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DISTRICT GOVERNMENT

Information on Its Fiscal Condition

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the results of our review of the District of Columbia's financial condition. On July 9, 1996, I appeared before the House Appropriations Subcommittee on the District of Columbia. At that hearing, I testified[1] on the District's financial condition and the District of Columbia Financial Responsibility and Management Assistance Authority's (Authority) efforts to resolve the financial and management problems facing the District. In addition, I testified on the actions taken by the control boards of New York City and Philadelphia.

As you requested, first, I will discuss financial and budget trends in the District's revenue flows and expense patterns, comparing and contrasting the District's historical experience through fiscal year 1995 with its enacted and proposed budgets for fiscal years 1996 and 1997, respectively. To identify the pertinent trends and patterns in the District's revenues and expenses, we performed some analyses for fiscal years 1980 through 1992 of the District's Comprehensive Annual Financial Reports (CAFR) and performed an extensive comparative analysis for fiscal years 1993 through 1995. In addition, we performed an analysis of the District's enacted fiscal year 1996 budget and proposed fiscal year 1997 budget and financial plan as approved by the Authority.

Where unusual trends were identified, such as when amounts changed in a way different than expected based on our knowledge of the District's operations, we met with District officials to determine the reasons for these differences. Where we deemed it necessary, we reviewed the detailed underlying supporting information and documentation to verify that the explanation provided was supported. We also reviewed reported fiscal year 1996 expenses incurred through March 31, 1996, to ensure that the trends identified in our analysis through the fiscal year ended 1995 were still appropriate. Finally, we reviewed congressional, GAO, Authority, Office of the Mayor, City Council, and consultants reports and testimonies to more fully understand the nature and history of the District's various sources of revenues and expenses.

Second, I will discuss the District's current cash position. We focused specifically on the District's cash position at the end of fiscal year 1995, as adjusted through March 31, 1996. To determine that the District's cash position as of the date of this testimony had not substantively changed

[1]District Government: Information on Its Fiscal Condition and the Authority's First Year of Operations (GAO/T-AIMD-96-126, July 9, 1996).

from what we found in our review, we discussed the results of our analysis with the District's Chief Financial Officer. In addition, we reviewed what actions New York City (starting in June 1975) and Philadelphia (starting in June 1991) and their respective control boards took to respond to their respective cash shortages. We performed an analysis of both cities' cash and overall financial condition for the periods noted, which were the first year the respective control boards were in place, and we interviewed several key members of each city's control board and current and former government officials to understand how and why they took the actions they did.

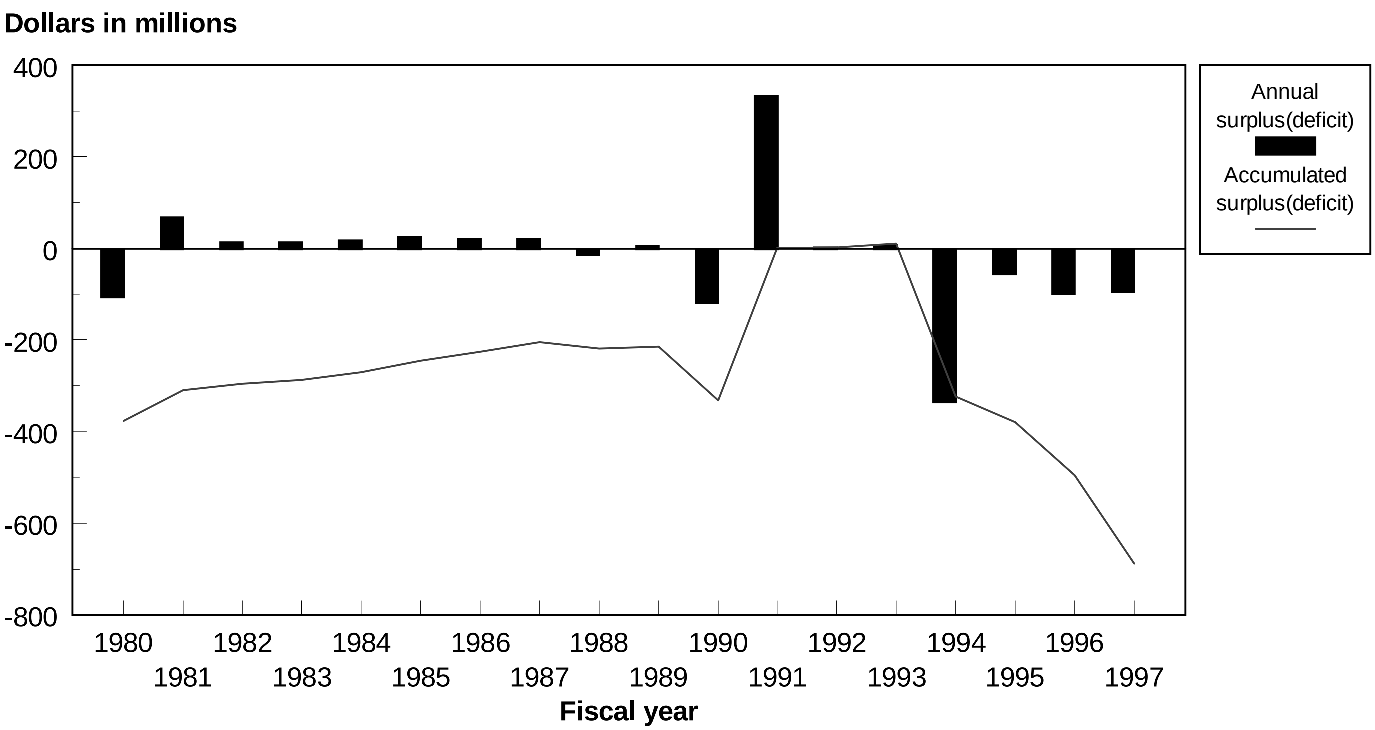
Financial and Budget Trends and Analysis

The District of Columbia Self-Government and Governmental Reorganization Act (Home Rule Act), Public Law 93-198, approved on December 23, 1973, initiated the process by which limited autonomy was conferred on District residents, with the approval of the Home Rule charter by referendum election on May 7, 1974. In addition to the limited autonomy conferred on the District to govern local affairs, certain financial responsibilities were transferred from the federal government to the District. The most significant of these were an unaudited accumulated deficit and an unfunded pension liability relating to previously established pension plans.

Fiscal year 1979 was the first fiscal year, post-home rule, that an audited balance sheet was prepared on the District. During this audit, it was determined that the accumulated deficit was $274 million; however, in a period subsequent to fiscal year 1980, this amount was changed to $284 million—an additional deficit of $10 million. Fiscal year 1980 was the first fiscal year that a full financial statement audit was performed on the District. For fiscal year 1980, the District reported a deficit of $104 million that increased the accumulated deficit to $378 million. From fiscal years 1981 through 1990, the District incurred surpluses and deficits that resulted in an audited net surplus of $46 million and an accumulated deficit of $332 million at the end of fiscal year 1990. This deficit was fully funded in fiscal year 1991 with deficit reduction bonds, and the District had a small surplus for fiscal year 1992.

It was not until fiscal year 1993 that the District began to experience consistent annual deficits. While fiscal year 1993 had a reported surplus of $8 million, it included 15 months of property tax revenues due to a change in tax year that resulted in an additional $173 million in property tax revenue reported for that period. Thus, fiscal year 1993, adjusted downward for the extra 3 months of revenues, would have reported a deficit of $165 million. Therefore, our analysis focused on fiscal years 1993 through 1995—the period when the District's current financial difficulties began to emerge. In addition, we have included the congressionally enacted fiscal year 1996 budget and the fiscal year 1997 proposed budget that was approved by the Authority in our analysis. Figure 1 shows the reported actual budget surpluses/deficits for fiscal years 1980 through those projected for fiscal year 1997.

Figure 1: The District's General Fund Annual and Accumulated Surplus/(Deficit) for Fiscal Years 1980 Through 1997



Note 1: 1980 was the first year that a full set of audited financial statements was prepared.

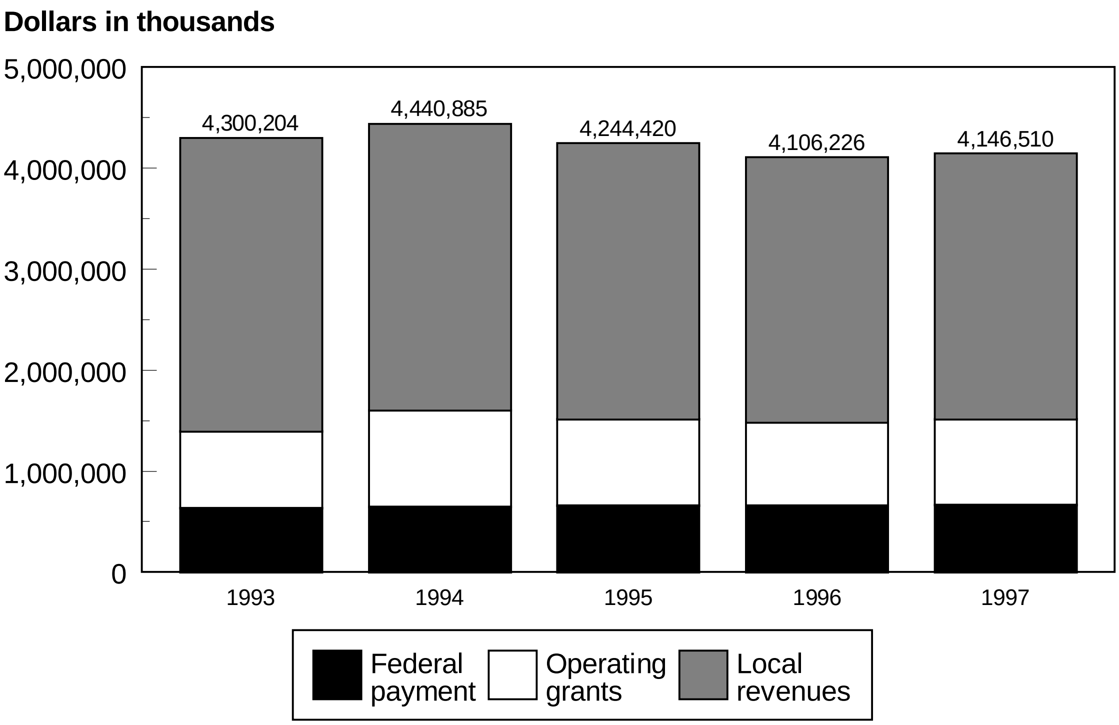
Note 2: Amounts for 1996 and 1997 are projected.

Source: Prior CAFRs and Fiscal Year 1997 Budget and Financial Plan.

General Fund Revenues

The District's revenue structure is made up of three types of revenue streams—locally generated revenues, operating grants, and the federal payment—as shown in figures 2 and 3.

Figure 2: The District's General Fund Revenues in Nominal Dollars for Fiscal Years 1993-1997



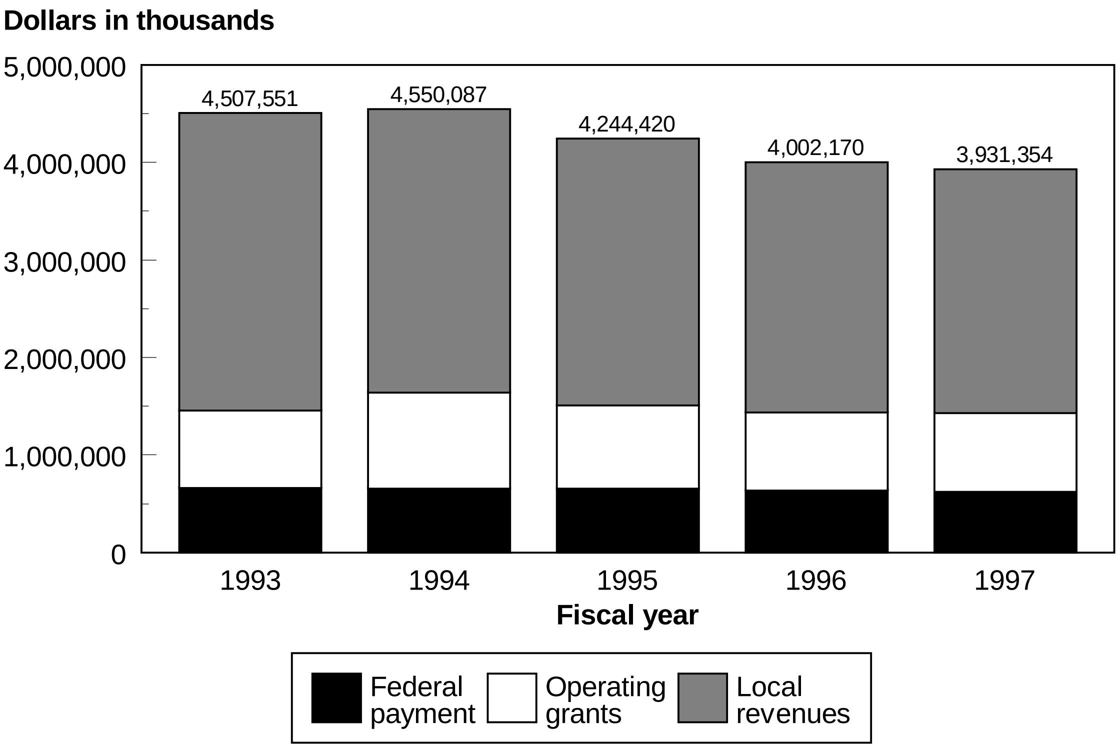
Note 1: Amounts for fiscal years 1996-1997 are projected.

Note 2: Local revenues do not include transfers from Lottery & Games.

Note 3: Nominal refers to revenues valued in actual dollars.

Source: Fiscal years 1993-1995 CAFRs and Fiscal Year 1997 Budget and Financial Plan.

Figure 3: The District's General Fund Revenues in Inflation-Adjusted Dollars for Fiscal Years 1993-1997



Note 1: Amounts are shown in fiscal year 1995 dollars. Amounts for 1996-1997 are projected.

Note 2: Indices used are from the Department of Commerce and the Bureau of Economic Analysis.

Local revenues consist primarily of levies that the District imposes, such as real property, income and business, and sales and use taxes. Operating grants consist mainly of reimbursements and grants from the federal government for the costs of social service programs, such as the federal share of Medicaid. Generally, the federal payment may be viewed as compensating the District for any unreimbursed services that the District may provide the federal government as well as revenue losses that may be attributable to (1) the large percentage of federally owned tax exempt property in the District, (2) the federally imposed limitations on the height of buildings in the District, and (3) the federally imposed limitation on the District's authority to tax the income of nonresidents.

Local Revenues

In fiscal years 1993 through 1995, local revenues declined by $175 million—from about $2.9 billion in fiscal year 1993 to about $2.7 billion in fiscal year 1995. In inflation-adjusted 1995 dollars, the decline and, thus, the loss of purchasing power, was even greater. In inflation-adjusted 1995 dollars, the District's local revenues decreased about $315 million during this period, primarily due to the decrease in real property tax revenues. However, increases in income and business taxes and sales and use taxes helped offset the real property tax decrease. For fiscal years 1996 and 1997, the District projects local revenues to remain relatively flat.

From fiscal years 1993 through 1995, reported real property tax revenues decreased by $274 million to $654 million. There are two primary reasons for this decline. The first reason relates to the previously mentioned, one-time accounting change that artificially inflated fiscal year 1993 revenues but did not affect the cash received from real property tax revenues. Specifically, the District changed its real property tax year-end, which caused an additional 3 months of revenue to be recognized for accounting purposes in fiscal year 1993. This change resulted in a small annual surplus in the District's financial statements. If the change had not occurred, as previously mentioned, the District would have recorded an annual deficit of about $165 million in fiscal year 1993. According to District officials, the tax year was changed so that the real property tax year-end would coincide with the District's September 30 fiscal year-end, which would ease reporting requirements. If fiscal year 1993 real property tax revenues had been adjusted by removing the additional 3 months of revenues, the decline between fiscal years 1993 and 1995 would not have been as great.

The second reason for the decline in real property tax revenue is a decrease in the assessed value of the District's commercial and residential property. Lower assessed property values generally equate to lower property tax revenues. From fiscal years 1993 through 1995, the assessed value of the District's taxable property declined by about 6.3 percent, with most of the decline attributable to commercial property. Consolidation of federal office space, increased competition from suburban office space, and the downward renegotiation of rents on existing space have contributed to the decline in the assessed value of commercial property. In addition, a declining population and falling employment among District residents have caused a decline in housing values and residential sales in all but a few District neighborhoods. The District forecasts real property taxes to decline slightly in fiscal years 1996 and 1997.

Operating Grants

Operating grant revenue has fluctuated in recent years. Operating grants increased from $760 million to $960 million from fiscal year 1993 through fiscal year 1994, but then decreased to $855 million in fiscal year 1995. Operating grants are primarily a function of the level of expenditures on social programs. As the level of expenditures in these programs increases or decreases, the level of revenues from operating grants increases or decreases accordingly.

In fiscal year 1995, over 75 percent, or about $653 million, of the District's operating grants were for health and welfare programs. In addition, a significant portion of the operating grant revenue is due to Medicaid expenditures—the District's largest health care expenditure. In fiscal year 1995, Medicaid expenditures for private providers of health care services totaled $744 million. The District is to receive 50 cents for each dollar spent on Medicaid from operating grants. Thus, at least $372 million, or 44 percent, of the total operating grant revenue for fiscal year 1995 represented reimbursements to the District for Medicaid expenditures.

The District forecasts operating grants to decrease from $855 million in fiscal year 1995 to $823 million in fiscal year 1996, due to an over $100 million decrease related to the housing authority being placed into receivership that was partially offset by increases to Medicaid and other grants. Further, operating grants are projected to increase from $823 million in fiscal year 1996 to $850 million in fiscal year 1997—a change of about 3 percent, which is primarily due to the Medicaid program.

The Federal Payment

The District has been receiving a federal payment since the 1800s. Historically, the federal payment has fluctuated because of changes in the method and calculations used to determine its amount. Recent history shows that in fiscal year 1992, the Congress adopted a formula to set the general purpose portion amount of the payment to 24 percent of the second prior fiscal year's own-source revenues (local revenues) collected in the District. In addition to the formula, the Congress also funded certain initiatives as part of the federal payment. The general purpose portion made up about 97 percent of the total federal payment for fiscal years 1993 and 1994.

In fiscal years 1993 and 1994, using the aforementioned formula, the federal payments were $636 million and $648 million, respectively. In fiscal year 1995, this formula was discontinued and replaced with a federal payment of $660 million that District officials projected to remain level through the year 2000. Assuming the inflation rate of about 3.3 percent per year through 2000 that the District used in its budget projections and no adjustment to the federal payment, the District will actually lose about $116 million in purchasing power during this period.

Major studies[2] performed on the District have concluded that there are inadequacies in the federal payment. For example, it does not fully compensate the District for (1) the additional responsibilities it carries as a result of the federal government's presence or (2) the loss of revenue due to federally imposed restrictions. This structural issue affects the District's relationship with the federal government and is one of the issues the Authority is expected to focus upon.

The District's ability to significantly increase its revenue is limited by the Home Rule Act and a large federal presence. Section 602 (a)(5) of the Home Rule Act prohibits the District from taxing nonresident income. Studies performed by the Rivlin Commission, the Appleseed Foundation, and the McKinsey & Company/Urban Institute concluded that this limitation deprives the District of a substantial potential revenue. The studies reported that the District's inability to tax nonresident wages results in a loss of revenue because nearly $2 of every $3 earned in the District is earned by nonresidents. In addition, about 42 percent of the assessed value of all land and improvements in the District is tax exempt and about 23 percent of the total assessed value is federal property. Thus, the District is unable to obtain revenues from a significant portion of its land.

Many sources have estimated the impact of eliminating the restrictions that prevent the District from taxing nonresident income and federal property. The D.C. Appleseed Center for Law and Justice[3] concluded that the removal of these restrictions could have resulted in estimated

[2]These studies include those by the Rivlin Commission, McKinsey & Company/The Urban Institute, and the Fair Budget Coalition.

[3]D.C. Appleseed Center For Law and Justice, The Case for A More Fair and Predictable Federal Payment for the District.

revenues for the District of $471 million in nonresidential income tax and $694 million in additional property taxes in fiscal year 1995, which is $505 million more than the $660 million federal payment received.

District's Overall Expenditures

The general fund, at $4.2 billion, or 79 percent of the District's $5.4 billion in gross[4] expenditures/expenses for fiscal year 1995, far exceeded the expenditures and expenses of the other funds that comprise the District's budget and, thus, is the primary focus of our analysis. Overall, expenditures/expenses increased from $5.5 billion in fiscal year 1993 to $6.0 billion in fiscal year 1994 and decreased to $5.4 billion in fiscal year 1995.

The significant change from year to year was primarily due to shifts in Medicaid and employee benefits expenditures/expenses between the years. Fiscal year 1994 had particularly large human support services expenditures because Medicaid expenditures increased by almost $300 million, of which more than $200 million was due to Medicaid cost reimbursement settlements with institutional providers for fiscal years 1991 through 1993. District officials do not expect this large Medicaid increase to reoccur in future years because the District has moved away from cost settlements for in-patient hospital services and now reimburses these providers based on predetermined rates. The District projects cost settlements of $66 million and $59 million for fiscal years 1996 and 1997, respectively.

Also, for fiscal year 1995 expenditures/expenses, human support services showed a reduction of more than $200 million, primarily because of a decrease in the projected liability for disability compensation. An error in the way the amount had been computed in the past was corrected in the fiscal year 1995 financial statement audit. Previous computations of future disability compensation had failed to show recipients being deleted after the legally required time for receiving such compensation had expired and the recipient was required to retire or go off of disability. This reduction should not reoccur and, thus, for trend analysis and comparison purposes, was added back to the reported human support services costs for fiscal years 1996 and 1997 budgeted amounts.

[4]These amounts are the sum of total expenditures from the All Government Fund Types and Expendable Trust Fund's Combined Statement of Revenues, Expenditures, and Changes in Fund Balance and total operating expenses from the All Proprietary Fund Types, Pension Trust Funds, and Component Unit's Combined Statement of Revenues, Expenses, and Changes in Retained Earnings/Fund Balances.

Notwithstanding the large Medicaid increases in fiscal year 1994 and the disability compensation adjustment in fiscal year 1995, our review found that the District's proposed expenditures in its fiscal years 1996 and 1997 budgets were generally comparable to the trends in its expenditures/expenses for fiscal years 1993 through 1995, as adjusted for its proposed initiatives.

This means that the District's projected fiscal years 1996 and 1997 budgets show expenses that (1) are about the same as those reported in 1995 adjusted for the aforementioned changes and (2) have slightly decreased on an inflation-adjusted basis. This outcome is consistent with most of the proposed initiatives in the District's financial plan being management initiatives, as opposed to significant restructuring (eliminating services, for example). Also, because they are management initiatives, they may be more difficult to achieve and will require a detailed plan for implementation and close oversight. However, in an effort to control spending, the Mayor, in his Transformation Plan, has proposed reducing full-time equivalents (FTE) from 40,000 to 30,000 by the beginning of fiscal year 2000.

Our more detailed review of the District's expenditures found that two critical cost drivers of the growth in the District's expenditures are Medicaid and pension costs. In addition, much discussion in the District's budget deliberations has focused on the subsidy costs related to two aspects of the District's operations—the general hospital and university. Each of these expenditures has a significant impact on the District's financial condition.

The discussion of these four expenditures in our testimony is not intended to minimize either the impact or the need to revisit other areas of the District's operations for budget savings or revenue enhancement opportunities. Clearly, areas such as the school system (the third largest expenditure), the court system, capital project needs, and others should be more closely evaluated. However, our review showed that Medicaid costs and pension costs are the greatest risks to the District's financial viability from a cost perspective. In addition, because deliberations on the District's budget by District officials and the Congress focused on the D.C. General Hospital and the University of the District of Columbia, we also focused on these costs.

Medicaid Expenditures

Similar to the current national trend, and as we recently reported,[5] Medicaid spending is consuming an increasing share of the District's total health care expenditures. From fiscal years 1991 to 1995, the District's records showed that Medicaid expenditures for private providers[6] increased from $427 million to $744 million, or approximately 74 percent. The District projected Medicaid expenditures of $776 million and $780 million for fiscal years 1996 and 1997, respectively, and has made efforts to contain Medicaid costs, such as moving from cost reimbursements for institutional providers to reimbursements based upon diagnostically-related groups (DRG). However, based on the recent growth history of these expenditures and the poor[7] condition of the District's financial records that track and account for Medicaid costs, we are concerned that so little growth is projected in Medicaid expenses.

The District is responsible for 100 percent of the nonfederal share of all Medicaid expenditures. In other jurisdictions across the nation, states assume responsibility for this nonfederal share or require local governments, such as counties, to pay a portion of these costs. As we previously reported,[8] only three[9] states require their local governments to pay more than 25 percent of this nonfederal share for Medicaid services. Most notable is New York state's requirement for its local governments, including New York City, to pay approximately 50 percent of this nonfederal share, except for the long-term care program, for which it pays 19 percent.

As noted, New York City pays a Medicaid matching percent significantly less than the District. In addition, Philadelphia pays nothing for Medicaid. If the District would pay 50 percent of its nonfederal share of expenditures, or the equivalent of a 25-percent match of its total Medicaid expenditures comparable to New York, or pay nothing, similar to Philadelphia, the impact on the District's financial condition would be

[5] District of Columbia: Information on Health Care Costs (GAO/AIMD-96-42, April 22, 1996).

[6] GAO's health-care report figures for Medicaid included expenditures for both public—District-owned facilities, such as St. Elizabeths Hospital—and private providers. The District 1997 budget and financial plan does not provide the total Medicaid expenditures but rather only provides the amount for private providers. During fiscal years 1991 to 1995, public provider expenditures approximated between $71 and $100 million per year.

[7] GAO/AIMD-96-42, April 22, 1996.

[8] Medicaid: Local Contributions (GAO/HEHS-95-215R, July 28, 1995).

[9] New York, New Hampshire, and Arizona are the only three states that require a contribution of more than 25 percent of the nonfederal share from their local governments for Medicaid services, not administrative costs.

significant. If the fiscal year 1997 budget submission, which included total private-provider Medicaid expenditures of $780 million, was modified to show either change, the District's financial picture would shift from having a net cost of at least $390 million (100 percent of the nonfederal share or a 50-percent match) to a net cost of $195 million, when made comparable to New York City, or zero compared to Philadelphia.

While placing the District on comparable footing with New York City and Philadelphia would significantly improve its financial and cash position, longer-term solutions would have to address many other issues that would need to be considered in such a complex discussion.

The Unfunded Pension Liability

In looking at the District's financial condition, the unfunded pension liability represents one of its greatest long-term challenges. Today, the unfunded liability stands at $4.7 billion and is expected to increase to $7 billion in 2004.

The Congress created defined benefit pension plans for District police officers and fire fighters in 1916; teachers in 1920; and judges in 1970. These funds were financed on a "pay-as-you-go" basis. The responsibility for these payments and the related, and then undetermined, unfunded liability were transferred to the District as part of Home Rule. The District of Columbia Retirement Reform Act, Public Law 96-122, in 1979 committed the federal government to pay $52.1 million annually from 1980 to 2004 to partially finance the liability for retirement benefits incurred before January 2, 1975.[10]

In 1980,[11] the federal government provided $38 million to the District in addition to the first of 25 annual payments of $52.1 million to the pension funds authorized by the Retirement Reform Act. The then present value of these payments equalled $649 million. The present value of the pension liability at the time of the transfer equalled $2.7 billion, resulting in an unfunded liability to the District of over $2 billion.

[10]See District Pensions: Federal Options for Sharing Burden to Finance Unfunded Liability, pages 14-18 (GAO/HEHS-95-40, December 28, 1994).

[11]GAO/HEHS-95-40, December 28, 1994, and D.C. Appleseed Center, The District of Columbia's Pension Dilemma—An Immediate and Lasting Solution.

The District has funded[12] (that is, covered the costs of the benefits participants have earned in that year) all benefits that the pension plans' participants have earned after fiscal year 1979 and paid in an additional $1.2 billion towards the unfunded liability through the end of fiscal year 1995. Table 1 shows an analysis of the unfunded pension liability since the plan was transferred to the District and the estimated payments for fiscal years 1996 and 1997.

Table 1: Unfunded Pension Liability

Dollars in millions

Fiscal year	Unfunded pension liability	District contribution	If fully funded 1979 net normal cost	Excess District contribution
1980	$2,006	$108	$89	$19
1981	$2,134	$110	$93	$17
1982	$2,336	$136	$89	$47
1983	$2,874	$143	$85	$58
1984	$2,936	$174	$103	$71
1985	$3,393	$165	$110	$55
1986	$3,594	$175	$119	$56
1987	$3,458	$173	$96	$77
1988	$3,614	$179	$103	$76
1989	$3,853	$193	$106	$87
1990	$3,820	$222	$118	$104
1991	$4,005	$225	$112	$113
1992	$4,249	$254	$121	$133
1993	$4,152	$291	$135	$156
1994	$4,337	$307	$142	$165
1995	$4,526	$297	$135	$162
1996	$4,780	$337	$133	$204
1997	$4,973	$321	$126	$195

Source: D.C. Retirement Board.

[12]D.C. Appleseed Center, The District of Columbia's Pension Dilemma—An Immediate and Lasting Solution.

Despite these efforts, the unfunded liability is now estimated at $4.7 billion[13] and is expected to increase to $7 billion[14] in 2004 due to the accumulation of interest owed on the unfunded portion of the pension liability transferred to the District back in 1979. Similarly, the District's pension payment, which is currently approximately $300 million a year, is expected to increase to $490 million starting in 2004.

The Appleseed Foundation[15] concluded that these pension plans' unfunded liabilities should be the responsibility of the federal government since the liabilities are the results of federal actions predating the Home Rule Act. Our analysis shows that if the District did not have the responsibility for the costs of these plans related to the unfunded liability, the pension expense in its proposed fiscal year 1997 budget would be reduced by $195 million from the $321 million currently shown in the proposed budget to $126 million. This change would have a major impact on the projected budget deficit for fiscal year 1997.

Similar to the Medicaid discussion, many other factors also need to be considered longer-term in deciding the best way to address the escalating pension costs that the District will pay.

Subsidy Payments

Two other major costs for the District that have been regularly discussed in budget deliberations are the costs for D.C. General Hospital and the University of the District of Columbia. The District paid subsidies to the hospital of $59 million, $47 million, and $57 million for fiscal years 1993, 1994, and 1995, respectively. It has projected for fiscal years 1996 and 1997 that it will pay subsidies of $47 million and $52 million,[16] respectively. Similarly, the District paid the university subsidies of $68 million, $66 million, and $50 million, for fiscal years 1993, 1994, and 1995, respectively, and projects to pay subsidies of $43 million and $44 million for fiscal years 1996 and 1997, respectively.

[13]D.C. Appleseed Center, The District of Columbia's Pension Dilemma—An Immediate and Lasting Solution.

[14]GAO/HEHS-95-40, December 28, 1994, and D.C. Appleseed Center, The District of Columbia's Pension Dilemma—An Immediate and Lasting Solution.

[15]D.C. Appleseed Center, The District of Columbia's Pension Dilemma—An Immediate and Lasting Solution.

[16]The projected fiscal year 1997 amount includes $15 million for the public health clinics, which were transferred to the hospital.

Our recently issued report on health-care delivery[17] in the District pointed out several challenges that confront the hospital if it is to remain viable, including major capital improvements. In New York City's effort to turn its financial problems around, it closed a municipal hospital, had massive layoffs at others, and relied on the other hospitals in the city to absorb some of the role it had in delivering hospital care for city residents. The District has proposed creating a Public Benefit Corporation to include the hospital's operations and that would allow the hospital to operate separately from the city entirely, including the city's personnel requirements and collective bargaining agreements. However, based on the projected budget subsidies, it is unclear as yet if this initiative will save the city money or, if so, how much.

The District has not yet evaluated the financial structure of its university system to identify ways to make it less costly. However, Authority officials stated that the University of the District of Columbia had raised its tuition to offset more of its costs. At the time of its financial crisis, New York City turned its senior university system over to the state to run and operate. New York City's presence in delivering this service was scaled back dramatically and, for the most part, involved delivering higher education at the junior-college level, charging tuition for the services, and providing the services at significantly less cost.

The District's Cash Position

From the inception of its financial crisis, the District has had cash flow problems. In fact, District officials project that the District will run out of money this month. The District took several measures to address its cash flow shortage. For example, in fiscal year 1994, the District delayed pension, vendor, and Medicaid payments and borrowed internally from its capital projects fund. In fiscal year 1995, the District again deferred payments to its vendors and, as stated by the Chief Financial Officer (CFO),[18] the District began fiscal year 1996 with approximately $200 million to $300 million in delayed payments owed to vendors and Medicaid providers.

In fiscal years 1995 and 1996, the District also borrowed short-term from the U.S. Treasury to finance operations and capital projects. Fiscal year 1996 borrowings against the fiscal year 1997 federal payment are estimated

[17]GAO/AIMD-96-42, April 22, 1996.

[18]Testimony of District CFO Anthony A. Williams before the House Subcommittee on the District of Columbia, Committee on Government Reform and Oversight, March 28, 1996.

to total $639 million of the $660 million fiscal year 1997 payment. Specific short-term borrowings for fiscal year 1996 are shown in table 2.

Table 2: Short-term Borrowings for Fiscal Year 1996

(Dollars in millions)

Fiscal 1996 short-term borrowings	
October 1995[a]	$96
January 1996[a]	$283
Planned July 1996[b]	$260
Total	**$639**
Fiscal Year 1997 Federal Payment	$660

[a]District's Cash Flow Statements—D.C. Treasurer.

[b]Office of the Chief Financial Officer.

By borrowing against future revenue to pay for these goods and services already received, the District has not resolved its cash flow problems but has only postponed them.

During fiscal year 1995, the District's investment grade general obligation debt was down-graded to noninvestment grade. Because of this noninvestment grade rating, the District's sources for obtaining long-term financing are limited and the interest cost of obtaining financing in the capital markets could be costly. The District's financial plan discusses two borrowing options, and another option was recently added for obtaining funds from capital markets. The District accepted a proposal to issue $220 million in general obligation tax revenue anticipation notes. The District expects these notes to be issued shortly. We did not review this proposal as part of our work.

The first option in the District's financial plan includes the District borrowing short-term from the U.S. Treasury using the subsequent year's federal payment as collateral to fund its operations and capital projects. The second option includes the District borrowing $500 million for accumulated deficit financing and $900 million (that is, $150 million in each of the next 6 years starting in fiscal year 1997) to meets its capital needs. In addition to these borrowings, the District will still need short-term borrowing for cash flow purposes.

Under the first option, the District projects that by April 1998, it will have borrowed against the entire fiscal year 1998 federal payment and will not have cash sufficient to meet its operating needs. Under current law, the District may borrow from the U.S. Treasury to meet its capital and cash flow needs, and such borrowings are payable from the subsequent fiscal year's federal payment.

There are no provisions in the current law for long-term borrowing from the U.S. Treasury or for deficit financing of the District's operating deficits. At present, the District must repay Treasury loans within 12 months. Also, section 461 of the Home Rule Act authorizes the District to enter into long-term borrowing by issuing general obligation bonds only for capital improvements or to refund outstanding indebtedness. The District of Columbia Emergency Deficit Reduction Act of 1991, Public Law 102-106, authorized the District (on a temporary basis ending on September 30, 1992) to issue general obligation bonds to finance payment of the $332 million accumulated operating deficit in the general fund at the end of fiscal year 1991. In addition, section 603 (b) of the Home Rule Act provides that the District may not issue general obligation bonds (other than to refund outstanding indebtedness) if the District's debt service in a fiscal year exceeds 14 percent of the estimated revenues during the year the bonds are issued.

By the end of fiscal year 1996, the District's debt service is forecasted to be at approximately 11.9 percent of estimated revenues. Thus, the District would need to seek additional legislative authority before it plans to issue long-term debt to fund capital improvements if it plans on exceeding the 14-percent limit or to finance the accumulated operating deficit. The District would also need to seek legislative authority in order to engage in long-term borrowing from the U.S. Treasury.

The New York City and Philadelphia control boards, during the first year that the boards were in place, obtained long-term borrowings to finance their respective accumulated deficits. New York City, which at the time had an accumulated deficit of $6.2 billion, received about $3.6 billion as deficit financing and exchanging of notes. Philadelphia had both accumulated and projected deficits at the time its control board borrowed $475 million, as shown in table 3.

Table 3: Pennsylvania Intergovernmental Cooperation Authority Borrowing: Uses of Proceeds of Fiscal Year 1991 Serial Bonds

(Dollars in millions

Funds to city for deficit reduction[a]	FY91 (cumulative)	$153.5
	FY92 (projected deficit)	$94.9
	FY93 (projected deficit)	$7.8
Subtotal		**$256.2**
Grants for capital projects		$120.0
Grants to productivity bank		$20.0
Debt service reserve fund		$47.5
Capitalized interest		$20.0
PICA expenses		$0.6
Financing costs		$10.9
Total		**$475.3**

[a]Philadelphia's actual deficit for fiscal year 1992 was $71.4 million, and it reported a surplus of $3 million in 1993. Thus, Philadelphia was only required to borrow $225 million for deficit financing.

Source: Offering Statement, June 1, 1992, p. 6.

Like New York City and Philadelphia, the District's accumulated deficit and any approved projected deficits should be fully funded through longer-term borrowings or other means, including the need for any approved capital projects funding. In addition, a funding mechanism should be established that ensures sufficient funds for its immediate short-term cash needs. Along with this funding, the District's financial plan should be modified with enough revenue enhancement efforts and/or deeper budget cuts to fund the repayment of any long-term debt incurred and current operations without incurring further budget deficits.

The New York City and City of Philadelphia Control Boards

We also reviewed the actions taken by the New York and Philadelphia control boards whose cities also faced serious financial problems. These were the New York State Financial Control Board (FCB) (including the Municipal Assistance Corporation (MAC)) and the Office of the State Deputy Comptroller (OSDC), and the Pennsylvania Intergovernmental Cooperation Authority (PICA).

New York City ended fiscal year 1976 with an annual operating deficit of $1.2 billion and was burdened with an accumulated deficit of approximately $6.2 billion. Throughout fiscal year 1976, numerous actions were taken with the assistance of FCB and MAC to prevent the city from going bankrupt.

During their first year in operation, in order to eliminate the budget deficits and cash shortages of New York City, the following MAC and FCB recommendations were implemented: (1) the workforce was reduced by about 40,000, or 13 percent, from its June 30, 1975, level,[19] (2) remaining city employees' wages were frozen for 3 years, (3) tolls on bridges and tunnels were increased, (4) commuter and subway fares were increased, (5) municipal hospitals had massive layoffs, (6) the tuition-free policy of the City University of New York was terminated, and (7) taxes were increased by about $775 million. In addition, the FCB adopted a resolution urging the State to assume the costs of maintaining courts and correction facilities, and the State enacted legislation in that year to assume these costs. MAC helped to establish the New York Council on the Economy, which addressed, among other things, (1) relieving the stock transfer tax burden on state and city businesses, (2) developing Battery Park City, which represented a stimulus to the financial real estate market, and (3) constructing a new convention center.

A key component in New York City's plan of recovery was the comprehensive overhaul and reform of the city's accounting and budgetary practices. The objective was the installation of a new integrated financial management system (IFMS), a computerized system for accounting, budgeting, purchasing, and payroll, linking the myriad of city departments and operations for the first time into one system with a single database.

This project received the highest possible priority as fiscal year 1976 advanced. The OSDC was given oversight responsibility for this project. Professional personnel were recruited, in some cases "loaned" by leading banks or corporations, and contracts were put into place with private accounting and systems management firms for work that could not be performed in-house. The system was implemented in July 1977. In addition, a management plan was implemented that enabled the city to monitor its operations continuously. The management plan and reports identified opportunities for improved performance. To strengthen management of this program, the Mayor, who was also a member of the FCB, established an office of operations.

[19]We did not receive sufficient information from New York City to quantify the savings that were realized from the FTE reductions, wage freeze, increases in transit fares, tolls, etc.

In addition, the oversight boards helped New York City gain funding from various sources, such as the state, commercial lending institutions, city and state pension funds, and the federal government. Despite the highest degree of commitment evidenced by New York State to avert a bankruptcy, it became apparent that federal assistance was essential. As a former congressman, and Chairman of the FCB, the State Governor worked with New York City in the first control year to attract needed federal assistance, which was key to the City receiving federal loans and loan guarantees. By the end of fiscal year 1976, MAC bonds and notes outstanding on behalf of the city were approximately $3.9 billion, which stabilized the City's cash position.[20]

According to New York City officials, the control boards made significant contributions. The governor, in his elected capacity and as chairman of the FCB, committed himself fully to assist the city. The FCB and its professional staff and the State Comptroller provided strong support and guidance. MAC carried out its distinctive role to finance the city and ease its debt obligations. The State Legislature and the U.S. Congress responded to New York City, and the U.S. Department of the Treasury expressed its faith in the city's plans and progress.

In fiscal year 1992, Philadelphia had an operating deficit of $98.7 million and an accumulated deficit of $153.5 million; however, by the end of the fiscal year, PICA had taken actions to eliminate the operating and accumulated deficit.

In PICA's first year, it borrowed about $475 million in Special Tax Revenue Bonds on behalf of the City of Philadelphia. The bond proceeds were used to fund the cumulative deficit, current year and subsequent year deficits, and certain capital projects and productivity enhancement initiatives.[21] In addition, Philadelphia imposed a 1-percent sales tax, renegotiated labor agreements, and collected back taxes. As a result of the 1-percent sales tax, revenues increased by $52.3 million for fiscal year 1992. The renegotiation with the labor union led to a 33-month wage freeze and extensive restructuring of health benefits agreements to achieve cost savings and reductions in paid holiday and sick leave. Delinquent tax collection increased by 10 percent annually.

[20]Municipal Assistance Corporation 1976 Annual Report.

[21]Pennsylvania Intergovernmental Cooperation Authority, Financial Statements for the Period from June 5, 1991, to June 30, 1992, and Independent Auditor's Report, September 3, 1992.

A PICA "authority tax" was approved by the Philadelphia city council in June 1991. This is a 1.5-percent tax on wages, salaries, commissions, and other compensation earned by residents of the city and on the net profits earned by businesses, professions, or other activities conducted by residents of the City of Philadelphia. This revenue goes into a Special Revenue Fund collected by the Commonwealth of Pennsylvania. A portion of the PICA tax is used to cover PICA debt service and other PICA expenses, with the remaining revenues going to the "City Account."[22]

In 1992, Philadelphia began the process of updating its financial and information systems to enable operating departments to obtain more detailed management information on a daily basis. It also began contracting out custodial work in all of its central facilities, saving the city an estimated $700,000 annually, in addition to improving the quality of services in city offices and transit concourse areas. Other productivity measures, which began in 1992, included a competitive contracting program and renegotiation of real estate leases resulting in savings of $1 million for fiscal year 1993.

Finally, Philadelphia achieved a balanced budget in fiscal year 1993, 2 years after its control board was established, and has sustained it through fiscal year 1995. New York City achieved a balanced budget in the sixth year of its control board's operation and has sustained small surpluses through 1995. The FCB has been in an advisory role since fiscal year 1986, after the city had sustained 6 consecutive years of balanced budgets.

Mr. Chairman, this concludes my statement. I will be happy to answer any questions that you or the other Members of the Subcommittee may have at this time.

[22]"The City account" is considered a trust fund for the exclusive benefit of Philadelphia, and is used to maintain the proceeds of taxes or other revenues pledged by the Authority to secure bonds.

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