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Joint Hearing before the US House Committee on Government Reform and the US Senate Committee on Governmental Affairs
HEARING ON THE OUTLOOK FOR THE DISTRICT OF COLUMBIA GOVERNMENT: THE POST-CONTROL BOARD PERIOD

Testimony of Natwar M. Gandhi, Chief Financial Officer, before the Subcommittee on the District of Columbia

Good morning, Madame Chairman, Mr. Chairman and members of the House and Senate Oversight Subcommittees on the District of Columbia. I am Natwar M. Gandhi, Chief Financial Officer for the District of Columbia.

We are now less than four months away from the end of a congressionally mandated control period that began in April 1995 with the enactment of the District of Columbia Financial Responsibility and Management Assistance Act. Since that time, with the assistance of the Congress, the work of the Financial Responsibility and Management Assistance Authority ("the Authority"), and the efforts of elected and appointed officials in the District of Columbia government, we have all witnessed a true turn-around in the management of the District of Columbia on both the program and financial level. It is accurate to say that what Congress intended when it passed the Authority Act has come to pass in just six years.

While much remains to be done, what has been accomplished is remarkable. The District has moved from an end-of-year operating cash deficit in FY 1996 of $201 million to a positive $538 million in FY 2000 – a turnaround of $739 million. Over the same period, total local source tax collections have increased by 28%, from $2.40 billion to $3.08 billion, partly as a result of a vibrant economy but also in substantial measure because of rejuvenated tax administration. Also over the same period, government local source expenditures actually declined from $3.4 billion to $3.1 billion, as did the total number of employees on the District government's payroll.

Today I would like to discuss with you the following questions. First, what is the current budget outlook for the District of Columbia? Second, what are the key components needed to keep the District financially viable in the future? Third, what role should be played by the Office of the Chief Financial Officer (OCFO) in ensuring this viability?

The FY 2002 Budget Outlook
The District's FY 2002 budget proposal submitted to the Congress on June 4 reflects the District's projected net operating margin through FY 2005. This presentation shows an average annual local source surplus of receipts over expenditures of approximately $80 million. On the surface this appears to present a very positive financial picture, and is based on a revenue forecast that was built using realistic economic and demographic assumptions generally accepted by the forecasting community and used by the federal government. In this regard, I believe it is safe to say that these estimates are neither unduly conservative nor optimistic, but represent a professional consensus view.

However, a closer examination of the budget proposal suggests the District is operating on a much tighter financial margin. First, in building the District's FY 2002 local source budget, we utilized all the data available to include all known costs for maintaining the current services of existing programs. We then built in the costs of the operating initiatives approved by the Mayor and the Council. This process, in which we worked closely with the Mayor and the Council, should go a long way to eliminating the types of spending pressures that occurred early this fiscal year. We also built into out-year projections a cost of living index to serve as a proxy for the on-going costs of current programs at current levels. However, no allowance was made for possible new initiatives in FY 2003 and beyond.

Second, current law requires that the District have a set-aside budgeted reserve of $150 million. In our FY 2002 through FY 2004 projections, we have assumed that this reserve is funded annually from that year's local source revenues and that roughly one-third of the reserve is expended, thereby contributing to each year's overall positive operating margin.

Based on experience, I believe we can keep the costs of maintaining current services within the amounts projected. However, it is unlikely that the District will operate over the next several years without program initiatives. Should this occur, the District would be operating on a narrower positive margin indeed. All this suggests that the District needs to maintain and improve its financial diligence in managing its resources and look for ways to improve services through business process improvement rather than additional program spending. It also suggests that, despite current positive trends, there may be a long-term structural imbalance in the District's financial situation that ultimately will have to be remedied. I will return to this issue later.

Key Components of Financial Viability

The District needs to maintain its financial viability at three distinct levels.

Financial Viability. First, on a week-to-week, month-to-month basis, the District needs to understand costs and their sources, revenue flow from various sources, and meet payroll and other operating costs just like a business. The District has not always done this. Speaking as a financial manager, one key benefit of the control period was that it gave the District both the requirement and incentives to greatly improve its capabilities in this arena.

During the control period, the District made improvements in consolidating and standardizing budget and accounting controls. Information on its cash position improved greatly. We no longer "call the bank" to find out how much money we have, but are able to reconcile our cash balances on a monthly basis. Revenue accounting improved immensely and will soon approach best practice levels once the Integrated Tax System is fully implemented in FY 2002. Internal controls over financial transactions need substantial improvements, but are still light years better than when the control period began in 1995.

Borrowing practices have similarly improved. With the securitization of tobacco settlement payments and other debt retirement actions, the District reduced its overall debt load from $3.21 billion to $2.76 billion between Sept. 30, 1999, and the present, and on a per capita basis from $6,177 to $4,819.

We still have much to do in building the type of information systems infrastructure and procedures needed to move quickly to respond to changing programmatic or financial conditions. I have testified before the Council of the District of Columbia that we must work to interface the procurement and personnel systems with the financial system, if we are to have the type of real-time information needed in today's environment to manage an enterprise the size and complexity of the District government. Also, now that we have implemented our new System of Accounting and Reporting (SOAR) and worked out the operational details, we need to build out its full capabilities of fixed asset accounting and performance budgeting. Both efforts are underway. We also need to use the budget monitoring capabilities of SOAR to drill down into the organization to isolate organizational and program costs so that performance standards and spending expectations can be matched with available revenues.

Fiscal Viability. The second level of financial viability is at the year-to-year level. Starting this year, the District is building a rainy day fund in the form of two cash reserves provided for in the FY 2001 DC Appropriations Act. When fully funded, an event projected for FY 2003, the District will have a cash fund equivalent to 7% of local annual expenditures (nearly $260 million) to deal with emergencies and unforeseen economic downturns similar to that of many other jurisdictions. It will also have a fund balance well over a half-billion dollars that will rise to well over three-quarters of a billion dollars by FY 2005.

The Council of the District of Columbia has directed that it receive a tax expenditure budget from the OCFO. This budget will identify the cost of tax preferences so that, in establishing spending programs and making tax decisions, it can weigh the costs of its current tax expenditures against other competing needs.

Despite these positive steps, we have much work to do. Budget modeling remains an area in need of major improvement despite the steps that have been taken over the past few years. The City Administrator's office and the OCFO have undertaken a joint project to build out the capabilities of SOAR to track costs in great program detail and to tie this cost tracking to specific program or work plan expectations at a comparable level. This Account Structure/Performance Budgeting Project will provide for the first time the kind of detailed financial information necessary to see what the District is getting for what it spends. With this information, agency and unit work plans will be tied to a corresponding financial plan. We will be able to hold managers accountable for both their program and financial performance just as in a private business.

However, much of what is needed to drive good budget modeling requires a link between the District's personnel systems and the financial system. Personnel costs account for about one-third of the District's gross operating costs, and we know little about what drives them – promotions, with-in grades, attrition, vacancies. The first task that must be undertaken before this can be accomplished is to rationalize the District's personnel system, which over the years has devolved into a series of independent systems with multiple pay tables, work rules and other distinctions.

Grants management is also an area in need of close monitoring. The District needs to ensure that it is taking advantage of opportunities to avail itself of federal funds while closely tracking and accounting for the expenditure of those funds once received.

Finally, I believe the District needs to work with the Congress to address the degree of financial flexibility it has permitted the District. For example, the District is on a path to build a 7% cash reserve – above average for jurisdictions that have such reserves. But at the same time, it is still required to have an additional $150 million in reserves that are budgeted each year. Also, while the District has built a substantial fund balance from its annual surpluses, and will continue to do so under current law, it does not have the capability common in other jurisdictions to draw on these balances for its budget. The District also has no way of certifying and allocating additional revenues that may be estimated, either one-time or recurring, once its budget has been submitted to the Congress – except through the time-consuming supplemental appropriations process. This area particularly needs to be addressed as we move to the post-control period.

Economic Viability. The third level of financial viability is long-term. I foresee a time within the next few years when the District will have effective controls over all operating spending. We will be able to describe costs down to the first or second line in the organization and be able to relate those costs to program outputs. Budgets will be built using effective standards and cost models. Production of financial statements on a monthly and annual basis will be a routine matter. We will have reduced the number of District bank accounts from 1,500 to approximately 300 by the end of FY 2002, and will be able to forecast our cash flow with great accuracy. Despite having reached this high plateau of performance, there will remain, unless otherwise addressed, a structural imbalance that may cause District expenditures to exceed revenues.

This imbalance has been well documented. For example:

- Tax exemptions from federal commercial activity reduce District revenue by as much as $193 million;
- The District provides as much as $339 million in public services to support federal property, which comprises over 40% of District property by area;
- Lacking a state or state-like support from the federal government, the District spends as much as $588 million per year on state-like functions; and,
- The District can tax only 34% of income earned in the District.

The federal assumption of certain pension liabilities and court and prison functions was an important step in correcting this imbalance, but only a step. Most financial analysts would conclude that the District government is a going concern in a good economy, but will face major problems in any serious or sustained economic downturn. As important as good government and financial prudence is, it cannot by itself overcome the fundamental imbalance the District now faces.

The long-term solutions to this imbalance are matters to be addressed by District and congressional policy-makers. Federal tax incentives may be part of the answer. Adjusting restrictions on the District's local taxing capabilities to reflect the structure of today's economic and residential patterns might be another. Delegate Norton in the past has sponsored legislation to enact a nonresident wage tax with a corresponding federal tax credit, and may do so again. Further addressing the federal/local partnership for providing city services is yet a third path that could be explored.

At the same time, there are steps that the District can take to improve its economic posture on its own. Both the Tax Parity Act and the Tax Clarity Act were first steps in this direction, but the DC Code can be made more business friendly. The District's tax expenditures might be reviewed and streamlined. Also, consideration should be given to creating the District equivalent of the federal Budget Enforcement Act, under which pay-as-you-go rules would apply whenever proposed legislation has not been scored and incorporated in the District's approved, multi-year financial plan.

The Office of the Chief Financial Officer in the Post-Control Period

For the past five years, my predecessors as chief financial officer and I have been engaged in facilitating a fundamental change in the financial management of the District. It takes some time for a culture of fiscal and financial discipline to be created. Making significant change takes time, commitment and perseverance. The provisions of the Authority Act, and related subsequent legislation, provided the framework for effecting such change. It is my view that the body of law that has been established to improve District financial management should be carefully reviewed so that those portions that have facilitated the financial turn-around can be retained in organic statute. In this respect, positive action on the part of District and congressional policymakers will be required. Otherwise, with the dormancy of certain provisions of P.L.104-8, the provisions of prior law, either federal or District, will take effect by default.

I agree with the Mayor, the Council, and the Authority that it is important for the OCFO to be able to make financial judgments and share information without prior restraints or approval. The District's business community and the financial markets in New York are particularly sensitive to these issues. For the post-control period, I believe that changes made to the Home Rule Act in the FY 2001 DC Appropriations Act have gone a long way toward creating the environment necessary for this independence in the post-control era.

At the same time, I believe the OCFO can discharge its financial management responsibilities without being independent from the District of Columbia government in the same sense that the Authority is independent. We have already begun the process of reintegrating OCFO processes into the broader management systems of the District. For example, we are working with the Chief Technology Officer on information technology decisions, we participate directly in the overall executive department governance meetings, and in most cases we act in parallel with other components of the District government on such issues as pay and personnel policy. We are also working closely with the City Administrator on restructuring the District's system of accounts and the introduction of performance budgeting.

We are an "equal opportunity" sharer of information and analysis, working with both the Office of the Mayor and the Council. The OCFO is a resource for both the executive and legislative branches as well as outside stakeholders such as bondholders and the Congress. Because of this, and in light of the past financial history of the District, my opinion is that the District would be served best by an independent CFO.

This needs to be done in congruence with the District's cherished Home Rule and in a manner where the OCFO is the scorekeeper, so to speak, of the financial process rather than gatekeeper, a role played by the Authority. To me, the way to accomplish this is to place the CFO in the role of transparent developer and certifier of financial numbers – revenue estimates, fiscal or contractual impact statements, budget formulation cost estimates, and budget execution monitoring. With this type of system in place, the OCFO can play a role similar to that of the Congressional Budget Office with respect to assessing revenues and reviewing the costs of legislation. Policy officials can focus on the direction of government knowing the financial constraints within which they must operate and that these constraints have been established by a non-partisan body without a stake in policy outcomes. Prior to the control period, too often financial constraints were tailored to fit the desired policy outcome rather than the reverse.

Financial management in the District of Columbia is clearly a work in progress. The recently published GAO report on Weaknesses in Financial Management Systems Implementation points to many of the matters we must address, and we are doing so, as I testified last month before Congress. In the context of today's hearing, we must remember that financial improvements do not exist in a vacuum. In many instances, a necessary precondition for making significant improvement in financial systems is a complementing business process improvement elsewhere in the District government. To effectively interface procurement actions with SOAR, procurement controls need to be automated. To acquire a new payroll system at reasonable cost, the personnel system needs to be streamlined. To implement performance budgeting, program managers must institute a work planning process that identifies cost centers and related measures. These are all areas the District is addressing. This is another reason that continuity of operations in the financial governance structure is important.

Madame Chair, Mr. Chairman, this concludes my testimony. I would be pleased to answer any questions you may have.