CHAPTER ONE:

THE FISCAL PROBLEM OF BEING WASHINGTON, D.C.

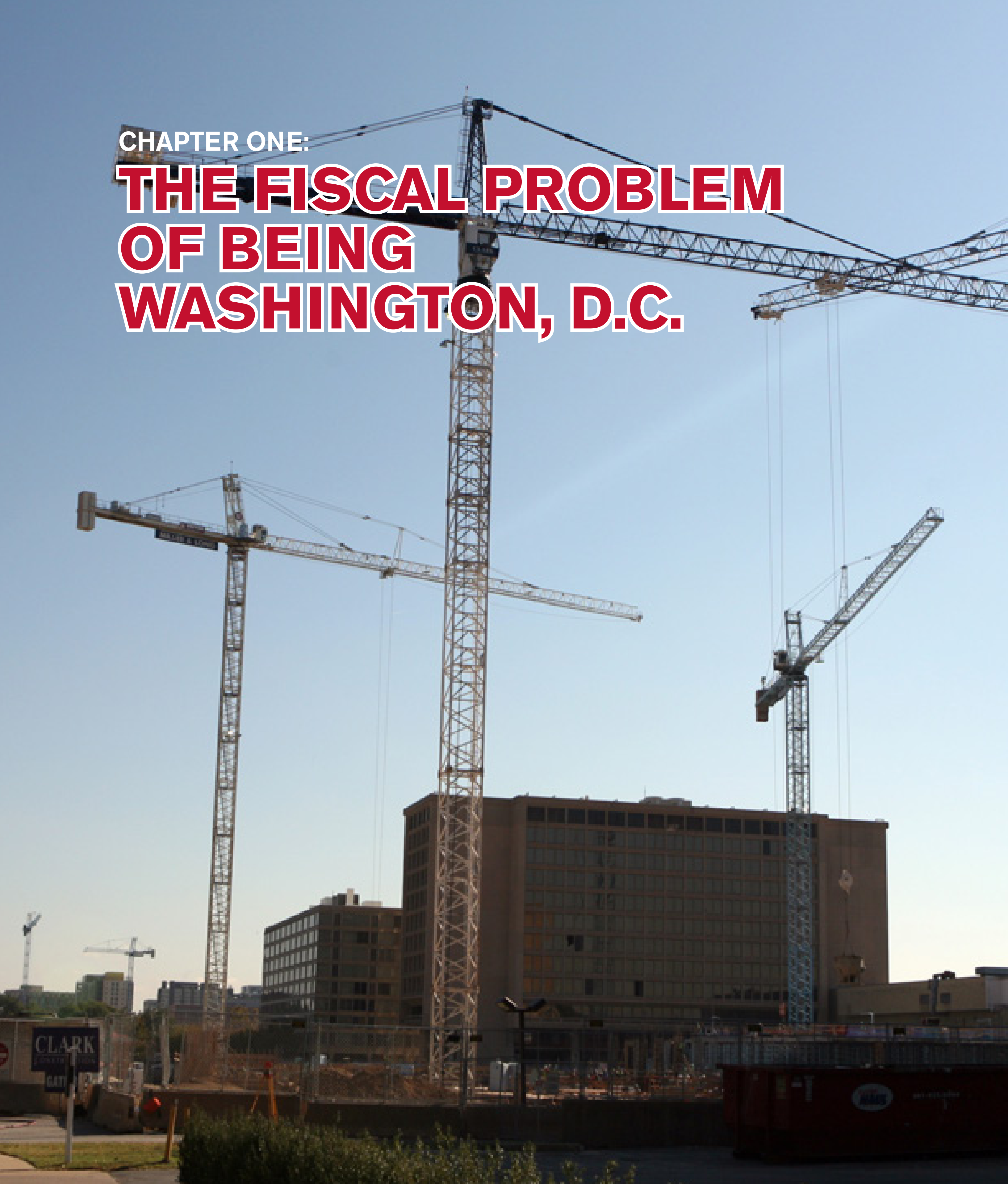

Photo by Michael Bonfigli

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In the past decade Washington has recovered from virtual fiscal meltdown in the mid-1990s and is currently in sound fiscal shape. The budget has been balanced for the past eleven years, its general fund balance is over $1 billion, and its bond ratings are high.[23] So, why worry about the finances of the District? The answer lies in the combination of unique fiscal limitations inherent in its constitutional status as a federal district and the way those limitations interact with the District's geography, economy, and history. These factors combine to make the District's fiscal outlook and undermine its ability to invest in the infrastructure needed to become a truly great city.

There are three big disadvantages that flow from the District's special status as the Nation's Capital. First, the District is not part of any state but must perform the functions of both a state and a city for its residents. Second, although it must perform state functions, it does not have the full taxing powers of a state. The Congress truncated those powers by prohibiting the District from taxing income earned within its borders by non-residents, a power that all states have. Third, because it is the capital of a large country with global responsibilities, its major industry, the Federal Government, dominates its economy and attracts large embassies, international institutions, and non-profit groups. This huge federal and federally-related establishment requires services but does not pay property taxes. These three limitations interact with the District's geography and history to produce fiscal fragility. The District is a small central city located in a large metropolitan area. Like many other central cities, it has a far higher poverty rate than its surrounding suburbs and a relatively small middle class.[24] Its large low-income population imposes costs on the District government, such as income support, special education, housing subsidies, subsidized health care and child care, and expenditures related to crime and substance abuse. At the same time the lower income population contributes less to revenues than a higher-income population would. Although there are affluent areas within the District, most of the middle- and upper-income people who work in the District live in the Maryland and Virginia suburbs. Moreover, a long period of population decline and an eroding economic base (plus considerable mismanagement) left a legacy of neglected infrastructure that requires substantial reinvestment. The revival of population and job growth in the last few years (plus improved management) has brightened the prospects for the operating budget but has not been sufficient to fund the modernization and improvement of the city's infrastructure that a great city would require. These points are elaborated in the next few pages.

A Small Non-State

The District of Columbia is very small. The founding fathers decided to carve a 10-mile square out of Virginia and Maryland to be the seat of the new capital of the United States. At the end of the 18th Century, when this decision was made, the 100 square mile land area seemed more than adequate for the capital of a struggling, largely agricultural nation. Indeed, the portion on the south side of the Potomac was later ceded back to Virginia. The truncated square that was left has an area of only 61.4 square miles.[25]

The decision that the capital should be a federal district, not a state, doubtless seemed sensible to the founding fathers at

the time. It kept any one state from having undue influence over the central government. It also kept federal employees from voting to keep the incumbent in power—an important consideration in the days before civil service, when all federal jobs were patronage jobs.

In those days, no one could have foreseen that Washington would become the capital of a powerful modern country with a high standard of living, the world's largest military establishment, and vast global responsibilities. Indeed, since World War II, Washington has become the most important capital in the world. It attracts companies that service the government and supply its technology. Most countries have their largest embassies in Washington and important international organizations with large staffs are located there.

This huge government-centered economy has far outgrown the District of Columbia and this has serious adverse fiscal consequences for the District that has evolved.

While the heart of the government remains in Washington, many government installations and government-related companies are located in the suburbs, and most of the employees of the government-related economy, including many of the best paid, live outside the District. If the founding fathers had made the District bigger—say, a thirty-mile square centered on the Capitol—it would now have an extraordinary economy and a tax base more than adequate to be a great city with world class services and infrastructure. In fact, the District is a small central city, in the middle of a thriving metropolitan economy with many typical central city problems. Yet it does not have the power to tax this broader economy or call for help on the surrounding states that do have that power.

State Responsibilities, Truncated Tax Powers, and No State to Turn To

The District is responsible for all the services normally performed by local governments, such as schools, police and fire protection, and recreation, to name a few. It also performs functions normally carried out by states, such as motor vehicle licensing, mental health services, and higher education. In 1997, in recognition of the state-like burdens, the Federal Government assumed the costs of the court system and incarceration of long-term felons and increased the federal contribution to the Medicaid program. However, substantial state-like functions remain the District's responsibility. Indeed, a joint 2005 DC Fiscal Policy Institute and Brookings study counted $1.1 billion in city funds devoted to state-like functions, such as Medicaid, child and family services, human services, higher education, and public transportation in addition to those previously mentioned.[26]

Because it has both state and local responsibilities, the District imposes the full panoply of local and state taxes—with the crucial exception that it cannot tax the income earned in the District by non-residents. It taxes income of residents, commercial and residential property values, general sales, alcohol and tobacco sales, and imposes a wide variety of fees. The combined tax burden on local residents, property owners, and businesses is comparable to that of neighboring Maryland and somewhat higher than that of Virginia. However, the crucial exception—the Congressional prohibition on taxing non-resident income—narrows the District's tax base dramatically because over two-thirds of the income earned in the District is earned by non-residents. In other words, this small central city in the midst of a thriving metropolitan area is deprived of two-thirds of the revenue it could raise by imposing a normal state income tax on income earned within its borders.

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The prohibited non-resident income tax is often referred to as a "commuter tax" as though it were comparable to the low-level wage tax that some cities impose on commuters. Philadelphia has a wage tax that applies to non-residents and New York City had one until it was abolished by the State of New York. But "commuter tax" is not the right analogy. All states that have income taxes (including Pennsylvania and New York) tax the income earned by non-residents within their borders at the same rates that residents pay. Through reciprocity agreements, non-residents can normally offset the income tax liability imposed by the state of employment against the liability to their state of residence. If the District had normal state tax powers, it could raise enough revenue to be a great city and would certainly be able to reduce its tax rates substantially. A 2002 Brookings study estimated that the District could raise almost $1.4 billion in additional revenues each year if it were to tax commuters at its then tax rate.[27] More recently, the Office of the Chief Financial Officer estimated that the District could raise almost $2.2 billion in additional revenue each year if it were to tax non-residents at its current statuary rates, though this figure would be smaller if the city lowered its income tax rate.[28] Alternatively, if the founding fathers had chosen a thirty-mile square, instead of the 10-mile one, the District would have an ample tax base—even with the prohibition against a non-resident tax—to become a great city.

The District is not the only small central city in the middle of a more affluent suburban area. Baltimore City, for example, has similar problems—high costs associated with a large, low income population and a limited tax base. The difference is that Baltimore receives considerable assistance from the State of Maryland, which has a broader tax base (including affluent Montgomery County, which is part of the Washington metropolitan area). Maryland carries a large part of the cost of Baltimore's schools, while the District's school system must be locally financed.

A Federal Establishment That Doesn't Pay Taxes

Being the Nation's Capital is of course a huge advantage for the Washington metropolitan area as a whole. The Federal Government not only employs a large, highly educated workforce, it attracts visitors and tourists, as well as institutions and corporations that also employ a relatively educated and well-paid workforce. If Washington were not the capital of the United States, the vibrant, knowledge-based economy of the Washington area would not exist. The fiscal problem for the District stems from the fact that the founding fathers carved out such a small area in the middle to be the federal district. That small area contains a high share of the monuments, museums and government offices that make the government work. Those federal installations require city services, but do not add to the tax base. Nor do the embassies and international institutions and nonprofit organizations that the government attracts. The Office of the Chief Financial Officer estimates that taxing federal property at current rates would increase revenues by $540 million.[29] The benefits of being the capital—the tax base created by the private corporations that service the government and the middle and upper income workers that they and the government employ—accrue mostly to the surrounding states and cannot be taxed by the District.

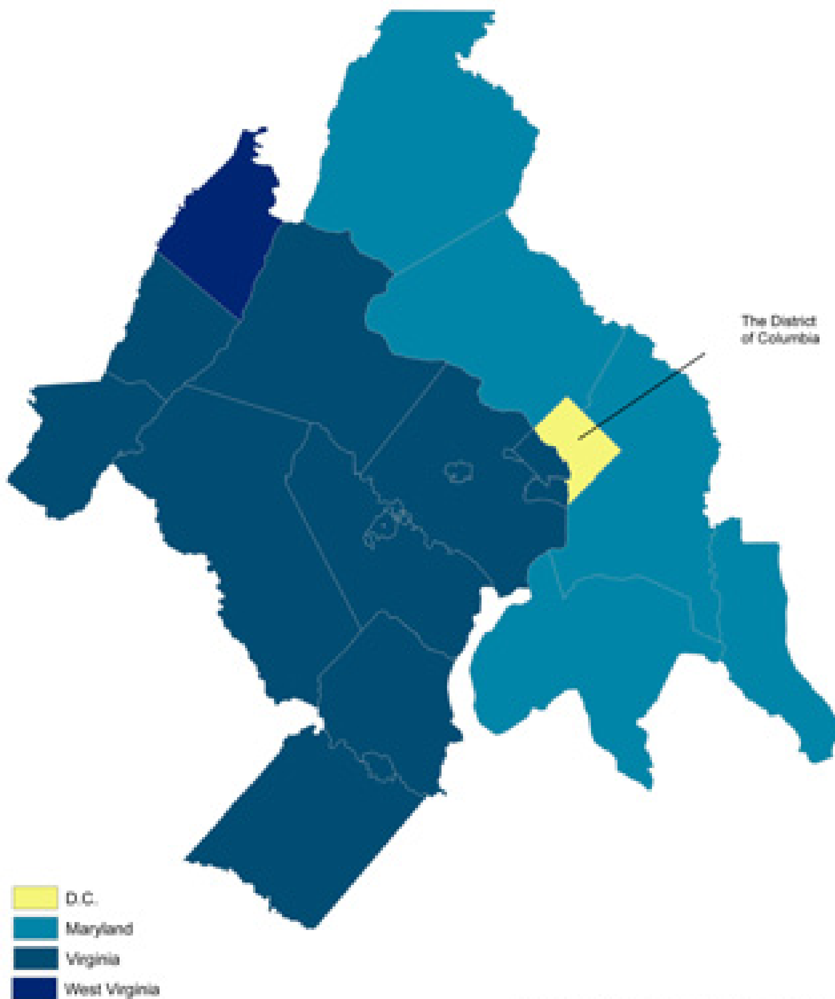
The Fiscal Problem of Capital Status

These revenue constraints of the District's status as a capital have resulted in a fiscal problem for Washington largely beyond its control. Numerous reports expound on this phenomenon, most notably the landmark 2003 GAO study.[30] The GAO reported that the District suffers from a substantial structural imbalance–a constant gap between its revenue capacity and the cost of providing typical public services. The GAO found that due to its restricted revenue base, Washington would need above-average tax rates to provide an average level of both state and city services, even if they were delivered efficiently. The GAO estimates deemed most reasonable placed D.C.'s structural deficit at $470 million to $1.1 billion.[31]

Legacy of History

The basic problem of the District's fiscal fragility is not new. Indeed, the picture is far brighter than ten or fifteen years ago. In the decades following World War II, the Washington area experienced the same rapid suburbanization that affected other cities. Suburbs burgeoned as the middle class moved to them from

The Washington Metropolitan Area



Source: Office of Management and Budget, 2003

the central city, which, in the case of Washington meant Maryland and Virginia. The white middle class moved out first, followed later by the black middle class, leaving the poor (and some of the affluent) behind. Neighborhoods decayed, retail establishments closed or moved out, and the tax base deteriorated. While many central cities began to revive in the 1980s and 1990s, the population decline in the District of Columbia did not begin to turn around until the beginning of this decade. The concentration of poverty in Washington also continued to increase in the 1990s, although it diminished in most other regions.[32]

Throughout much of this period the infrastructure of the city suffered from serious neglect. New buildings were rarely built because a declining population did not justify new construction, and older buildings were not well maintained because tax revenues had to be devoted to providing at least minimal current services. Poor management also contributed to the decline. The fiscal meltdown of the 1990s, which caused the imposition of a federally appointed Control Board, took an especially heavy toll on the city's infrastructure. As a result, even with a revived economy, improved leadership, and higher revenues in the current decade, the District still faces the daunting task of repairing, modernizing, and replacing an aging and outmoded infrastructure. In order to bring its infrastructure to acceptable levels and keep it in good working order, the District would need between $16 and $31 billion over 20 years ($800 million to $1.5 billion a year), according to a 2005 Center for Washington Area Studies report.[33] This small central city simply cannot carry that burden alone given its truncated tax powers, narrow tax base, and heavy state and local responsibilities.

ENDNOTES

23 Ending general fund balance in FY2007.

24 ALAN BERUBE AND TIFFANY THATCHER, THE BROOKINGS INSTITUTION, THE SHAPE OF THE CURVE: HOUSEHOLD INCOME DISTRIBUTIONS IN U.S. CITIES, 1979-1999 (2004).

25 U.S. Census 2000.

26 ED LAZERE & DAVID GARRISON, THE BROOKINGS INSTITUTION, A NEW FEDERAL CONTRIBUTION TO THE DISTRICT OF COLUMBIA? THE NEED, LIKELY IMPACT, AND SOME OPTIONS 3 (2005). Estimate based on 2005 local operating funds.

27 CAROL O'CLEIRACAIN & ALICE M. RIVLIN, A Sound Fiscal Footing for the Nation's Capital: A Federal Responsibility, (Washington: Brookings, 2002).

28 D.C. Office of the Chief Financial Officer, Office of Revenue Analysis, Calculating the Impact of Federal Preemptions on the District's Tax Revenue (Working Draft Paper, March 2008)

29 *Id.*

30 U.S. GEN. ACCOUNTING OFFICE, GAO-03-666, DISTRICT OF COLUMBIA STRUCTURAL IMBALANCE AND MANAGEMENT ISSUES (2003); O'CLEIREACAIN & RIVLIN, *supra note* 48; LAZERE & GARRISON, *supra note* 42.

31 GAO's structural deficit estimates are based on information from fiscal year 2000.

32 Paul A. Jargowsky, The Brookings Institution, Stunning Progress, Hidden Problems: The Dramatic Decline of Concentrated Poverty in the 1990s (2003).

33 Royce Hanson & Karen Melanson, The George Washington University, The Center for Washington Area Studies, An Estimate of Long-Term Infrastructure Needs of the Nation's Capital (2005). Figures are in 2005 dollar amounts.