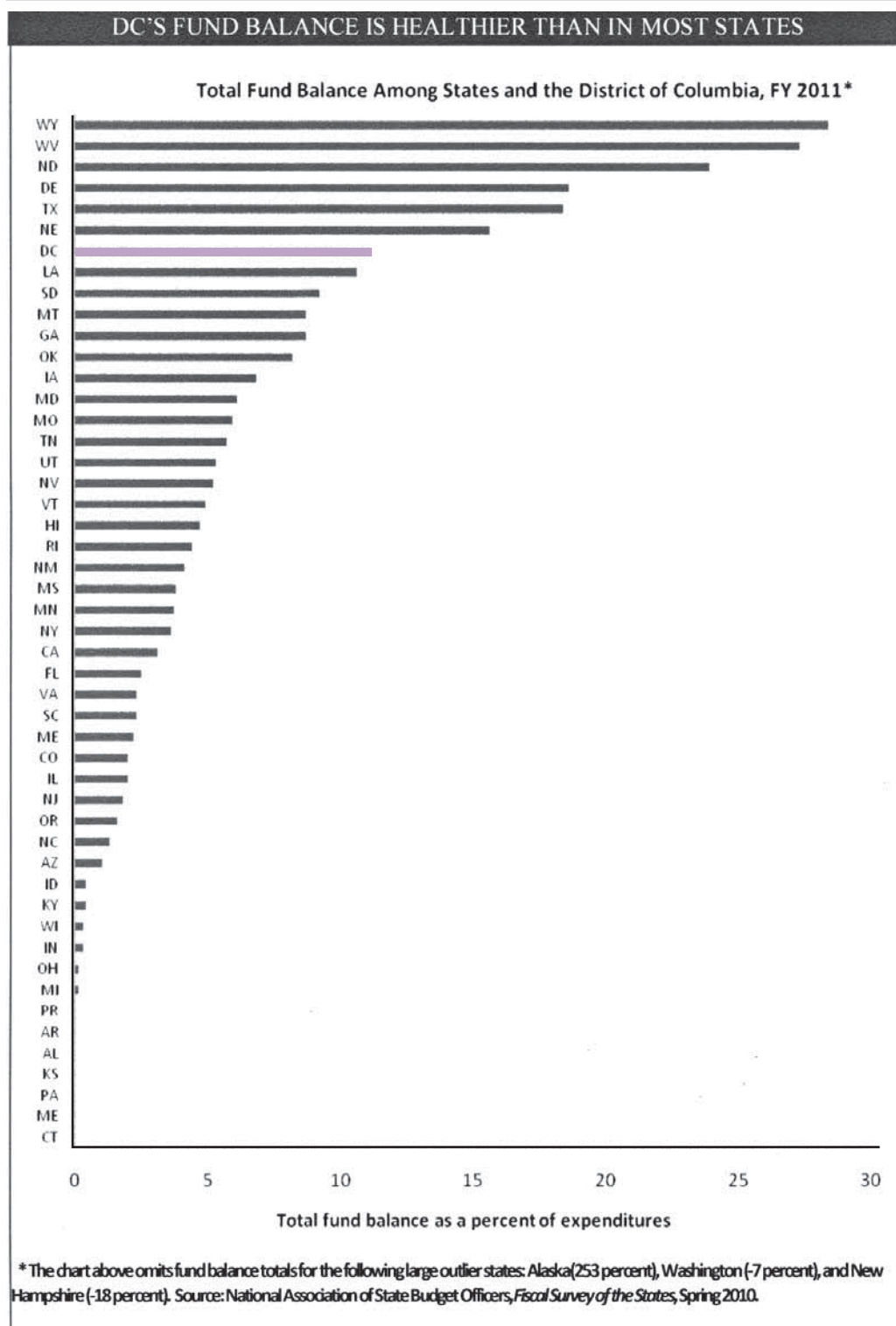


The Wrong Prescription

DC'S Financial Woes are Being Misdiagnosed

BY JENNY REED



You may have heard that DC is headed for another control board. But you know better than to believe everything you hear, right? Yes, DC's finances have suffered in the recession, as have every city's and every state's. But the District isn't anywhere close to the kinds of problems that actually would trigger a control board, such as consistently failing to pay its bills on time or running a year-end deficit.

So why the alarm? The reason is that the city's "fund balance" — essentially DC's bank account — has declined from a high of \$1.6 billion in 2005 to \$920 million in 2009 and perhaps as low as \$650 million by the end of 2011. The pace of the decline has justifiably raised some concerns.

But the reality is that the District is weathering the economic storm better than most states, which also are pulling money out of reserves to avoid major budget cuts in the midst of one of the worst recessions in history. In fact, DC's reserves are healthier than in 43 states.

The concern over the state of fiscal affairs has led to calls to shore up the city's dwindling reserves. While this goal makes sense, a plan just adopted by the DC Council goes too far too fast, and it will tie up a significant amount of any new resources. The middle of a recession is the wrong time to focus solely on building reserves, when limited resources are needed to avoid cuts in city services, and to make critical reinvestments as we start the long road to recovery.

So What Is 'Fund Balance,' and Why Is It So Important?

DC's Fund balance is essentially the city's checking and savings account in one. Not surprisingly, Wall Street credit agencies keep an eye on how well we manage the fund balance as one of many factors considered when they set our bond rating.

What's in the city's bank account? The fund balance includes lots of parts, including the city's rainy day reserves, escrow funds needed to back DC's bond payments, and taxes collected for specific purposes that haven't been spent yet. When DC's economy is strong and the city runs a surplus, that goes into the fund balance, too.

One critical use of the fund balance is to help the city meet its cash flow needs. Some tax collections come in as big chunks at different times of the year — like property taxes that are paid in September and March. Yet DC's bills come in every month. Having money in the bank — the fund balance — helps the city meet its regular payments and avoid short-term borrowing to cover expenditures.

Why Did DC's Fund Balance Go Up? And Why Is it Coming Down?

DC's bank account swelled in the mid-2000s as a result of large and unexpected budget surpluses. Our fund balance reached an unprecedented \$1.6 billion — equal to 37 percent of DC's budget at a time when the average for states was 8 percent.

In the face of that, DC's leaders made conscious and sensible decisions to put some of that excess to good use. Most notably, we devoted huge sums to fund a backlog of capital and infrastructure projects without the need for borrowing. And when the recession hit, the mayor and council tapped into a number of "special purpose funds" that were underutilized and had built up large surpluses, using those funds to avoid deep cuts to program and services.

DC's fund balance could fall by 2011 to a level equal to 10 percent of the city's budget. Yet that still is higher than in 43 states, including Maryland and Virginia.

Shoring up DC's Finances: What's the Most Important Thing to Do?

Even if DC's fund balance is not at a crisis state, we probably can't take out too much more — and at some point it would be good to build our savings back up. But how much and when are key questions to ask.

The budget just approved by the DC Council includes provisions to start rebuilding reserves now. While the council deserves credit for seeing this as an important issue, their plan ultimately will tie up a lot more money than is necessary at a time when DC's finances are still fragile.

Under the new budget, 100 percent of future budget surpluses will be used to fill two reserves until they reach a total of nearly \$700 million. (Yes, even in a recession, DC is likely to end the year with some surplus.) Initially, half of surplus funds will go to a reserve to help respond to unforeseen spending pressures that arise during the year. This makes sense, and it's similar to a \$50 million budget reserve DC maintained until fiscal year 2009 when it was eliminated. Under the new plan, the

operating reserve will be built up to \$145 million.

The plan for the other half of future surpluses is far more problematic. These funds will just sit in the fund balance — to help meet the city's cash flow needs — and will not be available for anything else, like an increase in Medicaid caseloads or another drop in revenue collections. This reserve will be built up to a whopping \$530 million even though DC has never had more than \$175 million sitting around for these purposes.

Building up the fund balance by \$675 million will take many, many years, which means a large amount of taxpayer funds will be tied up for a long time.

Tying Up a Significant Amount of Resources as We Exit the Recession Is the Wrong Prescription

In the end, this decision reflects the wrong diagnosis of DC's current financial ills — and the wrong prescription. Every dollar we put into a reserve is a dollar that can't be used to invest in our city. That balance needs to be weighed carefully going forward. DC's most pressing fiscal problem is the large drop in tax collections that has led to cuts in all parts of the budget — from libraries to parks to street sweeping to affordable housing. DC's finances are likely to be fragile as it comes out of the recession, which means preserving resources for the budget should be the top priority right now.

A more balanced approach would still include a rebuilding of our fund balance, but not by setting aside nearly all future resources or by building it up more than necessary. Setting aside a smaller portion of resources would help us rebuild our reserves while also giving the mayor and council enough flexibility right now to preserve services and to begin making critical reinvestments as we exit the recession.

Reed is a policy analyst with the DC Fiscal Policy Institute (www.defpi.org), which conducts research on tax and budget issues that affect low- and moderate-income DC residents. ★

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