



Examination of the District's Reserve Fund Policies

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A Report by the Office of the District of Columbia Auditor
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The Honorable Phil Mendelson, Chairman
Council of the District of Columbia
1350 Pennsylvania Avenue, NW, Suite 504
Washington, D.C. 20004

Letter Report: Examination of the District’s Reserve Fund Policies

Dear Chairman Mendelson:

Anticipating a discussion during the fiscal year (FY) 2016 budget process over whether to spend or save the District’s FY 2015 surplus, the Office of the District of Columbia Auditor (ODCA) examined the policies and practices governing the District’s reserve funds. We compared District policies with best practices as well as the policies of other U.S. states and large cities. ODCA also assessed the city’s revenue losses and gains and drawdown of reserve funds during the most recent economic downturn, as compared to other states and large cities, in order to benchmark the District’s performance. We offer this assessment to provide context for how the District is likely to weather a future economic downturn based on current reserve fund policies.

Background

Most states¹ and many large U.S. cities maintain what are called “rainy day” funds to protect against unforeseen economic downturns. These funds — typically known officially as budget stabilization funds, economic uncertainty funds, or simply reserve funds — vary dramatically with respect to their size and the rules governing their use across the states and cities, but their purpose is a common one: to offset revenue declines due to economic volatility in tax and non-tax revenues and protect the government’s ability to fund critical services provided to residents.

Thus, these reserve funds operate as a form of countercyclical economic policy. States and local governments generally have policies in place that require them to contribute a portion of revenues to these funds when revenues exceed expectations or to automatically replenish them within a set number of years after a withdrawal is made. As part of this process, most governments also set a target size or minimum balance for their budget stabilization funds, which is usually expressed as a percentage of general fund revenues or general fund expenditures. Such requirements allow the size of the fund to adjust automatically, as the size of the budget changes. During economic downturns or periods when revenues do not perform as well as projected, states and local governments may decide to draw upon these funds to close all or a portion of the budget gap, reducing (or eliminating) the need to cut spending as part of balancing the budget.

¹ Only four states—Colorado, Illinois, Kansas, and Montana do not have designated rainy day funds. See Elizabeth McNichol, “When and How States Should Strengthen Their Rainy Day Funds,” Center on Budget and Policy Priorities, April 16, 2014, <http://www.cbpp.org/sites/default/files/atoms/files/4-16-14sfp.pdf>.

District Reserve Fund Size and Funding Levels

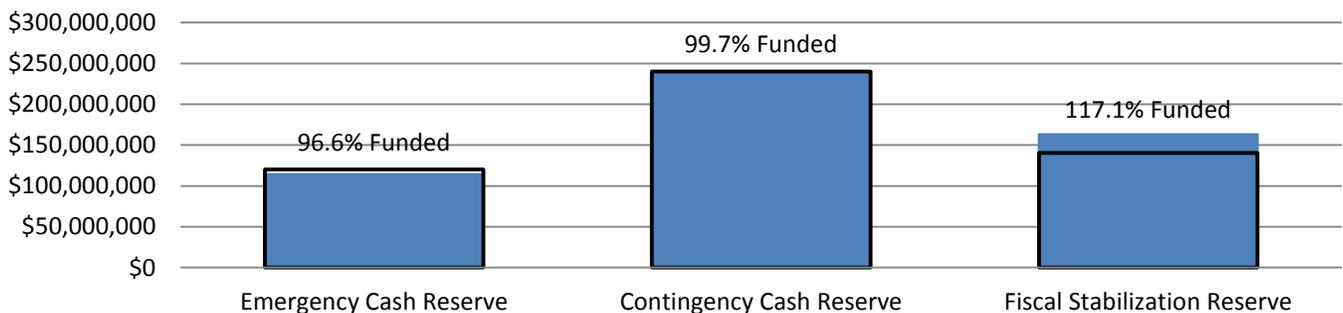
The District maintains three reserve funds.² Two of these funds — the Emergency Cash Reserve and the Contingency Cash Reserve — are mandated by Congress as part of the District of Columbia Home Rule Act.³ Combined, these two funds must equal six percent of the previous fiscal year’s general fund-local expenditures, minus debt service costs. At full funding, the emergency reserve consists of two percent of expenditures and the contingency reserve consists of four percent. A third fund — the Fiscal Stabilization Reserve — was created by the Council in 2010 to serve as an extra revenue buffer in times of economic uncertainty or unforeseen disaster.⁴ At full funding, it equals 2.34 percent of the District’s general fund operating expenditures (less debt service) for each fiscal year.

As of the most recently completed fiscal year (FY 2014), all three of these funds were either nearly or more than fully funded. The Emergency Cash Reserve contained \$116,016,000 — about 96.6 percent of its statutory full funding level of \$120,065,380 based on the general fund-local expenditures the previous fiscal year (FY 2013). The Contingency Cash Reserve contained \$239,401,000 or 99.7 percent of its full funding level of \$240,130,760. The Fiscal Stabilization Reserve was actually substantially over-funded at the end of FY 2014, in part due to mandatory appropriations of past years’ budgetary surpluses to the fund. It contained \$164,551,000 or 117.1 percent of the statutory requirement.⁵ Combined, the three reserve funds contained \$519,968,000 on September 30, 2014, or about 8.7 percent of the previous fiscal year’s general fund-local expenditures (less debt service). See Figure 1, which shows how the District’s three reserve funds were nearly fully funded as of the end of FY 2014.

Figure 1

District Reserves Funds Nearly Fully Funded at Close of FY 2014

FY 2014 fund balance as of September 30, 2014 and statutory requirements based on FY 2014 general fund expenditures less debt service



Source: Comprehensive Annual Financial Report for the District of Columbia for the Fiscal Year Ended September 30, 2014

■ End of FY2014 Funding □ Full Funding Level Per Statute

² In addition to the three rainy day funds outlined above, the District also maintains a separate Cash Flow Reserve which may be used by the CFO as needed to smooth over gaps in revenues collections. Because some revenues (such as property and personal income tax collections) enter the District’s coffers only during set periods each year, the CFO may need an advance on these funds to continue operations. This fund allows for that advance to occur. Any funds withdrawn from the Cash Flow Reserve must be replenished in the same fiscal year they were used. As such, this fund is not generally considered a “rainy day fund,” and ODCA does not include it as one in our analysis. See D.C. Official Code § 47-392.02(j).

³ See D.C. Official Code § 1-204.50(a).

⁴ See D.C. Official Code § 47-392.02(j-1).

⁵ D.C. Code requires the CFO to deposit 50% of the undesignated end-of-year fund balance into both the Fiscal Stabilization Reserve Account and the Cash Flow Reserve Account if either account is below full funding. See D.C. Code § 47-392.02(j-3).

As of the most recent quarterly update provided by the District Chief Financial Officer (CFO) on December 31 2014, the Emergency and Contingency Cash Reserves remain relatively unchanged in funding, excepting a small drop in the Contingency Reserve of \$7.4 million to pay out severance pay, annual leave, and transitional activities related to the November election and change in administrations.⁶

Statutory Requirements for Use and Replenishment of District Reserve Funds

Despite having similar guidelines and requirements for funding levels, the rules governing the withdrawal and use of monies from these funds differ substantially. The Fiscal Stabilization Reserve and the Contingency Cash Reserve may be drawn down by the Mayor to provide for nonrecurring or unforeseen needs (e.g. severe weather or other natural disasters, and unexpected obligations created by federal law) that arise during the fiscal year. They also may be used to cover unexpected revenue shortfalls due to economic circumstances experienced by the District for at least three consecutive months that are 5 percent or more below the budget forecast. The major difference between the two funds is that the Fiscal Stabilization Reserve cannot be used to cover short term cash flow management (i.e. paying operating expenses while waiting for monthly/quarterly tax receipts).

Unlike the others, the Emergency Cash Reserve fund may only be drawn down to provide for unanticipated and nonrecurring extraordinary needs of an emergency nature (e.g. natural disasters, public health emergencies, or calamities) and also may be used in the event that the Mayor declares a State of Emergency in the District.

All three funds are also governed by rules requiring any funds withdrawn to be replenished within a set period of time. For both the Contingency Cash Reserve and the Emergency Cash Reserve, any withdrawal of funds must be replenished fully within two full fiscal years. The Mayor and Council must appropriate at least 50 percent of the amount withdrawn each year for the subsequent two fiscal years after the funds are tapped, or enough to bring them back up to full funding, whichever is less. In addition to the replenishment requirements, there is also a limit on how much can be withdrawn from either fund. No single withdrawal can exceed 50 percent of the existing balance of the Contingency Reserve Fund at the time the withdrawal is made.

The Fiscal Stabilization Reserve operates slightly differently. If that fund (or the above mentioned Cash Flow Reserve — see Footnote 4) is below full funding when the Comprehensive Annual Financial Report is issued, the District's Chief Financial Officer must deposit 50 percent of the unassigned end-of-year fund balance to each of these two reserves, or 100 percent of the end-of-year unassigned fund balance to the reserve that has not reached full capacity. This requirement is designed to fully fund the reserves to the extent allowed by the end-of-year fund balance.

⁶ Office of the Chief Financial Officer (OCFO), "First Quarter FY 2015 Status Report on the Emergency and Contingency Cash Reserve Funds as of December 31, 2014," February 6, 2015.

Objectives, Scope, and Methodology

The primary objective of this letter report is to inform Council's deliberations with regard to possible additional allocations or policy changes to the District's reserve funds as part of the FY 2016 budget process and beyond.

The report's scope is limited to the following:

1. Research on leading practices regarding reserve fund policies and governance;
2. Data and analysis on the District's finances during the previous recession and subsequent economic recovery, including losses and gains in total tax revenue and the drawdown of reserve funds; and
3. Information on how the District's reserve fund size and policies and fiscal performance during the economic downturn compare with other states and large U.S. cities.

To accomplish this objective, ODCA conducted an extensive review of literature and data relating to reserve fund current best practices and state and local government finances from academic, nonprofit, government professional agency (e.g. the Government Finance Officers Association—GFOA), and ratings agency (e.g. Moody's, Standard & Poor's, Fitch) sources. Included in these collected data and presented here are findings from several analyses of U.S. states and large cities by organizations other than ODCA, which provide context for how the District's fiscal policies and performance compare to other states and cities. In a few cases, ODCA expanded on analyses that did not originally include the District by collecting data according to the original study's methodology and comparing the city's performance to the other states or cities. Those cases are noted throughout the report.

Because this is an analysis and not an audit, we did not conduct a data reliability assessment or otherwise verify the data collected from cited sources beyond ensuring that it was correctly transcribed in this report. Therefore, the numbers in this report should be regarded as unaudited figures. We did not conduct the examination as an audit as defined by the Government Accountability Office's Government Auditing Standards.

Results of the Auditor's Analysis

Leading Research on Reserve Funds Centers around Revenue Volatility

A significant amount of current public finance, academic, and nonprofit research and best practices surrounding reserve and rainy day funds focuses on three specific questions:

1. What is the optimal size of the reserve fund balance to guard against unexpected economic downturns or revenue losses?
2. What rules should govern deposits into the fund and repayments of withdrawn dollars to ensure the reserve remains available in times of need?
3. What rules should govern withdrawals from reserve funds to ensure that they are not mismanaged or over-used?

When it comes to the first question, the optimal size of reserve funds, a number of public finance organizations have developed guidelines and criteria based on their own analyses or standards. For example, the Government Finance Officers Association (GFOA) recommends as a best practice that “at a minimum,” general purpose governments (including states, cities and counties) “maintain unrestricted fund balance in their general fund of no less than two months of regular general fund operating revenues or regular general fund operating expenditures.”⁷ Put in terms of a percentage of annual spending, this rule of thumb recommends a total reserve fund of about 17 percent of general fund expenditures.

The three major credit ratings agencies (Moody's, Standard & Poor's, and Fitch) likewise have guidelines for the optimal size of reserve fund balances as a percent of operating revenues or expenditures that factor into how they rate general obligation debt of state and local governments, though their criteria varies. Moody's, for instance, bases 10 percent of its overall rating on the structural balance of a state's budget and the size of its rainy day fund, assigning the best rating to states with “available balances greater than 10 percent, with requirements to rebuild Rainy Day Fund if drawn upon.”⁸ Fitch Ratings similarly recommends that “a general target for prudent reserve levels is 5 percent - 10 percent of general government spending” but notes “the appropriate level ranges widely by state.”⁹ Standard & Poor's evaluates state finances differently, but takes reserve funds¹⁰ into account as either a net positive (if they are larger than 75 percent of general fund expenditures) or a net negative (if they are less than negative 5 percent)¹¹ that can raise or lower a final credit rating by one notch.¹²

⁷ Government Finance Officers Association, “Determining the Appropriate Level of Unrestricted Fund Balance in the General Fund,” October 2009, <http://www.gfoa.org/determining-appropriate-level-unrestricted-fund-balance-general-fund>

⁸ Moody's Investors Service, “US States Rating Methodology,” April 17, 2013, [http://www.nasra.org/Files/Topical%20Reports/Credit%20Effects/Moodys State Methodology April 2013.pdf](http://www.nasra.org/Files/Topical%20Reports/Credit%20Effects/Moodys%20State%20Methodology%20April%202013.pdf)

⁹ Laura Porter, Marcy Block, Karen Krop, *et al.*, “U.S. State Government Tax-Supported Rating Criteria,” Fitch Ratings, August 14, 2012, https://www.fitchratings.com/creditedesk/reports/report_frame.cfm?rpt_id=686033

¹⁰ Standard & Poor's defines reserve funds as “available fund balance” which includes general fund balances classified as unassigned, assigned, and committed according to the Governmental Accounting Standards Board's rule 54, plus any additional fund balances not in the general fund that can be used for operations. According to this definition, the District's Contingency Cash Reserve and Emergency Cash Reserve would not be classified as reserve funds because they are “restricted” according to GASB 54.

¹¹ A reserve fund or rainy day fund balance can be reported as a negative in financial reports if the fund was overdrawn during the fiscal year and required transfers from other funds to make it structurally balanced.

¹² Jeffery J. Previdi, Christopher M. Jrahe, Lisa R. Schroer, *et al.*, “U.S. Local Governments General Obligation Ratings: Methodology And Assumptions,” Standard & Poor's Ratings Services, September 12, 2013, http://www.standardandpoors.com/spf/upload/Events_US/US_PF_logo102014.pdf

With respect to the District's performance against these guidelines, the ratings agencies have differed somewhat on how the current size of the city's reserve fund is affecting its overall general obligation bond rating. Fitch ratings, in upgrading the District's GO bond rating from AA- to AA in September 2014, cited "solid" reserve fund balances that had "[rebounded] strongly after recessionary drawdowns" as reasons for the credit rating increase, but cited the city's "elevated debt burden" and federal government contraction as ongoing concerns.¹³ Moody's, on the other hand, which upgraded the District's rating from Aa2 to Aa1 in March of this year, noted that if there were "materially stronger fund balance ratios" and "the ability to access currently off limits portions of the tax base, such as the large portion of exempt property or nonresident commuter incomes" those conditions could increase the District's bonds to AAA status—the highest possible rating.¹⁴ A larger rainy day fund balance leading to a higher bond rating is a possibility not a certainty based on these conflicting criteria. But each upgrade to the District's rating offers the hope of a drop in the interest rates the city pays to borrow; a significant motivating factor when considering that debt service represents an ever growing expenditure line in the District's budget.

Recent academic and not-for-profit research caution against any "one size fits all" approach to reserve size. Many prior academic studies predicated on determining the "right" size of reserve/rainy day funds have focused on measuring how much money a particular state would need to weather hypothetical future or observed past economic downturns.¹⁵ Authors of more recent studies came to substantially different conclusions, finding that "no two states share identical political or economic characteristics... [or] dependence on specific taxes,"¹⁶ and that "there is wide recognition that [a one size fits all guideline] is oversimplified."¹⁷ Indeed, in research that spanned the 50 states, one set of authors found large differences in the reserve fund levels necessary to mitigate the effects of an economic downturn based on the revenue structure and industry mix in each state.¹⁸

Recent research released by the Pew Charitable Trusts — a national nonprofit organization with expertise in state fiscal policy — confirms that revenue volatility varies substantially across states. Pew reports: "Each state has a unique set of economic conditions, tax sources, and tax structures that affect the volatility of revenue streams and the severity of downturns," and suggests that states should tailor the size of their reserve funds to their expected level of volatility and periodically reassess those conditions and adjust the size of the fund as

¹³ Eric Kim, Karen Krop, and Laura Porter, "Fitch Rates District of Columbia's \$523MM GOs 'AA' & Upgrades Outstanding Bonds; Outlook Stable," Fitch Ratings, September 29, 2014, <http://www.businesswire.com/news/home/20140929006244/en/Fitch-Rates-District-Columbias-523MM-GOs-AA#.VSv8uvnFgqU>

¹⁴ Nicholas E. Samuels and Emily Raimés, "Moody's upgrades District of Columbia GO to Aa1 from Aa2; outlook stable," Moody's Investors Service, March 12, 2015, https://www.moody.com/research/MoodysupgradesDistrictofColumbiaGOtoAa1fromAa2PR_320648?WT.mc_id=Email_PR_320648_link2

¹⁵ See, for example Jon D. Vasche and Brad Williams, 1987, "Optimal Governmental Budgeting Contingency Reserve Funds," *Public Budgeting and Finance* 7(1), pp. 66-82; John C. Navin, and Leo J. Navin, 1997, "The Optimal Size of Countercyclical Budget Stabilization Funds: A Case Study of Ohio," *Public Budgeting and Finance* 17(2), pp. 114-127; and David L. Sjoquist, 1998, "Georgia's Revenue Shortfall Reserve: An Analysis of Its Role, Size, and Structure," Fiscal Research Program, Andrew Young School of Policy Studies, Georgia State University, Atlanta.

¹⁶ Gary C. Cornia and Ray D. Nelson, "Rainy Day Funds and Value at Risk," *State Tax Notes*, August 25, 2003, pp. 563-567.

¹⁷ Philip G. Joyce, 2001, "What's so Magical about Five Percent? A Nationwide Look at Factors That Influence the Optimal Size of State Rainy Day Funds," *Public Budgeting and Finance* 21(2), pp. 62-87.

¹⁸ See, for example Russell S. Sobel and Randall G. Holcombe, 1996, "The Impact of State Rainy Day Funds in Easing State Fiscal Crises During the 1990-1991 Recession," *Public Budgeting and Finance* 16(3), pp. 28-48.

necessary.¹⁹ Currently, most states (as well as the District) do not do this. According to Pew, 37 states²⁰ cap their reserve fund at a fixed percent of general fund revenues or expenditures and do not adjust the maximum savings limit based on regular volatility assessments. This creates a problem, Pew notes, when state reserve funds reach their maximum statutory capacity during economic boom years, but that maximum is still insufficient to cover revenue losses during downturns.

The appropriate level of rainy day funds is of special concern to the District given its unique status as a combined state, county, and city government. In addition to serving as countercyclical economic policy, the Office of the Chief Financial Officer (OCFO) considers the following additional factors when determining the level of reserves necessary:²¹

- The District’s reserves were crucial in keeping the District open during the recent federal government shutdown and a recession and a government shutdown might occur simultaneously;
- The reserves enable the District to minimize short-term borrowing to meet cash flow needs; and
- The level of pay-as you-go capital funding provides an additional degree of budget flexibility which can reduce the required level of reserves.

While the appropriate size of rainy day funds is a very important consideration, so too are the rules that govern deposits into those funds and repayments of withdrawn amounts. If legislators do not replenish the reserve following drawdowns, those resources will not be available during the next economic downturn. Here, previous research is more or less in agreement on best practice: states should have formal policies in place that dictate when year-end surpluses or appropriations should be diverted to reserve funds. Academic studies have shown that states that have a formal policy requiring the deposit of surpluses or the maintenance of a specific balance into their reserve funds maintain higher fund balances overall.²² Pew’s research takes this notion a step further, arguing that not only should states have formal policies in place covering the deposit of funds, but those policies should take revenue volatility and above average revenue or economic growth into consideration.²³

Figure 2 (below) combines research from Pew and the Center on Budget and Policy Priorities, a progressive think tank focused on issues affecting low-income Americans. It shows how the District compares with other states in both the statutory maximum size of its combined reserve funds, as well as, the rules governing deposits into them. In terms of overall maximum size, the District’s reserve funds are exactly in the middle, larger than the maximum balances of 25 states (including four that have no designated rainy day fund) and smaller than the remaining 25 — as a percent of revenues or expenditures. With regard to how those balances are maintained, the District’s policies are mixed. A plurality of states — 21 — simply allocate additional monies to their budget stabilization/rainy day funds based on the size of their year-end surplus. As Pew’s

¹⁹ The Pew Charitable Trusts, “Building State Rainy Day Funds: Policies to Harness Revenue Volatility, Stabilize Budgets, and Strengthen Reserves” July 2014, http://www.pewtrusts.org/~media/Assets/2014/07/SFH_Rainy-Day-Fund-Deposit-Rules-Report_ARTREADY_v9.pdf

²⁰ Pew did not assess the District as part of its analysis. However, the District has caps on all three of its reserve funds set at a fixed percent of revenues, so it would fall into this group.

²¹ ODCA email conversation with Fitzroy Lee, Deputy Chief Financial Officer and Chief Economist, Office of the Chief Financial Officer of the District of Columbia, April 15, 2015.

²² Elizabeth McNichol, “When and How States Should Strengthen Their Rainy Day Funds,” Center on Budget and Policy Priorities, April 16, 2014, <http://www.cbpp.org/files/4-16-14sfp.pdf>.

²³ The Pew Charitable Trusts, “Building State Rainy Day Funds,” July 2014.

research in this area has noted, this often means “contributions are often the last—and frequently the lowest—priority in the budget process.”²⁴ The District, like six states, requires an appropriation of funds each year to maintain a required balance in its reserve funds, a process Pew describes as “static” and “inflexible” in that it does not consider “either volatility or budget conditions.”²⁵ A better approach, Pew argues, would be to “[study] unique patterns of volatility and [connect] those observations to concrete rules that guide when, how, and how much to save,” and “require deposits into a budget stabilization fund when the state experiences unusual or above-average revenue or economic growth.”²⁶ Below, Figure 2 shows each state and the District’s total rainy day fund size and deposit rules.

Figure 2

Rainy Day Fund Size and Deposit Rules Vary by State		
State	Cap %*	How is Rainy Day Fund Deposit Determined? ^
Alabama	10.0/20.0	By voluntary appropriation
Alaska	No Cap	Linked to oil and gas settlement income, by appropriation
Arizona	7	Linked to personal income growth
Arkansas	<1	By voluntary appropriation
California	5	Based on year-end surpluses
Colorado	No RDF	N/A
Connecticut	10	Based on year-end surpluses
Delaware	5	Based on year-end surpluses
District of Columbia	8.34	Required budget allocation to maintain balance
Florida	10	Required budget allocation to maintain balance
Georgia	15	Based on year-end surpluses
Hawaii	10	Linked to total revenue growth
Idaho	5	Linked to total revenue growth
Illinois	No RDF	N/A
Indiana	7	Linked to personal income growth
Iowa	10	Based on year-end surpluses
Kansas	No RDF	N/A
Kentucky	5	Based on year-end surpluses
Louisiana	4	Linked to severance tax collections
Maine	12	Based on year-end surpluses
Maryland	7.5	Required budget allocation to maintain balance
Massachusetts	15	Linked to capital gains tax collections
Michigan	10	Linked to personal income growth
Minnesota	Goal (Varies)	Based on year-end surpluses
Mississippi	7.5	Based on year-end surpluses
Missouri	7.5	Required budget allocation to maintain balance
Montana	No RDF	N/A
Nebraska	No Cap	Revenue forecast error
Nevada	20	Based on year-end surpluses
New Hampshire	10	Based on year-end surpluses
New Jersey	5	Revenue forecast error
New Mexico	No Cap	Based on year-end surpluses

²⁴ *Ibid.*

²⁵ *Ibid.*

²⁶ *Ibid.*

Rainy Day Fund Size and Deposit Rules Vary by State		
New York	5	Based on year-end surpluses
North Carolina	Goal (8.0)	Based on year-end surpluses
North Dakota	9.5	Based on year-end surpluses
Ohio	5	Based on year-end surpluses
Oklahoma	15	Revenue forecast error
Oregon	12.5	Based on year-end surpluses
Pennsylvania	No Cap	Based on year-end surpluses
Rhode Island	5	Required budget allocation to maintain balance
South Carolina	5	Required budget allocation to maintain balance
South Dakota	10	Based on year-end surpluses
Tennessee	5	Linked to total revenue growth
Texas	10	Linked to severance tax collections
Utah	6	Revenue forecast error
Vermont	5	Based on year-end surpluses
Virginia	15	Linked to total revenue growth
Washington	10	Linked to total revenue growth
West Virginia	10	Based on year-end surpluses
Wisconsin	5	Revenue forecast error
Wyoming	No Cap	By voluntary appropriation

***Source:** Elizabeth McNichol, “When and How States Should Strengthen Their Rainy Day Funds,” Center on Budget and Policy Priorities, April 16, 2014, <http://www.cbpp.org/files/4-16-14sfp.pdf>

^**Source:** The Pew Charitable Trusts, “Building State Rainy Day Funds,” July 2014, http://www.pewtrusts.org/~/media/Assets/2014/07/SFH_Rainy-Day-Fund-Deposit-Rules-Report_ARTREADY_v9.pdf

One important final factor in determining the adequacy of reserve fund policies centers on the rules for withdrawals from those funds. Here, prior research suggests having policies in place that prevent rainy day funds from being drawn down during “sunny” times. One study concluded, “If rainy day funds are to meet their countercyclical objective, it is important that their use be limited to times of extraordinary need.”²⁷

Very little cross-state research exists to benchmark the District’s reserve fund withdrawal rules with those of other states, but one study found that 19 states only required appropriations to be made by the legislature, without any restrictions on when they could do so.²⁸ In only 16 states were withdrawals tied to deficits or unforeseen expenditures (as is the case with the District’s Contingency Cash Reserve and Fiscal Stabilization Reserve) and only 6 require the executive to declare a state of emergency as one possible condition for using funds (as the District’s Emergency Cash Reserve does).

The District’s current policies requiring funds to be used for “nonrecurring or unforeseen needs” and prohibiting funds from being appropriated by the Council or the Mayor to cover shortfalls during the budget process would seem to line up with the identified best practices to prevent excessive use of funds. In 2014, the Council proposed a change to the Contingency Reserve Fund that would amend the Home Rule Act to allow the fund to be tapped only for “nonrecurring and unforeseen needs.” This change was included in the Council-passed FY 2015 Budget Request Act in order to limit the Mayor’s authority to draw down the reserve, but was line-item vetoed by then-Mayor Vincent Gray. The scope of this analysis does not allow ODCA to determine whether this proposed change would substantially affect the integrity of the fund.

²⁷ Joyce, 2001, “What’s so Magical about Five Percent?”

²⁸ *Ibid.*

One final area of comparison ODCA explored in this analysis compares the District’s reserve fund policies with those of a select group of other large American cities. Unfortunately, no comparative analysis of cities exists that mirrors CBPP’s or Pew’s analysis of state level reserve policies. Instead, we looked at reserve funds in two cities—San Francisco and Denver—which may serve as somewhat comparable proxies given their relatively unique status as combined city-county governments. See Appendix I for a detailed breakdown of Denver and San Francisco’s reserve fund policies.

Analysis of the District’s Fiscal Condition Between 2007 and 2014

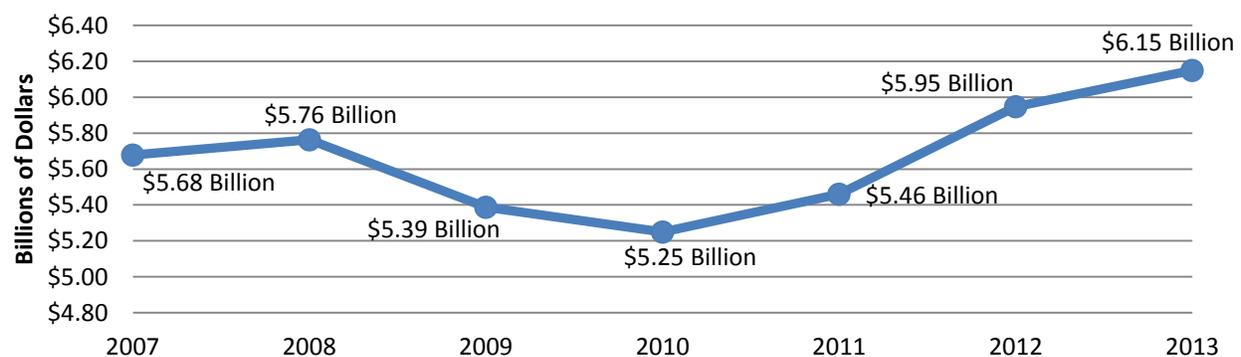
In order to provide additional context regarding how likely the District is to need to tap reserves during an economic downturn, this section of the report analyzes D.C.’s revenues, expenditures, and fund balances to determine the effect the most recent recession had on the city in terms of revenue lost and how much the city withdrew from its reserve funds. ODCA also examined existing research comparing the District’s fiscal performance during the recession to other states and large cities to determine how well it fared nationally. We share these analyses to help inform the Council’s decision-making regarding any changes or additional contributions to the District’s rainy day funds.

The District experienced a moderate economic downturn due to the 2007-2009 recession. ODCA’s analysis of the city’s comprehensive annual financial reports (CAFRs) between FY 2007 and FY 2013 found that adjusted for inflation, the city’s total governmental funds tax revenues fell from a high of \$5.76 billion in FY 2008 to a low of \$5.25 billion in FY 2010. Tax revenues recovered in subsequent years, however, and by FY 2012 tax revenues had surpassed their previous peak. In total, tax revenue fell by 8.9 percent between FY 2008 and FY 2010 before rebounding. Figure 3 shows that District tax revenue declined from 2008-2010, but recovered fast once the recession ended.

Figure 3

District Tax Revenue Declined from 2008-2010, Recovered Fast

Total government funds tax revenue, FY 2007- FY 2013



Source: Comprehensive Annual Financial Reports for the District of Columbia for the Fiscal Years Ended September 30, 2007 - September 30, 2013. Data adjusted for inflation using the U.S. Bureau of Economic Analysis’s Gross Domestic Product Price Deflator

Importantly, however, the District relies on a diverse mix of tax revenues that respond to economic downturns at different times, often mitigating the effects of a recession and resulting

in smaller total declines over a longer period of time. The city’s property tax revenue — which relies on assessments conducted the year before it is due — did not begin to decline until FY 2010, after the recession had officially ended. Sales and income taxes, however, are more sensitive to declines in economic activity and fell much sooner as residents spent less and unemployment rose.

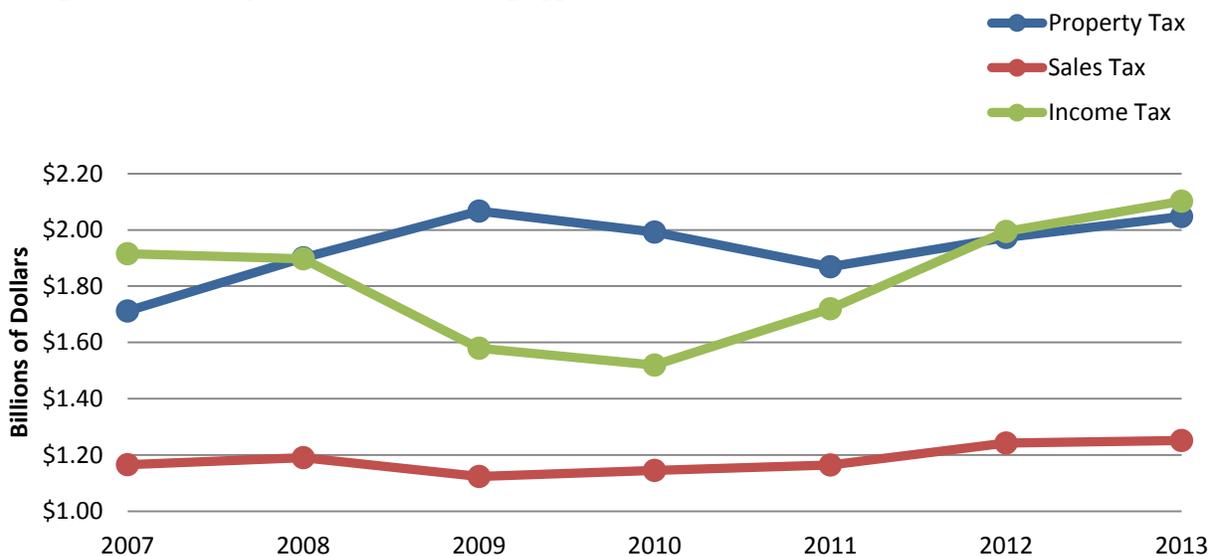
Also affecting the District’s tax revenue during this period were changes to tax rates that increased District revenue. In FY 2010, policy makers increased the sales tax from 5.75 percent to 6 percent and increased the motor fuel tax to 23.5 cents per gallon from 20.0 cents.²⁹ In FY 2012, the top income tax bracket increased from 8.5 percent to 8.9 percent, accelerating recovery of income tax revenue.³⁰

Overall, the city’s mix of tax revenues and the policy decisions of the Mayor and Council had the effect of partially shielding the District’s finances from the effects of the downturn. If the city instead relied on property or income tax more exclusively, it would have experienced a more substantial total drop. Figure 4 below demonstrates how the District’s mix of tax revenues fell at different points, mitigating the overall revenue decline from the recession.

Figure 4

The District’s Tax Revenue Mix Mitigated Effects of the 2007-2009 Recession

Total governmental funds tax revenue by type, FY 2007-FY 2013



Source: Comprehensive Annual Financial Reports for the District of Columbia for the Fiscal Years Ended September 30, 2007 - September 30, 2013. Data adjusted for inflation using the U.S. Bureau of Economic Analysis's Gross Domestic Product Price Deflator

Also, helping the District through the recession was a substantial increase in aid from the federal government through the American Recovery and Reinvestment Act (ARRA). ODCA’s analysis found that federal contributions and operating grants to the District increased dramatically

²⁹ Office of the Chief Financial Officer, “Comprehensive Annual Financial Report for the Year Ended September 30, 2014,” District of Columbia Government, January 28, 2015, pp. 173, http://app.dc.gov/pdf/DC_CAFR_Final_web-3.pdf.

³⁰ *Ibid.*

between FY 2007 and FY 2013. Prior to the onset of the recession, the District received \$2.69 billion in federal grants and aid in FY 2007. Aid increased over the next three fiscal years, peaking at \$3.79 billion in FY 2010. Federal contributions and operating grants remained between \$3.65 billion and \$3.51 billion each fiscal year following FY 2010, largely due to increased Medicaid funding resulting from the expansion of the program through the Affordable Care Act (ACA).

The additional ARRA funds helped to soften the blow of the recession by offsetting the decline in tax revenue the District experienced.³¹ The OCFO conducted an internal analysis of tax revenue volatility over a twenty-five year period from 1990 to 2014 and found that the latest recession was relatively mild for the District compared to the rest of the nation as the DC region benefited from an expansion of the federal government after the enactment of ARRA. The OCFO contrasted the decline in revenues during 2009-2010 with a protracted downturn the District faced between 1993 and 1996, when federal government downsizing exacerbated the impact of the recession.

As a result of the revenue decline, the District tapped its Contingency Reserve Fund in FY 2009, drawing about \$46 million from the fund. The fund was restored to its full level the following fiscal year, however, and has remained fully funded since—excepting relatively small, periodic disbursements to fund Mayoral priorities (such as the drawdown of \$9 million to fund the replacement of trash and recycling cans in the first quarter of 2014).³² Instead of tapping reserves to completely negate revenue declines, District lawmakers made targeted cuts to spending in a number of areas. This past policy suggests that a future recession of similar magnitude might similarly involve a modest drawdown of rainy day reserves coupled with spending cuts focused on achieving budgetary savings without reducing the effectiveness of city services. Figure 5 shows the balance in the District’s reserves between FY 2007 and FY 2014 and how they remained relatively untapped.

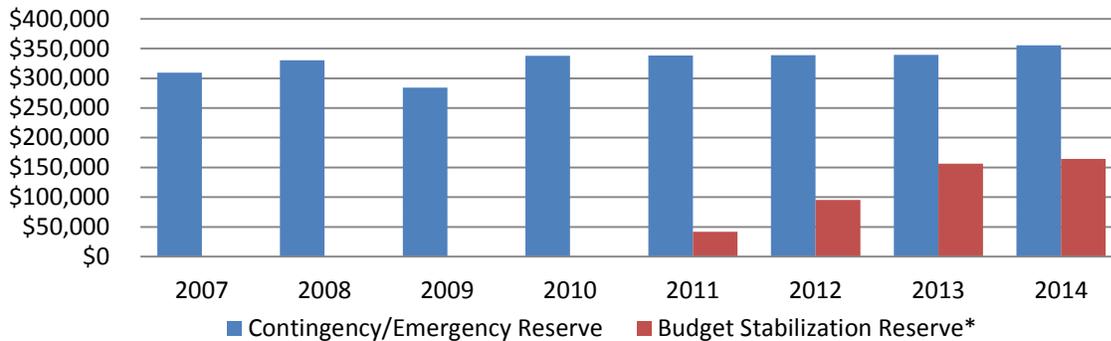
³¹ Note: Even though the increase in federal contributions and operating grants offset losses in tax revenue sources, most federal contributions and grants contain restrictions on how the funds can be spent, limiting their ability to completely negate the downturn’s effects. However, an increase in federal contributions and grants can free up local funds the District might otherwise have to spend on federally mandated programs.

³² Office of the Chief Financial Officer (OCFO), “Second Quarter FY 2014 Status Report on the Emergency and Contingency Cash Reserve Funds as of March 31, 2014,” June 10, 2014.

Figure 5

The District’s Reserves Remained Largely Untapped Following the 2007-2009 Recession

Fund balance at end of each fiscal year, in thousands of dollars



***Note:** The Budget Stabilization Reserve was created in FY 2010 and funded beginning in FY 2011.

Source: Comprehensive Annual Financial Reports for the District of Columbia for the Fiscal Years Ended September 30, 2007 - September 30, 2014.

If District lawmakers are inclined to completely offset any future tax revenue declines with funds from the District’s reserves, ODCA’s analysis suggests that the current size of the reserves alone may not be sufficient to accomplish that objective. ODCA’s analysis, presented above, found that the District’s total tax revenue fell by \$512.3 million between FY 2008 and FY 2010. This number is close to the current total reserve funding level of \$520.0 million discussed earlier in this report. This analysis does not take into consideration non tax revenue sources such as charges, fees, fines, and investment earnings. And it is the case that the greatly increased federal grants and aid, through ARRA, likely offset some federally mandated spending for which the District may otherwise have had to budget local funds during the recession years — funding that may or may not materialize during the next economic downturn.

The District Weathered the Recession Better than Most States and Cities

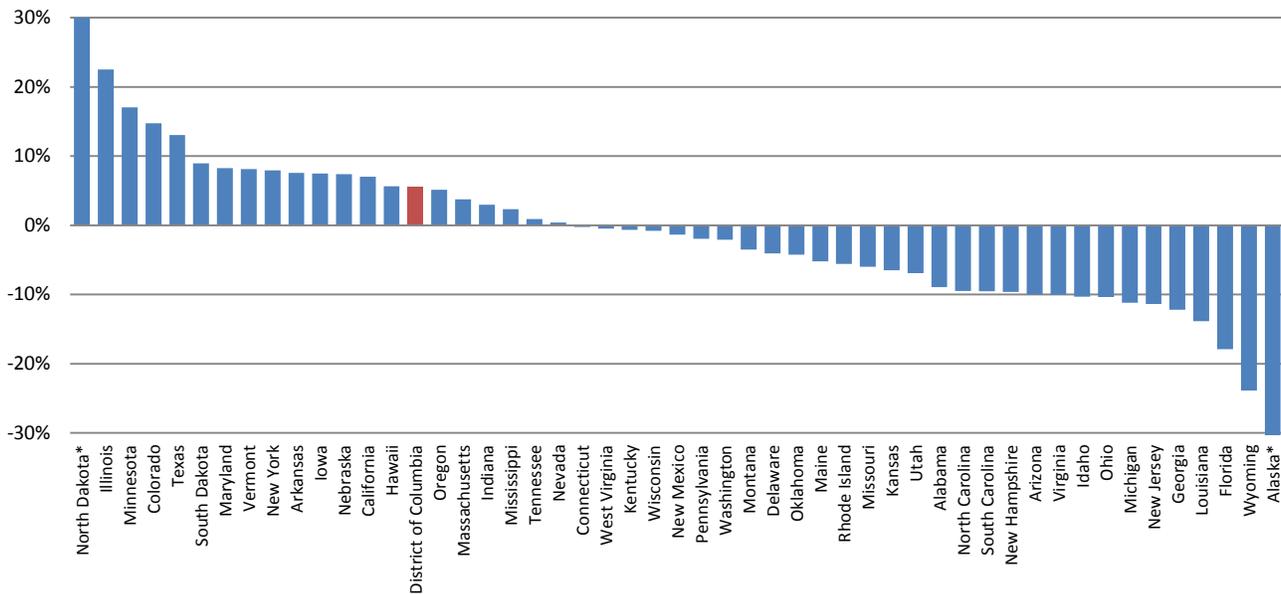
Although the District faced a moderate economic downturn, it weathered the recession with remarkable resiliency compared to other states and large U.S cities. The Pew Charitable Trusts conducted quarterly research on the change in total tax revenues in the 50 states following the 2007-2009 recession, most recently finding that these revenues remain below their pre-recession peak in three-fifths of the states.³³ Although this research does not include the District, ODCA was able to obtain Pew’s data and replicate their research methodology to compare the District’s total tax revenue collections to the 50 states over the same 2006-2014 time period.

Our analysis shows that the District’s tax revenue in the third quarter of 2014 was 5.5 percent above its pre-recession revenue peak—which occurred in the third quarter of 2008. While other states hit their pre-recession tax revenue peaks at different points, most remain below those levels according to the most recent available data provided by Pew. Overall, the District’s tax revenues outperformed 36 states relative to their past revenue peaks. See Figure 6, which shows how the District’s tax revenues as of Q3 2014 compare favorably to most states.

³³ The Pew Charitable Trusts, “Since Recession, Tax Revenue Lags in 30 States,” March 23, 2015, <http://www.pewtrusts.org/en/research-and-analysis/analysis/2015/03/23/since-recession-tax-revenue-lags-in-30-states>

Figure 6

District Tax revenues Compare Favorably to Most U.S. States
Percent change in total tax revenue from pre-recession peak, Q3 2014



***Note:** North Dakota's change of 125.9 percent and Alaska's change of -75.1 percent are not completely shown in order to maintain scale for other states.

Source: ODCA's analysis of The Pew Charitable Trusts, "Fiscal 50: State Trends and Analysis," tax revenue indicator, available at <http://www.pewtrusts.org/en/multimedia/data-visualizations/2014/fiscal-50#indo>

Pew's data and ODCA's analysis also found that the District lost less tax revenue as a percent of pre-recession peak than did 39 states. The District's tax revenue bottomed out in the second quarter of 2010, down 10.5 percent from its 2008 peak. On average, tax revenues fell 16.3 percent across the states from their peak to their lowest point, or trough. The city also recovered significantly faster than nearly all states. In the first quarter of 2013, the District's recovery was the 4th strongest in the nation, following only North Dakota, Illinois and Minnesota.

While Pew did not originally include the District in their analysis of state tax revenues, other research by Pew — focused on 30 of the largest cities across the country — shows the District's finances performed better than other large American cities through the 2007-2009 recession and subsequent recovery. Their most recent report, released in November 2014, uses data from the CAFRs of 30 cities and shows the District has had the most robust revenue growth of any of the cities they studied, compared with each city's prior revenue peak.³⁴ As of 2012 (the most recent year covered in Pew's report), the District's revenue was 113 percent of its previous peak, leading San Francisco — the city with the second largest revenue rebound — by 4 percentage points and making it one of just 10 of the 30 cities studied to have completely recovered revenue lost during the recession.

³⁴ The Pew Charitable Trusts, "Recovering From Volatile Times: The ongoing financial struggles of America's big cities," November 2014, <http://www.pewtrusts.org/~media/Assets/2014/11/RecoveringFromVolatileTimes1114.pdf>

Recommendations

Examining the District's revenue performance over the course of the previous recession and comparing both its reserve fund policies and fiscal situation to other U.S. states provides some context for the Council regarding policy changes or additional deposits into the District's rainy day funds that may increase the city's budgetary resilience in future recessions. The research and best practices outlined in this report suggest there are a number of concrete actions District policymakers may wish to take to improve the quality of information on which to base their policy decisions.

Our recommendations follow:

1. The Mayor and Council of the District of Columbia should instruct their respective budget staffs or the Office of the Chief Financial Officer to conduct a regular assessment of the District's revenue volatility in order to better understand how overall revenues are likely to increase or decrease based on economic conditions. In order to isolate the true volatility due to changes in the economy and determine how large a reserve is needed to withstand a recession, this study should be designed to control for changes in policy that may increase or decrease revenue (such as tax rate changes, new charges or fees, etc.) and also take into account the possibility that federal funds (which mitigated the impact of the recent recession) may be unlikely in the foreseeable future given the recent budget cutbacks put in place by Congress.
2. District policymakers should use the results of these volatility studies to periodically adjust rules governing deposits to and the maximum size of the Fiscal Stabilization Reserve to respond to long-term changes in revenue volatility that may increase or decrease the need for reserves during a downturn. Because District policymakers cannot alter rules governing deposits to or the maximum size of either the Contingency Cash Reserve or the Emergency Cash Reserve without changes to the District of Columbia Home Rule Act approved by Congress, it is important for the District's long term fiscal health to have a locally-controlled reserve fund that is calibrated to potential need.
3. The District currently has fairly robust rules for withdrawal and replenishment of all of its reserve funds. The Mayor and Council of the District of Columbia should ensure that these rules continue to provide for an adequately funded reserve so that the funds remain available when they are most needed.

Conclusion

Based on our examination and analysis, we found that the District maintains a relatively robust reserve fund that has significantly helped to mitigate the effects of economic downturns and strengthened the District's finances when compared with other U.S. states and cities. We note that leading research suggests a number of ways to further improve the quality of data District policymakers can use to gauge the necessity of additional contributions into the Fiscal Stabilization Reserve or for changes to the maximum size of the fund.

We hope this information is helpful to you throughout the budgeting process and encourage Council to consider our recommendations.

Sincerely yours,



Kathleen Patterson
District of Columbia Auditor

Appendix I

Appendix I: Reserve Fund Policies in San Francisco and Denver

One area ODCA hoped to explore in depth in this analysis was to compare the District's reserve fund policies with those of a select group of other large U.S. cities. Unfortunately, no comparative analysis of cities exists that mirror's CBPP or Pew's analysis of state level reserve policies, making it unfeasible to do a comprehensive assessment. Instead, we examined reserve funds in two cities — San Francisco and Denver — which may serve as somewhat comparable proxies given their relatively unique status as combined city-county governments. Through this, ODCA found that Denver's overall policies with regard to its reserve funds (required size, deposit rules, and withdrawal rules) are all similar to the District's. San Francisco's maximum reserve fund size policies are similar to the District's, but their guidelines for depositing money into the funds are more in line with Pew's recommendation that governments deposit surplus revenue due to economic growth into funds when possible.

San Francisco³⁵

Rainy Day Reserve – The City maintains a "Rainy Day" or economic stabilization reserve under Charter Section 9.113.5. In any year when the City projects that total General Fund revenues for the upcoming budget year are going to be more than 5 percent higher than the General Fund revenues for the current year, the City automatically deposits one-half of the "excess revenues," in the Rainy Day Reserve. The total amount of money in the Rainy Day Reserve may not exceed 10 percent of the City's actual total General Fund revenues. The City may spend money from the Rainy Day Reserve for any lawful governmental purpose, but only in years when the City projects that total General Fund revenues for the upcoming year will be less than the current year's total General Fund revenues, i.e., years when the City expects to take in less money than it had taken in for the current year. In those years, the City may spend up to half the money in the Rainy Day Reserve, but no more than is necessary to bring the City's total available General Fund revenues up to the level of the current year. The City may also spend up to 25 percent of the balance of the Rainy Day Reserve to help the San Francisco Unified School District in years when certain conditions are met.

Budget Stabilization Reserve – The City sets aside as an additional reserve 75 percent of (1) real estate transfer taxes in excess of the average collected over the previous five years, (2) proceeds from the sale of land and capital assets, and (3) ending unassigned General Fund balances. The City will be able to spend those funds in years in which revenues decline or grow by less than two percent, after using the amount legally available from the Rainy Day Reserve. The City, by a resolution of the Board of Supervisors adopted by a two-thirds' vote, may temporarily suspend these provisions following a natural disaster that has caused the Mayor or the Governor to declare an emergency, or for any other purpose. There is no maximum size for this reserve.

Recreation and Parks Expenditure Savings Reserve – The City maintains a Recreation and Parks Expenditure Savings Reserve under Charter Section 16.107, which sets aside and maintains such an amount, together with any interest earned thereon, in the reserve account, and any amount unspent or uncommitted at the end of the fiscal year shall be carried forward to the next fiscal year and, subject to the budgetary and fiscal limitations of the Charter, shall be appropriated then or thereafter for capital and/or facility maintenance improvements to park and recreation facilities and other one-time expenditures of the Park and Recreation Department. There is no maximum size for this reserve.

³⁵ City and County of San Francisco, California, "Comprehensive Annual Financial Report Year ended June 30, 2014," pp. 51, <http://sfcontroller.org/modules/showdocument.aspx?documentid=6059>

Denver³⁶

The City has multiple reserves in its General Fund to address budgetary shortfalls. A Contingency Reserve of no less than 2 percent of total estimated expenditures, an Emergency Reserve mandated by the State Constitution equal to 3 percent of covered funds, and an Undesignated Fund Balance target of 15 percent of total budgeted expenditures. The City's budget policy concerning the use of reserves varies depending on the reserve type but generally limits the use of reserves to respond to revenue shortfalls, unanticipated expenditures, or severe economic downturn. The policy further states that use of reserves should be combined with structural changes to bring the budget back into balance. The City has a target of maintaining a General Fund balance reserve that is 15.0 percent of budgeted expenditures and should not go below 10.0 percent of budgeted expenditures, except in response to a severe crisis, economic or otherwise.

³⁶ City and County of Denver, Colorado, "Comprehensive Annual Financial Report Year Ended December 31, 2013," pp. 5; 84-85, http://www.denvergov.org/Portals/344/documents/CAFR/2013_CAFR.pdf