DC Fiscal Policy Institute

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DC'S FUND BALANCE REMAINS LARGER THAN MOST STATES
Current Proposals to Rebuild DC's Reserves May Overly Restrict DC's Ability to Respond to Ongoing Budget Needs

DC's fund balance — essentially the city's savings account — has declined in recent years, after rising in the early 2000s. This has raised concerns among policymakers and has spurred new proposals in the FY 2011 budget to replenish the fund balance. But the level of concern — including speculation that DC's current fiscal practices could lead to the return of the federal control board — is exaggerated. Most states have drawn down their fund balance in response to the recent recession, which has been one of the worst on record. Despite substantial use of the fund balance over the past five years, DC's fund balance at the end of 2011 will be larger than in 43 states.

Moreover, DC's use of its fund balance in recent years in many cases reflected conscious decisions to use surpluses that had built up unexpectedly. The District utilized a substantial portion of its fund balance to pay directly for capital improvement projects rather than borrowing for them, as well as to address a change in government accounting standards that requires the city to set aside large payments for health benefits for DC government retirees. In the current recession, DC has used a portion of its fund balance to prevent severe cuts to city services. Much of the recent use of fund balance comes from a number of "special purpose" funds that were underutilized and had built up large surpluses.

The FY 2011 budget includes a proposal to set aside 100 percent of future surpluses – about $530 million – in a new "cash flow reserve." While the District is moving in the right direction by working to replenish the fund balance, the questions of when to do so and how much, need to be carefully considered. The proposal to designate all year-end surpluses for the cash flow reserve is concerning, especially at a time when city finances are still fragile, because the fund would likely not be available to address fiscal problems. Also, the proposal would build DC's reserves to a level that is higher than the city's peak fund balance in 2005 – and to the upper limits recommended by the National Association of Government Finance Officers. This could restrict the city's ability to respond to ongoing budget needs.

In addition, the budget includes a proposal to use surpluses to create an operating budget reserve of about $120 million for unforeseen spending pressures. While such a reserve makes sense, it would not be funded until after the $530 million cash flow reserve is fully funded — which would take years — and it would be larger than the $50 million reserve included in DC's budget in recent years. Perhaps most important, a large operating reserve could create disincentives to address spending pressures through budget savings.

Both of these proposals should be modified. In particular:

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- The District should designate a portion of surpluses— such as 50 percent —for these reserves, but not 100 percent. This is important because it would leave some funds available for unanticipated problems. Any rule that is set now will be hard to change, because loosening a proposal to build up the fund balance may be seen as fiscally irresponsible.

- The fund balance should be built up to give the city one month of "working capital," as recommended by government finance experts. This would mean setting aside about $143 million, rather than $530 million, in addition to the current six percent rainy day reserves.

- The operating cash reserve should be set at a lower amount – such as $50 million — and it should be funded before the cash flow fund is filled. This is important to ensuring that the city has flexible funds to address unforeseen fiscal problems.

DC's Fund Balance Remains Larger than in Most States

DC's fund balance includes funds for a variety of important purposes — including the city's rainy day reserves, escrow funds to back DC's bond payments, and taxes dedicated to specific purposes. When DC's economy is strong, the fund balance also includes accumulated budget surpluses. The money in DC's fund balance also provides "working capital" — funds that can be used to meet operating expenses when revenues don't come into the District coffers at the time that certain expenditures need to be made. A stable supply of working capital thus helps avoid the need for short-term borrowing to cover expenditures.

During the mid-2000's, when the District's economy was booming, the fund balance grew to a high of $1.6 billion. The fund balance fell to $920 million at the end of 2009 and current projections suggest that the fund balance could fall to $656 million at the end of FY 2011, although this is the worst-case scenario.

While this reduction has raised legitimate concerns, nearly all states began reducing their fund balances after FY 2008, following the start of the national recession. Moreover, DC's fund balance has consistently been higher than in nearly all states and remains so even with the recent declines.

- In 2008, a majority of states had fund balances that exceeded 5 percent of their general fund expenditures, according to a survey of the states completed by the National Governors Association and the National Association of State Budget Officers. (See Table 1).

- By the end of FY 2011, 32 states are expected to have fund balances of 5 percent or less of expenditures.

- In FY 2008, the District had a fund balance equal to 20 percent of general fund expenditures. This could drop to 11 percent of general fund expenditures by the end of FY 2011, using currently available budget information (see table 2).[1] While this represents a significant drop, it still leaves the District's fund balance higher than in 43 states (see table 3, next page).

[1] The FY 2010 and FY 2011 fund balance figures are estimated by DCFPI using the actual fund balance for FY 2009 and subtracting the fund balance uses that are proposed in FY 2010 and FY 2011 in the Mayor's FY 2011 proposed budget. Actual fund balance levels will not be determined until the end of the actual fiscal year and are likely to change based on revenues the District collects and actual spending.

TABLE 1: THE MAJORITY OF STATES HAVE REDUCED THEIR FUND BALANCE LEVELS DURING THE ECONOMIC RECESSION

TOTAL YEAR-END BALANCES AS A PERCENTAGE OF EXPENDITURES, FY 2008-FY2011

	Number of States			
Percentage	FY 2008 (Actual)	FY 2009 (Actual)	FY 2010 (Appropriated)	FY 2011 (Appropriated)
Less than 1.0%	2	11	14	15
1.0% to 4.9%	12	16	16	17
5.0% to 9.9%	16	14	12	10
10% or more	20	9	8	8

Source: National Association of State Budget Officers, *The Fiscal Survey of the States*, Spring 2010.

TABLE 2: THE DISTRICT'S FUND BALANCE HAS FALLEN SINCE THE START OF THE RECESSION, FOLLOWING THE NEED TO MITIGATE SEVERE BUDGET CUTS IN THE MIDST OF A RECESSION

DISTRICT OF COLUMBIA FUND BALANCE, GENERAL FUND EXPENDITURES, AND FUND BALANCE AS A PERCENT OF EXPENDITURES, FY 2008-FY2011 (in millions)

	FY 2008	FY 2009	FY 2010 (estimated)*	FY 2011 (estimated)*
Fund balance	$1,244,700	$920,500	$822,000	$655,700
General fund expenditures	$6,232,400	$5,926,700	$5,788,600	$5,884,000
Fund balance as a percent of total general fund expenditures	20.0%	15.5%	14.2%	11.1%

*Figures for FY 2010 and FY 2011 are estimates using currently available budget information and are very likely lower bound estimates. Actual fund balance levels will not be determined until the end of the actual fiscal year and are likely to change based on revenues the District collects and actual spending. Source: District of Columbia Proposed FY 2011 Budget and Financial Plan.

The District Intentionally Used Its Accumulated Fund Balance to Meet Several Important Needs

When DC's economy boomed during the mid-2000s, the District built up a substantial fund balance, reaching a peak of $1.6 billion in FY 2005 (see table 4). The District's leaders made a decision to draw down a significant amount of that fund balance, starting in FY 2006, for a series of purposes. In other words, the reduction in DC's fund balance — which had reached beyond 25 percent of DC's budget — was intentional. In particular, the fund balance was

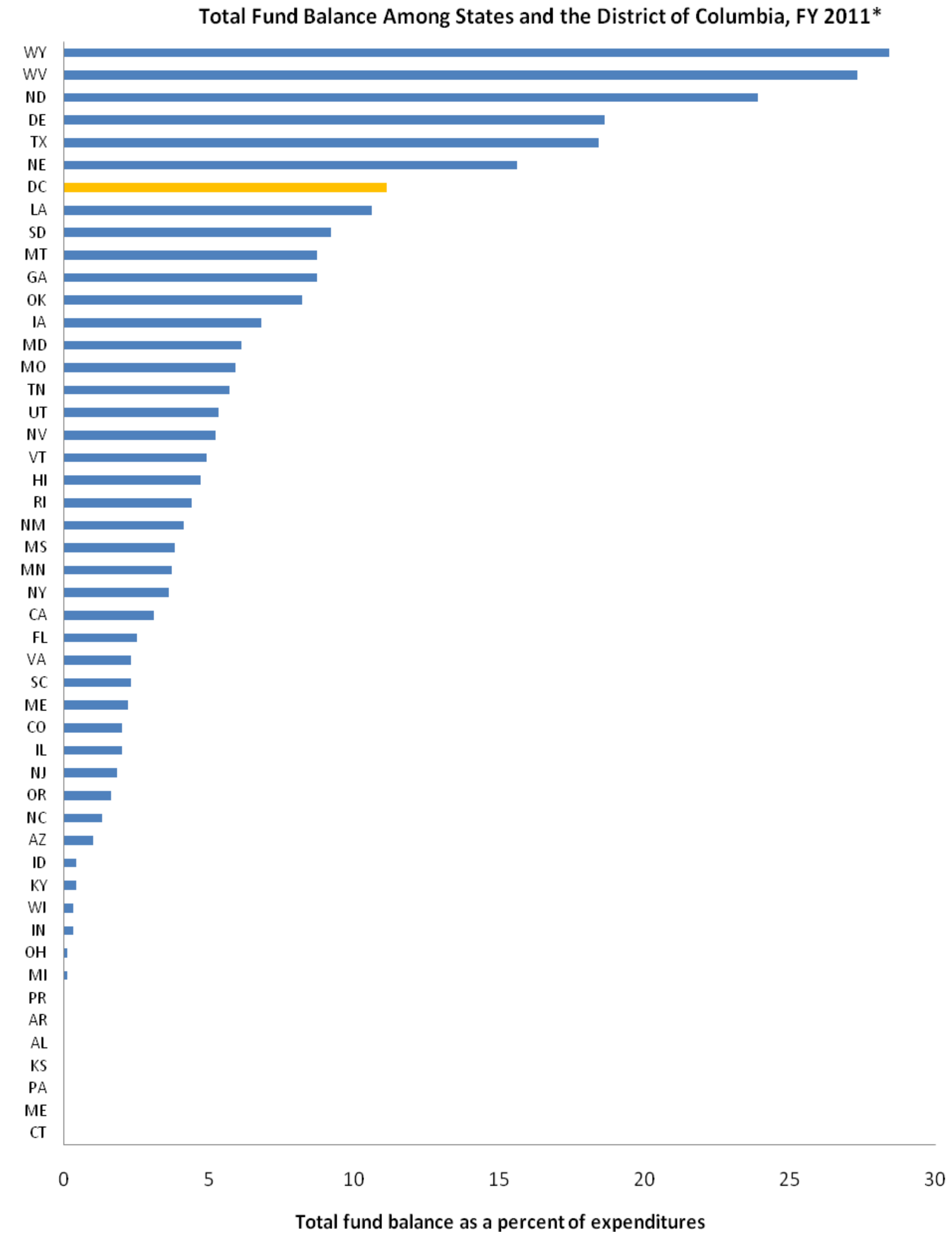
TABLE 4: DC HAS USED FUND BALANCE FOR CAPITAL IMPROVEMENTS, POST RETIREMENT BENEFITS, AND TO AVOID SEVERE CUTS TO PROGRAMS AND SERVICES IN THE MIDST OF A RECESSION

End Year Fund Balance and Fund balance use for the District, FY 2004 - FY 2011 (in millions)

	End Year Fund Balance	Fund balance use
FY 2004	$1,215	$129
FY 2005	$1,585	$81
FY 2006	$1,435	$528
FY 2007	$1,494	$122
FY 2008	$1,245	$473
FY 2009	$920	$477
FY 2010*	$822	$153
FY 2011*	$656	$167

*Figures for FY 2010 and FY 2011 are estimates using currently available budget information and are very likely lower bound estimates. Actual fund balance levels will not be determined until the end of the actual fiscal year and are likely to change based on revenues the District collects and actual spending. Source: District of Columbia Budget and Financial Plan.

TABLE 3: DESPITE SUBSTANTIAL USE, IT IS EXPECTED THAT DC'S FUND BALANCE WILL REMAIN FAR HEALTHIER, AND HIGHER, THAN THE MAJORITY OF STATES AT THE END OF FY 2011



* The chart above omits fund balance totals for the following large outlier states: Alaska (253 percent), Washington (-7 percent), and New Hampshire (-18 percent). Source: National Association of State Budget Officers, *Fiscal Survey of the States*, Spring 2010.

used to fund post-retirement health benefits for DC government employees and to make substantial payments to fund the growing need of infrastructure improvements without borrowing.

- From FY 2005-FY 2012, the District has spent, or appropriated, a total of $576 million on "pay-go" capital projects, including $265 million in FY 2006, the year the District spent its largest amount of fund balance.

- From FY 2005- FY 2012, the District has spent, or appropriated, $630 million on post-retirement benefits, including $138 million in FY 2006, the year the District spent its largest amount of fund balance.

TABLE 5: THE DISTRICT HAS MADE LARGE PAYMENTS TOWARDS POST RETIREMENT BENEFITS AND PAY-GO FUNDING, SOME IF IT PAID FOR WITH FUND BALANCE

Total general fund spending, or appropriation, on "pay-go" capital projects and post-retirement benefits, FY 2005-FY 2012 (in millions)

	Pay-go	*Post-retirement*
FY 2005	21	0
FY 2006	265	138
FY 2007	119	5
FY 2008	141	111
FY 2009	20	81
FY 2010	3	91
FY 2011	8	99
FY 2012	0	105

Source: District of Columbia Budget and Financial Plan

Table 5 shows the total amount of general fund spending on pay-go for capital projects and post-retirement benefits from FY 2005-FY 2012.

In more recent years, a significant amount of the fund balance use has come from drawing resources from numerous special purpose revenue funds — funds financed by fees and fines that are then used for designated purposes — which the city maintains. In many cases, these funds have not been utilized fully, even though the full balance of the fund was appropriated in the budget. As a result, these funds built-up substantial reserves. Using these reserves is reasonable since the surpluses were not part of an intentional plan to build up the city's fund balance.

In FY 2010, a total of $153 million of fund balance was used. Nearly 65 percent of that fund balance, or $98 million, consisted of special purpose funds. For FY 2011, $77 million of the total $167 million in fund balance use — 46 percent — came from special purpose funds.

The FY 2011 Budget Proposal to Re-build DC's Reserves Would Overly Restrict DC's Finances

The FY 2011 Budget Support Act includes proposals to rebuild both the fund balance, through the creation of a working capital reserve, and to create an operating cash reserve by designating all end-year undesignated surplus to both reserves until they are built up to a specified level. While the direction of these proposals is prudent, it would re-build reserves in a way that restricts DC's finances and would build them to a level beyond what is necessary. This could hinder the city's ability to respond to our ongoing budget needs.

Working Capital Reserve

The FY 2011 Budget Support Act calls for setting aside all end-year undesignated surpluses into a new fund solely available for "working capital" needs. Working capital is used by the District to manage cash-flow needs, because revenue collections don't always come in at the same time that expenses need to be made. Having more working capital helps the District avoid the need for short-term borrowing.

The Budget Support Act would call for setting aside an amount equal to nearly 15 percent of DC's budget for working capital, including a new reserve of nearly nine percent and six percent from the already established emergency and contingency reserves (our rainy day reserves). Adding a new working capital reserve equal to nine percent of our expenditures would mean that the District would be setting aside, at minimum, an additional $531 million.[2]

However, these changes would result in the District creating a reserve for working capital that would go beyond what the District has historically had for such purposes and beyond what experts say is the minimum necessary.

- Under the proposal, DC would have $531 million in fund balance beyond resources needed for purposes such as the rainy day fund or bond escrow.

TABLE 5: THE LARGEST AMOUNT OF UNDESIGNATED FUNDING AVAILABLE IN THE DISTRICTS FUND BALANCE SINCE FY 2004, WAS $175 MILLION

Total Amount of Undesignated and Unreserved Funds in the District's Fund Balance, FY 2004-FY 2011 (in millions)

FY 2004	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010 (estimated)*	FY 2011 (estimated)*
$54	$175	$138	$81	$87	$0	$0	$0

* Figures for FY 2010 and FY 2011 are estimates using currently available budget information and are very likely lower bound estimates. Actual amounts of unreserved and undesignated fund balance levels will not be determined until the end of the actual fiscal year and are likely to change based on revenues the District collects and actual spending. Source: Figures for FY 2004-FY 2009, District of Columbia Certified Financial Audit Report. Figures for FY 2010 and FY 2011 are estimates using currently available information from the District Budget and Financial Plan.

- Yet since FY 2004, the District has never had more than $175 million in undesignated funds, in FY 2005 (see table 5).

- The Government Finance Officers Association (GFOA) recommends states have a one to two month level of working capital, which would equal approximately 8 percent to 16 percent of expenditures. In order to create a reserve equal to one month of expenses, the District would only be required to create a reserve of just over two percent, or $143 million, because DC already has an emergency/contingency reserve equal to six percent that can also be used for working capital.

Moreover, the proposal to set aside 100 percent of the District's undesignated and unreserved end-year surplus could restrict DC's ability to respond to ongoing budget needs that may rise in the future. This is significant because once financial rules that dictate our fiscal management practices are set into law, they may be hard to undo without risking an unfavorable view on the District by Wall Street rating agencies

[2] All figures used to determine actual funds that could be set aside under the current FY 2011 Budget Support Act proposals are based off of the total general fund expenditures budget for FY 2011. The actual amount set aside for the reserve could change, depending on the total amount of general fund expenditures.

The District's recently adopted debt cap, which limits debt payments to 12 percent of the budget, is a good example. Wall Street rating agencies would undoubtedly look unfavorably upon any effort to increase the debt cap. Given the fact that it is likely to take 10 years or more to rebuild our fund balance, it is crucial that the District pick a repayment method that it is sure it can live within.

Policymakers may want to have greater flexibility to dictate our resources where they are needed most, particularly as the District climbs out of one of the worst economic recessions in history and finances remain extremely tight.

As a result, it would make more sense to designate a portion of year-end budget surpluses — such as 50 percent — to be deposited into the new reserve for working capital purposes. This would put into place rules to re-build the fund balance, while also allow giving the District some flexibility to respond to unforeseen ongoing budget needs. Additionally, DCFPI recommends a working capital fund that would total one month of the District's budget. This would require creating a new reserve of just over two percent, or $143 million, since the emergency contingency reserve fund — equal to six percent of the budget — also can be used for working capital. This would help ensure that the District has a steady supply or working capital but that it isn't setting aside more funds than are necessary in reserves.

Operating Cash Reserve

In order to rebuild an operating cash reserve, the FY 2011 Budget Support Act also calls for setting aside 100 of undesignated end-year reserves, <u>after</u> the working capital fund has been built up, into a reserve that can be used for operating budget needs. This fund would be a total of two percent of the District's budget, or approximately $123 million.

An operating cash reserve is an important fiscal tool. It allows the District to respond to unforeseen spending pressures that arise during the year. The District had a $50 million operating reserve until FY 2009 when it was eliminated.

The proposal to rebuild the operating reserve is prudent, but there are two key concerns about the current proposal needs.

First, the proposed operating reserve would be far larger than the $50 million reserve that had been in place prior to FY 2009. A reserve as high as two percent could lessen incentives to keep spending under control, or to address spending pressures through finding budget savings elsewhere in the budget.

Second, the operating reserve would not be funded until after the cash flow reserve is fully funded. Since the operating reserve provides important flexibility to address fiscal problems — and may be especially important as DC's finances remain weak due to the recession — it would be more beneficial to fund the operating reserve first.

This leads to two recommendations. First, the District should set aside a reserve equal to $50 million for operating needs. Second, the operating reserve should be funded first, before the larger and more restricted cash flow reserve is funded. These recommendations would ensure that the District can maintain its flexibility to respond to ongoing budget needs and also would not be setting aside more money than has been historically utilized to meet unforeseen spending pressures.

Conclusion

Because a healthy fund balance is an important fiscal tool for all states, it is important that the District's leaders come up with a plan to begin replenishing its fund balance when the city's finances stabilize and recover. The District's budget is still feeling the effects of the recession, and it is important that the budget remain flexible to respond to the District's needs. In addition, the financial rules set today will very likely not be able to be undone without risking unfavorable views from Wall Street. It is critical then, that the District ensures it is choosing limits with which it can live by. Building up the fund balance and operating reserve — by over $650 million — by setting aside 100 percent of all end-year undesignated surpluses will likely take a number of years. It would be more prudent for the District to set aside 50 percent of undesignated end-year surplus and lower the amounts of reserves to be in line with more historical use to ensure we remain fiscally responsible and have the flexibility to deal with our budget needs now, and in the future.