HEARING ON

EXAMINING THE CHALLENGES THE DISTRICT WILL FACE TODAY, TOMORROW AND IN THE FUTURE

Before the

Subcommittee on Oversight of Government Management, the Federal Workforce and the District of Columbia
Committee on Homeland Security and Governmental Affairs
U.S. Senate

The Honorable George V. Voinovich, Chairman

July 18, 2006, 10:00 a.m.
Room 342, Dirksen Senate Office Building

Testimony of
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Good morning, Chairman Voinovich and members of the subcommittee. I am Natwar M. Gandhi, Chief Financial Officer for the District of Columbia, and I am here to offer brief remarks about the accomplishments of the District with regard to its fiscal health and the challenges we face today and in the future.

First, I will summarize the fiscal recovery over the past decade. I will also address our capital spending needs and the continuing structural imbalance – that is, the mismatch between capital spending needs and the ability to raise local revenues sufficient to fund those needs. Finally, I will address our on-going commitment to remain fiscally balanced in the future, despite facing significant challenges especially in the area of infrastructure needs.

Fiscal Recovery 1996 – 2005

The chart that appears as Attachment A to my testimony and that appears here before you is a history of the remarkable fiscal comeback achieved by the District over the past decade. Our fiscal low point occurred in FY 1996, when the general fund balance hit a negative $518 million. Through the efforts of Mayor Williams, the District Council and the congressionally-mandated control board, we were able repeatedly to balance the District's budget for nine consecutive years. The control board was de-activated in 2001. Between FY 1996 and the end of FY 2001, there was a $1.1 billion increase in the fund balance, to a positive $562 million by the end of FY 2001.

The real test for the District was the challenge of sustaining fiscal stability in the post-control period. As you can see, at the end of FY 2005, the general fund balance had risen another $1.0 billion, to $1.6 billion total. Of the $2.1 billion increase in the general fund balance between FY 1996 and FY 2005, the amount of gain since the end of the control period was about equal to the gain during the control period, demonstrating the commitment of the District's leadership to ongoing fiscal restraint.

The measure of this success is reflected in the District's bond ratings. All three rating agencies – Fitch Ratings, Moody's Investors Service, and Standard & Poor's – recognized the improved creditworthiness of our bonds by raising the District's bond ratings from "junk bond" status during the control period to "A" category ratings – the highest level ever achieved by this jurisdiction.

It is notable that compared to other major cities that experienced periods of extreme financial stress, including New York, Philadelphia, Cleveland and Detroit, this turnaround was the fastest in terms of both the time it took to return to investment grade ratings and the time to achieve their highest ratings. For example, New York City remained below investment grade for eight years, Cleveland for seven years, Detroit for six years, and Philadelphia for five years. In contrast, the District achieved investment grade ratings within four years and has since received multiple upgrades from all three rating agencies.

How was this successful turnaround accomplished? A great deal of the increase in fund balance was driven by the growth in local revenues, specifically by real estate, income and sales taxes resulting from the strong regional economy. That was the easy part. Credit for making the difficult decisions necessary to restore the District to fiscal health must go to Mayor Williams, the Council and the members of the congressionally-mandated control board. The Congress also transferred to the federal budget some of the functions normally provided by state governments. The Mayor and Council demonstrated their commitment to prudent fiscal stewardship by controlling spending, cutting unnecessary and inefficient programs and adding new spending only for essential services.

The Office of the Chief Financial Officer, which was created in its current form by the Congress, was given the task of strengthening our tax administration in order to collect every dollar that was due to the District, and we have made significant improvements in this area. Over the past 10 years we have collected an additional $1.6 billion despite declining tax rates.

On the revenue side, the role of forecasting revenues – a difficult and essential part of budgeting – was also the responsibility of the chief financial officer. In every year for the past decade, our actual revenues have met or exceeded our forecasts, demonstrating the careful, conservative approach we have taken to estimate revenues. Further, by controlling expenditures the District's elected leaders ensure that the city will live within its means. Table 1 below shows a comparison of tax revenues, the general fund balance and reserve funds in FY 1996 compared to FY 2005; it reflects the revenue growth and prudent financial management that contributed to the increased general fund balance.

Table 1

Comparison of Key Financial Measures
($ in millions)

	FY 1996	FY 2005	Change
Tax Revenues	$ 2,402.5	$ 4,052.1	+$1,649.6
Operating Surplus/(Deficit)	($33.7)	$369.7	+$403.4
General Fund Balance	($518.2)	$1,584.7	+$2,102.9
Reserves Available for Operations*	($332.4)	$428.9	+$761.3
Operating Reserves as % of Expenditures	--	8.5%	

*Includes Congressionally-mandated Emergency and Contingency Reserves plus unreserved undesignated General Fund balance.

General Fund Balance Use

It is the function of government to provide badly needed services. With this in mind, the FY 2006 budget included provisions for spending a portion of the funds that had accumulated over the years as a result of unprecedented growth in local revenues. This drawdown of fund balance was largely driven by one-time spending on capital needs and programs. We currently estimate a net reduction by September 30, 2006, of roughly $550 million in the general fund balance for urgent capital infrastructure needs and major investments to meet future pension obligations.

It should be noted that despite this reduction in cumulative fund balance, the District will still retain about $350 million in operating reserves (including the federally mandated emergency and contingency reserves) every year throughout the five-year budget and financial plan (see Attachment B).

Structural Imbalance

Despite efforts to fund the District's considerable capital needs, I must point out to the committee that this government continues to struggle to function with a structural imbalance. This means that the District's revenue capacity, under national norms, falls far short of the cost of delivering services assuming average efficiency, again as measured by national norms. The reasons lie in a large population in need; high regional costs for labor, land, and other resources; and accumulated infrastructure deficiencies.

The District is unique in many ways. It has the economy and needs of a city plus the added public responsibilities of a state, county and school district. We cannot tax nonresident workers, who account for two-thirds of income earned in the city.

Over one-third of all assessed property value in the District – or $43.2 billion – in 2005 was exempt from taxation, and the District cannot tax its largest employer – the federal government. Not only that, but 10 of the District's 13 largest employers are exempt from taxation.[1]

The District also faces unique expenditure requirements. State-like services provided by the District government to its residents amount to $1.2 billion per year (see Table 2). This is in addition to state-like services provided by the federal government. Under the National Capital Revitalization Act of 1997, the federal government assumed some state-like services (in the areas of the judiciary, Medicaid and pensions), which were offset by the end of the federal payment. Since then, the annual net value to the District has risen from $200 million to $250 million in constant dollars.

Table 2 **Program Function**	**2005 Local Funds (Operating)** ($ in millions)
Medicaid (remaining 30% share not paid by federal government	$ 362
Mental Health	153
Child and Family Services	143
Human Services	259
UDC subsidy	50
Motor Vehicle registration and inspection	41
WMATA operating subsidy	164
Total	**$1,172**

Source: DC Fiscal Policy Institute and The Brookings Institution, "A New Federal Contribution To The District of Columbia? The Need, Likely Impact, and Some Options", November 2005.

The District continues to provide services to the federal government and to the region, some of which are not reimbursed. For example, the District maintains the

[1] Tax-exempt employers include Howard University, George Washington University, Georgetown University, Washington Hospital Center, Children's National Medical Center, Howard University Hospital, American University, Georgetown University Hospital, Providence Hospital and George Washington University Hospital. Taxable employers include Fannie Mae, Washington Post and Potomac Electric and Power Company.

local streets and bridges that the federal and suburban workforces use to travel to and from jobs in the District.

The accumulated unfunded needs of the past and present show up as real problems for residents and visitors in the form of:

- Crowded Metro cars, stalled trains, and unreliable escalators;
- Potholes in the streets;
- Crumbling swimming pools, libraries, and school buildings (the average age of school buildings is more than 60 years);
- Concerns about potable water; and
- Numerous other outcomes.

These matters will only get worse without intervention. Intervention to rebuild in the short-term will not prevent a future infrastructure meltdown unless maintenance funding becomes available.

The District's fiscal stress was confirmed by the GAO in its 2003 study of the District's finances. This study was an extensive analysis comparing D.C.'s revenue and expenditure bases to those of state and local jurisdictions all across the U.S. From every perspective on structural imbalance examined by GAO, the District is at or near the top of the most burdened jurisdictions in the nation. The report verifies that the District suffers from a long-term structural imbalance of $470 million to $1.143 billion <u>annually</u>.

Although the District has made great strides in fiscal management and in providing better services, two difficult consequences of the structural imbalance between the District's revenue base and its spending requirements remain. These are: (1) a high per capita tax burden with some of the highest tax burdens in the region and the country; and (2) the highest per capita borrowing. The District's tax burden on households ranks in the upper one-third when compared to the largest cities in the U.S. (for total state and local burden of sales, income, property, and automobile taxes) according to a highly-regarded annual study, prepared by my office, comparing tax burdens in D.C. to those of the largest city in each state.[2]

The burden is greater on businesses. The District's tax rate on net business income is 9.975% (compared to 7.0% in Maryland and 6.0% in Virginia, and exceeded by only two states, Alaska and Iowa); the gross receipts tax on public utilities used by businesses is 11% (compared to 2% in Maryland and 1% in Virginia); and the real property tax on commercial property is $1.85 per $100 of value as compared to a range of $0.92 to $1.16 in neighboring suburbs.

The GAO ranks the District's tax burden among the very highest in the country:

> "The District's tax burden (actual revenue collected from local resources relative to their own-source revenue capacity) is among the highest of all fiscal systems . . . The District's actual tax burden exceeded that of the average state fiscal system by 33 percent, based on our lower estimate of its own-source revenue capacity, and by 18 percent, based on our higher estimate of that capacity."[3]

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[2] Government of the District of Columbia, Office of the Chief Financial Officer, Tax Rates and Tax Burdens in the District of Columbia, A Nationwide Comparison, various years. This annual study is the basis for many public uses, such as an annual analysis by Money Magazine, and has been cited in the New York Times, Wall Street Journal, CNN, and many other places. It is available on the web at www.cfo.dc.gov under Tax Rates and Revenues, Tax Burden Comparisons.
[3] GAO-03-666, District of Columbia, Structural Imbalance and Management Issues, May 2003, page 41.

There is no way for the District to tax its way out of structural imbalance – indeed, higher taxes simply make the problem worse.

The District's very high per capita borrowing reflects the city's effort to sustain infrastructure generally provided by multiple jurisdictions. The District's per capita tax-supported debt burden now exceeds $8,000, the highest of any major city in the nation and fully 20% above New York City, the second-highest. Furthermore, with the additional borrowing anticipated in the four-year capital plan, it is projected to increase to more than $13,000 per person. Clearly, we cannot borrow our way out of the structural imbalance.

Future Challenges

Challenges may arise, adding to D.C.'s structural imbalance in coming years. First, all state and local revenue systems are stressed by the changing nature of the economy, as it evolves into a more service-oriented economy. Because state and local tax systems were developed around the manufacturing and sale of goods, the old ways of gathering tax revenue are increasingly inadequate. The revenue challenge is made even greater in the District by the federal prohibitions against taxing incomes earned by non-resident workers and incomes earned by certain professional services. Additionally, a recent court ruling challenges the District's capacity to tax any unincorporated business income generated in the District except as reported on the individual returns of residents. Already, the partnership income of District residents that is earned elsewhere is exempt from taxation here, reducing the District's potential income tax revenue by about $60 million in tax year 2004.

Second, the District has a large urban population that needs help. Like other cities, the District is accountable for greater efforts to help the less advantaged in the city's population. Unlike other cities, however, the District does not have a state or suburbs that share in its overwhelming costs.

Census data for 2004 estimate the District's poverty rate at about 19%, the fourth highest in the nation when compared to states, after Mississippi, Louisiana, and New Mexico, and comparable to other large urban populations like Baltimore, Boston, Cleveland, and Philadelphia (see Table 3 below). Of D.C.'s 248,563 households, 18% have income of less than $15,000.[4] Fully 25% of residents are Medicaid eligible, as compared to 12% in Maryland and 9% in Virginia. The District spends, on average, $7,242 per enrollee, compared to $5,509 in Maryland and $5,177 in Virginia. (Recall that, unlike Maryland and Virginia, the District has no rural areas with lower costs to help offset the much higher cost of care in urban areas.)

The cost per District resident to provide Medicaid services is $1,776, compared to $649 in Maryland and $445 in Virginia. The extra per capita burden of Medicaid costs in D.C. is quite high. Even if it were realistic to improve efficiency by 25 percent, the District's cost per capita would still remain twice as high as Maryland's and three times that of Virginia.

[4] American Community Survey, 2004.

Table 3

City	Population Change 2000-2004	Adult Poverty Rate	Child Poverty Rate
Detroit, MI	-5.0%	33.6%	47.8%
Milwaukee, WI	-2.1%	26.0%	41.3%
Philadelphia, PA	-2.9%	24.9%	35.7%
Baltimore, MD	-1.9%	23.9%	34.6%
Washington, DC	**-3.1%**	**18.9%**	**33.9%**
Cleveland, OH	-3.8%	23.2%	32.2%
Boston, MA	-3.4%	19.0%	26.9%
Denver, CO	0.3%	15.1%	24.8%
Portland, OR	0.7%	16.5%	23.3%
Seattle, WA	1.3%	17.3%	22.0%
Las Vegas, NV	10.6%	11.6%	16.9%
Top 30 Cities	1.5%	NA	NA
Top 251 Cities	2.7%	NA	NA
United States	4.1%	12.7%	17.3%

Sources: Population Division, US Census Bureau and American Community Survey, US Census Bureau, 2004

Median household income is about $46,600. This contrasts weakly with the Washington metropolitan area's median household income of about $70,400.[5] Only about a third of D.C.'s households are at or above the metropolitan median.

Conclusion

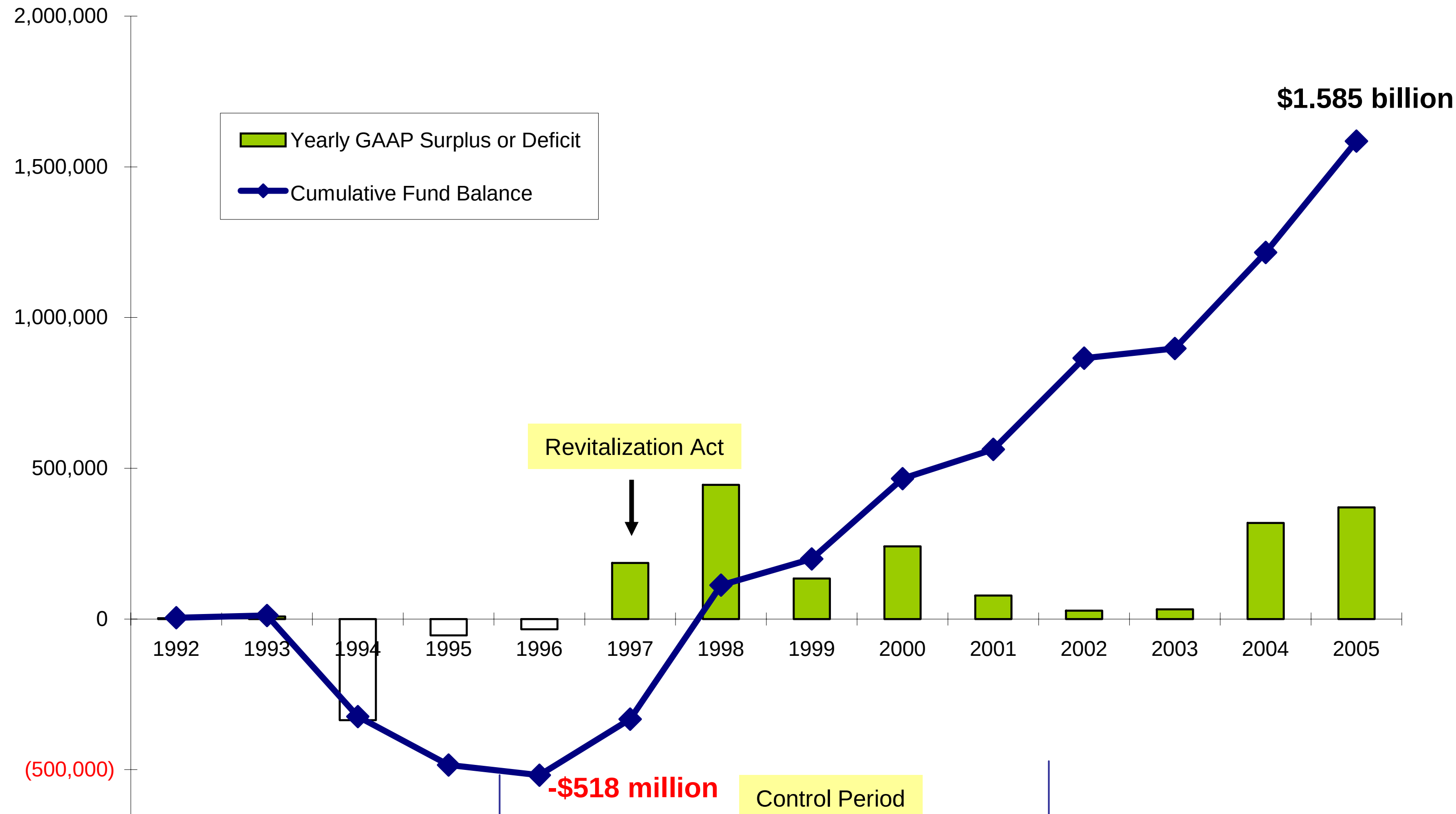
The leadership provided by the Mayor and the Council allowed the District to return to fiscal health. I would like to thank this committee for its diligent and continuous oversight work on the District's finances during this sustained recovery period. We look forward to continuing to work with you to ensure that the nation's capital remains fiscally strong and ready to meet the challenges of the future.

[5] American Community Survey, 2004 and Economy.com, 2004.

Next January, the District will have a new Mayor and a new Council chair, and it is possible that we will have a number of new Council members. Though our current financial position is strong, the new leadership will face the need for ongoing vigilance to protect the gains that were hard won. Until the District's tax base is widened, given our needs and the on-going structural imbalance, we are still in a precarious position. Like many American families who are just a paycheck or two away from financial hardship, the District continues in a critical struggle for financial security.

We are committed to making the hard decisions in order to balance our budgets. But clearly, the District needs federal assistance to provide adequate infrastructure improvements to secure the safety of the city's residents and the millions of Americans who visit our nation's capital every year.

Surplus and Bond Rating History

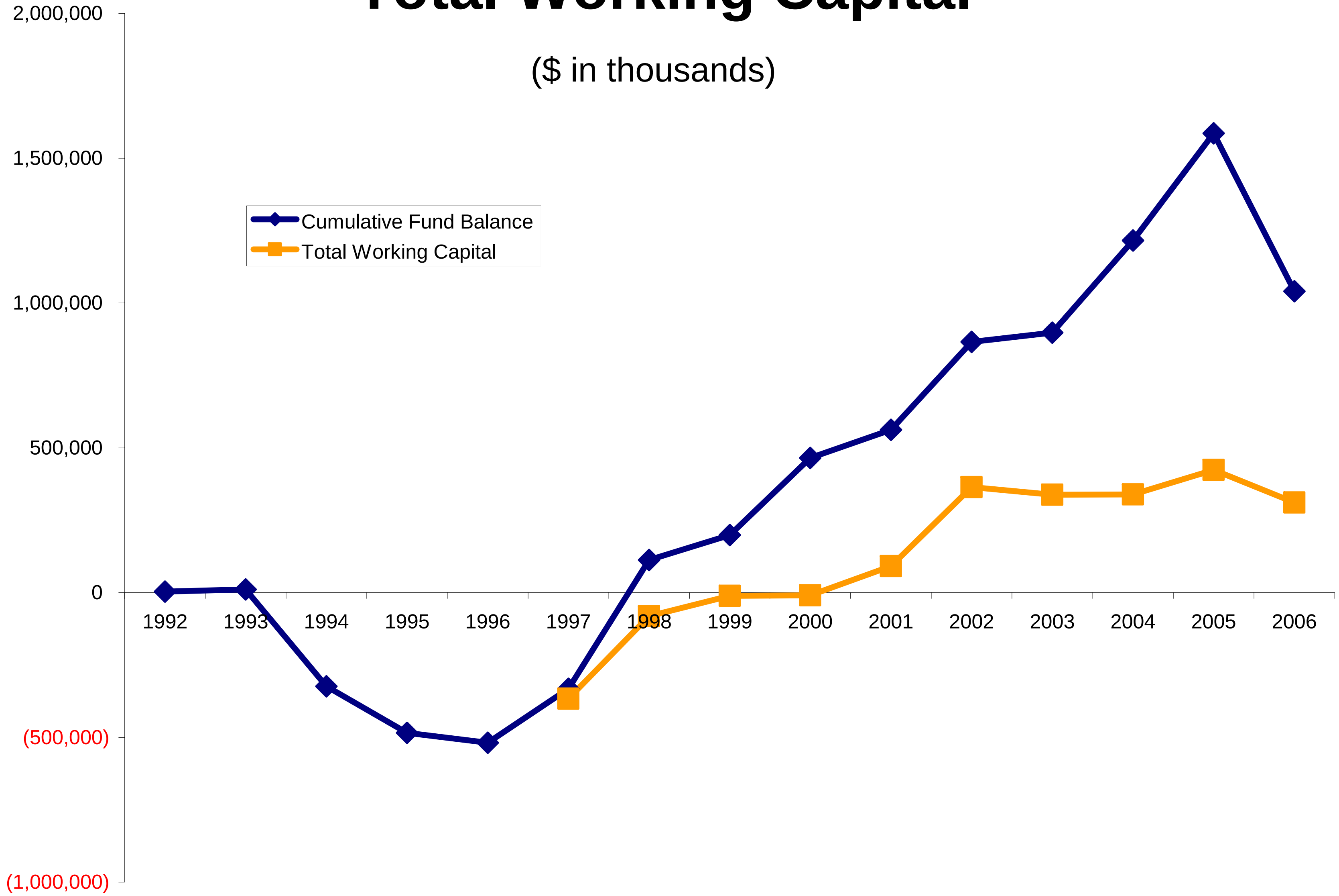


															Outlook
A-	A-	A-	BBB-	B	B	BB	BBB	BBB	BBB+	BBB+	A-	A	A+	: S&P	Stable
Baa	Baa	Baa	Ba	Ba	Ba2	Ba1	Ba1	Baa3	Baa3	Baa1	Baa1	A2	A2	: Moody's	Positive
	A-	BBB+	BB	BB	BB	BB+	BB+	BBB	BBB	BBB+	A-	A-	A	: Fitch	Positive

ATTACHMENT A

Projected Fund Balance vs. Total Working Capital

($ in thousands)



ATTACHMENT B