FY 2021 Loudoun County Budget Preparation[1]

Still Hooked on Growth?

Discussion Note

January 15, 2020

SUMMARY

The crux of the matter. Loudoun is now preparing the FY2021 budget, its first under the new 2019 Comprehensive Plan. Will this budget and the next for FY2022 begin to confront its high expenditure growth rates and unsustainable revenue dependence on new development? Will they address Loudoun's near-term fiscal risks?

The aim of the Discussion Note: (i) to review the current status of FY2021 budget development, (ii) to enumerate some key fiscal issues underlying the questions above, and (iii) to outline for discussion purposes some measures for the first two budgets of the new Board's four-year term in order to help set a course toward *long-term sustainable fiscal performance in Loudoun.*

We've been "hooked on growth" over the past decade. Loudoun has demonstrated a repeating sequential process since about 2010 of (i) an aggressive land use housing development policy, (ii) that generates heavy demographic growth in population, schools and traffic, (iii) that drives an exorbitant public spending growth spiral, (iv) that relies on more residential and commercial development to pay for it, (v) that enables popular reductions in real estate tax rates; and (vi) that generates *yet more dependence on new development* to pay the bills.

Its effects are producing exceptional concerns. Yes, Loudoun is exceptional in many positive ways. But its policy choice to develop the housing market over the past two decades at 2-3 times the pace of other inner DC and outer DC area counties has produced (i) record growth in population, school enrollment and traffic congestion, and (ii) exceptional concerns about its public spending, debt and taxation:

- *Galloping government spending over 20 years.* Demographics have in part driven County total expenditures at galloping rates of nearly 10% each year on average between FY2000 – 2019. In contrast, this was *two- to threefold* the rates of other DC Metro area counties. Apart from the population push, the budget is also spiraling up at 3-4% per resident per year.

- *Heavy dependence on new development to pay mounting bills.* Since 2010, at least 70% on average of the expansion of Loudoun's real property tax base has come from new residential and commercial development. In contrast, neighboring Fairfax and Arlington counties (like most others) have expanded their tax bases with only about 30% from new development; the vast majority comes from the revaluation of existing residential and commercial property.

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- *Extreme revenue growth dependence on a single industry.* Between FY2011 – 2016, data centers helped to diversify Loudoun's tax revenue structure, rising from about 2% to 8% of total General Fund income. This year, they account for about 20% of total revenues and will jump further in FY2021 to an estimated 23%,[2] dwarfing taxes from the other local business. Data centers have emerged as *the major County revenue growth financier*, accounting for 57% of total additional revenues between FY2015 – 2020 and 85% over FY2017 – 2020. Data center revenues now *support about 17% of County operating costs and debt service*. [3]

- *A decade of real property tax rate cuts.* Homeowner tax bills over 2000-2008 rose under a pay-as-you-go policy to meet rising public costs. But over 2010-2019, real property tax rates *descended yearly by nearly 20% to today's $1.045 – a rate comparable to 1996.* The average homeowner tax bill, nominally the same as in 2010*, has fallen by about 13% when inflation-adjusted.* Elsewhere in the DC region, tax rates increased by between 6 - 13% over 2010-2019. And Arlington, Fairfax and Prince William counties have raised homeowner property tax bills by 3.6% per year on average – *about twice the region's inflation rate*.

And these concerns are growing. The Final Budget Guidance Memorandum and Board discussion of January 7, 2020 show that the above-mentioned trends continue to play out in the current FY2021 budget development: public service pressures continue to grow from some 11,000 new residents, nearly 2,000 new students and quality improvement needs in the school system; a new government staffing classifications and compensation system to *bring it back* to market levels; heavy continued capital investment commitments, particularly for transportation; and other new spending needs from the Metro opening to workforce housing.

Underlying this is a sense of how difficult public expenditure control and funding *is now and is becoming*. Operational spending per resident continues to grow. Implementation of the Capital Implementation Plan may well slide. Dependence on data center property taxes will rise again. Even applying the upper $1.055 real property tax rate option will leave a *deficit* between funding and the government and school system budget requests. *And all this after an increase in the FY2020 total expenditure budget by an eye-popping 23% - a 15-year record high!*

The current fiscal path is not sustainable in the longer term. Beyond the FY2021 budget, structural changes are on the horizon for the longer term. The overall growth in residential housing development will moderate under the 2019 Comp Plan. There are visible limitations coming by the mid-2020s on large new investments by data centers and on windfall growth in their property tax revenues as space becomes no longer unavailable. And while the broader Loudoun business sector is poised to continue providing moderate tax revenue growth, it cannot supplant anytime in the foreseeable future the levels or growth of data center revenues. Strategic business diversification (including in the professional, scientific and technical services market) faces strong regional competition, while even the local business environment is shifting with the sharp rise in land, construction and wage costs spilling over from the information industry.

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[2] Author's estimate from County staff budget data. Figures include both personal property and real property taxes.
[3] The County's allocation in FY2020 of $15 million of data center revenues to the CIP reduces this share marginally.

And it is risky in the near term. Loudoun's experience in the recession of 2008-2010 was wrenching. Despite an economic decline, growth was persistent in population and public services demand. It involved sizable multi-year cuts in staff and services (by 12% in FY2010 alone), contractions in property values (by -14% over FY2008-2010), and tough decisions to increase tax rates (by 24% in FY2009) when residents were least able or ready to accept them.

The near-term likelihood of a recession is considered high, as noted the staff memo to the BOS of July 9, 2019 (page 3) on the economic outlook. Loudoun is fiscally vulnerable given its (i) heavy pressures on current and capital spending, (ii) high fiscal revenue dependency on new development, (iii) heavy reliance on a single industry to produce incremental revenues each year, (iv) significant annual rise in debt service obligations at 6 - 7% through FY2024 and the capacity limit policy on new borrowings, and (v) unpredictable future expenditure demands.

Though the County has a culture of careful fiscal management, the need for it is only increasing - particularly management of cash reserves in the face of budget gaps and the raising of new debt in economically uncertain waters. Beyond this, there are currently no specific fiscal provisions for recession. And, more fundamentally, unlike the longer-range land use plans provided under the 2019 Comp Plan, *there is no companion strategic fiscal revenue policy framework to chart the financial future*. Its absence only increases the chances in the near-term that County finances continue their reliance *ad hoc* on rising data center taxes and property tax rate choices.

It is time for a transition. Current fiscal policies and practices are not adequate to ensure sound fiscal responsibility going forward. Now is the time to begin to adopt *transitional measures* under the 2019 Comp Plan. While honoring the overall residential housing development targets under the Plan, the current rate of permitting needs to be slowed significantly over FY2020 – 2024. This adjusted trajectory would set the County on course sooner rather than later to lower demographic pressures, public expenditure growth rates and the expansion of tax-supported debt.

Slowing expenditure growth will be the best news for those most concerned about raising taxes and debt, and will help ensure the lowest possible property tax bills. Still, property tax levels reflect that "you get what you pay for". Despite good intentions, the equalized tax policy over the past decade has had the unintended effect of curtailing important government services needed by a growing population, imposing an experiential "indirect growth impact tax" on residents' quality of life, and excessively narrowing the tax base structure. This policy also needs reform, particularly given annual surveys that reflect a willingness of the majority of residents to pay more taxes to address specific issues. *For FY2021, even maintaining the real property tax rate at $1.045 or adjusting it to $1.055 would bring the <u>inflation-adjusted</u> average homeowners property bill only back to the inflation-adjusted levels paid in FY2014 and FY2015 (see page 11 of the Discussion Note).*

First steps for discussion. This note offers for discussion some specific measures and guideposts which could be undertaken <u>this year</u> as (1) part of the adoption of the FY2021 budget, and (2) inputs to the Initial Budget Guidance discussed by the Board in October for the FY2022 budget. They are summarized below and addressed more fully in the Discussion Note.

Loudoun Fiscal Policies and Practices
Some Actions for Discussion

***Over January - March 2020* as part of the adoption of the FY2021 Budget:**

(1) **Strengthen fiscal management practices related to data center revenues,** by
   a. Redirecting a larger share of data center property tax revenues to fund the CIP.

(2) **Adjust real property tax rates,** so as to ensure funding of
   a. the new classification and compensation structure, other base budget operations and maintenance, Departmental first and second priority requests, and the LCPS budget.

***Over March - September 2020* as part of the Intial Budget Guidance for the FY2022 Budget:**

(1) **Begin to reduce total annual budget expenditure growth rates,** aiming to progressively reach parity with long-term sustainable revenue growth [see Discussion Note page 6]
   a. Incorporate benchmarks from DC Metro area counties of their annual property tax base growth rates derived from existing property revaluation and new development;
   b. Adopt budget indicators that reflect progressive significant reductions over FY2022 – FY2024 in the annual rate of new residential housing permits.

(2) **Articulate a sustainable fiscal revenue policy framework and replace the equalization tax rate policy** [Discussion Note pages 9 & 10]
   a. Benchmark (with outside assistance as useful) revenue policies and practices elsewhere in the DC Metro region and the United States;
   b. Prepare and adopt an overall fiscal revenue policy framework governing annual taxation and revenue decisions;
   c. Replace the equalization tax rate policy and ensure that, as a minimum, real property tax revenues are inflation-adjusted annually to maintain purchasing power.

(3) **Strengthen fiscal management practices of data center revenues** [Discussion Note p. 13]
   a. Prepare and adopt a long-term policy framework that defines (i) land use for data centers within the 2019 Comp Plan, and (ii) the maximum share of local tax paid by a single industry source that may fund annual operating costs and debt service;
   b. Allocate tax revenues in excess of this share to fund the CIP.

(4) **Make the County budget "recession ready"** [Discussion Note p. 16]
   a. Incorporate a budget stress test analysis of revenues, spending expenditures, service levels, indebtedness and tax incentive programs;
   b. Make recession risk adjustments as needed in projections and budget allocations to reduce the probability of future jarring expenditure cuts and tax hikes.

(5) **Strengthen resident participation in annual budget development** [Discussion Note p. 18]
   a. Prepare a series of focus groups and designing an interactive website on the budget;
   b. Utilize these tools in October or November 2020 to get public reaction and views on the BOS Initial Budget Guidance for FY2022.