

# Reforming and Rationalizing Tax Expenditures: Developing and Testing a Framework

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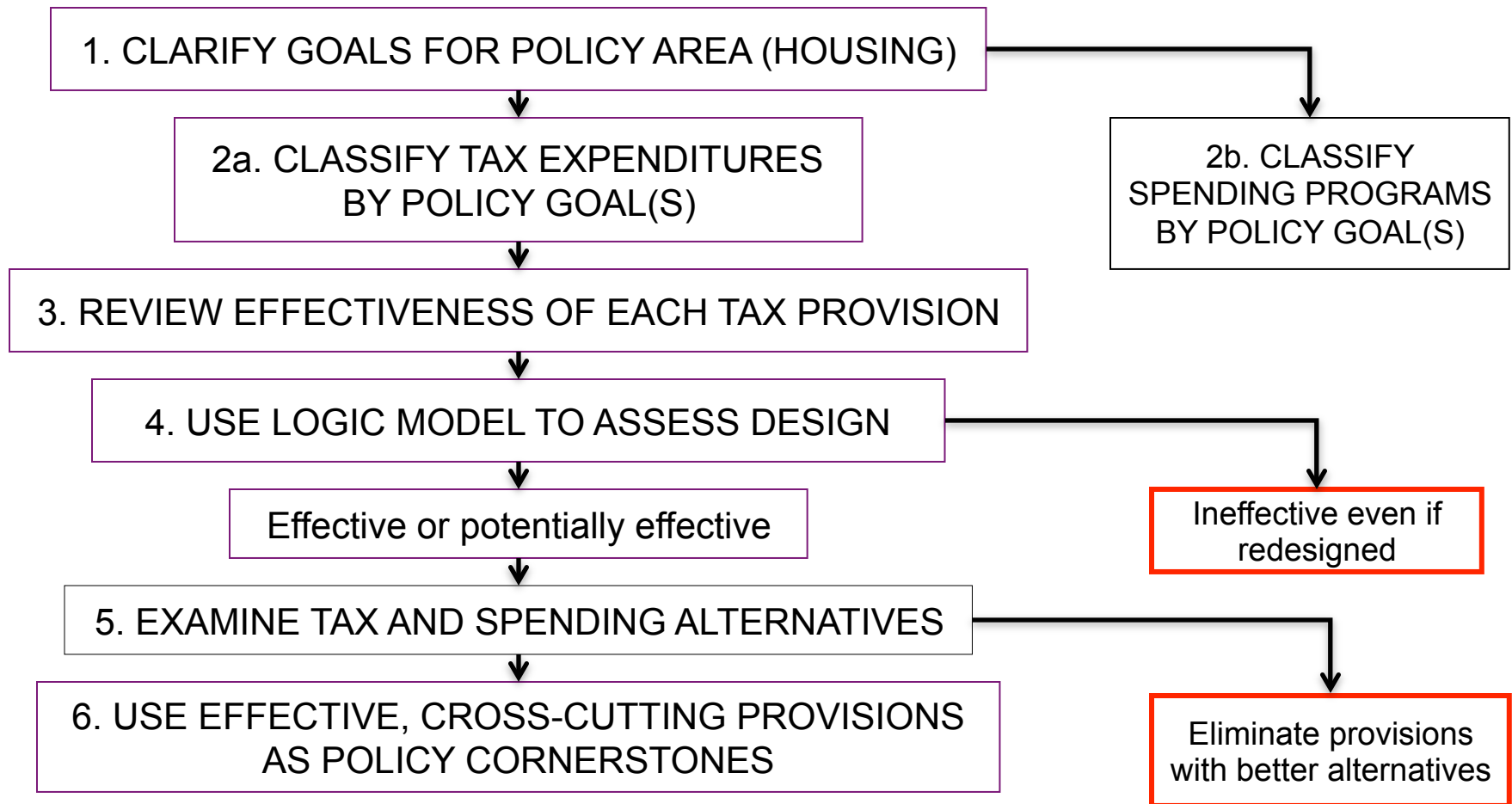
D.C. Office of Revenue Analysis

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*The views expressed herein are solely those of the author, and do not represent any official views of the District of Columbia chief financial officer.*

# Basic Framework



Note: Boxes highlighted in RED represent opportunities to repeal tax expenditures.

# Tax Expenditures and Their Discontents

- tax expenditures: “revenue losses attributable to provisions of the ... tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.” (federal definition)
- potential problems: open-ended commitments that avoid regular scrutiny; understate the size of government; are not coordinated with spending programs; are often regressive; create efficiency costs; and complicate tax administration.

# The Tax Expenditure Challenge: Turning Principles into Practice

- Broad agreement among experts that tax expenditures should be reviewed and scaled back:
  - President Bush’s Advisory Panel on Tax Reform (2005)
  - National Commission on Fiscal Responsibility and Reform (Bowles-Simpson, 2010)
  - Bipartisan Policy Center (Rivlin-Domenici, 2010)
  - Academics such as Martin Feldstein, Len Burman
- Rhetorical agreement among politicians, but little action:
  - President Obama (28% cap on some deductions and exclusions)
  - FY 2014 House and Senate budget resolutions
  - 2012 “fiscal cliff” deal extended dozens of tax preferences
  - Federal government revenue loss is around \$1.3 trillion annually

# Tax Expenditures in the District of Columbia

- Identified 111 “federal conformity” tax expenditures as well as 118 tax expenditures authorized by D.C. law.
- Aggregate revenue loss for FY 2012 was almost \$2.9 billion – roughly 75% of revenue loss is from local (D.C. law) tax expenditures.
- Between 2010 and 2012, four new tax expenditures were created; none repealed.

# Why Examine D.C. Tax Incentives for Housing?

- Housing is the policy area with the most tax incentives (22) created by local law. Broad array of housing provisions suggests need for reform.
- Several provisions are widely-used (homestead exemption, assessment increase cap); some are moderately-used (circuit-breaker, exemptions for affordable housing); and some are rarely or never used (improvements to low-income housing; resident management corporations).

# Step 1: Clarify Goals of D.C. Housing Policy

- Need to evaluate whether D.C.'s housing tax incentives are consistent with housing policy goals. This was done by examining:
  - budgets;
  - D.C. laws and legislative history;
  - publications of the D.C. Department of Housing and Community Development; and
  - March 2013 report of the Comprehensive Housing Strategy Task Force (expert panel appointed by Mayor)

# D.C.'s Housing Policy Goals

## 1. Expand access to affordable housing

- help residents meet housing costs (“demand side”)
- retain and expand stock of affordable housing (“supply side”)
- serve at-risk groups: homeless, people with disabilities, elderly, people with AIDS, mentally ill, very poor, households that spend more than 30% of income on housing.

## 2. Increase homeownership

- target efforts on low-income households

## 3. Revitalize distressed communities

- combine housing with “wraparound” services, particularly for those with incomes below 30% of area median
- expand mixed-income housing

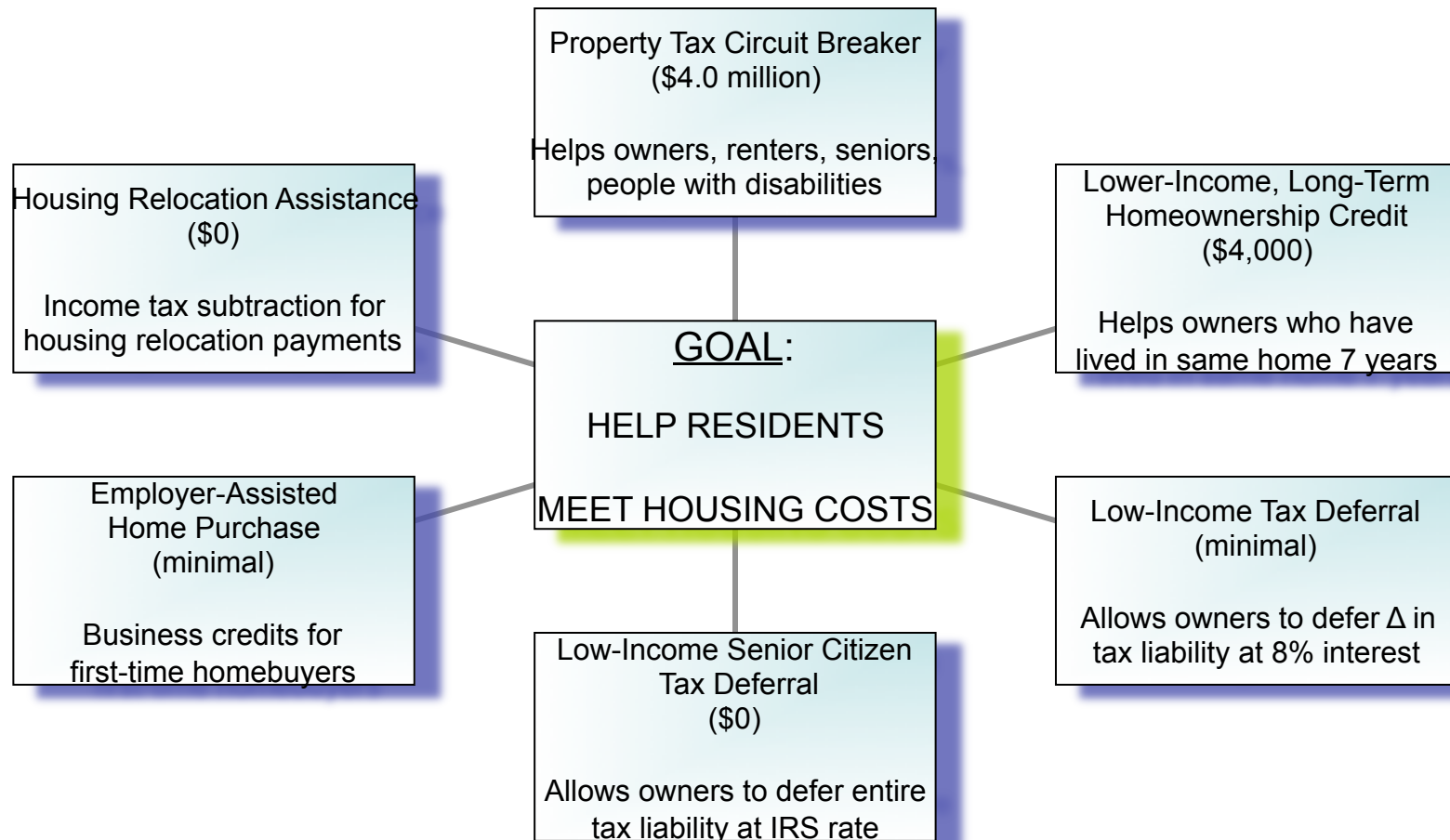
## 4. Stabilize residential property tax burden



## Step 2a: Classify Tax Expenditures by Policy Goal(s)

- Most provisions support a housing policy goal:
  - exemption for NOMA residential developments (market-rate housing) seems inconsistent with goals
  - three items seem questionable: new residential developments, resident management corporations, single-room occupancy
- Several provisions target multiple goals, and could serve as “cornerstones.”
  - Property tax circuit breaker – stabilizes property taxes for homeowners; helps low-income renters, seniors, and people with disabilities.
  - Non-profit housing association exemption: expands stock of affordable housing and promotes homeownership for low-income residents.

# Step 2a (cont.): Classify Tax Provisions by Policy Goal(s)



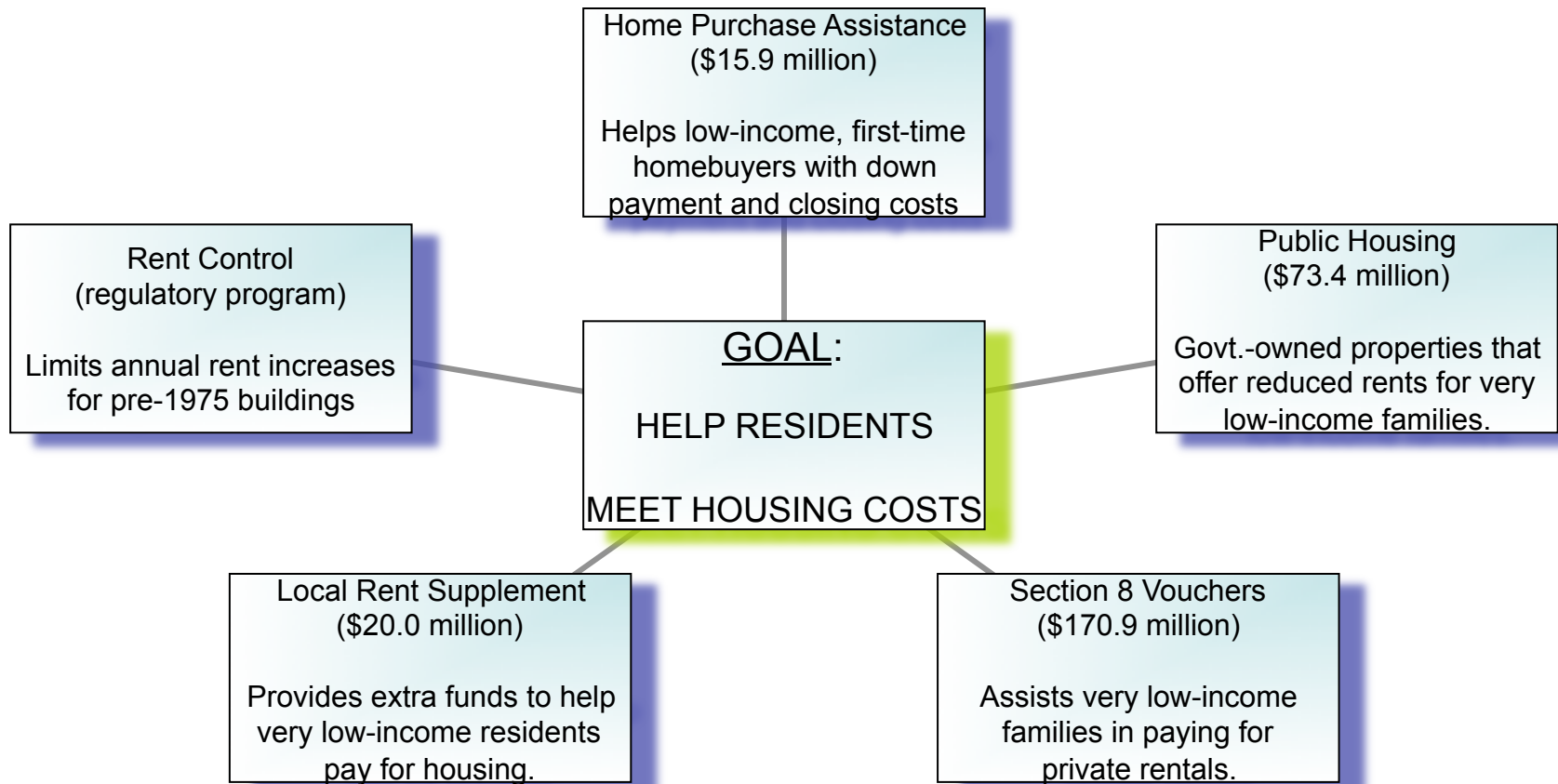
# Tax Provisions Focus on Stabilizing Tax Burden (Goal #4)

- 3 largest housing tax expenditures limit real property tax burden and account for 74% of estimated revenue loss for housing (FY 2012).
  - homestead deduction: Homeowners may deduct \$69,100 from taxable value of a principal place of residence in the District.
  - assessment increase cap: Annual increase in taxable value of owner-occupied home is limited to 10% annually.
  - credit for senior citizens and disabled. Senior citizens and people with disabilities qualify for 50% property tax credit for an owner-occupied home if household AGI is below \$125,000.
- Affordable housing tax expenditures are much smaller.

# Why Is There Such a Mismatch?

- Influence of middle- and upper-class residents.
- Use of tax system may create inherent bias
  - many poor people are not in system
  - exemptions and deductions are more valuable if marginal tax rate or home value are high.
- Affordable housing needs might be met by direct-spending programs.
- Affordable housing tax incentives may be poorly designed.

# Step 2b: Classify Program Expenditures by Policy Goal(s)



# Step 3: Review Data on Tax Expenditure Effectiveness

- 12 provisions are rarely or never used:
  - inclusionary zoning
  - employer-assisted home purchases
  - lower-income, long-term homeownership
  - low-income homeowner tax deferral
  - low-income senior citizen tax deferral
  - homeowners in enterprise zones
  - resident management corporations
  - newly-constructed rental housing
  - single-room occupancy housing
  - preservation of section 8 housing
  - improvements to low-income housing
  - housing relocation assistance



## Step 4: Use Logic Models to Assess Program Design

- Logic models depict graphically how a program works.
  - also show assumptions and external factors that affect program
- Inclusionary zoning tax exemption: affordable housing units are starting to come through pipeline. *Retain.*
- Improvements to low-income housing exemption: complicated eligibility requirements; two applications; approval uncertain. *Repeal?*

# Logic Model: Inclusionary Zoning

Assumptions: The need for bonus density will encourage developers to participate in the IZ program.  
**The residential construction market will remain strong.**  
 D.C. government agencies will publicize and administer the IZ program effectively.  
 Applying for the deed transfer tax exemption at the Recorder of Deeds will be fairly simple.

External Factors: **Only 18 IZ units had been produced by December 31, 2012, and none had been occupied. Nevertheless, the Department of Housing and Community Development states that 104 IZ projects are in the pre-development stage.**

INPUTS	ACTIVITIES	OUTPUTS	OUTCOMES
<p>Developers plan new housing developments with affordable housing set-asides in return for an increase in allowable density (“bonus density”)</p>	<p>Developers file Certificates of Inclusionary Zoning Compliance with Department of Consumer and Regulatory Affairs and obtain building permits.</p> <p>Developers file Inclusionary Development Covenant with Recorder of Deeds.</p> <p>Developers build inclusionary zoning (IZ) units and obtain Certificates of Occupancy for Inclusionary Zoning (IZ) unit.</p> <p>Department of Housing and Community Development uses lottery or other means to select eligible households for IZ units.</p>	<p>Low- and moderate-income families apply for IZ units and obtain affordable housing.</p>	<p>Developers file transfer tax exemption form with Recorder of Deeds and gain exemption.</p> <p>Transfer tax exemption encourages developers to participate in IZ program and produce affordable housing units.</p>



# Logic Model: Improvements to Low-Income Housing

**Assumptions:** Offering abatements that freeze property tax for five years will encourage owners to upgrade low-income housing. Owners will undertake improvements even though application process is required and approval is uncertain. Eligibility requirements (25% of rents affordable to households below 50% of area median income) are clear.

**External Factors:** The housing market citywide and in certain neighborhoods will affect the effectiveness of the abatement. For example, if property values are rising rapidly, owners may prefer to sell or redevelop properties rather than upgrade them for low-income housing.

INPUTS	ACTIVITIES	OUTPUTS	SHORT TERM OUTCOMES	LONG TERM OUTCOMES
<p>5-year property tax abatements are available for property owners who improve low-income housing by at least \$10,000 per housing unit over a two-year period.</p> <p>Abatement equals 100% of increase to property tax liability for 5 years.</p> <p>At least 25% of the units must offered at rents that are affordable to households with income below at least 50% of the area median.</p>	<p>Availability of the abatements is publicized by the D.C. government and housing groups.</p> <p>Owners file application for tax abatement with Department of Housing and Community Development at least 30 days before renovations begin and after they are completed.</p> <p>Owners make the required improvements to low-income housing, and offer at least 25% of units at rents affordable to those with household income below 50% of area median.</p>	<p>DHCD determines that the improvements were unlikely to be completed without the tax abatement and approves abatement.</p> <p>OTR implements abatement for qualifying owners.</p>	<p>The supply of safe and affordable housing is maintained and increased..</p>	<p>The city remains diverse economically and socially, with decent housing available throughout the income spectrum.</p> <p>Homelessness is prevented and reduced.</p>

# Step 5: Examine Tax and Spending Alternatives

Employer-Assisted Home Purchases	Home Purchase Assistance Program (S) First-Time Home Purchase for D.C. Government Employees (T)
Lower-Income, Long-Term Homeownership	Property Tax Circuit Breaker (T)
Low-Income Homeowner Tax Deferral	Property Tax Circuit Breaker (T)
Low-Income Senior Citizen Tax Deferral	Property Tax Circuit Breaker (T) Property Tax Credit for Senior Citizens (T)
Homeowners in Enterprise Zones	Community Development Block Grants (S) New Communities (S)
Resident Management Corporations	Lower-Income Homeownership Households (T) Cooperative and Rental Housing for Low-and Moderate-Income Households (T) Non-Profit Housing Associations (T)
	<u>Note:</u> “S” = spending program, “T” = tax program.

# Step 5: Examine Tax and Spending Alternatives (p. 2)

<p>Newly-Constructed Rental Housing</p>	<p>Cooperative and Rental Housing for Low-and Moderate-Income Households (T)          Non-Profit Housing Associations (T)          Multifamily Mortgage Revenue Bonds (S)          Low-Income Housing Tax Credits (S)</p>
<p>Single-Room Occupancy Housing</p>	<p>Cooperative and Rental Housing for Low-and Moderate-Income Households (T)          Non-Profit Housing Associations (T)          Multifamily Mortgage Revenue Bonds (S)          Low-Income Housing Tax Credits (S)</p>
<p>Preservation of Section 8 Housing</p>	<p>Cooperative and Rental Housing for Low-and Moderate-Income Households (T)          Non-Profit Housing Associations (T)          Low-Income Housing Tax Credits (S)</p>
<p>Improvements to Low-Income Housing</p>	<p>Multifamily Mortgage Revenue Bonds (S)          Low-Income Housing Tax Credits (S)</p>

# Result: A Revamped System of Tax Expenditures

## Retain (11)

Homestead deduction  
Assessment increase cap  
Senior citizen and disabled credit  
Rental and cooperative housing  
Non-profit housing association  
Property tax circuit-breaker  
Lower-income homeownership households  
Inclusionary zoning  
Resident management corporations  
Low-income housing tax credits  
Housing relocation assistance

## Repeal (11)

Lower-income, long-term homeowner  
Employer-assisted home purchases  
Low-income homeowner tax deferral  
Low-income senior citizen deferral  
Homeowners in enterprise zones  
Improvements to low-income housing  
Preservation of section 8 housing  
Newly-constructed rental housing  
Single-room occupancy  
NOMA residential developments  
New residential developments

# Result: A Revamped System of Tax Expenditures (p. 2)

- Cross-cutting, flexible provisions serve as “cornerstones”
  - homestead deduction
  - assessment increase cap
  - senior citizen and persons with disabilities credit
  - property tax circuit-breaker
- Possibility of coordinating or consolidating 5 provisions with similar goals
  - rental and coop housing for HUD program participants
  - low-income housing tax credits
  - non-profit housing associations
  - lower-income homeownership households
  - resident management corporations

# Lessons about Design of Tax Expenditures

## Do's

- Use simple eligibility rules tied to income or wealth
- Implement incentives through tax agency and its forms & procedures
- Provide sufficient incentive to change behavior
- Create bright-line rule for claiming tax benefit

## Don'ts

- Use rules with complicated or multiple criteria
- Implement with multiple agencies (e.g. housing & tax) requiring multiple forms
- Provide minor incentive that won't change behavior
- Create subjective rule for claiming tax benefit

# Lessons about Design of Tax Expenditures (p.2)

## Do's

- Target fairly broad activity or set of activities
- Consider programs and incentives already in place

## Don'ts

- Target very narrow, specialized activity
- Create duplicative or inferior options (e.g., tax deferral at 8% interest)

# Recap

- clarify policy goals
- take inventory – classify tax and spending programs by goals
- review effectiveness
- examine possibilities for re-design
- retain (and expand) effective, well-designed programs
- identify “policy cornerstones”



program budget