Government of the District of Columbia
Office of the Chief Financial Officer

Natwar M. Gandhi
Chief Financial Officer

March 9, 2012

The Honorable Vincent C. Gray
Mayor of the District of Columbia
1350 Pennsylvania Avenue, NW – 6th Floor
Washington, DC 20004

Dear Mayor Gray:

Thank you for your letter dated March 1, 2012, regarding the revised revenue certification that was issued February 29th. I have provided detailed responses to the questions in the addendum to this letter.

First, I would like to address your concern that the revenue estimate is "unrealistically low". The baseline revenue growth—that is, revenue growth before adjusting for one-time increases in revenue in FY 2012 and the effects of the federal sequestration—is consistent with the average revenue growth over the last five years of 3.3% (see Table 1 of Addendum). This growth is also in line with forecasts by nationally recognized forecasters for key economic indicators, including wages and salaries of District residents, employment, and the stock market

Furthermore, of the $240 million surplus for FY 2011 over half consisted of agency under-spending. Most of the remainder is attributable to the most volatile components of the revenue system: capital gains, estate tax, and real estate transactions tax revenue from sales of several high-priced office buildings. Revenue from these sources tends to fluctuate wildly from one year to the next. Given the many risks in the current economic environment, it would not be fiscally prudent for the revenue estimate to bet that these revenue sources will continue to perform as well as they did last year.

The realities of the District and the risks inherent in revenue forecasting mean that conservative revenue estimates must be at the heart of a prudent budget and financial plan. The budget and financial plan for a fiscal year is prepared 20 months before the end of that fiscal year. In that time frame, the economic environment can and has changed drastically. We were painfully reminded of this over the last few years when we were forced to revise the revenue estimate *downward* with each successive revision.

We recognize that surpluses are an unavoidable consequence of conservative revenue estimation when the economy performs better than expected and risks do not materialize. That is why it is also important to revisit the revenue estimate every quarter, as my office does. Revising the

estimate every quarter and informing policy makers of those revisions not only gives us an opportunity to reassess the economic outlook and the risks in the economic environment, but also provides the elected leadership with an opportunity to adjust their budgetary decisions accordingly.

Finally, and most importantly, revenue forecasting is a discipline that must focus on available data and information on the economy and revenue trends, without regard to, or consideration of governmental spending needs and priorities. To inject these factors into the process would undermine the reliability of the estimate, the integrity of the overall budget process, and could damage our credibility in the financial markets.

Please feel free to contact me with any further questions that you may have.

Sincerely,

Natwar M. Gandhi

Enclosure

cc: The Honorable Kwame R. Brown, Chairman, Council of the District of Columbia
Members of the Council of the District of Columbia
Allen Lew, City Administrator
Christopher Murphy, Chief of Staff to the Mayor
Eric Goulet, Deputy Chief of Staff and Budget Director
Jennifer Budoff, Budget Director, Council of the District of Columbia

Addendum:
Responses to questions raised in letter dated March 1, 2012

Is the Revenue Estimate "unrealistically low"?

As mentioned in the certification letter last week, the baseline growth of the tax revenue—growth from economic activity, before the effects of legislation or the federal sequestration—reflects a strengthening yet still sluggish economy. Also, as we noted in the certification letter, the baseline growth rate of the revenue is masked by effects of legislation included in the FY 2012 budget that significantly increase revenue only for FY 2012. Table 1 below shows the baseline growth rate, as well as the baseline growth rate plus the effects of legislation and the baseline growth rate plus the effects of legislation and federal sequestration.

Table 1: GROWTH IN GROSS REVENUES
(Before Transfer of Dedicated Taxes)

	FY12	FY13	FY14	FY15	FY16
Baseline	3.7%	3.4%	2.6%	3.2%	3.3%
Adjusted for legislation	5.4%	2.3%	3.1%	3.2%	2.7%
Adjusted for legislation and federal sequestration	5.4%	1.9%	2.4%	3.1%	2.7%
5 Year Compound Growth (2006-2011)	*3.3%*	*3.3%*	*3.3%*	*3.3%*	*3.3%*
10 Year Compound Growth (2001-2011)	*4.7%*	*4.7%*	*4.7%*	*4.7%*	*4.7%*

Baseline growth in revenue in FY 2012 is 3.7 percent, but when the effects of legislation are included, the growth rate jumps to 5.4 percent. Because much of the legislative impact in FY 2012 is one-time, the growth rate in FY 2013 after adjusting for legislative changes is only 2.3 percent. When the effects of federal sequestration are also included, revenue growth in FY 2013 falls to 1.9 percent. It is important to note, however, that before the effects of legislation and federal sequestration are included, forecasted revenue growth for FY 2013 is 3.4 percent. Is this "unrealistically low"? Table 1 also compares the baseline growth with the 5-year historical average growth rate (which includes years before and after the 2007-2009 recession) and the 10-year historical average growth rate (which includes the years of the real estate bubble). **The estimated baseline growth rate is below the 10 year historical average because we are not forecasting the revenue boom of the bubble years, but in line with 5 year average which is consistent with macroeconomic forecasts of a sluggish recovery**.

Table 2 compares forecasts by IHS Global Insight and Moody's Analytics of key variables for the District economy with the forecast ORA used to develop the recently revised revenue estimate. The two most important indicators are wages of District residents and the Standard & Poor's 500 stock market index (SP500). As the table shows, there is considerable disagreement in those two forecasts about the course of the District economy, particularly regarding stock markets.

ORA has balanced these forecasts with information from collections, particularly sales tax and withholding, which are the most timely barometers of the economy, from discussions at recent advisory group meetings where real estate professionals and regional economists met to provide us with insight and from other state and federal information.

As the District economy has continued to improve, year to date collections of sales and withholding have been in line with our projections. Deed taxes appear strong relative to the same period last year but last year saw a surge in the spring and summer: complementary data from CoStar shows commercial property sales slowing in the first quarter of the fiscal year.

Table 2: February 2012 ORA forecasts compared with Global Insight and Moody's Analytics - Before Adjusting for Federal Sequestration

(%)	Economic Outlook w/o Federal Cuts			
Indicator	**FY 2011**	**FY 2012**	**FY 2013**	**FY 2014**
Employment in DC (10yr growth = 0.9%)				
Global Insight	0.7	0.7	0.2	1.2
Moody's Analytics	0.7	-0.6	-0.9	1.6
ORA	0.7	0.5	0.2	0.7
DC resident employment (10yr growth = 0.2%)				
Global Insight	-0.4	0.0	0.7	0.8
Moody's Analytics	-0.4	-1.6	-1.9	1.5
ORA	-0.4	1.1	1.2	0.8
Wages earned in DC (10yr growth = 4.8%)				
Global Insight	3.4	3.3	2.0	3.7
Moody's Analytics	3.4	1.5	2.2	6.2
ORA	3.4	3.1	2.0	3.3
Wages earned by DC residents (10yr growth = 5.5%)				
Global Insight	3.8	4.4	2.4	5.9
Moody's Analytics	3.8	5.8	3.6	4.9
ORA	3.8	4.5	3.6	3.7
Personal Income (10yr growth = 5.7%)				
Global Insight	5.9	3.1	1.7	5.3
Moody's Analytics	5.9	3.5	3.5	4.7
ORA	5.9	3.3	2.7	4.1
Households (10yr growth = 0.8%)				
Global Insight	1.7	1.7	1.1	0.9
Moody's Analytics	2.0	1.0	0.2	0.3
ORA	2.1	1.8	0.9	0.6
S and P 500 stock index*				
Global Insight	1.8	-12.8	6.4	6.3
Moody's Analytics	3.3	-11.3	25.6	9.4
ORA	1.8	0.0	3.9	5.5

**4th quarter of CY*

Source: Global Insight, Moody's Analytics, and ORA. Global Insight and Moody's Analytics forecasts are for January 2012.

The key risk however is one that we must take very seriously: possibly deep federal cuts in employment and procurement in the District. **As of December 2011, the District has lost 1,700 federal jobs and the current political climate makes the risk of even further reductions too high to ignore.** As much as the District has diversified its economy, we are still very dependent on the federal government. That is why in December, ORA adjusted the economic outlook to reflect cuts in both employment and procurement which in turn has reduced the revenue estimate. In the February estimate, ORA revised those assumptions based on better information about the possible cuts. We discuss these changes below under "Sequestration".

Population. The 2011 U.S. Census Bureau estimate that D.C.'s population rose to almost 618,000 was most welcome news and reflects well on the efforts our city government has made over the years to attract new residents. **Our revenue estimate reflects this change and assumes that significant growth will continue. We estimated that an additional 15,200 (2.5%) people would live in the District by FY 2013. We also assumed a 7,300 (2.7%) increase in households by FY 2013, with corresponding estimates for labor force growth. This is a significant increase in households.** For comparison, Reis, Inc., a nationally recognized company which tracks real estate in D.C. and elsewhere in the U.S., anticipates that from 2011 to 2013, there will be an increase of 5,665 in the number of occupied units in all of D.C.'s market-rate apartments that contain at least 40 units. (According to Census Bureau definitions, an occupied housing unit is equal to one household.)

While it is clear at this point that population is growing, it is not possible at this point to draw a conclusion about the rate of future growth based on the most recent Census estimate alone. Population growth can vary significantly from year to year, reflecting things like the housing market, employment, and other factors. The 2010 Census showed that Census had earlier overestimated DC's 2010 population by about 6,000 (1%).

Regarding your concern as to whether population growth is properly factored into our estimate, **I must emphasize that the impact of population increases are immediately captured in our estimates in higher individual income tax revenue through the income tax withholding.** We raised the estimate for the individual income tax early in 2011 as soon as our data showed higher withholding tax growth, and *before* the U.S. Census Bureau announced its higher population estimate for the District. In fact, the U.S. Census Bureau uses withholding tax information in updating its population estimate for the District because it has been a consistently accurate barometer of the population changes in the District. In the mid 2000s, when the Census estimate undercounted the District's population, the income tax data suggested a rising population, which was confirmed eventually by the 2010 Census. The higher amounts of withholding received in FY 2011 became the base for estimating revenue in FY 2012 and subsequent years.

Falling unemployment. The most recent data released on February 29th shows that D.C.'s unemployment rate has been falling in recent months. The unemployment rate was 10.1% in December 2011, and had been as high as 10.5% in July and August. However, the rate in December 2011 was also exactly the same as December 2010. The impact of changes in the unemployment rate on revenues depends on the incomes of the additional persons who become unemployed or who return to employment, and our experience over the past several years confirms that variation in the unemployment rate has not been a good predictor of changes in our

income tax revenue. In fact, the relatively high level unemployment rate would suggest a lower level of income tax revenue than we observe in the tax data.

An expanding economy. **While the District's economy has consistently outperformed the U.S. economy over the past few years, this phenomenon is largely the result of the substantial federal presence in the city.** Much of the increase in growth in the national economy is now occurring in sectors, such as manufacturing, that have little impact on the District. Indeed, because we did not fall nearly as much as the national economy during the recession, by the same token it would not be expected that we grow as fast during a recovery. In addition, with federal employment in D.C. already lower now than it was a year ago, a great deal of caution is in order about the outlook for D.C. As I noted in my February 29 revenue certification letter, the District's economy is currently caught between slowing growth in the federal sector and modest growth in the private sector. The outlook becomes much more uncertain due to the prospects of sequestration or other drastic measures to reduce federal employment, wages, contracting, and office space rental.

In preparing the estimate we review carefully the forecasts prepared by national and international forecasters such as IHS Global Insight and Moody's Analytics. This is standard practice among state and local government revenue estimators, and it assures that the information used in forecasts is consistent with developments in the national economy. When there is great uncertainty in the economic outlook—as there has been over the past year due to such factors as the tepid national economic recovery, the Euro debt situation, possible disruption in the Middle East and oil markets, and lack of consistent direction in financial markets—we generally have adopted the more conservative of the forecasts from these groups as a starting point for our estimates. That said, our revenue estimates are by no means based on the most pessimistic assumptions, such as the ones that anticipate a double dip recession.

Sequestration. As I explained in my certification letter, we revisited the estimate of the federal sequestration's impact on the District's finances in light of the January 2012 Congressional Budget Office's report. Our re-estimate also reviewed our assumptions about what revenue sources would be most affected by sequestration. In December, we estimated that federal sequestration would reduce sales tax revenue more than individual income tax revenue. But given recent data showing a growing population and higher wages and salaries, we now estimate that federal cutbacks will have a relatively larger effect on wages and salaries, and therefore the individual income tax revenue. The net effect is that, even though we have reduced the impact of federal sequestration on the District, the revised estimate shows only a small increase in the individual income tax revenue. For the same reason, the revised revenue estimate now shows a relatively large increase in the sales tax revenue. **This is not a contradiction**, just a change in the composition of the federal sequestration's impact on the District's revenue sources based on the most recent data. Table 3 below shows the details of this change:

Table 3: Change in Composition of the Impact of Federal Sequestration

	FY13	FY14	FY15	FY16
December 2011 Estimate				
Sales	(40,372)	(49,747)	(52,234)	
Income	(6,369)	(27,536)	(32,702)	

Deeds	-	(4,429)	(4,205)	
TOTAL	**(46,741)**	**(81,711)**	**(89,142)**	
February 2012 Estimate				
Sales	(6,120)	(13,407)	(14,271)	(15,192)
Income	(18,015)	(38,961)	(39,585)	(40,421)
Deeds	-	(4,429)	(8,633)	(8,633)
TOTAL	**(24,135)**	**(56,796)**	**(62,490)**	**(64,247)**

Property Taxes. The Office of Tax and Revenue's Real Property Tax Assessment division is finalizing the assessments for FY 2013 and we will include this data in our next estimate of the real property tax revenue. Until that data is available, growth rate assumptions are based on information about past assessments and annual tax bills. In FY 2012, the Class 1 (residential) tax base declined by 0.6% while the Class 2 (commercial) tax base grew by 11.4% and revenue collected is expected to increase by 7.2%. In FY 2013, we estimate a decrease in Class 1 of 0.4% and an increase in Class 2 by 8% and revenue overall revenue increase of 6%. The forecast for FY 2013 – FY 2015 has not been changed since the September forecast as we await the latest assessment and billings data.

Deed tax collections declined for the three consecutive fiscal years of 2007 to 2009, amounting to about a 50% total reduction in collections in FY 2009 relative to FY2006. Some growth began to materialize in FY 2010, but the brunt of the surge of buying large commercial office buildings (likely the pent-up demand for buying office buildings that did not take place during the recession and financial crisis) took place in FY 2011. This surge in activity caused FY 2011 deed tax collections to grow 40% compared to FY 2010 collections. Given that an unusual surge in activity took place in FY 2011, total deed tax collections in FY 2012 is not expected amount to as much as what materialized last fiscal year. Already, according to CoStar data, the dollar value of sales in the first quarter of FY 2012 is 10 percent below the first quarter of FY 2011. FY 2012 collections are expected to decline 3.4%. However, FY 2013 collections are expected to grow almost 6 percent. One of the assumptions from the federal sequestration analysis is that it will have a negative impact on the commercial property markets through lower federal leasing such that deed tax revenue will not grow in FY 2014 and FY 2015.

Individual income taxes. A list of the economic assumptions used to estimate resident employment in the District of Columbia, including population and employment, are contained in the table attached to the revenue estimates. The income tax revenue is forecasted using a statistical model based on a quarterly time series of aggregate data for the last 40 years. The primary drivers of the model are resident wages and salaries and the Standard & Poor 500 stock market index, which captures the relationship between the individual income tax revenue and capital gains income.

The assumptions made about sequestration obviously affect the forecast. For FY 2013 sequestration reduced total employment in DC by 8,500, resident employment by 2,200, wages

earned by DC residents by 1.0%, and Personal Income by 0.6%. The revenue forecast with and without federal sequestration is shown in the table below. The growth in FY 2012 is strongly influenced by recent legislation which had a one-time impact for FY 2012 (changes to withholding, etc.) and this reduces the rate of growth in FY 2013. The underlying growth is more consistent with the historic average. FY 2013 growth is lower than the historical average because we are assuming no stock market growth for 2012 given the potential for a major downward adjustment if a major European bank fails.

Can we fix the column headings so they are directly over the data?
Table 4: Comparing Growth Rates of Individual Income Tax

	FY12	FY13	FY14	FY15	FY16
Individual Income Tax – Baseline	4.0%	2.5%	3.2%	3.8%	3.8%
Individual Income Tax - With Legislation	11.6%	-1.5%	3.1%	4.0%	2.5%
Individual Income Tax - With Federal Sequestration and Legislation	11.6%	-2.8%	2.1%	4.0%	2.5%
5 Year Compound Growth (2006-2011)	*1.0%*	*1.0%*	*1.0%*	*1.0%*	*1.0%*
10 Year Compound Growth (2001-2011)	*1.7%*	*1.7%*	*1.7%*	*1.7%*	*1.7%*

Business Income Taxes. Business income taxes are increasing throughout the forecast but were revised down in February from the December 2011 estimate, reflecting the more pessimistic view of the SP 500.

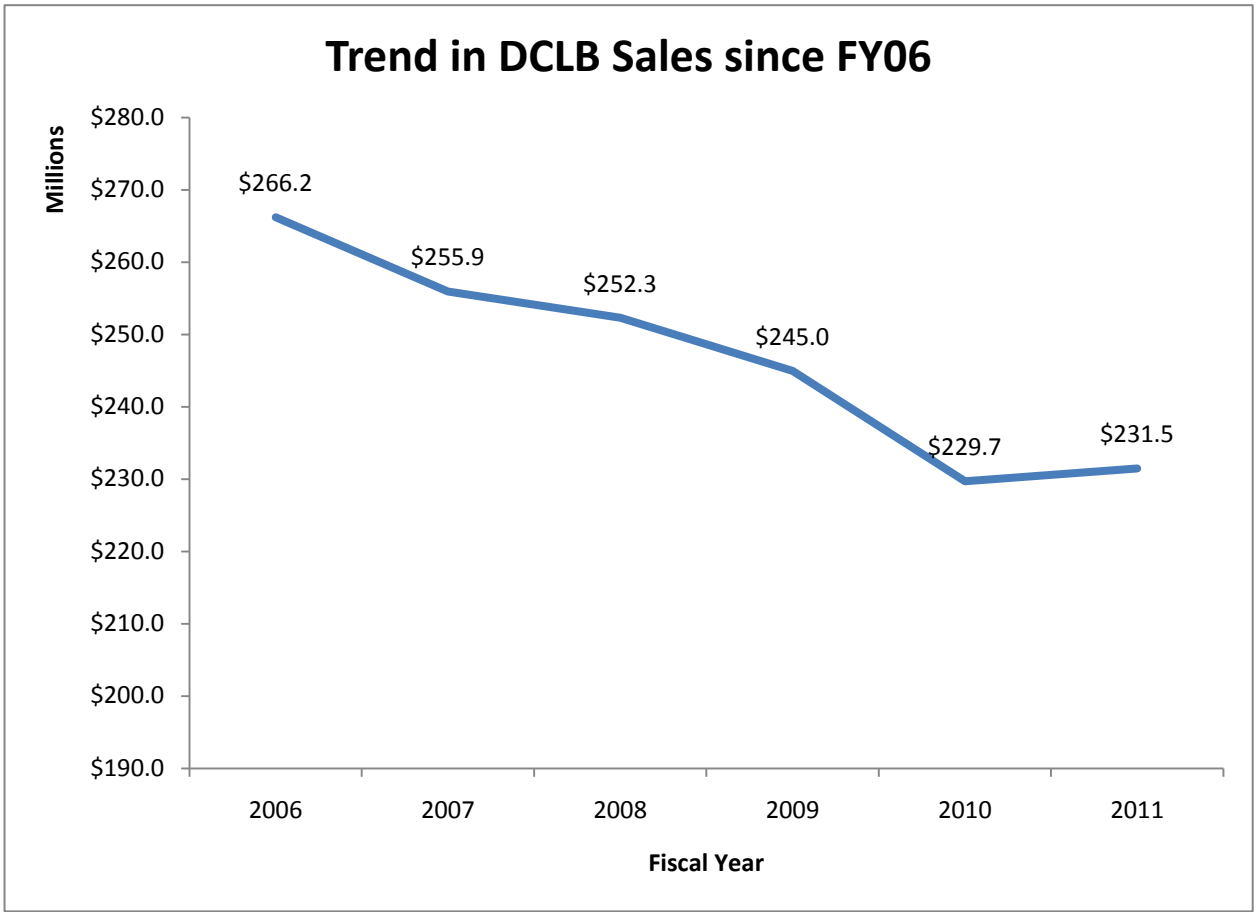
A list of the economic assumptions used in the revenue estimate is contained in the table attached to the revenue estimates. Business income tax revenue, like the individual income tax revenue, is forecasted using a statistical model based on a quarterly time series of aggregate data for the last 40 years. The main driver of the model is the Standard & Poor 500 stock market index, a leading indicator of business profitability.

In December, there was an assumption that the federal sequestration would impact business taxes in FY 2013. In the revised analysis, no impact on business taxes is assumed for sequestration in FY 2013.

Lottery. The anticipated $5 million revenue increase as a result of the implementation of the new gaming system was based on a lower contractor fee rate associated with the new contract. The fee dropped from 4.2% of sales under the old contract to 2.6% upon implementation of the new one. An estimated annual sales volume of $300 million was assumed resulting in a savings of approximately $5 million. This sales volume increase has not been realized for a variety of reasons.

Powerball, DC3 and DC4 sales exhibited a sharp decline between FY07 and FY11. The decline was due to the economic recession, changing demographics and the cross-selling of Powerball.

The decision to allow Maryland and Virginia to sell Powerball eliminated the District's exclusive franchise. These games provided the lion's share of revenue transfer to the District. These trends required the DCLB to refocus its game strategy and develop new more interactive games that engage the player in order to restore lost revenues. As a result, we have begun to see a reversal in the declining trend. The new games are catching on and providing the fuel for increased sales and transfer.



Our goal is to maintain the current numbers game sales (PB, MM, DC3, DC4, DC5) while we focus our energies on expanding the reach of our new games and instant tickets, as well as developing new product lines that capture the attention of an increasingly sophisticated player base looking for challenging and exciting interactive games. We cannot grow the lottery by focusing on the traditional numbers games.

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Below are the detailed statistics for FY11 and FY 2012 sales and transfer (both as of February 29th) for comparison purposes.

FY12 Actual Sales Compared with FY11 as of 02/29

	FY12 Act.	FY11	Δ	%Δ
Powerball	7,181,000	5,655,000	1,526,000	27.0%
Mega Millions	2,957,000	3,724,000	-767,000	-20.6%
Hot Lotto	1,211,000	1,525,000	-314,000	-20.6%
DC Daily 6	0	486,000	-486,000	(game discontinued)
DC3	21,619,000	22,127,000	-508,000	-2.3%
DC4	27,592,000	27,315,000	277,000	1.0%
DC5	5,830,000	4,950,000	880,000	17.8%
KENO	5,217,000	4,377,000	840,000	19.2%
INSTANT	23,827,000	22,320,000	1,507,000	6.8%
Race To Riches	2,747,000	792,000	1,955,000	246.8%
Fast Play	2,219,000	0	2,219,000	
TOTAL	**100,400,000**	**93,271,000**	**7,129,000**	**7.6%**

FY12 Actual Transfer Compared with FY11 as of 02/29

	FY12 Act.	FY11	Δ	%Δ
Powerball	2,625,000	1,975,000	650,000	32.9%
Mega Millions	800,000	1,175,000	-375,000	-31.9%
Hot Lotto	470,000	575,000	-105,000	-18.3%
DC Daily 6	10,000	275,000	-265,000	-96.4%
DC3	7,665,000	6,725,000	940,000	14.0%
DC4	9,800,000	9,925,000	-125,000	-1.3%
DC5	2,525,000	2,200,000	325,000	14.8%
KENO	940,000	965,000	-25,000	-2.6%
INSTANT	1,285,000	1,715,000	-430,000	-25.1%
Race To Riches	360,000	170,000	190,000	111.8%
Fast Play	395,000	0	395,000	
TOTAL	**26,875,000**	**25,700,000**	**1,175,000**	**4.6%**