PUBLIC OVERSIGHT HEARING ON

THE FISCAL YEAR 2005 AND 2006 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

February 27, 2006, 2:00 p.m.
Council Chamber, John A. Wilson Building

Testimony of
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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 2005 and year-to-date in FY 2006.

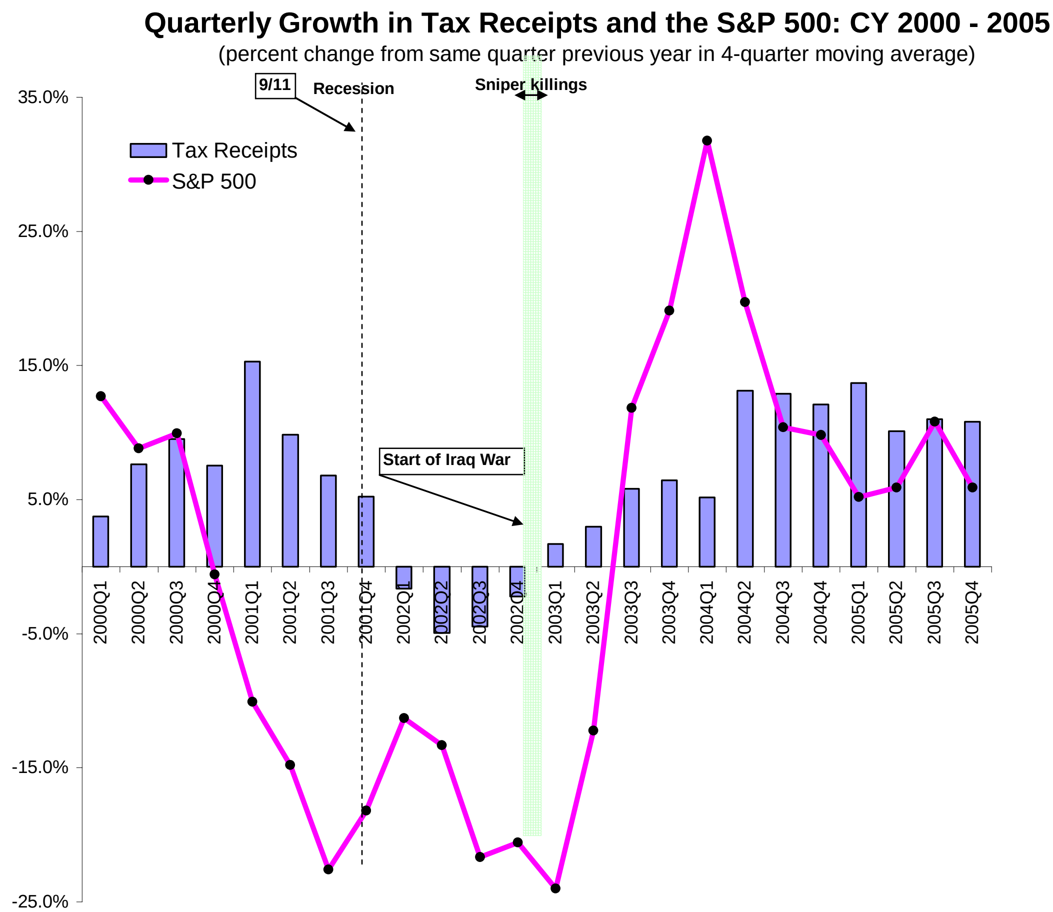
The mission of ORA is to forecast, monitor, and analyze the District's economy, revenue streams and policy proposals in a manner that permits sound budgeting practices. The mission focuses on our core responsibility: to provide high quality, professional analysis of the revenues and economy of the District 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 database of the District's revenue sources. ORA also maintains a repository of information on the District's taxes and economy.

For FY 2006 ORA's staffing is 19 FTEs, similar to the FY 2005 level. The FY 2006 budget for ORA is $2.45 million. Operating expenses through February 6, 2006, total $913,000, or 37 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. 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. As the following graph demonstrates, in that 21 month period any number of changes can happen to the economy and the revenue stream – changes that cannot reasonably be anticipated and included in the revenue estimates.



Further complicating the revenue estimating process is volatility of the District's revenue system. 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.

Policy changes in the period generally reduced this volatility. In FY 2004, however, the temporary tax rate increase on real property transactions caused even greater volatility. The annual change in tax revenue ranges 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 – yet subject to large swings. "Normal" or average growth in the last 5 years is about 5.9 percent, and in the last 3 three years the percentage is about 4.9 percent. Yet tax revenue did not grow by either of these specific percentages in any one of the last 6 fiscal years.

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.

Given the volatility of the District's revenue and the long time frames required between revenue estimates and the close of the budget period, 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 2005, several re-estimates were issued, as summarized in the table below.

Certification History and Tax Policy Changes for FY 2005 Estimates ($ in 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		
Deed taxes rate reduction		(99.7)
Gross receipts tax reduction		(15.4)

The stronger than expected performance of the District's economy was reflected in successive revenue estimates. As a result, we anticipated higher fund balances at the end of FY 2005, some of which was appropriated for use in the development of the FY 2006 budget. Furthermore, the higher revenue estimates that were reported throughout FY 2005 triggered more tax cuts and additional expenditures for FY 2006. These additional tax cuts and triggered expenditures are illustrated in the following table.

Tax Reductions and Triggered Expenditures ($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
Expenditure Triggered	$25.8	$25.8	$25.8	$25.8
Total Use of Revenues	**$106.6**	**$116.9**	**$122.7**	**$127.7**

The recovery in the District's revenue, which started in FY 2004, continued with strong tax revenue growth in FY 2005. Compared to FY 2004, tax revenues grew by 10.3% 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 almost 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 fourth quarter of 2005, single family and condominium average prices were up 21.7% and 17.8%, respectively, over the previous year.

Withholdings were up 5%, reflecting strong D.C. wages and salaries growth in the last two years. Declarations grew by 15.3%, tax payments with tax returns grew by 11.8%, while refunds grew by just 3.3%. As these figures demonstrate, the surge in growth in individual income tax revenue was driven by the strong growth in the non-wage related components of the individual income tax; these tend to determine the level of declaration payments submitted quarterly by some taxpayers.

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 override 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.

The Economic Outlook of the District of Columbia

The state of the economy in the District of Columbia in FY 2006 and FY 2007 is strong and expected to remain strong. This is despite the fact that income growth is not expected to be as great as in FY 2005.

We project steady growth in employment, wages, and personal incomes for the District during the next couple of years, similar to what is projected by most economists for the nation as a whole. However, we also expect the District to benefit from some additional strengths of its own. Continued high levels of federal spending mean an extra "kick" locally because so many of these dollars will be spent here. As a result, we expect growth in businesses adding jobs and enhancing economic activities. With continued growth in the number of retail outlets in the District, shoppers are expected to shift some spending more toward the District than away from it.

Our estimating assumptions for FY 2006 and FY 2007 include 1.2 percent and 1.1 percent growth each year in total jobs, 5.4 percent and 5.6 percent increases in personal income of District residents, and inflation of 3.3 and 2.2 percent, respectively. Leading private sector service industries, such as professional and business services, education, health, membership organizations, retail, and hospitality services, will be responsible for most of the increases in jobs and wages in the District.

During fiscal years 2003 through 2005, rising real estate assessments and transactions were major sources of revenue gains. The key fundamentals affecting the District's real estate market remain strong: the District's economy is growing, individuals and businesses both continue to demonstrate a desire to locate in the District, and the supply of housing and land for commercial development cannot increase rapidly. Accordingly, the contributions of the real estate sector will continue to be significant in FY 2006 and FY 2007, even as the number of transactions moderates. Prices will continue to rise.

In FY 2004 and FY 2005 the assessed value of all taxable property in the District (before the application of any caps or credits) increased 14.5 percent and 12.6 percent, respectively. We anticipate the real property tax baseline will continue to increase by about 12.6 percent and 9.7 percent during FY 2006 and FY 2007. However, policy changes implemented in FY 2005 – an increased homestead exemption to $60,000, capped homestead tax increases at 12 percent, and a rate reduction – will moderate the revenue impact of the rising assessments. Real property tax revenue gains in FY 2006 will be 5.8 percent, rising to 9.8 percent in FY 2007.

The total value of taxable real property sales grew 38.1 percent in FY 2005, following a 31.6 percent increase in FY 2004. For FY 2006 and FY 2007 the value of all transactions are expected to increase only modestly beyond FY 2005's high level, due primarily to declining transactions rather than prices. Revenues from deed taxes are expected to increase by 9.7% and 9.6%, respectively, in FY 2006 and FY 2007. (Deed tax collections actually declined by 1.8 percent in FY 2005 due to the 26.7 percent rate reduction – from 1.5 percent to 1.1 percent on deed transfers and recordations that took place at the beginning of that year.)

Growth in personal income and gains in financial markets are expected to expand the individual income tax base, but rate reductions will cut FY 2006's revenues to 2.1 percent below FY 2005. Revenue is expected to grow slightly by 0.8 percent in FY 2007 before returning and becoming more consistent with growth in the District's income in FY 2008. Franchise tax revenue also is anticipated to grow, by 3.9 percent in FY 2006, with 7.8 percent growth expected in FY 2007. By contrast, the increase in FY 2005 was almost 16 percent.

Sales tax revenues are expected to increase in FY 2006 and FY 2007, but the rate of growth will be considerably less than the 14.0 percent that occurred in FY 2005. Developments that gave a special boost to sales tax revenues in FY 2005 include the presidential inauguration, the return of Major League baseball, the full operations of the new Convention Center, and the opening of two new attractions on the Mall – the World War II memorial and the National Museum of the American Indian. Sales tax gains in FY 2006 are expected to be 3.2 percent – dampened a bit by reclassifying sales tax on parking as a non-general fund revenue – and should return to more normal growth in FY 2007 of 6.5 percent.

In all, despite a growing D.C. economy, total revenue available for general fund purposes in FY 2006 is forecast to be just 0.8 percent greater than in FY 2005, rising to 5.2 percent in FY 2007. The growth in total general fund revenue in FY 2005 was 9.9 percent over FY 2004.

Although the national and local economies continue to show considerable strength, recent developments point to a number of possible risks. For example, the U.S. economy continues to grow, but much of this depends upon continued gains in consumer spending. Consumers are heavily indebted, with the net saving rate close to zero. Were consumers to cut back on spending, a slowing U.S. economy would eventually impact the District economy, primarily through its dampening effect on tourism receipts, other retail sales, and corporate profits.

Also, driven primarily by higher oil prices, inflation may be a real threat to the national economy. Rising inflation combined with current imbalances in the economy – in particular, the record-level budget and trade deficits – could lead to a rapid upward movement in long-term interest rates. The District’s revenue estimates are vulnerable to a sharp rise in the interest rate; our forecast calls for a gradual rise in long-term interest rates. More rapid increases in interest rates could cause greater slowing of growth in the real estate market than we are forecasting here. The uncertainties involved in projecting changes in real estate markets and revenues are comparable with those encountered a few years earlier in trying to anticipate the performance of the stock market, which had such a large impact on income tax revenues.

Factors other than cut backs in spending by the heavily indebted consumer sector could lead to faltering employment and income growth. For example, weakening of the dollar compared to other major currencies in the world or continued increases in the national debt may raise interest rates further, which could slow the economy and damage real estate markets.

Another source of risk is the pattern of federal expenditures. Government spending is a significant economic underpinning of the entire Washington, D.C., Metropolitan area, including spending by the District of Columbia itself. Security concerns arising out of 9/11 and the Iraq war have resulted in large increases in government spending that benefited the Washington, D.C., area. Efforts to reduce government spending over the next few years to bring greater balance to federal fiscal policy could dampen growth in the District of Columbia.

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 2005, ORA analyzed and prepared fiscal impact statements on approximately 200 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, was published as part of the revenue chapter in the FY 2005 Budget Submission to Congress.

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