DC
Fiscal Policy Institute

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USING FUTURE REVENUES TO BUILD A PAY-GO ACCOUNT MAY FORCE THE DISTRICT TO CUT THE BUDGET FOR CURRENT SERVICES, AND WILL LIKELY NOT REDUCE BORROWING AS INTENDED

A proposal in the FY 2011 Budget Support Act would establish a new mechanism to build up a "pay-go capital" account using a significant portion of future revenues. Pay-go capital refers to supporting infrastructure improvements with operating revenues rather than by borrowing. Yet because DC's finances are still weak, and revenue growth is expected to be less than even the rate of inflation, devoting a portion of future revenue increases to pay-go capital would likely lead to cuts in basic services.

Moreover, while the intent of this proposal may be to reduce the amount of borrowing the District is required to do, the proposal would not in fact guarantee any reduction in general obligation borrowing.

The current proposal would dedicate 35 percent of all future revenue growth into a fund to be used for pay-go funding for capital projects, (using the current revenue projection for FY 2011 as a base). Revenues would be deposited into the account every year unless the District's debt service expenditures fall to five percent of total expenditures. Currently, the District spends nearly 12 percent of expenditures on debt service and is expected to continue spending at that level through at least FY 2014.

DCFPI recommends that the Council remove the pay-go proposal from the FY 2011 Budget Support Act. It is not clear at this time why a substantial pay-go account is a priority, and it could limit the flexibility of policymakers to respond to ongoing budget needs. Instead, funding allocated to pay-go should be decided on an annual basis and based on the District's financial climate and the projects that need to be completed.

The Current Proposal Could Force the District to Cut Current Services to Fund Pay-Go

The current proposal to build a "pay-go" fund could force the District to make significant cuts in other parts of the budget Current revenues are expected to grow approximately $60 million per year from 2010-2014, according to the FY 2011 Budget and Financial Plan. That represents growth of approximately one percent per year, which is far less than even inflation. If revenues grow slightly more than expected, undoubtedly those will be needed just to maintain basic government services, as costs typically rise every year at least at the rate of inflation.

Using operating revenues for capital projects is a practice that should be limited to times when finances are strong. The standard way to fund infrastructure projects — projects that have a lifetime — is through general obligation bonds that are then repaid over the life of the project. DC's policymakers have set aside substantial amounts of money for pay-go since 2006, when economic times are good, particularly from FY 2006 through FY 2008 (see table 1). But it is reasonable to expect that during a recession, limited revenues should be used to preserve city services rather than pay-go capital, and that capital projects should be funded only with long-term borrowing

TABLE 1: IN STRONG ECONOMIC TIMES, THE DISTRICT HAS MADE SUBSTANTIAL PAYMENTS TOWARDS PAY-GO

Total General Fund Spending, or Appropriations, towards Pay-go, FY 2004-FY 2011 (in millions)

FY 2004	$0
FY 2005	$21
FY 2006	$265
FY 2007	$119
FY 2008	$141
FY 2009	$20
FY 2010	$3
FY 2011	$8

Source: DC Budget and Financial Plan

The Proposal Provides No Incentive to Actually Reduce Borrowing; Capital Funding Could Skyrocket under Proposal

The current proposal appears intended to set aside funds for pay-go capital in order to reduce the need for borrowing. However, there is no mechanism in the proposal to actually reduce borrowing as pay-go spending is increased. Without such a mechanism, it is likely that the District would continue to borrow at its limit of 12 percent and simply use pay-go funding as an added source of capital funding. This would result in more that 12 percent of DC's operating budget being allocated towards capital projects.

Additionally, the proposal effectively places no limit to the amount of pay-go funding that could be built up. It requires 35 percent of revenues to be deposited into a pay-go account until the District's spending on debt service equal five percent of expenditures. Currently, the District is spending nearly 12 percent of expenditures on debt service. Reducing debt service payments to just five percent of the budget would require a reduction of more than 50 percent in such payments. Because much of DC's debt service reflects repayment of funds borrowed in prior years — and because borrowing needs for current projects remain high — there is no easy way in the short term to reduce debt service payments substantially. It will be well into the future before the District is able to reduce its debt service to a level of five percent, and it may not even be feasible in the long-term. Thus, the current proposal could result in rebuilding a substantial amount of pay-go at a time when the District is struggling to maintain services in the midst of a recession.

Recommendations

DCFPI recommends that the current proposal to fund pay-go by using 35 percent of all future revenues be removed from the FY 2011 budget support act. As the District struggles to fund services in the midst of one of the worst recessions in history, allocating even more funds for capital projects could force the District to cut the budget further. The proposal would ultimately limit the flexibility of policymakers to respond to ongoing budget needs. Instead, funding allocated to pay-go should continue to be decided on an annual basis by both the Mayor and Council, depending on the District's financial climate and the projects that need to be completed.