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# DISTRICT OF COLUMBIA

# Structural Imbalance And Management Issues

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# DISTRICT OF COLUMBIA

## Structural Imbalance and Management Issues

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Highlights

Highlights of GAO-04-908T, testimony before the Subcommittee on the District of Columbia, Committee on Appropriations, U. S. Senate

### Why GAO Did This Study

District of Columbia officials have reported both a current services budget gap and a more permanent structural imbalance between costs and revenue-raising capacity. They maintain that the structural imbalance largely stems from the federal government's presence and restrictions on the District's tax base. Accordingly, at various times District officials have asked the Congress for additional funds and other measures to enhance revenues. In that context, the Subcommittee has asked GAO to discuss its May 2003 report, *District of Columbia: Structural Imbalance and Management Issues* (GAO-03-666). This testimony addresses the key findings and concluding observations of the May 2003 report. Specifically, this testimony discusses: (1) whether, or to what extent, the District faces a structural imbalance between its revenue capacity and the cost of providing residents with average levels of public services by using a representative services approach; (2) any significant constraints on the District's revenue capacity; (3) cost conditions and management problems in key program areas; and (4) the effects of the District's fiscal situation on its ability to fund infrastructure projects and repay related debt.

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### What GAO Found

GAO used a multifaceted approach to measure structural imbalance, which involves comparing a fiscal system's ability to fund an average level of public services with revenues that it could raise with an average level of taxation, plus the federal aid it receives. This approach compared the District's circumstances to a benchmark based on the average spending and tax policies of the 50 state fiscal systems (each state and its local governments). GAO also reviewed key programs as well as infrastructure and outstanding debt. GAO found:

- The cost of delivering an average level of services per capita in the District far exceeds that of the average state fiscal system due to factors such as high poverty, crime, and a high cost of living.
- The District's per capita total revenue capacity is higher than all state fiscal systems but not to the same extent that its costs are higher. In addition, its revenue capacity would be larger without constraints on its taxing authority, such as its inability to tax federal property or the income of nonresidents.
- The District faces a substantial structural deficit in that the cost of providing an average level of public services exceeds the amount of revenue it could raise by applying average tax rates. Data limitations and uncertainties surrounding key assumptions in our analysis made it difficult to determine the exact size of the District's structural deficit, though it likely exceeds $470 million annually. Consequently, even though the District's tax burden is among the highest in the nation, the resulting revenues plus federal grants are only sufficient to fund an average level of public services, if those services were delivered with average efficiency.
- The District's significant, long-standing management problems in key programs waste resources and make it difficult to provide even an average level of services. Examples include inadequate financial management, billing systems, and internal controls, resulting in tens of millions of dollars being wasted, and hindering its ability to receive federal funding. Addressing management problems would not offset the District's underlying structural imbalance because this imbalance is determined by factors beyond the District's direct control. Addressing these management problems would help offset its current budget gap or increase service levels.
- The District continues to defer major infrastructure projects and capital investment because of its structural imbalance and its high debt level.

If this imbalance is to be addressed in the near term, it is a policy issue for the Congress to determine if it should change federal policies to expand the District's tax base or provide additional support. However, given the existence of structural imbalances in other jurisdictions and the District's significant management problems and the federal government's own fiscal challenges, federal policymakers face difficult choices regarding what changes, if any, they should make in their financial relationship with the District. If the District were to receive additional federal support to compensate for its structural imbalance and enhance its ability to fund capital investments, it is important that the District follow sound practices to avoid the costly management inefficiencies it has experienced in the past. These practices include evaluating and selecting capital assets using an investment approach, integrating organizational goals into the capital decision-making process, and providing transparency and accountability over the use of federal funds.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss our report, *District of Columbia: Structural Imbalance and Management Issues*.[1] Though our report was released a year ago, its focus on fundamental aspects of the District's financial structure continues to be relevant. In recent years, District of Columbia (District) officials have reported that a continuation of the District's current spending and taxing policies would result in ongoing current services budget imbalances. While District officials have demonstrated their resolve to maintain fiscal discipline by taking the steps needed to balance their budgets for fiscal years 2004 and 2005, those officials claim that the District faces a more permanent structural imbalance between its revenue-raising capacity and the cost of meeting its public service responsibilities that are the result of many factors, several stemming from the federal government's presence in the District and the restrictions on the District's tax base.

Although there is no uniform definition of structural imbalance, there are two concepts that can be used to measure it—current services and representative services imbalances. A *current services imbalance* answers the question: If a jurisdiction were to maintain its current level of services into the future, would it be able to raise the revenues necessary to maintain that level of service under its *current* taxing policies? This type of longitudinal analysis compares a jurisdiction's projected fiscal position with its current position and is independent of other similarly situated jurisdictions. In contrast, a *representative services imbalance* answers the question: If a jurisdiction were to provide a representative basket of public services with average efficiency, would it be able to generate sufficient revenues from its own taxable resources and federal grants to fund the representative basket of services if its resources were taxed at *representative* rates? This type of analysis uses a basket of services and tax structure typical of other jurisdictions with similar public service responsibilities as a benchmark against which to compare imbalances between the cost of public services and revenue-raising capacity. The approach attempts to compare differences in jurisdictions' fiscal positions under a common set of policies regarding levels of services and taxation. The District has reported both a current services and a more permanent structural imbalance between its costs and revenue-raising capacity.

[1] U.S. General Accounting Office, *District of Columbia: Structural Imbalance and Management Issues*, GAO-03-666 (Washington, D.C.: May 2003).

My statement today will discuss (1) whether, and to what extent, the District faces a structural imbalance between its revenue capacity and the cost of providing residents and visitors with average levels of public services *by using a representative services approach*; (2) any significant constraints on the District's revenue capacity; (3) cost conditions and management problems in key program areas; and (4) the effects of the District's fiscal situation on its ability to fund infrastructure projects and repay related debt.[2] We performed our work assessing the structural imbalance and management issues from August 2002 through May 2003 in accordance with generally accepted government auditing standards, and in June 2004 we obtained updated budget information.

## GAO's Methodology for Assessing Structural Imbalance

We used a representative services analysis to conduct our work on whether and to what extent the District has a structural imbalance. This approach allows us to compare the District's fiscal circumstances against a benchmark based on services and taxation that is typical of jurisdictions with similar fiscal responsibilities, which is different from a current services approach, which would be based on the District's historical spending and tax choices.

When analyzing a representative service imbalance, the choice of a benchmark for a representative level of public services and taxation is a critical decision. In fact, the appropriate level of services and taxation is a matter of perennial debate in every jurisdiction in the nation. For this reason, we used as a benchmark national average levels of spending and taxation because they are independent of individual jurisdictions' particular preferences, policy choices, and efficiency of service provision. National averages provide benchmarks that are "representative" of the level of services that a typical state fiscal system (the collections of a state, counties, cities, and a myriad of special purpose district governments) employs. A fiscal system is said to have a structural imbalance if it is unable to finance an average (or representative) level of services by taxing its funding capacity at average (or representative) rates. Because we defined structural imbalance in terms of comparisons to national averages, for any given time period a significant proportion of all fiscal systems will have structural deficits.

[2] Prior to our May 2003 report, we issued a preliminary report on these issues in September 2002. See U.S. General Accounting Office, *District of Columbia: Fiscal Structural Balance Issues*, GAO-02-1001 (Washington, D.C.: September 2002).

Determining empirically whether the District has a structural imbalance is a complex task that involves making judgments about: (1) the appropriate set of governments to use when developing benchmarks for the District's spending and revenue capacity; (2) the influence that various workload and cost factors, such as the number of school age children and number of vehicle miles traveled, have on the cost of public services; and (3) the best way to measure revenue capacity.

Using economic modeling, we were unable to provide a single, precise point estimate of structural imbalance, but provided a range instead. Given the lack of professional consensus and a limited empirical basis for many of the decisions underlying our methodology, which was vetted with key experts, we performed several sensitivity analyses to show how our estimates changed as we varied key assumptions. In addition, the precision of our estimates is adversely affected by data limitations for various cost and tax bases. Nevertheless, we believe that the consistency of our basic result over a broad range of alternative assumptions and approaches provides sufficient support for the conclusions offered in this report. Moreover, we supplemented our quantitative analysis with a programmatic review of the District's three highest cost program areas to provide additional insights into the level of services, costs, management, and financing.

For our cost analysis, we computed two separate sets of benchmarks: one based on a "state" services basket, the mix of services typically provided by state fiscal systems (each state and all of its local governments), and a second based on an "urban" services basket, the mix of services that are typically provided by governments in more densely populated areas. The scope of services included is the same for both baskets; what differs is the proportion of total spending that is allocated to each service. For example, the "urban" basket of services gives greater weight to public safety functions and less weight to higher education than does the state basket of services.

To estimate total revenue capacity of each state fiscal system, we combined estimates for the two principal sources from which those systems finance their expenditures: (1) revenues that could be raised from each system's own economic base (own-source revenue), and (2) the federal grants that each system would receive if it provided an average basket of services. Two basic methodologies have been employed to estimate the own-source revenue capacity of states: (1) the total taxable resources (TTR), which uses income to measure the ability of governments to fund public services;

and (2) the representative tax system (RTS), which measures the amount of revenue that could be raised in each state if an average set of tax rates were applied to a specified set of statutory tax bases "typically" used to fund public services. Because experts disagree as to which approach is superior, we computed separate results using both methodologies.

We estimated the size of the District's structural imbalance as the difference between its cost of providing an average level of services and its total revenue capacity—the amount of revenue the District would have (including federal grants) if it applied average tax rates to its taxable resources.

## The District's Public Service Costs Are the Highest in the Nation

Using other state fiscal systems as a benchmark, our analysis indicated that the cost of delivering an average level of services per capita in the District exceeds that of the average state fiscal system by approximately 75 percent (or a total of $2.3 billion more annually than if it faced average costs circumstances) and is over a third more than the second highest-cost state system, New York. If state fiscal systems were to provide a basket of services typically provided in more densely populated urban areas, we estimated that the District would have to spend over 85 percent more (or a total of $2.6 billion more annually) than average to fund an average level of services.

The District faces high-cost circumstances, largely beyond its control, in key program areas including Medicaid, elementary and secondary education, and police and fire services that increase the fiscal burdens on the District's budget. For example, regarding Medicaid, we estimated that high-cost circumstances, such as its large low-income population, would require the District to spend well over twice the national average per capita. Consequently, to provide an average level of services the District would have to spend a total of $437 million more than if it faced average cost circumstances. Similarly, we estimated that the District's per capita cost of elementary and secondary education is 18 percent above the average state fiscal system due to circumstances such as a disproportionately high percentage of low-income children. As a result, to provide an average level of services the District would have to spend a total of about $136 million more than if it faced average cost circumstances. Likewise, for police and fire services, the District's per capita costs of providing an average level of services are well over twice the national average due to circumstances such as its relatively young population, especially high crime rates, and its dense living conditions. As a result, to provide an average level of services the District would have to spend about $480 million more than if it faced average cost circumstances. Further, our cost estimates do not explicitly account for the various public safety demands and costs associated with the federal government's presence.

## The District's Revenue Capacity Is Among the Highest in the Nation, Despite Some Constraints on Its Taxing Authority

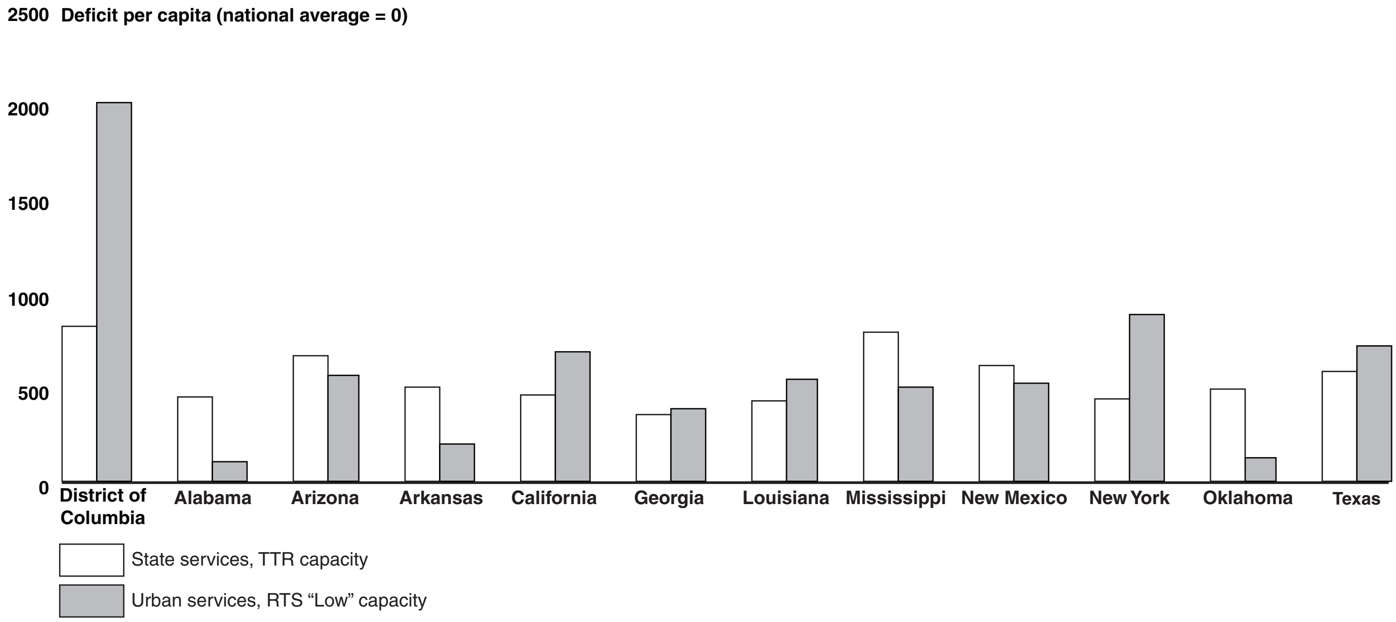
Our analysis indicated that the District's per capita total revenue and own-source revenue capacities are higher than those of all but a few state fiscal systems. Its capacity is high even though the District faces some significant constraints on its taxing authority, such as the inability to tax federal property or the income of nonresidents who work in the District.

The two estimation approaches we used to measure the District's revenue capacity yielded the same basic result: The District's own-source revenue capacity per capita ranked among the top five when compared to those of the 50 state fiscal systems. This high own-source revenue capacity, combined with the fact that its per capita federal grant funding is over two and one-half times the national average, gives it a higher total revenue capacity than any other state fiscal system. Depending on which estimation approach we used, the District's total revenue capacity ranged from 47 percent above the national average (based on a conservative version of the RTS approach) to 60 percent above (based on the TTR approach).

## The District Faces a Structural Deficit

We concluded that the District does have a substantial structural deficit in the sense that the cost of providing an average level of public services exceeds the amount of revenue it could raise by applying average tax rates, although considerable uncertainty exists regarding its exact size. We obtained our lowest deficit estimate of about $470 million per year by combining the lowest estimate of the District's costs (the one based on the state basket of services) with the highest estimate of the District's total revenue capacity (TTR). In contrast, we obtained the highest deficit estimate of over $1.1 billion per year by combining the highest estimate of the District's costs (the one based on the urban basket of services) with the lowest estimate of the District's total revenue capacity (RTS). Among the contributing factors to the structural imbalance are high-cost conditions largely beyond the District's control, such as high poverty rates, large concentrations of low-income children and the elderly, and high crime rates. Figure 1 shows how the District's structural deficit per capita compares to the state fiscal systems with the largest structural deficits.

Figure 1: Fiscal Systems with the Largest Structural Deficits Per Capita

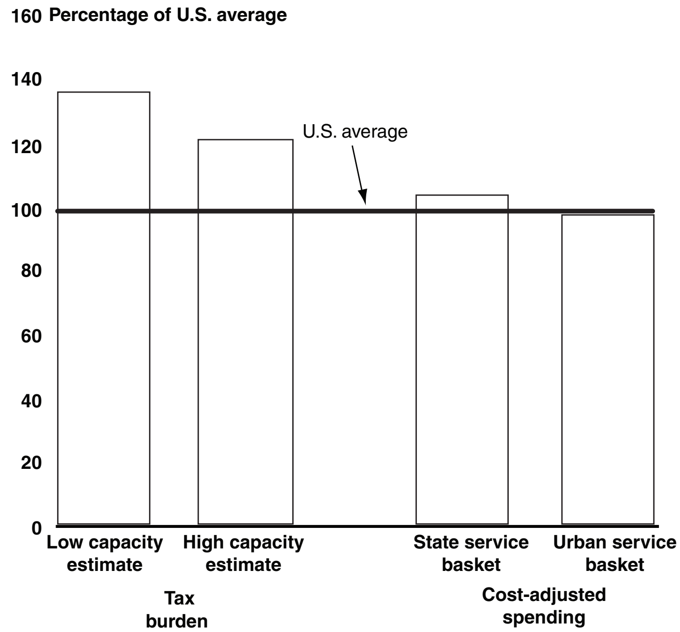



Source: GAO.

## Despite a High Tax Burden, the District's Revenues Are Only Sufficient to Fund an Average Level of Services

In addition to having high revenue capacity, the District also imposes above average tax rates; however, high taxes are only sufficient to fund an average level of services. Figure 2 shows the District's tax burden and cost-adjusted spending. Because of its high tax rates, actual revenues collected by the District exceeded our lower estimate of its own-source revenue capacity at an average tax burden by 33 percent and exceeded our higher estimate of that capacity by 18 percent (see the first two bars of fig. 2). However, the District's actual fiscal year 2000 spending was only equal to the cost of an average level of public services, based on the basket of services provided by the average state fiscal system. Using the basket of services typically provided by urban governments as a benchmark, the District's spending is 5 percent below that needed to fund an average level of services (see the last two bars of fig. 2). Our estimates of the cost of delivering an average level of services presume that they are provided with average efficiency. To the extent that the District does not deliver services with average efficiency, its actual level of services may be below average.

Figure 2: District's Tax Burden and Cost-adjusted Spending




Source: GAO.

## Management Problems Result in Unnecessary Spending That Compromises the District's Ability to Provide an Average Level of Public Services.

The District's long-standing management problems waste resources that it cannot afford to lose and draw resources away from providing even an average level of services. In three key program areas (Medicaid, elementary and secondary education, and police and fire services), our original report identified significant management problems, such as inadequate financial management, billing systems, and internal controls. While the District has taken some actions to correct management inefficiencies, more improvements are needed. In the case of Medicaid, in fiscal year 2001 the District wrote off over $78 million for several years worth of unreimbursed claims for federal Medicaid matching funds. The District was not able to claim this reimbursement because of late submission of reimbursement requests, incomplete documentation, inadequate computerized billing systems, providing services to individuals not eligible for Medicaid at the time of delivery, and billing for services not allowable under Medicaid. The independent auditor of the District's financial statements continued to report Medicaid accounting and claims processing as a material weakness in fiscal year 2003. The extent of these management problems suggests that the District continues to bear more of the burden of Medicaid costs than necessary.

In the case of education, in the recent past District public school officials were not able to track either the total number of employees or whether particular positions were still available or had been filled. For example, in March 2003, District officials announced that the school system had hired 640 more employees than its budget authorized, resulting in the District exceeding its personnel budget by a projected amount of $31.5 million over the entire fiscal year. In another example, the District's lack of internal control for procurement practices in its public school system resulted in $10 million in unauthorized purchases. While our cost analysis shows that the District is spending an amount that could provide an average level of services, the extent of these management problems suggests that the District provides less than the national average of education services.

In the case of police and fire services, the District historically has not adequately tracked the costs it incurs to support the federal presence, in areas such as providing protection to federal officials and key dignitaries and dealing with an array of special events and demonstrations. This hinders its ability to make a case for additional federal reimbursement, requiring it to spend more of its own resources to support the federal presence.

## The District Continues to Defer Improvements to Its Infrastructure While Debt Pressures Remain

Although the District is making some attempts to address its backlog of infrastructure needs, it has nonetheless continued to defer significant amounts of infrastructure projects because of constraints in its operating budget. Most of the District's infrastructure and capital improvement projects are financed by using general obligation bonds. The interest and principal payments (debt service) on those bonds are paid from the District's operating budget. Although the District is not close to its legal debt limit, it cannot accommodate additional debt without cutting services or raising taxes that are already higher than those of other jurisdictions. Contributing to the District's difficulties is its legacy of deteriorated infrastructure and its 40 percent share of funding the metropolitan area's costly mass transit system. However, the District is attempting to address its backlog of infrastructure needs through increased capital expenditures (estimated at roughly $371 million in fiscal year 2003). Nevertheless, the reality is that the District continues to defer major infrastructure and capital investment in part because of its structural imbalance.

From 1995 to 2002, the District's outstanding general obligation debt changed little, totaling slightly over $2.67 billion as of September 30, 2002, and debt per capita has remained fairly constant. The District's total outstanding general obligation debt as of September 30, 2003, was $3.25 billion. As a percentage of local general fund revenues, debt service costs, which were 7.5 percent of revenue for fiscal year 2003, are expected to climb to approximately 10 percent by 2006. The District's projections assume that debt service costs will increase at a higher rate than local revenues. Furthermore, when compared to combined state and local debt across the 50 states, the District's debt, both per capita and as a percentage of own-source revenue, ranks among the highest in the nation. Despite the challenges it faces, the District has been successful in having its bond rating upgraded by all the major rating agencies in part due to the improving economy and improved financial management.

## Concluding Observations

Due to a combination of its substantial structural deficit and significant management problems, the District is likely providing a below-average level of services even though its tax burden is among the highest in the nation. By addressing its management problems, in the long term the District could reduce future budget shortfalls. However, management improvements will not offset the underlying structural imbalance because it is caused by factors beyond the direct control of District officials. As a consequence, District officials may face more difficult policy choices than most other jurisdictions in addressing a budget gap between spending and revenues based on current policies. Since the District may not be providing an average level of services, it would also be difficult to cut services further and the tax burden it imposes is among the highest in the nation. An alternative option to raising taxes or cutting services would be for District officials to continue deferring improvements to its capital infrastructure. This strategy also is not viable in the long run in that deteriorating infrastructure would of necessity lead to further reductions in the levels and types of services provided and ultimately would necessitate either higher taxes or cuts in services.

Although it would be difficult, District officials could address a budget gap by taking actions such as cutting spending, raising taxes, and improving management inefficiencies. However, a structural imbalance is beyond the direct control of local officials. Without changes in the underlying factors driving expenses and revenue capacity, the structural imbalance will remain. If this imbalance is to be addressed, in the near term it may be necessary to change federal policies to expand the District's tax base or to provide additional financial support. However, given the existence of structural imbalances in other jurisdictions and the District's significant management problems, federal policymakers face difficult choices regarding what changes, if any, they should make in their financial relationship with the District. Further, another consideration for the Congress is that the federal government faces its own long-term fiscal challenges with the prospect of large, persistent deficits. Nevertheless, by virtue of the District being the nation's capital, justification may exist for a greater role by the federal government to help the District maintain fiscal balance. At the same time, the District must achieve basic management performance and accountability standards to ensure an efficient use of any resources.

Accordingly, if the District were to receive additional federal assistance to compensate for its structural imbalance and enhance its ability to fund capital investments—as is proposed in the District of Columbia Fair Federal Compensation Act of 2004 (H.R. 4269)—it is important that the District follow sound practices in order to avoid the costly management inefficiencies it has experienced in the past. The Congress needs assurance that any federal assistance to the District would be spent effectively and efficiently. It is critical to have clear, transparent reporting and accountability mechanisms in place to ensure the proper use of federal funds. Also, the Congress might want to consider incentives to encourage the effective utilization of any federal funds.

Specifically, we have issued detailed guidance—based on best practices of public and private entities— for the planning, budgeting, acquisition, and management of capital assets, including infrastructure projects and technology upgrades.[3] Key elements of this guidance are to closely link any planned capital investments to a government or agency's strategic goals and objectives, ensure that effective information systems are in place to support sound decision making and management, and for city leaders to clearly communicate their vision and goals to project managers. In addition, our past work has shown that it is useful to make capital decisions based on the following five basic principles and to follow related practices.

[3] U.S. General Accounting Office, *Executive Guide: Leading Practices in Capital Decision-Making* GAO/AIMD-99-32 (Washington, D.C.: December 1998).

- Integrate organizational goals into the capital decision-making process, such as conducting comprehensive assessments of needs in relation to the current inventory of assets, and evaluating alternative approaches to meeting needs.

- Evaluate and select capital assets using an investment approach, meaning that a clear project approval framework should be established, projects should be ranked based on established criteria, and long-term capital plans should be developed.

- Balance budgetary control and managerial flexibility when funding capital projects, which entails budgeting for the projects in segments and considering full, upfront funding.

- Use project management techniques to optimize project success, such as monitoring project performance, establishing incentives for accountability, and using cross-functional teams to manage the projects.

- Evaluate results to make sure goals and objectives are being met and incorporate lessons learned into the decision-making process, including occasional reappraisals of decision-making and management processes.

We have not examined the District's capital planning and management functions. District officials may already be following these principles and practices. Nevertheless, all of them are important to consider in order to maximize investment.

Mr. Chairman, this concludes my prepared statement. I would be pleased to answer any questions you or the other members of the Subcommittee may have at this time.

For future contacts regarding this testimony, please call Patricia A. Dalton, Director, Strategic Issues, at (202) 512-6806. Other individuals who made key contributions to this testimony were Thomas Yatsco, Eric Mader, Jeanette Franzel, Norma Samuel, Ann Calvaresi Barr, Jerry Fastrup, and James Wozny.

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