July 11, 2001
U.S. Senate Committee on Appropriations
HEARING ON THE FY 2002 BUDGET FOR THE DISTRICT OF COLUMBIA

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

Good afternoon, Madam Chairwoman, Senator DeWine, Congresswoman Norton and members of the Subcommittee. I am Natwar M. Gandhi, Chief Financial Officer for the District of Columbia, and I am here to testify about the District's FY 2002 budget. My remarks will briefly touch on the FY 2001 supplemental, the FY 2002 budget request and process improvements in its formulation, planned improvements for the FY 2003 budget cycle, and two proposals that would help improve the District's overall financial picture.

Overview

When I was confirmed as the Chief Financial Officer just over a year ago, I noted three overarching goals that had to be achieved for my office to be successful: (1) obtaining a clean opinion on schedule from the District's independent auditor for FY 2000 and all subsequent years; (2) ensuring a balanced budget; and (3) providing effective, efficient financial systems and business methods to support the decision processes of District policymakers. Since then, we have met the first two goals and made progress on the third, although additional improvements are needed and possible. In addition, we have completed the securitization of the District's tobacco settlement funds and achieved a round of bond upgrades from all three rating agencies.

The District's FY 2001 Budget Supplemental

Before I turn to the FY 2002 budget, let me thank our House subcommittees and the House, and our Senate subcommittees and the Senate, for your positive action on the District's FY 2001 supplemental.

The District's FY 2002 Budget

Now I will turn to FY 2002. In total, the District's budget for FY 2002 as amended is $ 5.3 billion from all funding sources, which represents an increase of about $ 439 million or 9% over approved FY 2001 levels, or an increase of about $283 million or 6% over revised FY 2001 levels. The total number of positions in FY 2002 from all funding sources is 33,364, which represents a decrease of 1,016 positions or 3% from approved FY 2001 levels.

The budget for the District projects positive net operating margins through FY 2005. This projection appears to show a positive financial picture, and is based on a revenue forecast built using realistic economic and demographic assumptions generally accepted by the forecasting community and used by the federal government. We can safely say these estimates represent a professional consensus view.

But a closer examination suggests the District is operating on a much tighter financial margin. While we believe the costs of maintaining current services can be kept within the amounts projected, it is unlikely the District will operate over the next several years without program initiatives or finding a reason to tap its budget reserves. Should either of these likely events occur, the District would be operating on a very thin positive margin. This means the District needs to continue to build financial diligence in managing its resources and looking for ways to contain costs, while improving services through new business processes instead of additional spending. It also suggests a long-term structural imbalance in the budget that needs to be addressed, as I will discuss later.

Development of the FY 2002 Budget

The role of the Office of the Chief Financial Officer (OCFO) in the budget process is to provide timely, quality analyses and alternatives built around the policy interests and directions of elected officials. The Office of Budget and Planning (OBP) leads this effort, and was quite successful in assisting both the Mayor and the District Council in the formulation of the FY 2002 budget now before the Subcommittee.

This success was the result of many improvements, including the following:

- instituting structured, advance consultation and information-sharing with the Mayor and the Council;
- estimating the effects of key budget drivers, such as salary increases, inflation, and non-recurring items, more precisely;
- eliminating unspecified savings in favor of identified savings in particular agencies that were achievable and were included in those agencies' baseline budgets; and
- costing fully program initiatives and legislative changes.

In addition, and in a larger sense, the Office of Budget and Planning has made great strides in working with the Mayor and the City Administrator to enhance "truth in budgeting," so that the budgets presented to the Council and the Congress are realistic and can be delivered for the District's citizens.

Improvements for the FY 2003 Budget
We have already begun planning for additional improvements to the budget process for FY 2003. We will devise a plan for Mayoral and Council approval that will implement performance-based budgeting, while at the same time streamlining the reprogramming process. A new account structure will ensure that we capture accounting information at levels necessary to monitor spending effectively and build budgets more accurately. This will provide the kinds of information the recent GAO report on our financial management system noted are not now available.

On April 26, the City Administrator and I signed a memorandum to all agency directors and agency CFOs officially beginning the transition to performance-based budgeting. This multi-year effort will begin in the FY 2003 budget cycle. We believe this new approach, once implemented, will improve policy development, service delivery, and accountability for District programs.

Structural Imbalance in the District Budget
I believe 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 sources of this imbalance are well known and documented:

- the District provides as much as $227 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 $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, 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. 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 equitably compensate the District 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.

Change in the District's Reserve Policy
Today, the District has $102 million in its cash reserves, an amount projected to grow to nearly $260 million by the end of FY 2003. Now that the District is building cash reserves, and will have an accumulated fund balance (representing an accumulated excess of revenues over expenditures) of over 3/4 of a billion dollars by FY 2005, we would like to revisit the requirement that the District have an annual budgeted reserve of $150 million. This is prudent because the growing cash reserves lessen the need for

the budgeted reserve, and because removing the budgeted reserve provides the elected leaders with greater flexibility to manage the city.

Existing District reserve requirements – both budgeted and cash – total about 11% of local funds. By contrast, median state reserves are only 3.5% of total expenditures and are generally held as fund balances, and a common benchmark reserve rate for cities is 5% of operating expenditures. Our proposal would ultimately set the District's combined cash reserves at over 8%.

The proposal for your consideration is to phase out the budgeted reserve, beginning with a reduction in FY 2002 and concluding (as already scheduled) in FY 2004. At the same time, we would establish a new $50 million operating cash reserve in FY 2004. The new cash reserve would be held at the $50 million level, and be replenished as needed. Funds in this new reserve would be available as certified by the CFO.

We believe this new structure would provide the District with much needed financial flexibility for the future, and we urge your consideration of it.

Conclusion
Madam Chairwoman, this concludes my prepared remarks. I request that this testimony be made part of the record. I will be pleased to answer any questions you or the other subcommittee members may have.