October 19, 2001
Council of the District of Columbia
OVERSIGHT ON THE DISTRICT'S FINANCIAL OUTLOOK

Testimony of Natwar M. Gandhi, Chief Financial Officer, before the Committee on Finance and Revenue

Good Morning Chairman Evans and members of the Committee. I am Natwar M. Gandhi, Chief Financial Officer of the District of Columbia. With me today are Dr. Julia Friedman, Deputy Chief Financial Officer for Research and Analysis; Gordon McDonald, Acting Deputy Chief Financial Officer for Budget and Planning; and Bert Molina, Chief Financial Officer for DC Public Schools.

As we all know, the District of Columbia government has experienced a series of financial shocks over the past few months. The overall economy of the United States has been slowing. Additionally, the events of September 11 have had a serious, adverse impact on our economy, and the duration of this impact has yet to be determined. Finally, we need to address certain spending pressure issues that emerged at the DC Public Schools (DCPS) and elsewhere. I am here today to give you our best assessment of the impact these events may have on the overall financial posture of the District of Columbia government, especially as they will affect the execution of our FY 2002 budget and the upcoming development of the FY 2003 budget.

The FY 2002 proposed budget projects total revenues of $ 5.293 billion and total general fund expenditures of $ 5.257 billion. This results in a positive budget margin between expenditures and revenues of $ 36 million, or less than one percent of planned expenditures. After various accounting adjustments, the operating margin on an accounting basis is $ 86 million, but these adjustments do not translate into readily available financial flexibility. It goes without saying that this margin is very narrow indeed. Ensuring that we maintain a balanced budget at all times throughout the year will require diligent oversight by us all. As I will discuss later, for the next few years, I do not believe we will have the financial safety net we have had over the past few years created by revenue collections exceeding forecasts.

This means that the Office of the Chief Financial Officer (OCFO) will need to be more vigilant in monitoring spending and spotting potential problem areas timely. It also means that program managers must match their program goals to financial availability, and agency directors must enforce this discipline. Finally, it means that the Council must be very circumspect in approving any action that would have the effect of increasing operating costs or reducing revenue receipts beyond those contained in the operating budget.

This past June, I testified before the Congress that the District faces a long-term structural imbalance between its revenue base and required expenditures. You are familiar with the nature of this imbalance caused by restrictions on the District's taxing authority, its unique status as a core city without a state counterpart and its relationship with the federal government. Our debt burden, long the highest and now second highest in the nation among cities, gives us only a limited borrowing capability, even though it has been reduced from $ 3.21 billion to $ 2.76 billion, or from $ 6,177 to $ 4,819 per capita, since September 1999. The economic good times the District has experienced for the last five years – a period in which each year's growth of revenues has significantly exceeded inflation – have masked this imbalance. However, in an economic downturn, the imbalance will become glaringly apparent.

Revenues

You have probably all read about the downward revisions made to revenue projections in Maryland, Virginia and New York City, and the consequent spending adjustments being contemplated as a result. These jurisdictions are all on a July/June fiscal year, and hence three months ahead of the District in their revenue projection cycle. Our next official revenue estimate is not due until February 2002, at which time we will have the first quarter of FY 2002 operating results in hand. However, the portents are not good. The general consensus of economists is that we have entered an economic slowdown that will have consequences for all taxing jurisdictions. The Congressional Budget Office, one source we use to develop the District's revenue projection, has recently revised its FY 2002 gross domestic product estimate downward by 0.8%. Were we to apply this general benchmark to our particular revenue situation, it would completely wipe out our positive operating margin unless adjustments were made to spending plans.

For the past few years, the District's economy performed well, and even better than the national average, in the growth in employed residents from April 1998 – March 2000, the growth in earnings in seven of the last nine quarters, and the growth in jobs from March to August 2001. This was due in part to the fact that DC's recovery from the previous recession was as strong as, but proceeded later than, the nation as a whole. A slowing of the local economy has clearly begun, even before the tragic events of September 11. There is no doubt that the recent terrorist attack on the Pentagon, the temporary closing of National Airport and the resultant drop-off of travel into the District are adversely affecting our economy, the full measure and duration of which we cannot yet determine. Overall, it seems possible that local source revenues could be reduced by as much as $ 90 million to $ 100 million in FY 2002 compared to the FY 2002 budget estimate. Similarly, the current revenue estimate for FY 2003 will also need to be reduced.

FY 2002 Spending Issues

Before we started FY 2002, we made an assessment of where the budget seemed out of balance with current plans and spending expectations. In general, and in no way related to our potential revenue problem, we need to resolve approximately $ 145 million in spending pressures. A total of $ 48 million is attributable to our on-going problem with correctly estimating Medicaid revenue. Our FY 2001 experience makes it likely that we have shortfalls in DCPS, the Department of Health and the Department of Mental Health. Another $ 12 million is attributable to labor pay agreements in excess of amounts budgeted – a figure that could rise – while a projected $ 81 million is related to DCPS programs (including special education) and $ 4 million to miscellaneous matters. The attachments to my statement provide more information on these spending pressures and on potential options for resolving them.

Were it not for the likely drop in projected revenues, I believe the District would have the financial flexibility to address these problem areas. Changes to the District's reserve requirements proposed in our FY 2002 Appropriations bill will make $ 57 million available for application to potential problem areas. Also, we will carry forward about $ 41 million from the FY 2001 Budget Reserve that will be available to us to address spending issues in FY 2002 even though these funds will be recorded for accounting purposes as an FY 2002 expenditure if used. Under FY 2001 appropriations law, any unexpended budget reserve funds effectively fell into the fund balance that the District is not authorized to use as an expenditure source. The DCPS CFO is working with school officials to develop proposed changes to spending plans that DC Public Schools policy officials may consider to reduce their projected spending gap by up to $ 42 million.

Using these flexibilities coupled with taking a hard look at areas where savings can be made or spending can be deferred, we should be able to bring the FY 2002 budget back into balance for the beginning of the fiscal year. However, as occurred last year, we need immediate policy action on the part of the executive and legislative branches to either validate the proposals the OCFO has made for resolving these pressures or institute other solutions.

FY 2003 Flexibility

Even before the emerging decline in revenues became clear, I was greatly concerned that the confluence of revenue receipts and program spending placed the District in a position where it has very little incremental flexibility in developing the FY 2003 budget. Looking back on the three years after the 1997 Revitalization Act, which changed the District's expenditure and revenue structure, we can see how this happened. In the very good economic years of FY 1998 through FY 2000, total actual expenditures grew faster than total revenues. We await final information for FY 2001 and are now planning for very little revenue growth in FY 2002.

The expenditure and revenue trend lines were projected to be perilously close in FY 2003 – even if we fund programs at baseline or current services levels only. However, there are factors on the spending side of the equation that could cause expenditures in the range of $ 110 -$ 210 million above those projected for FY 2003 in the Multi-Year Plan completed this past June. Even a small drop in projected FY 2003 revenue will further exacerbate this problem.

All of us need to monitor carefully the economy and our revenues in the next several weeks, to ensure that we are ready to make any changes necessary based on that activity.

Medicaid

There are a number of areas in need of analysis as we build the FY 2003 budget. First, Medicaid accounts for approximately 20% of the District's gross operating budget. Greater attention needs to be focused on program operations across the District government that rely on federal Medicaid revenues.

An effort has been underway for several years to increase the proportion of costs incurred by the District government for which we receive Medicaid reimbursement. With the federal government increasing its contribution for reimbursable health care costs to 70% in 1998 (up from 50% previously), it is particularly important that this be a focus of program and financial staff across District agencies.

From a preliminary review of the District's efforts to increase federal Medicaid revenues, it is apparent that there are significant shortcomings. First, the aggressiveness of the District's forecasting of Medicaid revenues outstripped the District's performance in billing and accounting for Medicaid reimbursable services. This is largely a result of a second factor, the infrastructure and attention required to ensure timely and accurate Medicaid billing is not fully in place across District agencies.

The City Administrator and I have initiated a joint task force to see what steps should be taken to sharpen our capabilities in this regard. This work is well underway and a preliminary District-wide strategy will be developed by the end of the month. Nevertheless, based on this year's experience, we will need to recalculate downward likely Medicaid receipts – possibly in the range of $ 50 to $ 100 million. While this reduction does not translate into a one-for-one cost to DC's local funds, we will have to work through the program funding implications during the FY 2003 budget formulation.

Public Schools/Special Education

The Public Education Appropriation, of which DCPS is by far the largest component, accounts for approximately 20% of the total operating budget. Within DCPS, special education accounts for one-third of all costs, and is growing. We will work with DCPS to get a much better financial monitoring system in place, but the real solution is developing new approaches to managing special education programs. Depending on DCPS success in this arena, maintaining current levels of service in special education could add $ 50 million to $ 80 million to DCPS baseline FY 2003 costs. While only 17% of students in DCPS are in special education, they comprise nearly one-third of the costs for the entire school system, and their numbers continue to grow and exceed budget projections. Cost containment actions in this area can help, but we should not count on any quick fixes.

Payroll Costs

If our workforce remains at its current level, labor agreements already negotiated, as well as anticipated agreements and proposed raises for nonunion employees, will increase baseline costs in FY 2003 by at least $ 8 million. If the District works on pay equity between comparably graded union and non-union employees, an upper range for labor cost increases beyond those assumed in the FY 2002 Multi-year Plan would be at least $ 23 million. Labor costs are the largest single category of expense in DC budgets, accounting for approximately 39 percent of total local source expenditures.

Financial Action Plan

The District is now removed from the control period and assumes complete responsibility for its financial planning and spending decisions. Should the Morella-Norton Bill pass as proposed, the District would assume complete authority over its local source spending beginning with the FY 2004 budget, one we will begin developing in less than one year from today. While this is a tremendous opportunity for us all, it is also a considerable challenge. We will be entering a period where we will be completely responsible, and accountable, for all significant financial decisions affecting the District.

As I have mentioned previously to the Council and to the Congress, these financial decisions affect three key components of the city's financial viability: first, financial viability on a week-to-week, month-to-month basis; second, fiscal viability on a year-to-year basis; and third, long-term economic viability. The Office of the Chief Financial Officer (OCFO) has responsibility in all of these areas.

To execute this responsibility, I believe we need to be taking the following actions.

Look for Business Process Reengineering Possibilities. Cutting program costs is one way to provide money for strategic initiatives. We need to look at current ways of doing business to streamline operations. For example, in my own area of responsibility, I have testified that significant savings could be realized over a twelve to twenty-four month period if we were to restructure the way we deliver financial services to agencies. Currently this requires over 600 people. We can do better. I have proposed a more streamlined structure to both the Mayor and the Council, and look forward to working with you to effect needed changes. In addition, the City Administrator and I have agreed to review certain functional areas across the government to ensure that we have consistent, effective activities in individual agencies.

Manage the Cost of New Legislation and Binding Agreements. The federal government emerged from "deficits as far as the eye could see" by imposing discipline on its legislative actions. Essentially it established a pay-as-you-go process, through which any legislative act that would reduce revenues or increase spending had to have an offsetting counterpart that either cut spending or increased revenue. I urge the Council to consider its own legislation along this line.

Focus on Strategic Priorities. During the FY 2003 budget process, the Mayor and the Council will agree on strategic objectives for the District. In past budgets, we have tended to add these onto a budget that attempts to maintain all programs at baseline levels. I do not think this approach will be possible in FY 2003. It will be necessary to make room for new or enhanced programs at the expense of reducing the level of effort on some programs. Early discussion as to where such reductions might be made without compromising key priorities should be held.

Approve Comprehensive Financial Management Policies. The FY 2001 District of Columbia Appropriations Act required the District to develop a comprehensive financial management policy with which to conduct financial management activities. The OCFO developed a set of policies based on benchmarks and best practices in other local jurisdictions in such areas as debt management, fiscal management, and economic development. These policies were approved by the Mayor and transmitted to the Council earlier this year, and must still receive Council approval and undergo congressional review before becoming official. While we already try to conduct our business in accord with these policies, it would be beneficial to have the Council and the Congress officially approve them, both as a reassurance to the bond markets and as a tool for ensuring compliance by all city agencies.

Address the Structural Imbalance. As I noted at the beginning of this statement, the District faces a structural imbalance between its costs and its revenues. Resolving this imbalance will require support from the federal government. Federal tax incentives may be part of the answer. Adjusting local tax capabilities would be another. A third avenue would be to address the federal-local partnership for providing city services. We need to aggressively pursue solutions to this imbalance if we are to maintain the economic viability of the District of Columbia. The long-term solutions to this imbalance are matters to be addressed by District and congressional policymakers.

Mr. Chairman and Members of the Committee, this concludes my oral comments. I request that my prepared remarks be included in the hearing record. My associates and I will be happy to answer your specific questions at this time.

FY 2002 Spending Pressures

Agency/Program	Amount ($ million)	Explanation
Medicaid Issues:		
DC Public Schools	$ 21	Estimate assumes loss of most cost settlement refunds.
Department of Mental Health	16	Estimate is subject to change; audits have not yet been completed.
Department of Health	11	Increase in fee-for-service provider rates.
Subtotal: Medicaid	**48**	
Other Issues:		
DC Public Schools	81	Non-Medicaid pressures.
Labor Costs (Workforce Investment)	12	Increased labor costs based on union and nonunion raises.
Cash Reserve	3	Replenishment of cash reserve used in FY 2001.
Department of Public Works	1	Lease for new impoundment lot.
Subtotal: Other	**97**	
Total	**$145**	

Potential Options to Resolve FY 2002 Spending Pressures

Proposal	Amount freed up ($ million)	Explanation
Reserve proposals in pending legislation	$ 57 (1) Cash reserve deposit rather than debt service = $ 29 (2) Freed-up FY 2002 budget reserve = $ 28	(1) Deposit of $ 122.48 million into reserves: • would reduce FY 2002 required payments into reserves (saves $ 46 million), but • would also increase amount required for FY 2002 debt service (costs $ 17 million). • Net savings: $ 29 million. NOTE – A supplemental appropriation might be required to access $ 13 million of this $29 million (2) Total reserve relief would be $ 30 million: • $ 12 million designated for schools – ✓ $ 2 million to Charter Schools (would not address pressures), and ✓ $ 10 million to DCPS (could address DCPS pressures). • Remaining $18 million is free for other pressures.
Use carryover from FY 2001 budgeted reserve	41	Assumes following spending from FY 2001 budgeted reserve: • $ 104 million for PBC, and • $ 5 million for IMF-related expenditures.
Specified changes in DCPS spending	42	• Cuts in central administration. • Salary lapse and other savings. • Increased appropriation.
Smaller items affecting multiple agencies	18	• Redirect some of “Non-Departmental” budget. • Possible encumbrance of unused NPS funds, similar to FY 2001. • Other actions for agencies with reduced needs.
Total	**$158**	