

**HEARING
ON THE
BUDGET REQUEST OF THE
DISTRICT OF COLUMBIA
FOR FISCAL YEAR 2004**

**Before the
Subcommittee on the District of Columbia
Committee on Appropriations
U.S. Senate**

The Honorable Mike DeWine, Chairman

**June 11, 2003; 10:00 a.m.
Room 192, Dirksen Senate Office Building**



**Testimony of
Natwar M. Gandhi
Chief Financial Officer
Government of the District of Columbia**

Good morning, Mr. Chairman, Senator Landrieu, 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 2004 budget request to the Congress. My remarks will briefly touch on the FY 2003 financial outlook, the FY 2004 request, and the structural imbalance that threatens the District's long-term financial viability.

Overview

As the Chief Financial Officer, my 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 sixth consecutive "unqualified" (or clean) opinion from the city's independent auditors, with the FY 2002 Comprehensive Annual Financial Report (CAFR) completed ahead of time and with a balanced budget. Overall, the city ended FY 2002 with a general fund surplus of \$27.4 million, and a positive general fund balance of \$865.3 million. In FY 1996, there was a negative fund balance of \$518 million, so we have witnessed a turnaround of over \$1.3 billion since then. Even allowing for the restatements necessary to conform our financial reporting to the new requirements of Governmental Accounting Standards Board (GASB) Statement Number 34, this result is clear evidence that the District is qualified for Home Rule.

I believe we are in a good position to continue this progress. We instituted several changes in financial systems that will give us a much better picture of our financial posture as we go through the year. We successfully implemented GASB 34 on time with minimal outside assistance. During FY 2003, we began to implement

standardized spending plans and to report actual performance against those plans using CFO\$ource, a new online financial management tool for controlling agency budgets. At the end of FY 2001, we had \$100.9 million in cash reserves; this amount grew to \$248.7 million by the end of FY 2002, and will increase to nearly \$254 million by the end of FY 2003 to remain at seven percent of total local expenditures. These reserves were fully funded five years before the legislative deadline. Along with the fund balance noted earlier, these steps solidified the District's bond ratings and led Moody's to upgrade their outlook on the District's \$3 billion in general obligation bonds from "stable" to "positive". This is particularly significant at a time when rating agencies are downgrading or looking negatively at numerous states and localities. We hope our positive outlook will lead to a ratings upgrade later this year, which would contribute to even lower borrowing costs in the future.

We have made progress on other fronts as well. This year, for the second 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 is 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 worked

with another 27 agencies (the remainder of the Mayor's cabinet) to convert them to performance-based budgeting.

A long-term replacement strategy for the District's payroll systems and their integration with other administrative systems has been developed as part of the Administrative Services Modernization Program (ASMP), spearheaded by the Office of the Chief Technology Officer. Over the next two to three years, all of the District's administrative systems – personnel, payroll, 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 three years of operating experience with SOAR, we are utilizing more of its capabilities. We already have an Integrated Tax System, rated as among the best in the country by the Federation of Tax Administrators, and the District is the first city to offer free online tax filing and the only city to provide account balances via the Web.

FY 2003 Financial Outlook

Through the leadership and cooperation of our elected officials, the District made the necessary tough decisions to assure a balanced budget for FY 2003.

As of early June, remaining spending pressures for FY 2003 are estimated at \$50 million, primarily driven by higher utilization costs for the Health Care Safety Net. This amount will be addressed. I am confident we will end the year with a balanced budget.

I want to thank you, Mr. Chairman, and you, Senator Landrieu, and the subcommittee members and staff for your leadership and support on the District's portion of the FY 2003 budget supplemental that was enacted in April of this year.

FY 2004 Budget Request

The Council of the District of Columbia voted to approve the consensus FY 2004 budget request on May 6. Copies of the budget documents have been distributed, and CD-ROMs will be made available shortly. I would like to briefly summarize some of the key points in the request.

In total, the District's gross fund operating request for FY 2004 is \$5.69 billion, which represents an increase of about \$119 million, or 2.1 percent, over approved FY 2003 levels. The total number of positions in FY 2004 from all funding sources is 33,867, which represents an increase of 233 positions, or less than one percent.

In local funds, which comprise about two-thirds of the total budget, the FY 2004 budget request is about \$3.83 billion, an increase of about \$230 million, or 6.4 percent, over approved FY 2003 levels. The total number of positions funded with local funds is 26,245, a decrease of 150 positions, or less than one percent.

Over the four-year period from FY 1998 to FY 2002, the District's local fund expenditures increased by 6.1 percent annually, or a total of \$741 million over this period, from \$2.768 billion in FY 1998 to \$3.509 billion in FY 2002. Of this \$741 million increase, \$621 million (nearly 84 percent) came in two areas: \$316 million for the D.C. Public Schools and the Public Charter Schools, and

\$305 million for the Departments of Human Services, Mental Health, and Health, and the Child and Family Services Agency (all of which were part of the Department of Human Services in 1997). At these six agencies, expenditures increased at a rate of 11.1 percent annually over the past four years. Expenditures in all other District agencies combined increased by \$120 million, or 1.8 percent annually, over the same period.

As you will see, the budget projects positive net operating margins through FY 2007. 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 close examination of the data suggests that the District is operating on a slim financial margin. Fortunately, we expect local revenues to begin to grow in FY 2004, after the decline and stagnation of the past two fiscal years. But the growth that can be expected is nothing like the 7.4 percent annual change between FY 1999 and FY 2001. The District now faces a more slowly rising revenue curve, as financial and real estate markets return to more normal patterns, generating revenues that are expected to grow around 4.5 percent per year. We believe that it will be challenging for this revenue to sustain our current level of service, and there is no room for consideration of additional program initiatives, significant infrastructure investments, or tax cuts. For these reasons, the city and its elected leadership will face difficult program and financial decisions in the years to come. One of the reasons for the difficulty is a structural imbalance in the District's budget that needs to be addressed.

Structural Imbalance in the District's Budget

Over the past several years, the District has submitted balanced and responsible budgets during periods of increasing as well as stagnating and declining revenues. Our restrained budgeting in the good years helped us work through some of the hard times in FY 2002 and FY 2003. For FY 2004, the District is submitting a balanced budget in a particularly challenging economic environment, a testament to the ability of the District's elected leaders to manage through difficult times. However, despite this balanced budget, and despite the surpluses the District has generated over the past six years, the District has a serious long-term financial problem – a structural imbalance that transcends short-term challenges and cyclical revenue fluctuations. This structural imbalance is a long-term gap between the District's ability to raise revenue at reasonable tax rates and the District's ability to provide services of reasonable quality to its residents. It is driven by expenditure requirements and revenue restrictions that are beyond the control of District leadership.

Several outside assessments of the District's financial condition have affirmed the presence of this imbalance. In March 2002, a McKinsey & Company report funded by the Federal City Council stated, among other things, that federal constraints impose an annual opportunity cost of at least \$500 to \$600 million. In October 2002, Alice Rivlin and Carol O'Cleireacain of the Brookings Institution assessed the District's relationship with the federal government and concluded that a strong rationale exists for additional federal financial assistance to the District. And just last week, the General Accounting Office (GAO) released its final report, thoroughly assessing the District's financial structure and corroborating the existence of a structural deficit in the District's finances.

Economic changes have lead other jurisdictions to begin identifying structural issues as well, and the District shares in the breadth and depth of problems facing most states and localities. In addition, however, the District's structural imbalance is more extreme, driven by the unique set of services provided by the District and the unique set of restrictions that limit the District's revenue raising capacity. I have testified to these requirements and restrictions on several occasions. In the District, we provide city services, state services, county services and even the services of a school district; we provide public safety and public works services to the federal government itself. We do all this with an artificially constrained tax base. We cannot tax the income of people working in the District and living elsewhere, a restriction faced by no state. We cannot tax 42 percent of the property value within the city because it is owned by the federal government. We cannot count on high-density property to make up for our limited taxable property because of the height restrictions on District buildings.

The cumulative effect of these requirements and restrictions is that the District faces a long-term structural imbalance, whereby it is unlikely that we can provide a standard quality and range of services to our citizens, even with tax burdens that exceed those elsewhere. This imbalance manifests itself in many ways:

- The District's per capita expenditure requirements are very high. We face high per capita expenditure requirements because we provide public services in a market with high labor costs; we provide services to a large commuter population; and we have many residents with high service needs. On top of these cost drivers, the District provides about \$500 million in services of a state-like nature, and we provide millions of dollars of services as host to the nation's capital. Although the District certainly has the potential to improve the

efficiency of operations, the District's higher costs are determined by factors beyond our control and cannot be offset entirely by improved service delivery.

- The District compensates for its very high expenditure requirements with taxes that are very high. The District's tax effort is among the highest, if not the highest, in the nation. The need for high taxes is driven further by restrictions on the District's ability to tax income earned in the District and a significant portion of the property within the District.
- The structural imbalance is not just a reality facing the District's operating budget. The imbalance contributes to a significant capital budget and infrastructure problem as well. The District faces an accumulated infrastructure backlog of \$2.5 billion, which has not been funded in recent capital improvement plans. The District continues to defer capital investment to avert the operating costs associated with debt service. The problem is acute because additional borrowing could raise outstanding debt to levels that adversely affect the District's credit rating.

When it comes to addressing the structural imbalance, we have few options. Increasing the tax burden on District businesses and residents even further could have an adverse impact on total receipts, because it could influence potential and current residents or businesses to locate in adjacent, lower-tax states. Given the structural imbalance, the District must choose between tax levels that are even higher than the national average, service levels that are lower than the national average, or combinations of both.

An alternative solution is federal compensation for the District's unique relationship with the federal government. Not only does the District provide unreimbursed services to the federal government and fund itself with a federally

restricted tax base, but the federal government has a strong interest in a fiscally secure District of Columbia. Ultimately, the long-term solution to the structural imbalance is a matter to be addressed by District and congressional policy-makers. A dialogue must continue that revisits the federal/local partnership and arrives at a long-term solution for equitable support of District services.

It is my hope that the recent GAO report helps Congress and the District move beyond questions of whether there is a structural imbalance to questions of how the federal government and District government can work together to address this problem. And this problem must be addressed with urgency to ensure the long-term financial viability of the nation's capital city.

Conclusion

Mr. Chairman, 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.

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