

June 24, 1999

Financing District Tax Reductions

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The District has enacted tax changes that will reduce its annual revenues by an estimated \$287.6 million when fully implemented in 2004. The major tax reductions are summarized in accompanying tables. Substantial tax reductions by a government that only eliminated its accumulated deficit in 1998 need to be carefully monitored to ensure that they are financially manageable. This report evaluates the current outlook and concludes that the reductions in 2000 and 2001 will be manageable, but that there are too many uncertainties to judge whether the reductions in the following three years should go forward.

Affordability

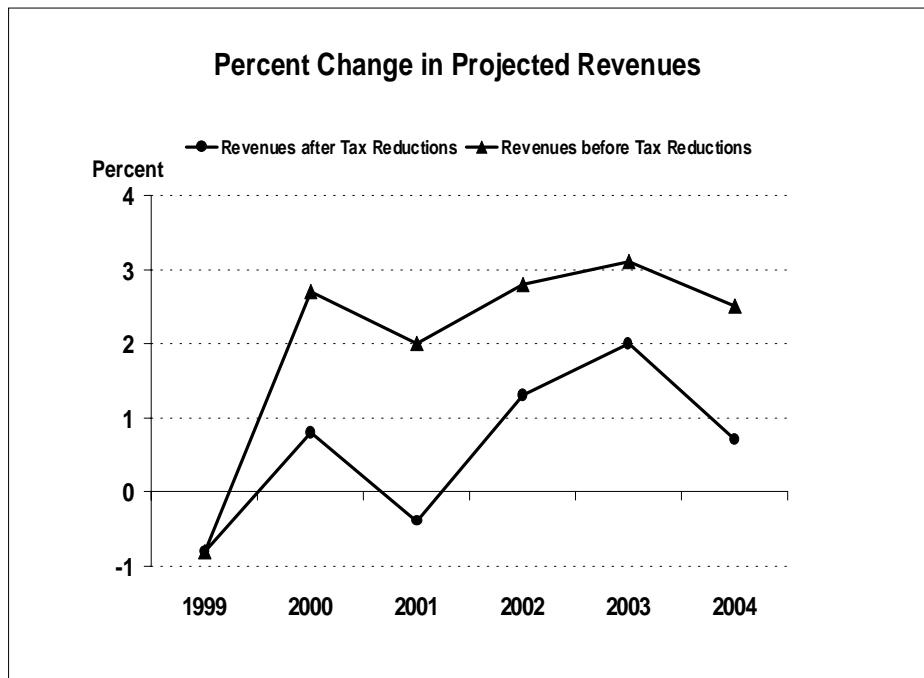
Evaluating whether the District can afford tax reductions that are phased in over five years requires anticipating five-year changes in the national and local economies that will affect both revenue and expenditure projections. In addition, it is necessary to consider the effects of recent reductions in District expenditures and efforts to improve revenue collections that took place in 1997 and 1998. Some of the effects from those changes will be long term; others were only one-time improvements. The installation of new accounting and reporting systems in 1999 hinders the analysis by making it difficult to compare current trends to prior years.

Revenue Outlook

A key to successful financing of the tax reductions will be future revenue performance. In 1998, District revenues from taxes and other local sources increased by an amazing 11.5 percent, but in 1999, currently available data indicate that those same revenues will increase by only about 1.0 percent. No clear explanation for this dramatic change is available, although some of the 1998 increase resulted from better tax enforcement and the one-time payment of delinquent taxes. In addition, a decrease in property tax revenues is projected by the city in 1999 partly because the conversion to a three-year assessment cycle has deferred current value increases. Moreover, this change in assessment policy will delay the full effects of some current property value increases for six years.

Given these confusing revenue trends, the city estimated that its revenues would increase less than 3 percent each year over the next five years, if there were no tax reductions. After tax reductions, revenues are estimated to decrease slightly in 2001 and increase less than 2 percent in each of the following three years (see chart). Some evidence suggests that revenues before the tax reductions will grow at a faster annual rate than projected. Now, halfway through the budget year, both the personal income tax and the general sales tax are currently exceeding 3 percent growth rates, and with the eventual translation of higher real estate values into higher property tax revenues, an overall growth

rate in excess of 3 percent seems possible. However, it is also possible that there will be an economic slowdown within the next several years that could reduce the growth of personal income and sales taxes and offset the increasing property taxes resulting from the higher property values.



Expenditure Outlook

Projecting District spending is difficult because of recent budget changes. Spending decreased almost \$600 million in 1998 as a result of federal assumption of some District responsibilities and tight spending controls insisted on by the Control Board. Even with tight controls continuing in 1999, the District's 1999 budget still increased 3.9 percent. The 2000 budget submitted to Congress increases 7.6 percent, but this increase includes a \$150 million congressionally required reserve. However, the city plans to spend up to \$90 million of this reserve in 2000 for additional program improvements. The budget also includes a one-time expenditure reduction resulting from delaying debt repayment. If none of the reserve is spent and the debt delay is not implemented, the budget increase for 2000 would be 4.5 percent. Based on these conflicting alternatives, the 2000 spending increase will be between 4.5 percent and 7.6 percent. Annual spending increases after 2000 are projected to be less than 2.0 percent to meet projected revenues after tax reductions.

Future spending levels are also complicated by assumed budget reductions resulting from management savings that are intended to reduce spending without affecting the quality or quantity of District services. These net savings are assumed to be \$21.5 million in 2000, followed by an additional \$61.9 million reduction in 2001. Savings of this magnitude will require unspecified major agency and

program budgets to be reduced. Until more information is available about which agencies or programs will be reduced, it is hard to judge how achievable and acceptable these projected savings may be.

Evaluating the 2000 and 2001 Budgets

While uncertainties about future revenues and expenditures cloud the longer-term outlook, it is possible to evaluate with greater confidence the 2000 budget revenues and expenditures and to a lesser extent the 2001 budget outlook. Beyond those two years, predicting budget revenues and expenditures is very speculative.

Three criteria can be used to judge the future financial viability of the District's budgets: (1) the relationship of current ongoing revenues to current ongoing expenditures, often referred to as structural budget balance; (2) the accumulated deficit or surplus at the end of each year; and (3) the adequacy of District spending to meet its service needs. The budget summary shows a capsule description of the 1999, 2000, and 2001 currently estimated budget results. The revenues are the estimates contained in the approved budget for 2000, *after tax reductions*. The expenditures do not include the one-time reductions from delaying debt repayment or the increase to fund the required reserve.

Fiscal Year	Budget Summary (\$ in millions)		
	1999	2000	2001
Revenues	\$3,065.5	\$3,090.0	\$3,077.3
Percent Change	-0.8%	0.8%	-0.4%
Expenditures	2,869.0	2,997.9	3,053.7
Percent Change	3.9%	4.5%	1.9%
Excess/ (Deficiency) of Revenues	196.5	92.1	23.6
Accumulated Surplus	\$309.0	\$401.1	\$424.7

The 2000 budget easily accommodates both the \$59 million tax reduction slated for that year and a substantial increase in spending while still resulting in an excess of revenues and a healthy accumulated surplus at the end of the year. The 2000 budget provides for over \$70 million of increases in public schools, \$18.6 million additional for mental health, and \$16 million for public safety. Based on this outcome, there should be no need to delay debt repayment by \$61.9 million in 2000. However, if the reserve is used to fund \$90 million of additional spending, the budget will be in balance by only about \$2 million.

The projected budget for 2001 does not fare as well as the 2000 budget. With \$135 million in tax reductions leading to a 0.4 percent decrease in total revenue, spending is restrained to a 1.9 percent increase. This budget results in a small excess of revenues, which increases the accumulated surplus. While it is too early to make final judgments about the 2001 budget, it does appear that tight spending constraints will be required to ensure the budget is balanced. It may not be possible to continue program improvements made in the 2000 budget.

A planned delay of about \$400 million in scheduled debt repayments makes the outlook for both the 2000 and 2001 budgets more favorable, but the delay will have adverse long-term effects, including increased debt to finance the restructuring costs and increased interest costs. The District currently

has \$3.1 billion of long-term debt outstanding or the equivalent of over \$6,000 per capita. This amount of debt far exceeds the average for combined state and local debt burdens of other cities.

Conclusions

The District's budget for 2000 and the projected budgets for the following four years are difficult to evaluate because they are based on projected slow growth in revenues; substantial tax reductions; a required reserve, part of which is planned to be spent; large unspecified spending cuts; and a substantial delay in debt repayments. Nevertheless, it appears that the tax cuts in 2000 and 2001 can proceed as planned without endangering the District's fiscal health. The tax reductions in the following three years may be feasible, but until the actual revenue performance for 1999 is known and expenditure trends and management improvement results become clearer, it is too early to judge. The District's prospects for those years should be reevaluated when the 2001 budget is considered next year.

Summary of Major Tax Reductions

Property Taxes

	Current	2000	2001	2002
Commercial	\$2.15	\$2.05	\$1.95	\$1.85
Hotel	1.85	n.c.	n.c.	n.c.
Apartment	1.54	1.34	1.15	0.96
Homestead	0.96	n.c.		
Vacant Land*	5.00			

Corporate Income Taxes

Current	2000	2001	2002	2003	2004
9.975%	n.c.	n.c.	n.c.	9.0%	8.25%

Personal Property Taxes

Exempt first \$50,000 of Value
Technological Equipment Depreciated at 30% to 10% Minimum
Effective July 1, 2000

Individual Income Taxes

	Current	2000	2001	2002	2003	2004
Up to \$10,000	6.0%	5.0%	n.c.	n.c.	4.5%	4.0%
\$10,000 - \$20,000	8.0	7.5				6.0
\$10,000 - \$30,000			7.5	7.0		
\$10,000 - \$40,000					7.0	6.0
Over \$20,000	9.5	n.c.				
Over \$30,000			9.3	9.0		
Over \$40,000					8.7	8.5

* Classification discontinued in 2000 n.c. = No charge