

**PUBLIC OVERSIGHT HEARING ON
THE FISCAL YEAR 2004 AND 2005 SPENDING AND
PERFORMANCE BY THE OFFICE OF THE CHIEF
FINANCIAL OFFICER (OCFO)**

**Before the
Committee on Finance and Revenue
Council of the District of Columbia**

The Honorable Jack Evans, Chairman

**March 9, 2005, 10:00 a.m.
Council Chamber, John A. Wilson Building**



**Testimony of
Julia Friedman
Deputy Chief Financial Officer
Office of Revenue Analysis**

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

Good morning, Mr. Chairman and members of the Committee. I am Julia Friedman, Deputy Chief Financial Officer for Revenue Analysis and the District's Chief Economist. I am pleased to appear before you today to testify on the performance of the Office of Revenue Analysis (ORA) in FY 2004 and year-to-date in FY 2005.

The mission of ORA is to forecast, monitor, and analyze the District's economy, revenue stream and policy proposals in a manner that permits sound budgeting practices. The mission focuses on our core responsibility: to provide high quality, professional analysis of the revenues and economy of the District of Columbia. ORA staff has established extensive procedures for analyzing the District's economy and revenue, including the development of econometric and micro-simulation models that rely on a data base of the District's revenue sources. ORA also maintains a repository of information on the District's taxes and economy.

For FY 2005 ORA's staffing is 19 FTE, one less than in FY 2004. The FY 2005 budget for ORA is \$2.6 million, which supports functions and operations that have been transferred to other OCFO operations as part of our restructuring. Operating expenses through December 2004 total \$805 thousands, or 31 percent of our budget. We expect to end the fiscal year within our approved budget.

Carrying out the Mission of ORA

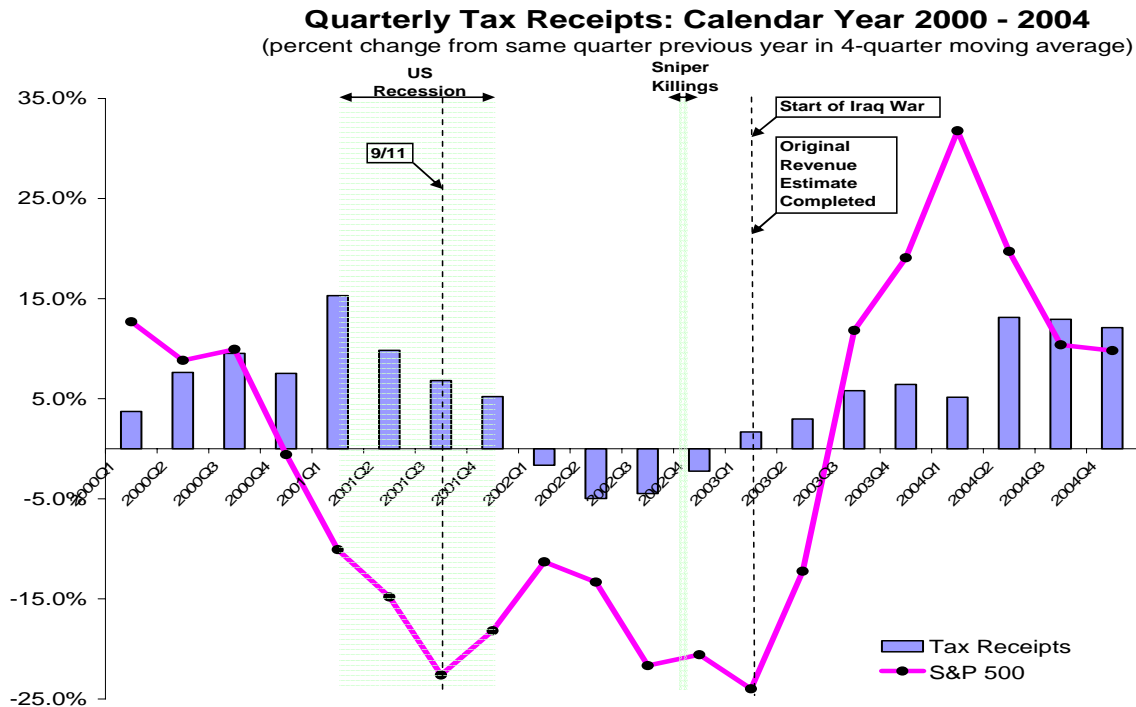
Revenue Estimation

Revenue estimates in the District are encumbered by certain limitations not experienced in other jurisdictions. These limitations, imposed by the Congressional approval process, constrain the District's ability to react to changes in the revenues and adjust its budget accordingly. The baseline revenue estimate, in the District, occurs about 9 months before the start of a new fiscal year and 21 months before the end of the estimating period. In that 21 month period any number of changes can happen to the economy and the revenue stream – changes that cannot reasonably be estimated.

For example, when the original baseline estimate for FY 2004 was made in January/February 2003 the nation and the District were still in a recession that was followed by a jobless recovery. The stock market continued its two and a half year plunge. The District was still recovering from the effects of the sniper incidents that resulted in several killings and the Iraq war was starting. All of this is illustrated at the second dotted line of Graph 1 below. Little wonder that the original estimate did not anticipate the 11 percent GROWTH in tax revenue that ultimately occurred.

During FY 2003 and 2004, as in any budget cycle, there were projections and updates following the original estimate. Still these do not guarantee an opportunity to submit a supplemental budget for Congressional approval. Other jurisdictions, empowered by their own legislative processes, are able to identify and make any needed budgetary adjustments throughout the year. Our convoluted legislative process delays the benefit to District residents from any new realized revenue.

GRAPH 1



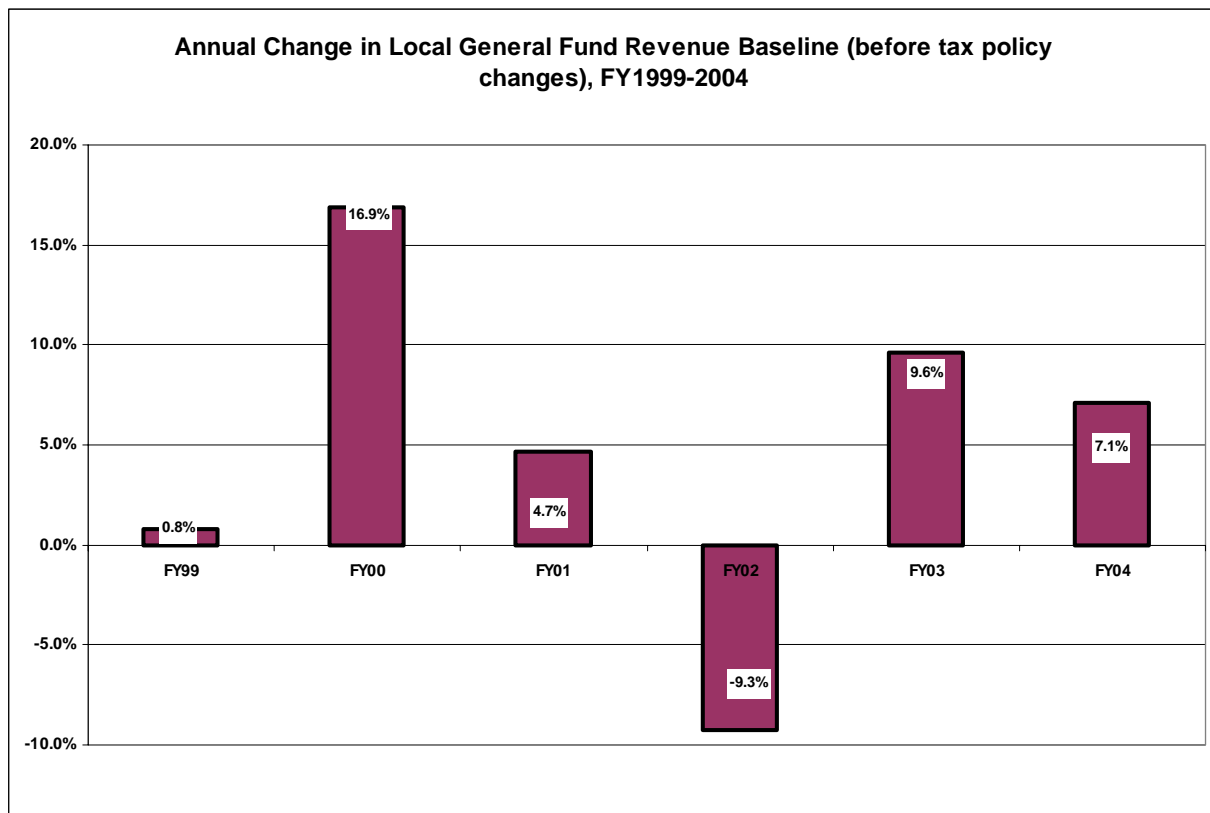
The District's revenue stream is quite volatile and this provides a great challenge both for revenue estimating and for budget development and management. When examining the revenue baseline from FY 1999 forward – the revenue D.C. would have collected with no policy changes – the range is astonishing with a maximum of 17 percent growth in FY 2000 and a minimum of 9 percent decline in FY 2002. This is shown in Graph 2.

Policy changes in the period generally reduced this volatility, as seen in Graph 3 that reports the volatility in the period FY 1999-2004. In FY 2004, however, the temporary tax rate increase on real property transactions caused even greater volatility. As you can see, the annual change in tax revenue shows a range from minus 1.9 percent in FY 2002 to a high of +11.3 percent in FY 2004. The challenge for the Council and the Mayor is to find what is “normal” in this growth

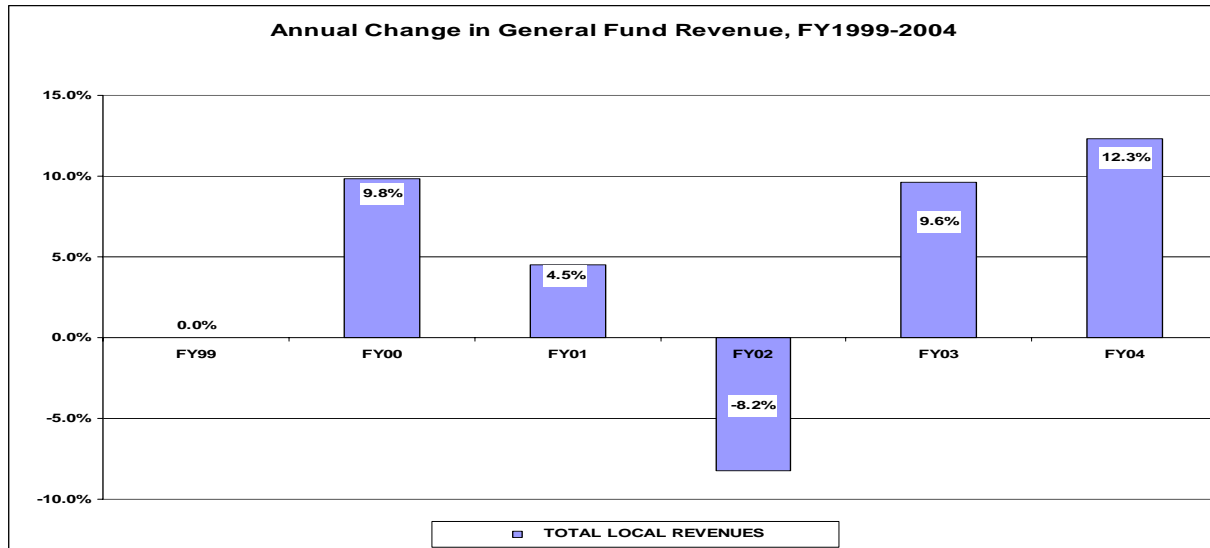
and plan for a budget supported by normality – and subject to large swings!

“Normal” or average growth in the last 5 years it is about 5.7 percent, and in the last 3 the percentage is about 4.5 percent. Yet tax revenue did not grow by either of these specific percentages in any one of the last 6 fiscal years!

GRAPH 2:



GRAPH 3



In recent years the District has twice grappled with this volatility. First, in FY 2002 income tax revenue fell abruptly and precipitously. When the trend was clearly identified in the summer, the challenge for the Council and the Mayor was to create a balanced budget using revenue enhancements and expenditure reductions. This was done, with great success, and we ended both FY 2002 and FY 2003 with very small but positive surpluses. In FY 2003 the opposite swing began with transactions in real property. Arising out of a year of no change in FY 2002, by the end of FY 2004 the annual value of transactions had more than doubled. Due to tax policy changes in the period, related revenues grew even more than that. Phenomena like these could not have been projected 21 months in advance.

Best practices call for periodic re-evaluation of annual revenue estimates. In other jurisdictions, and even in the District with our somewhat restrained ability to act on the new information, these re-evaluations matter greatly. For FY 2004, several re-estimates were issued, as summarized in the table below.

FY2004 Local Source Tax and Non-Tax Revenues: Estimating History and Actual Revenues					
Source, \$000	February 2003 Estimate	February 2004 Revised Estimate	Summer 2004 Revised Estimate	Fall 2004 Revised Estimate	Actual
Total taxes	3,373,372	3,471,217	3,561,295	3,630,849	3,665,195
Local Non-Tax	294,501	286,672	298,241	298,241	328,151
Total Tax and Non-Tax	3,667,873	3,757,889	3,859,536	3,929,090	3,993,346

Changes in Deed tax collections and income tax collections were the drivers of the increasing revenue estimates during FY 2004. Deed taxes averaged 13 percent growth annually between FY 1999 and FY 2003. In FY 2004, the growth in collections was 20 percent in the first quarter, 35 percent by the end of the first 6 months, 56 percent by the end of the third quarter as 53 percent over-all. Quite a performance compared to 13 percent as a “norm”. Individual Income Tax collections actually had an annual average of slightly negative average growth in the period FY 1999-FY 2003. In FY 2004 the first quarter growth was 11 percent and, by the end of the year, total growth was 12 percent. As the story unfolded on these and other tax revenues, the periodic re-evaluation of estimates that we provided to the Council and the Mayor were both important and necessary.

As a result of this new information, many policy actions were taken that now affect District taxpayers and service delivery. More would have been possible IF there had been an opportunity for a supplemental budget in FY 2004. But lacking that opportunity, the Mayor and Council nonetheless made effective use of the new information as it became available. These actions include both automatic and new policy changes that reduced tax burdens by about \$24 million in FY 2004, about

\$175 million in FY 2005, about \$250 million in FY 2006, and about \$330 million in FY 2007.

We recognize the need for ever better revenue projections and continue to make advances toward that objective. In the face of volatility and uncertainty, the estimation process, benefits from a wide array of professional and scientific knowledge. And, as a result of growing economic strength of the District, and due to work completed in FY 2004 related to this economic growth, we are forecasting a much stronger baseline for the District's economy in FY 2005 and years to come. We already have transmitted estimates growing from this baseline to the Council.

Given volatility of revenue and the long time frames required between revenue estimates and the close of the budget period, there is substantial reason for cautious revenue estimates. We have, however, yet another more compelling reason. The Financial Management Control Period may seem like a distant memory but it is always an immediate possibility hidden in dormancy. Any number of financial events can bring it out of dormancy. Because basic freedoms are lost in a control period – for example a Control Board can over-ride decisions made by the Council and the Mayor – we do not want to see them resurface. Cautious revenue estimates are one component of avoiding another control cycle.

Fiscal and Legislative Analysis

The other core responsibility of ORA, both past and present, is to prepare fiscal impact statements that analyze the impact of proposed policy changes on the District's expenditures and revenues. The purpose is to estimate the net cost to

the government of achieving policy goals. In this way a proposed policy change may be compared to other goals in allocating a limited budget.

During FY 2004, ORA analyzed and prepared fiscal impact statements on 192 bills considered by the Council of the District of Columbia. All fiscal impact statements prepared by the OCFO since May 2001 are retrievable on the OCFO Web site at www.cfo.dc.gov. Requests for fiscal impact statements may also be made electronically from the Web site.

ORA also conducts fiscal analysis on a broad range of special projects and issues. For example, in FY 2004 we completed our second analysis of the tax expenditures of the District of Columbia. This report, mandated by Council on a biannual basis, is published as part of the revenue chapter in the FY 2005 Budget Submission to Congress.

Economic Development, Financial Reporting & Competitive Services

In early FY 2004, the economic development finance functions of ORA spun off to be the Economic Development Finance Office of the Chief Financial Officer. However, ORA still plays an instrumental role in providing analyses for District's many economic development projects. In light of the fact that the OCFO's objective is to insure and promote financial integrity for the District of Columbia as a whole, ORA also provides services to others, in an advisory capacity. We were involved in financial analyses of several economic development proposals, including the baseball stadium, retail TIF districts, and mixed use neighborhood projects. We also have reviewed and analyzed a variety of proposals prepared by a host of other agencies.

In FY 2004, ORA responsibilities for maintaining the multi-year financial plan were transferred to the Office of Budget and Planning. ORA retains the responsibility to improve the usefulness and availability of information about the District's Special Purpose Revenue funds (or O-type funds). This year alone, roughly 200 O-type funds, belonging to 37 District agencies, have been analyzed and certified by ORA.

FY 2005 Performance and Plans

In FY 2005, the Office of Revenue Analysis will continue the core functions of estimating tax, non-tax, and special purpose revenues, of preparing fiscal impact statements, and of completing special projects such as the tax expenditure study now mandated by the Council. As always, we strive to enhance and assist the decision-making and performance capacity of the Office of the Chief Financial Officer, the Council of the District of Columbia, the Office of the Mayor, the Congress, and others who are involved in the policies and administration of the District of Columbia.

Thank you for the opportunity to testify before you today. I would be happy to respond to any questions you may have.

#