
**A SOUND FISCAL FOOTING
FOR THE NATION'S CAPITAL:
A FEDERAL RESPONSIBILITY**

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Dedicated to:

Philip M. Dearborn

In recognition of his lifelong contribution to
understanding fiscal issues in the greater
Washington region.

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ABSTRACT

The city of Washington has the potential to be a truly great capital city— not only the home of the United States government, but a model of urban living. However, the unique status of the District of Columbia and the fiscal restrictions placed on it by the federal government prevent Washington from fully realizing its potential as a first-rate place to live, work, and raise a family. This paper makes the case for the federal government playing a new role in supporting the District of Columbia by making a substantial and continuing payment to the budget of the city of Washington. It examines the arguments for such a payment, provides cost estimates for alternative forms that it might take, and offers ways the District can assure federal taxpayers that the money is well spent without impairing the ability of District citizens to govern themselves.

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A SOUND FISCAL FOOTING FOR THE NATION'S CAPITAL: A FEDERAL RESPONSIBILITY

I. INTRODUCTION

Great nations take pride in great capital cities—and support them. Paris, London, Rome, and Tokyo each epitomize their countries, and each of their nations invests substantial resources in their well-being. Washington, D.C., should enjoy the same prominence and support. For that reason we propose that the federal government play a similar new role in supporting this nation's capital. This it should do by providing a continuing contribution to the budget of the city of Washington. And so in the following pages we examine the arguments for such a contribution and explore several alternative forms that such a contribution might take. We also suggest ways the District can assure federal taxpayers that the money is well spent without impairing the ability of District citizens to govern themselves.

Many people have a stake in Washington being a well-run, safe, and attractive city that provides good services to those who live, work, and visit here. All Americans, to start with, should desire to create a capital city that they not only enjoy visiting, but which displays the world's most powerful country to advantage. The burgeoning communities that surround Washington in nearby Maryland and Virginia have even stronger reasons for wanting the focal point of their region to be a viable well-functioning city. And the more than half million residents of the capital, like other citizens, want to live in a safe city with thriving neighborhoods, good services for people at all income levels, and a responsive democratic government.

In the mid-1990's, however, Washington reached the depths of a fiscal and governmental crisis that had been long in the making. The city was effectively bankrupt and unable to pay its bills, collect taxes, access the credit markets, or deliver adequate services to its citizens. The opening chapter of Carol O'Cleireacain's book, *The Orphaned Capital*, tells the grim story of a city with a rapidly declining population and stagnating economy, whose government was close to dysfunctional and using budgetary gimmicks to mask its fiscal collapse.

But that was then. Today, the status of Washington is very different—thanks to drastic actions taken by the city under the direction of the federally imposed Financial Responsibility and Management Authority (Financial Authority), assistance from the federal government, new elected and appointed city leadership, and a stronger national and regional economy. Today the city has had five consecutive balanced budgets and improved both its credit rating and its cash position. Public services are demonstrably improving. The population outflow has ceased, and people are moving back into the city. New buildings are transforming downtown and property values are increasing in many parts of the city.

The mood of the city seems far more upbeat than five or six years ago. Citizens and city leaders, indeed, are coming together to talk about their visions of a future Washington. These visions have common themes: Washingtonians increasingly speak of desiring a city with safe, attractive neighborhoods; effective schools preparing children for productive lives; decent

affordable housing; accessible shopping; job opportunities, with chances for training and promotion; and high-quality public services, including responsive police, fire and emergency services, well-maintained streets, and convenient public transportation. Such a city, which seemed merely fanciful a few years ago, is beginning to seem attainable. From this perspective, the return of the city to fiscal solidity and the dissolution of the Financial Authority in September 2001 remains a major watershed for the nation's capital.

At the same time, the city's fiscal future remains precarious. The impact of the September 11th attacks on travel and tourism and the effects of recession have left the city struggling once again to balance its budget. Although the current recession has been far less serious in Washington than in many parts of the country, it has served as a warning that the financial health of the capital city is not assured. Much of the improvement in the city's fiscal situation since the crisis of the mid-1990's, for example, reflected the technology-driven surge in the national economy and the local building boom. Moving toward a brighter vision of a future Washington—and avoiding falling again into fiscal crisis—requires putting the city's finances on a stronger permanent foundation.

To meet this challenge, the city must grow its tax base to generate more revenues on a continuing basis. In an earlier paper, "Envisioning a Future Washington," we argued for an economic development strategy focussed on increasing the city's residential population. A residential strategy makes sense for Washington, because the city already has a strong job base and is prohibited from taxing the incomes of the large number of city workers who live in the suburbs. As we showed in the earlier paper, growing the population—by revitalizing neighborhoods and associated commercial corridors, building additional subsidized and market rate housing, and improving schools and other services—could generate substantial new revenue to pay for needed services and lower the District's tax rates.

In many different ways, then, Washington is striving to develop its economy and enhance its local tax base. But this process will take time and resources. In the near term, though, it is by no means certain that the city can raise the revenue necessary to provide good-quality services and revitalize its neighborhoods without additional help from the federal government. For that reason, we explore in the next section three arguments for additional federal assistance to Washington as it continues its efforts to become a world-class capital city.

II. THREE RATIONALES FOR FEDERAL ASSISTANCE TO THE DISTRICT OF COLUMBIA

Many people assume that the federal government—like many national governments—makes a substantial contribution to budget of the capital city. In fact, however, there is no general-purpose federal subsidy to Washington at the present time. To be sure, the city receives the grants that are available to other state and local jurisdictions under federal programs, and some special treatment to compensate for having no state government. But most of its revenue comes from its own sources. With the permission of the federal government, the District imposes a full range of state and city taxes on its own residents, including personal income, sales, property, and business taxes. To a surprising degree the District must go it alone.

This state of affairs brings about two initial arguments for a federal payment to the District of Columbia. The first relates to the city's status as the national capital. Its major industry, the federal government—as well as much of the activity it attracts—does not pay taxes, imposes costs on the city, and severely restricts the city's tax base, especially by prohibiting taxation of income earned in the District by non-residents. The second rationale relates to the fact that the city must provide both state and city services to its residents, but lacks the state aid, financed out of a broader state tax base, available to other cities.

An additional argument, specific to the current situation, relates to the long neglect of the District's public infrastructure, exacerbated by the fiscal crisis, and the federal government's special stake in ensuring that the District's public infrastructure remains adequate and up to date.

A. Capital Losses

Being the national capital brings benefits and difficulties. The federal government is a large, stable employer with a relatively skilled and well-paid workforce. The government draws embassies and international organizations to Washington, a host of think tanks and non-profit organizations, as well as providers of profitable legal, accounting, and consulting services. The federal government provides parks, monuments, and capital security that add to the District's appeal to visitors and help sustain a substantial hospitality and entertainment industry.

But on the negative side, the hometown industry requires services, although it does not pay taxes. Federal and other exempt buildings require police, fire, and emergency services. The city's chief financial officer (CFO) estimates that the public services the District provides to the federal government alone cost \$240 million a year.¹ Indeed, the federal presence assures that the District's central business district contains one-third of the region's office space. During business hours, 70 percent of the vehicles on downtown roads come from outside the District. Providing services to other tax exempt organizations adds to the cost. Workers who commute to federal and other tax-exempt buildings also cause traffic congestion and wear out the city's infrastructure.

¹ N. Gandhi, "District of Columbia Structural Imbalance," presentation dated January 10, 2002, p. 6.

However, federal law prohibits the District from taxing these commuters' income; neither has Congress allowed the District to introduce user fees, such as tolls on bridges, into the District.²

In addition, when large numbers of tourists and other visitors flock to the capital at once, they impose exceptional costs, including policing, emergency services, crowd control, and clean-up after parades, mass demonstrations, and major public events. The Metropolitan Police Department estimated that increasing the police presence in the District for a weekend of protests in April 2002, for example, cost the city \$5 million.³ The District's budget has been only sporadically and inadequately compensated for the costs of these events, generally as a partial reimbursement after the fact.

More significantly, the presence of the federal government restricts the District's tax base enormously. Federal laws and treaties exempt from tax property owned by the federal government, as well as by the foreign embassies and international organizations and many non-profit organizations. This property generally remains exempt even if its use is commercial. Sales to the federal government, diplomats, and international agencies, and by museum shops, are not taxed.

Fully 42 percent of the real and business personal property base is exempt from taxation, with the federal government alone accounting for 28 percent of the exemption. These exemptions cost the District about \$550 million dollars a year in foregone property tax revenue at current tax rates. Sales and excise tax exemptions for diplomatic and military personnel cost about \$70 million at current tax rates; the District estimates that if these were subject to taxes, these tax rates could be reduced by about 12 percent.⁴

Along these lines the District's CFO recently placed the District's revenue losses due to its inability to tax the "commercial" activity of the federal government, alone, at almost \$200 million, including \$150 million of property taxes on commercial (office) property; about \$35 million in business-type personal property taxes; and just under \$10 million in taxes on sales at the Smithsonian Institution and other federal entities.⁵

And there is more: By far the most disabling restriction the federal government imposes on the District remains its prohibition against the District taxing income earned by non-residents. As it happens, non-residents—mostly commuters living in the Maryland and Virginia suburbs and working in the District—make two-thirds of the income earned in the District. If the District were able to tax commuter incomes at its current rates, we estimate it could raise almost \$1.4 billion in additional revenue annually. Then it would be able to spend substantially more for services and significantly lower its tax rates. (It is true that commuters pay some taxes as they shop in the

² Numerous cities burdened with heavy regional commuter traffic (New York, for example) defray significant portions of their transportation infrastructure by charging tolls for bridge and tunnel access to the city.

³ Petula Dvorak, "Like Protesters, Chief Hit the Streets of DC." *The Washington Post*, April 24, 2002.

⁴ District of Columbia, *FY2002 Proposed Budget and Financial Plan*, p. 36.

⁵ N. Gandhi, "Redressing the Fiscal Imbalance: A Presentation Before the Federal City Council," May 24, 2001.

District and eat in restaurants, but sales-tax gains—estimated at \$40 million in FY 2000—remain tiny compared to the income tax loss.⁶)

In this regard, the federal prohibition effectively transfers the bulk of the District's income tax base to the treasuries of Maryland and Virginia, leaving District taxpayers with a commensurately higher tax burden. The District's loss is in this respect an enormous boon to the treasuries of Maryland and Virginia, which are able to tax the income earned in the District by residents of their states. About 65 percent of the benefit flows to Maryland (\$900 million) and 35 percent to Virginia (\$480 million).⁷

The prohibited tax on non-resident income is often called a “commuter tax,” as though it was analogous to the taxes some cities impose on the wages of commuters. However, the analogy is misleading, since the District functions as both a city and a state. New York State, for example, recently abolished New York City’s commuter tax, which, at a low flat rate, was yielding a relatively modest amount of revenue. The State of New York, however, continues to derive substantial revenues, via its progressive income tax, by taxing the incomes of New Jersey and Connecticut residents who work in New York City, and part of this revenue supports services in New York City. The District, by contrast, receives no support for its services from a state.

At the same time, a precedent exists for federal aid to the district. For many years, the federal government addressed the extra burdens of the nation’s capital—as well as the issue of the District’s lack of an associated state—by making an annual “federal payment” for general support of the District government. The federal payment had a long and checkered legislative history. Numerous commissions opined on its justification, method of calculation, and desirable size.⁸ Some of the time it was based on a formula, such as half the District's budget. At others it was simply a negotiated amount worked out between the Congress and officials in charge in the District.

When it granted home rule to the District in 1973, at any rate, Congress explicitly acknowledged the justification for a federal payment. The Home Rule Act required the mayor to detail and quantify the costs and benefits of being the nation’s capital when preparing the annual budget, including the revenue impact of the exemptions from the tax base and the extra expenditures required of the nation’s capital. Again in the District of Columbia Revitalization Act of 1997, which phased out the federal payment and provided for increased federal services, Congress allowed for future federal “contributions,” based on the finding that “Congress has restricted the size of the District of Columbia’s economy[,] ... imposed limitations on the District’s

⁶ The \$40 million is dwarfed by about \$239 million generated from out of town visitors (including motor vehicle excise taxes and funds earmarked for the DC Convention Center), according to letter from N. Gandhi to the Clerk of the House Subcommittee on Appropriations, District of Columbia Subcommittee, Feb.28, 2001.

⁷ This estimate uses the most recent income, earnings, employment and tax data, combined with 1990 census commuter patterns, to update estimates made by Carol O’Cleireacain in *The Orphaned Capita* for 1995. Unfortunately, the 2000 Census commuter patterns are not yet available.

⁸ Carol O’Cleireacain, *The Orphaned Capita: Adopting the Right Revenues for the District of Columbia*. Washington, D.C.: Brookings Institution, 1997. See Chapter 7 for a short history of the District’s fiscal relationships, the issues debated over the centuries, and further references on this issue.

ability to tax income ...[, and recognized that] the unique status ... as the seat of government...imposes unusual costs and requirements.”

Despite its endorsement of the case for compensating the District for the costs of being the capital, however, Congress never based the size of the federal payment on estimates of those costs. Instead, the payment fluctuated unpredictably until the financial crisis of the mid-1990's, when Congress introduced a measure of stability by committing to a payment of \$660 million (20 percent of the revenue raised by the District from its own sources (see Charts I and II)).⁹ Immediately thereafter, though, Congress phased out the federal payment—slashing it from \$666 million in FY1997 to zero in FY1999—in return for federal assumption of certain state-like functions. As the charts illustrate, since the phase out of the federal payment District tax revenues have grown to take its place.

A strong case for a federal payment remains, however, both as compensation for the costs of being the capital (especially the prohibition on taxing incomes of non-residents) and, as we shall see in the next section, because of the absence of a state.

⁹ Ibid., pp. 152-4.

Chart 1: The Federal Payment to the District of Columbia Related to Local Fund Revenue and Tax Revenue, 1990-2001

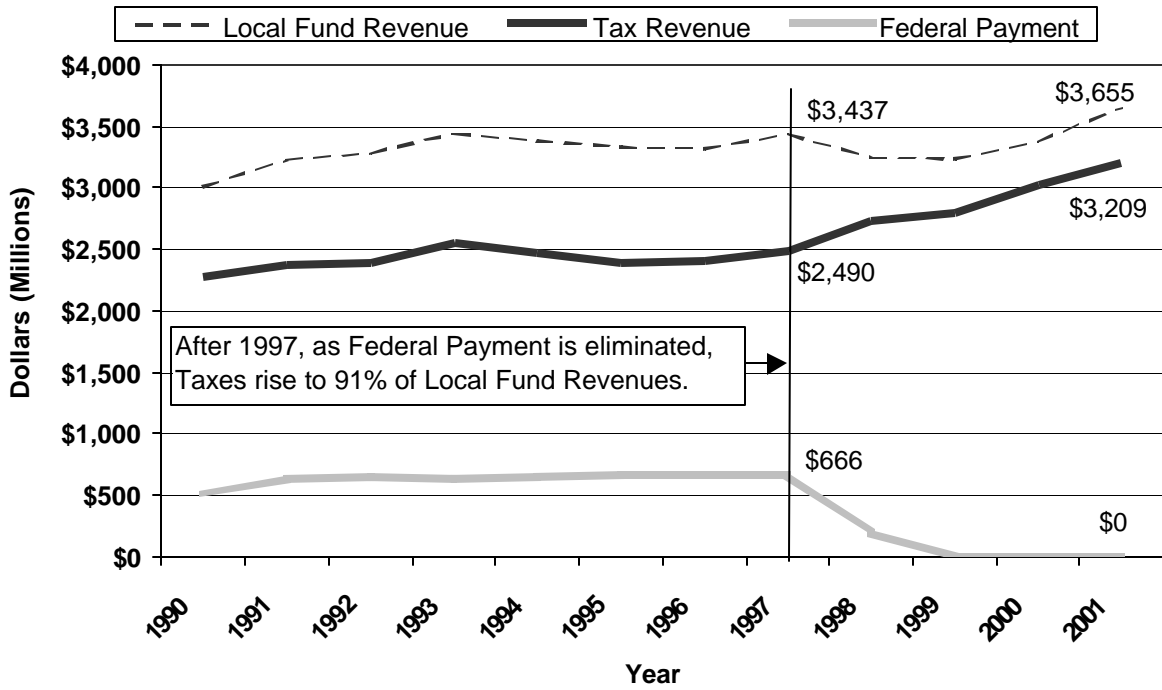
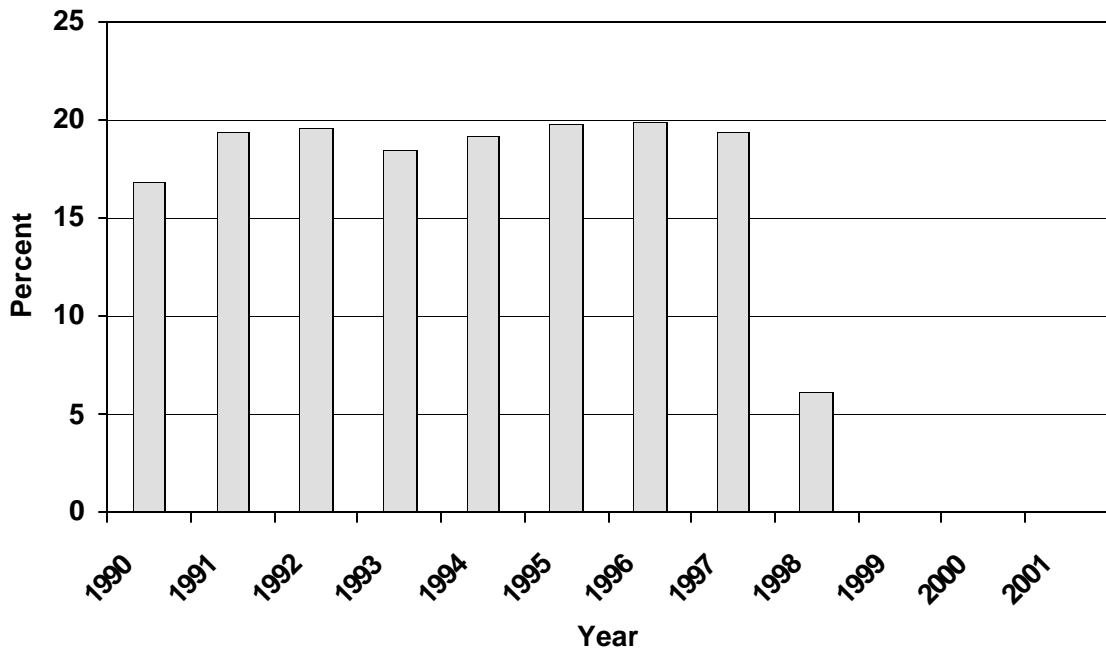


Chart 2: Federal Payment Share of Local Funds for the District of Columbia, 1990-2001



B. Statelessness

The second argument for federal assistance to the District of Columbia follows from the District's peculiar jurisdictional status. Under the U.S. Constitution, the nation's capital carries the unique status of a federal district, carved out of Virginia and Maryland, but not part of any state, and dependent on Congress to safeguard its well-being.¹⁰ This special arrangement has placed the District outside state rivalries, as was intended by the nation's founders, but it has also left it without either voting representation in Congress or the powers reserved to states.

Because no state supports or contains it, the District of Columbia must provide public services normally provided by a state government, as well as those usually supplied by a local government. Recognizing that the District had to provide state-like services, Congress has allowed it to levy "state-type" personal and business taxes, such as an income tax, not normally imposed by cities.¹¹ But there is one glaring exception. States may tax all income generated within their borders, whether or not it is earned by residents. The District, however, may tax only the one-third of the income that happens to be earned by its residents (and the comparatively tiny amount earned by District residents in Maryland and Virginia).

Moreover, state governments are able to collect revenue from diverse tax bases that include suburbs and industrial areas and redistribute those resources to local jurisdictions to equalize public services among localities of differing income and wealth. Central cities, which carry a heavy burden of costs associated with concentrations of inner city poverty, normally benefit from this redistribution. But the District has to carry these costs without state aid.

In this regard, the District has won a measure of recognition of its plight, if not a resolution of the problem. In 1997, in an effort to help the District recover from its fiscal crisis, Congress acknowledged that the District carried a state-like burden and transferred part—but by no means all—of that burden to the federal budget. Under the District of Columbia Revitalization Act of 1997, the federal government assumed fiscal responsibility for the custody of the District's convicted felons, as well as the cost of the local court system, including prosecutions, in the District.¹² It also increased the federal matching rate on Medicaid from 50 percent to 70 percent to allow for the District's receiving no state contribution to Medicaid. And the act transferred to the federal government the District's unfunded pension liability, created when the federal government ran the District's pension system, along with the corresponding assets of the pension system. At the same time, the Revitalization Act ended the annual federal payment to the District's budget, even while it retained language recognizing the justification for such a payment.

¹⁰ The U.S. Constitution established the nation's capital city. Article I, Section 8, Clause 17 states: "Congress shall have the power to exercise exclusive legislation in all cases whatsoever, over such district...as may, by cession of particular states, and the acceptance of Congress, become the seat of the government of the United States."

¹¹ Many states do not grant sales and personal income tax raising authority to cities. Business income taxes are generally state-only (except for New York City).

¹² Andrew Brimmer, chairman of the Financial Authority at the time, testified to Congress on March 13, 1997 that the District was spending about \$120 million on "judicial functions."

Removing the pension liability—clearly a federal responsibility—definitely improved the District's fiscal outlook. It is less clear that the rest of the provisions of the Revitalization Act were a net plus for the District. The answer depends on whether the cost of the state-like functions transferred to the federal government would have risen faster or slower than the federal payment the District gave up.¹³ Obviously, no one knows. In any case the Revitalization Act left the District with significant state-like functions that most cities do not perform and whose annual costs are estimated by the District's CFO to be \$500 million.¹⁴ Among these services are mental health, child welfare, and other services for low-income people. State provision (or funding) of these services would spread the costs associated with inner-city poverty over the larger state tax base, including industrial sectors and better-off suburban areas. The District's budget, by contrast, carries both the city and the state burden of 44 percent of the region's poor population.

States also normally pay for higher education. The District, without such aid, struggles to finance the University of the District of Columbia (UDC), and lacks a community-college system. Here again, though, the federal government's recent recognition of a state-like role in higher education in the District (District of Columbia College Access Act of 1999 and the District of Columbia College Access Improvement Act of 2002) has had both positive and negative consequences for the city. These acts allow District residents to attend any public college or university anywhere at in-state tuition rates (up to \$10,000 per year) or to receive a \$2,500 stipend to attend any private college in the region or any historically black college nationally.¹⁵ These provisions help District residents, but they may reduce enrollment at UDC, by encouraging potential students to study elsewhere.

The budget for elementary and secondary education further illustrates the problem of "statelessness." The District is a unified school district, responsible for a public education system, without the state help typically available to big-city school districts. By average national norms, the absence of state aid, conservatively estimated, costs the District's schools between \$200 and \$285 million annually.¹⁶ Meanwhile, both Maryland and Virginia provide their school districts with substantial state aid that varies with the wealth of the district. The Baltimore City School District, for

¹³ District estimates cited in a recent GAO report ("District of Columbia: Fiscal Structural Balance Issues." GAO, September 4, 2002. GAO-02-1001), Appendix II, suggest that the net benefit of the Revitalization Act to the District would be about \$200 million in 2002. These estimates, made shortly after the Act came into effect, reflect projected cost increases in the transferred expenditures, but hold the revenue losses (principally the loss of the federal payment) constant. If it is assumed that the federal payment would also have risen, the net benefit of the Revitalization Act to the District would have been smaller.

¹⁴ N. Gandhi, "District of Columbia Structural Imbalance," p.6.

¹⁵ See <http://tuitiongrant.washingtondc.gov/main.htm>.

¹⁶ According to the latest American Council on Intergovernmental Relations (ACIR) data, direct state expenditures for elementary and secondary schools averaged about \$500 per capita, both nationally and in the mid-Atlantic region, which would amount to about \$285 million for the District's population. State aid to school districts in the mid-Atlantic region was about \$350 per capita (lower than nationally), which would have been worth about \$200 million for the District's size. See American Council on Intergovernmental Relations, "State General Expenditures, FY1994," Tables 73 and 15. The D.C. population estimates used in these calculations are from Census 2000

example, relies much more heavily on the State of Maryland and the federal government for its resources than do the richer Maryland suburbs.¹⁷ In FY2001, Baltimore’s schools received 59 percent of their operating fund revenue from the state and 15 percent from the federal government. In stark contrast, Washington D.C., without a state to support its school district, relies on local taxpayers for more than three-quarters of its public school resources, compared to Baltimore’s local tax support of only 24 percent (See Table 1). The difference between Baltimore’s local share and Washington’s amounted to \$340 million to the District in FY2001.¹⁸

To be sure, Baltimore city residents contribute to the state’s education aid, because they pay taxes to the state of Maryland. However, the City of Baltimore receives 20 percent of the state’s aid to education, while providing less than 10 percent of Maryland’s major tax revenue.¹⁹ Baltimore’s high share reflects its high concentration of low-income children. In effect the state’s grant system spreads the cost of educating Baltimore children over the tax bases of Maryland’s numerous jurisdictions. By contrast, not only is there no state aid mechanism to spread the costs of educating the District’s low-income children, but the District’s Maryland suburbs share their resources with Baltimore but not their own center city.²⁰

Table 1: Public School Revenue, FY 2001

	Percent Share Total Revenue			
	Local	State	Federal	Other
WASHINGTON, D.C.				
Washington DC Public Schools	78.2	0.0	16.6	5.3
MARYLAND				
Baltimore City Public Schools	23.9	59.1	15.0	2.0

Sources: Government of the District of Columbia, FY 2001 Proposed Operating Budget and Financial Plan; Baltimore City Public School System, Adopted Budget, Fiscal Year 2002.

¹⁷ In the 2000 school year, 60.5 percent of the Baltimore City schools’ revenue flowed from state aid, compared to a statewide average of 38 percent. The next highest district relied on state aid for 56 percent of its revenue, while state aid to wealthy Montgomery County amounted to only 20 percent of its total resources. See Maryland State Department of Public Education, “Selected Financial Data, Maryland Public Schools 1999-2000, Part 1: Revenue, Wealth and Effort.” April 2002.

¹⁸ One percent of local support equals \$6.3 million for the District.

¹⁹ The bulk of Maryland’s revenues flow from the personal income and sales tax, which make up 80 percent of FY2001 general fund revenues. Of that, the City of Baltimore provided only 6 percent of the state income tax receipts and 9 percent of its sales tax receipts (we can safely assume not significant shifting of these taxes). These tax shares constitute far smaller shares of state totals than Baltimore’s share of the state’s population (14 percent) and education aid (20 percent). See State of Maryland, *Fiscal Year 2001 Consolidated Revenue Report*, “General Fund Revenue Collection,” p. 14.

²⁰ Fully 87 percent of Maryland’s population lies in a belt containing two metropolitan areas: metro Baltimore and suburban Washington.

The net result of all of this is that the federal government only partially compensates the District for the disadvantages of not being part of a state. It performs some state-like functions for the District, but leaves the District responsible for many others. It grants the District incomplete state-like tax powers, by prohibiting the taxation of non-resident income, thus leaving the District with far less revenue than it would have with full state tax powers.

C. Compensating for a Legacy of Neglect

A final argument for federal assistance to the District relates to the neglected state of the District's infrastructure and the opportunity the federal government has to help the city become a showcase capital city in which the whole nation takes pride. In the longer run, the city will be able to maintain its infrastructure with a continuing annual payment from the federal government. But in the meantime the capital city needs federal investment to make up for a long period of neglect.

In the 1970s, 1980s and early 1990s, Washington, like many central cities, lost middle-class population to the suburbs. This exodus eroded the District tax base and left the District with a concentration of lower-income families who have difficult and costly problems. Neighborhoods and public services deteriorated; the city's infrastructure was badly neglected and maintenance often suffered. Serious mismanagement and an economic downturn, in addition, combined to throw the city into a financial crisis that reached its nadir in 1995 and resulted in the creation by the federal government of the Financial Authority. The Financial Authority, which had extraordinary powers over the city's finances and management, helped the District regain fiscal solvency. Balancing the budget, however, required drastic efforts to restrict spending, which often involved further deferrals of needed maintenance, capital replacement, and modernization.

One result of the District's fiscal history, then, is a legacy of aged and badly deteriorated infrastructure—antiquated school buildings, health facilities, and police stations; out-of-date and inadequate computer systems; and an aging sewer system that contributes to water pollution. About half the District's school buildings are over 50 years old. Many are expensive to maintain and ill-adapted to the needs of modern technology-oriented education. Although the school system has made substantial progress in recent years in eliminating the worst problems, such as leaky roofs and obsolete boilers, and has increased investment in school facilities, the legacy of neglected buildings still seriously impedes efforts to up-grade school programs. Roads are also improving, but 43 percent of the District's roads still score fair or poor by Federal Highway Administration standards. The Washington Metropolitan Area Transit Authority (WMATA) struggles with major capital needs created by rapid increases in the number of riders and an aging system, while the District of Columbia Water and Sewer Authority (WASA) is in a similar bind. WASA's antiquated combination of storm-water and sanitary-sewer systems discharges raw sewage into the Anacostia River after heavy rains. The legacy of neglect has also left an urgent need to improve the city's management systems, train employees, and improve the effectiveness of city services.

None of the challenges now facing the nation's capital city is unique to it. Other older cities face many of the same problems. The fact that Washington is the nation's capital and the

constitutional responsibility of the Congress, however, provides an opportunity for the federal government to work with the city's leadership to demonstrate that these problems can be solved and to illustrate effective improvements. Washington should be more than a beautiful city with monuments and museums and unresolved urban problems. With strong local leadership and additional financial assistance from the federal government, it could become a model of efforts to revitalize older cities and a showcase of effective government.

The gap between the city's neglected state and its potential creates a third argument for federal assistance to the District. The District's legacy of neglect should be corrected at the same time the city is provided a more secure fiscal basis going forward. In this way righting the past can be seen as a complementary rationale to the two principle reasons to address the District's fiscal plight: the extraordinary costs and restrictions imposed on the capital city and the fact that it lacks a state.

III. IS THE DISTRICT'S CURRENT RECOVERY SUSTAINABLE?

There are other reasons for concern about the District's fiscal predicament. Despite its remarkable fiscal recovery, the District's financial future remains fragile, because the recovery depended in large part on a series of special circumstances. The transformation of deficits into surpluses owed much to a strong national and regional economy, including a downtown building boom. Unsustainably strict spending controls imposed by the Financial Authority, the restoration of

**Table 2: The District of Columbia: Transformation from Deficits to Surpluses
Budget Balance by Fiscal Year (\$ Millions)**

	Annual Surplus/(Deficit)	Fund Balance at Beginning of Fiscal Year	Fund Balance at End of Fiscal Year
1993	7.8	3.5	11.3
1994	(335.4)	11.3	(324.1)
1995	(54.4)	(324.1)	(378.5)
1996*	(33.7)	(484.6)	(518.3)
1997	185.9	(518.3)	(332.4)
1998	444.9	(332.4)	112.5
1999	86.4	112.5	198.9
2000	240.7	224.2	464.9
2001	77.6	484.6	562.2
2002	32.2	562.2	548.9

* During FY1997 audit, the FY1996 operating deficit was restated from \$75.3 million to \$33.7 million and the accumulated deficit as of Oct. 1, 1995 was increased from \$378.5 million to \$484.6 million.

access to the credit markets, conservative revenue forecasts and a budget process that locks in revenues well before the start of the fiscal year, all contributed to creating annual operating-budget surpluses. A conscious strategy of safeguarding these surpluses resulted in more than a \$1 billion turnaround in the general fund balance—from negative \$518 million in FY1996 to positive \$549 million in FY 2002.

Congress' imposition of demanding obligations on the District governing the accumulation of cash reserves also strengthened the District's fiscal recovery. Congress required the District to set aside funds from its operating budget each year until its emergency reserve and contingency funds reached a total of 7 percent of operating expenditures by 2007. The debt-service savings from the securitization of the District's tobacco settlement money also had to be deposited in these funds until the goal was reached. The District has exceeded these requirements and is on track to meet the 2007 requirement in 2002, an achievement which will free the tobacco savings for other uses. The additional congressional requirement for a budgeted reserve of \$150 million to cover

contingencies arising during the year has been reduced. It will be replaced by a continuing requirement to budget a \$50 million cash reserve annually beginning in 2004. These reserves have to be replenished if used. This plethora of congressional reserve requirements has accomplished the intended purpose, even if some argue that they interfere with the District's budget autonomy. The probability of future crisis has declined and the bond markets look more favorably on the District's securities.

Despite these accomplishments, the future remains uncertain. Even in good times the District has had to work hard to deliver a balanced budget. Meanwhile, a growing economy and soaring stock market generated upward revisions of revenues, which helped to achieve relative political harmony during budget adoption and absorbed significant budget overruns. Nor did the national recession of 2001 hit Washington as hard as some other cities. Although the drop in travel drastically affected Washington's tourism and hospitality sectors after September 11th, the city's economy as a whole suffered less than city economies more dependent on manufacturing and financial services. Nevertheless, revenue growth stalled and District officials had to struggle to balance the budget in 2002.

Larger revenue shortfalls are expected in 2003—probably in the range of \$200 million. In short, significant cuts in budgeted spending will be necessary to achieve balance in FY 2003 and, mostly likely, FY 2004 will prove difficult as well. A slow recovery or, even worse, a double dip recession, could widen the budget gaps still further.²¹

Looking Ahead

Absent additional federal assistance, the District's longer-term fiscal future is worrisome. Although stronger reserves have put the District in a better position to weather unexpected storms, reserves are not income. They should not be confused with ongoing revenues available to support ongoing expenditures. They cannot substitute for the sustained tax and unrestricted aid revenues that must underpin spending and program commitments.

In this regard, the District is required to produce a multiyear financial plan, which lays out the major elements of its budget four years into the future. The District's financial plan is less exact and transparent than it ought to be, and it is required by law to show balance. Even before the latest revenue shortfalls announced in September 2002, however, the financial plan clearly was only in precarious balance. Baseline revenues do not grow as quickly as spending, and the District's CFO has pointed this out repeatedly. Estimates of the difference between the revenue and spending growth paths are inexact,²² but they illustrate the persistence of the problem.

²¹See McKinsey & Company, *Assessing the District of Columbia's Financial Position: A Report to the Federal City Council*. March 16, 2002, p. 8 for estimates.

²² Before adoption of the FY2002 budget, the difference between the expenditure and revenue growth paths was estimated by the CFO to be as much as one-half a percentage point. See the letter from N. Gandhi to Mayor Anthony Williams forwarding the District's revised FY2002 Proposed Budget and Financial Plan, May

The District has much more rigorous and sophisticated methods of projecting baseline revenues than baseline expenditures. For example, the District has not developed models that could use data on population, eligibility, and client usage to generate spending projections for major services (e.g., schools, special education, Medicaid, or health coverage for the uninsured) which would be more precise. Instead, inflation factors are applied to current spending, implying no increase in real spending. In fact, real spending does rise for a variety of reasons, and these budget items suffer from chronic under-budgeting (or over-spending). They are major cost drivers generating pressures in the out-years of the financial plan.²³ Employee compensation is also trended for general inflation and steep increases—a procedure that tends to provide a floor for future collective bargaining increases. Furthermore, the potential impact of the imminent end of welfare (TANF) for many District recipients has not been integrated into the financial plan. We are also skeptical of the current financial plan’s forecast of debt service (a significant cost), which may turn out to be higher than expected.

While the national and regional economies were growing rapidly, the availability of new, sometimes one-shot, revenues allowed the District to push off to the future some very hard decisions. Rapidly rising spending in the schools (much of it associated with special education), the persistent inability of the uniformed forces to contain overtime use and cost, and the persistent under-budgeting of Medicaid and some other costs all undermine budget discipline and create claims on additional revenues.²⁴ Without a good economy pushing tax collections above forecasts, these gaps become critical.

McKinsey & Company, in a recent study for the Federal City Council, identified a growing budget gap likely to reach half a billion dollars by FY2005.²⁵ The study did not attempt any sophisticated reestimates of baseline spending and revenues.²⁶ Rather, it extrapolated the combination of slowing revenue collections and rising spending.

Given this discouraging outlook, the District’s ability to balance its budget and finance needed improvements in public services—especially schools, health, and social welfare—turns on the answers to three questions: Can the District raise more revenues? Can it control its current spending? And can it improve efficiency?

31, 2001). After budget adoption, the CFO put the difference at about \$100 million annually over the life of the plan. (See N. Gandhi, “District of Columbia Structural Imbalance,” p. 4.)

²³ McKinsey & Company, *Assessing the District of Columbia’s Financial Position*.

²⁴ For example, from budget adoption to the end of FY2001, strong tax revenue and the release of fund balance together lifted local fund revenues by more than \$400 million; at the same time, spending on a range of ongoing services—schools, human services, public safety, general support and the receivers—grew by an almost identical amount.

²⁵ McKinsey & Company, *Assessing the District of Columbia’s Financial Position*, p. 3.

²⁶ *Ibid.*, p. 1. Here McKinsey & Company notes that it “did not conduct a comprehensive review of D.C.’s financial situation.”

If the answers to these questions do not seem affirmative the question then becomes: Does the District need additional federal assistance? Let us consider the three basic questions about the District's fiscal prospects.

1. Raising Revenues

The District raises 90 percent of its \$3.3 billion local-funds budget from tax revenues, but increasing those revenues by raising its tax rates appears unlikely. Most political leaders in the District believe that current District tax rates should be lowered, because they discourage businesses and middle- to high-income individuals from moving into the District. This belief motivated passage of the Tax Parity Act of 1999, which simplified the District tax structure and lowered rates gradually over a period of five years. The act contained a clause that suspended the cuts in a recession, and further cuts were, in fact, suspended in 2002.

A comparison of District tax burdens with those of other jurisdictions underscores the District's lack of maneuvering room on raising rates. With respect to the tax burden on businesses, there is little doubt that the District burden exceeds averages in the region and likely will continue to even at the end of the tax-parity reduction program. The chief reason for this is the high District business franchise tax, which arguably results from District efforts to compensate for its inability to tax either the individual income of non-residents or the income of non-resident partners through its unincorporated business tax. Although the McKinsey study recommends abandoning implementation of the current five-year tax reduction program for individuals, it endorses the business tax cuts, citing the District's lack of competitiveness within the region.

With respect to individuals, the Congress requires the District to produce reports each year comparing its tax burden with that of the largest city in each of the fifty states (including all state and local taxes paid by residents of the city) and with the surrounding suburbs. Comparing the District with other large cities shows that it ranks between high-tax cities, such as Philadelphia, and lower-tax ones, such as Atlanta. In 2000, the District had the 15th-highest tax burden (of 51 cities) on families with annual incomes of \$25,000 and the 9th-highest on families with annual incomes over \$150,000.²⁷

Recent comparisons of the District's tax burden with the burdens in its surrounding suburbs generally show that the District imposes comparable or lower burdens than the Maryland suburbs at annual incomes below \$75,000 and higher ones above that up to \$150,000.²⁸ The comparable

²⁷ These comparisons are based on a hypothetical family of four (two wage earners and two children) at different income levels. The different relative tax burdens reflect the relative progressivity of the District's tax structure. See District of Columbia, Office of the Chief Financial Officer, *Tax Rates and Tax Burdens in the District of Columbia – a Nationwide Comparison 2000*, August 2001, Table 1.

²⁸ These comparisons are based on a hypothetical family of four (two wage earners and two children) at different income levels. The difference indicates that the District's tax structure is relatively progressive. See District of Columbia, Office of the Chief Financial Officer, *Tax Rates and Tax Burdens Washington Metropolitan Area 2000*, August 2001, Table 2, and Ed Lazere and Jason Lakin, "D.C.'s Excessively High Taxes: Just Another Urban Legend." D.C. Fiscal Policy Institute, April 11, 2002.

combined state and local taxes in suburban Virginia, however, are consistently lower than those of the District. The McKinsey study, comparing the burdens for a hypothetical married couple in rental housing, earning annually \$120,000, finds the District's tax burden roughly competitive with the surrounding area under the Tax Parity Act. Postponing the act's individual tax reductions would leave the District placing a 10-percent higher burden on the hypothetical couple than if they lived in Maryland and almost a 25-percent higher burden than if the couple lived in Virginia.²⁹

In any case, given the strongly expressed conviction of District political leaders that raising District tax rates, or even postponing planned cuts, was to be avoided, we do not believe that raising the future growth rate of the District's revenues through rate increases is a viable budget option.

2. Controlling Spending

On the other side of the ledger, spending projections for the District exclude some major needs. The District has deferred investment for many years, although we have no accurate measure of the District's suppressed capital spending needs, as the District has limited investment-planning capacity.³⁰ Yet, we know the likely areas: schools, roads, the Anacostia River, and public transit.

Making up for deferred investments in infrastructure will generate large capital budget expenditures, with mounting annual-debt service costs in the operating budget. According to the District of Columbia Public Schools (DCPS), "the overall condition of the schools is fair to poor," and half are more than 50 years old. The average age of the seventeen high schools is 70 years, with only eight of those still in operation having ever had major renovations. The District's CFO estimates that the D.C. Public Schools Facility Master Plan, would cost \$2.2 billion.³¹ Under the current Capital Improvement Plan, \$868 million would be allocated to the schools' infrastructure from FY2002 to FY2007.³² The District's roads—43 percent of them scoring fair or poor by federal

²⁹ McKinsey & Company, *Assessing the District of Columbia's Financial Position*. Exhibit 2, p.12.

³⁰ Such capacity would include professional engineering and design staff to work up reliable plans and numbers. It would establish a capital budget process that includes a strong multiyear planning component, based on an inventory of existing capital, regular assessments of the state of repair and use, ongoing maintenance, and a schema for the regular replacement of outmoded and depreciated equipment and facilities. Neither such a process nor these sorts of assessments are in place in the District; without them, capital budget estimates are unreliable.

³¹ These estimates do not represent the actual cost of designing and building to specifications a new school in Washington. Instead, they are stylized estimates "derived by reviewing school construction costs in the Mid-Atlantic region," with add-ons for design, management, and other fees and application of an inflation factor for future years. See D.C. Public Schools, *D.C. Public Schools Facility Master Plan*, December 2000; pp. III-20. In addition to the debt service costs, there would be increased operating-budget expenditures for transition space, future repairs for schools scheduled for later renovation, and funding for a first-rate capital planning and project management capacity, some of which would be operating budget expenditures (without addressing issues of educational staffing, quality and special education needs). See N. Gandhi, "Redressing the Fiscal Imbalance," p. 2.

³² District of Columbia Office of the Chief Financial Officer, "Fulfilling Infrastructure Needs," September 18, 2001, p. 2.

standards—could absorb an additional half billion dollars over the financial plan period. Bringing local roads up to a “good” standard would use half of that, with the rest being taken up with improving alleys, adding new sidewalks, and replacing the South Capitol Street Bridge.³³ Eliminating the problems of the combined sewer overflows (CSO), a major source of pollution to the Anacostia River, could cost \$1.1 billion in capital outlays, with significant additional costs to improve and restore the natural habitats along the Anacostia.³⁴ The recent McKinsey report estimates \$85 million annual additional costs by 2005 to cover the District’s contribution to WMATA’s expanded capital improvement plan.³⁵ All of these estimates are approximate.

It is unlikely that such high levels of capital spending can be financed over the longer term. Even after the Financial Authority-driven reductions in debt service, the rating agencies put the District at the high end of the range of similar cities for debt burdens related to resources.³⁶ If the District had to maintain per capita debt at the 2001 level and finance incremental capital spending only from the operating budget, McKinsey & Company estimate that annual deficits over the next several years would increase by \$180 to \$220 million per year, resulting in a 2005 projected gap of about \$700 million.³⁷ Even if such spending could be financed in a technical sense, the District’s current lack of technical capital-ready staff would delay the ability of the city to put funds to use and bring new infrastructure projects on line on a timely basis. Another concern, probably involving the need for additional operating subsidies as well as capital spending, is UDC. Washington’s only public institution of higher education, is seriously under-funded.

Adding to these spending pressures in the short term and potentially offsetting them in the longer term are several areas of government reform yet to be completed. The District will have to re-incorporate and normalize three agency receiverships, accounting for about 12 percent of local-fund spending, as well as undertake a permanent rationalization of health and hospital services. In addition, there is the long-standing, difficult task of capacity building within the municipal government. With employee compensation accounting for 40 cents of every dollar of local fund spending, personnel initiatives (e.g., training, new technology, incentive plans) make a significant

³³ N. Gandhi, “Redressing the Fiscal Imbalance,” p.3.

³⁴ District of Columbia Water and Sewer Authority (WASA), “Combined Sewer System Long Term Control Plan.” Draft Report, June 2001.

³⁵ McKinsey’s cost estimate is based on the existing regional contribution formula, in which the District bears 40 percent of WMATA’s cost burden, and assumes the contribution would be paid through the operating budget. See McKinsey & Company, *Assessing the District of Columbia’s Financial Position.*, p. 7. See the following section of this paper for more detail on the regional contribution formula and the District’s share of the burden of WMATA’s costs.

³⁶ The rating service Standard & Poor’s observed in an upgrade note that “despite the planned use of tobacco settlement and other funds for debt reduction, the District still will have a high debt burden, projected at \$4,589 per capita and 6.1 percent of market value.” Parry Young, “The Outlook for the District of Columbia Government: The Post-Control Board Period.” Testimony to a Joint Hearing of the House Subcommittee on the District of Columbia, Committee on Government Reform, and the Senate Subcommittee on the Oversight of Government Management, Restructuring and the District of Columbia, Committee on Government Affairs. June 8, 2001.

³⁷ McKinsey & Company, *Assessing the District of Columbia’s Financial Position*, p. 8.

budget dent. Some of these government reform actions (and others not yet addressed) might result in net savings over the long term.

3. *Improve Efficiency*

Unless it can greatly improve its efficiency or eliminate truly discretionary services, the District appears unlikely to be able to improve its public services, or even avoid their deterioration, without help from the federal government. But what are the prospects for such efficiencies?

District spending is high, compared to other cities, even allowing for the fact that the District must provide state as well as city services. Two obvious questions therefore need asking: Is spending high because the District offers more services than it should? Or, is it because the city delivers services inefficiently or at unnecessarily high cost?

On the first question, a 1997 study on service-provision by the Greater Washington Research Center found that little of what District agencies do is discretionary. The authors estimated that while “expenditures for discretionary services could not be precisely measured . . . they probably total less than \$100 million.”³⁸ On the second question—that of cost—no recent evidence exists. The 1997 study considered 1995 data, at the depths of the District’s financial crisis before the reforms instigated by the Financial Authority and Mayor Anthony Williams. That study noted that the District’s expenditures exceeded the combined state and local spending for many comparable services in Baltimore. Three factors—workload, retirement, and debt service—accounted for the bulk of the difference.³⁹ In instances where the study determined that a service was being provided at higher unit costs, the reasons ranged from excess employees, higher compensation, higher Washington-area costs for health care, and inefficient organization and management.⁴⁰

The more recent McKinsey study cites a need for management efficiency and estimates that “improved management efficiency in four key departments [Department of Human Services, Department of Health, Metropolitan Police Department, Department of Transportation] and at DCPS could yield an incremental \$110 million to \$160 million per year by 2005, a four percent decrease in the local funds budget.”⁴¹ According to McKinsey, the District’s per-recipient costs for services provided by these four agencies exceed those in peer cities by 30 to 100 percent.⁴² To

³⁸ Philip M. Dearborn and Carol S. Meyers, “The Necessity and Cost of District of Columbia Services.” Washington, D.C.: Brookings Institution, 1997, p. 4.

³⁹ *Ibid.*, p. 1.

⁴⁰ It is time to update this study. At the time of publication, Dearborn and Meyers recommended “improved analysis of District workloads, improved expenditure reporting, and assignment of debt service costs to specific programs.” To our knowledge, there has been no formal follow-up by the District. A new financial management system and the changes wrought by the Revitalization Act add weight to their recommendation.

⁴¹ McKinsey & Company, *Assessing the District of Columbia’s Financial Position*, p. 9.

⁴² These figures are adjusted for population, cost of living, and poverty levels, although not necessarily for state and local responsibilities.

arrive at the potential budget savings, however, McKinsey discounted the actual differences between Washington and its peers, Baltimore and Philadelphia, and then discounted again the District's ability to actually capture savings. Such an approach does not give us great confidence in the estimates.

We accept that there is some degree of cost inefficiency built into the District's spending levels. We do not know how large that is. Neither does anyone else.

Accepting that efficiency can and should be improved, however, does not eliminate the underlying fiscal crisis that threatens the health of the nation's capital. The special status of the District imposes a burden of spending on state-type services while simultaneously restricting its tax base. The lack of state-level support disproportionately burdens the District's residents with obligations for services to the region's low-income population, without any compensating revenue flow. Decades of population losses, a political focus on the short-term, a lack of capital planning, and a fiscal crisis have left an investment and modernization backlog and the pressing need for a growth strategy, without the ongoing ability to fund them. In view of these sobering realities, we conclude that the issue is not whether but how the federal government should contribute to the future stability of the District of Columbia. With this in mind, we propose in the next section a range of options for the federal support of Washington, D.C.

IV. OPTIONS FOR FEDERAL ASSISTANCE

The federal government has used a variety of tools to aid the District of Columbia in the past and could choose among numerous forms of assistance in the future. Aid could be directed to the operating or capital budgets; it could be general support or directed to particular purposes; it could be based on a formula or arrived at through *ad hoc* negotiation.

We do not see additional room for federal takeover of the District's state-like functions. Under the Revitalization Act of 1997, the federal government assumed federal responsibility for the District's convicted felons. This transfer of functions was a unique opportunity, because the District's Department of Corrections and the federal Bureau of Prisons were in essentially in the same line of business. There are no other major areas of District service spending that the federal government is easily equipped to take over, although additional federal funding for some state-like functions is an option.

At the same time, we believe that the District faces a continuing gap between needed operating funds and the revenues it can generate from its own tax base without getting its taxes too far out of line with competing jurisdictions. Priority, therefore, should be given to a federal operating contribution. Moreover, operating support should be available for general purposes, not restricted to particular functions, in part to avoid the risk of its being earmarked for projects supported by members of Congress, but not having high local priority.

The support should also be reasonably predictable so the District can plan for its use. To that end, the amount of any aid should be based on criteria unlikely to change erratically or abruptly. Moreover, the formula for calculating the aid should not involve perverse incentives. For example, a federal grant to the District of a percent of the District's revenue from its own taxes would give the District an incentive to raise its tax rates, which could be regarded as a perverse incentive and can also prove to be pro-cyclical, e.g., declining, as tax revenue is falling.

Additional funding for capital projects of particular importance to the national government also would be desirable. Limitations on the District's ability to raise revenue place stress on its ability to fund capital projects, either on a pay-as-you-go basis or via debt financing, which requires commitments to ongoing debt service. Such constraints can lead to delays in capital projects and even postponement of the renovation and rehabilitation of structures that would have extended their lives.

A Five Alternative Forms of General Operating Support for the District Budget

What follows are suggestions of five ways for the federal government to structure general operating support for the District. Some are tied more closely to the "capital losses" rationale and others to the "statelessness" concern, but all rest on the contention the national interest argues for helping the District provide quality services to its citizens. From the District's point of view, it may

not matter which vehicle is chosen—the fiscal relief would be much the same under any alternative rationale.

Clearly, the amount of such aid will be the critical question to be negotiated with the federal government. We do not have a measure of the structural budget gap (to provide a context against which to measure the District’s claims and problems). We have, though, presented estimates, where they exist, of the budget costs (or foregone revenue) that result from the District’s special constitutional status. And the scale of these costs is considerable: By itself, for example, the prohibition on District taxation of non-resident income— represents a net loss to the city of \$1 billion annually—a number so large that political realism prevents us from putting it forward as a claim.

We think, at any rate, that the District needs \$300 to \$500 million a year in federal operating budget support. Assistance in that range would still necessitate prudent budgeting, competitive tax policies, and serious management efficiency. In the face of the evidence and analysis in the first two sections of this paper, this target range for federal help seems both moderate and reasonable. The options we present are non-exclusive options. They could be adopted, separately or in combination, at a variety of dollar levels.

Here, then, are five ways the federal government could stabilize the finances of the District of Columbia and enhance its fiscal viability.

1. *Make a Payment-In-Lieu-Of-Taxes (PILOT)* **\$395 M/yr.**

One form federal support might take would be the establishment of an annual payment-in-lieu-of taxes (PILOT) from the federal government to the District of Columbia. A PILOT would provide general operating revenue to the District in an amount calculated by applying commercial property tax rates to the value of federally exempted property. The argument for such a payment is compelling. A PILOT would provide a predictable amount not subject to frequent economic fluctuations. Local government services are generally paid for through property taxes. Owners of exempt property use public services (police, fire, roads, and street lighting) without payment. Indeed, the District provides about \$227 million of services annually to the federal government alone, according to its CFO.⁴³

Although all cities have tax exempt property, the District’s exemptions from the property tax base are unusually large and dominated by the presence of the federal government. Moreover, a PILOT would not be a novel departure. For decades, the federal government has made PILOT payments to states and counties where it owns certain kinds of land, recognizing the impact on the tax base. According to the National Association of Counties, the FY2001 federal budget authorized

⁴³ District of Columbia Office of the Chief Financial Officer, “Fulfilling Infrastructure Needs,” September 18, 2001, p.15.

\$200 million in PILOT payments throughout the country, less than \$10,000 of which went to the District.⁴⁴

The property to be covered by the PILOT could be defined narrowly to include only the federal government's own holdings, or more broadly to include embassies, international organizations, and non-profit organizations that need to locate in the nation's capital. Our estimate is for a PILOT that would apply to federal buildings, embassies and other diplomatic entities (including international organizations), and organizations specifically exempted from property taxation by federal legislative or executive acts. Traditionally exempt local organizations, such as universities, hospitals, churches, and charities, would not be included in a PILOT.

2. *Redirect part of the federal income tax paid by the District's non-residents to the District* **\$400 M/yr.**

This has already been proposed by D.C. Delegate Eleanor Holmes Norton in federal legislation numbered HR3923. For non-resident employees working in the District of Columbia, the Norton bill would redirect, to the District from the federal government, the equivalent of 2 percent of an employee's pay from the employer's withholding of federal taxes.⁴⁵ There would be a revenue gain to the District, but no change in the take home pay of workers and no change in the resident income tax receipts of the jurisdictions where these workers live. The entire revenue gain to the District would fall on the U.S. Treasury.

This proposal clearly has been structured to provide revenue to the District, linked in some way to income generated by non-residents employed in the District, without imposing any revenue losses on Maryland and Virginia, the chief opponents of repealing the prohibition on District taxation of income earned within its borders. These states have successfully fought past efforts to give the District the right to tax income earned in the jurisdiction by non-residents. Their state treasuries stood to lose substantial revenue from such a change, because taxes paid by non-residents to the District would be credited against income tax paid to their home states.

The Norton proposal has spawned a number of alternatives, the simplest of which would be for the federal government simply to rebate to the District a percentage of federal income taxes collected from District residents. Such a proposal could be constructed to produce the equivalent amount of revenue. Some feel it might be more acceptable to representatives of surrounding jurisdictions, who fear that Norton's proposal might set a precedent for a future tax on commuters' income even though it has no impact on state treasuries. The logical connection between the federal grant and the services the District must provide to non-residents would, however, be lost with such an alternative.

⁴⁴ Department of the Interior, Bureau of Land Management, *2003 Budget Justifications* and the National Association of Counties, www.naco.org.

⁴⁵ It also includes the self-employed.

3. *Compensate for the burden of state-type services*

\$600 M/yr.

The Revitalization Act of 1997 broke new ground in addressing the District's missing relationship to a state. It transferred to the federal government responsibilities for certain state-type criminal justice services, including courts, prosecution, and incarceration of convicted felons. It also increased the federal share in District Medicaid, effectively substituting federal money for state money (which, in the case of the District, is city money). The transfer of prisons and courts was feasible because the federal government already runs prisons and courts.

Most of the District's remaining state-like services are not particularly viable candidates for transfer, because they have no existing federal counterparts. There are, however, several state programs besides Medicaid for which the federal government shares the costs with the states and treats the District as if it were a state. The federal government could agree to increase its share of these programs in the District in order to substitute for the District's non-existent state share. Such an agreement would supply the District with a new ongoing flow of budget resources. Candidates for such a share increase might be mental health and child welfare.⁴⁶ Another approach might be for the federal government, acting *in lieu of* state government, to contract with and pay for surrounding states to supply specific state-type services, such as licensing, professional qualifications, consumer inspections, higher education, and tax collection for the District of Columbia.

Alternatively, rather than performing state-type functions itself, the federal government could simply compensate the District for providing an efficient level of state-type services. The cost of full compensation cited here is provided by the District's CFO, based on current service levels, withholding judgment on the level of efficiency.⁴⁷

4. *Restore the federal payment as a per capita grant*

\$330-660M/yr.

The federal government historically accepted the logic of supplying general revenue to the District. The most recent version was the federal payment legislated at the time of home rule and phased out by the Revitalization Act. Restoring such a payment would provide the District with general operating revenue. Basing it on population would link it to pressures on the city to provide services, which rise roughly in proportion to population. Population based formulas are a common form of state aid to cities. In this context a per-capita payment could be viewed either as compensation for the District's lack of a state or as making up for the fiscal disadvantages of being the capital or both. The initial per-capita amount could be set at any desired level, but legislating a constant per-capita amount, possibly indexed for inflation, would provide predictability.

⁴⁶ The District of Columbia spent about \$125 million of its own tax revenue in FY2001 to provide mental health services, including the costs of running St. Elizabeths Hospital, an acute and long-term adult psychiatric facility.

⁴⁷ District of Columbia Office of the Chief Financial Officer, "Fulfilling Infrastructure Needs," September 18, 2001, Table, p. 17.

5. Provide state-type aid to education (K-12)

\$200–340 M/yr.

A major portion of state government spending is the provision of grants-in-aid to local governments for K-12 education. The funds are often reserved for specific use, such as special education, transportation, school construction, teacher education, reducing class size, or English-as-a-second-language classes. State aid varies with the wealth of the recipient district. Under this proposal the federal government would become the District's "state" with respect to funding elementary and secondary education. Such aid would help the District improve its schools and at the same time help relieve the general fiscal burden of not being part of a state.⁴⁸

Direct federal aid to school districts is not unknown or unprecedented. The federal government provides "impact aid" to a number of school districts in the country where the federal presence affects education budgets. According to the U.S. Department of Education, impact aid provides basic support payments to school districts that enroll significant numbers of federally connected pupils, such as those residing on Indian lands or living with a parent in the uniformed services. Impact aid also is used to make up for significant losses of real property tax base due to the acquisition of local property by the federal government. Beyond this, the federal government provides national funding for programs in school districts (including the District of Columbia) and is playing an increasingly active role in education policy, as Congress and the Bush Administration have made education a major policy goal.

In this light, strong precedent exists for significant aid to the District's educational system. For example, if the federal government were to provide the national or regional norm of state education aid to the District, the aid would total at least \$200 million (to reduce the District's share of total spending to the national norm of 53 percent), and could reach \$285 million (to reduce the District's burden to the region's 42 percent local share of education outlays). And there exist other standards of support. If the federal government were to match the State of Maryland's support of Baltimore, a city roughly equivalent in population size and composition to the nation's capital, federal support would need to reduce the District's local share of education funding to 24 per cent at a cost of \$340 million.

As to the form of such potential aid, it could be sent directly to the schools or to the District, to be distributed to the schools, since the city's general budget incorporates the District of Columbia Public Schools. Either way, the payments would provide ongoing operating budget relief, freeing up District tax revenues for alternative uses, including tax reductions.

⁴⁸ Although such aid might also fall into the special categories below, we have placed it under general operating relief because the District's budget is responsible for K-12 education, which represents a large portion of the city's overall spending. In the end, one dollar of relief on education spending is one dollar of general budget relief.

B. Five Proposals for Special-Purpose Funding

Providing general operating support is not the only way for the federal government to aid the District, although in our opinion it is by far the best way. Another approach would be for the federal government to invest significant special-purpose funding in the capital city’s betterment. The five proposals discussed below would all help the District become a more workable and attractive capital city—a Washington of which Americans would be proud and that visitors would enjoy. They would also provide visible evidence that the problems of older cities can be solved. They would not, however, guarantee ongoing fiscal stability for the District. Individually, these five proposals offer neither adequate relief to the District’s operating revenues nor recurring help. Some affect only the capital budget. Nevertheless, they would together—or in combination with one of the proposals for general operating support—make a significant contribution to the strength of the District.

1. Proposals to Support District Service Provision

- a. Restructure the Washington Metropolitan Area Transit Authority’s (WMATA) financing and governance \$32-107**
M/yr.

Crossing city, county, and even state boundaries, metropolitan transportation systems have become a common form of regional cooperation in America, as is the case with Washington.⁴⁹ For funding, they rely on fares and a combination of aid from federal, state and local governments. Federal support for the operating costs of the nation’s urban transit systems has been declining, while state shares have been rising.⁵⁰ In the capital region, the fare box presently provides half of WMATA’s operating costs.⁵¹ The other half is provided through an intricate system of subsidies from the member jurisdictions. Maryland picks up the entire local share for its suburban jurisdictions. Virginia shares the costs with its suburban localities—and controversy over the shares is ongoing. The District, by contrast, carries both state and local shares. District officials argue that District taxpayers carry a disproportionate share of the burden, in part because the shares have not been adjusted to reflect the fact that the suburban economies have been growing faster than

⁴⁹ President Johnson created the Washington Metropolitan Area Transportation Authority (WMATA) prior to home rule. There are six votes on the board, two each from the Maryland and Virginia suburbs, and two from the District of Columbia. Supervising metrorail and buses only, WMATA today consists of the 103-mile Metro train system of 83 stations and 5 lines, serving an estimated population of 3.5 million in a service area of 1,500 square miles, with about half a million weekday riders. Metro buses, meanwhile, operate largely in the District and part of the Maryland suburbs (with Fairfax, Arlington and other Virginia suburbs operating their own bus systems to supplement Metro bus in Northern Virginia) Metro buses transport another 500,000 weekday riders.

⁵⁰ American Public Transportation Association, *Public Transportation Fact Book*, 2001. <http://www.apta.com/stats/>

⁵¹ Of the nation’s top ten transit systems, the capital region ranks second only to New York for reliance on the fare box. See U.S. Dept. of Transportation, Mass Transit Administration, *Transit Profiles Report*, 1998.

the District's.⁵² At any rate, in FY2002, according to the District's CFO, the District's WMATA subsidy for Metro alone amounts to \$266 per capita, compared to \$109 per capita on average for the region.

As the region's largest employer, the federal government has much to gain from a first-rate metro transit system in the Washington area. One-third of WMATA's riders are federal employees,⁵³ and many Metro stations are located at or under federal employment centers to facilitate federal employees getting to and from their jobs.

Federal leadership is needed to help the Washington area create a more effective transportation system that will reduce pollution and congestion. The short-term problem is the distribution of WMATA's existing costs and subsidies, which are especially burdensome for the District. Maryland has already picked up the local share. In Virginia, voters in the northern region will vote on a referendum in November 2002 to raise the sales tax by one-half cent to pay for transportation projects in Northern Virginia.

The District, meanwhile, provides 88 per cent of the total local government support to Metro. With only two of the six votes on the WMATA governing board, it is unlikely that the District can win any change in the formula to redistribute this excessive burden without the help of the federal government. A short-term solution would be for the federal government to make a state-like contribution to the District's subsidy. Based on the FY2002 Metro budget and the average state contribution to the nation's ten biggest transit systems, it would cost \$32 million for the federal government to act as a state and contribute average state-type aid. If the contribution were to bring the District's per capita subsidy down to the average of those systems or this region, the costs would be as much as \$90 to \$107 million per year.

In the longer-term, we believe the federal government should help the region create a full-fledged, integrated regional transportation authority with responsibility over surface and commuter rail transport. This authority would have the power to price, levy taxes and tolls, and share revenues and costs across the entire regional system and all participants. Increasingly, the region's residents, employers, and elected leaders express dissatisfaction with mounting congestion costs, the lack of a dedicated funding stream for Metro, and irrational pricing between alternative modes of transportation. Without such a federally sanctioned regional authority, it will be almost impossible for the fragmented jurisdictions of the area to take the steps necessary to create an effective transportation system from which they, and the national government, could benefit so much.

⁵² Since the creation of WMATA, the economic balance of the region has changed significantly. From 1970 to 2000, the District's population decreased 24 percent while the population in Fairfax County and Montgomery County increased 113 percent and 67 percent, respectively. This shift within the region has been accompanied by suburban job growth, the regional dispersion of federal workplaces, significantly greater highway road traffic, and urban sprawl.

⁵³ District of Columbia Office of the Chief Financial Officer, "Fulfilling Infrastructure Needs," pp. 12-13.

b. Reimburse costs, or allow a special assessment, for specific national events

Presidential inaugurations and demonstrations designed to affect federal or international policy are clearly national, not just local events. In recent years crowds have gotten bigger and some demonstrations have been violent.

In the past, the federal government has recognized the fiscal burden on the District of some national events, such as presidential inaugurations. The reimbursement has been sporadic, after-the-fact and, even in the case of inaugurations, has not usually covered the full cost of the event.⁵⁴ This proposal suggests that operating revenue be provided on a regular basis to compensate for the extraordinary costs of national events. Predictable events, such as inaugurations should be budgeted in advance. In the case of demonstrations, such as those at the World Bank and the International Monetary Fund, the most direct approach simply would be for the federal government to compensate the District for the costs incurred. Some have proposed that the federal government give the District the authority to levy a special assessment on the property of the bank and the fund, but such a step would violate principles of diplomatic immunity and set potentially costly precedents for U.S. agencies operating abroad.

Regularizing federal compensation for the costs of national events would not offer ongoing budget relief but would prevent the costs of protecting the exercise of citizens' constitutional rights of free speech and protecting the citizenry and visitors from falling fully on the residents and business in the nation's capital city.

2. *Proposals for Federal Promotion of Economic Development in the District*

Economic development policy—direct public investment, the use of publicly borrowed funds on behalf of private development, and the geographical targeting of tax relief to promote job creation, economic activity, and a growing tax base—is traditionally the role of state government. During the fiscal crisis of the 1990s and in the Revitalization Act that followed it, the federal government made a state-type commitment to improving the private economy of the District. It included the District in the national Empowerment Zone program, which offers both federal and local tax relief to business. It has provided a federal income tax credit for first-time homebuyers in the District. It provided the initial \$25 million of capital to support the establishment of the National Capital Revitalization Corporation original proposal. And it has made a specific budget appropriation for a new subway station on New York Avenue to help anchor the District's economic development in that area.

⁵⁴ Police Chief Charles H. Ramsey stated that his department spent about \$3 million keep officers on 12-hour shifts for four days of inaugural events. He also said another \$900,000 was spent for 1,600 officers brought in from other jurisdictions, putting the combined costs well above the \$2.9 million the Presidential Inaugural Committee gave the department. (Marlene L. Johnson, : Ramsey says inaugural costs outstripped funds. *Washington Times*, Feb. 2, 2001. p. C4)

Many other opportunities exist for the federal government to help the District accelerate its economic development and grow its tax base. Two such opportunities are highlighted here, because they involve property owned by the federal government that cannot be developed without federal cooperation—the St. Elizabeths Hospital campus and the Anacostia waterfront. The third involves the federal government, which is the District's largest employer, acting as a good corporate citizen in enhancing the economic growth of its head-office city.

c. Resolve the future of the St. Elizabeths Hospital site. \$8.5-128M

St. Elizabeths Hospital complex encompasses more than 300 acres, two miles south of the U.S. Capitol. The site has magnificent views of the city and exciting potential for development. A National Historic Landmark (NHL), it also has unused, dilapidated buildings and a Civil War cemetery, in addition to medical and administrative buildings currently in use. The site is divided into an East campus, now owned by the District, and a West Campus still owned by the federal government.

The federal government has declared the West Campus excess property, but major obstacles still have to be overcome before its development potential is realized. The biggest obstacles appear to be: the federal property disposition process; the constraints of the NHL designation; unknown cost of remediating environmental damage; ongoing physical deterioration; and “a lack of funding and the absence of a clear direction for the future.”⁵⁵

Creative development of the site for both public and private uses could boost the economy and the quality of life in one of the poorest parts of the city. But the federal government and the District will have to work together to untangle numerous legal issues and overcome a long history of inaction.

The District's government should have a seat at the table as the federal government seeks to extricate itself from this site. There is also a strong case for the federal government bearing most of the costs of cleaning up the site for reuse, because it caused the damage and continues to allow it to worsen.⁵⁶ The immediate step should be for the federal government and the District to establish a joint task force, or some other formal working relationship, to prepare a plan for the property that is “agreeable to all the interested stakeholders.”⁵⁷

A U.S. General Accounting Office (GAO) study put an \$8.5 million price tag on the initial work of stabilizing and mothballing the buildings and beginning the planning process. Calling this

⁵⁵ The responsibility seems quite clear in a GAO Report, which states that “HHS is responsible for the environmental assessment and any required remediation.” Unfortunately, these costs are continuing to rise. Given the degree of inaction and the complexities of the environmental and landmark issues, development of this site must be seen as a long-term goal. See U.S. General Accounting Office, *St. Elizabeths Hospital: Real Property Issues Related to the West Campus*. GAO Report 01-434, April 2001, p.8.

⁵⁶ *Ibid.*, p.14.

⁵⁷ *Ibid.*, p.16.

“an early step” and “the bare minimum required to prevent any further deterioration . . .” the District’s Deputy Mayor for Planning cites a “1993 plan for the West Campus which places the costs for preparing the property for productive reuse at \$116 million to \$128 million . . .” or higher.⁵⁸ Whatever the ultimate costs, they will be spread over a number of years. It would be helpful if the executive branch and Congress were to commit the federal government at last breaking out of this long deadlock and facilitating use of this beautiful and potentially valuable site for the benefit of the nation’s capital city.

d. Clean up and develop the Anacostia River waterfront. \$400M

In 2000, the District, the federal government, and other local public entities committed themselves to the Anacostia Waterfront Initiative.⁵⁹ The initiative encompasses the Anacostia River and its shoreline from the Tidal Basin and Poplar Point to the Maryland border. Key target areas include the Southwest Waterfront, the Near Southeast Waterfront, Poplar Point, the RFK Stadium area, and Anacostia Park. The District Planning Office has laid out a comprehensive plan for the Anacostia river, with five strategic focuses: environment, access, parks, destinations, and neighborhoods/housing. The U.S. Department of Transportation has committed \$1.3 million for the design phase of the Anacostia Riverwalk, a District and federal government partnership, with several demonstration sites currently under construction. If completed, the 16-mile riverwalk would provide District residents and visitors easy access to 95 percent of the riverfront and connect the Potomac waterfront with the Bladensburg Marina and the Anacostia Tributary Trail System.

Creative development of the Anacostia waterfront for residential, commercial, and recreational uses could transform the city and augment its tax base. But the project represents a lengthy and costly undertaking. Federal involvement and resources are essential both to the cleanup and restoration of the Anacostia River and to acquisition of land along the waterfront.

The quality of the Anacostia environment currently imposes a significant hurdle for improvement. Combined sewers, which carry sanitary and storm water runoff, serve approximately one-third of the District of Columbia (a majority of the area is in the older developed sections of the District). In dry weather, the system delivers wastewater to the Blue Plains Wastewater Treatment Plant in southeast Washington. In wet weather, however, storm water also enters the system, and if the conveyance capacity of the system is exceeded, the excess overflows into the waterways of the

⁵⁸ Ibid., p.19.

⁵⁹ The memorandum of understanding for the Waterfront Revitalization Endeavor was signed on March 22, 2000 by the General Services Administration, the District of Columbia, the federal Office of Management and Budget, the Naval District Washington, the Military District Washington, the Marine Barracks Washington commanding officer, the U.S. Department of Labor, the U.S. Department of Transportation, the National Park Service, the U.S. Army Corps of Engineers, the Environmental Protection Agency, the District of Columbia Housing Authority, the Washington Metropolitan Area Transit Authority, the National Capital Planning Commission, the District of Columbia Sports and Entertainment Commission, the District of Columbia Water and Sewer Authority, the National Arboretum of the United States Department of Agriculture, and the U.S. Small Business Administration.

District of Columbia. This discharge is the combined sewer overflow (CSO). Approximately 66 percent of CSO drains into the lower Anacostia River from 17 outfalls.⁶⁰

Cleaning up the Anacostia River involves drastically reducing CSO drainage and restoring the natural habitats of the river. The task is estimated to cost nearly \$2 billion—a very large one-time expenditure. Throughout the nation, the cost of meeting such federal mandates is largely falling to states; where localities have such responsibilities, they turn to their states for help. The District cannot do that. In addition, the federal government’s dominance of the District environment means that it has contributed to the problem. According to WASA, federal properties generate about 18 percent of the CSO overflow, creating an inherent federal responsibility for at least some of the clean up. Further, these increasingly strict water and environmental standards have been mandated by the federal government on communities throughout the country and represent national policy goals.

Figuring out how to share the costs of meeting stricter environmental mandates has preoccupied elected officials, from the Congress to state houses to city halls, for the past decade. In general, local water and wastewater costs are recovered through user charges (primarily based on metered water usage) rather than property or income taxes.⁶¹ States and the federal government have tried to alleviate the impact on low-income ratepayers from the costs of meeting this CSO cleanup mandate. Maryland, for example, provides low interest loans to Baltimore. But the District, again, does not have a state to turn to.

Other cities, such as Boston and San Diego, have received federal money for this problem—\$750 million over a ten-year period and \$360 million over six years, respectively. We base our estimate of the cost of the federal commitment on that precedent.

The District also must have federal help in gaining access to the river, as much of it is owned by the federal government—70 percent of it by the National Park Service. The Park Service and other federal agencies have an opportunity to turn neglected and underutilized federal land into a beautiful living waterfront.

e. Position the federal government as a good corporate citizen

The District of Columbia is a company town, and the federal government has an interest in the vitality and viability of its central location. Typically, the goal of good corporate citizenship is to improve the quality of life. Doing so usually includes active involvement in economic development, technical assistance/loaned executives, beautification, cultural and philanthropic contributions and activities, and educational programs and help to the schools. The federal government, however,

⁶⁰ See “Combined Sewer System Long Term Control Plan.” District of Columbia Water and Sewer Authority (WASA), Draft Report, June 2001.

⁶¹ Baltimore and New York City offer East Coast examples of the use of water metering and charges, which are imposed on non-profits and governments as well.

has generally not thought of itself as major employer with a stake in improving the work environment or living conditions of its employees.

In “Envisioning a Future Washington,” the authors presented a neighborhood-based strategy that included building strong public-private partnerships through the leadership of an anchor institution. The federal government is perfectly positioned to play such an anchor role in several District neighborhoods. The Navy Yard has already begun to work intensively with the surrounding business and residential community to improve amenities and opportunities in the area for current residents and Navy Yard employees. Other agencies could work with their neighborhoods and with the city in creating opportunities for employees at all income levels to live closer to their jobs and to improve the schools and child care facilities in their neighborhoods.

V. ACCOUNTABILITY AND RESPONSIBILITY

The federal government, we believe, ought to contribute to the operating budget of the District of Columbia on an ongoing basis. But if the federal government were to make a regular contribution to the District's general operating budget, Congress would rightly ask: How do we know the money will be well spent? What assurances will the federal taxpayer have that the money will not be wasted? These questions should be asked about any federal appropriation, whether to a federal agency or to programs run by other levels of government. Indeed, federal agencies have devoted increasing attention in recent years—with mixed success—to improving controls on federal spending and providing measures of the outcomes of federal programs.

Given the District's history of poor management and accountability, it would hardly be surprising if many members of Congress were skeptical of the District's ability to spend money effectively. At the depths of the District's fiscal crisis in the mid-1990s, taxes were not being assessed accurately and collected uniformly, expenditure and financial controls were weak, service delivery was often inadequate and inefficient. Several major programs were performing so poorly that the courts turned their management over to receivers. Since then, the improving fiscal condition of the District and the joint efforts of new leadership in the city government and the federally appointed Financial Authority have produced substantial progress in the management and effectiveness of District services. Financial information systems have been modernized, fiscal and management controls strengthened, and efforts launched to measure the effectiveness of services and consumer satisfaction with the government's performance. Several programs have been removed from receivership and returned to District control. More remains to be done, but the management capacity and effectiveness of the District government have clearly improved. Nevertheless, because of the history, Congress is likely to be wary of giving the District operating funds without attaching strict conditions and requirements. Congressional strings, however, are threatening to the District's hard-won home rule, and the District is understandably leery of federal oversight.

The District is already required to submit numerous reports to the federal government. A recent GAO report listed 48 reporting requirements imposed on the District by Congress.⁶² These reports are costly and time-consuming to prepare, and it is by no means clear that they add to congressional or public understanding of how money is spent or help managers use it more effectively.

District budgets are also subject to a double legislative process. The Council of the District of Columbia reviews the mayor's budget proposal, holds hearings and expresses its budget priorities. Since the mayor has a veto, the budget that ultimately goes to the Congress is a compromise between the city's executive and legislative branches. The budget resulting from this already-cumbersome process is then reviewed by the House and Senate appropriations

⁶² U.S. General Accounting Office, *District of Columbia Reporting Requirements Enacted by Congress*, September 2001.

committees and debated on the floor of each house, often leaving the District operating on a continuing resolution if Congress fails to appropriate the funds by the beginning of the fiscal year. Congress frequently overrides the wishes of the District's elected officials by earmarking funds for projects favored by committee members and prohibiting some kinds of expenditures to please their own constituents elsewhere in the country.

Congressional interference with how the District spends its own tax revenues, combined with the fact that the District has only a non-voting delegate in the House and no representation in the Senate, perpetuates the District's sense of colonial status. This perception makes it difficult to attract talented public servants to the District's government and undercuts citizen participation in civic affairs. If a federal contribution to its operating budget were to result in even more Congressional restrictions on the District's autonomy, the cause of responsive democratic government in the nation's capital could be further set back.

We believe that Congress should want the nation's capital to be an example of top-flight city government. It should want Washington to have a democratically elected city government that is responsive and accountable to local citizens, with active citizen participation in elections and civic affairs, a strong professional civil service and high quality elected leadership. To that end, Congress should refrain from second-guessing the District's elected leadership and reduce onerous reporting requirements. At the same time, we believe that the federal government should help the District fund its budget and ensure that federal taxpayers are reassured that funds are being well spent.

Fortunately, the objectives of accountability to federal taxpayers and creating a better functioning democratic government in the District do not conflict. This is because the questions that should be asked by Congress on behalf of federal taxpayers are not, in fact, different from those that the District's council and civic organizations should be asking on behalf of District citizens and taxpayers. The District needs to work hard to demonstrate that it has become a modern, effective city, worthy of the respect and confidence of its own citizens and the rest of the country. To do that it needs to continue to make progress in at least four directions:

- Improving financial and management information
- Measuring the results of government programs and satisfaction with them
- Developing a more effective planning process, including contingency planning
- Improving the budget decision process
- Recruiting and retaining high-quality staff

If the District moves strongly and visibly to improve the functioning of its government and accountability to its own citizens, it may be able to forestall additional federal interference and even roll back some that now exists.

A. Improving Financial and Management Information

A well-run, modern city should have a financial management system that allows managers to assess the financial condition of the city at frequent intervals. It should permit them to see how rapidly revenues are coming in and to track how budgeted funds are being spent, including borrowed funds and grants, tax revenues, and expenditures on capital projects. A modern and technologically based financial management system reveals the city's cash position and current indebtedness and makes it easy for both internal and external auditors to perform their functions in a timely manner. It links together the central financial operations and those in the agencies. The system should be a tool to help managers at all levels and should be adapted to producing timely public reports as well.

The federal legislation that created the Financial Authority to address the District's financial crisis also established an independent CFO. At that time the District's financial and management information systems were antiquated, and the information they produced sketchy, often inaccurate, and routinely delayed. Under the leadership of the CFO and the pressure of the Financial Authority, much progress was made. Systems have been modernized and employees trained to use them. The quality and timeliness of information has improved enormously, and outside auditors are able to produce their reports on time. But tracking and control of expenditures are still weak; unexpected over-spending continues to occur. Steady progress is imperative if the Congress and the public are to be satisfied that District officials are getting a true picture of the financial condition of the city and sharing it promptly with all who need it.

B. Measuring Results and Customer Satisfaction

In recent years many cities have tried hard to improve the information available to the public about who is being served by government programs, how long people have to wait to get services, how effective the service is, and how well their customers are satisfied. In the last several years, after having almost no such information, the District has begun to move in this direction. Mayor Williams put out a "scorecard" early in his administration and has continued to update citizens on a limited list of measures. Several District agencies now publish waiting times and consumer satisfaction surveys.

Such measures are not easy to create. Choosing the wrong measure can produce misleading results and even create perverse incentives to managers and employees (for example, when excessive focus on speed leads to inferior service). Here again, however, continuous visible effort to measure the results of programs, combined with credible efforts to get feedback from customers, would enhance the confidence of the public and Congress that the District government is doing a good job.

C. More Effective and Long-Term Budget Planning, Including Contingency Planning

A well-run city should make a major effort to anticipate economic and demographic trends and to make decisions in the light of as much information about the future as it can assemble. It should revisit its plans frequently, assess how they are working out and make mid-course corrections when needed. This is particularly true with respect to budgeting and finance. Budgets are never set in stone; rather, they are works in progress, constantly needing reshaping at the margin, on both the revenue and spending sides.

The discipline of producing, revising, and adhering to a multi-year plan can help both the government and citizens to examine the future implications of present budget decisions. Examination of the assumptions used to forecast specific spending, payroll, and revenue growth, as well as the inclusion or exclusion of expected program and policy changes, create transparency for decisions, illustrate the implications over time of meeting competing priorities, and help to keep the budget in balance into the future.

Unfortunately, rigorous financial planning is hard and usually gets pushed aside by the demands of the moment, so few cities regularly engage in it seriously, unless forced to do so. The District has been particularly weak in budget planning. Although a four-year budget and financial plan have been produced since the Authority's tenure, the process involved more mechanical projection of current year spending and revenues than serious planning. To our knowledge, the only time the out-year gaps have been examined during budget policy making was when the Financial Authority insisted on it during the negotiations over the Tax Parity Act. It has not been common practice for District policy makers, unfortunately, to look to the financial plan implications of new programs or project spending decisions. Greater effort to refine projections and to examine the effects of possible new policies would improve the quality of decision-making and the confidence of stakeholders in the process.

Since events do not always go according to plan and cities can suffer unexpected setbacks due to events beyond their control, contingency plans and reserves for emergencies are highly desirable. Many cities maintain "rainy day" funds, although most are inadequate. The District did not have such a fund until recently. At the insistence of the Congress in the financial crisis, the District budgeted reserves for contingencies and built up its cash balances. As a result, it was in a far better position to deal with the 2001 recession and the aftermath of the terrorist attack than it would otherwise have been. Adequate reserves need to be maintained in the future.

D. Improving the Budget Decision Process

The District has made important progress in improving its budget process in recent years. It has rejected its past history of politically motivated, overly optimistic revenue projections. It now relies on experienced professional revenue estimators, who tend to err on the side of caution and prefer to be surprised on the upside.

Better information and a more disciplined decision process has also improved the ability of the mayor to put together a budget proposal that reflects his priorities and can be understood by the public and the Council. Much remains to be done, however. The District's budget documents are still far more arcane than necessary. Information on the results and effectiveness of programs, as noted above, is still extremely sketchy. These aspects of the budget process should improve as current efforts at measurement begin to take hold.

One particularly weak aspect involves the capital budget. Capital projects are expensive and require technical expertise to plan, cost and evaluate. The District has not had the capacity and technical sophistication in many areas to do the planning and the follow-through to complete capital improvements in timely fashion. Often the District has not had the ability to spend the capital funds that it has borrowed. As a result, neither managers nor citizens can have confidence that the District's capital investments will come to fruition or that the District is making the best use of its hard-won resources. A major effort is needed to repair the entire capital planning, budgeting and execution process.

The District could turn for assistance in capital planning to one or more states with stronger systems. Virginia, for example, has quite a well-developed capital planning system. Typically, the state and local government capital budget process begins with a strong multiyear planning component, based on an inventory of existing capital, regular assessments of the state of repair and use, ongoing maintenance, and a schema for the regular replacement of outmoded and depreciated equipment and facilities. This process and such assessments are not in place in the District. And, without such capital planning elements, capital budget estimates are unreliable. Finally, once capital financing takes place—generally through borrowing—the lack of technical capital-ready staff delays the ability to put funds to use and bring new infrastructure on line on a timely basis, which is a persistent problem for the District.

E. Recruiting and Retaining High-Quality Staff

The legacy of the fiscal crisis has been improved financial systems, personnel, and processes. The introduction of the office of an independent CFO has been at the core of these changes. Law and tradition now protect a strong CFO, with independence and immunity from political reprisal. To solidify these gains further, the District needs next to make a major effort to recruit and hold high quality professional staff, not only in the CFO's office, but throughout the government. The District can sustain its momentum only if the District works hard to become a city government that competent professionals are proud to work for.

The need for strong staff of the budgeting processes applies equally to the Council and the executive branch. The Council works hard on the budget, but it has a tiny staff. It lacks the depth of expertise necessary to examine the mayor's budget adequately and have a well-informed debate about budget priorities. To play its part in the budget process more skillfully, the Council needs a small but highly qualified budget staff—a mini-Congressional Budget Office—to assist it. And it

needs to play a much stronger role in forcing quarterly examination and modification of the current budget and the out-years of the financial plan.

If the District makes a sustained, visible effort along the lines discussed above to improve information and make it available to the public, the Congress should not need to impose additional obligations on the District in the name of accountability to federal taxpayers for a federal contribution to the District's budget. A full range of reporting and oversight requirements already exists. These requirements should satisfy Congress, as well as federal and District taxpayers, that federal money is being well spent without interfering with the District's ability to govern itself.

VI. CONCLUSION

Washington has the potential to be a truly great capital city. It already is a beautiful city that is home to the United States government. Visitors come from across the nation and around the world to participate in the business of government and to enjoy its monuments, parks, and cultural life. It could also be a model of urban living—a diverse community with lively neighborhoods, safe streets, excellent schools, and good-quality public services.

However, the unique status of the District of Columbia and the fiscal restrictions placed on it by the federal government prevent Washington from fully realizing its potential as a first-rate place to live, work, and raise a family. Washington's predicament, in this regard, stems in large part from its special status as the nation's capital. As these pages have noted, the District must provide services to its citizens that are normally provided by state as well as city governments. It also bears extra costs of serving the millions of visitors that come to the city because it is the capital. Yet, the District's biggest employer, the federal government, does not pay taxes. Nor do the international institutions and many of the national organizations that locate in Washington to be near the seat of government. Most important, the federal government specifically forbids the District from taxing the income earned in the District by non-residents. This prohibition, which would not exist if the District were a state, reduces the District's income tax base by two-thirds and effectively transfers that revenue-raising capacity to the states of Virginia and Maryland.

If the District were part of a state, the cost of education and other city services, especially the high cost of services to a concentrated low-income population, would be spread over a larger tax base including suburban and industrial areas. While the federal government has assumed some state-like costs on behalf of the District, it has left many others to the local taxpayers. Moreover, years of neglect and fiscal stringency have left the city with antiquated and inadequate infrastructure.

Washington has recovered from the deep financial crisis of the mid-1990's that put the city under the control of the federally appointed Financial Authority until 2001. As a result of recession, falling equity markets and the aftermath of the terrorist attacks, however, the District's elected leadership is now struggling to deal with the sharp revenue shortfall that affected almost all states in 2002. Coping with the this shortfall will be stressful, although the District has a relatively stable economy, is still enjoying a real estate boom, and has far more adequate reserves than it did a few years ago.

But even when income tax revenues begin to rise again, the basic fiscal predicament of the District will remain. Its revenue-raising capacity will still be severely restricted, while it must carry the responsibilities of a city, state, and national capital. The District cannot provide first-rate public services without raising tax rates to levels that undercut its economic viability. Without regular fiscal assistance from the national government, the District will be hard-pressed to improve its services, have difficulty maintaining its infrastructure, and face fiscal crisis when the economy slows.

This paper outlines the case for inaugurating substantial and continuing federal support for the District of Columbia. It presents a variety of mechanisms for providing such support and discusses some of the advantages and disadvantages of each. We hope it will spark a serious debate both in the District and in Congress about the fiscal future of the national capital and how federal assistance can best be used to strengthen it. In the end, it matters less which option is chosen and more that the federal government recognize a continuing responsibility to help the citizens and taxpayers in the District turn Washington into an exemplary capital.