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DC Agenda
ANNUAL CITY LEADERSHIP FORUM

Statement of Natwar M. Gandhi, Chief Financial Officer for the District of Columbia

Good morning, members of DC Agenda's Leadership Forum. I am Natwar M. Gandhi, Chief Financial Officer for the Government of the District of Columbia. I want to share with you my perspective on the financial health of the District as we complete FY 2001, move forward into FY 2002, and begin work on our FY 2003 budget.

The District's Financial Recovery

Let me begin by saying that it does not take an accountant to determine that the District of Columbia has made a remarkable recovery from virtual bankruptcy over the past five years. The proof is visible to the naked eye: new buildings are springing up all over the city; renovations and additions are being made to existing structures; the F Street and 14th Street corridors are hardly recognizable. Couple these facts with clean streets, timely trash collection and other investments in better government and I believe even the casual observer would say the District is in the best position it has been in for many years.

My judgement is that this turn-around is the direct result of effective and responsible leadership by the elected officials of the District. This leadership is responsible for the end of the congressionally mandated control period, effective with the close of FY 2001. It is also the result of one of the most remarkable economic expansions the US as a whole, and DC in particular, has ever experienced. Without this leadership, even the remarkable economy of the late 1990s would not have saved the District.

From FY 1996 through FY 2000, District local source tax revenue increased by 28%, from $2.4 billion in FY 1996 to $3.1 billion in FY 2000. Coupled with spending restraint and the federal assumption of pension and certain other on-going costs, this increase in revenues permitted the District to make major investments in key government programs while liquidating its deficits. Overall, the District moved from a negative accumulated fund balance in FY 1996 of $518 million to a positive balance of $465 million in FY 2000. Over the same period, year-end operating cash went from negative $200 million to a positive operating amount of $538 million.

FY 2001 CAFR and Current Financial Picture

We are still a few weeks away from issuing our FY 2001 Comprehensive Annual Financial Report (CAFR), but I think it is safe to say that the report will reflect a continuation of our experience since FY 1996. I am confident we will end FY 2001 with an unqualified audit opinion and an end-of-year surplus. This will be the case despite addressing such major financial issues as the transition of the District's method of delivering public health services and other expenses not incorporated in the FY 2001 budget.

That is the good news. However, economic good times never continue upward forever without correction. Those on my staff who are fortunate enough to have stock portfolios tell me this is so. Even before the events of September 11, the U.S. economy was in recession, and it was only a matter of time before that recession took its toll on the District. While the District economic take-off lagged that of the US and regional economy, it is also true that our good times have extended past the more general downturn.

In fact, many of our economic indicators are still strong. For example, housing permits are still 25% ahead of where they were this time last year – 896 permits for the most recent four quarters ending September 2001. For commercial property, new units under construction are up nearly 41% to 3803. The commercial property vacancy rate is 3.7%, well below the regional average. The average price of single family homes has increased by 20%. At the same time, indications are that the District's population decline has stopped and that we may be looking at a period of stability or even growth in this area.

These are all signs that the District has a solid long-term foundation on which to build. However, there is no question that for FY 2002 and FY 2003 we face some serious challenges. Due to the recession, District unemployment is now 6.5%. The city's economy is also feeling a direct impact from the terrorist attacks. While overall wage and salary employment in the District is up, in areas heavily dependent on tourism – restaurants, hotels and business services and other retail – employment is down by 2,500 jobs.

The economic downturn is having a corresponding effect on tax collections, which are down for October and November by 6.3% compared to the same period one year ago. We do not think this decline will represent a drop in revenue for the entire fiscal year, but even if the drop were only 2%, it would mean a revenue loss of $70 million, and for 3% that number is $105 million.

FY 2002 Financial Assessment
This potential revenue shortfall must be put in the context of unanticipated FY 2002 budget pressures. I believe the record shows that over the past three years, major improvements have been made in the District's accounting systems. However, budget formulation remains very much a work in progress and a priority area for improvement.

In FY 2001, we resolved about $280 million in spending pressures through a combination of reductions in spending plans, application of reserve resources and a supplemental appropriation to apply additional revenues collected over the amounts originally projected. With all of this, the District will still end the fiscal year with a healthy surplus.

Now in FY 2002, we are in a somewhat comparable position, although the causes of the pressures are much more focused. At this point, we have identified approximately $165 million in spending pressures and another $100 million as a contingency against decreased revenues that we must address – a total of $265 million requiring balancing action.

I have already spoken to the issue of a potential revenue shortfall against projection. Next month, in February, we will have an official estimate. With regard to spending pressures, we are looking at two main causes: Medicaid-related costs of approximately $59 million that the District must bear and unbudgeted DC Public Schools (DCPS) pressures of approximately $81 million. Other miscellaneous matters total $25 million. Were it not for these first two problems, the District would be comfortably positioned to deal with the recent economic downturn.

We are working with all agencies that receive and depend on Medicaid payments to underwrite a portion of their expenses, to improve their Medicaid-related systems. The basic problem is that money must be spent on Medicaid programs in advance of billing for and then receiving reimbursement from the federal Medicaid administrators. The District's challenge is to accurately estimate Medicaid revenue reimbursements going forward, and to maintain records that satisfy Medicaid documentation requirements. Although we share this problem with many other jurisdictions, it is clear the District is not doing a satisfactory job in these areas. Another challenge is to improve the documentation of past expenses, so that the money already spent is reimbursed. I have previously testified on the spending problems of DCPS. Here, issues related to the District's special education programs are driving up costs, as is the desire of the Board and the Superintendent to remedy what they view as long-standing system deficiencies.

Even though the potential total budget problem is a large one, the District has the financial flexibility this year to resolve all problems without the sort of draconian steps being undertaken or contemplated by other jurisdictions. The DCPS has committed to taking steps to reduce spending by $35 million to meet higher priority needs. We have also identified $19 million in other agency savings that can be reprogrammed without affecting frontline programs.

The balance of resources needed to close spending gaps will come from the District's uncommitted budget reserves. The District has a budget reserve, apart from its emergency and contingency cash reserves, of $120 million. Also, changes made by the Congress in our FY 2002 Appropriations Act give us access to prior year, unspent budget reserves. Finally, debt service and other financial savings will free up an additional $46 million. Even with the use of these reserves, we plan on ending the fiscal year with remaining total cash reserves of approximately $250 million.

However, having used these financial flexibilities – and I should say that in all cases, they will require the approval of the Mayor and Council, and in some cases, the Congress – the District will have exhausted its remedies for dealing with financial problems without affecting programs. From this point on, decisions become much more difficult.

FY 2003 Budget Formulation

Our major concern right now is how to build a balanced budget for FY 2003 that responds to programmatic needs. Many of the spending pressures identified for FY 2002 will carry forward into FY 2003. We also know that baseline costs to maintain current employment levels and other ongoing expenses will increase. It is also quite possible that estimated revenues for FY 2003, on which by law we must build our budget, will be lower than previously projected. We may need to develop a very austere operating budget for FY 2003. Compared to all other budget years during which I have worked in the District, we will not be working with a rising revenue curve. There will be little room for new initiatives without reductions elsewhere, and the whole government will have to work together to identify areas where savings can be made or revenues increased. Until we have completed our analysis, I do not want to speculate on exactly how tight our budget position will be.

Structural Imbalance in the District Budget

The Mayor has said that the District is always operating one catastrophe away from insolvency. Whenever there is an opportunity, policy makers and other stakeholders should drive home the point that there is a structural imbalance inherent in the city's budget, which if not addressed, may eventually precipitate spending in excess of revenues or serious cuts in city services. *The Washington Post* has aptly summarized the sources of this imbalance, which are well known and documented:

- the District routinely provides as much as $227 million in public services to support federal property, which comprises over 40% of District property by area (these expenditures are greater during a time of crisis);
- lacking a state or state-like support from the federal government, the District spends as much as $486 million per year on state-like functions, even after accounting for the net contributions of the 1997 Revitalization Act;
- the District can tax only 34% of income earned in the city; and
- tax exemptions of federal commercial activity reduce District revenues by as much as $193 million.

The federal assumption of certain pension and Medicaid liabilities and courts and prison functions was an important step in correcting this imbalance, but I believe that even good government and fiscal prudence will not be enough in the event of a serious or sustained economic downturn. If the District's economy does not rebound quickly, we may find ourselves at the point where the structural imbalance becomes manifest to all.

The long-term solutions to this imbalance are matters to be addressed by District and congressional policy-makers, and there are several options. Federal tax incentives may be part of the answer. Revising restrictions on the District's local taxing power might be another. Congresswoman Norton sponsored legislation in the 106th Congress to enact a nonresident wage tax with a corresponding federal tax credit. These funds could be used either to compensate the District equitably for services provided to the federal government, or to create an infrastructure fund for city improvements. Now is the time – while the District is in good financial condition – to begin working on this issue and to put a solution in place.

It was a pleasure to be here this morning. Thank you for your time and attention.