"If the District of Columbia becomes a State: Fiscal Implications"

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Council of the District of Columbia

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Council Member Michael A. Brown, Chairman

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Mr. Chairman and Members of the Committee:

The nation's founders decided to carve a separate entity, the District of Columbia, out of Maryland and Virginia to serve as the capital of the new country. The decision doubtless seemed right at the time, but it has left the residents of modern DC with two serious problems: (1) they lack the democratic rights enjoyed by Americans who live in states: full self government and an equal voice in the national political process; (2) they lack sufficient financial resources to pay for high quality public services.

Statehood for the District of Columbia is frequently proposed as a solution to both these problems, but it faces formidable political obstacles at the national level. The purpose of today's hearing is to explore the fiscal implications of DC statehood. Statehood would certainly give DC residents the democratic rights and responsibilities of other Americans, but would it also give them significantly enhanced public resources that could be devoted to improving public services or reducing tax rates or both? How significant would these enhancements be likely to be?

Fiscal disadvantages of the District's current status

The District's special status affects its ability to raise revenue and provide public services. First, although it is not a state, it must perform the functions of a state as well as those of a city government. Besides providing local services, such as schools, police and fire, it is responsible for motor vehicle services, Medicaid and mental health services, as well as higher education and other functions normally handled at the state level. Second, despite its state-like responsibilities, the District does not have full state taxing authority. Congress expressly prohibited the District from taxing the income earned within its borders by non-residents, a power that all states have. State income taxes apply to income earned in the state, by residents and non-residents alike. A few cities also have commuter taxes that apply to income earned by commuters in the city, but these are normally small. It is the lack of a state-level income tax on non-resident income that depresses the District's revenue-raising capacity significantly. Third, the city's largest employer, the federal government, uses city services, but does not pay property, sales or income taxes. The same is true of embassies and international institutions. Many tax-exempt non-profits also locate here to be near the federal government. Moreover, the federal government often fails to reimburse the District for the costs of dealing with major national events, such as inaugurations and demonstrations.

These limitations are exacerbated by the small size and demographics of the capital. The District is an extremely small central city (only 61.4 square miles) at the heart of a prosperous and growing metropolitan area. It is ringed by relatively affluent suburbs, many of whose residents work in the District, use its roads and parks and other services, but pay no income tax to the District. Indeed, two thirds of the income earned in DC is earned by non-residents, most of whom live in Maryland and Virginia. Moreover, the District, like many central cities, has a large low-income population with way-above-average needs for public services. The cost of providing services in the city is high as a result of elevated rents and property values, wages that reflect the need to compete with suburban jurisdictions and the federal government for employees, and expenses associated with security in distressed neighborhoods. Other central cities face similar problems, but often get substantial financial help from their state. The State of Maryland, for example, provides major assistance to Baltimore, especially for education.

The fiscal handicaps of the District have been described in several studies and reports, including one I co-authored seven years ago with Carol O'Cleireacain. (Carol O'Cleireacain and Alice M. Rivlin, "A Sound Fiscal Footing for the Nation's Capital: A Federal Responsibility, The Brookings Institution, 2002). One of the most detailed studies was carried out by the agency now called the Government Accountability Office (GAO), which attempted to estimate the size of the District's structural deficit (*District of Columbia Structural Imbalance and Management Issues*, 2003). By "structural deficit" the GAO meant the gap between the District's actual resources and what it would need to be able to deliver an average level of public services with average tax rates (calculated by averaging the fifty states, including their local governments). GAO estimated the District's structural deficit at somewhere between $470 million and $1.1 billion a year, depending on specific assumptions and made clear that the prohibition against taxing non-resident income was a major contributor to the District's budgetary disadvantage.

For many years the District received an annual payment from the federal government to compensate for some of the fiscal impairment suffered as a result of its special status as the nation's capital, especially its truncated taxing power. In 1997, however, as the District was beginning to recover from the severe fiscal crisis that brought on the "control period," the federal government took a new approach. It phased out the federal payment, but assumed the cost of the District's courts and the responsibility for incarceration of the District's convicted felons. It also compensated the District for the unfunded pension liability created while the federal government ran the District Government prior to Home Rule and raised the percentage that the federal government contributed to Medicaid from 50 to 70 percent.

Balancing the Fiscal Positives and Negatives of Statehood

Over the years, new states have been admitted to the union after negotiations, sometimes lengthy, over the terms. Historically, consideration has been given to the fiscal viability of the state; for example, whether it has sufficient industry or commerce and whether it has an adequate revenue-raising capacity. New states typically received grants of federal land or equivalent cash to help defray public expenses. No new state has been admitted since Alaska and Hawaii in 1959, and there is certainly no precedent for the admission of a state consisting of a fully built-up urban area, such as Washington, DC.

The dominant fiscal question in a negotiation over statehood for DC would involve taxation of non-resident income. Since all states have the right to tax income earned within their borders, it is hard to imagine that District statehood would not include that power. The CFO's office estimates that if DC were able to tax non-resident income at its current tax rates it could raise more than $2 billion additional revenue, more than doubling the current yield of the District's individual income tax of about $1.3 billion. Including non-resident income in the tax base would give the District the option of cutting its income tax rates in half and still raising substantial additional revenue to improve public services. Better services and lower income tax rates would make the District a more attractive place to live and might precipitate substantial in-migration, especially of upper income people whose location decisions are sensitive to income tax rates.

The fiscal losers in this scenario would be the State of Maryland and the Commonwealth of Virginia, which benefit enormously from the fact that DC cannot tax their residents on income they earn in the District. These states would likely fight hard to block statehood for the District, to restrict the new state's tax powers if statehood appeared inevitable, and to get federal compensation for their loss if all else failed. The understandable opposition of these two powerful states to incurring fiscal losses seems to me far more likely to derail DC statehood than considerations of party or racial politics.

As Walter Smith points out in his testimony, it is possible that the District might find itself in the position of having to choose between statehood with severe restrictions on its ability to tax non-resident income and no statehood at all. Moreover, the terms of statehood might include carving out a substantial federal enclave whose workers would not be subject to DC income tax unless they lived in the District.

As to the fiscal downsides of statehood, the major issues in the negotiation would be whether the District would be forced to give up the advantages it gained in the Revitalization Act of 1997. There would be some advantages to the District to taking back the responsibility for funding its courts, since the District might gain more control over such spending that it has over an obscure item buried in the budget of the U.S. Department of Justice. Taking back responsibility for incarceration of convicted felons, however, would involve building and operating a prison or compensating the U.S. Bureau of Prisons for the costs it incurs on behalf of the District. As to the higher Medicaid match, the District would certainly argue that its relatively high poverty rate warranted more favorable treatment than other states with similar incomes. These other states, however, would argue against special treatment for the District, and the District's protestations might not prove persuasive.

Losing the budgetary benefits of the provisions of the 1997 Act related to courts and Medicaid would have cost the District approximately $941 million in 2007 (see Table) —a substantial offset to the potential additional revenues from taxing non resident income.

The net effect of all these fiscal positives and negatives associated with statehood is extremely uncertain. My guess is that statehood would bring positive net fiscal benefits to the District, provided it included the power to tax non-resident income (except for a federal enclave), although losing the savings from the Revitalization Act of 1997 would offset a large fraction of the gain.

Table (Revised as of July 14, 2009)

District Losses if the Revitalization Act of 1997 were Repealed

Potential Costs and Benefits Associated with Statehood (Dollars in thousands)

Costs

Return of state-like services from Federal government	FY 2007 Actual
Adult Felony Prisoners	211,647[1]
Public Defender	31,000
Pre-trial Services	45,000
Defender services	38,000
Community Supervision	134,000
Court of Appeals	9,000
Superior Court	87,000
DC Court System	41,000
Subtotal	596,647
Capital Improvements at Courts	67,000
	FY 2007 Actual
Base FMAP change from 70% to 50% (FY 2008)	277,508[2]
Total	941,155

Sources: United States Office of Management and Budget. *Budget of the United States Government (Fiscal Year 2009)*; [1]Government of the District of Columbia, Office of Revenue Analysis; and [2] the Henry J. Kaiser Family Foundation. *District of Columbia: Federal and State Share of Medicaid Spending, FY2007*. Retrieved at http://www.statehealthfacts.org.

A Personal View

I would dearly love to live in the State of Columbia, represented in Congress by two non-shadow Senators and a Representative with full voting powers. I would want Columbia to have full fiscal autonomy and the same revenue-raising powers as other states. However, I think statehood is so unlikely to happen in the foreseeable future that pursuing it is a serious distraction from more important and feasible policies that could improve both the autonomy and fiscal health of the District. These include; voting representation in the House and maybe even a voting Senator and more federal compensation for DC's fiscal disadvantages, including a federal contribution to DC's operating budget and/or a larger federal investment in making Washington a world class capital. A recent volume to which I contributed, *Building the Best Capital City in the World* (DC Appleseed and Our Nation's Capital, Dec. 2008), lays out an action plan for partnering with the federal government to improve DC's infrastructure. I would urge the Council to give high priority to making DC's current government more effective and taking feasible steps toward greater autonomy and fiscal resources—rather than devoting your talents and energies to pursuing the faint hope of making DC a state.

Thank you, Mr. Chairman.