HEARING

ON

THE POTENTIAL EFFECTS OF A FLAT FEDERAL INCOME TAX IN THE DISTRICT OF COLUMBIA

Before the

Subcommittee on the District of Columbia
Committee on Appropriations
United States Senate

The Honorable Sam Brownback, Chairman

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Remarks of
Natwar M. Gandhi
Chief Financial Officer
Government of the District of Columbia

Good afternoon, Mr. Chairman and members of the Senate Appropriations Subcommittee on the District of Columbia. I am Natwar M. Gandhi, Chief Financial Officer of the District of Columbia. I am here to testify on the matter of the fiscal relationship between the federal government and the District of Columbia and to discuss your idea for a voluntary federal flat tax for the District's businesses and households.

A voluntary federal flat tax may add to the desirability of D.C. as a place to live and to work. However, it will also give rise to additional challenges within the District as more activities compete for the limited amount of available space.

In this testimony I will speak in general terms about the concept of a voluntary federal flat-tax in the District. If a legislative plan is presented by the Congress for implementing a flat tax in the District, I will work with the Congress to provide an analysis of the plan. Consistent with my role as the District's independent Chief Financial Officer, my testimony will only address the fiscal and economic impact of the flat tax. I will not discuss the political or social policy aspects of a flat tax, since that role is reserved for the elected officials of the District.

Unique Relationship

As the nation's capital, D.C. enjoys national galleries, monuments and parks that are the envy of the world and that attract millions of tourists and business travelers. These travelers and the government that draws them create the economic and fiscal bases of the city.

The federal-city relationship is complex and not without problems, particularly fiscal problems. The words are well-worn – D.C. has the jurisdictional responsibilities of a city, county, state, and school district, while it has only the tax base of a core city. There is a mutually beneficial relationship between the District and the federal government stemming from the District's position as the home of the federal government. At the same time D.C.'s complex jurisdictional responsibilities and limitations result from this special relationship with the federal government. The end result is that the District has an artificially constricted tax base and the overwhelming needs of an inner city.

For D.C., the juxtaposition of a limited tax base against the responsibilities of multiple jurisdictions produces chronic budgetary distress – ranging annually from $470 million to $1.1 billion, according to the GAO in their May 2003 report. Even in the wake of D.C.'s phenomenal fiscal recovery of the past decade, it faces pervasive infrastructure problems, high tax and debt burdens, and the needs of a large number of urban poor (like that found in every city).

The District's economic recovery in the late 1990s was hastened by federal wisdom and action – for example, in the fiscal improvements brought by the 1997 Revitalization Act. Still, the District now struggles, and will continue to struggle, with multi-jurisdictional requirements on a limited urban tax base. And, there are additional federal constraints on use of significant parts of the tax base that is here. For example, approximately two-thirds of the income tax base and more than one-quarter of the real property tax base are exempt from local tax due to federal restrictions.

Two consequences of this structural imbalance between the District's revenue base and its spending requirements are: 1) a high per capita tax burden with some of the highest tax burdens in the region and the country; and 2) the highest per capita borrowing. D.C.'s tax burden on households ranks in the upper-one third when compared to the largest cities in the U.S. (for total state and local burden of sales, income, property, and automobile taxes).

The burden is greater on businesses. D.C.'s tax rate on net business income is 9.975 percent**;** the gross receipts tax on public utilities used by businesses is 11 percent; and the real property tax on commercial property is $1.85 per $100 of value, as compared to a range of $0.92 to $1.16 in neighboring suburbs.

The GAO ranks D.C.'s tax burden among the very highest in the country. "The District's tax burden (actual revenue collected from local resources relative to their own-source revenue capacity) is among the highest of all fiscal systems. . .The District's actual tax burden exceeded that of the average state fiscal system by 33 percent, based on our lower estimate of its own-source revenue capacity, and by 18 percent, based on our higher estimate of that capacity."[1]

The District's very high per capita borrowing reflects the city's effort to sustain infrastructure generally provided by multiple jurisdictions. The District's per capita tax-supported debt burden exceeds $8,000, the highest per capita debt of any major city in the nation.

Challenges may arise, however, adding to D.C.'s structural imbalance in coming years. First, all state and local revenue systems are stressed by the changing nature

[1] GAO-03-666, District of Columbia, Structural Imbalance and Management Issues, May 2003, page 41.

of the economy, as it evolves into more of a service-oriented economy. Because state and local tax systems were developed around the manufacturing and sale of goods, the old ways of gathering tax revenue are increasingly inadequate to the newer economy. The revenue challenge is made even greater in the District by the federal prohibitions against taxing incomes earned by non-residents workers and incomes earned by certain professional services.

Second, the District has a large urban population that needs help. Census data for 2004 estimate the D.C. poverty rate at about 19 percent, the fourth highest in the nation when compared to states, after Mississippi, Louisiana, and New Mexico. Of D.C.'s 248,563 households, 18 percent have income of less than $15,000.[2] Median household income is about $46,600 – in a metropolitan area where median household income is $70,900. Only about a third of D.C.'s households are at or above the metropolitan median. Like other cities, D.C. is accountable for greater efforts to help the less advantaged in the city's population. The FY 2007 budget, recently submitted by the Mayor to the Council, works hard to manage the expenditure needs and fiscal requirements of D.C.'s lower income population.

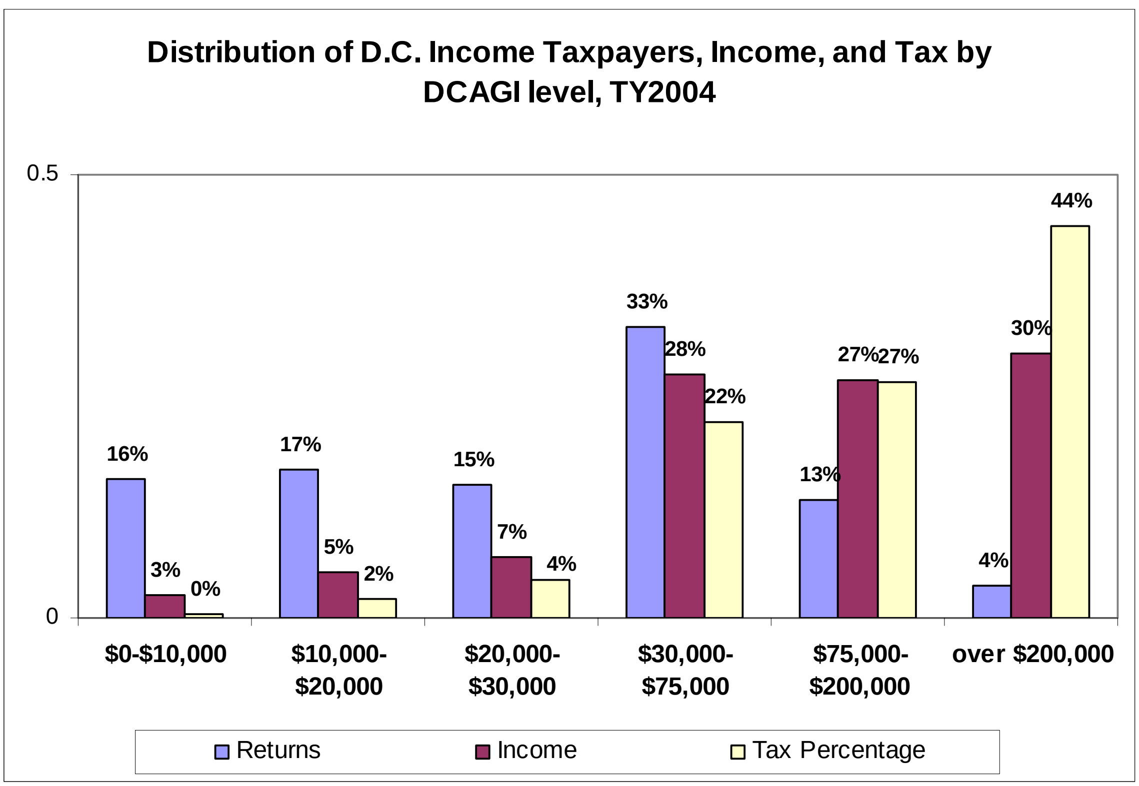
Income discrepancy among D.C. residents is reflected in the distribution of D.C. Adjusted Gross Income (AGI), as shown in Table 1. The concentration of both income and tax burden on a small number of filers is evident– those filers with adjusted gross income of $75,000 and more make up 17 percent of filers, have 57 percent of the income, and pay 71 percent of the District's individual income tax. Filers with more than $200,000 in gross income comprise just 4 percent of all filers, 30 percent of income, and 44 per cent of local income tax collections. At the

[2] American Community Survey, 2004.

lower income levels, about one-half of all filers have $30,000 or less D.C. AGI – 16 percent have $10,000 or below.

TABLE 1: TY 2004 Individual Income Tax Filers, D.C., by D.C. Adjusted Gross Income Category, from form D-40							
		DCAGI $0-$10K	DCAGI $10-$20K	DCAGI $20-$30K	DCAGI $30K-$75K	DCAGI $75K-$200K	DCAGI over $200K
Number Returns	262,328	41,368	43,718	39,596	85,971	35,041	9,821
Returns	100%	16%	17%	15%	33%	13%	4%
Income	99%	3%	5%	7%	28%	27%	30%
Tax Amount ($ millions)	$1,037	$4	$22	$44	$229	$277	$459
Tax Percentage	100%	0%	2%	4%	22%	27%	44%
EITC Returns	99%	33%	33%	28%	5%	0%	0%

Note: 6,813 filers have DCAGI of less than or $0. These are not included here.



Voluntary Federal Flat Tax

The Chairman has suggested a federal flat tax in the District of Columbia. The tax would apply both to individuals – on their earned incomes – and to businesses on their gross income net of costs, wages, and investment in plant and equipment. Individuals would be taxed only on personal earnings. Businesses would not be taxed on tangible investment. The flat tax, thereby, eliminates any potential double taxation of rents, profits, and interest and eliminates tax disincentives to investment. (Because unearned incomes are partly held in tax exempt portfolios, not all are currently double-taxed.) The tax would be calculated at a constant tax rate on taxable income, and the rate could be applied either on all income or on income above some threshold amount that is tax exempt. There would be no other exemptions or deductions.

Taxation of Individuals: Depending on how it is formulated, a federal flat tax could benefit few, some, or most individual income taxpayers living in the District. Under the Chairman's proposal, District taxpayers will have the choice of either the flat tax or the current tax, depending on which method gives them a more favorable tax liability.

Table 2 illustrates the federal tax liabilities on current residents, based on filer groups and average income of the filer groups. The table also identifies the District's relatively unusual distribution of taxpayer-types. Fifty-five percent of D.C. income taxpayers are single filers with no dependents, another 22 percent are single individuals with dependents, and 3 percent are dependents with taxable income. This leaves only 20 percent who are filing as a married household.[3]

[3] The corresponding federal distribution of filers for TY 2003 is 45 percent married, 13 percent head of household, and 42 percent single (including dependents).

Table 2:

Current Tax on Federal Income Tax Filers Filing from a D.C. Address, by Filer Type and by Average Income, TY2004, data source: calculations based on DC form D-40							
	Number of Filers	Percent of TotalFilers	TYPE OF FILER	EST AVERAGE INCOME, by filer group	AVE DEDUCTION, by filer group	EXEMPTION	Current FEDERAL TAX LIABILITY
TOTAL	262,328	100%					
SINGLE	145,433	55%					
			Standard deduction	45,745	3,370	1	6,046
			Itemized deduction	45,745	12,920	1	4,079
HEAD OF HOUSEHOLD*	57,197	22%					
			Standard deduction	30,891	7,300	3	(1,350)
			Itemized deduction	30,891	13,756	3	(2,171)
MARRIED FILING JOINT (1 INCOME)	27,829	11%					
			Standard deduction	116,802	10,000	4	15,186
			Itemized deduction	116,802	27,975	4	10,686
MARRIED FILING JOINT (2 INCOMES)	14,825	6%					
			Standard deduction	201,060	10,000	3	40,540
			Itemized deduction	201,060	30,274	3	35,326
MARRIED FILING SEPARATELY	8,003	3%					
			Standard deduction	58,631	5,000	2	9,271
			Itemized deduction	58,631	17,039	2	6,259
DEPENDENT FILER	7,799	3%					
			Standard deduction	6,952	5,000	0	196
			Itemized deduction	6,952	5,000	0	196

* The mean head-of-household filer is eligible for the Refundable Earned Income Tax Credit. Without EITC, the filer would pay $0 tax .

The incomes reported in Table 2 are the average D.C. AGI for the filer group in TY 2004.

Table 3 identifies the impact of various formats of a federal flat tax on D.C. resident filers. To do this, the table first identifies how much wage and salary "earned" income a filer has – and also notes that some filers have no such income and, instead, rely on other types of income such as dividends, interest, and profit. This is critical because current taxpayers with no "earned" incomes pay no individual income tax under the flat tax. Overall, about 86 percent of D.C. filers have earned income; the other 14 percent (adjusted for those with earned income deferred from a prior year for current use) would have zero liability and most likely prefer a flat tax.

Single filers have average D.C. AGI of $45,745 and, for those with wage and salary income, average earned income of $44,934. With the first alternative of the flat tax – a $4,000 personal exemption and 18 percent tax on the remainder – the calculated tax is $7,368. This amount exceeds current tax both for itemizers (at $4,079) and for those taking the standard deduction (at $6,046). The average single person is not most likely to choose this flat tax. The only filer type that most likely prefers this tax is the married, two-earner type that has much higher average income at $201,060 and $155,537 from combined wages and salaries. This filer currently pays $35,326 or $40,540, depending on deductions; the liability drops to $25,837 with the flat tax at $4,000 per exemption and 18 percent tax rate.

The second alternative flat tax is much less restrictive and would likely be chosen by many filers, including – at average incomes – singles with standard deductions and married people with standard deductions, as well as married two-income filers with itemized deductions. This alternative has a more generous $8,000 personal exemption and a lower 16 percent tax rate. Even with this form, the approximately 50,000 D.C. filers who take the federal Earned Income Tax Credit (EITC) are likely to prefer the current tax. This federal credit can actually refund more than the total tax owed by a working, low-income filer. Under current tax treatment for the average head of household, for example, the refund adds $1,350 for a filer with standard deductions and $2,171 for a filer with itemized deductions.

The third alternative of a federal flat tax in Table 3 is a simple compromise of the two previous ones, with the more generous personal exemption at $8,000 and the more restrictive tax rate at 18 percent. In this format there is likely to be a greater mixture of those choosing the flat and those choosing the current tax forms.

The final column of Table 3 confirms that a filer with no earned incomes will benefit significantly from a flat tax on individual income. As compared to the current tax, an average single filer taking the standard deduction saves $6,046; a married filer with one income saves $15,186.

Table 3:

Filers who have no incomes from wages, salaries, or other earned income sources will pay no tax under a flat tax. This explains the blank column under “no-wage filer” for each flat tax option.

Current Tax and Flat Tax Options on D.C. Federal Income Tax Filers, by Filer Type and by Average Income, TY2004, data source: calculations based on DC form D-40

	Number of Filers	Number Wage & Salary Filers	Percent of TotalFilers	TYPE OF FILER	EST AVERAGE INCOME, by filer group	Average W&S Income fo W&S Filers	EXEMPTIONS	Current Federal Tax	Flat Tax liability at $4,000 & 18%	Flat Tax liability at $8,000 & 16%	Flat Tax liability at $8,000 & 18%	Any Flat Tax
									Wage & Salary Filer	Wage & Salary Filer	Wage & Salary Filer	Non-W&S Filer
TOTAL	262,328	224,684	86%									
SINGLE	145,433	122,958	85%									
				Standard	45,745	44,934	1	**6,046**	**$ 7,368**	**$ 5,909**	**$ 6,648**	$ -
				Itemized	45,745	44,934	1	**4,079**	**$ 7,368**	**$ 5,909**	**$ 6,648**	**$ -**
HEAD OF HOUSEHOLD*	57,197	53,619	94%									
				Standard	30,891	30,531	3	**(1,350)**	**$ 3,336**	**$ 1,045**	**$ 1,176**	$ -
				Itemized	30,891	30,531	3	**(2,171)**	**$ 3,336**	**$ 1,045**	**$ 1,176**	**$ -**
MARRIED FILING JOINT (1 INCOME)	27,829	22,804	82%									
				Standard	116,802	107,594	4	**15,186**	**$ 16,487**	**$ 12,095**	**$ 13,607**	$ -
				Itemized	116,802	107,594	4	**10,686**	**$ 16,487**	**$ 12,095**	**$ 13,607**	**$ -**
MARRIED FILING JOINT (2 INCOMES)	14,825	12,589	85%									
				Standard	201,060	155,537	3	**40,540**	**$ 25,837**	**$ 21,046**	**$ 23,677**	$ -
				Itemized	201,060	155,537	3	**35,326**	**$ 25,837**	**$ 21,046**	**$ 23,677**	**$ -**
MARRIED FILING SEPARATELY	8,003	6,478	81%									
				Standard	58,631	59,600	2	**9,271**	**$ 9,288**	**$ 6,976**	**$ 7,848**	$ -
				Itemized	58,631	59,600	2	**6,259**	**$ 9,288**	**$ 6,976**	**$ 7,848**	**$ -**
DEPENDENT FILER	7,799	6,232	80%									
				Standard	6,952	7,245	0	**196**	**$ 1,304**	**$ 1,159**	**$ 1,304**	$ -
				Itemized	6,952	7,245	0	**196**	**$ 1,304**	**$ 1,159**	**$ 1,304**	**$ -**

* The average head-of-household filer is eligible for the refundable Earned Income Tax Credit. Without EITC, the filer would pay $0 tax .

Shading shows preference for Flat Tax Option for a filer at with average DCAGI by filer-type.

Dots indicate preference for current federal tax treatment.

Renters and those who choose standard deductions on the current tax are more likely to benefit from a flat tax than many homebuyers and others who itemize (because their federal tax burden is not eased by deductible expenditure on mortgage interest, real property tax, and other itemized deductions). While itemizers also may benefit from flat taxation, the magnitude of the benefit is likely to be smaller simply because itemizers already benefit from some tax breaks.

Individuals with incomes from rents, interest, capital gains, and other unearned sources will gain from a flat tax; these incomes will no longer be taxed under the individual income tax. They will be taxed only as part of the income of the business that generates them.

The first alternative, with a $4,000 personal exemption and 18 percent tax rate on earned income, would be selected by approximately 15 percent of D.C.'s current individual income tax filers with earned income, based on our very rough calculations. The second alternative, $8,000 personal exemption and 16 percent tax rate, would be chosen by about 75 percent of current filers with earned income (as derived from a similarly rough calculation). And the third alternative, with an $8,000 exemption and 18 percent tax rate, would be chosen by roughly 60 percent of current filers with earned incomes. We assume that filers with income only from other sources also will choose the flat tax alternatives. These approximate ratios are based on TY 2003 D.C. individual income tax filers.

Voluntary Flat Tax: In providing the choice between flat and current tax methods, the Chairman offers a significant benefit to residents of the District. The federal government would lose revenue from D.C. taxpayers at least in the start-up years – the amount could be $1 billion in the first year, as roughly approximated based on

D.C.'s data. The $1 billion is a calculation made by the Office of the Chief Financial Officer (OCFO) and is based on the District's own tax base and tax code. It is not to be considered authoritative because: 1) federal revenue depends on the federal code and federal base, and 2) actual first year losses depend on the alternative flat tax that is selected. Scoring of actual losses must come from federal sources.

In later years, the amount of federal revenue loss will depend on how much economic activity is stimulated by the voluntary flat tax. Individuals moving to D.C. in order to take advantage of the flat tax would increase federal losses – because their total federal tax liabilities would fall. True economic growth, however, could offset these losses. Some economists argue that businesses will want to locate in D.C. for tax purposes, because their tangible investments would be fully expensed by the flat tax and therefore not subject to federal taxation. This incentive to invest could then produce economic growth.

The incentive is partly offset by transition costs to businesses that would lose depreciation benefits under a flat tax. The voluntary aspect of the proposal is, effectively, a transition plan, allowing current assets to be depreciated before electing the flat tax. An explicit transition plan would directly address assets currently being depreciated. A critical component of the transition plan is to identify how often a taxpayer can choose between flat and current treatments: is it annually, only once for all time, or some intermediate number of choices? Taxpayer behavior will be affected by this component. Also, taxpayers generally prefer that tax policy be predictable, allowing them to plan in terms of it. Any flat tax proposal should be offered as permanent, not temporary or experimental, if taxpayers are going to adjust their basic behavior around the policy change.

Impact on the District's Revenues

The District's own tax base could grow under a voluntary federal flat tax, due to two influences: 1) businesses and households that move to District to get preferred federal tax status, and 2) expansion of the current economic base. Both income and real property tax revenues would grow. This assumes that D.C.'s own tax treatment of households and businesses does not change and that the optional federal flat tax is enacted as a permanent change to federal tax law (a perception that it is temporary would substantially reduce these effects). D.C. would continue to base tax calculations on the equivalent of current federal AGI and would continue to tax all incomes received by households, not just earned income.

The fiscal impact on D.C. from the flat tax on business income is difficult to assess. For D.C., the revenue gains from adding more incorporated and unincorporated businesses would depend on the degree to which new businesses could apportion net income to non-D.C. sources. In D.C., about 70 percent of business tax filers pay only the local minimum tax of $100 annually under the existing apportionment formula. Partnerships and proprietorships with 80 percent or more of their income due to services of the owners do not even file locally. The issues in taxing business income are known well across state and local jurisdictions, and tax planning is a complex art.

In general, we would not expect that franchise tax revenue to the District government would grow at a rate comparable to the growth of local business income. This assumes that D.C.'s tax policy for business income does not change and that D.C. de-couples from the federal change in the definition of taxable income. If instead D.C. were to adopt the proposed federal treatment of expensing investment outlays, then local revenue would decline.

We would expect growth in real property tax revenue as competition for limited space becomes fiercer. Property values, assessments, and costs inevitably will rise with demand because the District is a small, highly developed jurisdiction with federally mandated height limitations.

Tax Administration and Compliance: A voluntary flat tax will complicate tax compliance for District residents, as well as tax administration at both the federal and local level. With a voluntary flat tax, a District taxpayer will have to compute the tax both ways prior to deciding which option is best for his or her situation. Assuming that the District de-couples from the federal flat tax, a District taxpayer who chooses the flat tax will have to maintain separate records of information, which currently is copied from federal tax forms, in order to comply with the D.C. tax system. At the federal level, the Internal Revenue Service (IRS) would have the added burden of auditing residency, as the voluntary flat tax will create new tax sheltering opportunities based on where a taxpayer lives. At the local level, the D.C. tax administration would lose the benefit from IRS audit and enforcement activities.

Impact on Households: A small group of very high-income taxpayers, especially those with no wage income (fewer than 1,000 current households), will be major beneficiaries of the flat tax.[4] These taxpayers rely on income from interest earnings, rental activity, and profits and capital gains. Further, we expect that others with similar sources of income would want to move into the District for the federal tax benefit.

[4] In the District 86 percent of filers have wage or salary income and an unknown number of others take deferred earnings as part of current year income. This is subject to a flat tax. Of those filers with incomes of $500,000 or more, only two-thirds have wage or salary income.

For example, a married, two-income filer living elsewhere, with $650,000 gross income, currently pays about $185,000 in federal tax and may pay $40,000 in local (non-D.C.) tax. If all of the income is from non-wage-and-salary sources, the filer could save $185,000 in federal tax annually by moving to D.C. The filer would pay about $60,000 in D.C. income tax, about $20,000 more than previously, thus netting $165,000 annual tax savings from the move. If all the filer's income is due to wage earnings and the couple moves to D.C., federal tax could drop to $115,000 under the most restrictive of the flat tax options. D.C. local tax adds back $20,000 – leaving the taxpayer with a net tax reduction of at least $50,000 annually. Even with higher costs in D.C., some households are likely to find D.C. a beneficial new location.

Once they move to the District, these new residents would owe the District's local income tax. If, for example, D.C. added about 500 households, or about 5 percent, to the number with incomes more than $200,000, then individual income tax revenue would increase roughly $30 million annually. Similarly, an addition of 1,000 more such households might generate $60 million of additional D.C. government revenue. Of course, it is very difficult to estimate how many may move in or out without analyzing a concrete flat tax proposal. More new residents would mean more revenue, and fewer new residents mean less increase in revenue. While D.C. could not close the structural imbalance with these new residents alone, their net fiscal contribution to D.C. would be beneficial.

Non-wage income is not limited to the very wealthy; other middle to upper-income households might want to move here to shelter retirement savings and other investment income from federal tax. Much as Florida is a haven from state income taxes in retirement, D.C. could be a partial haven from federal income taxes for retirees. (Pension income could continue to be taxed under the flat tax.) Households attracted in this way are likely to have net fiscal benefit for the District's budget.

Because of this tax incentive, a voluntary federal flat tax could add to housing price pressures in D.C. While a positive occurrence for budgetary purposes, this is a serious problem for other reasons related to the loss of the urban middle-class. For more than 50 years the population of the District has been falling. Within the smaller total population, D.C. has more people at the lower end of the income distribution, far fewer in the middle class, and a declining upper-income population. A recent study by the Brookings Institution documents this change for the period of 1979-1999. The data separate households into national quintiles (the top 20%, next 20%, and so forth) and then locate households from 100 cities, including D.C., within those groups. When compared to 1979, the number of D.C. households in the middle quintile in 1999 is down by nearly 14 percent and, in fact, declined in all but the lowest quintile group. The number of D.C. households in the lowest national quintile group increased 14 percent in the 20 year period.[5]

[5] A recent study of the 100 largest cities finds that "in just a handful of divided cities (7), including Washington, D.C., does the number of households at the extremes of the (income) distribution exceed that in the middle." The study finds the following for D.C., based on the U.S. Census of 1979 and 1999. Income groups are determined based on national quintiles.

# Households	Low Income	Lower-Middle	Middle	Upper-Middle	High
1979	57,837	53,611	50,019	40,141	53,897
1999	66,094	51,759	43,157	38,505	49,076
Change	+14%	-3%	-14%	-4%	-9%

Source: Alan Berube and Thacher Tiffany, "The Shape of the Curve: Household Income Distributions in U.S. Cities, 1979-1999, The Brookings Institution, August 2004

D.C. has lost middle-class population in a very pronounced way. This decline is closely entwined with the:

- loss of school-age population as families have moved out,
- rise in property values as higher-income singles and couples have moved in, and
- decrease in upward mobility because lower income people have fewer affordable housing options as they work and improve their earnings capacity.

Indeed, much of the out-migration is known to be of middle-income families looking for better housing and schooling opportunities.

In recent years, the number of households in D.C. is growing again, but not the population. Many of these new households are higher income – a nearly necessary condition in a city where housing prices grew an average of 15% percent annually over the last 5 years and roughly doubled in the period. With only a 2 percent increase in households overall, the number of households with at least $100,000 income grew by 27 percent in 2000-2004.[6]   Population has not grown because, as a generalization, the filers moving-in are single, or sometimes couples, while the filers moving-out are more likely to have children.

D.C. is a core city and, like other core cities, is the home of a disproportionate share of the region's poor, both those permanently poor and those working upward out of poverty. Housing prices that "squeeze out" the middle-class pose serious obstacles for lower-income earners. Without access to potentially better housing, they also have less access to better transportation, safer neighborhoods and higher

[6] American Communities Survey, U.S. Census, 2000 and 2004.

performing schools. The whole promise of upward mobility is damaged – except for those who leave.

We believe that the federal flat tax for D.C. would add to housing price pressures in the District. Given the recent demand for housing, especially among higher-income homeowners, it is hard to describe how much more dramatic the impact might be.

We do not know how much the voluntary flat tax would add to price pressure. Because a flat tax neutralizes the favorable tax treatment of itemizers – most of these are homebuyers – additional housing price pressure is dampened. Compared to the current tax system, a person electing to use the flat tax would not be able to deduct either mortgage interest or real property taxes from taxable income, thereby limiting the boost to a potential offer-price for housing. However, if theorists are right and business demand rises for D.C. locations under a flat tax, then commercial users will bid up prices, shifting the property market somewhat away from residential land uses and further increasing housing prices.

A New-View of the Federal/City Relationship

The similarity between the OCFO's estimated $1 billion initial revenue loss at the federal level and the magnitude of D.C.'s structural imbalance of about $1 billion is striking. Clearly, the benefits of reduced federal taxation will accrue to citizen and business taxpayers, while the structural imbalance is a problem of local government. Still, thoughtful policy management could find a way to narrow the local budgetary problem as a result of this windfall. It is, after all, much like a negotiated middle between current federal tax policy for D.C. and the current federal treatment provided to Puerto Rico, where there is no federal tax on local earnings. In Puerto Rico the state government receives the revenue from taxation of local earnings.

Mr. Chairman, I thank you for holding this hearing and providing this forum. The possibility of a new, deeper, and better federal/city relationship is very exciting. I look forward to any questions.