PUBLIC OVERSIGHT ROUNDTABLE

ON

THE ECONOMIC AND FINANCIAL IMPACTS OF DISTRICT OF COLUMBIA STATEHOOD

Before the
Special Committee on Statehood and Self-Determination
Council of the District of Columbia

The Honorable Michael A. Brown, Chairman

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Introduction

Good afternoon, Chairman Brown and members of the Special Committee on Statehood and Self-Determination. I am Robert D. Ebel, Deputy Chief Financial Officer and Chief Economist of the District of Columbia Government. I am pleased to appear before you today to provide testimony on the Economic and Financial Impact of DC Statehood.

The process of becoming a state includes, at its core, the negotiation of a "Compact with the United States" that must be approved by Congress and includes provisions that a new state must adhere to in order to become a state. The potential economic and financial impact of the District of Columbia statehood will depend on the provisions included in this compact. My testimony attempts to identify the potential impact of several key economic and fiscal issues in the context of statehood. The actual impact of these issues will depend on political decisions associated with the negotiation of the District's "Compact with the United States" as well as local decisions on the structure and function of the new state government.

Potential Economic Impact of Statehood

From an economic perspective, there does not appear to be any significant impact from the District's becoming a state. From the standpoint of business interactions, the District already functions effectively as a state. For example, the District already has its own business tax system, business fee structure, worker's compensation system, and unemployment compensation system. In addition, the District provides both state and local services to business entities including police, fire, infrastructure development, business regulation, and economic development.

One change that could affect the economic environment is in the area of the taxation of personal and non-corporate business income. This issue is addressed below.

Potential Fiscal Impact of Statehood

We have identified five potential fiscal impacts of statehood: 1) federal grants, 2) federal payments, 3) the taxation of non-resident income, 4) the return of state services from the Federal government and the associated costs of those services, and 5) budget autonomy.

1) Federal Grants

At present, the District receives Federal grants that are allocated to both states and localities. Thus, for example, under current arrangements the District receives

- The Temporary Assistance to Needy Families (TANF) grant, which is allocated to states.
- The Head Start grant, which is allocated to local governments.

The Community Development Block Grant (CDGB) program is an example of a grant program that has a state component and a local component. In the case of CDBG, the District currently receives the local component of the grant and does not receive the state component. Under statehood the District would receive the state grant, but it is not clear if the District statehood structure would include localities that would be eligible to receive the CDBG grant allocated to localities.

There are some cases where the District gets special treatment because of its fiscal relations with the Federal government. One such case is Medicaid. The District's current base Federal Medical Assistance Percentage (FMAP) is 70 percent (this is before the increases associated with the American Recovery and Reinvestment Act). This means that the federal government pays 70 percent of DC Medicaid costs. The District's FMAP was increased from 50 percent to 70 percent under the *National Capital Revitalization and Self-Government Improvement Act of 1997*. The District's FMAP was previously set at 50 percent based on the methodology used to calculate FMAP for states using an allocation formula that compares a state's per capita income to the per capita income of the U.S.[1] States with per capita income below the U.S. average are provided higher FMAPs (no greater than the statutory maximum of 83%) and those states with per capita income above the U.S. average are given lower FMAPs (no less than the minimum of 50%).

For the District of Columbia, per capita income was the highest in the nation and over 1.6 times that of the US average in 2008 due to a relatively high number of very wealthy individuals and a relatively small population. As a result, if DC were treated the same as the other states, it would be provided the minimum FMAP of 50% as opposed to its current FMAP of 70%. The potential change in the base FMAP from 70 percent to 50 percent could result in more than $310 million in additional state expenditures for Medicaid.

[1] The formula is $FMAP_{state} = 1 - (\text{(Per capita income}_{state})^2/(\text{Per capita income}_{US})^2 \times .45)$

This discussion highlights the fact that the FMAP formula does not accurately capture the economic situation in DC, where poverty rates are among the highest in the country and a disproportionately large percentage of the nonelderly population is covered by Medicaid: 22% vs. the US average of 13.9%.[2]

2) *Ad Hoc* Federal Payments

Another aspect of the District's current fiscal relations with the federal government is that the District currently receives *ad hoc* earmarks (Federal payments) which sum to $165 million (FY 2009). The largest Federal payments are for education-related uses including $40 million for D.C. public schools, $35.1 million for the Tuition Assistance Program (TAP), and $20 million for Public Charter School Improvements. Other areas that generate significant Federal payments include $38.8 million for Homeland Security and Emergency Management Agency, $21 million for the consolidated forensics lab, and $7 million for renovation and rehabilitation of the D.C. Public Libraries. It is not clear how these earmarks will be affected by statehood. One possibility is that these payments were an acknowledgement of the District's special status and would decline if DC achieved statehood. Another possibility is that since these payments are essentially earmarks, under statehood the District's elected Senators and Representative could use their collective leverage to obtain such funds for the District.

[2] Data for 2006-2007. Source: State Health Facts, Kaiser Family Foundation.

3) Income Taxation

The third potential fiscal impact is on the District's personal income tax base. Under the Home Rule Act, Congress prohibits the taxation of non-resident income.[3] This is also known as the Federal pre-emption of District taxing authority. If DC were granted statehood, then it is reasonable to expect that the Federal/State Compact would treat the new state like the other fifty and lift this pre-emption. The implications for "own-source" (local fund) taxation are significant since, at present, about two-thirds of the income is earned by non-residents. There are at least three options to consider:

- <u>Prevailing District of Columbia Rates</u>. A first option is to apply current District of Columbia tax rats to the broadened tax base. If in Fiscal Year 2006 the District had taxed the income of non-residents at the prevailing statutory rates, the tax yield to the city would have raised annually an additional $2.26 billion in revenue [FY 2006 est.].[4]

- <u>Equal Yield (Personal Income Tax Revenue Neutrality).</u> Taxing non-residents while collecting the same amount of total revenue as the District's current revenue would reduce the average income tax rate from 6.6 cents per dollar to 2.2 cents per dollar.[5]

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[3] Section 602(a)(5), Home Rule Act.
[4] Yesim Yilmaz, "The Effect of Federal Preemption on the District of Columbia's Tax Revenue," *State Tax Notes*, Jan. 5, 2009, p. 31.
[5] Ibid.

- Representative Revenue System[6]. A third alternative is to choose a tax policy somewhere between the prevailing and the equal yield rate. This option of a reduced statutory rate has been recommended by both the 1978 and 1998 D*istrict of Columbia Tax Revision Commissions*.[7] To illustrate, if the District were to adopt a rate representative of what prevails in the nation for average state and local structure in the 44 states (including DC) that levy a tax on personal income, the rate would be 3.8%, which yields an additional $1.3 billion.

The prohibition on taxing non-resident income also affects the District's unincorporated business tax. In its decision in *Bishop vs. District of Columbia*, handed down 20 April 1979, the District of Columbia Court of Appeals ruled that the unincorporated business tax, which the City Council extended to professionals in 1975, was a tax on the income of non-residents and therefore violated the Home Rule Act. As a result, the District now exempts professionals (including lawyers and accountants) from taxation as unincorporated businesses. Since the Court's decision, the District's unincorporated business tax has become in effect an income tax on proprietors and small businesses. Under statehood the District's unincorporated business tax base could expand to include professionals.

[6] The representative revenue system was developed by Selma J. Mushkin and Alice M. Rivlin, *Measures of State and Local Fiscal Capacity and Tax Effort* (Washington, DC: US Advisory Commission on Intergovernmental Relations, 1962).

[7] *Financing an Urban Government* , The *Final Report of the District of Columbia Tax Revision Commission*,(Washington, DC: District of Columbia Government, 1978); and *Taxing Simply*, *Taxing Fairly*, District of Columbia Tax Revision Commission (Washington, DC: District of Columbia Government 1998)

An important consideration in estimating the potential impact of the non-resident income tax is how DC statehood is geographically defined. Discussions of statehood generally indicate that a Federal enclave would be established within the borders of the District of Columbia and the new state would comprise the balance of the area not included in the Federal enclave. Presumably Congress would retain control over the Federal enclave and could continue to prohibit the taxation of non-resident income within the newly defined Federal enclave. As a result, the size of the enclave and the types of buildings included in the Federal enclave could impact the non-resident tax base of the newly formed state. For example, if the Federal enclave includes the Federal office buildings located in the Federal Triangle, and Constitution and Independence Avenues and the workers in those buildings are exempt from a non-resident income tax, then that would shrink the tax base gained by the new state.

One final note is that achieving statehood would not affect the large amount of Federal government property that is tax exempt in the District. Federal government-owned property is tax exempt in every state, although in some cases the Congress has agreed to make to some states and localities payments-in-lieu of taxes on Federal real property.

4) State/Local Expenditure Assignment

The potential impact of statehood on the provision of services and associated expenditures is related to *Revitalization Act*. Under the Revitalization Act, the federal government assumed responsibility for a number of District government services traditionally provided by state governments, including incarceration of felony prisoners, funding and administration of the courts (i.e., Court of Appeals, Superior Court, and the DC court system), services for defendants awaiting trial, public-defender services, and parole services for adult offenders in the District of Columbia. Also, as noted previously, the District's Medicaid match rate was increased from 50 percent to 70 percent. If the District regained both administrative and fiscal responsibility for the judicial services currently provided by the Federal government the potential impact on the District's budget would be significant – an estimated $685 million in operating expenditures and $76 million in capital expenditures. These estimates are based primarily on current actual costs; the District under statehood may choose to spend more or less on these services.

In addition, under the *Revitalization Act* the federal government reversed the transfer of pension liability to the District under the Home Rule Act of 1973 and assumed responsibility for the majority of the District's unfunded pension liability for retirement plans for teachers, police officers, firefighters, and judges. This liability had placed pressure on the District's operating budget in terms of annual pension contributions and had also hindered its ability to borrow for capital needs because it negatively impacted the District's long-term fiscal outlook. In exchange for the federal government's assumption of the unfunded pension liability, the District government transferred most of the pension assets, over $5 billion, to the federal government. It is unclear whether the transition to statehood would affect the current treatment of this pension liability.

5) The Budget Process

Under statehood, the District's budget would no longer be subject to Congressional review. The removal of Congressional oversight would allow the District to consider changing its fiscal year. Currently, the District must use the federal fiscal year, which runs from October 1st to September 30th. As a result, the District does not conform to the standard state and local government fiscal year of July 1st to June 30th.[8] This means, in turn, that the District's current budget cycle does not align well with the operational cycles of the DC Public Schools (DCPS) and the University of the District of Columbia.

Concluding Comment

Overall the range of possible impacts, both positive and negative, will depend on the specifics of the statehood Compact and the manner in which the Governor and Legislature restructure the new State's revenue system. And, as discussed above, some of the fiscal implications are significant. Furthermore, and, indeed, potentially even more significant than the key financial issues identified above, is what a future U.S. Congress might come up with in terms of further financial mandates on, or pre-emption of, the authority of the District of Columbia to function as an autonomous local self government in the same manner as the "other" fifty states now enjoy.

This concludes my remarks. I would be pleased to address any questions you may have.

[8] Four other states do not conform to the July 1st to June 30th state fiscal year: Alabama (Oct. 1 to Sept. 30) Michigan (Oct. 1 to Sept. 30), New York (April 1 to May 30) and Texas (Sept. 1 to Aug. 30).