PUBLIC BRIEFING

ON

THE COMPREHENSIVE ANNUAL FINANCIAL REPORT (CAFR) FOR FY 2005

Before the
Committee of the Whole
Council of the District of Columbia

The Honorable Linda Cropp, Chairman

February 2, 2006, 11:00 a.m.
Council Chamber

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

Good morning, Chairman Cropp and members of the Committee of the Whole. I am Natwar M. Gandhi, Chief Financial Officer of the District of Columbia government. With me are deputy chief financial officers with whom you are familiar – Tony Pompa of the Office of Financial Operations and Systems, Bert Molina of the Office of Budget and Planning, and Lasana Mack of the Office of Finance and Treasury – as well as Fitzroy Lee, director of revenue estimation for the Office of Revenue Analysis. It is our pleasure to be here today to discuss the fiscal year 2005 Comprehensive Annual Financial Report (CAFR). As it has come to be expected, this report was submitted on a timely basis, with an unqualified, "clean" audit opinion from the independent auditors, and reflects a balanced budget.

OVERVIEW OF THE FY 2005 CAFR

The FY 2005 audit highlights the District's continuing excellent financial position, as evidenced by the District's ninth consecutive balanced budget and a $370 million surplus. The steadfast commitment of the District's elected leaders to sound fiscal management has resulted in a "clean" audit opinion that reflects a $2 billion turnaround in the cumulative General Fund balance since 1996, from a $518 million deficit to a positive $1.585 billion (Attachment 1). We have a fund balance and cash reserves that are a far cry from a decade ago, substantially improved bond ratings and well-deserved respect in the financial markets.

I must stress again this year, however, that there remain structural issues that result in large capital needs in the District's infrastructure – such as substandard school buildings, roads, and bridges. We have a much higher tax burden and higher debt ratios than other large jurisdictions. These are hurdles that continue to challenge the District even in the course of profound financial achievement. The District's elected officials addressed some of those needs in the 2006 budget by funding certain projects through a planned reduction in the General Fund balance, primarily for one-time spending items.

Local Fund Budget

The General Fund is composed of Local and Other Funds. Almost one-half of the Local Fund surplus, and one-third of the $370 million General Fund surplus, is the result of actual tax revenues exceeding the original estimates used in formulating the budget. Local Fund expenditures were $67 million lower than budgeted, for a variance of 1.6% (Attachment 2).

The variance between the originally estimated revenues and actual revenues reflects a continuation of the variability in tax collections in the District. Indeed, since FY 2000, the annual change in total tax revenue collections has varied from an increase of 11.3% (in FY 2000 and FY 2004) to a decrease of 1.9% (in FY 2002). Furthermore, the improved revenue picture (see display below) has been incorporated into our financial plan for FY 2006 to FY 2009 through the tax policy changes implemented throughout the year.

Certification History and Tax Policy Changes for FY 2005 Estimate ($ millions)		
Revenue Estimates		
February 2004		3,992.3
Added June 2004		150.4
Added November 2004		70.4
Added February 2005		109.0
Added May 2005		50.6
	TOTAL	4,372.7
Tax Policy Changes		
Revenue enhancements		69.6
Deed taxes rate reduction		(99.7)
Gross receipts tax reduction		(15.4)
plus Neighborhood Investment Trust Fund		10.0
plus federal reimbursement		6.4
less Lottery estimate		(70.0)
	TOTAL	(99.1)
Revised Revenue Budget in A-4 of CAFR		**4,273.6**

The strong tax revenue growth that started in FY 2004 continued in FY 2005. Compared to FY 2004, tax revenues grew by 10.6% in FY 2005, including 14.5% growth in sales and use tax revenue, 11.7% growth in real property tax revenue, and 11.3% growth in individual income tax revenue. Deed tax growth was flat despite an almost 30% cut in the tax rate, implying an underlying real growth of roughly 36%. The sales and use, real property, and individual income taxes accounted for about three-quarters of all the additional revenue.

Despite some moderation in growth, the strong real property market continues to be a major driver of District tax revenue. In the quarter ending September 30, 2005, single family and condominium average prices were up 23.3% and 18.5%, respectively, over the previous year.

These results reflect the prudent revenue estimates on which the budget was based. As I have said before, the District's revenue estimates must be somewhat conservative as a matter of both necessity and good financial management. Having successfully completed one financial control period, the District's leadership is very clear about not risking a second. Financial control, however well-intentioned, still means the loss of basic freedoms granted under Home Rule. Conservative estimates are at the heart of a balanced budget and adequate cash flow and, hence, at the heart of avoiding a second control period. The District must end every fiscal year with a balanced budget.

General Fund and Fund Balance

The General Fund results reflect the favorable Local Fund results, as well as all other revenues and expenditures (Attachment 3). Total General Fund revenue was $4.9 billion in FY 2005, exceeding revised budget estimates by $113 million or 2.4%. General Fund expenditures were $195 million lower than budgeted – one-third Local Fund, two-thirds Other – for a variance of 4.3%. The $370 million General Fund surplus represented 7.6% of actual General Fund revenues, with the differences driven largely by the variances in Local Fund.

As presented in the FY 2005 CAFR, the District ended the year with a General Fund balance of $1.6 billion (Attachment 1). This means that since the beginning of FY 1997, when the General Fund balance was a negative $518 million, the District's General Fund balance has increased by an average of $200 million per year. This fund balance clearly indicates the healthy financial position of the District.

However, it is important that we truly understand the components of the fund balance (Attachment 4). The principal components are $254 million for debt service, $270 million in purpose restricted funds, $166 million in designations for post-retirement health benefits liability, $253 million for past and current capital spending, $76 million for one-time expenditures or "resident dividends," and $137 million for other restrictions.

Other important components of the fund balance are $253 million in congressionally-mandated cash reserves and $176 million of undesignated and unreserved funds. Together, these last two amounts represent a cushion of one month's spending for the District, which is considered prudent financial management to be held in reserve (Attachment 5). Indeed, according to the Government Finance Officers Association, "best practices" recommend that municipal governments maintain a cushion equivalent to one to two months expenditures.

Bond Ratings

At the beginning of 1997, the ratings the District received from the three major bond rating agencies were B, Ba and BB. These were below investment grade, or "junk bond", ratings. Today, for many reasons, not the least of which is our healthy reserves, the ratings are A+, A2 and A (Standard and Poor's, Moody's, and Fitch, respectively), which are considered to be sound investment grade ratings. These improved ratings help reduce the District's borrowing costs. We estimate that the effect of these upgrades is an annual savings of more than $5 million in debt service and fees. These upgrades will also benefit future bond issues. For example, if the District were to issue $300 million in general obligation bonds, the savings in debt service alone are estimated at approximately $1 million over the life of the bonds.

Cash Reserves

Credit rating agencies cite the District's Emergency/Contingency Cash Reserves as a positive factor in their analysis and decision to upgrade the District's ratings (Attachment 6). The District currently holds $253 million in these cash reserves. As you can see from Attachment 5, these reserves, along with the undesignated and unreserved fund balance, provide a reasonable cushion to protect the fiscal position of the District and distinguish it among other major cities and states.

FINANCIAL MANAGEMENT IMPROVEMENTS

Yellow Book Report

The District continues to make great strides in financial management. A clear indication of this can be found in the Independent Auditors Report on Compliance and on Internal Control over Financial Reporting. This document, commonly called the "yellow book" report, lists no material weaknesses and only two reportable conditions. Material weaknesses and, to a lesser degree, reportable conditions are significant deficiencies in the design or operation of internal controls over financial reporting. This is the second time since before the control period that the District was not reported to have any material weaknesses, the more significant category of deficiency.

Budget Execution

A major factor contributing to the District's high bond ratings (A+ by S&P, A2 by Moody's and A by Fitch) is the District's continuing ability to effectively manage its operating budget. In FY 2005, the Office of the Chief Financial Officer aggressively monitored agencies' budgets and brought action items before the Council, including reprogramming and funding requests in a timely manner to address $142 million in policy initiatives and spending pressures.

Budget System Innovations

Our ability to monitor and control expenditures has steadily improved through the use of new innovative budget and information systems. Systems were implemented in FY 2003 to require online spending plans for agencies to comply with the District's Anti-Deficiency Act. Capital funds have now been included in this spending plan process. In FY 2004, we implemented a managerial tool, the CFO$ource Executive Dashboard, to provide decision-making information to senior managers. In FY 2005, we extended CFO$ource to other areas: grants and the capital program. The Grants Management System (GRAMS) and Project Management System (PROMS) are being further refined to assist agencies in monitoring their use of grant funds and capital dollars.

LOOKING AHEAD

Other Postemployment Benefits (OPEB)

District law requires the District government to provide health and life insurance benefits to retirees first employed by the District after September 30, 1987. Under the law, the District pays 75% of the cost of health insurance, and up to 33% of the cost of life insurance for retirees. The District also pays 75% of the premium for retirees' spouse and dependent health insurance coverage. (District employees and retirees first employed before October 1, 1987, can receive federal health and life insurance benefits.)

Unlike retirement plans in other cities and states, the District's postemployment benefits plan is relatively new, and we have very few recent retirees for which we currently pay. However, the District's liability will grow rapidly. The actuarial liability was calculated at $562 million as of October 1, 2005, and is projected to grow to $1.5 billion over the next 8 years.

To address this looming liability, the FY 2005 General Fund balance reflects the reservations and designations established in FY 2004 for "Other Postemployment Benefits" (OPEB). Of the $166 million reserved and designated, the FY 2006 budget transfers $138 million to an irrevocable trust. The other $28 million, accumulated over several years primarily from planned forfeitures, is available for transfer as well, if the Mayor and Council so choose. As reported in *The Washington Post* on January 30, 2006, all state and local governments must address this long-term liability, and the District's action last year was appropriate to help alleviate OPEB's impact on future operating budgets.

Capital Projects Fund

The District has slowed its rate of spending on projects financed with general obligation bonds. As a result, the deficit in the Capital Projects Fund was reduced from $250 million to $246 million at the conclusion of FY 2005. As the first step in eliminating this deficit, the Mayor and Council transferred $54 million of the General Fund balance to the Capital Projects Fund in the FY 2006 budget. An initiative to further reduce the deficit in subsequent fiscal years is the development and approval of a deficit reduction plan, which would utilize a combination of operating transfers from the General Fund and incremental general obligation bond borrowings to eliminate the Capital Projects Fund deficit. We will work with the Mayor to develop a plan to present to the Council in the FY 2007 proposed budget.

We still face challenges in catching up from many years of neglect or inability to fund capital improvements. It is very tempting to address these substantial needs through additional borrowing. Borrowing too much, however, could mean increasing the District's debt burden and reversing its hard earned gains. The District has made extraordinary improvements in its fiscal position, and should not lose the ground we have gained by taking the easy way of funding capital projects by burdening future taxpayers with a heavy debt service load (Attachments 7 and 8).

Continuing Financial Stability

In summary, I continue to believe the District has the ability to sustain all that it has accomplished in the past nine years (Attachment 9). In many respects I see a very bright future. The city's elected leadership possesses a steadfast commitment to fiscal responsibility that is becoming widely recognized, most notably in the financial markets where the District is enjoying its highest bond ratings in more than a decade. The District's leaders also realize that taxpayers carry a heavy tax burden compared to other jurisdictions. In response to this, and with continued growth in revenues, policy leaders responded with a number of tax reductions and rollbacks. Deed taxes were reduced 30% from 1.5% to 1.1% of sale value. The standard deduction for the personal income tax was increased to $2,500, and the personal exemption was increased to $1,500. There was an increase in the property tax Homestead Deduction to $60,000. Residential property tax rates were reduced from 96 cents per $100 of assessment to 92 cents, and the property tax cap was lowered from 12% to 10%. Finally, the local Earned Income Tax Credit match was expanded to 35%, and earned income tax credit benefits were extended to non-custodial parents. The effect of these tax reductions and rollbacks will be to save taxpayers more than $370 million over the next 5 years (Attachments 10 and 11).

Structural Imbalance

There are still major challenges. Even with the District's strong financial position, we struggle with the structural imbalances that were enumerated by the General

Accounting Office in 2003 – between $470 million and $1.143 billion per year. Unlike many of the other problems that the District has faced and resolved in recent years, this is a problem that the District cannot solve on its own. Our unique position as a city, county and school district with no “parent” state to assist with funding capital needs leaves us with only the federal government to look to for assistance. Indeed, the District must receive assistance from the federal government.

The District has proven that it has the resources and ability to manage its service delivery responsibilities. It is in the area of maintaining the capital infrastructure of the District that the assistance is needed. The District cannot “borrow” its way out of this problem. Our debt policy and sound fiscal management dictate that we are at our debt limit; our per capita debt is the highest among any major city in the country. Much of our property and much of the income earned in the District cannot be taxed, leaving our residents with one of the highest tax burdens in the nation. Specifically, the District cannot tax non-resident earnings. This means we cannot tax the income of workers who commute into the District and who account for two-thirds of the income earned within the District. Also, a disproportionate amount of real property within the District is owned by tax exempt entities, including government, educational and religious institutions and not-for-profits. We are unable to tax, in any way, the city’s largest employer: the federal government. Additionally, of the 10 largest non-governmental employers in the District, not one pays franchise taxes and only one pays property taxes.

This imbalance places an undue burden on the citizens of the District and has resulted in the highest per capita debt burden of any major city in the nation. Assistance from the federal government is the only solution that I can offer at this time. We must continue to call on Congress and the President to recognize the remarkable improvement in fiscal stability and independence that the nation's capital has made in the post-control period, and ask for a reasonable level of financial assistance to resolve the larger infrastructure problem.

CONCLUSION

I want to take this opportunity to thank the many employees, from both the financial and program areas, who have worked so long and hard to ensure the successful closure of the District's books and the maintenance of the high-quality records required for an unqualified audit opinion. In particular, I want to commend Tony Pompa, D.C.'s controller, his deputy Bill Slack, and the rest of the team at the Office of Financial Operations and Systems for their hard work and dedication. I would also like to thank the rest of my senior management team and their staff: Bert Molina, Dr. Julia Friedman, Lasana Mack, Sherryl Hobbs Newman, Barbara Jumper, Henry Mosley, Deloras Shepherd, Pamela Graham, Steward Beckham, and John Musso. The District owes them its thanks.

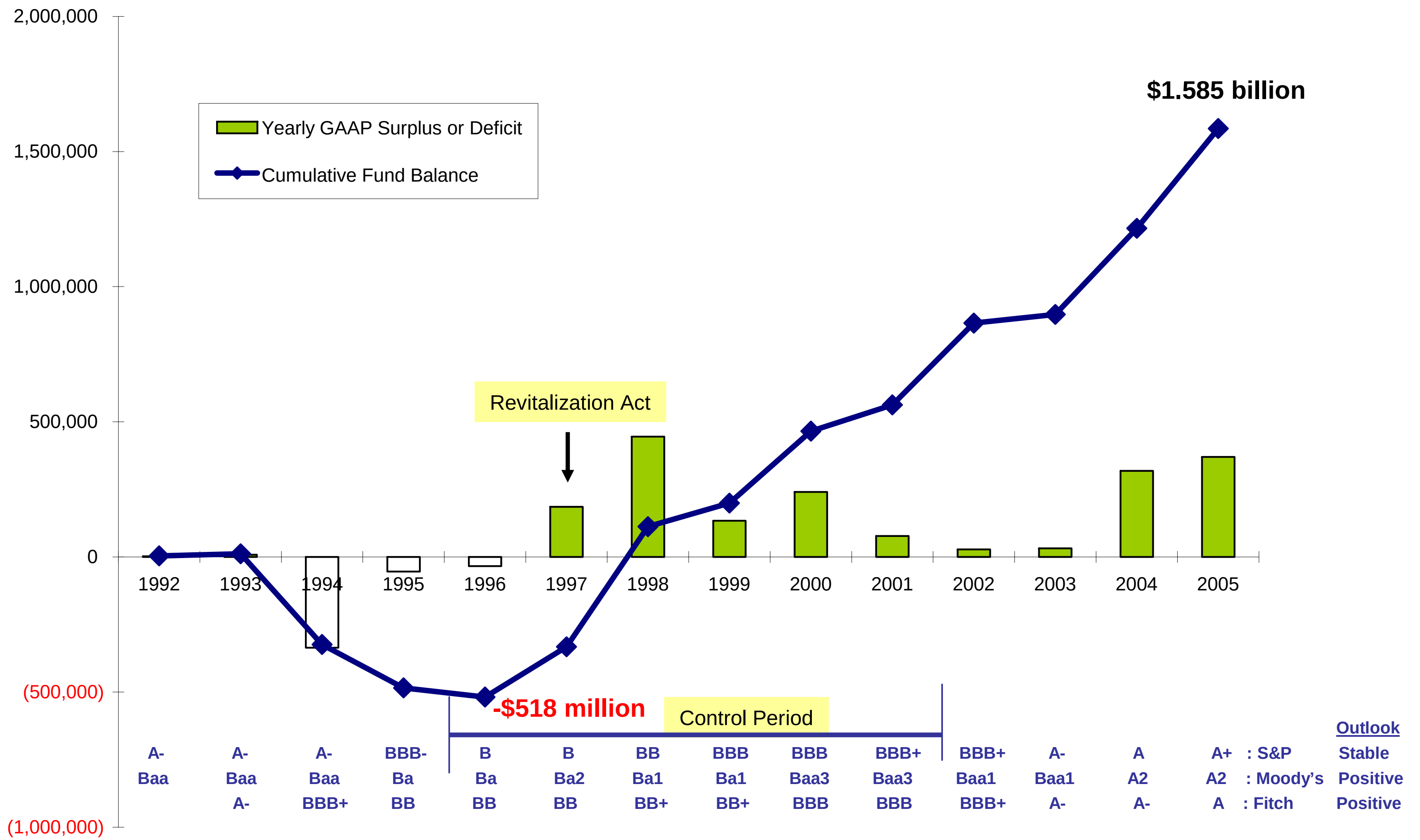
I also want to thank the public accounting firm of BDO Seidman, LLP, who were assisted by Bert Smith and Company and Thompson, Cobb, Bazilio and Associates, for their efforts throughout the audit engagement. Their highly professional staffs worked equally long and hard during the past few months to successfully complete this audit. In particular, I want to commend Wayne Berson, Bill Eisig and Abdool Ahkran for their efforts.

Let me also extend my deepest thanks to the Mayor; to you, Mrs. Cropp; to Mr. Evans; to the Council; to City Administrator Bobb; and to the Inspector General for their guidance, support and oversight of the process over the past few months.

Their leadership and commitment to fiscal prudence was an essential part of this successful endeavor.

This concludes my remarks. I would be pleased to answer any questions you may have.

Surplus and Bond Rating History



ATTACHMENT 1

FY 2005 Local Fund Surplus

($ in millions)

	Revised Budget	**Actual**	Actual vs. Revised	Percent Variance
Revenues				
Taxes	$3,935.3	**$4,052.1**	$116.8	3.0%
Non Taxes	$338.3	**$352.4**	$14.1	4.2%
All Other Local Fund Source	$155.4	**$143.7**	($11.7)	-7.5%
TOTAL	$4,429.0	**$4,548.2**	$119.2	2.7%
Expenditures				
FY 2005	$4,227.7	**$4,160.8**	($66.8)	-1.6%
FY 2006 Advance to Public Education	$63.2	**$63.2**		
Revenues vs. Expenditures	$138.1	**$324.2**		
	Accounting Adjustments	**($65.2)**		
	SURPLUS	**$259.0**	**(5.7% of actual revenues)**	

ATTACHMENT 2

FY 2005 General Fund Surplus

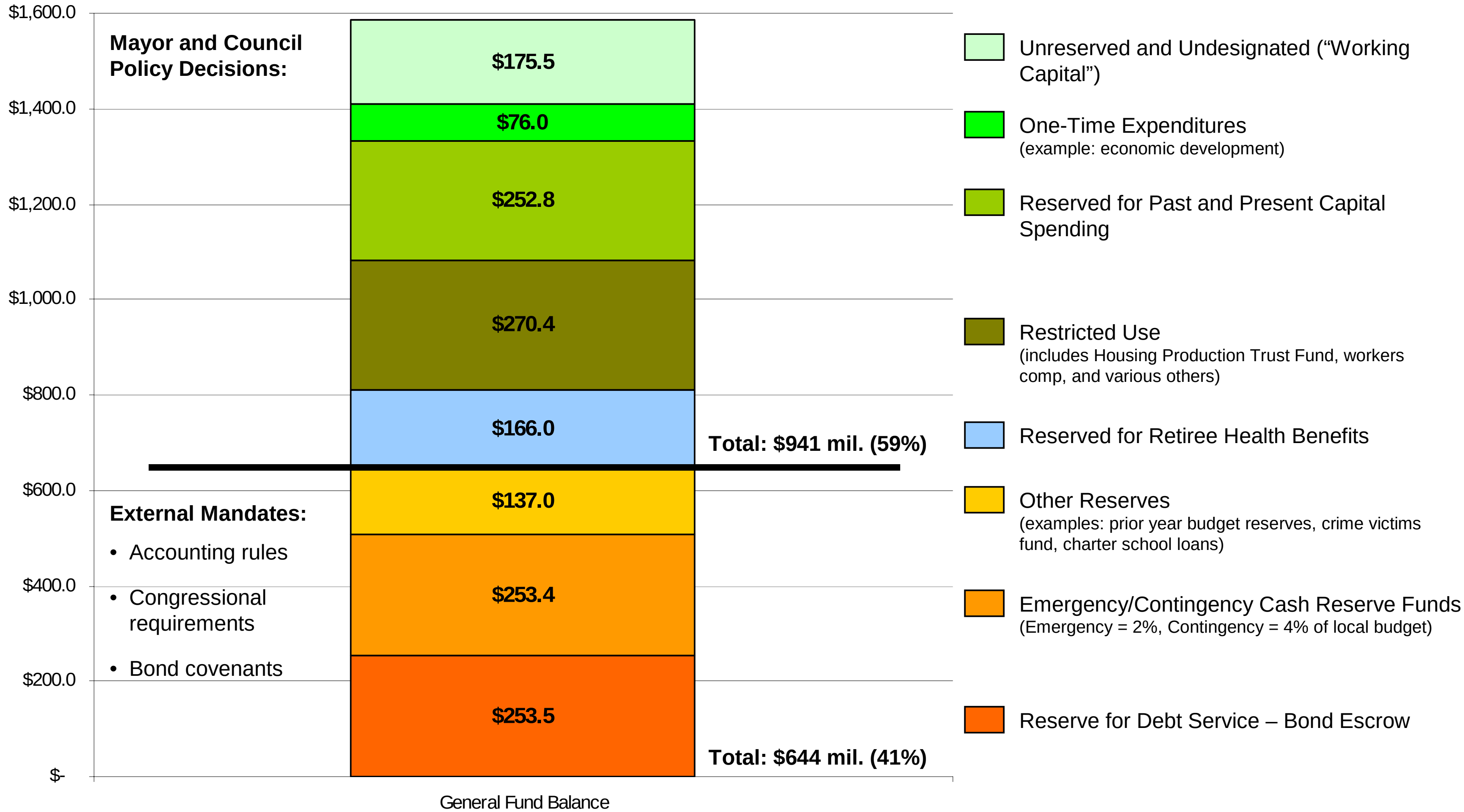
($ in millions)

	Revised Budget	**Actual**	Actual vs. Revised	Percent Variance
Revenues				
Taxes	$3,935.3	**$4,052.1**	$116.8	3.0%
Non Taxes	$338.3	**$352.4**	$14.1	4.2%
All Other General Fund Source	$487.0	**$469.0**	($18.0)	-3.7%
TOTAL	$4,760.6	**$4,873.5**	$112.9	2.4%
Expenditures				
FY 2005	$4,559.2	**$4,363.9**	($195.3)	-4.3%
FY 2006 Advance to Public Education	$63.2	**$63.2**		
Revenues vs. Expenditures	$138.2	**$446.4**	$308.2	
	Accounting Adjustments	**($76.7)**		
	SURPLUS	**$369.7**	**(7.6% of actual revenues)**	

ATTACHMENT 3

FY 2005 General Fund Balance

($ in millions)

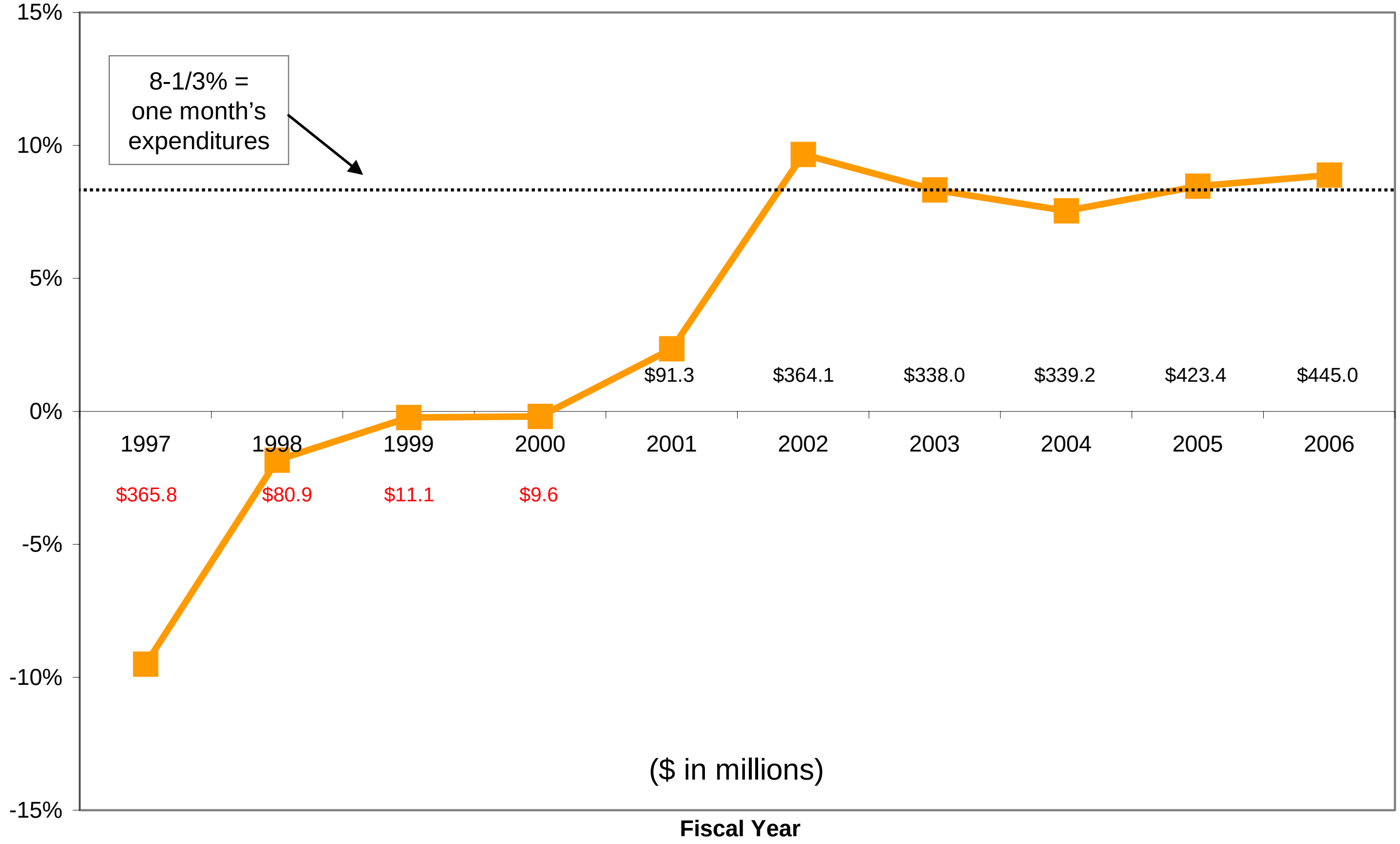


Total as of September 30, 2005: **$1,585 million**

ATTACHMENT 4

Total Working Capital

Unreserved/Undesignated Fund Balance Plus Congressionally Mandated Emergency/Contingency Reserves as a Percent of Next Year's Budgetary Expenditures

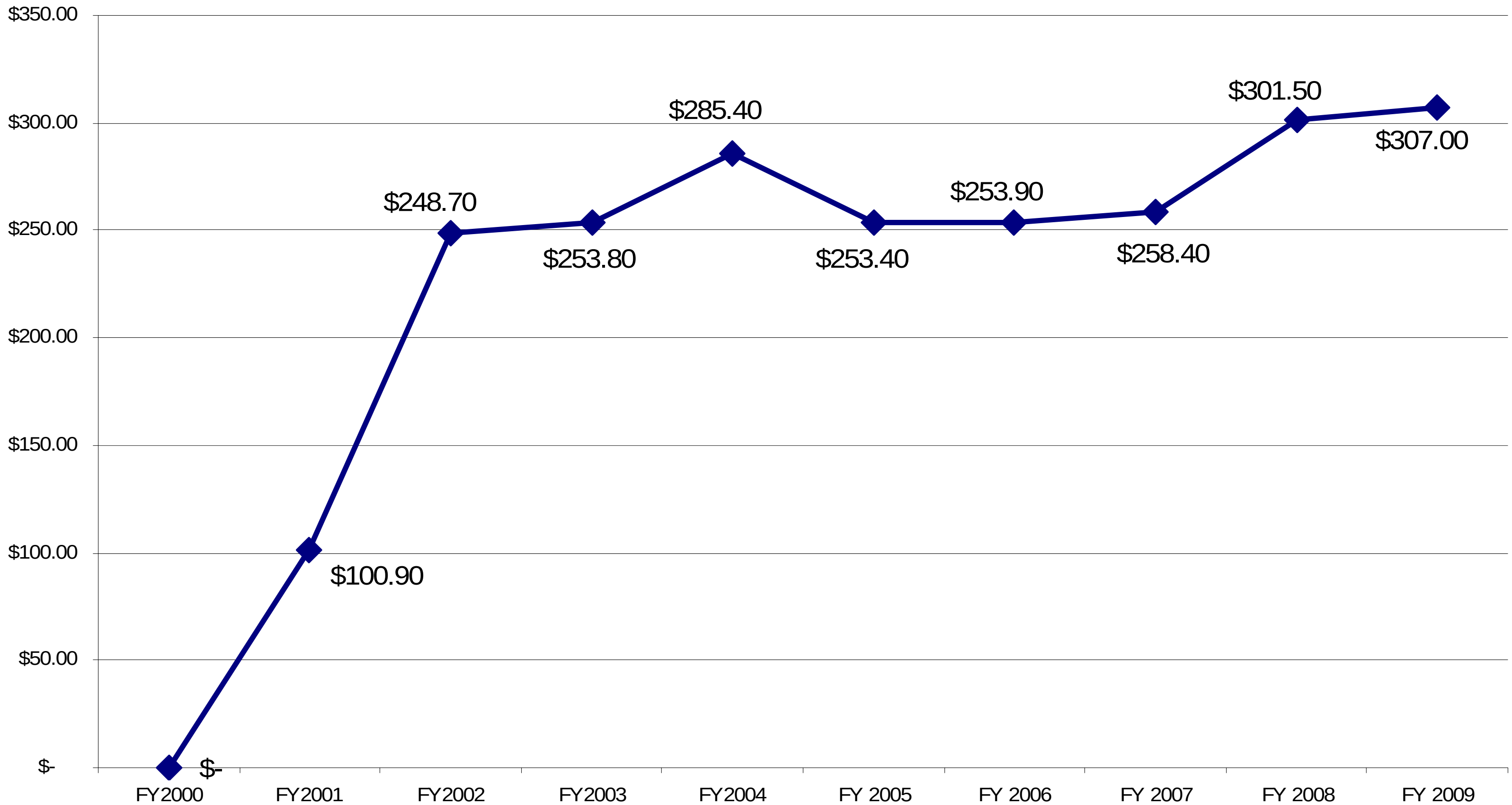


ATTACHMENT 5

Rainy Day Fund

Congressionally Mandated Emergency (2%)/Contingency (4%) Cash Reserves

($ in millions)



ATTACHMENT 6

Growing Debt Burden

Debt needed to fund capital needs is projected to grow to levels well above average for major cities:

Effect of Projected Additional Debt on Debt Ratios (as of November 2005)

		Projected Overall Tax-Supported Debt at End of Fiscal Year				
	Moody's 2002 Median	2005	2006	2007	2008	2009
Debt to Full Value	4.4%	6.5%	7.8%	9.7%	9.7%	9.6%
Debt Per Capita	$1,992	$7,663	$9,260	$11,507	$11,576	$11,513
Debt Service to Expenditures	11.5%	9.2%	9.2%	10.5%	11.7%	11.8%

ATTACHMENT 7

Capital Needs

The District's capital plans include debt issuances for the following needs:

Project	Approximate Cost	Schedule
Capital Improvements Plan (CIP) for general governmental capital projects	$300 million annually	FY 2006 and each year thereafter
Schools modernization	$150 million	Late FY 2006 or 2007
New mental health hospital	$200 million	FY 2006
New baseball stadium	$535 million	FY 2006
Department of Transportation projects	$143 million, supported by parking tax revenues	FY 2007 or 2008
Housing Production Trust Fund (HPTF) financing	$150 million, supported by dedicated HPTF revenues	First $60 million might be in FY 2006
Mayor's Government Centers project	$200 million	FY 2007
New general hospital (in partnership with Howard University)	$200 million	FY 2007
Various Tax Increment Financing (TIF) projects	$150 million	FY 2006 - 2009
Convention Center headquarters hotel and convention center expansion	$650 million	FY 2007

ATTACHMENT 8

Financial Plan

(Budgetary Basis, $ in thousands)

		FY 2005 Actual	FY 2006 Approved	FY 2007 Projected	FY 2008 Projected	FY 2009 Projected
	Revenues					
1	**Total Resources**	**$4,902,847**	**$ 5,397,858**	**$ 5,021,265**	**$ 5,305,740**	**$ 5,602,073**
	Program Expenditures					
2	General Program Expenditures	$4,406,544	$ 4,947,702	$ 4,958,714	$ 5,155,156	$ 5,354,062
3	Cash Reserve (Budgeted Contingency)	-	50,000	50,000	50,000	50,000
4	Paygo Capital	$20,550	207,083	10,000	-	-
5	Contribution to Capital Fund Balance	-	53,800	-	-	-
6	Transfer to Post Employment Benefits	-	138,000	-	81,000	86,200
7	**Total General Fund Expenditures**	**$4,427,094**	**$ 5,396,585**	**$ 5,018,714**	**$ 5,286,156**	**$ 5,490,262**
8	**Operating Margin, Budget Basis**	**$475,753**	**$ 1,273**	**$ 2,550**	**$ 19,585**	**$ 111,810**
	Tax Revenue Growth	-	2.1%	5.4%	6.4%	6.2%
	Recurring Expenditures Growth	-	10.6%	1.8%	4.0%	3.9%

ATTACHMENT 9

Tax Reductions and Triggered Expenditures

($ in millions)

	FY 2006	FY 2007	FY 2008	FY 2009
Tax Reductions:				
Property tax reductions	$66.5	$71.9	$76.7	$81.0
Income tax cuts	$14.3	$19.2	$20.2	$20.9
Total Tax Reductions	$80.8	$91.1	$96.9	$101.9
Expenditures Triggered	$25.8	$25.8	$25.8	$25.8
Total Use of Revenues	$106.6	$116.9	$122.7	$127.7

ATTACHMENT 10

Tax Reductions Enacted Since FY 2004

(thousands of dollars)

TAX REDUCTIONS TRIGGERED BY DECEMBER 2005 CERTIFICATION LETTER	FY 2006	FY 2007	FY 2008	FY 2009	TOTAL
Triennial Group Taxable Assessment Disparity Correction Act of 2005	(19,151)	(21,035)	(22,802)	(24,410)	(87,398)
Disabled Person Tax Reduction Act of 2005	(3,630)	(3,680)	(3,780)	(3,780)	(14,870)
Disabled Property Owners Tax Reduction Act of 2005	(1,492)	(1,639)	(1,776)	(1,902)	(6,809)
Total, Tax Reductions Triggered by December 2005 Certification	**(24,273)**	**(26,354)**	**(28,358)**	**(30,092)**	**(109,077)**
TAX REDUCTIONS TRIGGERED BY SEPTEMBER 2005 CERTIFICATION LETTER					
Residential Property Tax Rate and Cap Reduction Act of 2005	(20,908)	(22,964)	(24,894)	(26,649)	(95,416)
Limited Equity Cooperative Tax Fairness Act of 2005	(203)	(223)	(242)	(259)	(926)
Affordable Housing Preservation Tax Assessment Act of 2005	(415)	(456)	(494)	(529)	(1,894)
Total, Tax Reductions Triggered by September 2005 Certification	**(21,526)**	**(23,643)**	**(25,630)**	**(27,437)**	**(98,236)**
POLICY PROPOSALS IN FY 2006 BUDGET AFFECTING GENERAL PURPOSE REVENUE					
Income Tax Relief Proposals					
Expand Local EITC Match to 50%	(7,125)	(9,500)	(10,100)	(10,600)	(37,325)
Extend EITC Benefits to Non-Custodial Parents	(300)	(300)	(300)	(300)	(1,200)
Increase the Standard Deduction to $2,500	(3,375)	(4,600)	(4,800)	(4,900)	(17,675)
Increase the Personal Exemption to $1,500	(3,525)	(4,800)	(5,000)	(5,100)	(18,425)
Subtotal, Income Tax Proposals	**(14,325)**	**(19,200)**	**(20,200)**	**(20,900)**	**(74,625)**
Property Tax Relief Proposals					
Increase the Homestead Deduction to $60,000	(18,700)	(19,600)	(20,600)	(21,600)	(80,500)
Low-Income Property Tax Deferral	(2,000)	(2,300)	(2,100)	(1,900)	(8,300)
Subtotal, Property Tax Proposals	**(20,700)**	**(21,900)**	**(22,700)**	**(23,500)**	**(88,800)**
Total, Tax Reductions in FY 2006 Budget	**(35,025)**	**(41,100)**	**(42,900)**	**(44,400)**	**(163,425)**
Total, Tax Reductions Enacted since FY 2004	**(80,824)**	**(91,097)**	**(96,888)**	**(101,929)**	**(370,738)**
FYI only:					
Budget Support Act Subtitles Impacting Revenue					
Catholic University of America Property Tax Exemption	(1,000)	0	0	0	(1,000)
Carver 2000 Low-Income and Senior Housing Tax Exemption	(50)	(50)	(50)	(50)	(200)
Dupont Commons Low-Income Housing Tax Exemption	(100)	0	0	0	(100)
The Way of the Cross Church of Christ Tax Exemption	(10)	0	0	0	(10)
Appalachian State University Tax Exemption	(20)	(20)	(20)	(20)	(80)
Family Property Recordation and Transfer Tax Exemption	(44)	(44)	(44)	(44)	(176)
American Psychological Association Tax Exemption Continuation	(940)	(970)	(1,010)	(1,040)	(3,960)
Recyclable Materials Sales Tax Clarification	(373)	(100)	(100)	(100)	(673)
Subtotal, Budget Support Act Subtitles	**(2,537)**	**(1,184)**	**(1,224)**	**(1,254)**	**(6,199)**

ATTACHMENT 11