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Report to Congressional Requesters

May 2003

DISTRICT OF COLUMBIA

Structural Imbalance and Management Issues

GAO-03-666

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GAO Accountability • Integrity • Reliability

Highlights

Highlights of GAO-03-666, a report to the Ranking Minority Member, Subcommittee on the District of Columbia, Committee on Appropriations, United States Senate; and the Honorable Eleanor Holmes Norton, House of Representatives

Why GAO Did This Study

District officials have recently reported both a 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 a preliminary September 2002 report, GAO concluded that the District had not provided sufficient data and analysis to discern whether, or to what extent, it is facing a structural imbalance. At that time, GAO also agreed to perform a more comprehensive analysis and was asked to (1) determine whether, or to what extent, the District faces a structural imbalance between its revenue capacity and its public service responsibilities, (2) identify any significant constraints on the District's revenue capacity, (3) discuss factors beyond the control of District officials that influence the District's spending in key program areas as well as factors within its control, such as management problems, and (4) report on the District's deferred infrastructure projects and outstanding debt service and related expenses that might be affected by a structural imbalance.

The District concurred with our key findings.

www.gao.gov/cgi-bin/getrpt?GAO-03-666.

To view the full report, including the scope and methodology, click on the link above. For more information, contact Patricia A. Dalton at (202) 512-6806 or daltonp@gao.gov.

What GAO Found

GAO used a multifaceted approach to measure structural imbalance that GAO defines as a fiscal system's inability 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). However, the benchmark is adjusted by taking into account circumstances that are beyond the control of state and local government officials (e.g., number of school-age children and value of tax bases). GAO supplemented this analysis with reviews of the District's key programs to provide insights on factors influencing spending, and reviewed deferred 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 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. However, 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. These two factors make it difficult for the District to raise taxes, cut services, or assume additional debt.

Although difficult, District officials could address a budget gap by taking actions such as cutting spending, raising taxes, and improving management efficiencies. In contrast, a structural imbalance is largely beyond District officials' direct control. 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.

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Abbreviations

ACIR	Advisory Commission on Intergovernmental Relations
BEA	Bureau of Economic Analysis
CAFR	comprehesive annual financial report
CBO	Congressional Budget Office
CFO	chief financial officer
CFSA	Child and Family Services Agency
CIP	Capital Improvement Plan
CMS	Centers for Medicare & Medicaid Services
DCPS	District of Columbia Public Schools
DHS	Department of Homeland Security
DMH	Department of Mental Health
FEMS	Fire and Emergency Medical Services
FMAP	Federal Medical Assistance Percentage
GSE	government-sponsored enterprise
IDEA	Individuals with Disabilities Education Act
IEP	individualized education plan
IG	inspector general
IMF	International Monetary Fund
IRS	Internal Revenue Service
MAA	Medicaid Assistance Administration
MPD	Metropolitan Police Department
OFT	Office of Finance and Treasury
RES	representative expenditure system
RTS	representative tax system
SEO	State Education Office
TTR	total taxable resources
USDA	Department of Agriculture
USPP	United States Park Police
WASA	Water and Sewer Authority
WMATA	Washington Metropolitan Area Transit Authority
YYPL	years of productive life lost

GAO
Accountability * Integrity * Reliability

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

May 22, 2003

The Honorable Mary Landrieu
Ranking Minority Member
Subcommittee on the District of Columbia
Committee on Appropriations
United States Senate

The Honorable Eleanor Holmes Norton
House of Representatives

In response to your request, this report discusses the results of our review of the District of Columbia's (the District) reported structural imbalance between its revenue capacity and the cost of meeting its public service responsibilities. Specifically, it provides information on the nature of the District's structural imbalance as well as information on significant constraints on its revenue capacity; costs conditions that are beyond the control of District officials and management challenges in key program areas; and the District's ability to fund infrastructure projects and pay related debt.

We are sending copies of this report to other appropriate congressional committees, the Mayor and Chief Financial Officer of the District of Columbia, and other interested parties. We will also make copies available to others upon request. This report will also be available at no charge on the GAO Web site at http://www.gao.gov. If you or your staffs have any questions on this report, please call me on (202) 512-6737 or Ann Calvaresi Barr, Assistant Director, on (202) 512-6986. Key contributors are listed in appendix VII.

Patricia A. Dalton

Patricia A. Dalton
Director, Strategic Issues

Executive Summary

Purpose

District of Columbia officials have reported that, in addition to facing the prospect of their budget falling into deficit over the next several years, they face a more permanent imbalance between the District's revenue-raising capacity and the cost of meeting its public service responsibilities. They maintain that this more permanent imbalance is not related to their current budgetary imbalance, but rather is based on structural conditions that are beyond their ability to control, such as public service costs imposed on the District by the federal government, federal restrictions on its revenue capacity, and issues associated with having both state and local responsibilities. In response, at various times District officials have asked the Congress for additional funds and other measures to enhance revenues. To help inform the debate, GAO was asked to

1. assess whether, or 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,

2. identify significant constraints on the District's revenue capacity,

3. examine cost conditions and management problems in key program areas, and

4. study the effects of the District's fiscal situation on its ability to fund infrastructure projects and repay related debt.

Background

Defining Structural Imbalance

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* addresses this 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* addresses this 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 a 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 providing 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. As noted below, GAO employed a representative services approach in performing this engagement.

When analyzing a representative services 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, GAO 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 and taxation that a typical state fiscal system (the collections of a state, its counties, its cities, and its myriad 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 GAO defines structural imbalance in terms of comparisons to national averages, for any given period a significant proportion of all fiscal systems will have structural deficits.

The District's Estimates of a Structural Imbalance

The District has reported both a current services and a more permanent structural imbalance between its costs and revenue-raising capacity. According to recent projections by the District's Chief Financial Office, a continuation of the District's current spending and taxing policies would result in budget gaps, peaking at $372 million by fiscal year 2006 before declining to $325 million in fiscal year 2007.[1] District officials have demonstrated their resolve to maintain fiscal discipline by taking the steps needed to balance their budgets for fiscal years 2003 and 2004. However, 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. District officials claim the structural imbalance may amount to $1 billion annually.[2]

Last year, GAO examined issues related to the District's reported structural imbalance and, in September 2002, concluded that the District had not provided sufficient data and analysis to determine whether, or to what extent, the District is in fact facing a structural imbalance between its revenue capacity and the cost of meeting its public service responsibilities. To help inform the debate on this issue, GAO also committed to perform a more comprehensive analysis of the District's fiscal situation.

GAO's Estimation Methodology—Representative Services

GAO used a representative services analysis to determine whether and to what extent the District has a structural imbalance. This approach allowed GAO 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. The methodologies for all elements of this study are described in chapter 1. Appendixes I, II, and III provide additional detail about GAO's quantitative methodology.

Determining empirically whether the District has a structural imbalance is a complex task that involves making judgments about (1) the appropriate

[1] The District's approved fiscal year 2003 budget was $5.6 billion.

[2] See the District's comments in U.S. General Accounting Office, *District of Columbia: Fiscal Structural Balance Issues*, GAO-02-1001 (Washington, D.C.: Sept. 4, 2002), 33.

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.

Given the lack of professional consensus and a limited empirical basis for many of the assumptions underlying GAO's methodology, GAO performed several sensitivity analyses to show how its estimates changed as it varied specific judgments and choices regarding key assumptions. In addition, the precision of GAO's estimates is adversely affected by data limitations for various cost and tax bases. Consequently, uncertainty surrounds the specific numerical estimates GAO presents. Nevertheless, GAO believes that the consistency of its basic result over a broad range of alternative assumptions and approaches provides sufficient support for the concluding observations offered in this report.

Moreover, GAO supplemented its 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. GAO also reviewed the District's infrastructure and debt management experience. GAO's methodology was vetted among key experts, including individuals who designed the underlying methodology and District economists.

Choosing a Benchmark of Services

Determining the appropriate benchmarks for the District's spending is complicated by the fact that the District is a unique governmental entity. It has all of the fiscal responsibilities generally shared by state, city, county, and special district governments; however, it is a relatively small and densely populated area in comparison to the 50 states. No peer group of governments has both the same fiscal responsibilities and the same geographic and demographic characteristics as the District.

For this reason, GAO computed two separate sets of benchmarks—one based on a "state" services baskets, 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 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.

Calculating the Average Cost of Representative Services

To calculate the cost of providing a representative level of public services, GAO used the national average per capita spending for each expenditure function as a benchmark. For example, when using the state services basket, the national average per capita spending for elementary and secondary education was $1,338 per capita. GAO used this figure as a benchmark indicator of an average level of educational services. However, each benchmark had to be adjusted to account for the fact that an average level of spending does not support the same level of service in each fiscal system. For this reason, GAO adjusted for differences in workloads (e.g., number of school-age children) across states. GAO also adjusted for the fact that the private sector wage rate varies across states because that means the cost of hiring a given number of public employees also varies. These factors for which GAO adjusted represent circumstances beyond the governments' control.

GAO did not adjust for differences in preferences or policy decisions across states, nor did it adjust for differing degrees of efficiency in providing services. Rather, GAO's cost estimates were made on the presumption that services are delivered to residents with average efficiency. Therefore, governments that are relatively inefficient would have to spend more than the average amount to provide an average level of services. In addition, GAO made no adjustments for the unique public service costs associated with the District being the nation's capital. Although GAO's quantitative analysis did not reflect these service inefficiencies and unique costs, its programmatic work does provide insights about the extent and nature of these issues.

Estimating Revenue Capacity

To estimate the total revenue capacity of each state fiscal system, GAO 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.

In the past, two basic approaches have been employed to estimate the own-source revenue capacity of states: (1) those that use income to measure the ability of governments to fund public services and (2) those that attempt to measure 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. Total taxable resources (TTR), developed by the U.S. Department of the Treasury (Treasury), is a leading example of the first type of measure; and the representative tax system (RTS), developed by the Advisory Commission on Intergovernmental Relations, is a leading example of the second.

Because experts disagree as to which approach is superior, GAO computed separate results using both methodologies. Both the RTS and TTR take into account the restrictions placed on the District's taxing authority. GAO generally used the actual amounts that state fiscal systems received from the federal government as proxies for the actual amounts that each system would receive if it provided an average basket of services. However, GAO made special adjustments in the case of Medicaid grants because the current amount that each fiscal system receives would be significantly different if it were to provide average Medicaid coverage and benefits.

Calculating the Structural Imbalance

GAO 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 average level of services and average tax rates that GAO used should not be interpreted as the levels of spending and taxation that jurisdictions should seek to provide. Each jurisdiction is an autonomous governmental entity responsible for providing the package of services and level of taxation desired by its citizens. Depending on the preferences of local citizens and their representatives, levels of taxation and services may be higher in some jurisdictions and lower in others. The use of average levels in GAO's analysis should only be thought of as a convenient benchmark against which to gauge relative differences in the cost of providing public services over which local officials have little direct control and as providing an indication of the potential availability of revenue sources from which to finance those costs.

Results in Brief

No consensus exists regarding the "best" approach to estimating structural imbalance, and the empirical basis for many of the assumptions underlying GAO's methodology is limited. Consequently, GAO performed several sensitivity analyses to show how its estimates changed as it varied specific judgments and choices regarding key assumptions. The consistency of GAO's basic result over a broad range of alternative assumptions and approaches led GAO to conclude that the District does have a substantial

structural imbalance, even though considerable uncertainty exists regarding its exact size.

The existence of this structural deficit means that, even if the District's services were managed efficiently, the District would have to impose above-average tax burdens just to provide an average level of services. To the extent that services are delivered inefficiently, the District's high tax burden would likely not support even average service levels. GAO's programmatic review of three key areas (Medicaid, elementary and secondary education, and public safety) indicated that, in fact, significant management inefficiencies exist, totaling tens of millions of dollars annually. Consequently, the District's high tax burden is likely providing an actual level of services below the national average.

GAO 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 total amount of revenue it would have (including federal grants) if it applied average tax rates to its taxable resources. Based on GAO's use of a state fiscal system basket of services as a benchmark, GAO's analysis indicated that the cost of providing an average level of services per capita in the District exceeds that of the average state fiscal system by approximately 75 percent, or $2.3 billion more annually than if it faced average cost circumstances. If state fiscal systems were to provide a basket of services typically provided in more densely populated urban areas, GAO estimated that the District would have to spend over 85 percent, or $2.6 billion more annually to fund an average level of services.

GAO's analysis also indicated that the District's per capita total revenue capacity is higher than those of all state fiscal systems due to its large tax bases and federal grant funding that is over two and one half times higher than the national average. Depending on which estimation approach GAO 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). Using fiscal year 2000 information, GAO obtained its lowest estimate of the District's structural deficit—$470 million—by combining the District's cost of providing the average state basket of services with GAO's highest estimate of the District's revenue capacity. All other combinations led to higher estimates of the structural imbalance—up to more than $1.1 billion.

While the District's revenue capacity per capita is large relative to those of most state fiscal systems, it would be even larger in the absence of several existing constraints on the District's tax authority. These constraints include the prohibition against taxation of income earned by nonresidents working in the District and the relatively large proportion of the District's property tax base that is not taxable because it is either owned or specifically exempted by the federal government. Despite these revenue constraints, the per capita revenue capacities of the District's income and property taxes are higher than those for all but a few state fiscal systems, partly reflecting the indirect benefits of the federal presence for the District's economy. In contrast, the District may have a relatively low sales tax capacity due, in part, to a disproportionate share of sales to the federal government and other exempt purchasers.

GAO's review of three key program areas (Medicaid, elementary and secondary education, and public safety, particulary police and fire services) revealed that the District faces high cost conditions. GAO found that the District's spending for Medicaid and elementary and secondary education may be slightly above what it would take to provide an average level of services, if delivered with average efficiency, while police spending may be significantly below the average level. However, GAO's quantitative analysis was not able to account for all special circumstances beyond the control of the District, such as the high cost of special education services, and extra police and fire services associated with the federal presence, including those for political demonstrations. In recognition of the District's high-cost environment, the federal government provides certain supplemental financial support to the District, such as an enhanced federal share of the District's spending on Medicaid.

Significant and costly management problems—mostly under the District's authority to control—further increase spending unnecessarily in Medicaid, elementary and secondary education, and police and fire protection. These problems, documented in GAO's work and in that of others, include inadequate financial management, billing systems, and internal controls that result in unnecessary spending, drawing resources away from program services. Various reports have estimated wasted resources to be at least in the tens of millions of dollars. For example, serious management problems exist, such as poor financial and program management in education as well as inadequate compliance with the requirements of federal programs like Medicaid and the Individuals with Disabilities Education Act. The District has taken some actions to correct management inefficiencies, such as

creating an Office of Medicaid Public Provider Operations Reform; however, more improvements are needed.

By addressing such management challenges, the District could free up local funds and possibly gain additional federal funds for use in increasing the levels of services to its residents and closing its current budget gap. However, addressing these management problems will not offset the District's underlying structural imbalance, which is due to factors outside its direct control. In recognition of the District's management problems, the federal government provides the District with special technical assistance.

While capital spending has increased in recent years, the District continues to defer infrastructure improvements 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 take on additional debt without cutting services or raising taxes that are already higher than other jurisdictions. Contributing to the District's difficulties is its legacy of deteriorated infrastructure and its responsibility for funding its 40 percent share of the metropolitan area's mass transit system. However, the District is attempting to address its backlog of infrastructure projects through increased capital expenditures (estimated at roughly $371 million in fiscal year 2003). Nevertheless, the District continues to defer major infrastructure and capital investment in part because of its structural imbalance.

Principal Findings

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

Using other state fiscal systems as a benchmark, GAO's analysis indicates 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 cost circumstances) and is over a third more than the second highest cost fiscal system, New York. If state fiscal systems were to provide a basket of services typically provided in more densely populated urban areas, GAO 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 its budget. For Medicaid, GAO 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, GAO 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 the District's 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 its high crime rates, 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, GAO's cost estimates did not explicitly account for the various public safety demands and costs associated with the federal government's presence, although GAO's programmatic work does provide insights about this issue.

The District's Revenue Capacity Is among the Highest in the Nation, despite Some Constraints on Its Taxing Authority

GAO's 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. As noted earlier, the District's total revenue capacity equals the sum of its own-source revenue capacity (the revenue that it could raise by applying average tax rates to its own economic base), plus the amount of federal grants that the District would receive if it provided a representative level of services.

The two estimation approaches (RTS and TTR) GAO 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 federal grant funding is over two and one-half times the national average, gives the District a higher total revenue capacity than any other state fiscal system.

Depending on which estimation approach GAO 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). However, the distance between the District's revenue capacity and that of the next highest systems' capacity is not as extreme as is the case with the cost of funding an average service level.

The District Faces a Structural Deficit

Using a representative services analysis (which compares the District's circumstances to a benchmark based on average spending and tax policies of state fiscal systems), GAO found that the District faces a 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. As previously discussed, data limitations and uncertainties surrounding key assumptions in GAO's analysis made it difficult to determine the exact size of the District's structural deficit. Nevertheless, using a broad range of alternative assumptions and approaches, GAO obtained the same basic result—the District faces a substantial structural deficit.

GAO obtained its lowest deficit estimate of about $470 million per year by combining its lowest estimate of the District's costs (the one based on the state basket of services) with its highest estimate of the District's total revenue capacity (TTR). In contrast, GAO obtained its highest deficit estimate of over $1.1 billion per year by combining its highest estimate of the District's costs (the one based on the urban basket of services) with its 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.

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

In addition to having a high revenue capacity, the District also imposes above-average tax rates; however, high taxes are only sufficient to fund an average level of services. Because of its high tax rates, actual revenues collected by the District exceeded GAO's lower estimate of its own-source revenue capacity by 33 percent and exceeded GAO's higher estimate of that capacity by 18 percent. 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. GAO's cost estimates presume services 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.

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), GAO 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, services provided to individuals not eligible for Medicaid at the time of delivery, and billing for services not allowable under Medicaid. The extent of these management problems suggests that the District bears more of the burden of Medicaid costs than necessary.

In the case of education, District 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 acknowledged that the school system had hired 640 more employees than its budget authorized, resulting in the District exceeding its personnel budget by a projected $31.5 million over the entire fiscal year. Also, in December 2002, District officials announced that the school system paid $5 million for employee insurance benefits and contributions to tax-free retirement accounts for employees who no longer worked for the District. 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 GAO's cost analysis showed 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 level of education services.

In the case of police and fire services, the District does not adequately track the costs it incurs to support the federal presence, for example, 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 projects, it has nonetheless continued to defer significant amounts of infrastructure projects because of constraints in its operating budget. The Chief Financial Officer (CFO) is also taking steps to reduce the city's debt servicing costs, such as refinancing some bonds at lower rates. However, the District cannot take on additional debt without cutting services or raising taxes that are already higher than other jurisdictions. As a result, it has chosen to put off needed repairs to streets and schools and postponed new construction that would improve the District's infrastructure (estimated at $371 million in fiscal year 2003).

From 1995 to 2002, the District's outstanding general obligation debt changed little, totaling $2.67 billion as of September 30, 2002. Debt per capita has also remained fairly constant except for a dip due to debt retirement that was made possible by an influx of funds resulting from the 1998 tobacco settlement. As a percentage of local general fund revenues, debt service costs, which were 7.3 percent of revenue for fiscal year 2002, 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 ranks as the highest in the nation both per capita and as a percentage of own-source revenue.

Concluding Observations

Due to a combination of its significant management problems and its substantial structural deficit, 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 these 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. For example, given its existing high tax burdens, further raising taxes would likely worsen its competitive advantage in attracting new businesses and residents to locate in the District.

Since the District may not be providing an average level of services, it could also be difficult to cut services further. GAO's site visits and past studies identified myriad management problems that led GAO to conclude that the level of services provided to District residents is likely below the national norm. Therefore, cutting services means, in all likelihood, cutting an already low level of services to residents as well as businesses and visitors, which could also have undesirable consequences for the District's economy.

An alternative option to raising taxes or cutting services would be for District officials to continue deferring improvements to its capital infrastructure. While the rate of investment has picked up in recent years, GAO's analysis of its capital improvement plan reveals that the District continues to defer many improvements to its aging stock of infrastructure assets as a means of dealing with both a structural deficit and continuing budgetary pressures. However, this strategy also is not viable in the long run because 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 efficiencies. In contrast, a structural imbalance is largely beyond District officials' direct control. 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.

Federal policymakers could choose not to address the District's structural imbalance and require local officials to deal with the difficult choices it faces to meet its obligations. This approach recognizes that other jurisdictions also face substantial structural deficits and local officials are in the best position to decide for themselves the most effective means of balancing trade-offs between high tax burdens and reduced levels of public services for local residents and visitors to the nation's capital.

Alternatively, additional federal assistance (beyond the high level already provided) for the District could compensate for its structural imbalance. However, this assistance might suggest that officials of other fiscal systems, also with sizable structural imbalances, would have equally sound claims on additional federal assistance. 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. However, this strategy is not without its own risks. For example, significant management problems in the District mean that the aid provided, if not used wisely, could result in more wasteful spending or in the District simply postponing many management reforms. Given its management challenges, it is important that the District achieve basic management performance and accountability standards to ensure an efficient use of any resources.

District of Columbia Comments

GAO provided copies of a draft of this report to the Mayor and CFO of the District of Columbia for their review and comment. The CFO, in consultation with the Mayor, provided written comments agreeing with all key findings in the draft report. The District's letter is reprinted in appendix VI. Specifically, District officials commented on what they saw as the report's three major themes. First, they concur with the existence of a structural deficit. Second, they concur with the four fundamental features of the District's fiscal problems, mainly that the District's expenditure requirements for providing an average level of services are far higher than any state fiscal system; the District taxes itself very heavily; even with high taxes, the District may not be providing an average level of services to residents, commuters, and visitors; and the District has a serious infrastructure problem.

Third, the District agrees that GAO provides a constructive analysis of several issues about the District's finances and acknowledges that significant opportunities exist for addressing serious management inefficiencies. In addition, District officials state that spending and revenue

adjustments taken to maintain a balanced budget do not resolve the underlying structural deficit.

District officials stated their belief that, given the District's unique relationship with the federal government, a strong case exists for the federal government to assist it in addressing its structural deficit. They also presented four technical suggestions with respect to the content of the draft report. Specifically, they asked and GAO agreed to highlight in the executive summary that the District is taking some measures to address management inefficiencies and that the District has maintained balanced budgets, but these year-to-year adjustments do not address the underlying structural deficit. Although District officials also requested that GAO further emphasize that solving management inefficiencies alone will not resolve the District's structural deficit, GAO believes this discussion is adequately captured throughout the report. Similarly, District officials asked GAO to emphasize the unique situation involved in the District's fiscal deficit; GAO believes the report adequately addresses this issue as well.

Introduction

A perennial issue for federal and District of Columbia officials has been determining the proper level of federal assistance to the District. Federal assistance historically has helped the District offset costs associated with its unique status and position. However, according to District officials, this assistance is inadequate.

Based on the District's most recent budget analysis, District officials claim that they will be unable to maintain the District's current level of services into the future under its current revenue policies. District officials also point to a deeper structural imbalance, stating that they do not have sufficient revenue capacity to meet the high cost of providing residents and visitors with adequate public services. In addition, the District has experienced serious and longstanding management problems.

In September 2002, we published an interim report that concluded that the District had not provided sufficient data and analysis for us to determine whether, or to what extent, the District is, in fact, facing a fiscal structural imbalance.[1] To help inform this debate about the proper level of federal assistance, this report (1) assesses whether, or 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, (2) identifies significant constraints on the District's revenue capacity, (3) examines cost conditions and management problems in key program areas, and (4) studies the effects of the District's fiscal situation on its ability to fund infrastructure projects and repay related debt.

Characteristics of the District

While the District serves as the seat of the federal government, it also serves as home to over a half million people. The District is 61 square miles and had 9,316 residents per square mile in 2000. The District's primary industry after the federal government is tourism. Other important industries include trade associations, as the District is home to more associations than any other U.S. city. Table 1 describes some of the demographic characteristics of the District and compares them to national averages in 2000.

[1] GAO-02-1001.

Table 1: Demographic Characteristics of the District Compared to National Averages, 2000

Characteristics	District of Columbia	United States
Percentage of population under 19 years	24	29
Percentage of population 65 years and older	12	12
Percentage of population by race:		
• White	31	75
• Black or African-American	60	12
Estimated median household income	$40,926	$41,486
Percentage of individuals below poverty	18	12

Source: U.S. Census Bureau.

The District's Fiscal Relationship with the Federal Government

The fiscal relationship between the federal government and the District has been a subject of perennial debate. Although the U.S. Constitution gives the Congress exclusive legislative authority and control over the District as the seat of the federal government,[2] the Constitution did not specifically define the fiscal relationship between the District and the federal government. Accordingly, tension has existed between maintaining some degree of federal control over the District and the desire to grant District residents a say in how they are governed. As a result, local autonomy and federal fiscal support for the District have evolved throughout the last 200 years.

Through the 1870s to the present, the federal government has made financial contributions to the District's operations. Table 2 briefly describes the evolution of this fiscal relationship by highlighting the important milestones since home rule in 1973.

[2] U.S. Constitution., art. I, § 8, cl. 17.

Table 2: Significant Statutes or Actions That Affected the District's Fiscal Relationship with the Federal Government since Home Rule

Federal statutes or actions[a]	Purpose of statute or action	Implementation of statute or action
The District of Columbia Self-Government Reorganization Act of 1973[b] (subsequently renamed the District of Columbia Home Rule Act)	Provided for an elected mayor and city council. However, the District cannot obligate or spend funds unless appropriated by an act of the Congress. The act also continued the annual payment to the District, but the actual amount appropriated was within the discretion of the Congress.	In recognition of the constraints on the District's revenue capacity, such as its inability to tax the income of nonresidents, the act required the District to estimate the budgetary impact of these limitations each year and to include in its budget submission a request for a federal payment.
The District of Columbia Financial Responsibility and Management Assistance Act of 1995	Intended to restore the city to financial solvency and improve its management in response to a serious financial and management crisis. The act created a federal control board whose authority supplanted that of the elected mayor and city council; it also created a chief financial officer (CFO). The act also extended the powers of the District Inspector General (IG).	The control board was responsible for helping the District recover its financial solvency and improve management effectiveness. The CFO was charged with developing long-term financial plans and enforcing budget discipline among agencies. The IG was charged with performing annual audits and investigating allegations of waste, fraud, and abuse of city funds or procedures.
The National Capital Revitalization and Self-Government Improvement Act of 1997	Enacted to provide key structural changes to the District's finances and to repeal the annual federal payment. The act also repealed the provision in the Home Rule Act requiring the District to submit an annual federal payment request as part of its budget.	The federal government assumed the District's unfunded pension liabilities and a larger share of its Medicaid expenditures. The act authorized a federal financial contribution, but did not specify an amount. The act also shifted to the federal government certain financial and administrative responsibilities for justice, including the court system, corrections, offender supervision, and crime victim compensation.
In September 2001, the control board suspended its oversight responsibilities.	The control board certified that the provisions of the Financial Responsibility and Management Assistance Act had been met. However, under the law the control board will return if any one of seven events occur, such as if the District fails to meet its payroll or if it has a cash deficit at the end of any quarter.	The last of the preconditions for suspension of the control board was achieved in February 2001 when the fourth consecutive balanced budget for the District was certified based on the *Fiscal Year 2000 Comprehensive Annual Financial Report* (CAFR).

Source: GAO.

Note: GAO analysis of the federal actions and statutes described in this table.

[a]Pub. L. No. 93-198.

[b]For a comprehensive discussion of the history of District's relationship with the federal government, see Congressional Research Service, *The Evolution of District of Columbia Governance*, Order Code RL 30897 (Washington, D.C.: November 2001).

Reports on the District's Unique Circumstances, Fiscal Health, and Management Problems

Several recent reports address some of the unique challenges the District faces as the nation's capital, the status of its fiscal health, and the management inefficiencies that continue to affect its programs, costs, and service delivery. While these studies reach similar conclusions about the District's unique costs associated with the federal presence, as well as its high demand for services, these studies also recognize that the District needs continued management improvements. Table 3 highlights the conclusions reached in several recent reports about the District.

Table 3: Recent Reports on the District's Fiscal and Management Problems

Report	Conclusions
GAO's interim September 2002 report on the District's fiscal structural imbalance [a]	This report provided our preliminary assessment of several elements of the District's reported fiscal structural imbalance. The report concluded that the District had not provided sufficient data or analysis to determine whether, and to what extent, a fiscal structural imbalance exists. Instead, we committed to perform a more comprehensive analysis to address this issue.
Brookings Institution's October 2002 report [b]	Federal restrictions on the District and the burdens associated with the federal presence prevent it from reaching its potential as a great capital city. The report concludes that the federal government should make a continuing payment to the District in the range of $300 million to $500 million per year. Three arguments are made to support a federal payment. 1. Restrictions on the District's revenue capacity prevent it from obtaining reimbursement for services provided to commuters, tax-exempt property owners, and national and international officials. 2. The District plays a unique jurisdictional role, including providing many services typically provided by state governments, but without the fiscal tools available to pay for these services. 3. The federal government has a responsibility to address the neglected state of the District's infrastructure and to help it become a showcase capital city. While the report recognizes that some management inefficiencies contribute to the budget shortfalls, it concludes that no one knows the extent of its contribution to the shortfall or the effects improvements would have on its underlying fiscal crisis. The report presents a variety of options for providing federal support that range from payments in lieu of taxes, to restoring the federal payment as a per capita grant, to providing state-like aid to elementary and secondary education.

(Continued From Previous Page)

Report	Conclusions
Federal City Council report, *Assessing the District of Columbia's Financial Position* (conducted by McKinsey and Company 2002)[c]	The report concludes that the District is on a path that will lead to a budget deficit of $500 million annually by 2005. Factors contributing to the projected deficit include the economic downturn and unbudgeted spending increasing in several areas, including public schools, Medicaid, the Washington Metropolitan Area Transit Authority, and the constraints the District is faced with due to the presence of the federal government. The report calls for three actions. 1. Improve management efficiency, which could result in annual cost savings from $110 to $160 million by 2005. 2. Defer planned individual tax rate cuts from 2002 through 2004, which would add $150 million to 2005 revenue. 3. Seek additional financial relief from the federal government for costs associated with the burdens it faces by virtue of its status as the nation's capital—the report estimates that these annual costs are in the range of $500 million to $650 million.

Source: GAO.

Note: GAO analysis of the reports described in this table.

[a]GAO-02-1001.

[b]Carol O'Cleireacain and Alice Rivlin, *A Sound Fiscal Footing For The Nation's Capital* (Washington, D.C.: Brookings Institution, 2002).

[c]McKinsey and Company, *Assessing the District of Columbia's Financial Position* (Washington, D.C.: 2002). The Federal City Council commissioned this report. This council is a non profit, non partisan organization dedicated to the improvement of the nation's capital. It is composed of and financed by 170 of the region's top business, professional, educational, and civic leaders.

The Economic Slowdown and the District's Finances

After the economic boom of the 1990s, all levels of government are now experiencing serious fiscal challenges and are likely to face even more fundamental ones in the future. The federal budget has moved from unprecedented federal surpluses in the late 1990s to deficits, with the Congressional Budget Office (CBO) now projecting the federal government to run deficits of $246 billion in fiscal year 2003 and $200 billion in fiscal year 2004.[3] At the same time, spending demands are also on the rise, as the federal government deals with funding entitlement programs, such as Medicaid, Medicare, and Social Security, along with new and rapidly increasing health care costs and recent defense and homeland security needs.

[3] CBO's adjusted baseline assumes discretionary budget authority for 2003 will total $751 billion and grow with inflation thereafter. See CBO, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2004: An Interim Report, March 2003* (Washington, D.C.: March 2003).

Similarly, states are experiencing significant, recurring revenue declines—estimates show state budget shortfalls of about $80 billion by 2004.[4] States are not only facing a major decline in revenues—attributed to the recession, steep stock market declines and other factors—but also increased spending in areas like Medicaid due to increased enrollment and health care costs. This shortfall translated into reductions in aid to local governments, hiring and salary freezes, cuts in infrastructure projects and discretionary programs aimed at low-income individuals and families and even across the board spending reductions. Many states have also taken other actions like tapping "rainy day funds" or tobacco settlement money, or raising "sin" taxes.

Like those of other state and local governments, the District's finances have been adversely affected by the recent economic slowdown. The CFO's office projects that total local source revenues for fiscal year 2003 will be $53.5 million (or 1.5 percent) lower in inflation-adjusted terms than they were in fiscal year 2000. The principal reason for this decline is a significant deterioration in individual income tax revenue. In fact, the decline of $214.1 million in the individual income tax far exceeds the decline in overall revenues. The CFO's office attributes much of this decline to a steep drop-off in capital gains earned by residents, although the office does not have sufficiently detailed data to quantify the decline in this specific source of income.

Sales tax and business franchise tax revenues have also declined, but in smaller absolute amounts compared to the individual income tax. In contrast, revenues from property taxes (the District's second most important revenue source after the income tax), gross receipts, other taxes, and nontax sources have increased since fiscal year 2000. Table 4 shows the change in revenue from each principal source from fiscal year 2000 through fiscal year 2003.[5]

[4] National Associate of State Budget Officers.

[5] The projected fiscal year 2003 total local source revenues are higher than actual fiscal year 2002 revenues, but by less than 0.2 percent in inflation-adjusted terms.

Table 4: Changes in the District's Local Source Revenues since Fiscal Year 2000 (Revenues in Millions of Real Dollars)

Revenue source	Fiscal year 2000 actual	Fiscal year 2003 projected (as of February 2003)	Change in real dollars	Percentage change
Property taxes	$732.0	$897.1	$165.1	22.6
Sales and use taxes	738.5	708.6	-29.9	-4.0
Individual income taxes	1,138.3	924.2	-214.1	-18.8
Franchise taxes	276.0	200.9	-75.1	-27.2
Gross receipts taxes	224.0	250.7	26.7	11.9
Other taxes	149.6	204.9	55.3	37.0
Nontax revenue[a]	266.7	285.3	18.5	6.9
Total local source revenue	**$3,525.2**	**$3,471.7**	**-53.5**	**-1.5**

Sources: District's F*iscal Year 2000 Comprehensive Annual Financial Report* and CFO.

Note: Fiscal year 2000 dollars were adjusted to constant fiscal year 2003 values by using the Bureau of Economic Analysis' price index for gross domestic product.

[a]Excludes lottery revenue.

The District's approved fiscal year 2003 budget was $5.6 billion. As of April 2003, District officials projected that over the long term, continuing current spending and tax policies would lead to increasingly large deficits, growing to $325 million dollars annually by 2007.

Scope and Methodology

The Ranking Minority Member of the Subcommittee on the District of Columbia, Committee on Appropriations, United States Senate, and the Honorable Eleanor Holmes Norton, House of Representatives, asked us to study the District's fiscal position, including whether, or to what extent, the District faces a structural imbalance. To address our requesters' questions, we used a body of evidence approach that combined quantitative and programmatic analyses to identify any possible structural imbalance.

Our approach was not intended to provide a definitive point estimate of any imbalance, rather, it was expected to show whether the District's ability to provide an average level of services with its given revenue capacity is substantially different from that of most jurisdictions. The approach was also designed to examine cost conditions in key program areas and to identify management problems that could lead to wasted resources. In addition, we attempted to identify the effects of the District's fiscal

situation on deferred infrastructure projects and debt capacity. Our methodology was vetted among key experts, including individuals who designed the underlying methodology and District economists. We revised our methodology based on expert consultation as appropriate. (See apps. I, II, and III for more detail on our overall approach.)

Our methodology was based on previous efforts to define an objective measure of a fiscal system's structural balance. No consensus exists regarding the appropriate level of services and taxation, and this issue has been a matter of perennial debate in every state. For this reason, when public finance analysts have, in the past, compared the underlying or "structural" fiscal position of jurisdictions, they have attempted to estimate objective measures of each jurisdiction's spending that are independent of that jurisdiction's particular preferences and policies. Similarly, analysts have estimated measures of revenue capacity that are independent of each jurisdiction's decisions regarding tax rates and other tax policy choices.

As we explain in more detail below, these objective benchmarks for levels of service and for revenue capacity are based on the national average spending and the national average tax rates for state fiscal systems. Consequently, the benchmarks are "representative" of the level of services that a typical fiscal system provides and the tax rates that it imposes on its tax bases. A fiscal system is said to be in structural balance if it is able to finance a representative basket of services by taxing its funding capacity at representative rates.

Our use of an average level of services and average tax rates should not be interpreted as an indication that these are the levels of spending and taxation that jurisdictions should seek to provide. Each jurisdiction is an autonomous governmental entity responsible for providing the package of services and level of taxation desired by its citizens. Depending on the preferences of local citizens and their representatives, levels of taxation and the services they support may be higher in some jurisdictions and lower in others. The use of average levels in our analysis should only be thought of as a convenient benchmark against which to gauge relative differences in the cost of providing public services over which local officials have little direct control and as providing an indication of the potential availability of revenue sources from which to finance those costs.

Because the District has all the fiscal responsibilities generally shared by state, city, county, and special district governments, we used two baskets of services as benchmarks. The first is a basket of services typically provided by state fiscal systems (the state and all of its local governments), and the second is a basket of services typically provided in more densely populated urban areas. Both baskets include such functions as elementary and secondary education, higher education, public welfare, health and hospitals, surface transportation, public safety, and other public service functions.[6]

For the basket of services provided by state fiscal systems, we combined our separate estimates by weighting each spending function by its proportionate share of total spending of the average state fiscal system. For the second basket of services provided by governments serving densely populated urban areas, we combined our separate estimates by weighting each spending function by its proportionate share of total spending of the average urban areas.

To calculate the cost of providing an average, or representative, basket of public services, we used the national average per capita spending for each expenditure function as a benchmark for an average service level. For example, the national average per capita spending for elementary and secondary education was $1,338 per capita. We used this figure as a benchmark indicator of an average level of educational services. However, this benchmark has to be adjusted to account for the fact that an average level of spending does not support the same level of service in each fiscal system.

To estimate the cost of an average level of services for each state fiscal system, we adjusted our benchmark by cost drivers that reflect specific demographic, economic, and physical characteristics that are beyond the direct control of government officials to affect. For example, we used the number of school-age children (excluding children attending private schools) rather than actual school enrollments to represent the overall scope of government responsibility for elementary and secondary education since actual enrollments can be affected by the decisions of policymakers. Similarly, we used the average wage rate in private sector

[6] Functions not explicitly listed, such as housing and environmental services, and other comparatively small spending functions were aggregated into an all other spending category.

employment to measure the personnel cost of delivering public services rather than using actual government labor compensation rates since these too are affected by negotiations with public employees and, therefore, reflect government policy choices.

Our estimates of the cost of providing an average level of services are likely to understate to some unknown extent the District's cost of an average service level for a number of reasons. First, by using the average per capita spending of all state fiscal systems as our benchmark of an average service level, by necessity the benchmark excludes any unique public service costs associated with being the nation's capital. Such unique costs would include, for example, above average costs for crowd control for political demonstrations and increased public safety and sanitation costs based on the disproportionate number of visitors. In addition, data for the various cost drivers (e.g., school-age children and low-income residents) are limited and may not fully reflect all relevant cost drivers affecting a jurisdiction's cost environment.

In addition, a degree of uncertainty exists regarding the relative importance each should have in the overall cost calculation. In these instances, we have generally attempted to choose conservative assumptions so as not to overstate the cost impact of factors used in our analysis. (See app. I for a more detailed discussion of our methodology and examples of instances where conservative assumptions were employed in calculating the cost of providing an average level of public services.)

To estimate total revenue capacity, we combined revenue estimates for the two principal sources from which state fiscal systems finance their expenditures: (1) revenues that could be raised from a fiscal system's own revenue sources and (2) the federal grants that the system would receive if it provided an average basket of services.

In the past, two basic approaches have been employed to estimate the own-source revenue capacity of states: (1) those that use income to measure the ability of governments to fund public services and (2) those that attempt to measure the amount of revenue that could be raised in each state if a standardized set of tax rates were applied to a specified set of statutory tax bases typically used to fund public services. Total taxable resources (TTR), developed by the U.S. Department of the Treasury (Treasury), is a leading example of the first type of measure and the representative tax system (RTS), developed by the Advisory Commission on Intergovernmental Relations, is a leading example of the second.

Because experts disagree as to which approach is superior, we present separate results using both methodologies. Both RTS and TTR take into account the restrictions placed on the District's taxing authority. For example, they do not include tax-exempt property or the income earned by nonresidents who work in the District. However, since other states may tax nonresidents' incomes, those incomes are included in their tax bases.

We generally used the actual amounts that state fiscal systems received from the federal government as proxies for the actual amounts that each system would receive if it provided an average basket of services. We do so because grant amounts generally are not likely to change significantly in response to changes in state and local spending choices. However, in the case of the Medicaid program, the federal government provides open-ended matching funds to the District and other state fiscal systems that automatically adjust to changing state policy choices regarding the coverage of their Medicaid programs and the benefits that are provided. In this case, we used an estimate of the Medicaid funding amount that state fiscal systems would likely receive if average Medicaid services were provided. We have not attempted to estimate the extent to which the District and state fiscal systems take advantage of all of their opportunities to receive federal grants. As a consequence, our grant estimates may understate the true potential that these fiscal systems have to receive grants. (See app. II for a more detailed description of the methodology we used to estimate the revenue capacity of state fiscal systems.)

To obtain information on federally imposed constraints on the District's revenue authority, 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.

In addition to the quantitative analysis, we conducted a programmatic analysis of the District's reported structural imbalance by evaluating the levels of service, costs, management, and financing of three of the District's highest cost program areas: Medicaid; elementary and secondary education; and public safety, particularly police, fire, and emergency medical services. We also conducted case study work on two similar jurisdictions: San Francisco, California and Boston, Massachusetts. These jurisdictions were selected based upon a literature search for empirically based comparisons of cities; opinions of experts of District finances; and a cluster analysis, using demographic and economic variables such as populations, measures of poverty, and number of school-age children. Cluster analysis is a technique that groups units (in this case, cities) into clusters based on their closeness on a set of measures.[7]

The case study work was conducted to assess how the District compares to other jurisdictions regarding the types and costs of similar services in Medicaid, education, and public safety, as well as to provide contextual sophistication to the quantitative analysis. In conducting the programmatic work, we collected and analyzed program data and interviewed government officials in the District, California, Massachusetts, San Francisco and Boston governments and in federal agencies responsible for overseeing or providing major funding in these three program areas.

Finally, we conducted companion work to identify the effects of the District's fiscal situation on deferred infrastructure projects and debt structure. To examine the factors involved, we met with officials of the District CFO's office and Capital Improvement Program (CIP). We also obtained and reviewed prior-year District budget and financial plans, current year expenditure reports for the capital projects, internal studies, and statistics and financial information on the current expenditures for the District's CIP. Our approach to analyzing the District's infrastructure projects differed from the approaches used to address the other objectives in this report. Because of the variety of ways infrastructure projects are owned, managed, and reported by other jurisdictions, comparative

[7] We included 100 high-population cities in our cluster analysis, and used the following measures to look for clusters: race; ethnicity; population size; population density; population change from 1990 to 2000; percentage of school age children; percentage of persons over age 65; percentage of unemployed; percentage in poverty; violent crime rates; property crime rates; average wage rate; percentage of employees in retail, food and hotel, manufacturing, and wholesale labor force; percentage of institutionalized; and percentage of female headed households with children.

information on infrastructure across states and local jurisdictions was not readily available; therefore, we did not do a comparative analysis of the District's infrastructure with states or other jurisdictions. We reviewed the data that the District had available in its annual budget and financial plans and CAFRs, and other documents. To assess the District's debt service, we obtained and analyzed information from the District's CFO on the District's debt levels and projected infrastructure needs. We also compared selected debt service measures for the District to other state fiscal systems.

Our work was performed from August 2002 through May 2003 in accordance with generally accepted government auditing standards.

The District's Cost of Meeting Its Public Service Responsibilities Exceeds Its Revenue Capacity, Resulting in a Structural Deficit

To determine if a jurisdiction has a structural deficit, we estimated, for the District of Columbia and the 50 state fiscal systems, the spending needed to provide an average level of public services, the revenues that could be raised with average tax rates and the amount of grant funding the jurisdiction can expect to receive. Our analysis indicated that the District's cost of delivering an average level of services per capita is the highest in the nation due to factors such as high poverty, crime, and a high cost of living. Our analysis also indicated that the District's total revenue capacity (own-source revenues plus grants) is higher than all state fiscal systems, but not to the same extent that its costs are higher. The District's own-source revenue capacity ranked among the top five when compared to those of the 50 state fiscal systems, and its federal grant funding is over two and one half times the national average.

To estimate a structural imbalance, we performed several sensitivity analyses to show how our estimates changed as we varied specific judgments and assumptions regarding cost circumstances and the value of specific tax bases. The consistency of our basic result over a broad range of alternative assumptions and approaches led us to conclude that the District does have a substantial structural deficit, even though considerable uncertainty exists regarding its exact size. Using fiscal year 2000 data, our lowest estimate was $470 million and our highest estimate was over $1.1 billion annually.

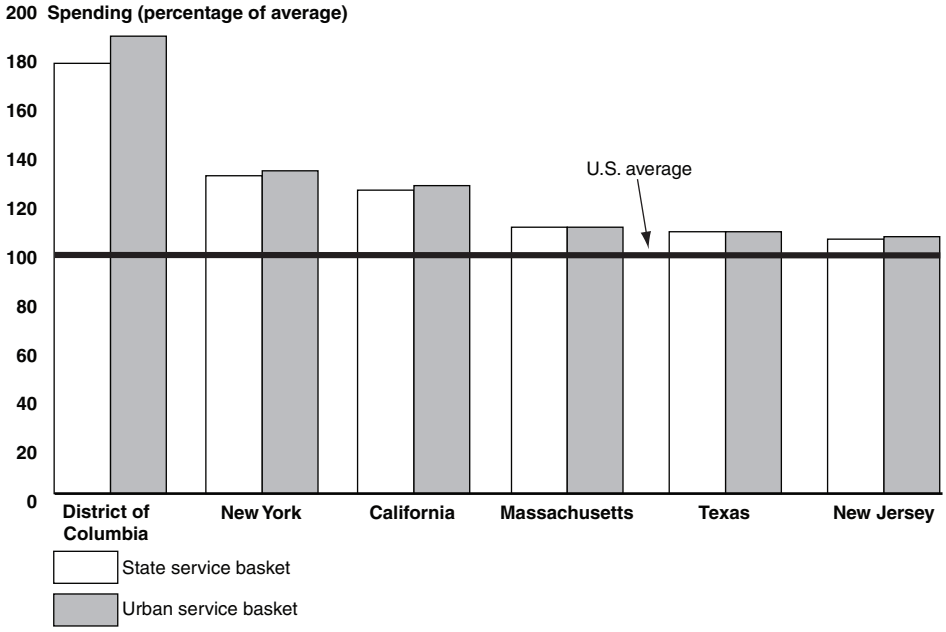
Our analysis did not take into account the unique public service costs associated with being the nation's capital; however, our analysis did take into account the significant federal restrictions on the District's taxing authority. The primary reason for the structural deficit is high costs due to conditions beyond District officials' direct control. To cope with its high cost conditions, the District uses its relatively high revenue capacity to a greater extent than almost all state fiscal systems. However, this relatively high tax burden, in combination with federal grants, is just sufficient to fund an average level of public services if delivered with average efficiency.

The Spending Necessary to Fund an Average Basket of Public Services Exceeds That of All State Fiscal Systems

Using an average of the 50 state fiscal systems as a benchmark, our analysis indicates that the per capita cost of funding an average level of services in the District exceeds that of the average state fiscal system by approximately 75 percent (and is over a third more than the second highest cost fiscal system, New York). In dollar terms, the District would have to spend $2.3 billion more each year to fund an average level of public services compared to what it would have to spend if it faced average cost circumstances. When we adjusted the basket of services to reflect those typically provided in more densely populated urban areas, we estimated that the District would annually have to spend over 85 percent more than the average state fiscal system per capita. As a result, to provide an average level of services the District would have to spend $2.6 billion more than if it faced average cost circumstances.[1] Figure 1 compares the District's per capita costs of funding an average level of services with those of the five state fiscal systems with the highest costs.

[1] Urban areas included in our analysis were those county areas with populations over 250,000 and whose population densities exceeded 3,000 persons per square mile.

Figure 1: Per Capita Spending Necessary to Fund an Average Basket of Public Services for Selected State Fiscal Systems (Percentage of Average State Fiscal System)



Source: GAO.

Note: GAO analysis based on the methodology described in app. I.

We used the U.S. average per capita spending for each specific expenditure function (for example, Medicaid, education, and public safety) as a benchmark for an average service level for that function. We then adjusted this benchmark to account for differing workloads and costs to reflect the fact that an average level of spending does not support the same level of services in each fiscal system because cost conditions differ across locations.[2]

For example, adjustments are necessary to reflect the fact that the District must compete with a high-wage private sector in attracting public employees, and high real estate costs push up the cost of government office space, making the provision of public services more expensive than in most

[2] We arrived at the cost of funding an average level of public services by summing the estimated dollar cost of each spending function separately. See app. I for a more detailed discussion of cost estimates for each expenditure function.

states. The adjustments also reflect the fact that the District faces unusually high workloads per capita, such as large numbers of low-income people and high crime rates that increase the cost of Medicaid and public safety.

The public service functions that contribute most to the District's high cost circumstances are Medical Vendor Payments (Medicaid), health and hospitals, and police and corrections. To provide average Medicaid coverage and benefits to its low-income population residents, the District would have to spend about $1,315 per capita, which is more than twice the national average of $551 per capita. (See table 5.) This added Medicaid cost accounts for $437 million of the $2.3 billion difference between what the District would have to spend to meet its high costs and what it would have to spend if it faced only average costs (based on the state basket of services). Similarly, we estimated the per capita cost of providing police services is more than four times the average state fiscal system, adding $436 million to the District's cost of providing an average level of services annually.

One area of the budget where costs are not as high is elementary and secondary education, where, due to a comparatively small percentage of school-age children, the estimated per capita cost of an average level of services is 18 percent above that of the average state fiscal system. The only expenditure function in which the District's per capita cost of an average service level is estimated to be well below the national average is highways, of which the District has comparatively few miles per capita. Table 5 provides information on the District's costs of funding services for all functions.

Table 5: The District's Estimated Per Capita Cost of Funding an Average Basket of Public Services, Fiscal Year 2000

	Average basket of services			
	State basket of services		Urban basket of services	
Expenditure function	Per capita	Percentage of national average	Per capita	Percentage of national average
All functions	$9,216	176	$9,783	187
Education				
Elementary & secondary	1,576	118	1,645	118
Higher	836	162	126	162
Public welfare				

(Continued From Previous Page)

	Average basket of services			
	State basket of services		Urban basket of services	
Expenditure function	Per capita	Percentage of national average	Per capita	Percentage of national average
Medical vendor payments (Medicaid)	1,315	239	1,315	239
Health and hospitals	732	162	608	162
Other public welfare	595	214	745	213
Highways	234	65	119	65
Public safety				
Police	964	478	1,718	478
Corrections	765	441	532	441
Fire protection	157	192	275	192
Interest on Debt	437	176	520	187
Administration	436	143	339	136
All Other	1,168	160	1,842	160

Source: GAO analysis of data from the U.S. Census Bureau.

The cost estimates shown in table 5 are likely to understate to some unknown extent the District's cost of an average level of services for a number of reasons. First, by using the average per capita spending of all state fiscal systems as our benchmark for an average level of public services, the benchmark by necessity, excludes any unique public service costs associated with the District being the nation's capital. Such costs would include, for example, crowd control for political demonstrations that occur disproportionately in the nation's capital and a disproportionate number of tourists and out of town visitors that impose public safety and sanitation costs on the District's budget.

In addition, limited data are available for the various indicators of workload used in our analysis and there is a degree of uncertainty regarding their relative importance in our overall cost estimates. In these instances, we generally chose conservative assumptions so as not to overstate the cost impact of factors used in our analysis. For example, in adjusting for differences in the cost of living, we took into account only differences in the cost of housing, but due to data limitations, we were unable to take into account other potential sources of such cost variation. Such conservative assumptions likely result in an underestimate of the number of low-income residents in our analysis. For more discussion and examples of instances where conservative assumptions were employed in our analysis, see appendix I.

The District's Per Capita Total and Own-Source Revenue Capacities Are High Relative to Those of State Fiscal Systems

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. As noted earlier, the District's total revenue capacity equals the sum of its own-source revenue capacity (the revenue that it could raise from its own economic base), plus the amount of federal grants that the District would receive if it provided a representative level of services.

Experts disagree on the best approach for estimating revenue capacity and numerous data limitations exist; thus, in the course of our analyses we made a variety of methodological decisions and assumptions. For this reason, we present a range of estimates for the District's revenue capacity based on two fundamentally different approaches that have been used in the past. All of the estimates we present include adjustments designed to account for significant constraints on the District's taxing authority, which are discussed in chapter 3.

For one measure of the District's own-source revenue capacity we used the U.S. Department of the Treasury's (Treasury) estimates of total taxable resources (TTR). TTR is a comprehensive measure of all income either received by state residents (from state or out-of-state sources) or income produced within the state but received by nonresidents.[3] We also developed a second set of estimates of own-source revenue capacity, using the representative tax system (RTS) methodology. The RTS methodology estimates the amount of revenue that could be raised in each state if a standardized set of tax rates were applied to a set of uniformly defined statutory tax bases typically used to fund public services.

Proponents of TTR believe that a measure of revenue capacity should be independent of policy decisions and should avoid judgments about the administrative or political feasibility of taxing particular bases. Proponents of the RTS approach believe that administrative and political constraints should be taken into account, even though it may be subjective to say what is a constraint and what is a choice.

[3] TTR is a more comprehensive measure of income potentially subject to taxation by state fiscal systems than either personal income or gross state product, two other potential indicators of revenue capacity. By applying the national average effective tax rate, TTR can also be expressed in terms of the revenues that could be raised by a state fiscal system with an average tax burden.

In producing our RTS estimates, data limitations compelled us to use a variety of assumptions and, in some cases, several different approaches when estimating individual tax bases.[4] Rather than present results for every possible combination of plausible assumptions, we developed "low" and "high" RTS estimates of own-source revenue capacity. The "low" estimate is the result we obtained when we used all of the assumptions that tended to lower our estimate of the District's capacity relative to those of the states; the reverse holds for our "high" RTS estimate. (See app. II for additional details.)

The two fundamentally different estimation approaches 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. According to the Treasury's TTR estimates, the District's per capita own-source revenue capacity was 34 percent larger than that of the average state fiscal system in fiscal year 2000. According to our RTS estimates for that same year, the District's per capita own-source revenue capacity was from 19 percent to 29 percent greater than the average. Although we believe it is likely that the District's actual revenue capacity falls within the range spanned by both Treasury's and our estimates, we cannot be absolutely certain that it does.[5]

The District's relatively high own-source revenue capacity, combined with the fact that the District has access to much larger federal grants per capita than any of the state fiscal systems, gives the District a higher total revenue capacity than any of the state fiscal systems. We estimated that, if the

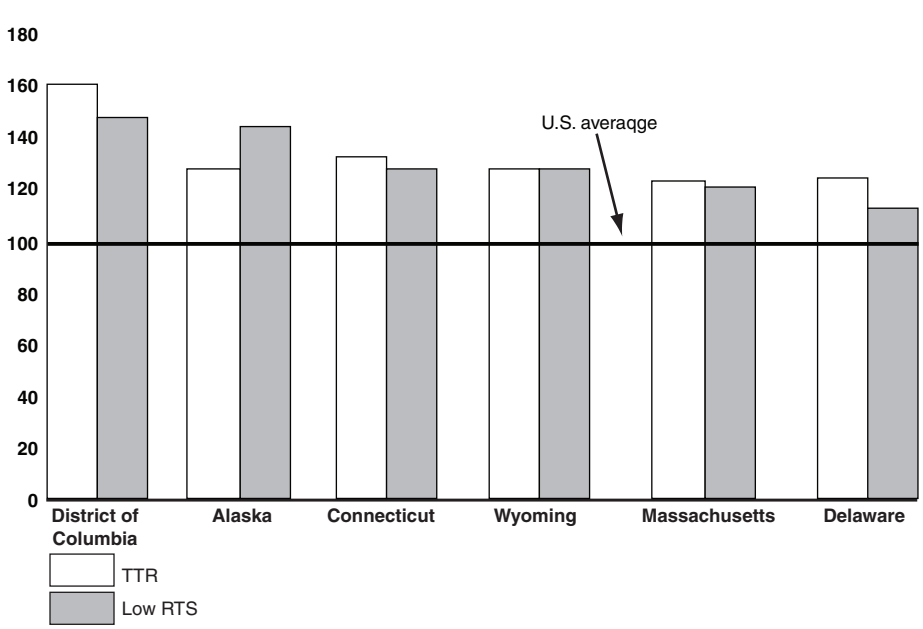
[4] For example, although aggregate data on sales in the retail trade and selected services sectors are available from the U.S. Census Bureau every year, state-by-state data are available only every 5 years. The last disaggregation available was for 1997. To estimate the state-by-state distribution of sales in 2000, we had the options of assuming (1) that the 2000 sales were distributed across states in the same proportions as the 1997 sales had been or (2) that the sales were distributed in the same proportion across states as was year 2000 employment in the retail and sales industries. We had no way to determine which assumption was more accurate, so we produced estimates using each approach.

[5] Given that our "high" RTS estimate (29 percent above average) falls between the other two estimates, we will not present any further results based on that estimate in this chapter. Our range of RTS estimates is broadly consistent with results produced by Tannenwald, who used a similar RTS approach. (See Robert Tannenwald, "Interstate Fiscal Disparity in 1997," *New England Economic Review* (Boston, Mass.: Federal Reserve Bank of Boston, Third Quarter, 2002).) Tannenwald estimated that the District's per capita own-source revenue capacity was 23 percent greater than that of the average state fiscal system in fiscal year 1997.

District had provided an average level of services in fiscal year 2000, its federal grants would have been more than two and one-half times as large as the average per capita federal grants received by state fiscal systems and over 50 percent more than the second largest recipient of federal assistance, Alaska. Adding these grants to the TTR estimate of own-source revenue capacity yields an estimated total revenue capacity for the District that is 60 percent greater than that of the average state fiscal system. The estimated total revenue capacity for the District, based on the grants plus our "low" RTS estimate, is 47 percent above the national average.

Figure 2 compares the District's total revenue capacity to those of the five state fiscal systems with the highest total revenue capacities. The values in the figure show the extent to which each system's revenue capacity exceeds the national average, which equals 100 percent. Although the District had the highest total revenue capacity of any fiscal system, the District's distance from the next highest fiscal systems is not nearly as extreme as it was for the representative expenditure estimates presented previously in figure 1.

Figure 2: Total Revenue Capacity Per Capita for the Highest-Capacity Fiscal Systems (Percentage of Average State Fiscal System)



Source: GAO.

Note: GAO analysis based on methodologies described in app. II. Total revenue capacity is the sum of own-source revenue capacity plus federal grant funding if an average level of services were provided.

The District's Structural Deficit Results from a High Cost of Funding an Average Level of Services

The District has a structural deficit because its costs of providing an average level of services exceed the amount of revenue that it could raise by applying average tax rates. This result holds regardless of which range of estimating approaches and assumptions we used. We obtained our lowest deficit estimate of about $470 million by combining our lowest estimate of the District's costs (the one based on the state basket of services) with our highest estimate of the District's total revenue capacity (the one based on the TTR approach). In contrast, we obtained our highest deficit estimate of over $1.1 billion by combining our highest estimate of the District's costs (the one based on the urban basket of services) with our lowest estimate of the District's total revenue capacity (the one based on the "low" RTS approach). While we cannot be certain that the actual size of the District's structural deficit falls within this range of estimates, we believe that the District's structural deficit is unlikely lower than our most conservative estimate of $470 million for the reasons explained earlier.

To better compare the size of the District's deficit to those of the state fiscal systems, we sought to control for the wide differences in the sizes of the fiscal systems by dividing each system's deficit (or surplus) by its population and own-source revenues. Table 6 presents the three alternative measures of the deficit and, for each of them, shows how the District ranks against the 50 state fiscal systems. The District's deficit is larger in per capita terms than that of any state fiscal system for both our higher and lower estimates. The District's deficit as a percentage of own-source revenue is sixth largest according to our lower estimate, and the largest according to our higher estimate.

Table 6: Estimated Size of the District's Structural Deficit in Fiscal Year 2000, Using Alternative Measures and Estimation Approaches

	Absolute deficit (in millions)		Deficit per capita		Deficit as a percentage of own-source revenue	
Estimation approach	Value	Rank	Value	Rank	Value	Rank
State services basket; TTR for revenue capacity	$470	18	$821	1	14.4	6
Urban services basket; Low RTS for revenue capacity	$1,163	8	$2,032	1	40.3	1

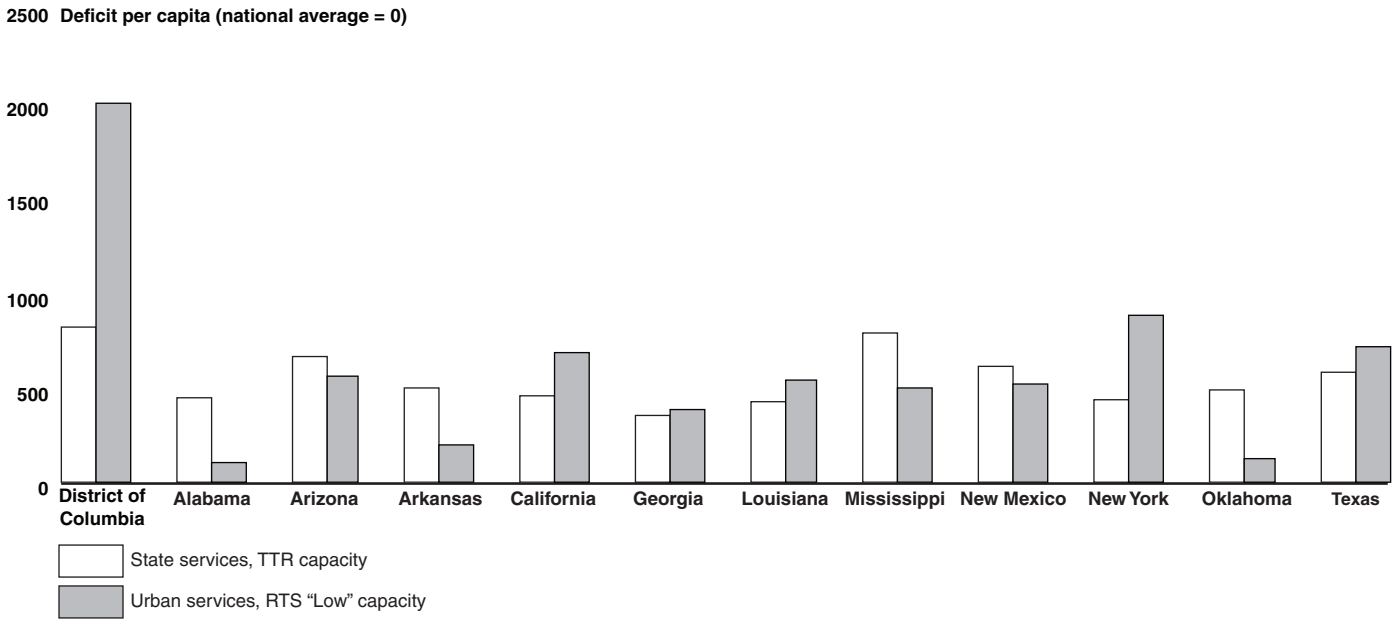
Source: GAO.

Note: GAO analysis based on methodologies described in apps. I and II.

Figures 3 shows how the District's structural deficit per capita compares to the state systems with the largest structural deficits.[6] The figure shows that, if the District's actual structural deficit is close to our lower estimate, then it is not much different than the deficits of most of the state fiscal systems in the top 10 in per capita terms. However, if the District's actual structural deficit is close to our higher estimate, then it is much larger in per capita terms than the deficits of any state fiscal system.

[6] The figure includes those fiscal systems whose deficits ranked among the top 10 under one estimation approach or the other. Figure 11 in app. III shows roughly the same pattern when deficits are compared as a percentage of own-source revenue capacity, although in that comparison five states have larger deficits than our low estimate for the District.

Figure 3: Fiscal Systems with the Largest Structural Deficits Per Capita



Source: GAO.

Note: GAO analysis based on methodologies described in apps. I and II.

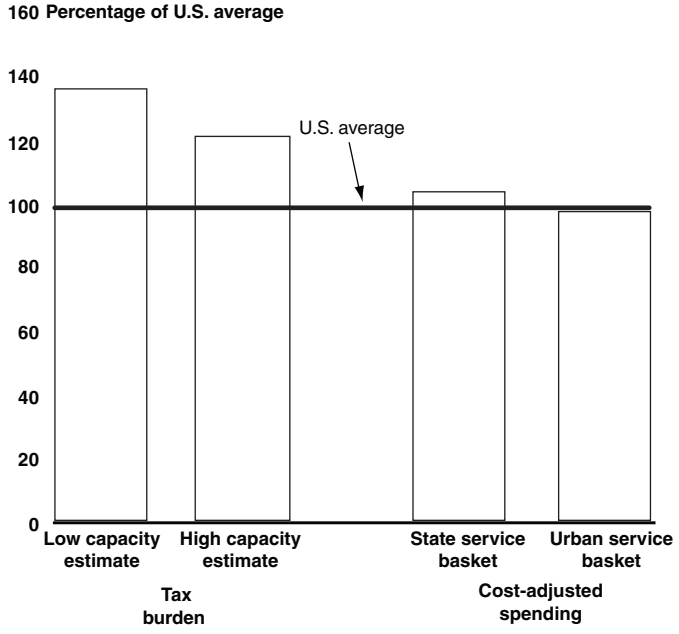
The District's High Tax Burden Yields Revenues That Could Only Support an Average Level of Services

The District's tax burden (actual revenues collected from local resources relative to their own-source revenue capacity) is among the highest of all fiscal systems, but that burden yields revenues that are only sufficient to fund an average level of services. The District's actual tax burden exceeded that of the average state fiscal system by 33 percent, based on our lower estimate of its own-source revenue capacity, and by 18 percent, based on our higher estimate of that capacity. (See the first two bars of fig. 4.)

The combination of a high revenue capacity and a high tax burden allows the District to fund a very high level of actual spending—$9,298 per capita in fiscal year 2000 compared to a national average of $5,236. However, when the District's high cost circumstances are taken into account, this high spending level would only be sufficient to provide an average level of services if those services were delivered with average efficiency. Specifically, for the state basket of services, the District's actual spending is nearly the same as the cost of an average level of public services; for the

urban basket of services, its actual spending is about 5 percent below average. (See the last 2 bars of fig. 4.) Moreover, as we discuss in chapter 4, the fact that the District's aggregate spending is approximately equal to the aggregate cost of an average level of services, suggests that the level of services it actually provides may be below average due to inefficient service delivery and other management problems. Nevertheless, even if the District were to provide its public services as efficiently as a typical state fiscal system, it would still face a structural deficit of $470 million or more.

Figure 4: The District's Tax Burden and Cost-Adjusted Spending



Source: GAO.

Note: GAO analysis based on methodologies described in apps. I and II.

The District's Revenue Capacity Would Be Even Higher in the Absence of Several Constraints on Its Taxing Authority

Although the District of Columbia's (District) own-source revenue capacity per capita appears to be large relative to those of most state fiscal systems, it would be even larger in the absence of several existing constraints on the District's taxing authority. The most significant constraints are (1) the unique prohibition against the taxation of District-source income earned by nonresidents and (2) the relatively large proportion of the District's property tax base that is not taxable because it is either owned or specifically exempted by the federal government. District officials say that building height restrictions also limit the District's property tax base.

We are not able to estimate the amount of revenue that the District would gain if these constraints were removed. However, our quantitative analysis indicates that, despite these constraints, the per capita revenue capacities of the District's income and property taxes are higher than those of all but a few state fiscal systems. In contrast, the District likely has a relatively low sales tax capacity due, in part, to a disproportionate share of sales to the federal government and other exempt purchasers. The fact that the federal government does not pay property or sales taxes to the District does not necessarily mean that the federal presence has a net negative effect on the District's finances. A significant portion of the private sector activity in the District is linked to the presence of the federal government.

The Federal Prohibition against a District Tax on the Income of Nonresidents Is Unique

Unlike that of any state, the District's government is prohibited by federal law from taxing the District-source income of nonresidents.[1] The 41 states that have income taxes tax the income of residents of at least some other states. Fifteen states participate in reciprocal nontaxation agreements, but no state has an agreement with more than 6 other states.[2] States that impose income taxes also typically provide tax credits to their residents for income taxes paid to other states.

[1] Section 602(a) (5) of the District of Columbia Home Rule Act (D.C. Official Code, 2001 Edition, Sec. 1-206.02 (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."

[2] This information comes from a Commerce Clearinghouse Web site that provides information on state tax withholding requirements for multistate businesses. We have not independently verified this information.

In addition, some cities such as Philadelphia, Detroit, Cleveland, and several other cities in Ohio, 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.[3] However, in those cases the state governments are able, if they choose, to redistribute 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.[4]

Critics of this restriction on the District's income tax base argue that commuters increase the demand for city services and, therefore, should contribute to defraying the additional costs that they impose. Although no data are collected on the amount of money the District spends on commuters, we have rough indications of some of the impacts based on our own quantitative analysis. For example, we estimated that the cost to the District of providing a representative level of police and fire services, solid waste management, parking facilities, local libraries, and transit subsidies in fiscal year 2000 was from $44 million to $77 million more than it would have been if the daily inflow of commuters to the District had only equaled the daily outflow.[5] We cannot separate the impact of commuters from residents on the District's highway costs. Commuters should not have a large impact on the District's costs for other services, such as primary and secondary education or Medicaid.

[3] The range of tax rates in the cities we identified as levying commuter taxes was verified using publicly available tax descriptions drafted by the individual jurisdictions.

[4] 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.

[5] These are all services for which we used average daytime population as one of the workload factors. We isolated the impact of the large net inflow of commuters on representative spending for these services by, first, producing estimates based on average daytime population, then producing alternative estimates based on resident population, and, finally, subtracting the latter from the former. These estimates of the commuter impact are subject to the same limitations that affect our other representative spending estimates. (See app. I for details.)

Although commuters impose costs, some local economists we interviewed noted that commuters already do contribute to the financing of these services, even without a tax on their income. Again, no data are collected on the amount of taxes paid directly by commuters or the tax revenues attributable to jobs supported by them. Some rough indications of the revenue contributions are available. One recent study estimated 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.[6] Another study indicates that spending by commuters supports jobs for District residents who are subject to the District's income tax.[7]

It is difficult to estimate the amount of additional revenue that the District would gain if it were allowed to tax the income of nonresidents. The revenue consequences and the distribution of the ultimate burden of a nonresident income tax for the District would depend on how the tax is designed and how nonresidents and neighboring governments respond to it. Particularly important is 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 was proposed in the "District of Columbia Fair Federal Compensation Act of 2002" (H.R. 3923), 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.[8] If 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 might 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.[9]

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

[7] 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.: May 2001.

[8] This bill was introduced in the House of Representatives on March 11, 2002 and referred to the Committee on Government Reform and the Committee on Ways and Means. This bill has not been re-introduced this year.

[9] The District currently has a reciprocity agreement with Maryland and Virginia under which residents only pay income tax in the jurisdictions where they reside.

If the District's tax were not fully creditable against either the federal or state taxes, then the commuters themselves would bear some of the tax burden.[10] Those commuters might try to pass the burden of the tax along to their employers by demanding higher compensation, or they might choose to work elsewhere. This, in turn, would reduce the amount of revenue the District would gain from the tax. Conversely, the higher taxes paid by commuters could result in decisions to relocate to the District to avoid paying the commuter tax. The difficulty of predicting the magnitudes of the various potential policy and behavioral responses makes it difficult to estimate the revenue that the District would gain from a typical tax on nonresidents.

The District's Property Tax Base Is Relatively Large despite the Disproportionate Presence of Properties Owned by the Federal and Foreign Governments

Like all state and local governments, the District is unable to tax property owned by the federal government and foreign governments. As the nation's capital, the District clearly has a higher percentage of its total property value owned by the federal government and by foreign governments than most jurisdictions and, therefore, would benefit more than most jurisdictions if the federal government and foreign governments paid property taxes or made payments-in-lieu-of-taxes. Nevertheless, our quantitative analysis indicates that the District's per capita property tax base is already larger than those of all but a few state fiscal systems. (See app. II.)

[10] When a state imposes an income tax on a nonresident, that taxpayer typically must report all income, calculate adjustments, and compute a tax liability based on his or her total adjusted income. This liability is then multiplied by the ratio of income earned by the taxpayer in the host state to the taxpayer's total adjusted income.

There does not appear to be a strong basis for concluding that the District's commercial property tax base is negatively affected by the federal presence. Given that a large portion of the private sector activity in the District is linked to the presence of the federal government and other exempt entities, it is unclear whether commercial property would fill the void left if federally owned property were reduced to the hypothetical average level seen in other cities. In fact, a good deal of the commercial property tax base locates in the District due to the federal presence. For example, commercial office buildings in the District are occupied by contractors who provide services to the federal government, lawyers who need to interact with regulatory agencies, and public relations firms that interact with congressional offices, among others. The District of Columbia Tax Revision Commission presented a comparison suggesting that, even with the large concentration of exempt property, the per capita value of the District's taxable property base is large compared to that of other large cities and comparable to the per capita values in surrounding jurisdictions.[11]

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 make to District revenues and the lack of information on the services they use. Tax-exempt entities do generate revenues for the District, even though they do not pay income or property taxes directly. For example, 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] Fully taxable properties also generate these indirect revenues and a fully taxable property that is similar to a U.S. government property in every respect, except for ownership, would contribute more to the District's finances than the government-owned property. However, as noted above, it is not clear

[11] The District of Columbia Tax Revision Commission, *Taxing Simply, Taxing Fairly* (Washington, D.C.: June 1998). Although it is possible to compare the value of taxable property across jurisdictions, it is difficult to compare the value of nontaxable property. Experts within and outside of the District government have told us that locally assessed values for nontaxable properties are likely to be significantly less accurate than those for taxable property.

[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, July 2000.

that the District would have more taxable property than it currently has if the federal presence were reduced to a level typical of other jurisdictions.

District Officials Believe That the Federally Imposed Height Restriction on Buildings Also Limits the District's Property Tax Base

District officials cite the congressionally imposed height restrictions on buildings[13] as another factor that constrains the District's property tax base. Although these restrictions may affect the distribution of commercial and residential buildings within the District, it is difficult to determine whether, or to what extent, these restrictions affect the aggregate amount and value of those buildings.

Two factors are likely to mitigate the potential negative impact on the District's tax base. First, the space available for building within the District has not been completely used. At least some of the office or residence space that would have been supplied on higher floors at certain locations, if it were not for the height restrictions, is likely to have been shifted to other locations in the District where building would have been less intensive otherwise. Second, in the face of a given demand for office space, a constraint on the supply of that space will increase its value per square foot. In addition, the restriction could have an effect on the cost of the District's services by influencing the District's population density. However, the size of any such effect on service costs is unknown.

Other Nationwide Restrictions on Taxing Authority Are Likely to Affect the District Disproportionately

In addition to the restrictions discussed above, the District is unable to tax the incomes or most purchases of foreign embassies and diplomats, purchases or sales by the federal government, the personal property of the United States or foreign exempt entities,[14] the income of military personnel who are stationed in the District but claim residence in another jurisdiction, or the income of federal government sponsored enterprises (GSE), such as the Federal National Mortgage Association and the Student Loan Marketing Association. All states and localities nationwide are potentially subject to these same restrictions on their taxing authority, even though some of the restrictions may have a disproportionate effect on the District, given the relatively high concentration of these nontaxable entities and persons within its boundaries.

[13] D.C. Code, 2001 Ed. Secs. 1-206.02 (6) and 6-601.05.

[14] Personal property refers to tangible property, such as machinery, equipment, and furniture, excluding real property, which refers to land and buildings.

In contrast to the case with the income and property taxes, where nontaxable income and property were already excluded from the data we used in our quantitative analysis, the sales data that we used contained some sales to the federal government, embassies, and military personnel that would be exempt. Given data limitations, we were required to make a range of assumptions to estimate the amount of sales that would be exempt (see app. II for details). Our lower estimate for the District's sales tax revenue capacity placed it below that of 49 of the state fiscal systems; our higher estimate placed it below 31 of the state fiscal systems.

The District Faces High Cost Conditions and Significant Management Problems

The District's high spending on the key program areas of Medicaid, elementary and secondary education, as well as public safety, particularly police, fire, and emergency medical services, is influenced by several cost factors, including high poverty, economically disadvantaged children and elderly, and high crime. Our quantitative analysis shows that the District's spending for Medicaid and elementary and secondary education is slightly above what it would take to provide an average level of services, while police spending may be significantly below what it would take to provide an average level of services if provided with average efficiency.[1] However, this analysis does not account for all special circumstances beyond the control of the District, such as high demand for Medicaid, high demand for special education services, and extra police and fire services associated with political demonstrations.

In addition, in each of the three key program areas we identified significant management problems, such as inadequate financial management, billing systems and internal controls that result in unnecessary spending, which draw scarce resources away from program services. In recognition of the District's high-cost environment and management challenges, the federal government provides financial and other support to the District, including an enhanced Medicaid match.

Special Circumstances and Management Problems Influence High Medicaid Costs in the District

Medicaid is a large and growing portion of the District's budget, with the per capita delivery costs of the program being more than twice the national average.[2] Certain population and delivery characteristics largely outside the District's control influence these high Medicaid costs. These characteristics include a high poverty rate that contributes to the large numbers of citizens who lack private health insurance and who meet existing Medicaid eligibility criteria, a heavy concentration of Medicaid beneficiaries with chronic health conditions that require expensive and ongoing care, and high real estate and personnel costs for health and long-term care providers. When we adjusted for these high-cost characteristics, our analysis revealed that the District spent only slightly more than that needed to fund the national average levels of coverage and services.

[1] Spending results for Medicaid, elementary and secondary education, and police (but not fire services) are similar whether District spending is compared to a state service basket or an urban service basket.

[2] See medical vendor payments in table 5 of chapter 2.

However, management problems, which are under the District's control, have further influenced the local share of Medicaid spending. For example, the District has been foregoing millions in available federal matching funds due to claims management and billing problems, requiring it to use more local funds than necessary in support of the program. If the District adequately addressed these problems and continued to actively pursue reforms already in place, it could receive more federal matching funds and free local funds for other purposes. In recognition of the high costs and management challenges, the federal government provides certain supplemental financial and other support to the District, such as an enhanced federal share of the District's spending on Medicaid.

The District's Spending on Medicaid Is Slightly More Than That Needed to Fund Average Levels of Coverage and Services

The District's per capita costs of providing Medicaid services were more than twice the national average. However, when we adjusted for the District's high-cost environment, it spent only 11 percent more than what it would take to fund the national average Medicaid coverage and services. Our analysis adjusted for several factors that affect costs but are to a large extent beyond the control of District officials, including people in poverty, the elderly poor, the high cost of living, and real estate and personnel costs for providers.

Special Population and Service Delivery Characteristics Influence High Medicaid Costs

Special population and service delivery characteristics create a high-cost environment in the District, requiring it to spend substantially more than other jurisdictions to fund an average level of Medicaid coverage and services. The District's high costs for Medicaid are caused by a high demand for Medicaid that, in part, can be attributed to its special population consisting of people at a very high poverty rate and a high proportion of citizens who lack private health insurance because their employers do not offer it or they cannot afford it; thus, a large number of District residents rely on Medicaid for public health care coverage. These factors lead to the District spending disproportionately more to fund an average level of Medicaid coverage and services. Specifically, the District's poverty level is the second highest among states, and many District residents meet income-based coverage criteria. For example, in 1999 the District had the highest percentage of individuals under age 65 with incomes less than 100 percent of the poverty limit covered by Medicaid (based on 1997 through 1999 data). Overall, one in four District residents receive Medicaid, which was high in comparison to its neighboring state, Maryland. However, when the District's high poverty rate is taken into account, its Medicaid coverage of low-income residents is about average,

as the District has not elected to provide optional coverage or services that are far above the national average.

An additional factor influencing costs is that District residents—many of whom rely on Medicaid for health care coverage—have a disproportionately high number of chronic health conditions that require expensive, ongoing care. The District ranks near the bottom in many health indicators relative to other states, a situation that affects the types and levels of services the population needs. For example, among states, it has very high rates of low birth weight infants, adult-diagnosed diabetes, lung cancer, and human immunodeficiency virus (HIV)/acquired immunodeficiency syndrome (AIDS) infection, which tend to be found disproportionately among the poor and in urban areas like the District. Further, these chronic health conditions for the most part are costly to treat, often requiring expensive institutional care or ongoing outpatient treatment, such as drug therapy—all at a time when health care costs, particularly prescription drugs, are increasing.

The HIV/AIDS epidemic has presented a particular fiscal challenge for the District's Medicaid program. For example, the Centers for Disease Control and Prevention reported that the District's 2001 AIDS prevalence rate was 152 per 100,000 people whereas the next highest state, New York, was 39 per 100,000 people. The costs of treating Medicaid beneficiaries with HIV/AIDS are very high and because the District has the highest infection rate in the country and a disproportionately large number of Medicaid beneficiaries, the fiscal burden of the HIV/AIDS epidemic on the District's Medicaid program is likely disproportionately larger than most states.

Another factor influencing the District's high Medicaid costs relates to the ways in which health and long-term care services are delivered. Providers generally are located in densely populated urban areas with high real estate and personnel costs, a situation which drives providers' costs upward. Specifically, many providers have high operating costs in the District, largely due to the high costs of purchasing or renting office space and the necessity of paying higher salaries to medical personnel. Moreover, according to District officials, many of the District's provider payment rates, particularly for physicians, are below average relative to operating costs.

The combined effects of high operating costs and low payment rates may contribute to physicians not accepting beneficiaries of the District Medicaid program. This could be a reason why many of the District's Medicaid beneficiaries rely on emergency rooms more so than in other jurisdictions. District Medicaid beneficiaries may also not obtain preventive care when needed, thus allowing health conditions to worsen, which could lead to hospital stays. Use of these more costly forms of health care are disproportionately high in the District. One report found the District had the highest emergency room visits per 1,000 of the population in the country as well as the highest hospital admissions rate.[3]

Management Problems Result in the District Foregoing Significant Federal Matching Funds, but the District Is Taking Steps to Address Them

Billing and claims management problems are forcing the District to forego millions in federal matching funds and, as a result, requiring it to use more local funds than necessary to pay for expenditures already incurred. Key issues that lead to rejected federal reimbursement claims include incomplete documentation, inadequate computerized billing systems, submission of reimbursement requests past federal deadlines, providing services to individuals not eligible for Medicaid at the time of delivery, and billing for services not allowable under Medicaid. According to a recent report, these problems resulted in the District receiving $40 million less in expected federal reimbursement during fiscal year 2002 than it had projected in its budget.[4] District officials and other experts told us it would be difficult to make any precise estimate of how much the District is foregoing in federal funding. These management problems involve the weaknesses in the processes and systems that several District agencies use to track and process claims for federal Medicaid reimbursement after services have already been provided. The difference between costs submitted for reimbursement and the costs actually reimbursed based on federal criteria result in the use of local, rather than federal money, to pay for these costs.

While many states have experienced similar financial management problems, the District's problems appear to be worse than most states, according to a federal official we interviewed. The magnitude of the problem is serious: Medicaid financial management was identified as a "material weakness" by independent auditors of the District's fiscal year

[3] AARP, *Reforming the Health Care System: State Profiles 2000* (Washington, D.C.: 2000).

[4] McKinsey and Company, 2002. McKinsey did not audit these numbers.

2001 financial statements. These problems have been addressed in several of our reports over the years, as well as in reports by the District Inspector General (IG), the District Auditor, and McKinsey and Company. According to these reports, less than projected federal reimbursements have amounted to millions of dollars across the various agencies, creating significant, unexpected pressures on the District's budget.

The management problems rest mostly with individual District agencies that bill for federal Medicaid reimbursement: Child & Family Services Agency (CFSA), Department of Mental Health (DMH), and District of Columbia Public Schools (DCPS).[5] For example, DMH, which was removed from federal receivership in May 2001, did not have an adequate billing process or information management systems in place. District officials told us that DMH's billing system contained system edits that permitted unallowable costs to go through undetected and then forwarded these claims to the Medical Assistance Administration's (MAA) fiscal agent for reimbursement,[6] which would reject them after the services were already provided. As a result, Medicaid charges, as well as Medicare, were not properly documented and deemed unreimbursable by the federal government. In fact, officials said the problems were so severe that DMH voluntarily ceased billing for Medicaid federal funds—as well as Medicare—for most of 2001 to resolve these problems and avoid almost certain disallowances from the federal government. DMH did not provide a precise estimate of the federal reimbursement that was lost during this period.

The District also does not have an effective centralized monitoring process for Medicaid. Officials of MAA told us they have a limited ability to control and monitor CFSA, DMH, and DCPS—unlike the private third parties that provide services under the regular Medicaid program. Because these public provider agencies are distinct units of the District government, the District's budget makes it clear that MAA does not have authority over these agencies in terms of financial management, programs, budget, claims for submission or billing, or estimation of federal reimbursement.

[5] These agencies are eligible to bill the federal government for specialized Medicaid services—estimated to be $121 million in fiscal year 2003. The District's Department of Human Services (DHS) is expected to start making Medicaid claims in the near future.

[6] MAA is the District's single state Medicaid agency.

Officials told us that historically individual agencies, such as DMH or DCPS, made their own Medicaid projections for inclusion in the District's budget and the projections were almost always highly inflated. Accordingly, the baseline of the District's budget would indicate a large influx in federal Medicaid funds that would never materialize due to billing and claims management problems. For example, DCPS's original estimate of expected federal reimbursement for fiscal year 2002 was $43 million, which was later reduced to $15 million by the District chief financial officer (CFO). In fiscal year 2001, the District wrote off over $78 million of several years worth of such unpaid federal claims, which were still in the baseline of its budget. If District agencies adequately addressed these problems, they could receive more federal matching funds and free local funds for other purposes, such as providing an above average level of Medicaid coverage or optional services. While the District has taken some positive steps to improve management, more improvements are needed.

Steps to Address Management Problems

District officials have acknowledged the severity of the District's Medicaid management problems and have taken steps to remedy them. Most significantly, improving management could help the District increase its share of federal Medicaid reimbursement. Most of these reforms have only been implemented within the past year, so it is unclear how effective they will be in the long run. Key examples include the following:

- The Office of Medicaid Public Provider Operations Reform, which was created in June 2002, has become a needed focal point in the Mayor's office for integrating billing processes across District agencies and helping these agencies modify their processes and management systems to maximize federal Medicaid reimbursement.

- The District recently created an $87 million Medicaid reserve to compensate for the costs of Medicaid reimbursements that may need to be covered by local funds and to serve as a cushion for any less than expected reimbursement in federal Medicaid funds, Medicare and Title IV-E.[7] District officials told us they expect to use at least a portion of these funds during the current fiscal year.

[7] Title IV-E of the Social Security Act (42 U.S.C. Secs. 670 – 679b (2000)) provides federal payments to states for foster care and adoption assistance. In the District, CFSA receives these payments.

- The District CFO is now responsible for analyzing and clearing any Medicaid projections made by CFSA, DCPS, and DMH (and eventually DHS) before they are incorporated into the District's budget. Officials told us that the District plans to be more conservative in its projections for federal Medicaid funds to avoid the negative effects of less than expected federal reimbursement.

- DMH has designed and implemented a new billing process for Medicare and Medicaid, in accordance with the business plan mandated by the court as part of its post-receivership agreement. CFSA is implementing a new computerized billing system, making changes to its data collection process, and working closely with federal Medicaid officials to ensure that any changes meet federal requirements.

The District Receives Enhanced Medicaid Matching Support and Other Assistance from the Federal Government

Recognizing the District's Medicaid situation, the federal government has provided additional funding, as well as technical assistance and other programmatic flexibilities. Most significantly, in 1997 Congress provided the District with a fixed, enhanced Medicaid federal medical assistance percentage (FMAP) of 70 percent, [8] which has resulted in an influx of millions of additional federal Medicaid funds that the District was not eligible to receive previously. Previously, under the statutory formula that establishes the federal matching share of eligible state Medicaid expenditures, the District received a 50 percent FMAP—the lowest possible under the law.

In addition, the District uses programmatic flexibility and technical assistance from the Centers for Medicare & Medicaid Services (CMS), the federal agency within the U.S. Department of Health and Human Services that is responsible for Medicaid. CMS officials told us they have more frequent contact with the District than with many other states. For example, they have reviewed the District's billing processes and computer systems in some cases to ensure they meet federal criteria.

[8] The federal government's share of a state's Medicaid expenditures is called the FMAP; states and the District must contribute the remaining portion to qualify for federal funds. Determined annually, the FMAP is designed so that the federal government pays a larger portion of Medicaid costs in states with lower per capita income relative to the national average. In fiscal year 2003, FMAPs ranged from 50 to 77 percent (the maximum allowable is 83 percent). Generally, with a federally approved state Medicaid plan, federal payments are not limited for Medicaid as long as the state contributes its share of matching funds.

Special Circumstances and Management Problems May Result in Increased Education Costs and Below Average Services

When we adjusted for the District's service costs and workload factors, our cost analysis suggests that the District spent 18 percent more than what would be necessary to fund an average level of services. However, our analysis was not able to take into account all of the special circumstances facing the District. Specifically, it is likely that significant management problems and disproportionately high special education costs are drawing resources away from elementary and secondary education, suggesting that the District provides less than the national average level of education services. The federal government to some extent has recognized the District's special circumstances and the extent of its management problems by providing it with special technical and other assistance.

The District's Education Spending Is Somewhat Higher Than What It Would Take to Fund an Average Level of Services

We estimate that the District's elementary and secondary education costs were 18 percent above what it would take to fund an average level of services. Our analysis incorporated several workload factors that represent cost conditions that are largely beyond the control of District officials, which include the number of school age children (excluding those enrolled in private schools), and the specific costs of serving elementary and secondary students and economically disadvantaged children. Our model also took into account the costs of attracting teachers and the maintenance of capital facilities, both of which are higher in the District. When the District's costs and these workload factors were considered, our analysis showed that the District's spending is somewhat higher than what it would take to fund a national average level of services.

Our analysis, however, probably understated the District's education costs because we were not able to quantify the District's significant management problems or high special education costs due, in part, to court mandated services. If these factors could be adequately taken into account, they may show that the District is actually spending less than what is needed to fund a national average level of education services.

Significant Management Problems Are Further Drawing Resources Away from Educational Services

We, along with the District IG, the District Auditor, and federal inspectors general have identified—and District officials have acknowledged—serious management problems throughout DCPS's programs and divisions in areas such as financial and program management, as well as compliance with the requirements of federal programs, such as Medicaid and the Individuals with Disabilities Education Act (IDEA). These reports estimate that the local costs of management problems could be in the millions of dollars.

However, our cost analysis did not take into account the costs associated with fiscal resources that are wasted due to inefficient management. This limitation likely results in significant amounts of DCPS's fiscal resources being lost.

Many of the management problems at DCPS can be attributed to inadequate financial management, including a lack of effective internal controls and clearly defined and enforced policies and procedures. For example, the independent audit of the District's financial statements for fiscal year 2001 classified DCPS's accounting and financial reporting as a "material weakness." The auditors found that DCPS did not ensure timely loading of budget information into its accounting system, which prevented DCPS from monitoring expenditures and having accurate financial reports.[9] In another instance, DCPS's procurement procedures were not routinely enforced, as exemplified by capital project purchase orders being processed directly through the DCPS CFO instead of through the procurement office. Recently, DCPS officials acknowledged that they face difficulties in tracking procurement costs, and as a result, individuals at schools may purchase goods without completing a purchase order. Often through a process known as a "friendly lawsuit," vendors will deliver goods without a purchase order and subsequently notify DCPS of the purchase to receive payment. Last year, DCPS set aside $17 million to compensate for such unauthorized purchases, and spent $10 million of it.

DCPS officials provided us with other examples of the limitations of DCPS's electronic financial management system. These limitations prevent DCPS from adequately tracking personnel costs, which represent approximately 80 percent of the school district's budget. The system also does not allow DCPS officials to track either the total number of employees or whether particular positions are still available or have been filled. Recently reported problems with managing personnel expenses further highlight DCPS's financial management problems. In March 2003, DCPS officials announced that the school system had hired about 640 more employees than its budget authorized, resulting in DCPS exceeding its personnel budget by a projected amount of $31.5 million over the entire

[9] As previously noted, the independent auditors also identified DCPS's management of Medicaid school-based services claims as a separate "material weakness" because DCPS's billing processes are not set up to adequately distinguish between health-related costs (which are reimbursable under Medicaid) and education-related costs (which are not reimbursable). This was noted by independent auditors as a second, separate material weakness in the District's fiscal year 2001 financial statements.

fiscal year. Also, in December 2002, DCPS officials announced that it paid $5 million for employee insurance benefits and contributed to tax-free retirement accounts for employees who no longer worked for DCPS.

Reports have also identified management problems in particular educational programs, which influence costs and negatively affect the quality and level of service provided to students, particularly in special education. For example, a September 2002 investigation by the District Auditor found that DCPS paid $1.2 million to vendors for providing special education services to individuals whose eligibility could not be determined from information on vendors' invoices. In November 2000, the District IG reported that DCPS paid more than $175,000 in tuition to nonpublic special education schools that failed to meet the standards for special education programs. The District IG also reported inaccuracies in DCPS's database for special education students, inadequate oversight of special education tuition payments, and insufficient monitoring of nonpublic special education schools. Finally, the District IG concluded that DCPS lacked adequate management controls to ensure that transportation services were adequately procured, documented, and paid. The IG concluded that by implementing certain cost saving measures DCPS could save at least $2.4 million annually.

In addition, DCPS has longstanding issues regarding its ability to comply with the laws and regulations of federal education programs, including IDEA, and the U.S. Department of Agriculture's (USDA) food and nutrition programs. The extent of DCPS's compliance issues with IDEA have been serious, and by 1998 the U.S. Department of Education (Education) entered into a compliance agreement with DCPS that mandated improvements in DCPS's special education program. Further, the District has experienced longstanding issues of complying with USDA's requirements for the National School Lunch Program and the School Breakfast Program. DCPS's poor management of USDA's food and nutrition programs resulted in the Mayor and the City Council removing oversight and monitoring responsibilities from DCPS and placing them under a new, independent District State Education Office (SEO). SEO officials told us that while oversight and monitoring have improved, they still face many problems in effectively managing USDA's food and nutrition programs.

High Special Education Costs May Result in Less Funding Available for All Other Elementary and Secondary Education Services

Our program review revealed that the District has a high demand for special education and related costs, which are not adequately captured in our quantitative analysis. The District has a disproportionately large share of special education due process hearings that often result in it having to provide more expensive services and pay large legal fees; relies heavily on costly non-public schools; and operates under an array of court orders springing from class action lawsuits, many of which mandate additional types and levels of services.

Accordingly, our cost analysis does not sufficiently consider a major education cost driver for the District because we assumed that the District's special education costs were typical of the average state system, which we found is not the case. For example, the number of special education students has grown rapidly in recent years. Between the 1998-1999 and 2000-2001 school years, the number of special education students in DCPS grew by over 25 percent, while the total number of nonspecial education students decreased slightly. Over the same period of time, the percentage of special education students attending Boston Public Schools and the San Francisco Unified School District declined about 9 percent and 4 percent respectively. DCPS projects that the number of special education students will continue to grow even as the general student population is expected to continue declining, which will likely cause the special education program to pose an increasingly significant financial burden on DCPS. Overall, the size of the special education population as a percentage of students attending DCPS exceeds the average size for 100 of the largest urban school districts in the United States. Further, evidence suggests that DCPS may also pay a higher cost per special education student than other urban systems.

The high costs associated with the District's large number of due process hearings divert resources from other critical education services. As required by IDEA, a due process hearing gives parents of special needs children the opportunity to present complaints on any matter relating to the education of their children and seek remedies to any shortcomings.[10] Some shortcomings that frequently spur due process hearings in the District include a lack of sufficient educational programs, older school buildings that are not handicapped accessible, failure to meet deadlines for

[10] The intent of IDEA is to provide a free and appropriate education for children with disabilities in the least restrictive setting.

providing services in accordance with students' individualized education plans (IEP), and not sufficiently involving parents in the development of IEPs. The number of due process hearings held in the District in 2000 exceeded every state except New York, and DCPS estimates that the number of hearings requested will continue to grow as these shortcomings continue.

DCPS officials also acknowledged that their special education program suffers from a range of shortcomings, such as a lack of early intervention and prevention and underinvestment in program capacity. For example, DCPS officials noted that many special education teachers are not certified to provide special education.

According to some officials, due process hearings in the District often become forums for parents to advocate moving their child out of public schooling and into a private facility—at the District's expense. Due process hearings may result in the placement of a child in a much more costly setting, such as the transfer of the student from a public to an out-of-District private facility at the expense of DCPS, or mandating additional types or levels of services. Furthermore, the due process hearings result in legal costs to the District because the parents of a student often use a law firm to handle their cases, and if the student prevails in the hearing, the District must pay the legal fees. DCPS officials and other key observers have told us that many parents in the District want their children to be moved into private facilities and lawyers respond to parents wishes and DCPS's deficiencies, thereby realizing financial gains. For example, DCPS staff informed us that one law firm alone represented students in over 900 due process cases between September 2002 and January 2003 and earned approximately $1 million in fees from the District in 1 year. Even though Congress implemented a cap on legal fees related to special education, District officials told us the cap does not appear to have affected the incidence of due process hearings, but we did not independently verify these claims.

DCPS officials indicated that DCPS has also incurred additional costs to comply with court orders and settlements resulting from class action lawsuits. For example, DCPS officials said that the costs of transporting special education students doubled after implementing service improvements as required by the court in the Petties case.[11] However, DCPS could not verify that some of the costs attributed to the Petties case were court ordered. DCPS officials stated that even with increased spending and greater services, they do not think they will be able to meet all of the court ordered service improvements. According to DCPS officials, another significant case was the Nelson case, which required DCPS to develop emergency evacuation plans for students with mobility impairments.[12] DCPS officials said that complying with the court order required DCPS to make significant capital expenditures.

DCPS also reported that it has a high percentage of special education students attending nonpublic special education schools because it lacks the staff and facilities to adequately serve its special education students. DCPS officials acknowledged that the school system historically has relied on contracting with non-public education facilities, and DCPS has never built up the capacity to deliver sufficient special education services within DCPS. Services provided in non-public special facilities services are much more costly to DCPS than services provided in public institutions, as non-public schools charge much more for their services. For example, a special education student attending a nonpublic institution costs about twice as much as one receiving special education within DCPS. Spending on these services draws resources away from other public education services, as well as helping to build up the capacity to deliver more special education services within DCPS.

[11] See e.g., *Petties v. District of Columbia*, Civ. No. 95-0148 (D.D.C.) (September 15, 1997, Order to comply with deadlines and recommendations in the Special Master's report of August 25, 1997), (November 14, 1997, Order regarding acquisition of 150 buses), (December 22, 1997, Order of approving schedule for partial abatement of the imposition of additional fines based on acquisition of additional buses).

[12] See, e.g., *Nelson v District of Columbia*, Civ. No. 1:00CV02930 (D.D.C.) (December 21, 1997, Order approving consent decree).

The Federal Government Provides Technical Assistance to the District, Recognizing Its Challenges

In recognition of the District's special circumstances and management problems, the federal government, to some extent, has provided technical assistance to the District. Specifically, Education has provided substantial assistance to DCPS, including, since 1996, a dedicated liaison to DCPS to help identify opportunities for providing technical assistance. According to an Education official, no other school district in the country has such a departmentwide liaison. In addition, Education officials told us they have provided extensive technical assistance to DCPS, including guidance for developing an education plan, as well as help in improving its special education program, establishing performance standards for students, and developing a new database to track student data to increase DCPS's capacity to comply with the future data requirements of the No Child Left Behind Act.[13] Education staff has also hosted conferences to help the DCPS leadership better understand their oversight responsibilities for federal funding programs.

The District Faces Significant Public Safety Demands due to the Federal Presence, but Related Costs Are Not Adequately Tracked

The District's costs for the key public safety functions of police and fire protection were far above average, according to our analysis. In fact, the District's costs were higher for police than any other category. However, our analysis showed that when we adjusted for the District's high-cost environment, the District spent far less on both police and fire than it would take to fund a national average level of services in these areas. However, the factors considered for both police and fire do not adequately capture the demands the District faces. Most significantly, our factors do not include any measures of the various public safety demands and costs associated with the federal presence and the District's status as the nation's capital, such as extra protection for federal officials, including the President and Vice President, as well as diplomatic personnel and foreign dignitaries who visit the city; nor did they capture the police and fire costs associated with the multitude of regular special events and political demonstrations that often draw thousands of people. As a result, the District's spending on traditional public safety services for residents, such as policing neighborhoods, traffic control, and fire and emergency medical services, is likely even further below average than our analysis would suggest—indicating the District is providing fewer traditional police and fire services to its citizens. In addition, the District's current cost tracking processes do not adequately capture the true total costs associated with

[13] Pub. L. 107-110.

providing police and fire services to support the federal presence, putting the District at a disadvantage in recovering more costs related to protection, special events, or demonstrations. Finally, while the District has received some special federal funding in recognition of the services it provides to support the federal presence, it is unlikely this funding fully compensates for all related costs—indicating that local dollars are being used in support of federal activities.

Our Analysis Shows the District's Police and Fire Spending Is Below Average When Its High-Cost Environment Is Considered

According to our analysis, the District's costs of providing police services were very high—at four and one-half times the national average—as were the costs of providing fire protection services, which were nearly double the national average. However, our analysis indicated that when we adjusted for the District's high-cost environment for both police and fire, it was spending below what it would take to fund an average basket of services typically associated with police and fire departments. Specifically, the District's spending on police was 66 percent below what would be necessary to fund a national average level of services based on the urban basket of services and 40 percent below using the state basket of services. Furthermore, fire protection was 28 percent below using the urban basket of services.[14]

Our analysis for police was based on three factors only—murder rates, the 18-24 year old population, and the general population. The District's murder rate, which served as an indicator of the prevalence of violent behavior, was extremely high at more than seven times the national average. Further, we found that the percentage of residents in the 18-24 age range—a group prone to commit more crimes than any other age group—was disproportionately large in the District. Similarly, our workload factors for fire protection—multifamily housing units and older housing units built prior to 1939—indicated that the District faced high costs related to providing fire protection services. Specifically, the District had disproportionately high instances of older housing units, which are more prone to fires, and disproportionately high numbers of dense living conditions in multifamily units, another indication of the extent of fire services a jurisdiction must provide. The workload factors for police and fire protection suggested that the District's costs of providing typical

[14] Alternatively, using the state basket of services, the District's spending for fire protection was 25 percent above the national average. These results reflect the fact that fire services are a larger share of urban government budgets.

services in these areas were disproportionately higher than in most other jurisdictions.

For several reasons, our analysis may understate what the District spends on police and fire services for residents. First, our factors may not fully capture the extent of police and fire demands or related costs in the District. Specifically, a great deal of uncertainty exists as to whether or not some of our factors adequately measure demand for services or cost burdens. In addition, we believe these factors understated the District's expenditure demands because they did not capture any costs related to services provided to the federal government. For example, the factors do not adequately reflect increases in the District's daily population due to tourists, college students and other commuters, as well as services related to the federal presence for which it does not receive full reimbursement, such as protection for federal officials and dignitaries, special events, or demonstrations. Because these costs were not taken into account in our analysis, we believe the District is likely providing less police or fire protection services to residents.

The District Provides Significant Public Safety Services to the Federal Government, Likely Resulting in Less Spending on Services for Residents

As the nation's capital, the District is continually faced with paying for expenses to support the federal government's presence, such as extra services for federal officials, including the President and Vice President, and diplomatic personnel and foreign dignitaries who visit the city. It is also responsible for paying for services related to an array of special events and political demonstrations that often draw thousands of people, sometimes with short notice. The federal government routinely provides the District with special funding and other forms of assistance; however, it is unlikely that the federal government fully compensates the District for all expenses associated with the federal presence, meaning many related services provided by the District are funded with local money.

Assistance in Protection of Federal Officials and Dignitaries

Although the 1973 Home Rule Act requires the District, including the Metropolitan Police Department (MPD), to support federal agencies in providing protection to the President and Vice President as well as foreign missions and embassies, the federal government does not routinely reimburse the District for these expenditures, which District officials say places a financial strain on their budget and could negatively affect the operations of public safety agencies. The District's Fire and Emergency Medical Services (FEMS) department also provides similar support to the federal government. Although the police and fire departments typically receive advanced notification of federal protection needs from the U.S.

Secret Service, they are sometimes notified the day of or hours prior to an event, resulting in additional costs by necessitating the shifting of employees, calling up employees to back-fill positions, and paying overtime to employees. It also makes it difficult to plan or budget for federally related expenses. For example, MPD reported to us that in fiscal year 2002 it incurred 3,240 hours in police officer overtime hours related to providing protection to federal officials and dignitaries, at a cost of over $101,000.

MPD operates a special dignitary protection unit that is solely responsible for assisting federal law enforcement agencies, such as the Secret Service, by providing police escort and protection for federal officials, such as the President and Vice President, as well as key foreign dignitaries. For example, when the motorcade of a federal official, such as the President or a key dignitary, travels anywhere in the District, MPD is responsible for closing off streets, sending out scout cars in advance of the motorcade, and placing motorcycles beside and in front of the official cars; for the President, as many as 100 traffic posts are sometimes needed. MPD officials noted that they have no choice but to provide these services because the District controls its streets, so MPD must assist the federal agencies in providing protective services for motorcades that travel upon them, as would be the case in whatever jurisdiction these officials visited.

Often the magnitude of the required duties exceed the capacity of the dedicated unit; as a result, other MPD officers must be pulled from their regular duties, including policing District neighborhoods. According to MPD, the key difference between the District and other jurisdictions is the extent of the protective duties. For example, District officials told us the President often leaves the White House several times a day, necessitating police and fire support, whereas he visits other jurisdictions, such as San Francisco, with much less frequency.

Similarly, FEMS regularly uses its resources to provide services to federal officials and dignitaries. For example, officials told us that a District emergency medical technician (EMT) unit is required to accompany the President whenever or wherever he travels within a 50-mile radius of the White House, as well as to the presidential retreat, Camp David, in Maryland. Further, FEMS is required to pre-inspect any District buildings where the President, Vice President, or a key dignitary is scheduled to appear.

Special Events and Demonstrations

District officials told us that special events and demonstrations also result in the District incurring costs funded with local dollars. Special events also

affect police operations by diverting police officers from their normal duties as well as incurring costly overtime payments to police officers who are called upon during their scheduled time off. In addition, MPD staff said that it often does not have enough officers in its special events unit to provide all the necessary security for large events, meaning it must call up officers on leave or contract with officers from other jurisdictions.

As the nation's capital, the District is an attractive and preferred venue for demonstrations, protest rallies, and other special events as it provides a "high profile" venue and potential for media coverage for individuals and organizations seeking a mechanism for national publicity and potential access to legislators and other government officials. Thus, the District frequently hosts numerous planned and unplanned special events that often are not fully reimbursed by event organizers or the federal government.

Although the District receives positive economic benefits generated by an influx of visiting demonstrators or protestors and dignitaries, such as revenue from sales taxes in restaurants, hotels, and stores, the District must also bear a financial burden in providing unbudgeted public safety services related to these events. A comparison of the District to our case study sites of San Francisco and Boston suggested that the magnitude of the District's expenses related to protection, special events, and demonstrations is disproportionately higher than those of San Francisco and Boston police departments, which are both major international cities. For example, we collected data on overtime hours from several recurring special events in the District, Boston, and San Francisco and found that the District's expenditures were roughly four to six times greater than those other cities.[15]

According to MPD officials, expenditures for the demonstrations resulting from the International Monetary Fund (IMF)/World Bank conferences represent the largest unreimbursed expenditures. A IMF/World Bank conference—and resulting demonstrations—is scheduled to occur at those organizations' headquarters in the District twice in a fiscal year, usually during the spring and fall. District officials noted that the conference occurs in the District only because it is home to IMF and World Bank offices. MPD reported incurring over 116,800 in police officer overtime

[15] However, for all three cities this information is neither comprehensive nor is it audited, rather the information is self reported.

hours at a cost of more than $5.7 million during the fall of 2002, and this figure did not include the costs of purchasing new equipment, such as security fencing, or wear and tear on existing equipment and automobiles. MPD officials told us they also had to contract for officers from other jurisdictions to provide added security. MPD officials told us they estimated that the total costs of IMF/World Bank conferences could be as high as $14.8 million, but did not provide documentation for this figure.

The national Independence Day celebration on the National Mall serves as a key example of a large scale, federally related special event that results in significant employee overtime expenses to the District. MPD officials told us that the U.S. Park Police (USPP)—which has jurisdiction over the National Mall, where the event is held—could not handle an event of this magnitude on its own. Because the National Mall is within the District's boundaries, it must assist in security and assume any costs. On July 4, 2002, MPD activated 1,500 officers to work overtime to supplement USPP, and MPD brought in officers from other jurisdictions as well. MPD paid officers from other jurisdictions for their services, but MPD officials told us the department received no reimbursement from the federal government. FEMS officials also provided extensive services during the Independence Day celebrations, including emergency medical technicians.[16]

A final example of the federal presence's impact on the District involves MPD's newly constructed state-of-the-art command center that is intended to coordinate the law enforcement aspects of special events or emergencies, such as the IMF/World Bank conference. MPD officials told us that their previous facilities were not sufficient to effectively manage such events, so they felt it necessary to construct a new one at a total cost of nearly $7 million—all out of the District's capital budget. The federal government has not provided financial support for constructing or maintaining the command center, but federal law enforcement agencies (e.g., the U.S. Secret Service, Federal Bureau of Investigation, the U.S. Capitol Police, and the USPP) nonetheless rely on the facility to coordinate and manage law enforcement responses to emergencies or large-scale special events within District boundaries. However, in the past the federal

[16] District officials noted that other agencies incur expenses during special events or demonstrations. For example, before any large-scale event like Independence Day, the Department of Public Works (DPW) must board up abandoned houses and clean the streets afterwards.

government has provided some funding to MPD for other capital improvements to MPD facilities.

Effects of Increased Terrorist Threats

District public safety officials told us that in recent years the number of special events and demonstrations, along with the potential for violence and security threats during them, have increased as have the security needs of federal officials and key dignitaries. Accordingly, District officials told us that unanticipated and unreimbursed expenditures have escalated. In addition, District officials told us that after the September 11, 2001, terrorist attacks—and the resulting national focus on enhanced homeland security preparedness and increased threats of additional terrorist attacks—their ongoing costs have escalated even more. Police and fire officials told us that since September 11 they have provided permanently higher levels of security and additional services to the federal government. The events of September 11 have also affected the security needs of special events and demonstrations, leading to increased costs to the District. For example, officials told us that, in 2002, expenses to ensure security were even higher for national Independence Day celebrations than in past years because of concerns about terrorist attacks on the National Mall. However, specific data are not available for this event and others.

Better Tracking of Costs Could Strengthen the District's Case for Federal Reimbursement

The District's current cost tracking processes do not provide officials in MPD or FEMS, or the District CFO, with reliable financial information to allow them to better estimate and budget for federally related expenditures, control overtime costs, or strengthen their cases for reimbursement from the federal government. In particular, the District is not collecting data and tracking all expenditures to determine its true total costs associated with its public safety programs and activities, putting the District at a disadvantage in capturing and recovering more costs related to protection, special events, or demonstrations.

MPD and FEMS do some tracking of personnel costs associated with large events, such as the IMF/World Bank conference as well as ongoing protection, but neither agency routinely tracks data regarding supplies, equipment, training, vehicle maintenance, and repair costs, and they are likely underestimating the full extent of expenditures related to federal protection, special events, and demonstrations. The absence of a rigorous cost tracking process in MPD and FEMS appears to have hindered their ability to determine the true costs of providing public safety and other services in support of the federal presence. For example, MPD data on special events related to overtime paid for federal holiday activities, such

as Independence Day, are aggregated with all other holiday overtime. The quality, accuracy and completeness of these data are also lacking.

Recently, MPD and FEMS have attempted to improve tracking of costs associated with special events in response to direction from the District CFO's Budget Office. For example, MPD reported that it now tracks special event overtime hours and associated costs by the respective police unit, and the District CFO's Budget Office recently established a separate account to track actual expenditures for these events.

The Federal Government Has Provided Some Amount of Financial Assistance

Although it is unlikely that the federal government fully compensates the District for all related expenses, the federal government has provided the District with special funding and other forms of assistance in recognition of the magnitude of public safety demands related to the federal presence. For example, the District recently received $16 million to compensate for any expenses related to the demonstrations resulting from the IMF/World Bank conferences. However, District officials told us this level of funding would not be sufficient to cover many costs incurred by District agencies. Specifically, District officials claimed that each IMF/World Bank event might result in total costs, including personnel and equipment, of as much as $15 million, and two events are scheduled to occur within a fiscal year—although the District was unable to provide documentation for this figure.

The District received an additional $15 million in fiscal year 2003 for emergency planning and security enhancements. Further, in April 2003 as part of its urban security initiative, the Department of Homeland Security (DHS) awarded the District an additional $18 million; DHS also awarded funding to other major cities. Another key example was Congress providing over $200 million to the District as part of the Defense Appropriations Act for fiscal year 2002 to improve emergency preparedness and the capacity of the District to deal with any terrorist attacks. This funding, which went to a number of District agencies including MPD and FEMS, as well as non-District entities, was intended to assist in purchasing equipment to respond to chemical or biological weapons, improve its public safety communications systems, improve emergency traffic management, and enhance training, among other things.

The District Continues to Defer Infrastructure Projects While Debt Pressures Remain

When forced to balance the budget when a structural imbalance exists, governments often choose to hold down debt by deferring capital improvements. The District has thus deferred infrastructure maintenance and new capital projects because of constraints within its operating budget. Contributing to the District's difficulties is its legacy of an aging and deteriorated infrastructure, particularly in the schools, and maintaining its 40 percent share of the funding for the area's metropolitan transit system. The District's Chief Financial Officer (CFO) is actively managing the District's debt, refinancing some bonds to reduce interest and issuing bonds backed by funds from the tobacco settlement. Nevertheless, the District cannot take on additional debt without cutting an already low level of services or raising taxes that are already higher than other jurisdictions, and so it has chosen to put off needed repairs to streets and schools and postpone new construction that would improve the city's infrastructure. In fact, our analysis shows that the District's debt per capita ranks the highest when compared to combined state and local debt across the 50 states.

The District operates with an aged and badly deteriorated infrastructure—antiquated school buildings, health facilities, and police stations; out-of-date and inadequate computer systems; and aging sewer systems—for which the District has been unable to fund the needed improvements. The District is, however, attempting to address its backlog of infrastructure needs which, as several studies[1] have noted, was long ignored throughout the 1970s, 1980s, and early 1990s. This legacy continues to exacerbate the current situation. The District's level of spending for infrastructure repairs and improvements has increased steadily since 1995 and 1996, when virtually all major projects were deferred. The reality is, however, that the District continues to defer major infrastructure repair and development and capital acquisitions due to its budget and debt issues, while the legacy from its history of neglected infrastructure needs continues.

Our approach to analyzing the District's infrastructure projects differed from the approaches used to address the other objectives in this report. Because of the variety of ways infrastructure projects are owned, managed, and reported by other jurisdictions, comparative information on infrastructure across states and local jurisdictions was not readily available; therefore, we did not do a comparative analysis of the District's

[1] Carol O'Cleireacain and Alice Rivlin and the Commission on Budget and Financial Priorities of the District of Columbia, *Financing the Nation's Capital* (Washington, D.C.: November 1990).

infrastructure with states or other jurisdictions. We reviewed the data that the District has available in its annual budget, financial plans, comprehensive annual financial reports, and other documents.

District Infrastructure Continues to Be Deferred

The District is deferring significant amounts of capital projects by not funding or taking action on specific repairs and improvements to the District's infrastructure. For the 6-year period fiscal years 2003 through 2008, the total number of projects that were not approved for funding was 115. These 115 projects represent about 43 percent of the total identified capital cost needs for fiscal years 2003 through 2008. Many of these capital projects affect the safety and health of citizens. Deferred public safety projects include, for example, renovation of the third and sixth police district buildings and a disaster vehicle facility. District of Columbia Public Schools' (DCPS) fiscal year 2003 deferred projects included the replacement of electrical systems and heating and cooling plants and the upgrade of fire alarms, intercoms, and master clocks. Public health deferred projects include asbestos abatement and lighting system retrofitting in local facilities. Deferred transportation projects included rehabilitating bridges, paving alleys and sidewalks, and resurfacing streets. Deferred maintenance[2] project costs for three agencies total 79 percent of the total percentage of all deferred maintenance projects for fiscal year 2003—DCPS totals about 34 percent, Department of Transportation is about 30 percent, and the Metropolitan Police Department is about 15 percent. Table 7 lists the agencies and their deferred maintenance project costs for fiscal year 2003 and the 6-year period fiscal years 2003 through 2008. See appendix IV for a detailed list of agency projects and funding requests that the District has deferred.

[2] Deferred maintenance is the postponement of regular routine maintenance necessary to keep a fixed asset in operating condition for use or occupancy. Such maintenance would include, but not be limited to, recurring inspections, cleaning, painting, oiling, adjusting, replacing moving components, and major overhauls.

Table 7: The District's Capital Improvement Program: Deferred Maintenance Projects and Costs for Fiscal Year 2003 and Fiscal Years 2003 through 2008

Agency	Deferred maintenance fiscal year 2003, capital improvement plan	Deferred maintenance fiscal years 2003-08
District of Columbia Public Schools	$126,011,441	$1,134,102,956
Department of Transportation	112,750,000	645,500,000
Metropolitan Police Department	54,511,420	142,802,983
Department of Mental Health	23,242,000	23,252,150
Office of Property Management	17,970,000	32,360,000
Department of Parks & Recreation	9,389,000	24,689,000
Department of Public Works	8,235,400	32,805,400
Department of Health	5,695,000	9,265,000
Department of Corrections	4,849,500	12,293,000
Department of Human Services	3,175,000	8,705,000
University of the District of Columbia	1,946,000	19,438,000
Fire and Emergency Medical Services Department	1,916,103	5,304,784
Office of the Chief Financial Officer	1,235,000	9,000,000
Office of the Chief Technology Officer	0	9,900,000
Office of the Secretary	0	3,386,000
Total	**$370,925,864**	**$2,112,804,273**

Source: District of Columbia, Office of the Chief Financial Officer, Office of Budget and Planning.

Note: Differences due to rounding.

The District's Capital Improvement Plan (CIP) funding for fiscal years 2003 through 2008 is currently budgeted at $3.3 billion for a total of 229 projects. For fiscal year 2003, the amount for planned funding and expenditures is $881 million for projects such as school modernization, street repairs, roadway reconstruction, Metro bus replacement, equipment acquisition or leases, fire apparatus, and emergency communication systems. See table 8 for an overview of the District's planned funding and expenditures for fiscal year 2003 and the period fiscal year 2003 through fiscal year 2008. These amounts do not include $371 million in deferred maintenance project costs from table 7, as well as an additional $51 million in other deferred project costs that were not approved in fiscal year 2003 due to budget concerns. In addition, the District estimates that the total amount of deferred projects not included in the plan for fiscal years 2003 through 2008 total

approximately $2.5 billion. In many instances, new project requests require more financing than the District could afford to repay in future years.

Table 8: Overview of the District's Capital Improvement Program: Planned Funding and Expenditures for Fiscal Year 2003 through Fiscal Year 2008

Overview	Amount
Total number of projects approved for the 6-year period	229
Number of ongoing projects	192
Number of new projects	37
Total fiscal year 2003 planned funding	$881,428,000
Total fiscal year 2003 planned expenditures	$881,428,000
Total fiscal year 2003 to fiscal year 2008 planned funding	$3,332,700,000
Total fiscal year 2003 to fiscal year 2008 planned expenditures	$3,332,700,000
Fiscal year 2003 appropriated budget authority request[a]	$639,069,780
Fiscal year 2003 appropriated budget authority (actual)	$671,020,000

Sources: Government of the District of Columbia Fiscal Year 2003 Proposed Budget and Financial Plan, June 3, 2002, and Pub. L. No. 108-7, 117 Stat. 11, 121 (2003).

[a]"Appropriated budget authority" is the spending threshold approved by Congress for the District's Capital Improvement Program. Each year, Congress grants the District spending authority to implement a citywide capital program.

As shown in table 9, a total of 115 capital projects with a cost of about $422 million were deferred in fiscal year 2003. District officials told us that, in an attempt to remain steadfast to spending affordability[3] limits, they did not recommend these projects for funding even though some projects ranked high in priority in the CIP process. Of the $422 million in deferred projects for fiscal year 2003, $371 million was deferred maintenance, and the remaining $51 million represented other deferred projects. These projects will eventually need to be funded, but possibly at a higher cost later. Table 9 shows the approximate amount of funding that would be required if all requested infrastructure projects had been approved for fiscal year 2003 and fiscal years 2003 through 2008.

[3] Spending affordability is determined by the amount of debt service and paygo capital funds that can be reasonably afforded by the operating budget, given the District's revenue levels, operating/service needs, and capital infrastructure needs.

Table 9: Total Costs of the District's Approved and Unapproved Capital Projects for Fiscal Year 2003 and Fiscal Years 2003 through 2008

Capital projects	Number of projects	Fiscal year 2003 costs	Fiscal years 2003-08 costs
Unapproved projects:			
Deferred maintenance projects	80	$ 371 million	$ 2.1 billion
Other deferred infrastructure projects	35	51 million	345 million
Subtotal unapproved projects	115	422 million	2.5 billion
Approved projects	229	881 million	3.3 billion
Total all projects	**344**	**$1.3 billion**	**$ 5.8 billion**
Unapproved projects as a percentage of total identified needs		32.5%	43.1%

Source: District of Columbia, Office of the Chief Financial Officer, Office of Budget and Planning.

Note: Differences due to rounding.

The category "other deferred infrastructure and acquisition projects" included 35 projects, at a total cost of about $51 million for fiscal year 2003 and about $345 million over the 6-year period fiscal years 2003 though 2008. Similar to the financial situation of deferred maintenance, these projects were not approved because the projects required more financing than the District could afford to repay in future years. (See table 10.)

Table 10: The District's Capital Improvement Program: Other Deferred Infrastructure and Acquisition Costs for Fiscal Year 2003 and Fiscal Years 2003 through 2008

Agency	Agency costs – 1- year request fiscal year 2003	Agency costs – 6-year request fiscal year 2003-08
Deferred Acquisition Projects:		
Metropolitan Police Department	$3,800,000	$11,030,000
Fire and Emergency Medical Services Department	4,500,000	4,500,000
Department of Human Services	4,060,000	8,560,000
Emergency Management Agency	2,302,000	2,302,000
Department of Public Works	1,315,000	1,315,000
Department of Mental Health	1,540,000	3,000,000
D.C. Public Library	275,000	2,275,000

(Continued From Previous Page)

Agency	Agency costs – 1- year request fiscal year 2003	Agency costs – 6-year request fiscal year 2003-08
Subtotal deferred acquisition projects	**17,792,000**	**32,982,000**
Other deferred infrastructure and acquisition projects:		
Office of the Chief Financial Officer	14,250,000	32,350,000
Commission on the Arts and Humanities	1,520,000	3,955,000
Office of the Chief Technology Officer	3,700,000	170,580,000
Fire and Emergency Medical Services Department	3,193,684	6,645,256
Department of Human Services	5,200,000	8,700,000
Washington Metropolitan Area Transit Authority	0	80,800,000
Office of Contracts & Procurement	1,500,000	1,500,000
Department of Mental Health	3,500,000	7,500,000
Subtotal other deferred projects	**$32,863,684**	**$312,030,256**
Total	**$50,655,684**	**$345,012,256**

Sources: District of Columbia, Office of the Chief Financial Officer, Office of Budget and Planning, and the Government of the District of Columbia Fiscal Year 2003 Budget and Financial Plan, June 3, 2002.

District Debt Pressures Remain

There has been little change in the District's outstanding general obligation debt, which totaled $2.67 billion as of September 30, 2002, except for a drop in 2001 attributable to the issuance of bonds backed by funds received from a multistate settlement with tobacco companies. Debt per capita has also remained fairly constant except for a dip as tobacco bonds were issued. In contrast, with expenditures holding steady, debt service costs as a percentage of expenditures have increased. As a percentage of local general fund revenues, debt service costs, which were 7.3 percent of revenue for fiscal year 2002, are expected to climb to approximately 10 percent by 2006.

The District's annual debt service for the fiscal year ended September 30, 2002, was $272 million, or approximately 7.3 percent of the local portion of general fund revenues, and the District's projected debt service for fiscal year 2003 is about $304 million, which represents 8.3 percent of the local portion of projected general fund revenues. Although this level of debt service is well within the statutory limit of 17 percent of general fund

revenues, the effect of issuing substantially more debt without a corresponding increase in general fund revenue or cuts in other areas of the budget would adversely affect the District's debt ratios, its future ability to service its debt, and, consequently, its credit rating.

The primary funding source for capital projects is through the issuance of tax-exempt bonds. These bonds are issued as general obligations of the District and are backed by the full faith and credit of the District. Several sources of funding for infrastructure and capital projects are presented in the capital budgets for fiscal years 2003 through 2008. However, only general obligation bonds and master equipment lease funding sources have an impact on the annual operating budget. These funding sources require debt service payments, which include principal and interest and are paid from general fund revenues. General obligation bonds represent about 52 percent of the funding sources for the District's capital plan for fiscal years 2003 through 2008. (See table 11.)

Table 11: Source of Capital Funds for Fiscal Years 2003 through 2008

Dollars in thousands

	Fiscal years							
Source	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**Total fiscal year 2003-08**	**Percentage of total fiscal year 2003-08 funding**
General obligation bonds	$587,833	$432,541	$320,372	$258,719	$118,860	$349	**$1,718,674**	52
Federal grants	208,440	240,950	218,859	194,737	146,984	136,615	**$1,146,585**	34
Rights of way fees	36,940	37,950	37,350	37,500	36,133	36,127	**$222,000**	7
Highway trust fund	38,330	43,544	41,576	36,639	25,606	24,447	**$210,142**	6
Equipment lease	9,885	3,200	0	0	0	0	**$13,085**	.4
Other	0	11,102	11,112	0	0	0	**$22,214**	.6
Total funding	**$881,428**	**$769,287**	**$629,269**	**$527,595**	**$327,583**	**$197,538**	**$3,332,700**	**100**

Source: Government of the District of Columbia Fiscal Year 2003 Proposed Budget and Financial Plan, June 3, 2002.

Faced with decreasing revenues and a significant backlog of unfunded capital projects, the District is taking steps to reduce debt service costs. In February 2003, the District's CFO testified that in the first quarter of fiscal

year 2003, the District issued general obligation bonds to finance capital projects through a complex transaction that produced historically low interest rates, and refinanced (refunded) outstanding general obligation bonds and certificates of participation, at lower interest rates. According to the Deputy CFO, Office of Finance and Treasury (OFT), the District took advantage of market conditions in October 2002 and used an interest-swap mechanism, resulting in an average interest rate of approximately 4 percent on a portion of the bonds. Another portion of the bonds was issued as variable-rate demand bonds, and the Deputy CFO reported that this allowed the District to benefit from extremely low interest rates (about 1.25 percent currently). The Deputy CFO also stated that OFT has continued to focus on issuing its bonds based on actual capital spending needs (as opposed to its previous approach of planned spending levels), reducing the amount of unspent bond proceeds on hand, and thereby reducing debt service expenses. District officials testified that these actions produced substantial debt service savings totaling about $20 million.

Total Outstanding General Obligation Debt

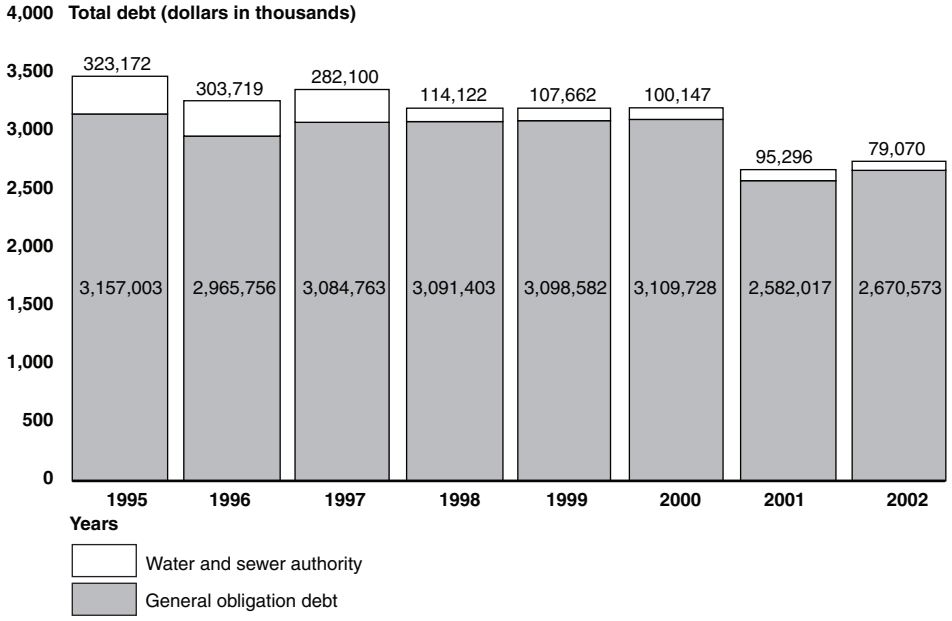
There was little change in the District's total outstanding general obligation debt for the period 1995 through 2000, as shown in figure 5. The drop in outstanding debt in 2001 was attributable to the issuance of tobacco settlement bonds[4] with the funds used to defease approximately $482.5 million of the District's outstanding general obligation bonds. As of September 30, 2002, the District's outstanding general obligation bonds totaled $2.67 billion. (See fig. 5.)

Since fiscal year 1991, the District's outstanding general obligation bonds have included balances related to the $331 million in deficit reduction bonds that were issued by the District in 1991 to eliminate the operating deficit in its general fund that year. As a result, the District's debt included amounts that were used to cover operating expenditures. The District has continued paying debt service on those bonds in the intervening years. In fiscal year 2002, $38.9 million of the District's $272.2 million in debt service expenditures was to cover principal and interest paymets on the deficit reduction bonds that had been issued in 1991. The District anticipates that

[4] The tobacco settlement bonds are asset-backed bonds secured by future payments from a Master Settlement Agreement with the major U.S. tobacco companies. The tobacco settlement bonds are not backed by the credit of the District, but by the future cash flows from the tobacco settlement agreement.

it will make the final payment on these bonds in fiscal year 2003, in the amount of $39.3 million.

Figure 5: The District's Total Outstanding General Obligation Debt for Fiscal Years 1995 through 2002



Sources: District of Columbia Fiscal Year 2002 Comprehensive Annual Financial Report (January 27, 2003) and also the Government of the District of Columbia Fiscal Year 2003 Budget and Financial Plan, June 3, 2002.

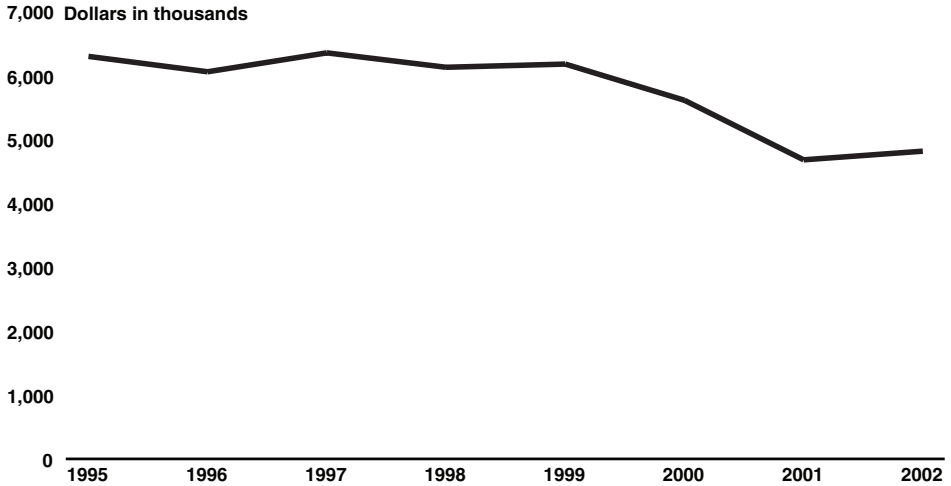
Note: This information includes separately stated amounts for general obligation bonds that were issued by the District prior to the creation of the Water and Sewer Authority (WASA). Although the WASA debt is serviced with funds provided by WASA as required by law, the District is still directly liable for the debt.

Debt Per Capita

Debt per capita measures the level of debt burden placed on each citizen of a state or city. Since the citizens are ultimately responsible for financing the debt through payment of taxes, debt per capita is a good way to measure changes in a city's debt load or compare a city's debt load to that of another municipality. The District's ratio of general obligation debt per capita was fairly constant from fiscal years 1995 through 1999. (See fig. 6.) The general obligation debt per capita further declined in 2001 because of the reduction in outstanding general obligation debt through the issuance of tobacco settlement bonds.

District officials offered the following explanations for the current situation of high debt per capita even while there has been a trend of significant deferred capital needs: (1) high funding for education and the Washington Metropolitan Area Transit Authority (WMATA), (2) funding projects with lifetimes shorter than the terms of the bonds, (3) funding enterprise fund activities, and (4) funding services that are now being provided by the federal government. The District's largest authorization items over the past 18 years have been public schools (16.8 percent of total funding) and WMATA funding (12.0 percent of total funding). District officials also explained that the District had funded projects with lifetimes shorter than the term of the bonds issued, as well as provided funding for the original convention center, WASA, the Washington Aqueduct, and public assisted housing. These activities are now operating outside the District's general fund. In addition, District officials identified past major events and circumstances that contributed to the present levels of long-term debt and deferred infrastructure projects, including the issuance of bonds in large amounts in fiscal years 1990, 1992, and 2002 for major authorization items such as public assisted housing and public education.

Figure 6: The District's Debt Per Capita for 1995 through 2002



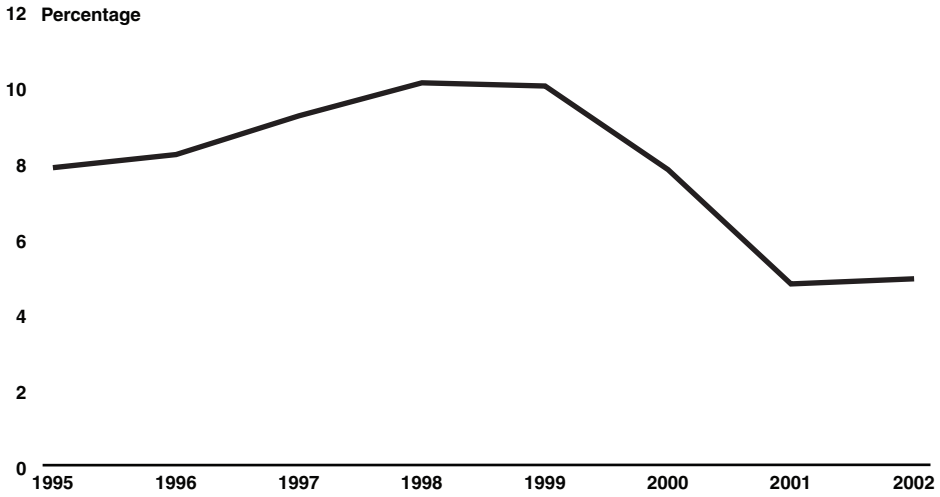
Source: District of Columbia *Fiscal Year 2002 Comprehensive Financial Annual Report* (January 27, 2003).

Expenditures Required to Service Outstanding Debt

From 1995 through 1998, the District's debt service costs as a percentage of total general fund expenditures increased slowly, as shown in figure 7. Most of the increase was attributable to a steady increase in outstanding

debt, while expenditures remained somewhat steady. However, from 1999 through 2001, the District's debt service as a percentage of expenditures decreased substantially, due primarily to the defeasement of approximately $482.5 million in general obligation bonds through the issuance of tobacco settlement bonds. This trend was a result of a unique, one-time, permanent reduction in the District's outstanding general obligation debt.

Figure 7: The District's Percentage of Debt Service Costs to Total General Fund Expenditures for 1995 through 2002 (Actual)



Source: District of Columbia *Fiscal Year 2002 Comprehensive Financial Annual Report* (January 27, 2003).

Note: This ratio is commonly used by local governments to measure the portion of expenditures that are required to service outstanding debt.

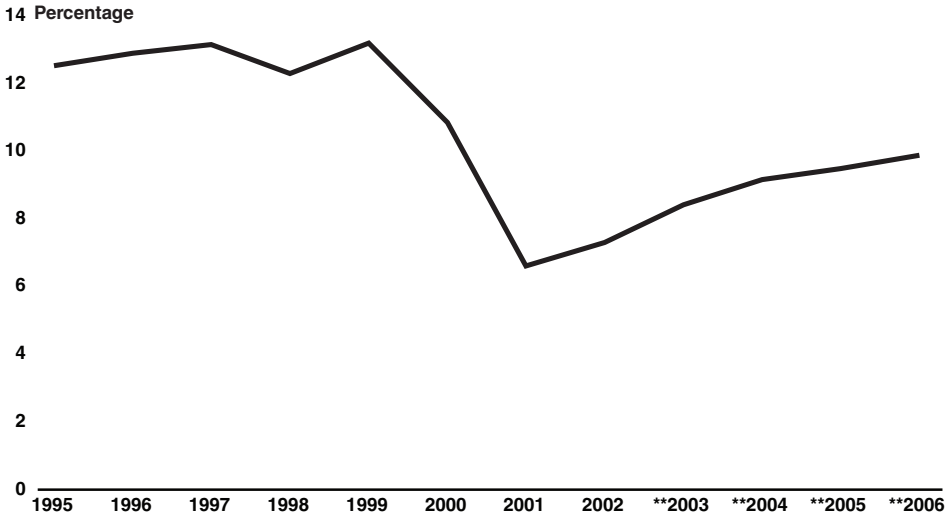
Revenue Available to Service Outstanding Debt

The most recent calculations show that, for 2002, the District's debt service costs amounted to about 7.3 percent of general fund revenues, as shown in figure 8. Based on the District's projections, the percentage of debt service costs to the local portion of general fund revenues is expected to climb steadily to approximately 10 percent by 2006. The District's projections assume that debt service costs will increase at a higher rate than local revenues.

Like debt costs as a percentage of expenditures, the District's debt service expenditures as a percentage of revenue remained level through 1999, then decreased substantially in 2000 and 2001 (see figure 8). The decrease was due to the issuance of the tobacco settlement bonds mentioned in the debt

service costs to general fund expenditures discussion, as well as an increase in general fund revenues over that same period.

Figure 8: The District's Percentage of Debt Service Expenditures to General Fund Revenues for Fiscal Years 1995 through 2002 (Actual) and 2003 through 2006 (Projected)



Source: District of Columbia *Fiscal Year 2002 Comprehensive Financial Annual Report* (January 27, 2003).

Note: Percentage of debt service costs to revenues is a common measure used by local governments to measure a municipality's capacity to issue debt.

[a]These numbers are estimates.

Credit Ratings

During fiscal year 1995, the District's general obligation debt was downgraded by all three rating agencies to "below-investment-grade" or "junk bond" levels. Since 1998, with the District's financial recovery, each rating agency has issued a series of upgrades to the District's bond rating. The upgrades that occurred in 1999 raised the District's ratings back to "investment grade" levels. The upgrades in the bond ratings by the rating agencies made the District's bonds more marketable, resulting in a lower cost of capital to the District. The District continues to have the goal of having its credit rating raised to the "A" level. In October 2002, the bond rating agency, Fitch IBCA, Inc., reviewed its rating for the District and reported that although the BBB+ long-term general obligation bond rating reflects the sound financial cushion that the District has built up over the last several years and the District's demonstrated ability to respond quickly and effectively to funding shortfalls and unexpected expenditure needs while still strengthening reserves, its debt levels remain high and capital needs are substantial.[5] While the District has seen significant improvement in its credit ratings over the last couple of years, its Baa1 from Moody's rating places the District in the lowest tier among 35 U.S. cities. (See fig. 9.)

[5] Fitch Press Release, "Fitch Rates District of Columbia's $375mm GO's 'BBB+'," Oct. 4, 2002.

Figure 9: Bond Ratings of 35 Largest U.S. Cities (Based on Revenue)

City	Revenue	Moody's rating
Dallas	1,487,356,000	Aaa
Seattle	1,276,337,000	Aaa
Indianapolis	1,121,129,000	Aaa
Columbus	797,579,000	Aaa
San Diego	1,577,934,000	Aa1
Denver	1,463,543,000	Aa1
Phoenix	1,372,605,000	Aa1
San Jose	921,473,000	Aa1
Minneapolis	918,720,000	Aa1
Virginia Beach	801,885,000	Aa1
Los Angeles	7,631,064,000	Aa2
Boston	2,126,398,000	Aa2
Memphis	2,093,600,000	Aa2
Nashville	1,816,080,000	Aa2
San Antonio	1,679,745,000	Aa2
Jacksonville	1,648,966,000	Aa2
Austin	1,366,541,000	Aa2
Long Beach	814,618,000	Aa2
Milwaukee	810,889,000	Aa2
San Francisco	3,765,464,000	Aa3
Houston	1,971,006,000	Aa3
Honolulu	1,113,601,000	Aa3
Atlanta	876,932,000	Aa3
Anchorage	870,628,000	Aa3
Richmond	818,935,000	Aa3
Kansas City, Mo.	736,297,000	Aa3
Chicago	4,731,877,000	A1
Baltimore	2,186,376,000	A1
Cleveland	813,678,000	A1
New York City	47,303,166,000	A2
Washington, D.C.	5,085,551,000	Baa1
Philadelphia	4,169,097,000	Baa1
Detroit	2,192,898,000	Baa1
New Orleans	768,944,000	Baa1
Buffalo	759,268,000	Baa2

Bonds rated at this level are judged to be of the best quality.
They carry the smallest degree of investment risk.
Interest payments are protected by large or stable margins and principal is secure.

Bonds rated at this level are judged to be of high quality by all standards.
Together with the Aaa group, they constitute what are known as high-grade bonds.
They are rated lower than the best bonds because margins of protection are not as large.

Bonds rated at this level are judged to be of upper-medium grade.
They possess many favorable investment attributes.
Security of principal and interest are considered adequate, but susceptible to impairment in the future.

Bonds rated at this level are considered medium-grade obligations.
They are neither highly protected nor poorly secured.
Such bonds lack outstanding investment characeristics and in fact have speculative characteristics.

Numerical modifiers are applied in each generic rating classification.

1=The obligation ranks in the higher end of its rating category.
2=The obligation ranks in the midrange of its rating category.
3=The obligation ranks in the lower end of its rating category.

Source: Governing.com, *The Government Performance Project 2000/Revenue Chart.*

Selected District Debt Statistics Compared to Other Jurisdictions

Our analysis shows that the District's debt per capita ranks the highest when compared to combined state and local debt across the 50 states. The District funds many infrastructure projects that in other U.S. cities would be financed either in part or in whole by state governments. For this reason, we have analyzed U.S. Census Bureau (Census) data that combine debt issued by the state government and all local governments within that state. The resulting debt per capita figure shows a complete picture of the debt burden for a state and all cities and municipalities within the state. From the Census data, we analyzed the portion of long-term debt[6] that is backed by the full faith and credit of the government entity issuing the debt.[7] This portion of long-term debt is supported solely by the taxing authority of the entity issuing the debt.

Based on the Census data[8] from all 50 states and the District of Columbia, the District shows the highest debt per capita level at $6,501. It is important to note that the Census data figures for the District's "full-faith and credit debt outstanding" as of April 2000 is significantly higher than the District's audited balance of general obligation debt as of September 30, 2000.[9] Therefore, we also included an "adjusted" level of debt to reflect the lower, audited general obligation debt level. Even using the audited lower level of debt, the District still ranked highest in debt per capita when compared to the 50 states. Based on the Census data, debt per capita in the other states ranges from a low of $173 (Oklahoma) to the second highest debt per capita of $4,348 (for both Hawaii and Connecticut). The median debt per capita is $1,462. The average debt per capita is $1,812. (See table 12.)

[6] Long-term debt is typically used to finance capital projects.

[7] Full-faith and credit debt is long-term debt for which the credit of the government concerned, implying the power of taxation, is unconditionally pledged. In contrast, the nonguaranteed portion of a jurisdiction's long-term debt is not backed by the tax base of the government associated with the debt, but is backed by a specific revenue stream or other source; for example, earnings of revenue-producing activities, such as municipal water and sewer authorities.

[8] Census data are as of April 2000, the most recent Census data available.

[9] The difference is likely due to inclusion of the Washington Convention Center bonds. The convention center bonds are backed by a dedicated tax revenue stream but are not general obligations of the District.

We also compared the District's outstanding debt burden to that of the 50 state fiscal systems in terms of debt as a percentage of own-source revenue capacity for fiscal year 2000, using our own range of estimates of that capacity. Our results show that the District's debt is larger relative to the resources it has available to repay it than that of any state fiscal system. (See the last two columns of table 12.) We estimated that the District's outstanding debt was equal to between 114 percent and 129 percent of the District's own-source revenue capacity in fiscal year 2000.[10] Both of these percentages were higher than those of any state fiscal system and well above the state median of 38 percent.

Table 12: U.S. Census Bureau Data on Debt Per Capita by State and as a Percentage of Own-Source Revenue Capacity

				Debt as a percentage of own-source revenue capacity	
State	Full faith and credit debt outstanding ($000)	Population (000)	Debt per capita	Low RTS	TTR
District of Columbia	$3,718,838	572	$6,501	129	114
DC (adjusted)[a]	3,209,876	572	5,611	111	99
Hawaii	5,270,348	1,212	4,348	104	107
Connecticut	14,808,632	3,406	4,348	76	73
Nevada	7,922,678	1,998	3,965	83	86
Massachusetts	22,766,965	6,349	3,586	66	65
Alaska	2,145,416	627	3,422	59	69
New York	63,242,280	18,976	3,333	71	66
Washington	17,921,583	5,894	3,041	66	68
Minnesota	14,075,859	4,919	2,862	62	64
Illinois	33,822,469	12,419	2,723	60	60
Wisconsin	13,968,405	5,364	2,604	63	67
Pennsylvania	28,329,230	12,281	2,307	57	58
Oregon	7,542,569	3,421	2,205	53	53

[10] The 114 percent is based on our highest estimate of the District's own-source revenue capacity (using the total taxable resources, or TTR, approach); the 129 percent is based on our most conservative estimate of that capacity (using the representative tax system, or RTS, approach).

(Continued From Previous Page)

State	Full faith and credit debt outstanding ($000)	Population (000)	Debt per capita	Debt as a percentage of own-source revenue capacity	
				Low RTS	TTR
Maryland	11,492,877	5,296	2,170	50	46
Texas	42,816,539	20,852	2,053	53	51
New Jersey	16,803,492	8,414	1,997	40	36
Colorado	8,080,104	4,301	1,879	38	41
Rhode Island	1,867,221	1,048	1,782	45	40
Delaware	1,363,973	784	1,740	36	32
South Carolina	6,916,351	4,012	1,724	48	51
Arizona	8,753,094	5,131	1,706	45	47
Michigan	16,583,026	9,938	1,669	40	43
New Hampshire	1,995,189	1,236	1,614	34	31
Mississippi	4,520,007	2,845	1,589	52	56
Vermont	964,792	609	1,584	38	42
Kansas	3,928,589	2,688	1,462	37	37
Tennessee	8,225,817	5,689	1,446	38	40
Virginia	10,183,759	7,079	1,439	33	32
Maine	1,743,816	1,275	1,368	36	39
Alabama	6,072,224	4,447	1,365	39	43
Utah	3,002,986	2,233	1,345	37	38
Ohio	15,229,929	11,353	1,341	33	35
Louisiana	5,936,496	4,469	1,328	38	37
California	44,666,627	33,872	1,319	29	28
Georgia	10,273,721	8,186	1,255	31	30
North Carolina	9,701,264	8,049	1,205	31	30
New Mexico	2,120,068	1,819	1,166	33	34
Nebraska	1,711,133	1,711	1,000	24	25
Iowa	2,919,449	2,926	998	25	27
Missouri	5,369,711	5,595	960	24	25
Florida	13,382,448	15,982	837	20	22
North Dakota	511,520	642	797	20	23
South Dakota	587,876	755	779	18	21
Arkansas	1,991,973	2,673	745	23	25
Montana	585,007	902	649	17	21
Idaho	788,739	1,294	610	17	17

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State	Full faith and credit debt outstanding ($000)	Population (000)	Debt per capita	Debt as a percentage of own-source revenue capacity: Low RTS	Debt as a percentage of own-source revenue capacity: TTR
Wyoming	297,923	494	603	12	12
Kentucky	2,286,543	4,042	566	16	16
Indiana	3,271,379	6,080	538	13	14
West Virginia	710,606	1,808	393	12	13
Oklahoma	1,963,110	11,353	173	17	18

Sources: U.S. Census Bureau and the District of Columbia *Fiscal Year 2002 Comprehensive Annual Financial Report* (January 27, 2003).

[a]Based on the District's audited balance general obligation debt.

Methodology for Calculating the Cost of Providing a Representative Basket of Public Services

The purpose of this appendix is to describe the methodology of previous studies that have employed the representative expenditure system to estimate the cost of providing an average (representative) level of public services and then describe modifications we have made to adapt it to reflect both the public service responsibilities and the relatively small urban environment faced by District. Dr. Robert W. Rafuse, Jr originally developed the representative expenditures system (RES) for the U.S. Advisory Commission on Intergovernmental Relations (ACIR).[1] The method developed was specifically designed to take into account those location-specific cost circumstances that are considered to be beyond the direct control of state and local government officials. The resulting estimate of a structural imbalance is, therefore, constructed so that it does not reflect conditions that are the result of discretionary policy choices made by local officials.[2] Our estimate of representative expenditures, in conjunction with our estimates of revenue-raising capacity, described in appendix II, provides the basis for determining the presence or absence of a structural imbalance.

Defining a Representative Basket of Public Services: The Rafuse/ACIR Method

The RES is designed to compare the cost of providing an average level of public services by state fiscal systems (a state government and all of its local governments). In the following sections of this appendix we describe the approach developed by ACIR and the modifications we made to make it more suitable for evaluating the presence of a structural imbalance for a small and highly urban jurisdiction like the District.

It would not be appropriate to compare the District to any single type of government, because fiscal responsibilities similar to those of the District are performed across the nation in varying proportions by state, county, municipal, school district, and special district governments. For this

[1] Robert W. Rafuse, Jr., *Representative Expenditures: Addressing the Neglected Dimension of Fiscal Capacity* (Washington, D.C.: ACIR, December 1990).

[2] While cleanly separating policy-related variables from cost factors beyond the control of government officials would be ideal, this is not possible. Dr. Rafuse, for example, acknowledges that private school enrollments are a policy related cost factor, and he uses vehicle miles traveled and lane miles of roads as an important determinant of highway costs, though both reflect a legacy of past policy choices. The best that can be hoped for is a degree of policy neutrality in which the effects of policy choices are indirect and gradual. In the long run, virtually all cost factors are influenced by policy choices; even resident population is the result of policies that influence migration and housing construction and rehabilitation.

reason, the RES compares the District to all governments that serve geographic areas. That is, our analysis compares the public service workloads and costs of the District with those of state areas where public services are typically provided by state, county, municipal, educational districts, and special districts collectively.

Ideally, it would be appropriate to compare the District to other geographic entities with similar economic and demographic profiles. However, this approach was not possible because comparable data for all governmental entities serving geographic locations similar to the District were not available. For example, expenditures for services provided directly by state governments are not typically reported for substate geographic entities. In addition, the structure of local government is diverse and their boundaries often do not coincide, so that, from a practical standpoint, it would be very difficult to consistently organize information on a comparable basket of public services for geographic entities below the level of state boundaries. For example, school district boundaries often do not correspond to either municipal or county government boundaries. Therefore, the services of a school district whose boundaries partly overlap that of two or more counties would have to be somehow apportioned among them. Imputing the value of these services would be problematic at best. The RES approach uses state boundaries to aggregate spending on public services provided by the state government and every local government within the state.[3] Based on this geographic unit, we defined a representative level of public service provided by the average state fiscal system.[4]

The Representative Expenditures System Defined

The representative basket of public services developed by ACIR is the sum of a representative expenditure level for seven categories of public spending:

1. Elementary and secondary education

2. Higher education

[3] We made small modifications to this original RES state area benchmark of comparison in order to reflect the particular circumstances of the District. These are described in detail subsequently in the subsection on our modification of the RES expenditure weights.

[4] Since we refer to all the states and the District here, the public expenditures of the average state fiscal system are equal to the national average.

3. Public welfare

4. Health and hospitals

5. Highways

6. Police and corrections

7. All other

For a given category of spending, the national average per capita spending is used as a benchmark for the spending that would be needed to fund an average level of services. A fiscal system's representative expenditures per capita are estimated by multiplying per capita expenditures in each expenditure function by two adjustment factors to account for differences in the cost of providing an average level of services: (1) an index of each jurisdiction's relative workload appropriate to the expenditure function (e.g., school age children in the case of education and miles of road in the case of highways) and (2) the costs of inputs (such as personnel, buildings, and materials) used to provide public services. Once the national average per capita expenditure for each expenditure function is adjusted for differences in workloads and costs, the representative expenditure amounts are aggregated into an overall average per capita amount that represents the funding necessary to fund an average level of public services. This is accomplished by weighting the per capita representative expenditures index of each expenditure function by its share of total spending for all functions. Table 13 shows fiscal year 1987 expenditures shares for the seven expenditure functions included in the ACIR analysis.

Table 13: Fiscal Year 1987 Weights Associated with the National Average Basket of Public Services

Expenditure category	Weight (percentage)
Elementary and secondary education	24.0
Higher education	9.2
Public welfare	12.3
Health and hospitals	8.7
Highways	8.0
Police and corrections	6.3
All other	31.4

Source: GAO.

Note: GAO analysis based on information in *Representative Expenditures: Addressing the Neglected Dimension of Fiscal Capacity.*

While the RES yields estimates of the expenditures necessary to fund an average level of services, this should not be interpreted to mean that states that actually spend that amount are providing an average service level. If services are delivered with an above average level of efficiency, the actual level of services may be above average. And similarly, if they are delivered with below average efficiency, the actual level of services may be below average.

Workload Indicators and Weights

Workload indicators generally represent the number of potential consumers of the service, but other indicators of the volume of activity are used as well. For example, school age children represent the number of consumers of educational services and low-income people represent the number of consumers of public welfare. However, the scale of activity for highway maintenance and repair is indicated by the number of miles driven by vehicles using the streets and highways, and also by the miles of roads to be maintained. The various workload indicators and the associated weights employed under the ACIR methodology are summarized in table 14.

Table 14: RES Workload Indicators and Weights by Expenditure Category

Expenditure category	Workload indicators	Workload factor weights
Elementary and secondary education	1. Children of elementary school age (5-13), net of private school enrollment	1. 0.60
	2. Children of secondary school age (14-17), net of private school enrollment	2. 1.00
	3. Children under age 18 living in poverty	3. 0.25
Higher education	1. Population 14-17	1. 1.32%
	2. Population 18-24	2. 22.44%
	3. Population 25-34	3. 4.16%
	4. Population 35 and over	4. 0.83%
Public welfare	1. Poverty population	1. 100%
Health and hospitals	Percentage shares of	
	1. Total population	1. 1/3
	2. Population below 150% of the poverty line	2. 1/3
	3. Population 16-64	3. 1/3
Highways	Percentage shares of	
	1. Vehicle miles traveled	1. 82.5%
	2. Lane miles of streets and roads	2. 17.5%
Police and corrections	Percentage shares of	
	1. Total population	1. 1/3
	2. Number of murders	2. 1/3
	3. Population 18-24	3. 1/3
All other	1. Total population	1. 100%

Source: GAO.

Note: GAO analysis based on information in *Representative Expenditures: Addressing the Neglected Dimension of Fiscal Capacity*, p. 9.

Unit Cost Adjustments

In addition to workload indicators reflecting circumstances that typically would require greater expenditure to achieve a given level of public service outputs, the cost of providing a representative level of expenditures depends on the unit cost of services provided. The ACIR RES methodology abstracts from unit cost differences other than those related to the cost of labor and other inputs used in the provision of services. The only specific factor input whose costs are taken into account is labor costs; the ACIR methodology assumes nonlabor costs do not systematically differ across states.

The ACIR methodology standardizes labor costs by controlling for differences in age, gender, and educational attainment across states. Differences in educational attainment are controlled for by using the national average percentage distribution of educational attainment to calculate an average level of earnings for males ages 45 through 54. Average earnings levels are divided by the national average to form an index of labor costs across states. A cost index for each category of spending is calculated by weighting the indexes of labor costs on the basis of the proportion of expenditures in each category of spending accounted for by employee compensation.

Limitations to the Interpretation of the Representative Expenditure Model

Dr. Rafuse discussed a number of limitations to the interpretation and understanding of the results of the RES model. This section explains that these limitations also apply to our modified version of the RES designed for use in measuring the District's costs of providing an average level of expenditures per capita (adjusted for workload and input cost differences.)

Rafuse says, "No implications should be drawn that the representative outlays are in any sense correct or 'needed' in any absolute sense. The estimates merely show how much it would cost each state to provide the national-average level of each service."[5] For the RES for every function and for the composite RES measure including all functions, the RES is a relative measure that employs cost, workload, and expenditure measures that, in effect, are indexed to the national average. For example, by using national averages as a benchmark, a fiscal system's actual spending may remain unchanged yet its spending relative to that average will have fallen. Since the national average spending for each function reflects policy and political preferences across the nation, it is apparently a more "typical" spending level, though there is no reason to suppose that it is more sensible or appropriate than the spending level that any individual state or the District chooses.

Further, state and local policymakers may decide, in the process of making budget choices for their area, that the policy goals associated with one function are best advanced by spending in other functional areas. For example, spending more for corrections (probation supervision, juvenile detention, etc.) and spending for extracurricular activities and after school

[5] Rafuse, v.

programs could be deemed more effective budget choices for purposes of reducing crime rates than increased spending for police. Another example is transit subsidies, which policymakers may view as a substitute for some highway spending.

Rafuse says that the RES assumes uniform efficiency and thus could not be adapted to make conclusions with respect to efficiency and management performance. It assumes, he says, that "a given level of spending per capita (adjusted for differences in compensation costs) buys the same level of service in each state. Hence, no inferences about operating efficiency can be drawn from the relationship between actual spending for a function and the representative expenditures." Further, he says, "Although we know that public services are not of equal quality per dollar spent everywhere in the nation, it is, regrettably, impossible to take this into account because credible measures of performance are not available."[6] Finally, for some functions, there are multiple policy objectives that the RES would model more accurately if it used a wider array of workload measures with appropriate weightings for each. To some degree, the workload indicators employed in the RES model are perhaps correlated with omitted indicators. For example, the workload factor for children in poverty may be correlated with some of the additional costs imposed on schools for providing an education to those of limited English speaking proficiency. The error created by the omission of key workloads in calculating the RES estimates is unknown.

Modifications to the Rafuse Methodology

The primary intent of the original RES analysis was to compare the fiscal circumstances of states without consideration of the fact that the District has boundaries that are geographically much smaller, demographic characteristics that are more urban, and an economy that is far more open to cross-border flows than is true of states. In modifying the RES, we sought to better reflect these considerations.

Our modifications to the RES was focused on three main areas:

[6]Rafuse, v.

- Workload Indicators: In circumstances where alternative workloads could better reflect community and population characteristics that, other things being equal, are associated with increased cost for providing a particular service outcome, we modified the indicators used in earlier analyses. Where this is not possible, we generally used the ACIR methodology as one that is conservative and unlikely to overestimate the District's representative expenditure levels.[7]

- Cost of Inputs Used to Provide Public Services: We used Bureau of Labor Statistics data to account for differences in labor costs and added an indicator of the cost of office space and related building assets used to deliver public services.

- Composition of Benchmark Basket of Public Services: In addition to using the basket of services typically provided by state fiscal systems, we also developed a basket of services typical of that provided by governments serving more densely populated urban areas.

As explained in detail below, with each of these broad types of RES modifications we have departed from the ACIR methodology where the improvement appears to us to be highly likely. Where there has been a choice required between alternative modifications, we have generally chosen the more conservative one. That is, we have chosen modifications that are likely to underestimate the District's RES measure and very unlikely to overestimate it. Conservative estimates of the District's representative expenditure, in turn, will tend to understate the District's structural imbalance.

Before discussing modifications by detailed expenditure category, it is worth observing that our modified RES workloads and input costs are not intended nor designed to capture the effects of a legacy of past problems (inefficiencies, poor policy decisions, deferred capital maintenance, etc.) that can, at present, be a serious impediment to effective service delivery, and the effects of which may take years to reverse. According to experts, the District's capital assets reflect many years of deferred maintenance, yet

[7] Dr. Robert Tannenwald calculated the District's 1997 RES to equal 121 essentially using the ACIR methodology. Robert Tannenwald, "Interstate Fiscal Disparity in 1997," *New England Economic Review*, Federal Reserve Bank of Boston (Boston, Mass.: Third Quarter, 2002), 24. Since the District's actual expenditures per capita are typically well above average, our preference for the use of the Rafuse method is a conservative approach toward estimating the District's RES expenditure levels.

RES makes the implicit assumption that the District's plant and equipment are of average quality and quantity per capita. To the degree that the District suffers from a legacy of undermaintained capital and inefficient operations that may take years to return to an average level, this is a unique circumstance that RES does not capture and it would thus underestimate the District's RES level compared to one that reflects the actual quantity and quality of capital assets.

Modifications to the Workload Indicators

In contrast to the 7 expenditure categories used in the ACIR report, we used a more detailed set of expenditure functions for our benchmark baskets of services using data from the U.S. Census Bureau (Census).[8] Specifically, we have (1) separated public welfare into medical vendor payments (largely Medicaid expenditures) and other public welfare; (2) separated expenditures for police and corrections into separate functions; and (3) disaggregated the other expenditure category into separate expenditure categories for fire, mass transit subsidies, sewerage, social insurance administration, libraries, parking facilities, solid waste management, housing and community development, parks and recreation, protective inspections and regulation, government administration, interest on debt, and general expenditures not elsewhere classified. Representative expenditures were calculated for each of the above expenditure functions and aggregated into the 12 expenditure categories shown in table 5 of chapter 2.

As described above, population and the number of people in poverty are used as workload indicators for several expenditure functions. Therefore, we will discuss our modifications to these factors and then point out where these changes occur as we discuss the workload factors for specific expenditure functions below.

[8] Detailed data from the state by type of government – public use format file downloaded on 11/14/2002 from www.census.gov/govs/www/estimate.html.

- Adjustment to population for commuting. Using data on the journey to work from the 2000 Decennial Census, we summed for each state and the District the number of workers who leave and come into another state to work. Taking the difference between the inflow of workers and the outflow, and adjusting that difference to reflect hours worked, provides us with a "daytime" population adjustment for each state and the District. We do not include any adjustment for visitors and commuting students because of the lack of data, although there is evidence to suggest that the District has large numbers of visitors as well. Therefore, our adjustment for commuters likely does not fully capture the District's daytime population.[9]

[9] The District has over three times the number of guestrooms per capita than the national average, and it ranks fourth among the states after Nevada, Hawaii, and Wyoming according to the 1997 Economic Census of Traveler Accommodations. However, we lack data on room occupancy.

- Adjustment of Poverty Population for Cost of Living. The poverty data used in ACIR's RES are based on an income threshold that does not account for geographic variation in cost of living. We apply a cost-of-living adjustment using a method suggested by the National Research Council (NRC) of the National Academy of Sciences: NRC's suggested index is the sum of 44 percent of an index of housing cost calculated using the Department of Housing and Urban Development's (HUD) fair market rent data[10] and 56 percent of an index to represent other factors that affect the cost-of-living that are, of necessity, assumed to not vary by location.[11] Differences in housing costs are identified as the single most important source of cost-of-living differences and the NRC says that these cost differences represent about 44 percent of a low-income household's budget. For the remaining sources of cost-of-living differences, NRC concluded that no reliable sources of data exist. Using an index of 1.0 for the nonhousing costs component of the index implies that such costs do not vary across geographic areas, an assumption that also serves to underestimate the District's representative expenditures.[12] Therefore, NRC suggests calculating cost of living differences using the formula:

  cost of living index = 0.56 + 0.44 x (rent index).

[10] The data we used are from fair market rents data collected by HUD for the Section 8 Housing Assistance Program. These data are available by metropolitan area and non-metropolitan areas of states. The data were aggregated to the state level by weighting each metropolitan area and the balance of the state by their respective shares of total population.

[11] Panel on Poverty and Family Assistance [et al], *Measuring Poverty: A New Approach* (Washington, D.C.: National Academy of Sciences, 1995), 197-200.

[12] The NRC report acknowledges, on p. 199, the assumption that 56 percent does not vary by region. However, the report views the method "as a modest step in the right direction. The procedure only takes account of housing cost differences and, even for those differences, will assign index values to people in some areas that are considerably in error."

Elementary and Secondary Education

The ACIR RES applies a weight of 0.25 to the workload factor of children in poverty to reflect the weighting many states apply in their school-aid formulas, based on fiscal year 1987 information.[13] Based on our 1998 study, [14] the median weight states accorded low-income children was 0.6. While some research suggests that still higher weights would be appropriate,[15] we thought that the median was a conservative choice and increased the weight accorded poverty to 0.60. The workload measure for the number of school-age children is measured net of children enrolled in private schools. Because the District pays for the cost of a private school for many special education students, this adjustment is also a source of underestimation of the District's education workload.

Higher Education

The workload methodology for the higher education function is unchanged from the original ACIR method (though the workload data have been updated to rely on the 2000 Decennial Census.)

Medical Vendor Payments

This category includes Medicaid.[16] Since this function largely benefits low-income households, and the cost of serving these populations varies substantially by age, we use the experience of the Medicaid program to develop age weights for the cost-of-living-adjusted poverty population. These age weights take into account both differences in the average cost per Medicaid recipient by age (children (0-18), adults (18-64), and elderly (65 and over)) and the different rates of participation in the Medicaid program. This procedure assumes that medical vendor payments of state and local governments generally reflect the experience of the Medicaid program.

[13] Rafuse, p. 10, footnote 9.

[14] U.S. General Accounting Office, *School Finance: State and Federal Efforts to Target Poor Students*, GAO/HEHS-98-36 (Washington, D.C.: January 1998), 51.

[15] Andrew Reschovsky and Jennifer Imazeki, "The Development of School Finance Formulas to Guarantee the Provision of Adequate Education to Low-Income Students," in *Developments in School Finance 1997* (Washington, D.C.: U.S. Department of Education, July 1997), 123-144.

[16] This functional category includes payments to nongovernmental medical providers. Medicaid payments to hospitals, nursing homes, and other institutions owned by state and local governments are included in the public welfare and hospitals categories, but cannot be separated out.

Public Welfare

For other public welfare expenditures, we use the estimate of persons in poverty with the poverty threshold adjusted for cost of living using NRC's suggested method.

Health and Hospitals

The ACIR method used the sum of equally weighted percentage distributions of (1) population age 16-64 with work disabilities, (2) population below 150 percent of the poverty threshold, and (3) total population. In the case of this expenditure category, we judged that most services would be delivered to residents so that the "daytime population" adjustment is not used. The poverty threshold is adjusted for cost of living using NRC's suggested method.

In the roughly 15 years since the ACIR research on workloads, there has been a significant amount of work on collecting, analyzing, and improving the data providing indicators of public health. Limitations of time and resources did not allow us to incorporate information from this literature into our RES modifications. However, it appears likely that the approach we have taken underestimates the District's workload levels for this function. One of our previous studies, for example, found that an indicator of premature mortality called years of productive life lost (YPLL) is well-suited as an indicator of public health workloads, and including it would have increased the District's RES.[17]

Highways

Vehicle miles traveled and lane miles of highways and streets are workloads that reflect a legacy of earlier policy decisions with regard to how many highways to build and the success of efforts to control the volume of traffic through mass transit service provision and fares, car-pooling, HOV, and other policies and programs. As mentioned earlier, to the degree that there has also been a legacy of relative undermaintenance of capital stock in this function, the workload measure would be an underestimate for the District.

[17] U.S. General Accounting Office, *Public Health: A Health Status Indicator for Targeting Federal Aid to States*, GAO/HEHS-97-13 (Washington, D.C.: November 1996). YPLL per capita is about 100 percent greater in the District than the average for the nation. Using our modified RES methodology for this expenditure function, the District's workload per capita is 29 percent greater than the national average. Consequently, had YPLL been incorporated into our workload indicators, it would have resulted in a higher cost estimate for the District.

Mass Transit Subsidies

The workload factor chosen is the population of the urbanized area of the state with the adjustment for commuter population. Census' urbanized area definition is based on the population density of the geographic area; however, it is still a rather broad population measure. The total of state and District population in urbanized areas in 2000 is 192 million, which is 68 percent of the total resident population of 281 million. The 2000 Decennial Census provides two other pieces of information that are relevant in this context: (1) the total number of workers age 16 and over who use mass transit is 6 million and (2) the total number of households, with householders aged 16 through 65 and no motor vehicle available to the household, is 7 million. These data suggest that the chosen workload factor of urbanized population is very broad, and thereby, is likely to provide an underestimation of the District's RES spending for this function.

Police and Corrections

The workload measure for both police and corrections under the ACIR methodology is the equally weighted sum of the percent distributions of: (1) resident population, (2) number of murders, and (3) population age 18-24. We applied the "daytime" commuter adjustment to the resident population factor for police, but did not adjust the population factor for corrections.

We thought the use of resident population unadjusted for "daytime" population was unlikely to risk overestimating the workload for corrections. Dr. Rafuse explains that workload factors (2) and (3) are connected to the incidence of crime and therefore are appropriate for corrections; however, no justification for including resident population is stated. The rationale for including (1) resident population is that "Many police responsibilities have little to do with crime. They include such tasks as accident investigation, traffic control, and enforcement of municipal safety and parking ordinances."[18] Such factors would clearly increase with a significant influx of commuters. Regarding corrections, Rafuse writes "The number of murders and the size of the 18-24 year population can also serve as crude indicators of the relative cost of corrections, on the assumption that these costs are directly related to the incidence of serious crime."[19] While the ACIR report is silent on the rationale for including population, we have continued with this procedure as a conservative approach for measuring the District's RES for corrections. The District's RES workload for corrections is over three times the average per capita and removing the resident population workload factor would increase it further. The District's actual incarceration rates are also high but not as high compared to the national average, and they have decreased rapidly in recent years.[20]

Fire Protection

Fire protection services in the ACIR methodology are subsumed under the "all other" category and thereby assigned population as a workload factor. We assign to fire protection the workload factors of 40 percent "daytime adjusted" resident population, 50 percent housing units in buildings with five or more units, and 10 percent housing units built prior to 1940.[21] These variables reflect the characteristics of older, densely settled urban areas where the risks of fire are greater and the costs of providing a given level of

[18] Rafuse, 15.

[19] Rafuse, 15.

[20] Ann L. Pastore and Kathleen Maguire, eds., *Sourcebook of Criminal Justice Statistics* [online] available: www.albany.edu/sourcebook/. While actual incarceration rates reflect policy choices, in the absence of full understanding of these trends, we think it conservative to use this information to influence our choice of workload factors. For example, table 6.24 shows a more than 50 percent drop in the District's rate of prisoners per 100,000 resident population from 1998 to 2000.

[21] These weights were derived from regressing a per capita index of 1997 fire expenditures by county area on adjusted population, and indexes of this housing information from the 2000 Census. All coefficients were significant.

fire safety are magnified by the need to rely on professionals rather than volunteers, by the need for more specialized types of equipment and apparatus, and other reasons.

While our method results in a workload measure for the District of 38 percent above the national average for fire (using the weighted sum of the three workloads), there is evidence that suggests it could be higher. Our model for fire workloads did not include neighborhood, housing, and population characteristics that research has shown to be strongly related to the incidence of fire.[22] Though we have not examined all such characteristics, these are typical of low-income, urban areas that the District has in much higher percentages than the national average. For example, 2000 Decennial Census data show that the District's per capita rate of families with a female head of household, no husband present, in poverty, is over twice the national average.[23]

Sewerage

Sewerage in the ACIR methodology is subsumed under the "all other" category and, thereby, assigned population as a workload factor. Housing units in many rural and suburban areas are not connected to a public sewer system and instead rely on septic tanks. We use the number of households connected to a public sewer system as the workload factor.[24] While this is only one aspect of the cost of supplying and maintaining sewer lines and treatment facilities, we believe it is superior to the use of population.

Social Insurance Administration

Census defines this category to consist of state and local spending on the unemployment compensation system and related employment search assistance.[25] Thus, we use the number unemployed as reported in the 2000 Decennial Census.[26]

[22] A review of the literature is contained in National Fire Data Center, *Socioeconomic Factors and the Incidence of Fire* (Washington, D.C.: Federal Emergency Management Agency, June 1997).

[23] National Fire Data Center, p. 18, discusses single-parent households with children present as a risk factor. Unfortunately, we do not have a consensus among the research studies as to the average impact such added risk factors have on the cost of fire services.

[24] These data are only available from the 1990 Decennial Census.

[25] See www.census.gov/govs/www/classfunc22.html.

[26] The District's unemployment rate was 10.7 percent compared to the national average of 5.7 percent.

Libraries, Parking Facilities, and Solid Waste Management

These three categories are subsumed under the "all other" expenditure category and are assigned population as their respective workload factors. In that commuters can reasonably be expected to use these services, in each case, we have assigned them population with the "daytime" adjustment for the net flow of commuters discussed above.

Housing and Community Development, Parks and Recreation, Protective Inspection and Regulation, and Governmental Administration

These four categories are discussed together because they share common treatment for their workloads. In the ACIR methodology, each is subsumed under the "all other" category and, in effect, assigned population as a workload factor. We have chosen to continue using population as the workload factor (without a "daytime" population adjustment), though we recognize that population may underestimate the workloads in some cases. For example, housing and community workloads would ideally reflect those blighted neighborhood conditions and lack of affordable housing that are more characteristic of urbanized areas than the use of population would indicate. Another example is governmental administration. For an area such as the District, with particularly high workloads per capita for most of its major expenditure functions (e.g., public safety, welfare, health and hospitals), it would seem reasonable to expect that more administrative expenses per capita would be necessary in order to effectively control the larger expenditures and larger numbers of public employees per capita that are needed to contend with the overall high level of workloads.[27] Thus, the workload for the governmental administration category should reflect, to some degree, the overall levels of workloads in other functional areas, and our use of population does not do that.

[27] Of course, as noted earlier, this assumes a given average level of administrative efficiency.

Interest on Debt

We assigned a workload factor equal to the average workload of all other categories (except that the average excludes this category and the "not elsewhere classified" category discussed below). The ACIR method assigned the workload of total resident population to this category. Our modification reflects the fact that the amount of interest owed is directly related to the amount of debt incurred. Everything else the same (e.g., time preferences for debt, revenue-raising capacity, policy decisions about capital investment for public services), the circumstances that ought to determine the amount of debt incurred are the workloads for various expenditure functions and the input costs for them. Thus, for this category, both the workload and input cost measures of each individual state and the District are set equal to the average workload and input costs indexes of all its other functions (e.g., education, welfare, public safety) in that state/the District.[28]

General Expenditures, Not Elsewhere Classified

This category is assigned a workload measure equal to the average workload of every category (except the average excludes this category and the previous one.) Subsumed under "all other" according to the ACIR method, this category was in effect assigned the workload of resident population. The category is largely composed of expenditures on multiple functions that cannot be allocated to a single one, such as centralized purchasing, data processing, and vehicle fleet operations. Our workload measure reflects an averaging of the multiple expenditure categories that obtain goods and services through expenditures for this type of centralized, multifunction expenditure. As with interest on general debt, the workload and input cost measures used for each state and the District are the average workload and input costs index of all its other functions (e.g., education, welfare, public safety). Table 15 summarizes the changes for each function and also the rationale for making those changes.

[28] While input costs indexes are discussed later, we mention it here because the rationale is the same.

Table 15: Modifications of Workload Indicators

Expenditure category	Workload modification	Rationale
Elementary and secondary education	1. To estimate children in poverty, apply a cost-of-living adjustment to the threshold used for determining poverty status. 2. Increase the weight applied to the children in poverty from 0.25 to 0.60.	1. The number of low-income people potentially eligible for public services, in principle, should be measured by a uniform standard independently of differences in costs. This adjustment allows the low-income population to be measured in real dollar terms. 2. Update this parameter to reflect current median state weighting of children in poverty.
Higher education	No change	NA
Medical vendor payments	1. Adjust the threshold of the poverty estimate for cost of living. 2. Weight children, adults, and elderly based on historical cost differences associated with serving these population groupings.	1. See elementary and secondary education 2. These are superior measures of potential workload and the cost of serving these populations.
Other public welfare	Adjust the threshold of the poverty estimate for cost of living.	See elementary and secondary education.
Health and hospitals	Adjust the threshold of the poverty estimate for cost of living.	See elementary and secondary education
Highways	No change	NA
Mass transit subsidies	Use urbanized population, with the "daytime population" adjustment.	Adding mass transit subsidies is intended to capture the fact that general purpose local governments often subsidize mass transit systems as an alternative to more highway building and maintenance. Therefore, including highway spending but ignoring these subsidies understates transportation needs in more urban settings. The use of urbanized population as a workload indicator reflects the role of population density in the typical choice to provide mass transit in an area.
Police	Apply the "daytime population" adjustment to the one-third resident population workload.	Population is used as a workload factor because some police responsibilities have little to do with crime. For such responsibilities, including temporary additions and subtractions to the resident population due to commuting to work seems appropriate.
Corrections	No change	NA
Fire protection	Assign to fire services the workload factors of 40 percent "daytime adjusted" resident population, 50 percent housing units in buildings with five or more units, and 10 percent housing units built prior to 1940.	Alternative workload factors reflect conditions associated with higher costs of providing fire prevention and suppression in dense urban areas. Such higher costs result from differences in equipment, apparatus, and staffing (e.g., greater reliance on professionals rather than volunteers.)
Sewerage	Assign the workload factor of 1990 Census data on housing units connected to a public sewer system, rather than total resident population.	In urban areas such as the District, 100 percent of housing units are connected to a public sewer system. In rural areas, it is a lower percentage because septic tanks are common.
Social insurance administration	The modified workload factor is the number of unemployed.	This category is the administration of the unemployment compensation system, including associated employment services such as job placement and counseling.

(Continued From Previous Page)

Expenditure category	Workload modification	Rationale
• Libraries • Parking facilities • Solid waste management	Resident population with the "daytime population" adjustment.	Adjusting resident population allows for the workload indicator to reflect the impact of the net inflow of workers.
• Housing and community development • Parks and recreation • Protective inspection and regulation • Governmental administration	No change. Resident population (without adjustment) is the workload measure.	NA
Interest on debt	Assigned a workload factor to equal to the average workload of all other categories (except the "not elsewhere classified" category).	The amount of interest owed is directly related to the amount of debt incurred. Everything else the same, the circumstances determining the amount of debt incurred are the workloads for various expenditure functions and the input costs for them. Thus, the overall workloads and input costs indexes for every other function are used.
General expenditures, not elsewhere classified	Assigned a workload factor to equal to the average workload of every category (except the average excludes this category and the previous one).	These expenditures are unallocable to other spending categories because they are multifunction goods and services supplied within state and local governments such as centralized data processing services, a motor pool, and so on. Since these expenditures provide goods and services to other expenditure categories, assigning the average of those workload factors (and the associated input cost indexes too) seems appropriate.

Source: GAO.

Note: GAO analysis of District expenditure data discussed in this appendix.

Modifications to Unit Cost Adjustments

As described above, in the ACIR methodology, the unit cost of public services is measured by a weighted average of an index of labor compensation rates across all industries, and the costs of other inputs used in the production of public services (assumed not to systematically vary across states). In addition, we control for cross-state differences in the age, gender, and educational attainment of the labor force. Adjusting for these differences presumably avoids attributing higher labor costs to governments whose labor forces contain a disproportionately large fraction of older and more expensive workers, such as males with disproportionately high educational attainment. The rationale would be that the cost of a standard worker used in the production of public services would be independent of differences in the composition of the labor force across geographic locations. For each state and expenditure category, the index of labor and nonlabor costs (assumed to be 1.0 for all states) is calculated as the national average labor and nonlabor shares of government expenditures within each spending category.

We modified the above procedure by (1) using an alternative wage index based on place of employment rather than residence, (2) including a proxy for differences in the cost of buildings and related capital assets used to deliver services, (3) for medical vendor payments, using an index of the average private sector wage in the health industry as a proxy for the cost of labor used to deliver services, and (4) for the public welfare function, including a cost-of-living adjustment to reflect the nominal cost of providing a real dollar value of public assistance benefits.

Use of an Alternative Wage Index by Place of Employment

The ACIR method used Census earnings data of residents to generate an index of unit labor costs. That data yield implausibly low estimates for the cost of labor. With an influx of 481,000 workers, according to the 2000 Decennial Census journey to work data, the Census earnings data for the District may not adequately reflect the labor market in which the District government seeks to hire and retain workers. Using 1990 earnings data (the latest available), the District's resident earnings per employee was only 104 percent of the national average. Since this figure appears less than the cost-of-living difference between the District and the nation, these data seem unlikely to reflect the competitive wage the District would have to offer to attract and retain workers. As an alternative, we chose to use Bureau of Labor Statistics (BLS) average wage rates for all private industry (but excluding manufacturing). However, using BLS data, it is not possible to control for the effects of age, gender, and educational attainment.

Include an Index of Capital Cost Differences

In addition to labor, another major input used to provide public services is the office space and related building assets used to deliver services. However, an index of office space costs across states was not readily available. We, therefore, used an index of rents for two-bedroom rental housing units as a proxy for these costs on the assumption that, where the cost of housing is high, office space costs will also be high. The cost of rental housing is currently used as a cost factor in the Substance Abuse and Mental Health Services Block Grant allocation process. The index is calculated from HUD's fair market rents for metropolitan and nonmetropolitan areas for its Section 8 Housing Assistance Program. The data were aggregated to the state level using population to weight data for each area within the state.

The choice of a percentage weighting to be applied to an index of office space costs would, in principle, be determined by this factor's share of total spending in each function. However, the data for this calculation are not readily available. As a rough alternative, we assumed that these costs represent 15 percent of total spending in each category of spending.

Use of Health Industry Wage Costs for Medical Vendor Payments

In principle, the opportunity wage used for each spending category should reflects the mix of skills required for that function; the labor market for educators is different from that for health care professionals. While development of a unique labor cost for each function is beyond the scope of this project, our past work in the health area has resulted in the development of a wage cost factor for health services. Because of its broad coverage of health industry personnel, we used BLS health industry wage data.

Cost-of-Living Adjustment for Cash Assistance in the Public Welfare Category

The basic premise of the RES is that it represents the nominal dollar cost of providing a real level of public service benefits. In the case of cash assistance,[29] the cost of providing a uniform level of real benefits per program beneficiary would reflect differences in the cost of living. For this adjustment, we use the same cost-of-living index described above in connection with measuring the number of people in poverty on a cost-of-living adjusted basis.

Alternative Expenditure Weights

To compute per capita RES amounts by function for the District (and all states), and to compute an overall RES amount as well, a set of national expenditure amounts for each function is needed. These expenditure shares for each category of spending are what provide the RES with the "average basket of services," that is, a set of proportions reflecting average expenditures for each governmental function. Expenditures enter into the RES calculation in order to compute RES amounts in terms of dollars or dollars per capita. While the RES indexes can be computed without expenditures for each of the detailed functions listed in table 15 by multiplying the per capita workload indexes by the respective input cost indexes, the overall RES index for all functions is, in effect, a weighted average of the individual indexes where the weights applied are the shares of total expenditures.

[29] The function in question here excludes medical vendor payments, welfare institutions, in-kind benefits, and welfare administration that are cost adjusted separately, and thus it consists solely of cash amounts paid to program recipients (e.g., under Temporary Assistance for Needy Families and other cash assistance programs.) More specifically, it consists of amounts Census classifies under codes E67 and E68, which exclude any intergovernmental payments (that could include some Medicaid), and exclude in-kind benefits. Also excluded from this category are amounts classified under codes 75 (payments to social service and income maintenance vendor payments), 77 (welfare institutions), and 79 (public employment for all public welfare activities and welfare activities not classified elsewhere).

The original ACIR method used national average spending by function. We basically continue with these weights, although we use a more disaggregated list of expenditure categories. However, we modified the RES expenditure weights in two ways. First, the category of mass transit subsidies was included in the RES while certain expenditure categories that did not pertain to expenditures in the District were removed. Second, as a form of sensitivity analysis, we employed a set of urban expenditure weights to test the degree to which the District's overall RES is sensitive to the expenditure weights chosen.

Modifying Expenditure Categories Included and Excluded from RES

The category of mass transit subsidies is basically excluded from the original ACIR method.[30] Since the District subsidizes transit provided by the Washington Metropolitan Area Transit Authority (WMATA) and does not provide transit itself, we chose to include the transit subsidy but not the full level of such spending. This is a departure from the usual practice under RES and the representative tax system of including consideration of all the governments in the geographic area (including special districts such as WMATA), but we believe that it is important to focus on the District's structural balance without including consideration of WMATA, which is an independent entity.

Had we continued to exclude mass transit from the RES, the effect would have been to make RES less appropriate for application to the District. A number of characteristics of the District make mass transit an important alternative to highway funding:

- Twenty-two percent of the District's total land area is devoted to highways,
- the District's streets and highways are already intensively used (vehicle miles traveled per lane mile of road are 175 percent greater than the national average),
- households with no vehicle available are three times as prevalent in the District as the nation, and

[30] The Rafuse method included only those mass transit subsidies provided to privately-owned transit companies and these were subsumed under the "all other" category with resident population assigned as a workload factor. Such subsidies are 5 percent of total transit subsidies.

- the District has to contend with air pollution problems connected with vehicle emissions.

Thus, we believe it is important that our estimate of the District's RES include transit subsidies. Further, by including only the transit subsidy, we are making a conservative change in terms of its impact on the District's RES amount.

The following detailed Census expenditure functions were eliminated from the RES in order to better reflect a basket of services that the District would actually purchase: state veterans' bonuses and services; miscellaneous commercial activities, not elsewhere classified; air transportation; water transportation; agriculture; fish and game; forestry; and other natural resources.[31] While state governments perform virtually all these functions, local governments and the District do not perform most of them.

Urban Alternative Expenditure Weights

As an alternative to the national expenditure weights, we calculated the aggregate expenditure of all local governments in 20 county areas that had over 250,000 population and population density in excess of 3,000 persons per square mile.[32] Though other methodologies could have been used to choose county areas, we thought this method would provide a simple way to choose areas more similar to the cost and workload characteristics of the District than all the state and local governments in the nation.

[31] While the other categories are relatively straightforward, the category of "other natural resources" is not. Census' classification manual (www.census.gov/govs/www/classfunc59.html) defines it to be "Conservation, promotion, and development of natural resources (soil, water, energy, minerals, etc.) and the regulation of industries which develop, utilize, or affect natural resources." Further, "Examples: Irrigation; drainage; flood control; soil conservation and reclamation including prevention of soil erosion; surveying, development, and regulation of water resources; regulation of mineral resources and related industries including land reclamation; wetlands and watershed management and protection; geological surveying and mapping; regulation of gas and oil drilling and production; dam and reservoir safety; public education programs related to the above; technical and fiscal assistance to private or other governmental efforts in these areas." The District's relatively insignificant workload per capita for such expenditure is undoubtedly a result of its geography: its area is 6 percent of the smallest state and its population density is 8 times the densest state.

[32] New York City was counted as if it were one county. That is, we collected data for the New York City area and 19 other county areas. The expenditure data used are for fiscal year 1997 because these are presently the most current data available by county area.

We adjusted the local government expenditures of these 20 county areas in two ways. First, the share of expenditure for medical vendor payments (Medicaid) is set equal to the state average, because Medicaid is a significant source of state expenditure benefiting these counties and because no data are available on the amounts that state governments directly spend in all these county areas. This increases the percentage share of total expenditures for medical vendor payments from the 0.9 percent actually spent by urban governments to the 10.5 percent that is the national average. Second, to make the per capita RES amounts under the urban alternative comparable to those under the state expenditure weights, we proportionally increased the urban weights so that the per capita RES amount for the nation was equal under either the national weights or the urban alternative weights.

Revenue Capacity Analysis: Methodology and Detailed Estimates

This appendix provides further details on our methodology for estimating the total revenue capacity of the District and the 50 state fiscal systems. In separate sections we explain how we estimated the two components of total revenue capacity: (1) the grants that a fiscal system would receive if it provided an average basket of services and (2) the fiscal system's own-source revenue capacity. At the end of the appendix we provide detailed results from our analyses.

Estimating Grants Associated with Average Services

Our analysis covers those categories of federal grants that are used to fund the types of functions that we covered in our expenditure analysis. Thus, we included grants in the education, employment security administration, general local government support, health and hospitals, highways, housing and community development, public welfare, sewerage, and the "all other" categories. For most of these grants we simply use the actual amounts that state fiscal systems received from the federal government because those amounts are not likely to change significantly in response to changes in state and local spending choices. In the case of the Medicaid program, however, the federal government provides open-ended matching grants to the District and the state fiscal systems and the federal assistance that those fiscal systems receive depends on the decisions that states make regarding the coverage of their Medicaid programs. To estimate the amount of Medicaid grants that each fiscal system would receive if it provided average Medicaid services, we multiplied its actual fiscal year 2000 Medicaid grant by the following ratio: the amount that the system would have to spend in order to provide average Medicaid services, divided by the amount that the system actually spent on Medicaid services.

Using the approach just described, we estimate that the District would have received about $2,700 per capita in federal grants if it had provided average services in fiscal year 2000. This amount was 2.7 times the national average.

Estimating Own-Source Revenue Capacity

This section provides background information on different measures of own-source revenue capacity and describes in detail how we implemented the representative tax system (RTS) approach for this study.

Measures of Own-Source Revenue Capacity

Two general types of measures have been used to estimate the own-source revenue capacity of states—those that use income to measure the ability of governments to fund public services with a standardized tax burden on state residents and those that attempt to measure the amount of revenue that could be raised in each state if a standardized set of tax rates were applied to a specified set of statutory tax bases "typically" used to fund public services. Total taxable resources (TTR), developed by the U.S. Department of the Treasury (Treasury), is a leading example of the first type of measure and the RTS, developed by the Advisory Commission on Intergovernmental Relations (ACIR), is a leading example of the second. Experts disagree as to which approach is superior. Proponents of TTR believe that a measure of revenue capacity should be independent of policy decisions and should avoid judgments about the administrative or political feasibility of taxing particular bases. Proponents of the RTS believe that administrative and political constraints should be taken into account, even though it may be difficult to say what is a constraint and what is a choice. In order to provide as much balance as possible, we will present separate results using both methodologies.

The TTR was designed to overcome limitations of two other indices of aggregate income in a state—state personal income (SPI) and gross state product (GSP). The former accounts for all of the income flows received by residents in a given state, while the latter accounts for all of the income produced in the state. There is considerable overlap between these two measures, but each contains items that are not counted in the other. Since states generally have the ability to tax the income counted in either SPI or GSP, the TTR was developed to count all of the income flows included in either of the two measures, but to count each flow only once.

A typical RTS analysis estimates the per capita tax yield that a uniform, hypothetical, representative set of tax rates would yield if applied to a specified set of statutory tax bases that states typically tax. For each tax a uniform base is defined, which excludes all tax incentives or "tax-breaks," it also excludes items that are rarely taxed in any jurisdiction. The analyst then applies a standard tax rate to each tax base across all of the states. Each rate is set equal to the national average effective tax rate that states actually impose for the particular tax. This average effective tax rate is computed by dividing nationwide state and local tax collections for a particular type of tax (from U.S. Census Bureau data on state and local government finances) by the aggregate tax base (across all state and local governments) for the tax. The result of this computation is that each state's revenue capacity for a particular tax is equal to the total national

collections for that tax, multiplied by the state's share of the national aggregate value for the tax base.

Identified Limitations of the Revenue Capacity Measures

Each approach to estimating revenue capacity has limitations, which are described below. This is one reason that we report results using both approaches. For the most part, both approaches appropriately reflect the atypical constraints on the District's revenue capacity. In order to address several specific concerns raised by District officials or others, we make special adjustments to the District's tax bases in at least one of our scenarios. These adjustments are identified below, in the descriptions of the methodologies we used for the various taxes.

In theory, the TTR should be computed by taking GSP; subtracting out depreciation, federal income and indirect business taxes, and contributions to social insurance; and then adding in various items of income earned outside of the state, along with federal transfers and accrued capital gains. In practice, data are not available to make all of these adjustments.[1] Specifically, depreciation and federal income taxes are not subtracted from GSP because they are not estimated on a GSP-consistent basis. Additionally, it is assumed that all interest and dividend income in SPI is earned out of state and all rent and royalty income is earned in state, and already included in GSP. Social insurance transfers are used in place of total federal transfers, because other components of federal transfers are not estimated on a SPI-consistent basis. Data on net realized capital gains are substituted for accrued capital gains, again due to data availability. One additional limitation of the TTR that has been noted in the literature is that it does not adequately reflect the capacity of states to tax nonresident tourists.

A principal limitation of the RTS is that its estimates of tax potential are distorted by the actual tax policies of states. This occurs because the sizes of the tax bases that are measured by the RTS are influenced by the tax rates that are currently being applied to them. For example, states with relatively high sales tax rates are likely to have smaller sales tax bases than they would with lower sales tax rates because the high rates will encourage consumers to make more purchases out of state. Our analysis of the

[1] For details, see Michael Compson and John Navratil, *An Improved Method for Estimating the Total Taxable Resources of the States*, Research Paper no. 9702 (Washington, D.C.: Office of Economic Policy, U.S. Department of the Treasury, 1997).

District's "tax effort" (the ratio of its actual revenues to its revenue capacity) indicates that, overall, the District's tax rates are higher than average. Therefore, this particular limitation of the methodology is more likely to cause us to underestimate the District's revenue capacity than to overestimate it.

Additional RTS limitations that have been noted in the literature are that:

- Because the size of a state's sales and property tax bases have a strong influence on that state's RTS score, the measure reflects patterns of consumption or resource use in the state, rather than resource availability or purchasing power.
- It does not include all sources of income, such as federal transfer payments.
- It does not reflect the ability of states with higher per capita incomes to pass on larger shares of their tax burden to the federal government (through the deductibility of state income taxes under the federal income tax) than states with lower per capita income.[2]

Our Implementation of the RTS Approach

The scope of our analysis actually falls in between that of a representative tax system study, which covers only taxes, and that of a representative revenue system, which covers all taxes, user charges, and fees. Our analysis covers all state and local government taxes and some of the fees charged by those governments. We exclude certain fees and user charges because they have either already been netted out from our expenditure estimates, or they are linked to private-sector-type services that are not covered by our expenditure analysis.

In the case of some tax bases where there is more than one valid estimation approach or more than one valid choice for a critical assumption, we estimated more than one distribution of the tax base across the states and the District. We computed estimates of total own-source revenue capacity

[2] For further discussions of these issues see Steven M. Barro, "State Fiscal Capacity Measures: a Theoretical Critique," in H. Clive Reeves, ed., *Measuring Fiscal Capacity* (Cambridge, Mass.: Lincoln Institute for Land Policy, 1986), 51-86. And Robert Tannenwald, "Fiscal Disparities Among the States Revisited" in *New England Economic Review* (Boston, Mass.: July/August 1999), 3-25; and Compson and Navratil, "An Improved Method."

for "high" and "low" scenarios. Under the high RTS scenario, for each tax we used the approaches and assumptions that yielded higher estimates of the District's tax bases, relative to those of the states. We did the converse for the low RTS scenario.

In considering the following methodologies one should keep in mind that what we call a "tax base" is not always the same as the statutory definition of the base upon which tax rates are applied. In some cases the "base" is simply a proxy whose distribution across states is expected to be highly correlated with the distribution of the actual tax base across states. An example of this is where we use the distribution of federal estate tax collections across states as a proxy for the distribution of the value of estates across states. What is important for obtaining accurate estimates of each state's revenue capacity for a particular tax is not how close the absolute value of our estimated base for a given state is to that state's actual base, but how close the percentage distribution of our estimated base across states is to the percentage distribution of the actual tax base across states.

Details on Individual Taxes

Property Tax

We used two quite different approaches to estimate the property tax base in the District and each state. Each approach has its own limitations so, as a sensitivity analysis, we present results using both approaches.

Under the first approach, total property value nationwide is estimated from national level data sources as the sum of farm property, corporate property, partnership property, utility property, and residential property. The value of farm property is obtained from U.S. Department of Agriculture state-level data on farm acreage and farm value per acre. Corporate and partnership property value[3] is estimated, by industry at the national level, from the Internal Revenue Service (IRS) for 1999, inflated to its 2000 value and then allocated to the District and the states based upon their shares of state personal income, by industry. National aggregates for utility property (the sum of the gas, electric and telephone industry property) are also obtained from IRS and are allocated to the District and the states based upon the percentage of national capacity (pipelines, telephone lines, etc.) that is located in each jurisdiction.[4] Tax-exempt property owned by governments, embassies, and other tax-exempt entities is not included in our estimated tax base because those entities do not file federal corporate or partnership tax returns.

Residential property is the sum of owner-occupied and rental property values. Owner-occupied residential property value and actual rent paid for rental property is reported, by state and the District, in the 2000 Decennial Census. An estimate of imputed rent for owner-occupied housing is reported in "Housing's Impact on the Economy," *Report of the National Association of Home Builders* submitted to the Millennial Housing Commission, November 2001. We assume that the ratio of property value to rent, imputed or actual, is the same across residential property types. This assumption allows us to arrive at a value for rental property.[5] Given that our empirical estimate for the ratio of property value to rent comes from a single study and that the relative size of the District's property tax base is likely to be overstated if this ratio is overestimated, we computed alternative results with the ratio reduced by half for our lower-bound estimate of the District's property tax capacity.

[3] Corporate and partnership property are comprised of the sum of depreciable assets, depletable assets, and land less accumulated depreciation and depletion.

[4] The 1999 values for corporate, partnership, and utility property are grown to 2000 values using indexes based on national-level data on fixed assets from the Bureau of Economic Analysis.

[5] We solve for x in the following formula: $\frac{x}{\text{actual rent}} = \frac{\text{owner - occupied housing value}}{\text{imputed rent}}$,

where x equals the value of rental property.

A principal limitation of this first approach is the reliance on allocating corporate and partnership to the states using industry-specific state personal income. While we believe that the choice of state personal income to allocate property is sensible and this approach has been used in a prior study, we have been unable to find empirical estimates to support the correlation between distribution of state personal income and the distribution of industry property value. Additional limitations to this approach include the unknown accuracy of self-reported data from the 2000 Decennial Census on rent paid and residential property value and the fact that our estimate for commercial property does not include property owned directly by individuals (rather than through corporations or partnerships).

The second approach for estimating property tax bases involved searching the Web sites of each state and contacting state property tax officials to obtain data on the total value of property in each state. We made a considerable effort to get the data for each state to be as close as possible to our uniform definition, which was: the total market value of all real property in the state, excluding the value of property owned by governments and other entities that are typically exempted from property taxes, but including the value of property owned by individuals who receive homestead exemptions or other forms of property tax relief. We tried to get the data on the market value of all such property, valued as close to January 1, 2000, as possible. We attempted to exclude the value of personal property from our data because the scope of the personal property tax base varied considerably across states and many states do not tax such property. In cases where the property value data were more than one-half year before or after January 1, 2000, we adjusted the values for both price and quantity changes (if both were needed) using indexes based on national-level data on fixed assets from the Bureau of Economic Analysis (BEA).

The principal limitation of this second approach is the fact that we were not able to apply our definition of the property tax base with perfect consistency across all states. For example, the states differed in how they valued agricultural land. Although most states valued this land on the basis of its productive value in agricultural use, some states estimated market values for the land. We were unable to adjust for these differences and simply used the values provided by the states. More important, we could not obtain adequate property value data from 5 states. We estimated the "state-reported" data for those states by multiplying the estimates that we obtained for those states with our first approach by the following ratio: the

aggregate state-reported market value for the 45 other states and the District, divided by the aggregate property value for those 45 states and the District as estimated with our first approach.

Personal Income Tax

We calculate two different estimates of the tax base for the personal income tax. Both of the estimates are based on federal tax return data for 2000, as reported by IRS' statistics of income. We start with the aggregate adjusted gross income that IRS reports by state and we add back in the aggregate adjustments to obtain an aggregate measure of gross income for each state. Then we subtract the aggregate value of personal exemptions that were claimed in each state. We use the resulting figures as one measure of the potential personal income tax base for states. For an alternative measure we take our first set of figures and subtract an estimate of the aggregate amount of deductions claimed in each state. We adjust each set of estimates using BEA's residence adjustment (in the same manner followed by ACIR (1993) and Tannenwald (1999)) to reflect the fact that states typically tax the income that nonresidents earn within their boundaries and provide credits to their own residents for income taxes that they pay to other states. No residency adjustment is made for the District because it is prohibited from taxing the income of nonresidents.

In response to concerns raised by District officials, we also examined how the District's personal income tax capacity would change if we used state personal income, reported by BEA, as a proxy for the tax base, instead of the income data from federal tax returns. The District officials were concerned that the use of federal tax data, which are allocated to states and the District on the basis of the addresses provided on the tax returns, would overstate the District's tax base because they believed that a substantial number of nonresidents used tax preparers in the District and used the latter's addresses on their returns. The District officials could provide no data to substantiate this concern. In any case, the substitution of state personal income resulted in a higher estimated personal income tax capacity for the District.

General Sales and Gross Receipts Taxes

Our starting point for estimating the general sales and gross receipts tax base were 2000 U.S. Census Bureau (Census) data on sales of the retail trade and service industries, which comprise most of the base of state and local general sales taxes. These Census data were disaggregated by the industries defined in the North American Industry Classification System

(NAICS). We included those NAICS sectors that are taxed under the general sales taxes of most states.

Census provides a state-by-state disaggregation of sales only every 5 years. The latest available disaggregation is for 1997.[6] Consequently, we needed to allocate the sales across states, either by applying the 1997 state percentage shares to the 2000 sales data, or by distributing the sales in proportion to employment, by state, in the retail and services industries.[7] We had no way to determine which approach is more accurate, so we present results using each approach.

Approximately 5 percent of sales in the retail sector are "nonstore" sales. Two-thirds of the nonstore sales are remote (mail order or Internet) sales; the remainder are sales by direct sellers. Given that states have difficulty collecting tax on remote sales in cases where the purchasers are individuals (rather than businesses) and the sellers do not have legal nexus in the state of the purchasers, we count only a fraction of such sales in our tax base.[8] Because we do not know what percent of the total remote sales are purchased by individuals and sold by retailers that do not have nexus, we cannot say precisely what share of these sales are effectively not taxable by state and local governments. We present results using the alternative assumptions that 25 and 50 percent of the remote sales are taxable.

[6] The two most recent state-by-state disaggregations of sales are available in the 1992 Economic Census and 1997 Economic Census, both of which are reported by the U.S. Census Bureau. The next edition of the Economic Census will capture conditions in 2002 and is expected to be released in early 2004.

[7] Brian D. Francis, *The Feasibility of State Corporate Data Internal Revenue Service, Statistics of Income Division* (Washington, D.C.: March 2000), provides empirical evidence that the distributions of sales and employment across states in the retail and services industries are highly correlated. For this employment-based approach, we made separate distributions for the retail sales, accommodations, and food services categories, which account for over 90 percent of the sales included in our tax base. These are categories in which one would expect a high correlation between location of employees and destination of sales or services. For the remaining category of sales, we used the 1997 percentage distribution of sales. The state-level data on employment by industry come from the Census county business patterns.

[8] We treat sales by direct sellers the same as we treat in-store sellers because we presume that the direct sellers have nexus in the state of their customers. For more information on states' difficulties with remote sales, see U.S. General Accounting Office, *Sales Taxes: Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain*, GAO/GGD/OCE-00-165 (Washington, D.C.: June 2000). We use only the extrapolation, not the employment distribution approach, for estimating state-level nonstore sales in 2000.

One limitation of the Census data for our purposes is that they do not cover sales to business purchasers by industries other than the retail and services industries. Some of these missing sales are taxable, while others are exempt. Unlike the case of retail and service sales, the exemptions of other business-to-business sales are typically dependent on the nature of the purchaser and/or the use that is made of the product or service purchased. Adequate data are not available on the purchasers or uses made of the sales by other industries, so we could not reliably estimate the proportion of those sales that would be taxable. For this reason, we excluded all such sales from our estimated tax base. This data limitation means that our distribution of general sales tax capacity across the states will be inaccurate to the extent that the missing business-to-business sales are distributed in different proportions than are the sales of the retail and services industries.

One concern that District officials have raised about our method for estimating the sales tax base is that our data include nontaxable sales to the federal government. If sales to the federal government are included, then the District's sales tax base may be overstated relative to those of the states because of the disproportionate federal presence in the District. We do not know the extent to which sales to the federal government are represented in the Census sales data because these data are not classified by type of purchaser and District officials had no information that would help us estimate the extent of such sales in the District.

We used data from the Federal Procurement Data System (FPDS) to get at least a rough idea of the magnitude of purchases by the federal government in the District and in each state, so that we could subtract those purchases from our estimated tax base. The FPDS purchase data available to us were distributed across states and across industrial sectors, but they were not distributed across both states and sectors at the same time. Therefore, we had to make the simplifying assumption that the percentage distribution of the purchases across sectors was the same in all jurisdictions (even though the absolute amount of purchases varied considerably). As we did with Census data, we determined which of the purchases are typically subject to general sales taxes (if sold to the private sector) on a sector-by-sector basis. We then subtracted these "taxable" sales to the federal government from our estimated sales tax base for each fiscal system. Given uncertainty regarding the categories of sales that would be subject to tax, we used two different selections of categories—a narrower selection that led us to subtract an amount equal to about 0.4 percent of District-based federal procurement from the base and a broader selection that led us to subtract an amount equal to about 3.0 percent of that procurement.[9]

[9] Our narrower selection included retail trade, personal services, hotels, motion pictures, amusement, and telecom services. In addition to the preceding categories, our broader selection included wholesale trade, furniture, and equipment and computers. The procurement is categorized on the basis of the seller's line of business. Even though sales by wholesalers to retailers generally are not taxed, some sales by wholesalers to final business purchasers are taxed. Although we do not include nonretail business-to-business sales in our tax base proxy (because we have no reliable means of estimating the taxable amounts of those sales and because we have no reason to believe that their exclusion would cause a significant over- or underestimate of the relative size of the District's sales tax base), we felt that ignoring the business-to-government sales in the District would result in greater inaccuracy than if we made this rough adjustment for those sales. However, in order to correct for the inconsistency of subtracting some nonretail sales to government from a tax base that does not include nonretail sales, we multiplied the nonretail sales to government by the following ratio: our aggregate retail sales tax base / (our aggregate retail sales tax base + sales in the nonretail categories included in our procurement adjustment).

A second concern that District officials have raised about our method for estimating the sales tax base is that our data include nontaxable sales to embassies and military personnel. To the extent that these sales are included, our estimate of the District's sales tax base may be overstated, relative to those of the states, because of the disproportionate presence of embassies and military personnel in the District. A 1995 study by the District included an estimate of the District's revenue loss due to the sales and excise tax exemption for sales to embassies and military personnel.[10] We are unable to assess the accuracy of the District's estimate but, lacking any other relevant information, we use their estimate to adjust our lower estimate of the District's sales tax capacity. We do this by assuming that the exempted sales are in the same proportion to total taxable sales as they were in 1995.

Corporate Income Tax

The tax base proxy for the corporate income tax is corporate profits in 2000, as reported by BEA. These data are not available on a state-by-state basis, so we needed to estimate the allocation across states. The profits data are disaggregated by industry and we allocated each industry's profits across the states on the basis of each state's share of national industry payroll. We make one District-specific adjustment to this methodology to subtract out the estimated payroll of two government-sponsored enterprises (GSEs) that have disproportionate presences in the District.[11] Given that state and local governments are not permitted to tax the profits of GSEs, it would not be appropriate to allocate taxable profits to the District on the basis of GSEs' payrolls. We estimate the District's portion of GSEs' payrolls using information from their financial statements and from the District's 1995 study of tax exemptions. We then subtract these amounts from the District's share of the financial services industry's total payroll.

[10] 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).

[11] The two GSEs that we adjust for are the Federal National Mortgage Association (Fannie Mae) and SLM Corporation (Sallie Mae).

Selected Sales Taxes

Motor Fuel	The base for selected sales taxes on motor fuels is the net volume of all motor fuels taxed by each state in 2000 as reported by the U.S. Department of Transportation, Federal Highway Administration.
Public Utility	The base for selected sales taxes on public utilities is the sum of gas, electric, and telephone revenue by state in 2000 as reported by the American Gas Association, the U.S. Department of Energy's Energy Information Administration, and the Federal Communications Commission, respectively.
Insurance	The base for selected sales taxes on insurance is the sum of premiums, by state, for life insurance and property/casualty insurance for 2000 reported by the American Council of Life Insurers and the Insurance Information Institute, respectively.
Tobacco	The base for selected sales taxes on tobacco is number of packs of cigarettes sold by state in 2000. Per capita information is provided by the National Center for Chronic Disease Prevention and Health Promotion, Tobacco Information and Prevention Source and inflated to totals using Census population data.
Alcoholic Beverages	The base for selected sales taxes on alcohol is the sum of wine, malt beverage and spirits sales by volume, by state, in 2000 as reported by the Beer Institute.
Amusements	The base for selected sales taxes on amusements is the sum of spending on arts, entertainment, recreation, motion pictures, and exhibitions minus the sum of spending on promoters of performing arts; sports and similar events; agents/managers for artists, athletes, and other public figures; independent artists, writers and performers and coin operated amusement devices (except slots) for 2000 from Census.

Parimutuels	The tax base for selected sales taxes on parimutuels is gross parimutuel wagering by state in 1997.[12]

Licenses

Motor Vehicle Registration	The tax base for motor vehicle registrations is the sum of motor vehicle and motorcycles registered, by state, in 2000, as reported by the U.S. Department of Transportation, Federal Highway Administration.
Motor Vehicle Operators	The tax base for motor vehicle licenses is the number of drivers licenses, by state, in 2000, as reported by the U.S. Department of Transportation, Federal Highway Administration.
Corporations	The tax base for corporate licenses is the number of corporate returns filed, by state, in 2000 as reported in "Internal Revenue Service Data Book 2000."
Hunting and Fishing	The tax base for hunting and fishing licenses is the number of hunting and fishing licenses sold, by state, for 2000 as reported by Automated Wildlife Data Systems using U.S. Fish and Wildlife Service information.

Estate and Gift Tax	The tax base for state-level estate and gift taxes is 2000 federal estate and gift tax collections, by state, reported in "Internal Revenue Service Data Book 2000."
Severance Tax	The tax base for severance taxes is the sum of the value of oil, coal, natural gas, and nonfuel mineral production, by state, for 2000. Nonfuel mineral production value is from the U.S. Geological Survey. All of the remaining information was reported by the U.S. Department of Energy, Energy Information Administration.

[12] The tax base used in Robert Tannenwald, *Interstate Fiscal Disparity in 1997*, *New England Economic Review*, (Boston, MA: Third Quarter, 2002) for parimutuels is sourced to Christian Capital Advisors LLC., "Table 3: 1997 Gross Wagering by State," *International Gaming and Wagering Business* (1997). We did not attempt to verify these figures.

User Charges and Special Assessments

The tax base for user charges and special assessments is state personal income, by state, of residence, from BEA for 2000.

Rents and Royalties

The tax base for rents and royalties is the actual receipts of rent and royalty taxes, by state, in 2000 from Census. This tax base was chosen because of the inherent difficulty in determining the state in which the rent or royalty actually takes place. The accuracy of this proxy for the actual tax base rests, in large part, on the assumption that, for each state, inflows and outflows are equal.

All Other Revenues

This category captures a variety of revenue sources that are either small or sporadically levied by the states, including lottery revenue. The tax base for this category is state personal income by state of residence from BEA for 2000.

Resulting Estimates of the District's Own-Source Revenue Capacity

Table 16 presents our lowest and highest RTS estimates (using the range of assumptions and approaches described above) of the District's revenue capacity for specific sources of revenue. We present the estimates in per capita dollar amounts and as indexes (where the national average capacity equals 100). We also show how the District's capacity would rank against the 50 state fiscal systems. Our "low" estimate of the District total own-source revenue capacity combines our lowest estimates for all of the revenue sources; our "high" estimate combines our highest estimates for all of the revenue sources. The dollar amounts represent how much the District could raise by applying national average tax rates to its estimated tax bases, multiplied by a small adjustment factor.[13] We also computed a

[13] The national average tax rate for each revenue source is computed as: (the aggregate amount of actual revenue collected by all state and local governments from that source) / (the aggregate value of the estimated tax bases for all of the state and District fiscal systems for that source). Each of these average tax rates was then multiplied by 0.9657. This latter adjustment is needed to make state and local budgets balance (in the aggregate) for fiscal year 2000. The aggregate value of actual state and local expenditures that we used when computing our RES estimates was less than the sum of the aggregate values of state and local own-source revenue, plus federal grants.

third estimate of own-source revenue capacity for the District based on the Treasury's estimates of the TTR.[14] The per capita value for this estimate was $5,684, the index value was 134, and the District's value was higher than that of any state fiscal system, except for Connecticut.

Table 16: RTS Estimates of the District's Own-Source Revenue Capacity

	"Low" estimates			"High" estimates		
Revenue source	**Per capita amount**	**Index**	**Rank**	**Per capita amount**	**Index**	**Rank**
Property tax	$1,108	130	3	$1,426	167	2
Personal income tax	940	129	3	946	130	3
Sales and gross receipts taxes	882	89	50	971	98	32
Corporate income tax	199	161	3	199	161	3
Other taxes	227	119	7	227	119	7
Nontax revenue	1,684	126	2	1,684	126	2
Total own-source revenue capacity	**$5,039**	119	4	**$5,445**	129	3

Source: GAO.

Note: GAO analysis of data from the methodologies described in this appendix.

[14] The TTR is a measure of taxable resources and is not expressed in terms of how much revenue can be raised from those resources. In order to facilitate comparisons with our RTS estimates, we took the same aggregate amount of state and local own-source revenue that we used in our RTS approach and distributed that amount across the fiscal systems in proportion to each system's share of aggregate TTR.

Computation of the District's Structural Deficit

This appendix explains how we used the estimates of the District's per capita cost of providing an average level of expenditures (presented in table 5) and per capita total revenue capacity (presented in app. II) to compute estimates of its aggregate structural deficit. It also provides a comparison of the District's structural deficit to those of the state systems with the largest structural deficits, as percentages of own-source revenues.

The Structural Deficit Computation

As discussed above, a fiscal system has a structural deficit when its cost of providing an average level of services exceeds its total revenue capacity. Most of our quantitative analysis was conducted in per capita terms. However, to compute the structural deficit or surplus for each fiscal system, we needed to inflate the per capita estimates of costs and total revenue-raising capacities to aggregate levels by multiplying our estimates for each fiscal system by that system's population.[1] We then subtracted each system's aggregate total revenue capacity from its aggregate cost to determine the size of its deficit or surplus.

We obtained our lowest estimate of the District's structural deficit ($470 million) by taking the difference between our lower estimate of DC's cost of services ($5,272 million), based on the state basket of services and our higher estimate of total revenue capacity ($4,802 million). That estimate of total revenue capacity was the sum of our highest estimate for the District's own-source revenue capacity ($3,251 million), based on the TTR approach, and our estimate of the amount of grants that the District would have received ($1,551 million) if it provided an average level of services. Table 17 summarizes this computation as well as the computation of our highest estimate of the Districts' structural deficit.

[1] Estimates of the District's per capita costs of providing an average level of services are reported in table 5. Total revenue capacity is the sum of representative grants and own-source revenue capacity; estimates for both of these components are reported in per capita terms in app. II. Apps. I and II describe the methodologies we used to make these per capita estimates.

Table 17: Computation of the District's Structural Deficit under Alternative Estimation Approaches, Using Fiscal Year 2000 Data

Dollars in millions

	Computation			
Estimation approach	Cost of an average level of services	Own-source revenue capacity	Federal grants	Structural deficit
State services basket; TTR for revenue capacity	$5,272	$3,251	$1,551	**$470**
Urban services basket; "Low" RTS for revenue capacity	$5,597	$2,883	$1,551	**$1,163**

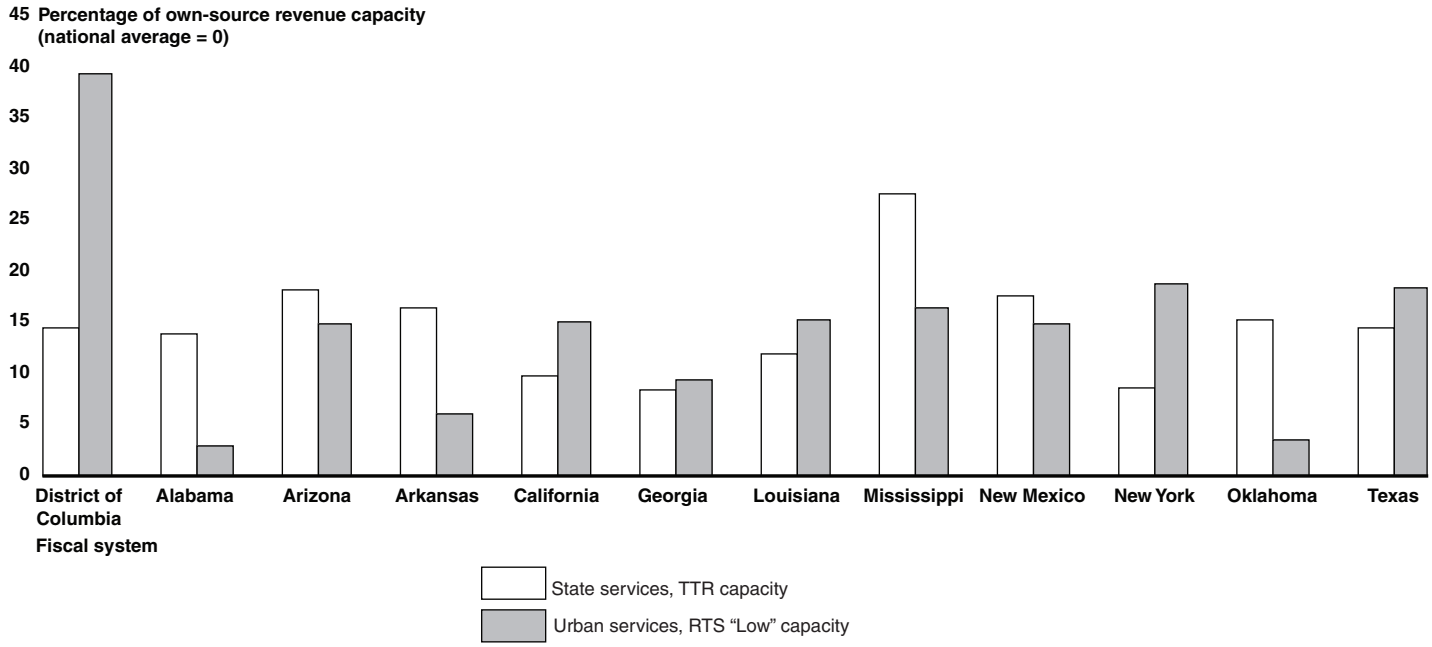
Source: GAO.

Note: GAO analysis of methodologies described in apps. I and II.

Deficit as a Percentage of Own-Source Revenue Capacity

Figure 10 shows how the District's structural deficit compares to the state systems with the largest structural deficits as a percentage of own-source revenues. The figure shows that, if the District's actual structural deficit is close to our lower estimate, then it is not much different than the deficits of most of the state fiscal systems in the top 10 as a percentage of own-source revenue capacity. However, if the District's actual structural deficit is close to our higher estimate, then it is much larger as a percentage of own-source revenue than the deficits of any state fiscal system.

Figure 10: Fiscal Systems with the Largest Structural Deficits as a Percentage of Own-Source Revenue Capacity



Source: GAO.

Note: GAO analysis based on methodologies described in apps. I and II.

The District's Deferred Maintenance and Acquisitions Projects

Table 18: The District's Capital Improvement Program: Deferred Maintenance Projects and Costs for Fiscal Year 2003 and Fiscal Years 2003 through 2008

Project name	Agency 1-year request for fiscal year 2003	Agency 6-year request for fiscal years 2003-2008
Office of Property Management		
D.C. Warehouse - Mechanical Upgrade	$470,000	$720,000
Recorder of Deeds - Complete Modernization	0	4,640,000
Government Centers - New DMV Facility	2,500,000	7,500,000
Government Centers - Improve Property Management ITS	0	4,500,000
Government Centers - Government Centers	15,000,000	15,000,000
Subtotal	**$17,970,000**	**$32,360,000**
Office of the Chief Financial Officer		
410 E Street Renovation	$1,235,000	$9,000,000
Subtotal	**$1,235,000**	**$9,000,000**
Office of the Secretary		
Archives Project - Modernization/Renovation	0	$3,386,000
Subtotal	**0**	**$3,386,000**
Metropolitan Police Department		
3rd District Station New Building - Mod/Renovation	$7,739,874	$12,571,902
6th District Station New Building - Mod/Renovation	7,739,874	12,571,902
Municipal Center Renovation	16,243,034	86,873,258
Evidentiary Property Warehouse	5,053,726	5,053,726
SOD Consolidation New Building	12,475,070	20,472,353
Multi-Function Facility	5,259,842	5,259,842
Subtotal	**$54,511,420**	**$142,802,983**
Fire and Emergency Medical Services Department		
Engine 5 - Complete Renovation/Modern's	$569,320	$2,724,919
Engine 12 - Haz Mat Unit Facility	263,386	491,771
Disaster Vehicle Facility	1,083,397	2,088,094
Subtotal	**$1,916,103**	**$5,304,784**
Department of Corrections		
Exterior Structural Finishing	$136,500	$1,184,000
Storage Space Const. Outside R&D	4,005,000	4,005,000

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Project name	Agency 1-year request for fiscal year 2003	Agency 6-year request for fiscal years 2003-2008
Lot Adjacent to CDF Parking Lot Construction	708,000	7,104,000
Subtotal	**$4,849,500**	**$12,293,000**
District of Columbia Public Schools		
Distribution Piping Upgrade	$27,257,986	$245,321,872
Terminal Unit Systems	13,642,583	122,783,250
Heating Plant Replacement	24,768,994	222,920,944
Boiler Plant Overhauls	2,172,598	19,553,380
Central Air Handling Systems	4,172,078	37,548,699
Cooling Plant Replacement	7,574,589	68,171,302
Generator System Replacement	1,547,771	13,929,935
Electrical System Replacement	1,019,168	9,172,509
Fire Alarm, Intercom, Master Clock Upgrades	35,977,562	323,798,054
Corrective Maintenance (Carpentry, Welding, Plumbing etc)	7,193,651	64,742,858
Corrective Maintenance (Grounds)	684,461	6,160,153
Subtotal	**$126,011,440**	**$1,134,102,956**
University of the District of Columbia		
Building 46E Auditorium	$550,000	$6,650,000
Building 32 - Cooling Plants - HVAC	223,000	1,846,000
Building 38 - Cooling Plants - HVAC	165,000	2,142,000
Building 39 - Cooling Plants - HVAC	165,000	2,142,000
Building 41 - Cooling Plants - HVAC	165,000	2,142,000
Building 42 - Cooling Plants - HVAC	223,000	1,846,000
Building 44 - Cooling Plants - HVAC	200,000	800,000
Building 46W - Cooling Plants - HVAC	125,000	900,000
Building 47 - Cooling Plants - HVAC	130,000	970,000
Subtotal	**$1,946,000**	**$19,438,000**
Department of Parks and Recreation		
Lammond Recreation Center	$1,807,000	$4,432,000
Mitchell Park Renovations	1,940,000	1,940,000
Aquatic Center New Construction	1,317,000	4,600,000
Douglas Recreation/Aquatic	1,680,000	10,272,000
Georgetown Pool Renovations	2,445,000	2,445,000
General Improvements Mitchell Park	200,000	1,000,000

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Project name	Agency 1-year request for fiscal year 2003	Agency 6-year request for fiscal years 2003-2008
Subtotal	**$9,389,000**	**$24,689,000**
Department of Health		
JB Johnson Facility - Renovation	0	$705,000
Asbestos Abatement - Asbestos Abatement	$1,000,000	3,000,000
Lighting System Retrofit	1,200,000	1,200,000
Fire Alarm Systems - Fire Alarm Systems	650,000	850,000
Security Monitoring System	450,000	450,000
Chiller Room Ceiling	460,000	460,000
Upgrade Mechanical Air Duct System	850,000	1,000,000
Plumbing System Upgrade	485,000	1,000,000
Building Renovation	550,000	550,000
Elevator Modernization 28 & 29	50,000	50,000
Subtotal	**$5,695,000**	**$9,265,000**
Department of Human Services		
Bundy School Upgrade	$3,000,000	$3,000,000
Blair Shelter - Complete Modernization	175,000	1,288,000
Crummel School	0	4,417,000
Subtotal	**$3,175,000**	**$8,705,000**
Department of Public Works		
Snow Equipment Dry Storage Building	$425,000	$4,935,000
Recycling Collection Expansion	3,370,400	4,270,400
Sweeper Repair and Storage Garage	2,340,000	3,600,000
Packer Storage Facility @ W Va Ave., NE	2,100,000	20,000,000
Subtotal	**$8,235,400**	**$32,805,400**
Department of Mental Health		
Elevator Modernization	$2,000,000	$2,000,000
Renovation - HVAC	4,500,000	4,500,000
Tunnel Repair - Structural Work	500,000	500,000
North Center Repair/Replacement	14,400,000	14,400,000
Replace Generator - Emergency System	100,000	100,000
Allison Relocation - Site Preparation	1,742,000	1,752,150
Subtotal	**$23,242,000**	**$23,252,150**
Department of Transportation		
Bridge Rehabilitation	$78,000,000	$470,000,000
Series Street Light Conversion	4,000,000	21,000,000

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Project name	Agency 1-year request for fiscal year 2003	Agency 6-year request for fiscal years 2003-2008
Street Light Pole Replacement	750,000	4,500,000
Alley Paving and Sidewalk	25,000,000	125,000,000
Street Resurfacing	5,000,000	25,000,000
Subtotal	**$112,750,000**	**$645,500,000**
Office of the Chief Technology Officer		
Tech City - Infrastructure Support System	0	$9,100,000
Share Facility Upgrade	0	800,000
Subtotal	**0**	**$9,900,000**
Total	**$370,925,863**	**$2,112,804,273**

Source: District of Columbia, Office of the Chief Financial Officer, Office of Budget and Planning.

Table 19: The District's Capital Improvement Program: Deferred Acquisitions Projects for Fiscal Year 2003 and Fiscal Years 2003 through 2008

Project name	Agency acquisition costs – 1-year request – fiscal year 2003	Agency acquisition costs - 6-year request- fiscal years 2003-2008
Emergency Management Agency		
Mobile Command Vehicle and Technology	$302,000	$302,000
Backup Emergency Operation Center	2,000,000	2,000,000
Subtotal	**$2,302,000**	**$2,302,000**
D.C. Public Library		
Digital Dimension of the 21st Century Library	$275,000	$2,275,000
Subtotal	**$275,000**	**$2,275,000**
Metropolitan Police Department		
IT-Automatic Personnel Locator	$2,000,000	$3,250,000
IT-MDC Index Fingerprinting	1,800,000	7,780,000
Subtotal	**$3,800,000**	**$11,030,000**
Fire and Emergency Medical Services Department		
800Mhz Metro Radio System	$4,500,000	$4,500,000
Subtotal	**$4,500,000**	**$4,500,000**
Department of Human Services		

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Project name	Agency acquisition costs – 1-year request – fiscal year 2003	Agency acquisition costs - 6-year request- fiscal years 2003-2008
Low Income Family Units - Site Acquisition	$1,500,000	$6,000,000
Acquire New Site for LaCasa Shelter	2,560,000	2,560,000
Subtotal	**$4,060,000**	**$8,560,000**
Department of Public Works		
Snow Event Management System	$1,315,000	$1,315,000
Subtotal	**$1,315,000**	**$1,315,000**
Department of Mental Health		
Procurement Systems and Implementation	$1,540,000	$3,000,000
Subtotal	**$1,540,000**	**$3,000,000**
Total	**$17,792,000**	**$32,982,000**

Source: District of Columbia, Office of the Chief Financial Officer, Office of Budget and Planning.

Information Related to the District's Debt

Table 20: The District's Total Outstanding General Obligation Debt

Dollars in thousands

	Fiscal years							
	1995	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
General obligation debt	$3,157,003	$2,965,756	$3,084,763	$3,091,403	$3,098,582	$3,109,728	$2,582,017	$2,670,573
Water & Sewer Authority	323,172	303,719	282,100	114,122	107,662	100,147	95,296	79,070
Total GO debt	**$3,480,175**	**$3,269,475**	**$3,366,863**	**$3,205,525**	**$3,206,244**	**$3,209,875**	**$2,677,313**	**$2,749,643**

Source: District of Columbia *Fiscal Year 2002 Comprehensive Annual Financial Report* (January 27, 2003).

Table 21: The District's Debt Per Capita for Fiscal Years 1995 through 2002 (Actual)

Year	Total general obligation debt ($000s)	Population	Debt per capita ($)
1995	$3,480,175	552,466	$6,299
1996	3,269,475	539,646	6,059
1997	3,366,863	529,895	6,354
1998	3,205,525	523,124	6,128
1999	3,206,244	519,100	6,177
2000	3,209,875	572,059	5,611
2001	2,677,313	571,822	4,682
2002	2,749,643	570,898	4,816

Source: District of Columbia *Fiscal Year 2002 Comprehensive Annual Financial Report* (January 27, 2003).

Table 22: The District's Percentage of Debt Service to General Fund Expenditures for Fiscal Years 1995 through 2002 (Actual) and 2003 through 2006 (Projected)

	Debt service costs					
Year	**Principal**	**Interest**	**Fiscal charges**	**Total**	**General fund expenditures**	**Percentage of debt service to general fund expenditures**
1995	$157,308	$184,510	$3,077	**$344,895**	$4,395,388	7.85
1996	191,247	173,807	2,650	**$367,704**	4,486,273	8.20
1997	207,903	174,085	13,567	**$395,555**	4,290,397	9.22
1998	219,435	171,430	8,997	**$399,862**	3,964,246	10.09
1999	261,534	191,903	6,597	**$460,034**	4,597,628	10.01

(Continued From Previous Page)

	Debt service costs					
Year	Principal	Interest	Fiscal charges	Total	General fund expenditures	Percentage of debt service to general fund expenditures
2000	220,054	172,326	2,732	**$395,112**	5,064,215	7.80
2001	108,725	146,043	3,134	**$257,902**	5,387,695	4.79
2002	131,750	135,688	4,744	**$272,182**	5,317,459	5.12
2003[a]	137,880	166,871	N/A	**$304,751**		
2004[a]	166,320	173,042	N/A	**$339,362**		
2005[a]	181,165	189,352	N/A	**$370,517**		
2006[a]	195,005	206,427	N/A	**$401,432**		

Source: District of Columbia *Fiscal Year 2002 Comprehensive Annual Financial Report* (January 27, 2003).

[a]These numbers are estimates.

Table 23: The District's Percentage of Debt Service Costs to General Fund Revenues for Fiscal Years 1995 through 2002 (Actual) and 2003 through 2006 (Projected)

	Debt service				
Year	Principal	Interest	Total	General fund revenues (local funds) ($000s)	Percentage of debt service to general fund revenues
1995	$157,308	$184,510	**$341,818**	$2,729,112	12.52
1996	191,247	173,807	**$365,054**	2,831,637	12.89
1997	207,903	174,085	**$381,988**	2,904,530	13.15
1998	219,435	171,430	**$390,865**	3,177,932	12.30
1999	261,534	191,903	**$453,437**	3,436,873	13.19
2000	220,054	172,326	**$392,380**	3,616,116	10.85
2001	108,725	146,043	**$254,768**	3,853,610	6.61
2002	131,750	135,688	**$267,438**	3,666,604	7.29
2003[a]	137,880	166,871	**$304,751**	3,654,072	8.34
2004[a]	166,320	173,042	**$339,362**	3,703,308	9.16
2005[a]	181,165	189,352	**$370,517**	3,906,512	9.48
2006[a]	195,005	206,427	**$401,432**	4,063,889	9.88

Source: District of Columbia *Fiscal Year 2002 Comprehensive Annual Financial Report* (January 27, 2003).

Note: Percentage of debt service costs to revenues is a common measure used by local governments to measure a municipality's capacity to issue debt.

[a]These numbers are estimates.

Comments from the District of Columbia

GOVERNMENT OF THE DISTRICT OF COLUMBIA
OFFICE OF THE CHIEF FINANCIAL OFFICER

Natwar M. Gandhi
Chief Financial Officer

May 9, 2003

Ms. Patricia A. Dalton
Director, Strategic Issues
General Accounting Office
441 G St, NW
Washington, DC 20548

Dear Ms. Dalton:

In your draft report on Structural Imbalance and Management Issues in the District of Columbia (GAO-03-666), the General Accounting Office (GAO) adapts public sector quantitative analysis methodologies to reach important findings about the District of Columbia's fiscal circumstances. The innovative effort to adapt these methodologies to the District's unique government and fiscal status is a significant achievement. The Office of the Chief Financial Officer of the District of Columbia agrees with all key findings in the draft report. Further, we have discussed the report and findings with the Mayor who also concurs in the report's findings. Our comments herein reflect the observations of the Mayor and his staff as well as our own views.

This draft report should prove enormously helpful to the Congress and others in understanding and solving long-standing structural problems with District finances. These matters must be addressed with some urgency to assure the long-term financial viability of the nation's capital city.

The draft report steps back from the details of individual programs or tax policies to compare the District's revenue and spending environment with that of other jurisdictions in the United States, using standard measures of revenue capacity and spending needs applied to each jurisdiction's specific demographic, economic, and labor market features. In this way, it excludes the impact of policy choices that might increase or decrease either revenue or spending. The result is comparisons that are as fair and objective as can be accomplished given the unique nature of the District of Columbia within the U.S. government structure of the United States.

The draft report reaches three major conclusions.

I. The report confirms the existence of a structural deficit in the District. We concur.

The GAO's analysis supports the District's and other independent analyses that the District faces an endemic structural imbalance, and calculates this deficit to be between $470 million

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and $1.1 billion annually based on FY 2000 information. It would appear to us that this imbalance is likely more toward the upper end of this range because of the District's urban character, a fact noted in the report. While noting that there is no empirical way to determine a specific estimate, the report is clear that there is a structural imbalance, it is substantial, and it adversely affects the ability of the District of Columbia to provide high quality services in the District of Columbia.

At the current time, state and local governments throughout the nation are struggling with cutting expenditures or raising taxes in order to keep their budgets in balance. The District, too, is caught up in this situation in making sure that its FY 2003 and FY 2004 budgets are in balance. These budget difficulties faced by the District and other governments are cyclical. While the current economic downturn exacerbates our structural imbalance, the report is clear that the imbalance is present irrespective of prevailing economic conditions.

II. The draft report clarifies four fundamental features of the District's fiscal problems which we agree are present.

1. The District's expenditure requirements for providing a standard group of services are far higher than any state fiscal system. Total expenditure requirements are much higher than the average state, and more than one third higher than those of the next highest state. The District faces these high expenditure requirements because it provides public services in a market with high labor costs, it provides services to a large commuter population, and it has many residents with high service needs. Although the draft report identifies areas where the District has the potential to improve the efficiency of operations, the District's higher costs are determined by factors beyond its control that are based on the provision of an average level of services.

2. The District taxes itself very heavily. The District's tax effort is as much as 33 percent higher than the average state. Although the District's tax capacity is large-- more than 47% above the national average--because of its large expenditure requirements, the District must compensate with a tax effort that is among the highest, if not *the* highest, in the nation. In fact, the District raises between $600 and $950 million more annually on the D.C. tax base than it would raise with an average tax effort.

3. Even with high taxes, the District cannot pay for average levels of service to residents, commuters, and visitors. Although the District's capacity to raise revenue is much higher than average, this additional capacity is not enough to compensate for the District's higher expenditure burden. The draft report suggests that the District's high tax effort is insufficient to pay for an urban-oriented basket of services given the District's population characteristics. The current tax effort is just barely enough to pay for an average level of a state-type basket of services, but the draft report points out that neither the urban nor state bundle estimates incorporates the millions of dollars that the District must pay for because it is the nation's capital. Nor do the estimates factor in the costs of providing services to tourists or the legal obligations that raise costs in the District's special education program.

4. The District has a serious infrastructure problem. The District faces an accumulated infrastructure backlog of $2.5 billion. The District has deferred capital investment to avert the operating costs associated with debt service. For example, in FY 2003 alone, the District trimmed $250 million in planned capital expenditures. The problem is acute because additional borrowing could raise outstanding debt above the levels that are acceptable to the agencies that rate the District's credit-worthiness. Whether expressed in per capita terms or in relation to revenue, the District's outstanding debt is greater than any other state fiscal system.

III. The draft report provides a framework for constructive analysis of several issues that often Cloud discussions about the District's finances. We agree.

1. Costs and benefits of the federal presence

In essence, this report treats the federal government as if it were like any other employer. The considerable benefits of the federal presence are therefore fully reflected in the District's high tax base. District personal income is high in part because of federal government salaries paid to DC residents. Sales tax revenues in part reflect the spending of tourists and conventions drawn to the nation's capital. Residential property values reflect the incomes of DC residents, many of whom work for the federal government. Commercial property values reflect the activities of business and associations who contract with, lobby, or otherwise interact with the federal government. All Federal grants that the District receives—either the local share of national programs or amounts given to the District for special purposes—are included in the report's revenue calculations.

However, the report also recognizes that the federal presence imposes costs and limitations as well. To the extent that the federal government's property and purchases are off the tax rolls, or that non-resident income earned in the District cannot be taxed, these limitations are reflected in the tax base. Given these limitations, in order to try to pay for even an average level of service, District tax rates on the tax base available to it must be high. While the report does not quantify the actual costs of services provided to the federal government or incurred as a result of being the nation's capital, it puts these costs in perspective. When millions of dollars of expenditures related to being the nation's capital are absorbed by the city, this diverts resources from ordinary services to residents, commuters, and visitors.

2. Inefficiencies in District programs

We concur with GAO's observations that improved program performance would permit the District to enhance the quality of the services it does deliver. The GAO points out that better documentation of costs in both the delivery of Medicaid services and public safety services to the federal government would position the District to obtain a higher level of reimbursement than it currently experiences. As the report notes, the District has recognized this area as needing management improvement and is taking corrective action. Specific examples include efforts to improve management oversight of Medicaid efforts, improve

documentation, and improve the quality of Medicaid revenue estimates. On a broader scale, the District has made operating budget reductions of over $190 million in FY 2003, in part to balance expenditures and revenues but also as part of a large effort to deliver services more efficiently. While significant opportunities for efficiency improvements exist within District programs, even with such improvements, the draft report points out that the District would still face a structural deficit.

3. Framework for evaluating options

The draft report points out that the District has few options for addressing its fiscal deficit. The District already has a higher tax effort than any state. And, as stated in the draft report, increasing the tax burden on District businesses and residents could have an adverse impact on total receipts because it could influence residents or businesses to move to adjacent lower-tax states. The District has tried to cut taxes, but has recently been forced to postpone some of these reductions. Also, over the FY 2003/FY 2004 period, the District has also cut back existing or planned spending by some $300 million dollars.

By law the District must balance its budget each year, but making the spending or revenue adjustments needed to do this is not the same as solving a structural deficit. By definition, the structural deficit would occur each year if the city were to provide an average level of public services, funded with an average tax effort and delivered with an average level of efficiency. Given the structural deficit, the District is forced to choose between tax levels that are even higher than the national average, service levels that are lower than the national average, or combinations of both in order to balance its budgets.

4. Unique nature of the Federal government's responsibility to the District of Columbia

Although the draft report makes no recommendations, it provides a strong case for federal action to assist the District of Columbia, the nation's capital. As noted, the structural imbalances in both the operating and capital areas result primarily from cost and workload factors that are beyond the District's control, and, in addition, the District must provide services to the federal government.

With tax and debt burdens higher than other jurisdictions, it is not feasible for the District to solve the problem by more taxes or borrowing. One option noted in the draft report is for the federal government to relax taxing restrictions on the District to compensate it for its special status as the capital city.

The draft report indicates that providing federal assistance to the District may encourage state fiscal systems with structural deficits to request the same or similar treatment. However, a strong case can be made that the District of Columbia is unique among all local and state jurisdictions and that unique conditions dictate unique solutions. All states have federally tax-exempt property, but the District has more in terms of value relative to the size of the economy. All states may forego some tax activity due to the federal commercial activity, but the District certainly loses much more. The District is also subject to revenue

and other constraints not imposed by the Federal government on any other jurisdiction. These factors have been many times documented and indicate that the District merits a unique fiscal relationship with the federal government that corresponds to its unique operational arrangement.

With respect to the text of the draft report itself, there are four suggestions we would like to make.

1. Although the text of the draft report points out that the District recognizes that there are management inefficiencies and is taking measures to address them, this is not reflected in the executive summary.

2. The executive summary could usefully point out that in acting on its FY 2003 and FY 2004 budgets the District has once again demonstrated its resolve to maintain balanced budgets, but these year-to-year adjustments do not address the underlying imbalance problem.

3. To help the reader understand the nature of the draft report, it would be useful for GAO to describe as clearly as possible the conclusion that solving inefficiencies alone will not close the fiscal imbalance.

4. In light of the current cyclical financial problems occurring in many jurisdictions throughout the United States, we urge GAO to review its draft report to make as clear as possible the unique situation involved in the District of Columbia's fiscal deficit.

There is a wide range of options available to the Federal government for assisting the District in overcoming its structural deficit and in providing a level of service quality that befits the nation's capital. The GAO has done a particular service by framing the magnitude of the issue at a time when economic conditions are highlighting the impact of this deficit.

We look forward to working with officials in the Administration and the Congress to find solutions to the District's underlying fiscal limitations.

Sincerely,

Natwar M. Gandhi
Chief Financial Officer

cc: The Honorable Anthony A. Williams, Mayor of the District of Columbia
The Honorable Linda W. Cropp, Chairman, Council of the District of Columbia
Gregory McCarthy, Deputy Chief of Staff for Policy and Legislative Affairs
Noel Bravo, Special Assistant, Executive Office of the Mayor

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