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Council of the District of Columbia
PUBLIC HEARING ON FISCAL YEAR 2003 BUDGET GAP CLOSING MEASURES

Testimony of Natwar M. Gandhi, Chief Financial Officer

Before the Committee of the Whole

Good morning, Chairman Cropp and members of the Committee. I am Natwar M. Gandhi, Chief Financial Officer of the District of Columbia. With me today are Dr. Julia Friedman, deputy chief financial officer for Research and Analysis, and Bert Molina, deputy chief financial officer for Budget and Planning. All of us will be available to answer any questions you or the other members may have at the conclusion of my testimony.

My testimony today will provide a context for taking steps to balance the FY 2003 budget of the District of Columbia, in light of the most recent revenue forecast. That forecast, as you know, projects a drop of about $323 million in revenue compared to the earlier revenue estimate that served as the basis for developing the FY 2003 budget this past spring.

Revenue Shortfall
Revenues for FY 2004 through FY 2006 are also significantly lower than previously estimated, suggesting strongly that we are faced with a significant, long term shift in the trajectory of District fiscal resources. Cumulatively, over the FY 2003 through FY 2006 period, we now estimate that, based on current law, total local source revenues will be approximately $1.3 billion lower than projected at the time the FY 2003 budget was formulated.

The shock of last September’s terrorist attack, coupled with a nationwide recession, initially caused the District’s sales tax revenues to fall. Year-to-date sales tax revenues for October 2001 were $13 million, or 24 percent, lower than the same period for the previous year. The continuation of the recession is now having a serious negative effect on individual income tax and business franchise tax collections.

This is part of a nationwide trend being experienced by state and local governments. For the District, the first revenue declines were experienced in sales and occupancy-based taxes, as people curtailed spending. The second wave of revenue drops is now being felt in the income tax and franchise tax areas. Almost all jurisdictions are finding the impact greater than originally forecast, as actual data on tax collections become available. In the District, after adjusting for one-time payments, underlying tax revenue declined this year by 8 percent. To put this in perspective, federal income tax revenue this year experienced the largest single year percentage drop in 56 years. These declines reflect a decrease in capital gains tax collections, which is understandable when you realize that since January of this year, the major stock market indices – the Dow Jones Industrial Average, the NASDAQ, and the S&P 500 – have experienced declines of 21%, 39%, and 27%, respectively. In 2001, these same indices declined by 8%, 30%, and 16%, respectively.

Structural Imbalance Status
A major issue for the District is that its solutions for dealing with the problem are curtailed by its structural imbalance between revenues and expenditures, an issue that we have been raising for over three years with various stakeholders. On the one hand, we have the programmatic obligations of a municipality, a county and a state, and cannot walk away from these obligations. We are also the nation’s capital and this status, in and of itself, carries with it certain cost consequences not borne by other US jurisdictions. On the other hand, we are restricted by federal statute from many revenue options that would otherwise be available to a state or municipality to resolve a long-term financial imbalance.

This is an issue that has been raised at the highest levels with both the federal executive and legislative branches. At the direction of the Congress, the matter is under review and study by both the Congressional Research Service and the General Accounting Office. However, the District cannot count on any change in the current relationship between the federal government and the District in this arena.

To avoid a return to a control period, it is imperative that the District maintain a balanced budget at the end of each fiscal year, and maintain a healthy cash position to meet its obligations on a timely basis.

Mandatory Spending

Our analyses strongly suggest that the District will be required to both curtail spending and raise revenue to maintain its financial viability. Of the total proposed FY 2003 local source budget of approximately $3.78 billion, $2.34 billion, or 62 percent, is for expenses that cannot be materially affected in FY 2003. These include rent, debt service, subsidies, entitlements and formula-driven, mandated costs.

This means that the opportunities for FY 2003 program cost reductions rest in the remaining $1.44 billion, or 38 percent, in planned local source spending. Were the entire revenue shortfall of $323 million to be taken against this discretionary spending, it would mean a 22 percent budget reduction across the board. In my own organization, such a cut would have catastrophic effects on the ability to collect revenue, maintain cash controls and properly account for spending and revenues. The same situation no doubt would apply to other agencies of the District government.

Revenue Enhancement

Because our flexibility over the near term to affect spending is limited to only 38 percent of the budget, it is clear that revenue enhancement must be part of the solution to balancing the budget. The OCFO has developed a wide range of choices in this regard that we have shared with the Mayor and the Council. Further, we stand ready to develop other options that either the Mayor or the Council wish to see.

Approach to Spending Cuts

I fully support the effort to address spending reductions on a program-by-program basis, rather than using an across-the-board approach. Across-the-board reductions would have the effect of crippling absolutely crucial functions of government, while leaving in place marginal programs or problematic business practices the District can no longer afford.

I believe the Council and the Mayor must also recognize that our current situation does not permit any sacred cows. Ten agencies account for two-thirds of all planned FY 2003 expenditures from local funds. Two agencies, DC Public Schools and the Department of Health, account for one-third of all planned expenditures from local funds. Clearly these agencies have to be part of the mix in determining spending reductions.

I do not believe it is financially responsible to certify a budget or a five-year financial plan that is balanced by the use of so-called “unallocated savings”, such as administrative reforms or productivity savings. Specified reductions should be required for certification.

Time Horizon for Making Financial Changes

In the case of both revenues and expenditures, I believe we must look at the problem with a multi-year time horizon in mind. One-time solutions will not help resolve a long-term problem. For the foreseeable future, we are on a different revenue track than we have been on for the past six years. Now is the time to examine underlying assumptions as to what constitutes necessary or required expenditures. Major changes in the District’s expense profile can be made over time if we are willing to change basic ways of doing business. For example, if changes could be made to the inventory of District facilities such as recreation centers, libraries, and police and fire stations, significant overhead savings could be realized over time. Or, policy makers might consider combining overlapping or duplicative programs or phasing out certain programs altogether. These savings, which could be realized in FY 2004 and beyond, could then either be used to enhance service in those program areas or redirected to other programs.

Immediate Actions

Steps need to be taken immediately to align FY 2003 planned spending with the revised revenue estimates. In this regard, the City Administrator and I have notified all program managers to freeze hiring and promotions until further notice. We have worked with the City Administrator and the Mayor’s staff on a FY 2003 spending reduction proposal. It is important that there be policy concurrence on the steps to be taken as soon as possible, so that agency heads can adjust their business plans to their new financial availability and implement the steps to reduce spending. The longer the delay in implementing an agreement, the more extreme will be the steps needed to assure the budget is balanced. Further, this policy agreement should constitute the basis for the formulation of the FY 2004 budget.

Reserves
For the time being, it would not be fiscally prudent for the District to look to its budget reserve or cash reserves as a way of balancing the FY 2003 budget. In FY 2003, $70 million is set aside as a budget reserve. I believe it is financially responsible to keep this reserve unallocated to any purpose until we are well into the fiscal year, and are better able to assess emerging needs and areas where spending reductions or revenue enhancements have been less productive than anticipated.

With regard to our cash reserves, we will start FY 2003 with $249 million. Of this amount, $142 million is in an emergency reserve, accessible only for emergencies such as natural disasters. The remaining $107 million is a contingency reserve that could be used in the event of a significant reduction in revenues against those earlier projected. Notwithstanding, we should not access this fund at this time for the following reasons. First, by law, whatever is borrowed from the fund must be restored the following year; consequently, the fund is not a viable source for solving a long-term financial problem. Second, revenues may actually fall off even more than currently projected. In this eventuality, we may need to look to this reserve as a short-term source of funds while further steps are taken to achieve balance.

Potential for Improved Collections
I would now like to turn to actions we are taking that should help the District's financial position and our collective ability to monitor it in a timely fashion. On the tax collection front, the new capabilities of the Integrated Tax System are paying off in additional assessments and collections. While it is not yet time to count these additional revenues and collections for budget purposes, we expect to increase collections in FY 2003 and beyond, through better identification of taxpayers not in full compliance with the law.

Financial Monitoring
In FY 2003, we will enhance SOAR to initiate a new operating financial plan monitoring system. All agencies, as well as the Council, will have access to online reports from SOAR on the status of spending by agency and by category of expense. These reports are structured so reviewers can see the data by component and expense category online. All managers and reviewers will be able to see actual spending against the spending plan and, as a second phase this upcoming fiscal year if funds are available, we will add revenue information and a projection capability to this new function.

In addition, in FY 2003 we will apportion the budgets of selected agencies, with other agencies to be phased in later as systems improvements are made to SOAR.

Conclusion
I realize that our strained revenue situation means we will have to make hard choices as a government. However, both our citizens and the financial markets are watching closely how we meet the challenges posed by this budget gap, which in many ways is the first real test of the District's elected leadership in the post-control board era.

We should remember that difficult times provide an opportunity to look at old problems in a new light. By looking at selected areas and business practices that are major contributors to our cost profile, it is possible that over the course of the next three years changes can be made in a way to minimize the impact of reductions on our customers.

However, I must point out that ultimately we will have to resolve structural issues by redefining our relationship with the federal government, or suffer a drastically reduced level of services. The District is not economically viable with its present constrained tax base.

Madame Chairman, this concludes my statement. I asked that my full statement be made part of the record. My associates and I stand ready to answer whatever questions you and the other members may have.