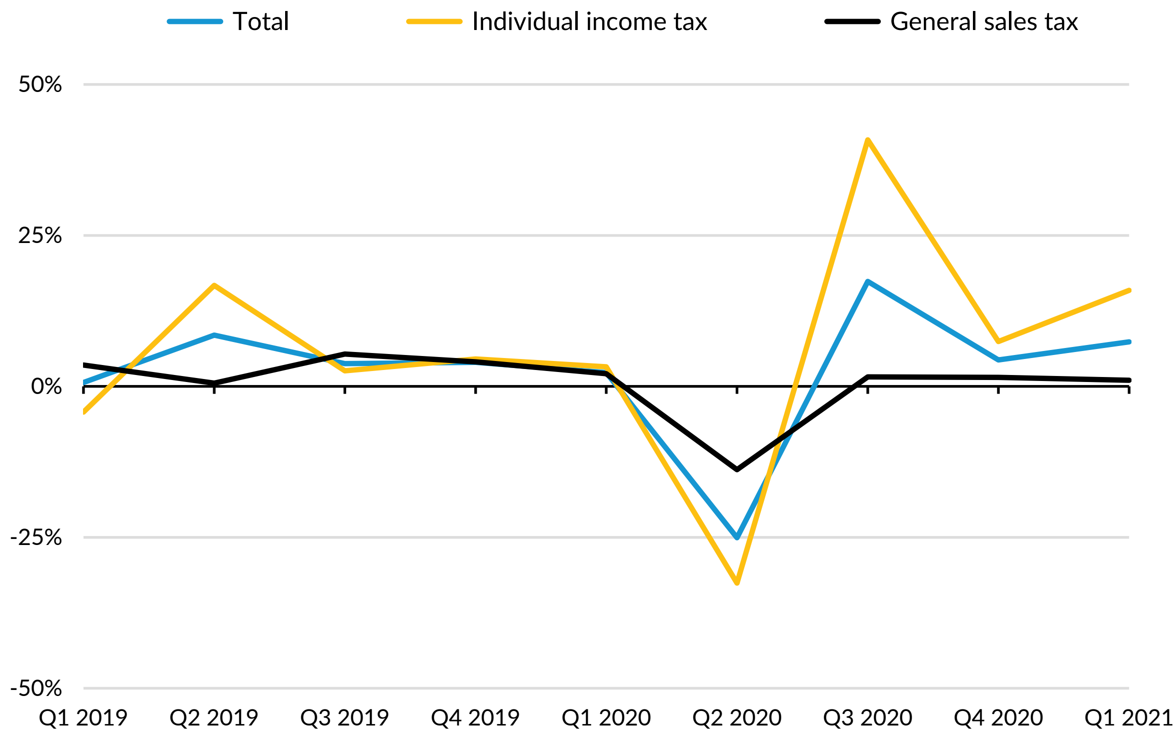
According to the Urban Institute, state tax collections in fiscal year 2020 did fall—down $45 billion compared with the previous year.[3] However, collections recovered in the latter half of calendar year 2020, and data from 2021 show many states' collections returning to pre-pandemic levels (see figure 1).

FIGURE 1

State Tax Revenue during the Pandemic

Percentage change for each quarter, year over year, real dollars



Source: Urban Institute State Tax and Economic Review.

Although comparable data for local revenue collections are not available at this time, in general, major cities are doing better than expected but not as well as state governments. A National League of Cities survey (conducted in March and April of 2021) found 41 percent of mayors reported a decline in general funds, and nearly one-in-five mayors cited revenue as "one of the most significant negative conditions affecting their communities."[4] Most mayors report strong property tax collections but sharp declines in revenue from taxes and charges levied on restaurant meals, hotel stays, parking, and other activities tied to city visits.

State and local revenue recovered quicker than expected for three major reasons.

1. **Congressional action**. From March 2020 to March 2021, Congress provided roughly $880 billion in pandemic-related funds for state and local governments.[5] It also spent trillions on economic assistance (e.g., stimulus checks, expanded unemployment benefits, and advanced child tax credits) that prevented a deeper and longer economic downturn.

2. **Unequal economic effects**. High-income workers generally worked from home during the pandemic and thus largely avoided economic hardship, while low-income workers, particularly those in the service industry, experienced acute job losses and economic pain. However, because high-income households pay more in tax (in sum) than low-income households, tax collections were higher than anticipated even while many families struggled. This dynamic was particularly

evident for jurisdictions with a progressive individual income tax (i.e., high tax rates on high income) and a relatively large number of high-income households (California and DC fit both descriptions).

3. **Consumption shift**. Consumers increasingly spent on goods rather than services during the pandemic.[6] Governments that levy a general sales tax benefited because purchases of goods are largely taxed (especially now that governments can tax online purchases[7]) while purchases of services often are not taxed.[8] However, this shift helped state governments far more than local governments.[9] States get a large share of revenue from the general sales tax, but cities rely more on taxes and charges related to in-person services, such as hotel stays, live entertainment, restaurants, and parking.[10] (DC utilizes both types of taxes but operates more like a state than a city in this respect. See the next section for more information.)

Key Questions and Best Practices

This memo includes several recommendations for continuing and building upon DC's fiscal and revenue policies, focused around three key questions (table 1).

TABLE 1

Summary of Key Questions and Best Practices

How can DC support revenue growth?	
	Take advantage of DC's revenue system and economic mix.
	Make only targeted and fiscally responsible tax cuts.
	Monitor new tax approaches to rapidly evolving economic trends.
How should DC navigate federal funds and federal policy changes?	
	Use one-time federal funds carefully.
	Watch federal tax legislation closely as it could change DC tax law.
How can DC promote equity as it recovers local revenue?	
	Continue leading on tax equity.
	Enact other equity-based tax changes that extend benefits to more communities.
	Reform fines and fees to protect low-income residents from excess harm.

How Can DC Support Revenue Growth?

The pandemic devastated the service sector and taxes related to it—a significant blow to DC and all other major cities. However, DC's relatively broad mix of taxes and economic industries give it an opportunity to overcome these losses better than most cities. If revenue growth remains strong, policymakers could consider tax cuts, but the focus should be on the residents most harmed by the pandemic and DC's long-term budget plans. DC should also monitor how economic shifts are affecting state and local tax practices across various jurisdictions.

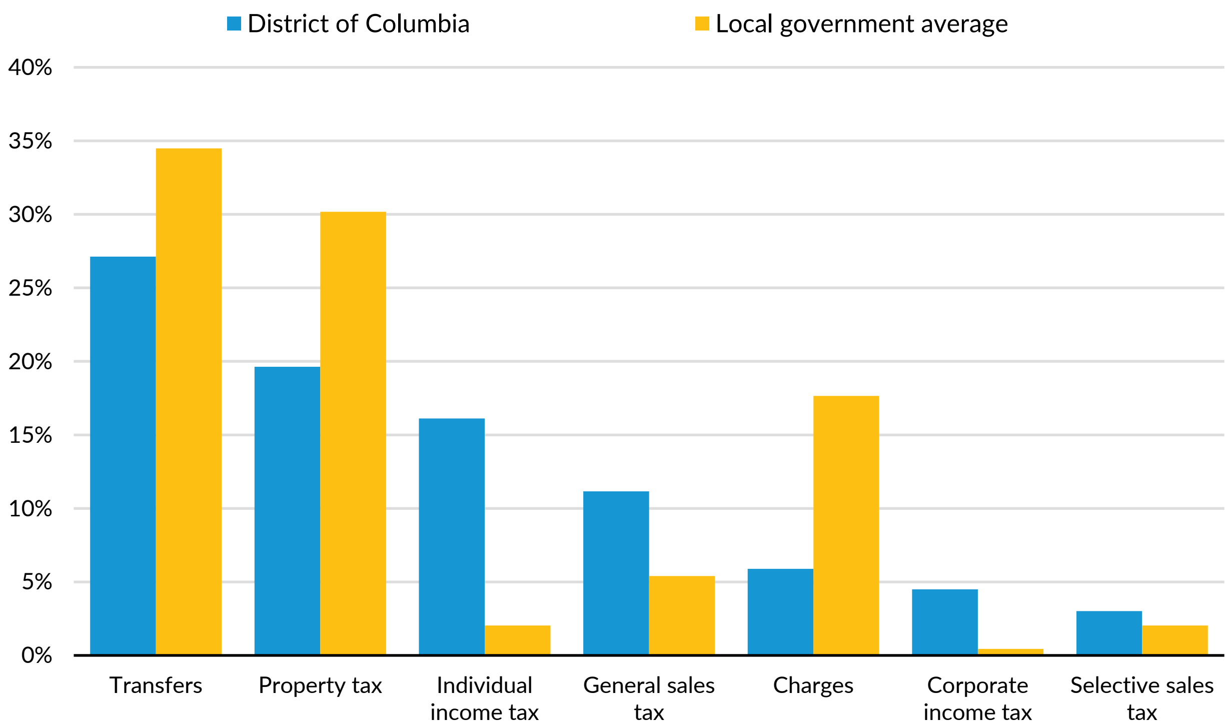
Take Advantage of DC's Revenue System and Economic Mix

Like other large cities, DC collects revenue from taxes and charges related to restaurants, hotels, and parking—the tax collections most harmed during the pandemic. However, because DC also operates and taxes like a state, these taxes and charges make up a far smaller share of revenue in DC than in other major cities.[11] In 2019, charges—defined as any public payments connected with a specific government service, such as parking payments and sewerage fees—accounted for 18 percent of national local government general revenue.[12] But charges accounted for just 6 percent of DC's general revenue in the same year. While charges include a wide range of government payments, they are in large part the types of collections that fell in major cities because of the pandemic.

FIGURE 2

The District's Revenue System Compared with Local Government Average

Sources as a share of general revenue, fiscal year 2019



Source: US Census Bureau.

Note: Sources are not comprehensive and do not sum to 100%. "Transfers" includes federal transfers to the District of Columbia and federal and state transfers to local governments. Local governments include cities, counties, townships, special districts, and school districts.

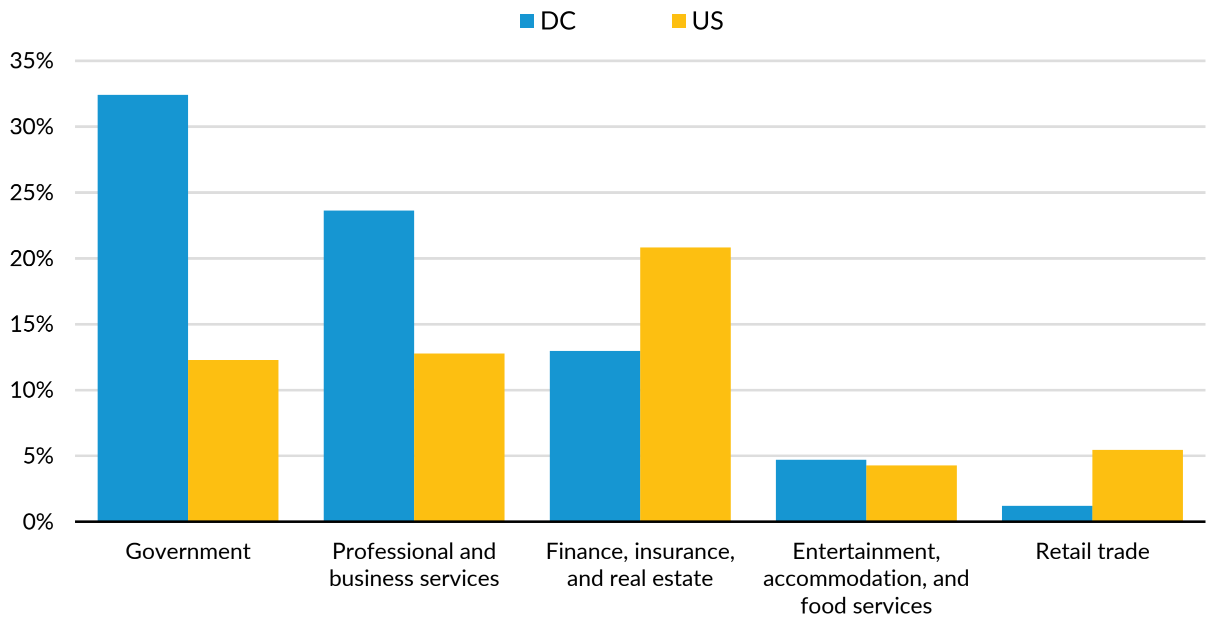
Conversely, individual income tax collections accounted for 2 percent of national local government revenue but 16 percent of DC's general revenue in 2019. Individual income tax revenue is largely responsible for the better-than-expected state tax collections nationally.[13] Property tax revenue as a share of general revenue also diverged (30 percent nationally versus 20 percent in DC in 2019), as did general sales tax revenue (5 percent nationally versus 11 percent in DC in 2019). DC's relatively broad mix of taxes, and particularly its individual income tax, should give it more fiscal capacity to weather the pandemic's negative revenue effects and more options for revenue increases if future problems emerge.

Similarly, DC's economic mix could help it recover revenue. DC gets a far greater share of its gross domestic product (GDP) from the government and professional and business services than does the average local government. DC's relatively high dependence on these sectors can sometimes cause financial issues (e.g., economic harm during a federal government shutdown), but it has largely helped DC during an economic downturn concentrated on entertainment, accommodation, and retail trade.[14] While these businesses were similarly hurt in DC, none of these sectors is particularly large in DC compared with national averages (see figure 3).

FIGURE 3

The District of Columbia's Economic Mix

Contributions to GDP, 2019



Source: Bureau of Economic Analysis.

Comparative city-level data are not readily available. However, metro-area data show the Washington metro area's entertainment and accommodation sector (3.8 percent of its GDP) is slightly lower than the metro areas surrounding New York City (4.4 percent) and San Francisco (4.0 percent) and considerably lower than Las Vegas (19.5 percent).[15] As such, while DC has suffered similar negative economic consequences from the pandemic, its losses should not be as severe as those in other major cities.

Related, per capita income in the Washington metro region is among the highest in the nation—particularly among large metro areas.[16] This tax base, when combined with DC's progressive income tax, gives the District a revenue recovery potential that is not available to most other local governments.

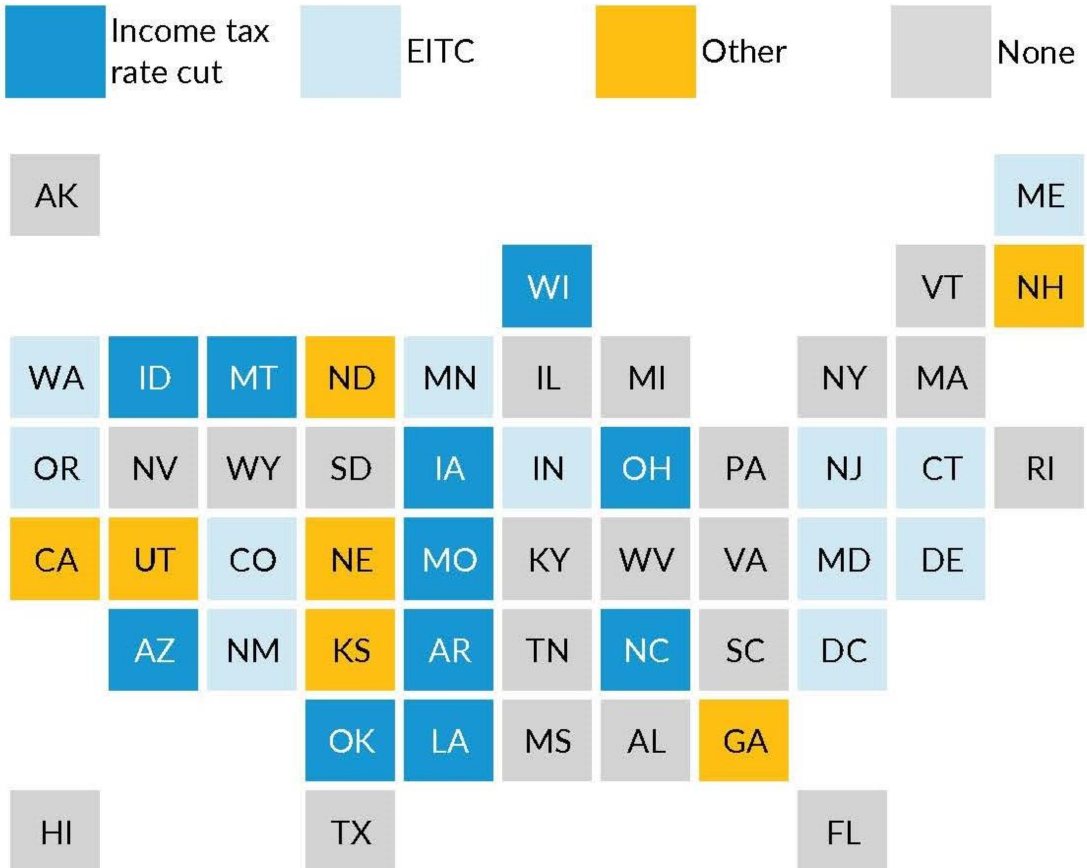
That said, many questions about major cities in a post-pandemic future remain unanswerable. Notably, we do not know how remote work will affect commercial property tax revenue. But, as with taxes and charges related to hotels, restaurants, and parking, DC's diverse revenue system could help the city offset negative revenue trends better than most other major cities.

Make Only Targeted and Fiscally Responsible Tax Cuts

Strong tax revenue growth in fiscal year 2021 helped create budget surpluses in many states.[17] State revenue officers stressed that "prior budget balancing actions, strong fiscal management, and conservative budgeting," and not solely revenue growth, contributed heavily to these state surpluses.[18] Still, 29 states decided to use these excess funds for tax cuts in calendar year 2021. Most were individual income tax cuts, generally delivered as either lower tax rates or an expanded earned income tax credit (EITC).[19] (See figure 4.)

FIGURE 4

State Tax Cut Type in 2021



Source: Authors' count based on media stories

Notes: Missouri and Oklahoma both lowered individual income tax rates and expanded their state EITC. "Other" includes states that made changes to the income tax but did not enact a rate cut or EITC change (California, Georgia, Kansas, North Dakota, and Utah) and states that significantly cut taxes but did not make changes to the individual income tax (Nebraska and New Hampshire). States that created or expanded a relatively small tax credit, or enacted a similarly small tax reduction, are not included in this count.

(Note: The American Rescue Plan (ARP) prevents states from funding tax cuts with ARP dollars, but Treasury guidelines allow states to cut taxes if they have sufficient revenue from economic growth.[20] In general, Treasury's rules give states ample flexibility to enact tax cuts.[21])

Arkansas, Arizona, Idaho, Iowa, Louisiana, Missouri, Montana, North Carolina, Ohio, Oklahoma, and Wisconsin lowered individual income tax rates or eliminated an income tax bracket. For example, Idaho reduced its number of income tax brackets from seven to five and lowered its top individual income tax rate from 6.925 percent to 6.5 percent.

Colorado, Connecticut, Delaware, the District of Columbia, Indiana, Maine, Maryland, Minnesota, Missouri, New Jersey, New Mexico, Oklahoma, Oregon, and Washington enacted or expanded their state EITC. Most calculate their state EITC as a percentage of the federal credit, so a state EITC expansion is typically an increase in the match rate—but the increases vary considerably.[22] For example, the District of Columbia's legislation will eventually increase its match of the federal EITC from 40 percent to 100 percent, whereas Indiana's legislation increased its match from 9 percent to 10 percent.

State policymakers cut taxes in different ways for various reasons. At this moment, an EITC expansion, such as the one implemented by DC, has two benefits over a tax rate cut:

First, the cost of an EITC expansion is far smaller than a rate cut. Annually, the former typically costs tens of millions of dollars while the latter can cost hundreds of millions of dollars. This point is critical because we do not know if the current economic and revenue upswing—driven in large part by expiring federal policy—is sustainable, but we do know that rate cuts create permanent large revenue costs.

Second, state EITCs (because they mirror the federal EITC[23]) target their benefits at the low-income workers who were hurt the most during the pandemic, while tax rate cuts provide the greatest benefit to high-income households. For example, a Tax Policy Center analysis of the tax changes in Maryland and Ohio found that 81 percent of the benefit from Maryland's EITC expansion went to households earning less than $30,000 while 73 percent of the benefit from Ohio's tax rate reduction went to households earning more than $100,000.[24]

There are many reasons and ways to cut taxes, and each proposal must be judged on its own merits. However, in 2022, policymakers should keep two things in mind when evaluating a possible tax cut:

1. The pandemic's economic effects were very unequal, with low-income workers faring far worse than high-income workers.[25]
2. Future revenue growth remains highly uncertain.[26]

For example, DC recently exempted unemployment benefits from its income tax. This change helps those hurt by the pandemic and has a relatively low long-term revenue cost.

Monitor New Tax Approaches to Rapidly Evolving Economic Trends

Both governments and workers are now navigating complex tax issues created by an increasingly mobile workforce. For example, a worker who lives in one state but performs her job (physically) in another typically owes income tax to the state she works in. Does she still owe tax to the state where her business is physically located if she works from home?

This is not a major issue in the District. The federal government prevents DC from taxing income of nonresidents, and DC has a reciprocity agreement with neighboring Maryland and Virginia, whereby people pay taxes where they live instead of where they work. Still, the ability of workers to perform their jobs anywhere is an increasingly important issue for state and local governments that rely on income tax revenue.

In 2021, the Supreme Court declined to hear a case involving these issues between Massachusetts and New Hampshire.[27] The case centered on Massachusetts's decision to continue collecting income tax from New Hampshire residents who worked at home for Massachusetts companies during the pandemic. New Hampshire's governor called the practice an "unconstitutional tax grab," while Massachusetts said the arrangement merely continued the "status quo" of state taxation. The court did not provide a reason for rejecting the case. The justices could have reasoned that the Massachusetts rule was temporary or that New Hampshire (which does not levy an income tax) did not lose any revenue from the Massachusetts rule. However, six states—most notably New York—have permanent rules to tax remote workers, and any state with an income tax stands to lose revenue via tax credits if its residents are taxed by another state. As such, the court or Congress might well establish new rules on taxing remote workers in the near future—and that could affect DC.

Other jurisdictions are grappling with other long-term economic shifts. Most notably, Maryland recently enacted a new tax on revenue from digital advertisements.[28] The tax is levied on an internet company's revenue from digital ads, with rates increasing with the company's revenue. (The tax's advocates argue that companies increasingly benefit from consumer data rather than consumer purchases.) Estimates indicate the tax will raise hundreds of millions of dollars in new revenue for

Maryland, and numerous other states are considering similar taxes.[29] However, the Maryland law is being challenged in court, and its future remains in doubt.

Matching their existing tax systems to the rapidly evolving economy is increasingly challenging for state and local governments. Policymakers must be both open to new ideas and careful not to put too much faith (or revenue) in a tax that the courts or Congress might restrict or overturn.

How Should DC Navigate Federal Funds and Federal Policy Changes?

The American Rescue Plan (ARP) funds create short-term opportunities but not long-term revenue. As such, federal funds could jump-start worthy programs but not support permanent expenditures. The federal government is also considering changes to tax laws that could affect DC's tax revenue—but there is no way to predict if those changes will help or hurt DC tax collections. In either case, caution is warranted.

Use One-Time Federal Funds Carefully

The District received roughly $3 billion in federal funds from the 2021 ARP. This total includes DC's ARP funds plus the federal funds DC did not receive when Congress misclassified DC as a territory and not a state in the 2020 CARES Act.

State and local governments can use ARP funds to respond to the public health emergency, replace lost tax revenue, offset the pandemic's negative economic effects, or invest in infrastructure.[30] They cannot use funds to cut taxes (with, as previously noted, important exceptions[31]) or support pension funds. Governments have until December 31, 2024, to allocate their ARP funds and can spend the money through December 31, 2026.

As of December 2020, the largest use of ARP funds by state governments was refilling unemployment insurance trust funds and replacing revenue losses caused by the pandemic (this spending ultimately supports public schools and other typical state expenditures).[32] Revenue replacement was also the most common use of ARP funds for large cities. San Francisco, for example, used its entire ARP allotment for this purpose.[33] When looking only at local government investments, the largest use of ARP funds for both city and county governments was infrastructure improvements.[34] However, many state and local governments had not yet spent a majority of their ARP funds by December 2020, in part because a significant share of those funds will not be delivered until 2022.

According to a summary put together by Mayor Muriel Bowser, DC has so far used its ARP funds for "access to safe and affordable housing, high-quality job training, healthy neighborhoods, academic acceleration, increased access to quality child care, programs to reduce gun violence, safe and accessible transportation options, and support."

Decisions about spending ARP funds, like all other budget decisions, are ultimately decisions about values and resources. Arguments can be made for spending ARP funds on unemployment insurance trust funds and for spending them on housing and other worthy social programs—but a dollar spent on one is a dollar not spent on the other. In general, policymakers should use the same guidelines for spending as for tax cuts: simultaneously focus on those most harmed by the pandemic (and past inequities) and plan for DC's long-term financial health. Specifically, on the latter, policymakers should be wary of relying too heavily on one-time federal funds for long-term expenditure programs because the federal funding will expire and ongoing local revenue growth is uncertain.

Watch Federal Tax Legislation Closely as It Could Change DC Tax Law

Some of DC's tax laws "conform" with federal tax laws.[35] That is, DC (and every other state) uses federal tax rules and calculations in its own tax code. As a result, if Congress changes a law that DC conforms with, then the DC law also changes. This point is increasingly important because Congress has recently made significant changes to the federal tax code and will likely continue to do so over the next few years.

For example, the ARP expanded the federal EITC for childless workers, and because the DC EITC calculation links to the federal EITC calculation, the ARP change also expanded the DC EITC.[36] The Tax Policy Center estimated that this federal-induced DC tax change provided an average DC tax benefit of $785 to eligible filers and cost DC $36 million in revenue.[37] The larger federal EITC applies only to tax year 2021, but if it is extended, the benefits for eligible DC taxpayers and cost to DC's budget would also continue.

Similarly, DC saw its standard deduction and personal exemption change when the Tax Cuts and Jobs Act (TCJA) altered these federal provisions.[38] All of the individual income tax provisions in the TCJA are set to expire at the end of 2025. If this happens, or if Congress passes new legislation to replace the TCJA, DC may see its tax policies and tax revenue altered again because of federal tax changes. However, the effect of such changes cannot be predicted. In 2018, for example, following enactment of the TCJA, some states that conformed with federal rules saw their state tax revenue go up in part because the TCJA resulted in higher state taxes for large families in their state.[39] This was not the intent of the federal or state laws but the consequence of existing state laws connecting to altered federal laws. If states did not agree with the changes, they could (and some did) take state legislative action to resolve them.[40]

In short, after roughly 30 years of little to no change in the federal tax base, Congress has made significant changes during the past few years and is likely—in part because of expiring federal laws—to make additional changes during the next few years. Thus, policymakers need to know how DC laws connect to federal laws, monitor federal legislation, and understand how possible federal changes might affect DC residents and DC tax revenue.

How Can DC Promote Equity as It Recovers Local Revenue?

DC has a venerable history of leading on tax equity issues, including the EITC, baby bonds, and creation of a government agency dedicated to tracking racial equity. But there are still some important reforms that could further improve DC's revenue system.

Continue Leading on Tax Equity

The EITC is one of the federal governments most effective poverty-fighting tools, with benefits disproportionally helping women of color.[41] And because state credits (including DC's EITC) are typically calculated as a percentage of the federal credit, expanding a state EITC is a simple and effective way to address economic and racial inequality.[42]

In August 2021, the DC Council unanimously passed a budget that increases the DC's EITC from 40 percent of the federal credit to 70 percent in tax year 2022 and to 100 percent in 2026.[43] As such, DC's credit now towers above other state credits. Of the 19 states that offer a refundable EITC as a percentage match of the federal credit, 13 provide matches of less than 20 percent. The next-highest state EITC match is 40 percent in New Jersey.

The District was also the first jurisdiction to expand its EITC specifically for childless workers.[44] Childless workers include both adults without children and those with children who live with another parent. As an Obama administration report noted, these adults often are young and unmarried and lack a college education—exactly the people the government should encourage to join the labor force.[45] Yet, childless workers remain the one group still taxed into poverty.[46] In 2014, DC expanded the credit's income eligibility for childless workers beyond the federal limits (providing the credit to more workers) and increased the match for childless workers to 100 percent (making those credits larger).[47] As a result, many childless workers in DC receive a DC EITC but not a federal EITC.

DC also recently approved a "baby bond" program that will provide annual payments into a trust fund for low-income kids that they can access when they turn 18.[48] The accumulated funds can then be spent on education, a home, or a business. Connecticut enacted a similar program this year.[49] This type of program is a new and innovative way for state and local governments to address racial and economic disparities.[50]

And these new policies build on other existing policies that support equity, such as DC's circuit breaker program that assists low- and middle-income residents with property taxes (or rent payments). Many states also provide help via circuit breaker programs, but DC's program is far more generous and accessible than programs in other states.[51]

Finally, as noted in a recent Tax Policy Center brief on incorporating equity into city revenue strategies, the DC Council's Office of Racial Equity and its racial equity impact assessments are models for equity-informed revenue approaches in cities across the nation.[52]

DC is to be commended for enacting such a broad set of forward-looking, equity-driven tax policies. As state policymakers across the nation map out a recovery from the pandemic, they should look to DC and its use of efficient and cost-effective poverty-fighting tools. Still, DC could take additional steps to further promote a more equitable economic recovery.

Enact Other Equity-Based Tax Changes That Extend Benefits to More Communities

One reform the District has not yet enacted is making its EITC available to undocumented immigrants.[53] These residents typically file tax returns with an Individual Taxpayer Identification Number (ITIN) instead of a Social Security number. This makes them ineligible for the federal EITC because every member of a filer's household must have a Social Security number to claim the federal credit. However, seven states—California, Colorado, Maine, Maryland, New Mexico, Oregon, and Washington—now allow ITIN filers to claim their state EITC, including five states that enacted this reform in 2021.[54]

Similarly, some states now allow childless workers ages 18 to 24 or age 65 and older to claim their state EITC even though they are not eligible for the federal EITC (which has age restrictions for childless workers). Three states enacted this type of reform in 2021: Colorado, New Jersey, and New Mexico.[55]

Reform Fines and Fees to Protect Low-Income Residents from Excess Harm

DC can also promote equity by changing how it collects revenue. One relatively small revenue change that could have an outsized positive effect on residents is reforming DC's use of fines and fees. Fines and fees include moving and parking tickets (including those from traffic cameras), court-imposed fines, and other criminal justice–related charges and penalties. In 2019, fines and fees accounted for a relatively small share of general revenue in DC (1.4 percent) and in localities nationally (0.6 percent).[56] The percentage in DC for 2020 and 2021 will most likely be lower because many fines and fees, such as parking tickets, were suspended during the pandemic.[57] Nonetheless, while not accounting for a large share of revenue, fines and fees can unfairly burden some residents and communities.[58] Studies show that the people most often subject to fines and fees are disproportionately low-income and people of color.[59] And these fiscal penalties can create harmful incentives for policing and sentencing practices.[60]

In addition, fines and fees are an inefficient revenue source because many recipients are unable to pay. However, for those people unable to fully pay what is owed, the punishments can be severe and life altering.[61] For example, in some jurisdictions residents can lose their driver's license because of an unpaid fine. In 2018, DC ended license suspension for drivers who did not pay traffic fines, but obstacles remain for residents with unpaid tickets.[62]

And, overall, when communities view their courts and police departments as exploitative, their confidence in the justice system is undermined.[63]

There is a growing understanding of how fines and fees can impose unjust burdens and create perverse financial incentives.[64] Only a few governments, though, have enacted reforms.[65] Among those governments that have enacted serious reforms, San Francisco is illustrative: in 2018, it eliminated all locally controlled administrative fees levied upon those exiting the justice system and also waived more than $32 million in unpaid debt.[66]

DC should consider lowering its reliance on fines and fees and adopt other reforms that reduce the pernicious effects of their collateral measures on residents.

Conclusion

DC's diverse revenue system, economic mix of industries, and policy leadership on equity issues put it in a position of strength to navigate the local revenue challenges caused by the pandemic. In fact, given its fiscal capacity and the infusion of federal funding, DC could use this moment to implement additional equitable reforms, such as expanding benefits to immigrant communities and reducing the city's use of harmful fines and fees. However, the remaining national uncertainty on economic and revenue trends—particularly for major cities—is cause for cautious long-term budget decisions. DC can simultaneously create a more equitable city and plan for a strong fiscal future.

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