June 11, 2002
US Senate
HEARING ON THE BUDGET REQUEST OF THE DISTRICT OF COLUMBIA FOR FISCAL YEAR 2003

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

Good morning, Chairwoman Landrieu, 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 today to testify on the District's FY 2003 budget request to the Congress. My remarks will briefly touch on the FY 2002 financial outlook and supplemental, the FY 2003 request, and the structural imbalance that threatens the District's long-term financial viability.

Overview
As the chief financial officer, my major responsibility is to ensure the overall financial viability of the District of Columbia in the short-, mid-, and long-term. In the past year, we have enjoyed some notable successes, including the fifth consecutive "unqualified" (or clean) opinion from the city's independent auditors, with the FY 2001 Comprehensive Annual Financial Report (CAFR) completed ahead of time and with a balanced budget. Overall, the city ended FY 2001 with a surplus of $77.6 million and a positive fund balance of $562.2 million. In FY 1996, there was a negative fund balance of $518 million, so we have witnessed a turnaround of over a billion dollars since then. This result is another milestone for the financial turnaround that began in the FY 1997 CAFR and is a fitting beginning for the District's return to Home Rule last October 1.

I believe we are in a good position to continue this progress. We have instituted several changes in financial systems that will give us a much better picture of our financial posture as we go through the year, and for FY 2003 we plan to apportion the budgets of the city's largest agencies. At the end of FY 2001, we had $100.8 million in cash reserves available; this now has grown to nearly $151 million. We expect this amount to grow to about $250 million by the end of FY 2002. Along with the fund balance noted earlier, these steps should solidify the District's improved bond ratings and contribute to lower borrowing costs in the future.

We have made progress on other fronts as well. This year, for the first time, the District of Columbia's "Comprehensive Financial Management Policy" appears as an appendix of the budget submission. This policy, required annually by the FY 2001 District of Columbia Appropriations Act (Public Law 106-522), is actually a compilation of policies in key areas and a financial management tool that codifies current policies and procedures. It will be updated annually.

Effective with the FY 2003 budget development process, we began the transition to performance-based budgeting. With the active support of the Office of the City Administrator, seven large operating agencies, including the OCFO, submitted performance-based budgets based on agency strategic business plans aligned with the mayor's citywide strategic plan. For the FY 2004 budget process, we anticipate converting another 20 agencies to performance-based budgeting.

In the area of payroll operations, we have moved all agencies except Fire and Emergency Medical Services back to the UPPS payroll system. This agency will be converted before the end of the fiscal year. A long-term replacement strategy for the payroll system and its integration with other administrative systems has been developed as part of the Administrative Services Modernization Program, spearheaded by the Office of the Chief Technology Officer.

Over the next two years, all of the District’s administrative systems – personnel, payroll, pension operations, procurement, property management, and budget – will be upgraded and integrated with the System of Accounting and Reporting (SOAR). For the first time, this will give the District a top quality, integrated information system with which to manage District operations. Now that we have two years of operating experience with SOAR, we are utilizing more of its capabilities.

FY 2002 Financial Outlook
Year-to-date spending pressures for FY 2002 are estimated at $283 million. Through various actions (use of reserves, reprogrammings, agency gap-closing plans, and the proposed supplemental appropriation), the District has resolved $250 million of the spending pressures. The remaining $33 million will be addressed through the District's budgeted reserve. Thus, I am confident we will end the year with a balanced budget.

The District submitted a FY 2002 supplemental budget request consisting of $37 million in appropriation authority changes and a set of language provisions to clarify the intent of Congress in selected areas. The Council of the District of Columbia passed the supplemental on April 9. The full committee reported out the supplemental on May 22, and it passed the Senate on June 7. We want to thank you for your leadership and support on the District portion of it.

FY 2003 Budget Request
The Council of the District of Columbia voted to approve the FY 2003 budget request on May 7, and copies of the budget documents were recently made available. I would like to briefly summarize some of the key points in the request.

In total, the District's general fund operating request for FY 2003 is $5.7 billion from all funding sources (local, federal, private, and other), which represents an increase of about $402 million, or 8 percent, over approved FY 2002 levels. The total number of positions in FY 2003 from all funding sources is 33,958, which represents an increase of 708 positions, or about 2.1 percent.

In local funds, which comprise about two-thirds of the total budget, the FY 2003 budget request is about $3.8 billion, an increase of about $209 million, or 5.9 percent, over approved FY 2002 levels. The total number of positions funded with local funds is 26,846, an increase of 524 positions, or 2.0 percent.

The District's expenditure growth since FY 1999 has been concentrated in several large agencies. The overall growth rates of expenditures in FY 2000 (over FY 1999) and FY 2001 (over FY 2000) were 8.9 percent and 10.8 percent, respectively. However, an analysis shows that the District's expenditure growth has been driven by four agencies – the DC Public Schools, the Public Charter Schools, the Department of Mental Health, and the Public Benefit Corporation subsidy (plus transition costs in FY 2001) – where expenditure growth was 28.5 percent and 29.3 percent in FY 2000 and FY 2001, respectively. These rapid growth rates are attributable to rising enrollments in Public Charter Schools, and, in the other three agencies, to Medicaid and other costs related to the health care needs of the District's low-income citizens. Outside of these four agencies, expenditures grew by only 2.5 percent in FY 2000 and 3.1 percent in FY 2001, aided in part by reductions in debt service. During this same period, the Consumer Price Index for the Washington Metropolitan Area grew by 3.1 percent and 2.9 percent, respectively.

As you will see, the budget projects positive net operating margins through FY 2006. This projection shows a positive financial picture and is based on revenue forecasts that use realistic economic and demographic assumptions generally accepted by the forecasting community and the federal government.

However, a closer examination of the data suggests that the District is operating on a much slimmer financial margin. While we believe the costs of maintaining current services can be kept within projected amounts, it is unlikely the city will operate over the next few years without program initiatives. Further, as we have seen recently, it has been necessary to use reserve funds. While revenues grew by 7.4 percent annually between FY 1999 and FY 2001, the District now likely faces a more slowly rising revenue curve, as financial markets return to more normal patterns and the frenzied pace of property renovations lets up. For these reasons, the city and its elected leadership will face difficult program and financial decisions in the years to come. For these same reasons and others, we believe there is a structural imbalance in the District's budget that needs to be addressed.

Structural Imbalance in the District's Budget

The "structural imbalance" is the difference in the long-term between the District's unreimbursed expenditures and its constrained revenue base. Working together, the elected officials of the District must find ways to balance expenditure needs with revenue requirements, in order to balance the city's budget and ensure that the control board does not return. This involves some very difficult decisions, due in significant part to the unique status of Washington, DC, and the challenges related to that status.

Others external to the District have looked and continue to look at the structural imbalance. The Federal City Council commissioned McKinsey & Company to independently assess the District's financial position. Their report, issued in March 2002, stated, among other things, that federal constraints impose an annual opportunity cost of at least $500-$600 million. As you know, both the General Accounting Office and the Congressional Research Service are conducting separate analyses of the city's financial structure.

What we already know is that the recent recession forced cities and states across the country into difficult budget decisions. Cities and states have dipped into rainy day funds, delayed tax reductions, and implemented service cuts. For cities, the economic downturn compounds other recent fiscal challenges. While the population of states rose by an average of 13.1 percent in the 1990's, the population of the largest 27 cities grew by a slower rate of 8.5 percent. While states provide services to a resident base with a poverty rate of 11.3 percent, cities provide services to a resident base with a poverty rate of 17.9 percent. And while the federal government and state governments experienced revenue growth of 136 percent and 97 percent respectively between 1988 and 2001, cities – which rely on revenue sources such as property taxes, which generally do not keep pace with the economy – experienced more modest growth of 69 percent. In the District, growth over this period was 34 percent. Excluding the federal payment, District revenues grew by 58 percent over this period, lower than the other jurisdictions.

In each of these three cases – population growth, poverty rate, and revenue growth – the District performed more poorly over the past decade than cities overall and the states. In the District of Columbia, the pressures facing all levels of government generally – and all cities particularly – are extenuated by restrictions on the District's revenue base and expenditure requirements reflective of the District's unique status as the nation's capital.

The revenue base is constrained because:

- 66 percent of the income earned in the District cannot be taxed by the city, meaning that 34 percent of the District's income tax base subsidizes the public services that the District provides its nonresident workers;
- 42 percent of the real property in the District is owned by the federal government and is exempt from city taxation;
- 11 percent of other real property in the District also is exempt from taxation; and
- District buildings have federally-imposed height restrictions, which reduce population and economic density, as well as property tax revenues.

The District also provides services beyond its capacity. For example:

- Services to the federal government, such as public works and public safety, are valued at $240 million in a normal year and more in times of crisis; between FY 2002 and FY 2006, this is estimated at $1.2 billion.
- Services of a state-like nature, such as human services, mental health, and the University of the District of Columbia, are valued at $500 million a year; between FY 2002 and FY 2006, this is estimated at $2.6 billion. These services are in addition to those absorbed by the federal government through the 1997 Revitalization Act.
- Services to the region, such as the 400,000 out-of-District vehicles that drive in the city every day – and represent 70 percent of traffic on District roads during business hours – but do not contribute to road repairs are valued at $150 million a year; between FY 2002 and FY 2006, this is estimated at $0.75 billion.

While these expenditure and revenue pressures are not unique to Washington, they represent a special challenge here, due to the District's limited ability to address them, because:

- District tax rates and burdens on both households and businesses already are high in comparison to neighboring jurisdictions when considering the complete menu of taxes – sales tax, income tax, property tax and business taxes. The individual income tax burden in the District is 34 percent higher than Virginia, and the city's real property tax burden is 15 percent higher than Alexandria.
- The District's capacity to borrow funds is limited, with a per-capita debt of $4,651, second only to New York City's per-capita debt of $4,664. Due to planned capital spending, the District's per-capita debt will rise steadily through FY 2006 to an estimated $6,531. Even that level of capital spending does not address all of the urgent infrastructure needs, particularly roads, Metro expansion, and the DC Public Schools. Deferring investments in infrastructure can cause crisis-like pressure on operating spending.
- Local fund expenditures also are constrained. Of the nearly $3.8 billion in budgeted expenditures, less than $1.5 billion is available for discretionary purposes. The remaining expenditures are mandatory, in the sense that they are required to fulfill financial or contractual obligations or to comply with federal or local legislation or court order. Even within the discretionary total of less than $1.5 billion, most is required to provide a basic level of municipal services, such as police, fire, and public works.

The long-term solution to the structural imbalance is a matter to be addressed by District and congressional policy-makers. Passage of the Federal Fair Compensation Act of 2002 (HR 3923), as introduced by Congresswoman Norton, would certainly improve the city's ability to service its residents as well as its non-resident workers. In the absence of this act, a dialogue must continue that revisits the federal/local partnership and arrives at a long-term solution for equitable support of District services.

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 members may have.