United States General Accounting Office

GAO

Report to the Chairman, Subcommittee on the District of Columbia, Committee on Appropriations, House of Representatives

September 2002

DISTRICT OF COLUMBIA

Fiscal Structural Balance Issues

GAO

Accountability * Integrity * Reliability

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United States General Accounting Office
Washington, D.C. 20548

September 4, 2002

The Honorable Joe Knollenberg
Chairman
Subcommittee on the District of Columbia
House Committee on Appropriations

Dear Mr. Chairman:

The District of Columbia has historically faced many challenges due to its unique circumstances and role as the nation's capital. After several years of struggling with financial crises and insolvency in the early 1990s, the District has significantly improved its financial condition by achieving five consecutive balanced budgets, an upgraded bond rating, and unqualified,[1] or "clean," opinions on its financial statements.

More recently, however, District officials have sounded the alarm that the District faces an imbalance between its long-term expenditure needs for program services and capital investment, and its capacity to generate revenues over the long run. These officials assert that the District faces a fiscal structural imbalance as a result of several factors, many stemming from the federal government's presence in the city, the absence of a state to provide funding for the state-like services provided by the District, and restrictions on the District's tax base.

In response to your June 26, 2002, letter, this report provides our preliminary assessment of several elements of the District's reported fiscal structural imbalance. However, we have not yet completed the work necessary to conclude whether, or to what extent, a fiscal structural imbalance may exist in the District. Specifically, you asked us to provide information on the following:

- the District's definition of fiscal structural imbalance and its contributing factors;
- the constraints on the District's revenue, including the prohibition of an income tax on nonresidents;

[1]An unqualified opinion means that the financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles.

- the District's estimates of its spending requirements, including its cost estimates for providing services to the federal government and its spending for state-like functions;

- changes in the District's financial relationship with the federal government resulting from the National Capital and Self-Government Improvement Revitalization Act of 1997 (Revitalization Act);[2] and

- alternative approaches to measuring structural imbalance in the District.

The information being presented in this report is based on our work performed to date on this issue. We currently have ongoing work in this area and plan to issue a future report which will provide a more comprehensive analysis of the District's reported fiscal structural imbalance.

Results in Brief

Like many cities, the District faces a series of substantial, long-term challenges to its financial position. The key question is whether city officials can provide an acceptable level of services to address the District's needs with their current tax base. The District argues that it faces a fiscal structural imbalance between revenues and its expenditures that undermines its capacity to meet its current responsibilities. In contrast with a cyclical fiscal imbalance caused by temporary economic downturns, the District suggests that its imbalance is longer term and more fundamental—and therefore, structural in nature. The District's estimated measures of fiscal structural imbalance are premised on the continuation of current budget policy over a longer term period spanning economic cycles, but do not consider the results of policy alternatives.

District officials have cited constraints they face in raising revenues as well as what they assert are unique expenditure responsibilities stemming from the District's position as a federal city that must also provide state-like functions. On the revenue side, unlike state governments, the District is prohibited by federal law from taxing the incomes of nonresidents working in the District. District officials also point to the fact that the District is unable to tax a significant portion of property due to the federal presence.

[2]The Revitalization Act is Title XI of Pub. L. No. 105-33, 111 Stat. 712 (1997). Public Law 105-33 in its entirety is entitled the Balanced Budget Act of 1997.

While federal tax exempt property does constitute a substantial amount of property in the District, the federal presence also draws substantial economic activity which provides the District with additional revenues from sales and income taxes generally not available to other cities of its size.

On the spending side, the District officials state that they are uniquely burdened by the responsibilities of a state and by requirements to provide services to the federal establishment. However, the District's estimated costs associated with providing state-like services are not supported by detailed analysis and data, and are derived from cost allocation formulas largely based on the judgment of District officials. Moreover, while the District does have responsibilities similar to those of many states, it also has state-like types of revenues. Similarly, the District's estimates of its costs for providing services to the federal government lack detailed support, and do not consider the services provided by the federal government for its own property in the District.

Perhaps most importantly, the District's estimates of its fiscal structural imbalance are premised on the maintenance of the existing level and costs of services now provided into the future. As a result, the estimates do not consider the potential for mitigating an imbalance with cost savings through management efficiencies, reassessing current policies, and restructuring of key programs. For instance, a 2002 McKinsey & Company, Inc. study concluded that about $110 million to $160 million of cost savings could be achieved annually in such areas as health, human services, education, and transportation if the District's costs were brought into line with those of comparable cities.

The District received some federal relief through the 1997 Revitalization Act, which required the federal government to take over certain services in such areas as criminal justice, transferring their financing from DC taxpayers to the nation's taxpayers as a whole. In addition, the federal government assumed financial and administrative responsibilities for one of the District's largest fiscal burdens, which it inherited from the federal government as part of the transition to Home Rule in 1973—its unfunded pension liability for vested teachers, police, firefighters, and judges. Also, the federal government's share of the District's Medicaid payments was increased from 50 to 70 percent. At the same time, the Revitalization Act eliminated the federal government's annual payment to the District, which had reached $660 million per year. As a result of the above changes, the District estimates net financial benefits ranging from a low of $79.1 million to a high of $203 million per year during the period from 1998 through 2002. Although District officials state that the Revitalization Act did not fully address their challenges, they indicate it was an excellent first step in helping the city move toward longer term financial stability.

While the District's estimates point to many specific factors they do not constitute a comprehensive assessment of imbalances between expenditures and revenue capacity. The District has not performed the analysis to determine whether it has the capacity to provide a level of services comparable to those provided by other cities with similar needs and costs. As a practical matter, such an analysis is key to determining the presence of an underlying structural imbalance in the District's finances. Compared to the District's estimates, this approach has the advantage of not being tied to current service levels, costs, management approaches, or tax policies. From the perspective of this more comprehensive, comparative approach, a jurisdiction could suffer from a fiscal structural imbalance even if its current budget were balanced—for example, the imbalance would be reflected in lower services, higher taxes, or deterioration of infrastructure when compared to averages in other communities. On the other hand, a jurisdiction with chronic current deficits may not have a structural imbalance if its deficits were prompted by spending levels or tax rates out of line with comparable jurisdictions with similar needs.

At the present time, however, comprehensive data and analysis are not readily available to say with confidence how the District's financial situation compares to that of other jurisdictions. Preliminary indications suggest that the District would have to sustain a high level of expenditures compared to other state and local areas to provide at least an average level of services after adjusting for its unique demographic profile and costs. However, when compared to other entities, previous studies suggest that the city also has among the highest revenue capacity, or the ability to raise revenues from its own sources, even accounting for the federally imposed constraints on the city's revenue-raising authority. Importantly, the two sides of the equation need to be put together to address whether the District has the revenue capacity to provide for its unique workload and costs with an average tax burden. Such a comparative analysis would need to adjust for the fact that the District is not strictly comparable to any current jurisdiction in the nation, due to its unique combination of state and city functions and revenues and its role as the nation's capital. We are currently undertaking such an assessment and plan to report the results of our study in the future.

We have been conducting our work on this issue since February 2002 in accordance with generally accepted government auditing standards, and our work is ongoing.[3] The information presented in this report provides our preliminary assessment of several elements of the District's estimates of its reported structural imbalance. However, we have not completed the work necessary to conclude whether or to what extent a structural imbalance may exist in the District.

In responding to a draft of this report, both the Mayor and the Chief Financial Officer (CFO) of the District stated their belief that the District faces a fiscal structural imbalance. However, they endorsed our conclusion to analyze this issue further, in greater detail, and with additional sophistication to discern the degree to which the District might face a structural imbalance. We continue to conclude that there is insufficient information to determine whether and to what degree the District faces a fiscal structural imbalance. Our ongoing work will provide more comprehensive information and clarify the appropriateness of additional information and estimates provided by the District's CFO. The comments we received from the District's Mayor and CFO are reprinted in appendixes III and IV, respectively, and have been addressed in the report as appropriate.

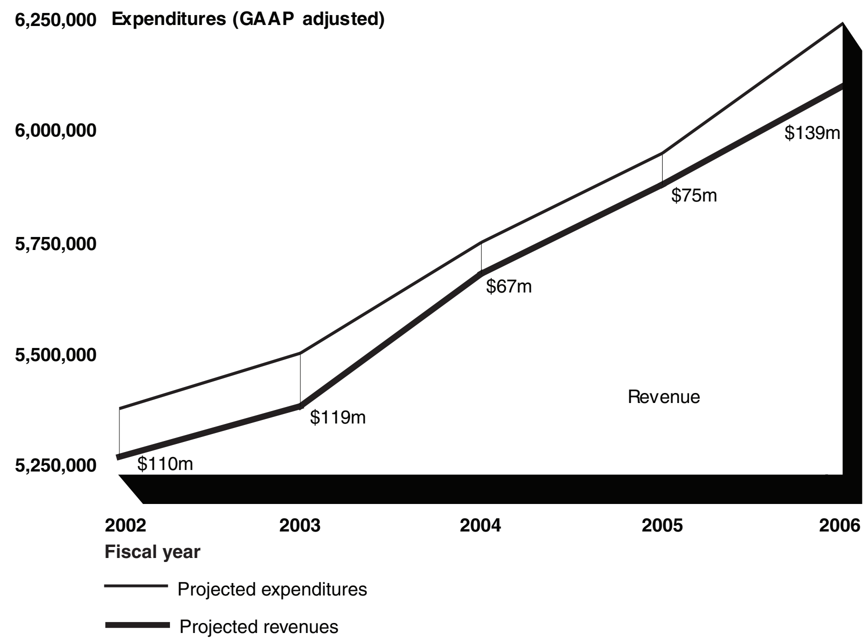
Background

One of the most significant challenges facing the District is to maintain the financial viability of the city. Earlier this year, District officials sounded the alarm that the District faces an imbalance between its long-term expenditure needs for program services and capital investment, and its capacity to generate revenues over the long run. In contrast with a cyclical imbalance caused by temporary economic downturns, the District suggests its imbalance is more fundamental in nature. These officials assert that the District faces a fiscal structural imbalance as the result of several factors, many stemming from the federal government's presence in the city, the absence of a state to provide funding for the state-like services provided by the District, and restrictions on the District's tax base. District officials have stated that the factors contributing to a fiscal structural imbalance have existed for years but that their effects had been masked during recent years of national and regional economic growth and increased tax revenues.

[3] Additional detail on our scope and methodology is presented in app. I.

As shown in figure 1, the District has projected operating budget shortfalls ranging from $67 million to $139 million between anticipated revenues and estimated baseline expenditures for each year during fiscal years 2002 through 2006 if corrections are not made. These projections assume a continuation of current tax policies and service levels into the future, without implementing changes to address the projected fiscal shortfalls.

Figure 1: The District's Projected Operating Budget Without Corrective Actions



GAAP – Generally accepted accounting principles.

Source: District of Columbia Chief Financial Officer, January 2002 (unaudited).

The operating deficit projections in figure 1 include the operating budget only and exclude the capital expenditure budget. Therefore, certain probable expenditures are not included in the above budget estimates, such as public schools' infrastructure needs, needed repair of public roads, and Washington Metropolitan Area Transit Authority (WMATA) capital needs. District officials have expressed concern that if the fiscal structural imbalance issue is not addressed, it will cripple the city's efforts to maintain financial viability and require the city to make drastic cuts in its budgets and related services to avoid future deficits.

In addition, a March 14, 2002, study[4] commissioned by the Federal City Council (FCC)[5] concluded that the District is on a path leading to budget deficits. The study estimated that without corrective action, the District could face budget deficits of at least $500 million by fiscal year 2005 due to a substantial decrease in revenue growth and unbudgeted spending increases in several key areas.[6] The study cited spending for public schools (including spending for special education), Medicaid, and WMATA as the most significant drivers of the growth in projected expenditure levels.

The District's Definition of Fiscal Structural Imbalance and Its Contributing Factors

The District's definition of fiscal structural imbalance is premised on an imbalance between projected expenditures necessary to maintain the current level of services and revenues that will be raised under current tax and other revenue policies. Under the District's definition, a current services analysis assumes the current level of services and revenue structure as the baseline for concluding whether a fiscal structural imbalance exists. A current services imbalance can develop for a variety of reasons, including expenditures growing more rapidly than expected revenues due to increasing workloads such as number of program recipients, a rapid growth rate in health care costs, or a decline in tax revenues. The District also points to its uniqueness and the fiscal issues stemming from its being the nation's capital and having the federal presence, as well as its responsibility for services ordinarily provided by state government.

[4]McKinsey & Company, Inc, *A Report to the Federal City Council: Assessing the District of Columbia's Financial Position* (Washington, D.C.: 2002).

[5]The FCC is a nonprofit and nonpartisan organization dedicated to the improvement of the nation's capital. FCC was established in 1954 and is composed of and financed by 150 business, professional, educational, and civic leaders.

[6]As discussed in a later section of this report, the McKinsey study also points out that the District has opportunities to achieve cost savings that would potentially mitigate the projected deficits.

Some current services imbalances are cyclical, rather than structural, in that revenues become insufficient to support existing levels of services during periods of economic decline but then return to sufficiency when the economy rebounds. In its August 2001 study,[7] the Center on Budget and Policy Priorities (CBPP) notes that it is extremely difficult to determine the degree to which a fiscal imbalance in any state is structural, rather than cyclical. The CBPP reported that states are currently facing their worst financial crisis in 20 years, and they are responding to their budget shortfalls in a variety of ways. Some are using short-term fixes, such as tapping into rainy day funds or imposing temporary tax increases or spending cuts; others are using long-term fixes, such as imposing permanent tax increases or spending cuts.

The revenue shortfalls projected by District officials for fiscal years 2002 through 2006, if accurate, would represent recurring deficits in the District's current services budget position if corrective action is not taken. These projected shortfalls are premised on the continuation of current budget policy over a long-term period spanning economic cycles. They do not contemplate changes in budget policy, nor do they compare the District's current budget policy with other jurisdictions. However, District officials also suggest that their current environment constrains their ability to respond to the projected imbalance through spending cuts, tax increases, or borrowing. For example, District officials point to deferred infrastructure improvements in public schools, roads, and utilities as the legacy of the long-term presence of a structural imbalance, low levels of service delivery in some programs, such as public education, and high tax rates in comparison to other states and local jurisdictions.

Although District officials have not formally estimated the size of their reported fiscal imbalance, they have cited the following expenditure responsibilities as the primary factors contributing to such an imbalance:

- the District is not directly compensated for services provided to the federal government such as public works and public safety, which the District values at $240 million annually;

[7]Center on Budget and Policy Priorities, *State Responses to Tight Fiscal Conditions: Short Term Fixes May Backfire if the Economy Does not Soon Recover; Cyclical Downturn Masks Structural Problems in Some States* (Washington, D.C.: 2001).

- the District is responsible for state-like services such as human services, mental health services, Medicaid, and the University of the District of Columbia, which the District values at $487 million annually; and

- the District estimates that approximately 400,000 out-of-state vehicles travel on city roads per day and do not pay for road repair the District values at $150 million per year.[8]

District officials also cite the following factors as contributing to limited revenue-raising capacity:[9]

- 66 percent of the income earned by employees working in the District cannot be taxed by the District because the employees are nonresidents;

- 42 percent of the real property (or 27 percent of assessed property value) in the District is owned by the federal government and is thus exempt from taxation;[10]

- an additional 11 percent of real property (excludes District-owned property, but includes nonprofit organizations and embassies) also is tax exempt;

- District buildings have congressionally imposed height restrictions[11] that have reduced the population and the economic density; and

- District tax rates and burdens on households and businesses are high in comparison to Virginia and Maryland and its tax base is limited, thus making it difficult to expand the tax base.

[8]These figures were provided to us by the District. We did not audit or verify the data.

[9]The figures relating to nonresident income and real property were provided to us by the District. We did not audit or verify the data.

[10]These figures were provided to us by the District based on real property tax records. We did not audit or verify the data.

[11]DC Code, 2001 Ed. §§ 1-206.02 (6) and 6-601.05.

Constraints on the District's Revenue Include Tax-Exempt Property and Federal Law Prohibiting a District Tax on the Income of Nonresidents

The District faces some real constraints on revenue. The District, like all state and local governments, is unable to tax property owned by the federal government. District officials say they face a particular hardship because a larger proportion of their property is owned or specifically exempted by the federal government than is the case with most jurisdictions. The District has stated that, according to its real property tax records, 42 percent of its property is federal property. It is difficult to estimate the net fiscal impact of the presence of the federal government or other tax-exempt entities because of the wide variety of indirect contributions that these entities have on District revenues and the lack of information on the services they use. The presence of tax-exempt entities generates revenues for the District, even though they do not pay income or property taxes directly. For example, these tax-exempt entities attract residents, tourists, and businesses to the District. In addition, employees of the tax-exempt entities and employees of businesses that provide services to these entities pay sales taxes to the District. We have found no comprehensive estimates of these revenue contributions; however, studies of individual tax-exempt entities suggest that the amounts could be significant.[12] Further, given the large portion of the private sector activity in the District that is linked to the presence of the federal government and other tax-exempt entities, it is unclear whether commercial property would fill the void if federally owned property were reduced to the average seen in other cities.

[12]See Stephen S. Fuller, "The Economic and Fiscal Impacts of the Proposed International Monetary Fund Building" and "The Economic Impact of George Washington University on the Washington Metropolitan Area," Greater Washington Research Center (Washington D.C.: 2000).

In addition to the amount of nontaxable property in the District, the District government, unlike state governments, is prohibited by federal law from taxing the income earned in the District by nonresident individuals.[13] States that have income taxes typically tax the income of nonresidents, although some states have voluntarily entered into reciprocity agreements with neighbor states in which they agree not to tax the incomes of each other's residents. States that impose income taxes also typically provide tax credits to their residents for income taxes paid to other states. In addition, some cities that have income taxes tax the incomes of commuters who work within their boundaries. These taxes are typically levied at a low flat rate (most of the ones we identified were between 1 and 2 percent) on city-source earnings. Other cities are not authorized to levy commuter taxes by their state governments.[14] However, in cases where cities are not authorized to levy commuter taxes, the state governments are able to compensate, if they so choose, by redistributing some of the state tax revenues collected from residents of suburbs to central cities in the form of grants to the city governments, or in the form of direct state spending within the cities.[15]

[13]Section 602(a) (5) of the District of Columbia Home Rule Act, D.C. Code, 2001 Ed. 31-206.02(a)(5) states that the District's Council may not "impose any tax on the whole or any portion of the personal income, either directly or at the source thereof, of any individual not a resident of the District."

[14]This general discussion is drawn from the State of Wisconsin, Legislative Fiscal Bureau, *Individual Income Tax Provisions in the States* (January 2001); Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, *volume 1*, (Washington, D.C.: 1995); Carol O'Cleireacain, *The Orphaned Capital: Adopting the Right Revenues for the District of Columbia* (Washington, D.C.: 1997); and District of Columbia Department of Finance and Revenue, *Study of Property*, *Income and Sales Tax Exemptions in the District of Columbia* (Washington, D.C.: 1995). The range of tax rates, in the jurisdictions we identified as levying commuter taxes, was verified using publicly available tax descriptions drafted by the individual jurisdictions.

[15]Grants from a state to city government do not represent the net fiscal flow between the two jurisdictions. States collect significant amounts of tax revenue from individuals, businesses, and transactions located in cities. The net fiscal flow would equal state grants and direct state spending in a city (excluding any pass-through of federal funds), minus all state revenues collected in that city.

District officials believe that it is unfair for the federal government to apply a restriction on their income tax base that does not also apply to the 50 states. Another argument that is commonly made in favor of removing this particular restriction on the District's taxing authority is that it would enable the District government to defray the costs of providing public services, such as road maintenance and fire and police protection, that benefit commuters. A recent study estimated that the average commuter increased total District expenditures by $3,016 per year, of which about $90 was for police and fire protection.[16] Some local economists that we interviewed noted that commuters already contribute to the financing of a portion of these services, even without a tax on their income. One recent study estimates that a typical daily commuter to the District pays about $250 per year in sales and excise taxes, parking taxes, and purchases of lottery tickets.[17] Another study suggests that spending by commuters supports many jobs for District residents who are subject to the city's income tax.[18] We were unable to find data on the amount of taxes paid directly by commuters, the tax revenues attributable to jobs supported by them, or the amount of money that the District must spend to extend services to them, nor have we assessed the accuracy of the estimates cited above. Consequently, we cannot determine conclusively whether the net fiscal impact of commuters in the absence of a commuter income tax is negative or positive.

[16] Howard Chernick, "*The Effect of Commuters on the Fiscal Costs of the District of Columbia*" (Washington, D.C.: 2002).

[17] Philip M. Dearborn, "Effects of Telecommuting on Central City Tax Bases," Brookings Greater Washington Research Program (Washington, D.C.: 2002). The study did not attempt to estimate the indirect fiscal contributions that commuters may have through taxes on their employers.

[18] Stephen S. Fuller, "The Economic and Fiscal Impacts of the Proposed International Monetary Fund Building at 1900 Pennsylvania Avenue, NW on the District of Columbia," prepared for the International Monetary Fund (Washington, D.C.: 2001).

Regardless of the current net fiscal impact of commuters, the District's finances clearly would benefit considerably from a tax on nonresidents' incomes. The ultimate burden of a nonresident income tax for the District would not necessarily be borne by commuters into the District. The distribution of the burden would depend on the nature of the crediting mechanism that would be established under such a tax. For example, if the District's tax were made fully creditable against the federal income tax liabilities of the commuters, as is proposed in the District of Columbia Fair Federal Compensation Act of 2002, then the federal government would bear the cost and would have to either reduce spending or make up for this revenue loss by other means. However, if the federal income tax credit was not available, and instead the states of Maryland and Virginia allowed their residents to fully credit any tax paid to the District against their state income tax liabilities, then those two states would suffer a revenue loss (relative to the current situation). The two states could respond to a District commuter tax by taxing the income of District residents who work within their jurisdictions or increasing the tax rates on all of their residents.[19] If the District's tax were not fully creditable against either the federal or state taxes, then the commuters themselves would bear additional tax burden.

The District's Estimates of Spending Requirements

Although the District's overall warning that it faces structural challenges in balancing revenues and spending requirements should be taken seriously, the District's estimates of its spending requirements have serious limitations. The District does absorb certain costs associated with supporting services typically provided at the state level as well as with providing services to the federal government. However, the District's estimates of its costs to provide services to the federal government and its costs of providing state-like services are not supported with detailed data or analysis. Also, the District's estimates do not reflect municipal-type services provided directly by the federal government. In addition, the District's estimates of its fiscal structural imbalance do not include potential cost savings from improving management efficiency. Further, the District has developed its budget estimates based on the current level of services as the baseline going forward. According to District officials, no studies have been done to determine the level of services necessary, and

[19]The District, Maryland, and Virginia currently have reciprocity agreements under which each government allows residents to pay income tax only in the jurisdiction where they reside.

the District continues to struggle to determine the level of services to provide, given the perceived political barriers to achieving structural changes in large programs such as public schools, Medicaid, and human services. Finally, the District has not considered potential savings in its estimates of its fiscal structural imbalance.

District-Estimated Spending for State-Like Functions

According to District officials, the District government performs state-like functions that contribute to what it considers a structural imbalance. Although the District has costs associated with certain state-like functions, it is important to note that the District also collects and retains state-like income and sales tax revenues to fund these functions and support the activities of some agencies.[20] The District estimated the cost of state-like functions to be $487 million in fiscal year 2002. However, this estimate is based on very limited analytic support. Broad assumptions were made and the analysis was made based on a review of only one jurisdiction.

To arrive at its cost estimate, the District has identified state-like functions in 10 different District agencies for fiscal year 2002. To identify the state-like functions, District officials reviewed the State of Maryland's fiscal year 2002 operating budget to identify state funding to local governments and compared this information with the District's fiscal year 2002 operating budget. Based on this review and comparison, District officials identified the following 10 District agencies that provide some state-like functions:

- Department of Mental Health,
- Department of Human Services,
- Child and Family Services Agency,
- University of the District of Columbia,
- Department of Motor Vehicles,
- Office of Tax and Revenue,
- Department of Insurance and Securities Regulation,

[20]Although some cities do levy income and sales taxes, they are usually at a relatively lower level than the income and sales taxes at the state level.

- Public Service Commission,
- Office of Cable and Television Communications, and
- District of Columbia National Guard.

Using the Maryland state budget as a guide, District officials used their judgment to assign a "state allocation ratio" to each function in the 10 identified District agencies. For example, if a function, such as Temporary Assistance to Needy Families, received more than half of its funding from the state, then District officials assigned that function a 100 percent state allocation percentage. If a function received less than half of its funding from the state, the District did not consider it a state-like function and gave it a zero state allocation ratio. District officials considered the Office of Tax and Revenue both a state and local function and assigned it a 50 percent state allocation ratio. Two other District agencies, the Department of Human Services and the Child and Family Services Agency, also had a combination of state and local functions and therefore had a weighted state allocation ratio.

District officials acknowledged that the state allocation ratios used to create their cost estimates were primarily based on their own judgment and knowledge of state and local programs. Other than providing a summary of Maryland's state budget, District officials were unable to provide additional documentation to support these decisions. District officials emphasized that, as with any of the cost estimates the District produced to illustrate what it considers a fiscal structural imbalance, these were only estimates. They cautioned that these estimates should not be added together to represent an aggregate cost resulting in a fiscal structural imbalance. A District official said that these estimates were meant only to illustrate different ways of understanding the structural imbalance issues that face the District.

The District's Estimated Costs of Services Provided to the Federal Government

The services identified by the District as being provided to support the federal government's presence are primarily administered by the District's public works and public safety and justice agencies and include:

- police protection for federal employees and for federally sponsored or sanctioned events in the District,
- fire suppression for federal buildings,

- emergency medical treatment for federal employees, and

- snow removal and street repairs on streets used by federal vehicles and by federal workers commuting to work in the District.

District officials estimated the services provided to the federal government cost the District up to $240 million annually. However, the District did not have a detailed list of actual services provided to the federal government to support its cost estimate. District officials estimated that 27 percent of the total assessed value of property in the District is owned by the federal government. As such, District officials have estimated that the cost of services provided to support the federal government's presence in the District is based on 27 percent of the proposed budgets for all of the District's public works and public safety and justice agencies. However, these budgets include functions, such as the Department of Motor Vehicles, that provide minimal services to the federal government.

The District's cost estimate for services provided to the federal government does not consider the services provided by the federal government to the District or expenditures made by the federal government for its own property, when in fact, many federal agencies and properties provide for their own public safety and security and public works services. The National Park Service, for example, provides an extensive network of historical, educational, and recreational opportunities within the District. The federal government provides upkeep, maintenance, and restoration of facilities including not only well-known national sites such as the National Mall or Ford's Theatre, but also parks such as those on Capitol Hill, including inner city medians, squares, and traffic circles, as well as other areas that provide urban green space within the city. According to the U.S. Department of Interior's fiscal year 2003 budget request, operating costs for these parks will be $59 million.

Federal law enforcement agencies operating within the District include large forces, such as the U.S. Capitol Police with more than 1,400 officers, and smaller forces, such as the Smithsonian Institution Protective Services with an estimated 600 officers. In addition, the General Services Administration's Federal Protective Service provides law enforcement services to some federal properties throughout the District. These services include a share of police protection from disruptions by major demonstrations, perimeter security for federal buildings, criminal investigations to reduce crime, and training of security personnel.

District's Estimates of Imbalance Do Not Address Potential Cost Savings

The District's estimates of its fiscal structural imbalance are premised on the maintenance of the existing level and costs of services now provided into the future. The District's estimates did not address potential cost savings that could be achieved by improving management efficiency at the agency level. Reducing expenditures by improving efficiency could reduce any imbalance between the District's revenues and expenditures without negatively impacting program service delivery to its citizens. For example, the March 2002 McKinsey & Company, Inc. study on the District's financial position[21] concluded that approximately $110 million to $160 million in annual cost savings could be achieved in health, human services, public safety, transportation, and the District of Columbia Public Schools (DCPS) by fiscal year 2005. If achieved, these potential savings could mitigate a fiscal structural imbalance in the District. However, considerable uncertainty exists about these estimates.

Potentially the District could also achieve cost savings by correcting problems that have resulted in disallowed Medicaid costs for the District. The District will not be receiving over $100 million of Medical Assistance Administration cost reimbursements for costs incurred in prior years. These cost reimbursements were disallowed for reasons including failure to file timely claims or provide adequate support for claims submitted.[22] Nonreimbursed costs are paid out of local funds, not federal funds.

[21]McKinsey & Company, Inc, *A Report to the Federal City Council: Assessing the District of Columbia's Financial Position* (Washington, D.C.: 2002).

[22]The District's 2003 proposed budget submission includes plans to improve Medicaid cost reimbursement in the future.

Another example where potential cost savings could be achieved is the DCPS. In the DCPS' fiscal year 2001 Comprehensive Annual Financial Reports (CAFRs), District officials reported a $64.5 million deficit in locally appropriated funds. During the fiscal year 2001 audit, the District's financial statement auditors identified material weaknesses within the DCPS accounting and financial reporting processes, such as the monitoring of expenditures and accounting for Medicaid expenditures related to services provided to special education students. DCPS could become more efficient by improving its internal controls over financial accounting and reporting and reducing the risk of overspending within the DCPS programs. Public education has been a large driver of expenditures in the District, representing $1.1 billion of expenditures in fiscal year 2001.[23] Since 1999, the annual increase in the District's spending for public education has ranged between 19.4 and 21.9 percent. Clearly, such spending increases are difficult to sustain.

Impact of the Revitalization Act on the District

On August 5, 1997, the Congress passed the National Capital Revitalization and Self-Government Improvement Act, referred to as the Revitalization Act. The Revitalization Act made substantial changes in the financial relationship between the federal government and the District of Columbia as well as in the management of the District government. The District and several nonprofit public interest organizations have stated that the Revitalization Act, while not fully addressing the District's fiscal challenges, is an excellent first step in helping the District to move towards long-term financial stability.

The Revitalization Act made the following adjustments in the financial relationship between the District and the federal government:

- eliminated the federal government's annual federal payment to the District, and
- shifted to the federal government the financial responsibilities and, in some instances, administrative responsibilities, for the following justice functions in the District:

[23]The District CAFR, exhibit S-2, p. 115.

- incarceration of sentenced adult felons (the Federal Bureau of Prisons assumed responsibility, and the District's Lorton Correctional Complex was recently closed);

- the Superior Court, Appeals Court, and Court System (the Pretrial Services Agency and Public Defender Service functions, and the D.C. Parole Board were abolished); and

- the District Retirement Program covering judges.

Also under the Revitalization Act, the federal government assumed financial and administrative responsibilities for one of the District's largest fiscal burdens, which it inherited from the federal government as part of the transition to Home Rule in 1973—its unfunded pension liability for vested teachers, police, firefighters, and judges. In 1998, the federal government assumed the accrued pension cost of $3.5 billion that existed at the close of 1997. The District remains responsible for funding benefits for services rendered after June 30, 1997, and continues the plan under substantially the same terms. In addition, the Revitalization Act was part of a larger act— the Balanced Budget Act of 1997—that increased the federal share of District Medicaid payments from 50 to 70 percent.

Prior to the Revitalization Act, the District had been receiving a federal payment since the mid-1800s due to the District's unique relationship with the federal government. The Congress recognized that the District's ability to raise revenues was affected by a number of legal and practical limitations on its authority—the immunity of federal property from taxation; the building height restriction, which has a limiting effect on commercial property values; the prohibition on the District from passing a law to tax the income of nonresidents; and the restriction on imposing sales taxes on military and diplomatic purchases.

Although the Revitalization Act repealed the federal payment to the District of Columbia, it also authorized a federal contribution. The Revitalization Act does not present a formula or methodology for translating the generalized notion of compensating the District for the federal government's presence into a predictable dollar amount, nor does it require that a contribution be made.

The changes to the District's finances resulting from the Revitalization Act impacted both the District's revenues and expenditures. The District estimates that the net benefit of the Revitalization Act has ranged from a net positive low of $79.1 million to a high of $203 million per year during the period 1998 through 2002. A detailed breakout of the estimated financial impact of the act on the District's revenues and expenditures is presented in appendix II.

Fiscal Structural Imbalance: More Comprehensive Approaches Should be Explored

The District's estimates of its fiscal structural imbalance point to many specific factors but do not constitute a comprehensive assessment of underlying imbalances between its expenditures and revenue capacity. The District has not yet determined whether even under the constraints they assert, it has the capacity to provide a level of services comparable to those provided by other cities with similar needs and costs.

The District's estimates essentially use a current services approach to analyzing its fiscal structural imbalance. Even if the District is able to resolve the measurement and analytical problems discussed in this report, this approach would be limited because it assumes the desirability and continuation of current service levels and tax policies. An alternative approach would measure the existence of a fiscal structural imbalance by comparing the District's spending and revenue capacity to levels in comparable jurisdictions. This approach assesses the ability of the District to provide at least an average level of services adjusted for its unique demographic profile and costs at an average tax burden.

The main advantage of this approach is that the measure of fiscal structural imbalance reflects the underlying social and economic conditions affecting the cost of providing public services as well as the underlying strength of the tax base.[24] For instance, this measure takes into account the specific factors influencing the demand for public services (e.g., a large number of school age children, road infrastructure) and its ability to fund these services with a tax burden on local residents that is comparable to other jurisdictions providing comparable services.

Under this framework, the structural position of a jurisdiction is not tied to current service levels, or spending or tax policies. From the perspective of

[24]For additional information on analyzing jurisdictions' expenditures and capacity, see U.S. General Accounting Office, *State and Local Finances: Some Jurisdictions Confronted by Short-and Long-Term Problems*, GAO/HRD-94-1 (Washington, D.C.: Oct. 6, 1993) and Robert Tannenwald, "Fiscal Disparity Among the States Revisited," *New England Economic Review* (July/August 1999).

this more comprehensive, comparative approach, a jurisdiction could suffer from a fiscal structural imbalance even if its current budget were balanced—in this case, the imbalance would be reflected in lower services, higher taxes, or deterioration of infrastructure when compared to averages in other communities. On the other hand, a jurisdiction with chronic current deficits may not have a fiscal structural imbalance if its deficits were prompted by spending levels or tax rates out of line with comparable jurisdictions with similar needs.

At the present time, however, comprehensive data are not readily available to do such a comparative assessment. Preliminary indications suggest that the District would have to sustain a high level of expenditures compared to other state and local areas to provide an average level of services adjusted for its unique demographic profile and costs. However, when compared to other entities, the city also has among the highest revenue capacity, or ability to raise revenue from its own sources, even accounting for the federally imposed constraints on the city's revenue-raising authority.

The most recent comprehensive comparison that we found uses the Representative Expenditure System (RES) to estimate the relative expenditure needs of states together with their localities, or in the terms used in this report, the benchmarked expenditures of the states and localities.[25] This study indicates that, in 1996, the District's per capita relative expenditures were higher than those of any state. However, this measure has certain shortcomings that could result in understatements of the District's relative expenditures.

[25]See Tannenwald. The RES approach estimates the amount of money each state, together with its localities, would have to spend in order to provide a standard, representative package and level of services.

The two most recent cross-state comparisons of revenue capacity indicate that the District's revenue capacity per capita compares favorably to that of most states.[26] These studies use two fundamentally different measures of revenue capacity, both of which largely take into account the fact that the District is prohibited from taxing the District-source incomes of nonresidents. For 1999, the most recent year for which the Department of the Treasury has estimated the Total Taxable Resources (TTR) of states, the District's value for this particular measure of revenue capacity exceeded that of every state, except Connecticut.[27] In 1997 and 1998, the District's value was higher than that of every state. The most recent available study that uses the Representative Tax System (RTS) methodology for estimating revenue capacity indicates that, in 1996, the District's revenue capacity per capita exceeded that of 46 states.[28]

However, results of these studies are imprecise and do not allow for conclusions on whether the District has a structural imbalance. The measures of the benchmarked expenditures and revenue capacity used in these studies are out of date. Moreover, as acknowledged by the author of the referenced study on expenditures, the estimates of the spending needed to realize average levels of service do not reflect certain relevant workload and cost differences across jurisdictions.

Ultimately, the revenue capacity and expenditure needs would have to be put together to address whether the District has the revenue capacity to provide for at least average levels of services for its unique workload and costs with an average tax burden. Such a comparative analysis would need to adjust for the fact that the District may not directly compare to any current jurisdiction in the nation, owing to its unique combination of state and city functions and revenues. GAO is currently undertaking such an assessment and will report the results of our study next year.

[26]U.S. Department of the Treasury, Office of Economic Policy, *2001 Estimates of TTR* (Sept. 28, 2001), and Tannenwald, pp. 3-25.

[27]TTR is defined as the unduplicated sum of the income flows produced within a state and the income flows received by its residents that a state can potentially tax.

[28]The RTS approach evaluates tax capacity by estimating the per capita yield that a uniform, hypothetical, representative tax system would produce in each state.

Conclusions

While it has made significant progress over the past several years, the District, similar to many other jurisdictions, continues to face a series of substantial, long-term challenges to its financial viability. Addressing these challenges requires continued dedicated leadership to make the difficult decisions and trade-offs among competing needs and priorities.

Presently, insufficient data or analysis exist to discern whether or to what extent the District is, in fact, facing a fiscal structural imbalance. On the revenue side, the District clearly has constraints in its ability to increase its tax base. However, the District's estimates of its possible fiscal structural imbalance have limitations and did not address the levels or costs of services for its citizens in the long term, whether such services could be supported by its present tax structure or tax base, or cost savings that can be achieved from management efficiencies. The available studies comparing revenue capacity and expenditures across jurisdictions are imprecise and some may not be applicable to the District.

As such, the Congress would benefit from more systematic information about the District as it considers proposals for addressing the fiscal structural imbalance that the District is currently asserting exists. A fundamental analysis of the District's underlying capacity to finance at least an average service level in relation to its needs can help determine if there is a fiscal structural imbalance. Such an analysis would provide a stronger foundation for decision makers at all levels to address the District's financial condition.

We currently have ongoing work in this area and plan to issue a future report with a more comprehensive analysis of the District's long-term financial condition. Therefore, we are not making any recommendations at this time.

Comments from the District of Columbia and Our Response

In responding to a draft of this report, both the Mayor and the Chief Financial Officer of the District stated their belief that the District faces a fiscal structural imbalance, but agreed that further analysis of the District's fiscal situation is needed because existing data and analysis are not sufficient to discern the degree to which the District is, in fact, facing a structural imbalance. The District reiterated the general areas it believes are drivers of the reported fiscal imbalance, and, in the District CFO's response, suggested that the annual imbalance was roughly twice the amount reported earlier this year. However, as we stated in our report, we concluded that insufficient data and analysis exist to substantiate the District's earlier estimates of its reported structural imbalance. In addition, as stated in our report, the District's estimates of its costs for providing services to the federal government and state-like services lack detailed support and have limitations.

We have work ongoing in this area and plan to issue a future report with a more comprehensive analysis of the District's long-term financial condition. Our future analysis will consider the extent to which the components of the District CFO's estimates and other important factors, including those where the District has advantages and disadvantages relative to other jurisdictions, impact the District's overall fiscal situation. The Mayor and the District's CFO stated that the District will support our efforts by providing necessary information and assistance.

We are sending copies of this report to the Ranking Minority Member of the Subcommittee on the District of Columbia, House Committee on Appropriations, and to other interested congressional committees. We are also sending copies to the Mayor of the District of Columbia, the Chair, DC Council, City Administrator/Deputy Mayor for Operations, Chief Financial Officer, and Inspector General. Copies of this report will also be made available to others upon request.

Please contact me at (202) 512-9471 or Patricia Dalton at (202) 512-6737 or by e-mail at franzelj@gao.gov or daltonp@gao.gov if you or your staff have any questions concerning this report.

Sincerely yours,

Jeanette M. Franzel
Director, Financial Management and Assurance

Scope and Methodology

To determine how the District and other jurisdictions define fiscal structural imbalance, including the factors that contribute to the District's reported imbalance, we

- interviewed and obtained information about fiscal structural balance and imbalance from officials in various District offices,
- analyzed reports and information received to define a fiscal structural imbalance, and
- analyzed the District's general fund revenue and expenditures in fiscal year 2001 and prior years to identify significant fluctuations and programs that were driving costs.

To provide information on the constraints on the District's revenues, we interviewed officials from the office of the District's CFO and several local experts on the District's economy and finances. We also reviewed a number of studies prepared by the District, independent commissions, and other researchers that contained information, evaluations, and estimates relating to these constraints.

To provide information on the District's estimates of its spending requirements, we interviewed District officials and analyzed District budget documents and financial statements. To analyze the services provided by the District to support the federal government, we interviewed District officials and analyzed relevant supporting information, such as budgets and financial plans. We also reviewed relevant information from the General Services Administration and other federal agencies on the costs and the types of services the federal government provides to its own property in the District.

To identify and analyze the functions that the District contends are state-like functions, we interviewed District officials and requested and analyzed pertinent supporting information. We also reviewed an April 15, 1997, study by the D.C. Financial Control Board entitled, "Toward A More Equitable Relationship: Structuring the District of Columbia's State Functions." This study compared the District's governmental functions to eight similar cities that were selected based on population size, degree of urbanization, the ratio of employed persons to total population, and other factors. In addition, we interviewed several local experts on the District's economy and finances to obtain their perspective on the state-like functions performed by the District and the expenditures the District makes related to the federal presence.

To address the question of the financial adjustments to the District of Columbia's finances as a result of the Revitalization Act, we reviewed

- relevant provisions of the Balanced Budget Act of 1997;[29]
- relevant provisions of the Revitalization Act;
- relevant provisions of the District of Columbia Home Rule Act;
- the District of Columbia Appropriations Acts for fiscal years 1998 through 2002;
- analyses of the impact of the Revitalization Act on the District's budget prepared by the Congressional Research Service;
- the Operating Budget and Financial Plans of the District of Columbia for fiscal years 1998 through 2002 and the Proposed Operating and Financial Plan for fiscal year 2003;
- prior GAO reports on District government financial operations; and
- the Department of the Treasury Accountability Report, Fiscal Years 1998 through 2001.

We also met with District officials and obtained their documentation related to their projected net savings from the Revitalization Act.

To provide information on the District's revenue capacity compared to other jurisdictions, we reviewed and summarized studies from the District's CFO's Office, the U.S. Department of the Treasury, and the relevant economic literature.

We conducted the work used to prepare this report from February to July 2002 in accordance with generally accepted government auditing standards. As stated previously, our work on this matter is ongoing. The Mayor and the CFO of the District of Columbia provided comments on a

[29]Pub. L. No. 105-33, § 4725(b), 111 Stat. 251 518 (1997).

draft of this report. Those comments are reprinted in appendixes III and IV, respectively, and have been incorporated in the report as appropriate.

The District's Estimated Financial Net Benefits from the Revitalization Act

Tables 1, 2, and 3 present the District's calculations of the projected net benefits from the Revitalization Act on the District's budget for fiscal years 1998 through 2002. As shown in table 1, the District estimates that the net benefit of the Revitalization Act has ranged from a net positive low of $79.1 million to a high of $203 million a year during the period 1998 through 2002.

Table 1: Projected Net Benefit of the Revitalization Act on the District's Budget (in millions of dollars)

Fiscal year	1998	1999	2000	2001	2002
Total revenue impact	(476.9)	(666.9)	(667.1)	(667.1)	(667.1)
Total expenditure impact	678.0	746.0	784.6	825.1	870.3
Net benefit	201.1	79.1	117.5	158.0	203.2
Net benefit as a % of total general fund revenue	4.6%	1.6%	2.2%	2.9%	3.8%[a]

Note: Differences due to rounding.

[a]Fiscal year 2002 ratio is based on estimated revenues.

Source: Fiscal year 1999 Operating Budget and Financial Plan, Government of the District of Columbia (unaudited).

Table 2: Estimated Reductions in Revenue as a Result of the National Capital Revitalization Act (in millions of dollars)

Fiscal year	1998	1999	2000	2001	2002
Loss of federal payment	(660.0)	(660.0)	(660.0)	(660.0)	(660.0)
Federal contribution	190.0				
Loss of court fees[a]	(6.9)	(6.9)	(7.1)	(7.1)	(7.1)
Total reductions in revenue	(476.9)	(666.9)	(667.1)	(667.1)	(667.1)

Note: Differences due to rounding.

[a] The fees are deposited in the DC Crime Victims Fund and used to pay the costs of the District's Crime Victim program.

Source: Fiscal year 1999 Operating Budget and Financial Plan, Government of the District of Columbia (unaudited).

Table 3: Estimated Reductions in Expenditures as a Result of the National Capital Revitalization Act (in millions of dollars)

Fiscal year	1998	1999	2000	2001	2002
Adult Felony Prisoners[a]	169.0	185.0	190.6	196.3	202.2
Pretrial Services	4.6	4.7	4.7	4.8	5.0
Parole Board	5.8	5.9	6.1	6.2	6.4
Court of Appeals	6.0	6.1	6.2	6.4	6.5
Public Defender	7.8	7.9	8.1	8.2	8.4
Superior Court	73.0	74.6	76.0	77.7	80.0
DC Court System	35.2	36.1	37.0	38.0	39.2
Medicaid	136.2	166.2	175.4	185.1	196.2
Pensions	250.0	269.0	290.0	312.0	335.9
Debt Service[b]	(9.5)	(9.5)	(9.5)	(9.5)	(9.5)
Total reductions in expenditures	678.1	746.0	784.6	825.2	870.3

Note: Differences due to rounding.

[a]Adult felony prisoner savings for fiscal year 1999 are based on the amount proposed in the President's fiscal year 1999 budget with a 3 percent growth in fiscal years 2000 to 2002.

[b]Debt service impact is based on $110 million intermediate-term borrowing in fiscal year 1998, and short-term borrowing of $200 million in each year for seasonal cash needs.

Source: Fiscal year 1999 Operating Budget and Financial Plan, Government of the District of Columbia (unaudited).

Appendix III

Comments from the Mayor of the District of Columbia

ANTHONY A. WILLIAMS
MAYOR

August 16, 2002

Ms. Jeanette M. Franzel
Director, Financial Management and Assurance
Attn: Ms. Norma Samuel
United States General Accounting Office
441 G. St. NW
Washington, D.C. 20548

Dear Ms. Franzel:

The purpose of this letter is to comment on the interim report to be issued on the District's structural imbalance. As an interim product, this report serves to outline the issues to be addressed in the full analysis currently under development by GAO. In so doing, it recognizes several key challenges faced by the District, including:

- major responsibilities for state level services;
- unique mandates for providing services to the federal government; and
- restrictions on taxing authority faced by no other state in the union.

This interim report also acknowledges, however, that further analysis must be completed to assess the degree to which the District's constraints can be offset by greater revenue collection and by efficiency gains. The District is actively reviewing all measures available to address this structural imbalance, and is working closely with the GAO to provide the information necessary to assist in identifying such opportunities.

As stated by our Independent Chief Financial Officer, however, meeting higher levels of revenue collection and operational efficiency can only partially offset the constraints placed by the federal government. Therefore, federal leaders must ultimately decide to either reduce their uncompensated service demands on the District, provide some direct compensation for those services, eliminate the restrictions on the District's tax base, or enact some combination of these actions.

I look forward to our continued cooperation with the GAO and federal leaders in finding an appropriate federal response to this challenge.

Sincerely,

Anthony A. Williams

Comments from the District of Columbia Chief Financial Officer

GOVERNMENT OF THE DISTRICT OF COLUMBIA
Office of the Chief Financial Officer

Natwar M. Gandhi
Chief Financial Officer

August 15, 2002

Ms. Jeanette M. Franzel
Director, Financial Management and Assurance
Attn: Ms. Norma Samuel
United States General Accounting Office
Washington, D.C. 20548

Dear Ms. Franzel:

Thank you for the opportunity to comment on your draft report entitled *District of Columbia: Fiscal Structural Imbalance.*

As I read the report, it concludes that the District has not decisively proved that there is a long-term structural imbalance because the District might be able to reduce spending or increase taxes. It further states that the extent of interplay between the costs to the District of providing service to the Federal Government and the benefits to the District of the Federal presence needs to be refined if a true picture of any structural imbalance is to be calculated.

The Office of the Chief Financial Officer of the District of Columbia endorses your recommendation to analyze this issue further, in greater detail and with additional sophistication. We will continue to support your effort with such information and analyses we have been able to develop using our own resources.

I believe the report should make a clear statement that the District is unlike any other U.S. jurisdiction, with the functions of a national capital, state, and municipality. Having been said so often, this statement has become a virtual truism. However, this difference from other municipalities has enormous significance in understanding D.C.'s finances and these differences need to be highlighted.

First, while the District has state-like taxes, especially the individual and business income taxes, it does not have state-like tax bases. Specifically, the suburban "ring" with its concentration of income is largely outside of D.C. boundaries and its taxing authority. States use revenue from the suburbs to support the urban core and poorer rural areas. Unlike states, D.C. cannot tax incomes earned by all those working here; only the much smaller income amount earned by residents is in the tax base.

Second, unlike other cities, D.C. has severe restrictions on its real property tax base imposed by the Federal government. These revenues are strictly constrained by the amount of federal and other property made tax exempt by the federal government or by foreign ownership. This adds up to 28 percent of the assessed value of the entire real property tax base (including both taxable and tax exempt property) according to real property tax records. The taxable base would increase by 48 percent if this tax-exempt property were taxed.

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Jeannette M. Franzel
August 15, 2002
Page 2

Third, D.C. exists because of the presence of the Federal government and clearly benefits from that presence. Other cities may also rely on one or a few big businesses for their existence and, usually, as their revenue mainstays. The federal government, however, both does not pay tax to D.C. and constrains D.C.'s tax bases. Like major companies in other cities, the Federal government provides indirect benefits to the District. Some sales tax revenues are raised from federal workers and visitors who come to the nation's capital. Some federal services protect D.C. against threats leveled at the federal government. None of these measures, however, change the fundamental imbalance created by revenue constraints.

There are no reductions to D.C.'s expenditure requirements comparable to its revenue constraints. This simple relationship between expenditures and a constrained tax base sets in place a structural imbalance. It is exacerbated by the District's role as the nation's capital, a place that is expected to be extraordinary in the eyes of the world and the pride of the nation's citizens.

The existence of a structural imbalance does not mean that D.C.'s budget is out of balance, nor does it tell us how efficiently the money is spent. In fact, riding the rising national economic tide, D.C.'s recent record in balancing budgets is quite good, although cost-effective spending remains a top priority for internal management reform. The time is upon us when the underlying economics and financial constraints imposed on D.C. will result in an inability to maintain adequate municipal services without instituting actions that are self-defeating for a viable community in the long-term.

In spite of its balanced budget and financial plan, the District currently faces severe budget pressures. These pressures are being managed in several ways. First, the District plans to improve management efficiency and reduce the cost of providing certain services by $150 million by FY 2005. Secondly, the District is and has been deferring capital expenditures. In FY 2003, $230 million in capital expenditures from the prior capital budget were eliminated to reduce debt service costs in the operating budget. Over the past two decades, about $4 billion in infrastructure needs have accumulated for such items as school repair, improvement of the WMATA rail system, and storm-sanitary sewers. D.C. simply does not have the capacity to fund all of these long-term service requirements. In formulating the FY 2003 budget, about $90 million in reductions were made to current services operations across the government. Even these kinds of measures will not allow a balanced budget going forward without tax increases deep spending cuts or a resolution to the structural imbalance issue.

Neither can the District's cash reserves[1] and budget reserve[2] protect against a structural problem for long. Any money that the District spends from these funds must be replaced the following year. Because structural problems are long-term in nature, replacing the funds will only exacerbate an underlying problem in the year after the funds are used.

The economic and revenue boom experienced in FY 1997-2000 cannot be the premise for revenue expectations going forward. Reliable economic growth is slower and more steady and is simply not sufficient to maintain current expectations regarding city services or the unaddressed backlog of needs from the past.

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[1] Restricted-use cash reserves totally 7% of local source expenditure will be in place by October 1, 2002.
[2] For FY2003, D.C. carries a $70 million budget reserve. It is replaced by an unrestricted $50 million cash reserve in FY2004.

Jeannette M. Franzel
August 15, 2002
Page 3

The Congress of the United States has always recognized the unique status of the District of Columbia and its responsibilities arising from that unique status. Its approach to addressing the financing of municipal services has varied over the years – from assuming complete financial responsibility for the provision of such services, to providing a Federal payment to underwrite a portion of those services to assuming responsibility for or providing targeted resources for selected programs. Currently, the Congress has directed through the 1997 Revitalization Act that some state-like functions be performed for the District by the Federal government. The Act provided expenditure relief to the District of roughly $200 million annually, arising from assumption of the unfunded portion of the federal pension liability,[3] prison costs, and 20 percent of Medicaid costs. The estimate is net of the annual federal payment of $660 million that was revoked. The Congress also annually funds selected municipal projects of particular interest.

We have estimated components of the Structural Imbalance in D.C. as follows:

	Estimated Annual Impact
Constrained income tax base	$540M[4]
Inability to tax federal office buildings	$180M[5]
Inability to tax other federal property	NA[6]
Services provided to the federal government	$240M[7]
Services provided to D.C. by the federal government	($200M)
State-like services provided by the District	$500M
Total	more than $1 billion

These components add to more than $1 billion annually. There is no doubt that the District benefits from services provided to the District such as additional law enforcement presence. Further analysis might also show a more complete picture of the cost of state-like functions, but the fact that D.C. carries these functions remains. Improved administrative efficiency can also help to balance budgets. With respect to taxes, the District competes for residents with other jurisdictions in the Metropolitan area. The issue is not what our residents could pay given their relative affluence, but what they expect to pay when they decide where to locate in the larger Metropolitan area.

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[3] The federal government's assumption of the federal portion of the Retirement Program relieved the District of the financial burden that it inherited from the federal government (approximately $1.9 billion of unfunded actuarial liability and $3.5 billion of accrued pension cost for prior service by participants--*Source - FY 1997 CAFR Note 1p Summary of Significant Accounting Policies*). The assets of the pension fund were transferred to the federal government in 1997.

[4] This assumes a wage tax on non-resident earnings of 2 percent. With the recent rise in wages, this value is increasing. Recent Bureau of Economic Activity data increase the estimate of earnings for the second time, putting yield from a 2% tax rate at about $540M annually.

[5] Federally owned office buildings are in direct competition with privately owned buildings.

[6] This category includes 'unique' federal properties. While no loss is imputed, in part because the monuments, parks, and official buildings bring visitors who help offset other revenues foregone, some loss may exist. The Federal government recognized this for 41 states having federal forestland in FY 2000 by providing formula-driving compensation for schools and transportation (The Secure Rural Schools and Community Self-Determination Act of 2000, P.L. 106-393, provided an alternative funding option to the revenue sharing arrangement in place since 1908). Because Federal property in the District has never been revenue-generating forestland, the District receives no payment under the system, though the Federal land, in cases such as Rock Creek Park, arguably have the same impact on revenues.

[7] The calculation is simply a proportion of D.C. expenditures on Public Works and Public Safety that equals the proportion of federal property of all property value in the District. With further work this estimate will be perfected.

Jeannette Franzel
August 15, 2002
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We recommend that, with respect to taxes, any subsequent tax analysis focus on our metropolitan region and not on a comparison with other local or state jurisdictions outside the area. While no means the only factor individuals assess in making a determination of where to live, tax rates are clearly a very significant factor. Our analysis has shown while the District has higher income tax rates and lower real property tax rates, its composite tax rate is as high or higher than any of the surrounding jurisdictions. The same is true with respect to businesses.[8] To us, this means the District has little latitude to tax its way to fiscal balance. A long-term strategy of taxing residents to close fiscal gaps will ultimately erode the tax base itself unless our actions are in concert with those of our neighbors.

Since I joined the District Government in 1997 it has become increasingly apparent to me that the District faces unique programmatic and financing issues. Taken together these issues create a long-term imbalance between spending needs and revenue resources. This is not a new insight. Discussions of D.C.'s structural imbalance have been around for a long time. The (Dr. Alice) Rivlin Report of 1990 identifies the problem, as did the work of Dr. Andrew Brimmer in 1986[9]. Going much further back in time, the U.S. Senate held extensive hearings on the issue in 1916 under Public Act 268.

We recommend that your charter be broadened to speak to the various methods the Federal government could use to redress any structural imbalance because we believe the real issue is finding a solution to the imbalance that meets today's circumstances. At this point your recommendations for subsequent analysis do not extend to providing any information on how the Congress might best address a structural imbalance. I am confident that further study will reveal to the GAO that this imbalance exists although your conclusions on the dimensions of its current magnitude may differ from ours. We would appreciate your bringing our recommendation on this matter to members of the Congress when you brief them on the final report.

I also ask that your next report be completed in time for deliberations on the FY 2004 budget. The District of Columbia by organic law is required to submit and maintain a balanced budget and we will do so. For FY 2003, the District's revenues are approximately $250 million lower than projected this time last year. To bring the District's budget into balance, policy makers have already reduced planned spending, forgone planned tax cuts and increased selected fines and fees. While program efficiencies can be a contributor to a balanced budget strategy, further program cuts will be required and will soon manifest themselves to the public.

Sincerely,

Natwar M. Gandhi
Chief Financial Officer

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[8] The District's individual income tax burden is about 34% higher than if District taxpayers were taxed at Virginia rates. It is also higher than in Maryland. The District's real property tax burden is 54% higher than Montgomery County and 15% above that of the City of Alexandria.

[9] "Fiscal Prospects for the State of New Columbia" presented September 11, 1986 to the D.C. Statehood/Compact Commissions by Brimmer & Associates.

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Presorted Standard
Postage & Fees Paid
GAO
Permit No. GI00

[redacted]