Date of Meeting: October 11, 2016

#14

BOARD OF SUPERVISORS
FINANCE/GOVERNMENT OPERATIONS AND
ECONOMIC DEVELOPMENT COMMITTEE
ACTION ITEM

SUBJECT:	**FY 2018 Budget Development Process: Preliminary Budget Guidance**
ELECTION DISTRICT:	Countywide
CRITICAL ACTION DATE:	October 11, 2016
STAFF CONTACTS:	Tim Hemstreet, County Administrator Erin McLellan, Management and Budget

PURPOSE: The purpose of this item is to provide a fiscal outlook for FY 2018 and seek budget guidance so that the County Administrator may prepare the FY 2018 Proposed Budget.

RECOMMENDATION:

Staff: Staff recommends that the Finance/Government Operations and Economic Development Committee (FGOEDC) recommend that the Board of Supervisors provide preliminary budget guidance to serve as a guide to the County Administrator and the Loudoun County School Board in preparing the FY 2018 Proposed Budget.

BACKGROUND: Each year the FGOEDC and the Board of Supervisors provide the County Administrator with policy parameters for the preparation of the Proposed Budget. This item constitutes the preliminary budget guidance from the FGOEDC that will be forwarded for consideration by the Board. Final budget guidance is typically proposed by the FGOEDC in December and then confirmed by the Board in January. This final guidance will occur after the year-end closeout, following revisions to the financial outlook and based on additional Revenue Committee review and updated figures on real property valuations.

Board direction on priorities will assist staff in prioritizing and refining the large number of requests that are elevated through the internal County Government budget development process. An early discussion of priorities or focus areas for the upcoming year will allow Department of Management and Budget (DMB) staff and County Administration time to work with departments to determine current levels of service or deficiencies in areas that the Board has targeted and to develop issue discussions that can return to the Board during budget development for more clarity and refinement.

In the absence of Board direction on priorities, staff will likely prioritize those areas in which known current service level challenges already exist and need to be addressed through adjustments to the budget or through a reallocation of resources from another area of the County Government. In addition, a focus on Board priorities, regardless of potential new funding availability, allows the Board to lead budget development forward in a strategic way that will provide both direction on potential enhancement areas if new funding is available or potential reduction areas if new funding is not available. As priorities are discussed and refined through the summer and fall, staff confidence in revenue and expenditure forecasts will concurrently increase and further refinement of the priorities can be tied more closely to funding availability.

ISSUES:

The following is a current outlook that staff will continue to monitor and update during the process. The current economic outlook is very similar to the one presented last year (with the exception of an improved real and personal property picture for FY 2018), namely continued slow economic growth for the current and next two years.

World Economy: The International Monetary Fund (IMF), the Organization for Economic Cooperation and Development (OECD), and the World Bank have lowered their prior projections of global economic growth for 2016; and they project only modest improvement at best in 2017. A survey of their analyses indicates the following:

- Worldwide economic output grew at about 3.0 percent in 2015. Expected growth in 2016 ranges from 2.4 percent to 3.2 percent, and growth in 2017 is expected to be only slightly better.

- Low commodity prices and outflows of financial capital are adversely affecting many developing economies (e.g., Brazil, Venezuela); and China is attempting to reduce its reliance on exports to expand its economy (now among the largest in the world) in favor of domestic consumption. This transition is occurring in the presence of a huge excess of debt-financed industrial capacity, which has contributed to volatility in Chinese and global financial markets.

- None of these organizations is predicting that a global recession will occur over the next two years, but all acknowledge the major risks to the current outlook. One such risk is the recent United Kingdom decision to exit the European Union. Thus far, the main consequence of this action has been increased volatility in financial markets which have since stabilized. However, if businesses delay planned investments in new plant and equipment until the future trade arrangements between Britain and the EU are clarified, an economic recession could result.

U.S. Economy: The September 2016 Wall Street Journal survey of U.S. economic forecasts shows average expected real GDP growth in 2016 of 1.8 percent (compared to 2.4 percent projected six months ago). The same survey shows average expected growth in 2017 and 2018 of 2.2 percent and 2.0 percent, respectively. None of the survey participants is projecting an economic recession within the next year, but they estimate the chances of such an event to be 1-in-5 as compared to 1-in-10 a year ago. Following are brief summaries of major segments of the national economy:

- *Housing Market:* Since the 2008-2009 recession, the rates of both household formation and homeownership have declined significantly from pre-recession levels. Consequently, sales of existing homes and construction of new homes fell sharply after the recession, which was triggered by the collapse of housing prices and a sharp decline in mortgage lending. Sales of existing homes sales are now close to the 5.3 million per year value that preceded the housing bubble[1]. However, construction of new homes in 2016 is running at an annual rate of 1.2 million units, an increase of about 11 percent over 2015 but well below the 1.5 million per year pace associated with the traditional rate of household formation. The September 2016 Wall Street

[1] Sales of existing units rose from 5.3 million in 2001 to more than 7 million units in 2005 as the U.S. Housing market over heated. (Source: HUD, Historical Data Table 7 from the National Association of Realtors)

Journal survey calls for a 7 percent increase in new home construction to 1.3 million units in 2017.

- *Labor Market:* U.S. payroll employment continues to increase each month, and the U.S. unemployment rate in August was 4.9 percent. In addition, the Labor Department reports that wages and salaries for civilian workers for the year-ended June 2016 were 2.5 percent higher than the 2015 value. The September Wall Street Journal survey projects that monthly job growth in 2016 will average 175,000, which is somewhat below the pace of the past few years. However, a higher rate of increase would require faster economic growth and an increase in labor force participation, which has been declining in recent years.

- *Financial Markets:* U.S. equity markets have experienced episodes of volatility in the past year, but both the DOW and the S&P 500 stock indexes remain at high levels. Some analysts contend that the high price-to-earnings ratios exhibited by many stocks indicate prices that are artificially inflated by investor reaction to the historically low interest rates maintained by the Federal Reserve's accommodative monetary policy. Federal Reserve policymakers have stated their intention to increase interest rates to more normal levels, but they disagree on the timing of such normalization. The risk is that higher interest rates will depress both stock and bond prices and make borrowing more costly for businesses and consumers, all of which could tip the economy into recession.

State and Local Economy: The state and local economies are exhibiting faster job growth in 2015 and early 2016 versus the previous two years now that federal discretionary spending has stabilized after declining for several years. Highlights of the state and local economic environments are summarized below.

- *State Revenue Outlook:* In August the Secretary of Finance for the Commonwealth conducted an interim review of the outlook for the Commonwealth's economy and revenues after FY 2016 revenue fell $269 million (1.5 percent) below the budget forecast (http://sfc.virginia.gov/committee.shtml). The August interim review projects that FY 2017-2018 General Fund revenue will be $1.2 billion lower than the amount contained in the official forecast. Although the outlook for employment and wage and salary growth in FY17-18 is similar to the rates in the official forecast from November 2015, the average overall wage level is not as high as previously projected. Available data suggests that much of the growth in professional and business services jobs has been concentrated in the lower-paying job categories. With a progressive income tax, the result is a lower amount of withholding revenue. Lower wage rates also have a negative impact on sales tax revenue. In the meantime, state agencies made their recommendations for proposed spending cuts to the Department of Planning and Budget on September 20, and those proposals are currently under review by the Governor. In compiling these recommended cuts for FY 2017, agencies were instructed to refrain from cutting aid to localities. However, aid to localities is not necessarily exempt from reductions in FY 2018.

- *Unemployment:* Loudoun County's unemployment rate continues to rank among the lowest in Virginia and nationwide. In July 2016, the unemployment rate in Loudoun was 3.2 percent, as compared to 3.7 percent in Virginia and 4.9 percent nationally. This statistic may be somewhat misleading as underemployment remains a significant issue in contrast to high housing costs for both ownership and rentals. In compiling the unemployment rate, a person is counted as employed if they are working part-time and/or are working in a job for which they are over-qualified.

- *Job Growth:* The latest available data on payroll employment within Loudoun extends through March 2016. In the first quarter of 2016, there were 7,600 (or 5.2 percent) more payroll employees in the County than were here in the first quarter of 2015. This compares to first-quarter growth of only 1.6 percent in 2015 versus 2014. Almost 20 percent of these additional jobs were in the Professional and Business Services category, which increased by 1,400 or 5.0 percent over the 2015 first-quarter level. (Some of this increase could be due to professional services required by the two large construction projects currently underway in Loudoun—the Silver Line and the Panda-Stonewall Energy project). 2016 first-quarter payroll employment in the Washington, DC, region exhibited an increase of 2.0 percent, as compared to 2.3 percent for Virginia and 2.0 percent for the U.S.

- *Residential Real Estate Market:* Dulles Area Association of Realtors (DAAR) reports a 3.5 percent increase in the number of closed sales of existing homes in Loudoun during the first seven months of 2016 as compared to the same period a year ago. The local existing home market in 2016 has shifted away from the buyer's market of a year ago since active inventory has been lower and the average number of days on the market through July was 13 fewer than in 2015. The July year-to-date median sale price was up 2.3 percent versus a year earlier. Although median sale price is not a perfect indicator of the overall annual rate of market appreciation, the reported upward tendency supports the current expectation of modest price appreciation in 2016 in the FY 2018 Adopted Budget[2]. New home construction in Loudoun measured on a 12-month moving average basis increased fairly steadily from the fall of 2010 to a peak of roughly 400 units per month in January 2014. Since then, the pace lessened to about 300 units per month in 2015. This pace is sufficient to meet the currently projected growth in the number of households during 2016 and 2017, but continued improvement in the regional economy and job market could generate some additional demand from individuals who have delayed purchasing a home. However, permitting activity in the first seven months of 2016 has averaged 277 per month versus 368 per month for the first seven months of 2015.

- *Commercial Property Market:* In 2015, Loudoun realized approximately $690 million of new investment in commercial and industrial real property, following $580 million in 2014. These amounts are significantly higher than the average annual value of $290 million experienced during 2011-2013. Investment in commercial and industrial property appears to be holding steady with substantial contributions by data center development. The County currently has 9 million square feet of data center space either currently in operation (approximately 6 million square feet) or slated to be developed. In addition, although technically classified as public utility property, construction has progressed on Panda Energy's $640 million Stonewall Power Project. Once completed this facility should increase the value of utility property in the County by nearly 40 percent.

[2] The annual real property assessment must assign a value to all of the approximate 124,000 residential properties in the County. The several thousand homes which are sold in a given year may not be a representative sample of all residential properties in the County, so the behavior of the sample average price or median price may over- or understate the countywide average rate of appreciation, which is assumed to be 1 percent in the FY 2018 Budget.

Preliminary Outlook—FY 2018 General Fund Shortfall

Review of preliminary revenue and expenditure trends indicate another challenging budget process for FY 2018, as a result of both school age and general population increases. Some enhancements will need to be considered in order to maintain service levels. Table 1 provides a preliminary outlook of the General Fund in FY 2018.

Table 1. ESTIMATED GENERAL FUND SHORTFALL

Anticipated Revenue Changes	**Amount @ $1.145** (millions, $)	**Amount @ $1.135** (millions, $)
Real Property Taxes	35.0	27.7
Personal Property, Sales, Utility and Other Local Taxes	62.5	62.5
Prior Use of Fund Balance	(27.1)	(27.1)
Local Tax Funding Subtotal	***70.4***	***63.1***
Other County Revenue (BPOL, Permit Fees, etc.)	(0.9)	(0.9)
Subtotal Anticipated Revenue Changes	***69.5***	***62.2***
Anticipated Expenditure Increases		
County/Schools CIP-CAPP-Debt Service Needs	(23.3)	(23.3)
County pay increase	(8.6)	(8.6)
County base growth and enhancements	(20.0)	(20.0)
Schools Estimated LTF increase (Per memo to Superintendent dated 8/9/16)	(74.3)	(74.3)
Subtotal Anticipated Expenditure Increases	***(126.2)***	***(126.2)***
Current Estimated General Fund Shortfall	***(56.7)***	***(64.0)***

Highlights of the data in the preceding table as well as issues associated with the FY 2018 budget process are as follows:

Revenue projections**:** Preliminary projections are generally conservative. It should be noted that revenue projections are subject to change based on final assessment data and Board adopted changes to the tax rates. No new fees are included in the current estimates.

One of the challenges, which will need to be addressed during the FY 2018 budget process is the reduced revenue outlook for local gasoline tax and the diversion of this revenue to the Washington Metropolitan Area Transit Authority (WMATA) beginning in FY 2019. A more detailed discussion of this issue appears in Item 17 on the October 11, 2016 FGOEDC agenda.

One of the largest drivers of the new revenue expected in FY 2018, aside from Real Property tax, is personal property tax, specifically taxes on business personal property such as computer and other equipment in data centers. Personal property tax revenue is projected to increase 8.0 percent in FY 2017 and an additional 10.0 percent in FY 2018. The computer equipment component of personal property tax alone is projected to increase by 15 percent in FY 2017 and another 15 percent in FY 2018. This continues a strong trend Loudoun has experienced in the past several years and is expected to continue for several more. However, one of the trends that is apparent to the Department of Economic Development

(DED) is the increasing competitiveness of the data center market. While Loudoun remains a world class location for data centers, it is no longer a cost-effective solution for many companies looking to co-locate or lease space in such facilities. When Virginia enacted its data center sales and use tax exemption in 2009, only seven other states offered such incentives. Today, over half of all states offer incentives for data centers and most of those states now offer additional incentives that are more competitive than Virginia's.

A major driver of local tax revenue is not just the data center building shells but the servers and other equipment that are inside them. This is where Loudoun is most vulnerable in its data center market. Approximately 90 percent of the data centers in Loudoun County are co-location facilities that rent space to technology companies of all sizes. In fact, more than 3,000 technology companies are hosted inside of Loudoun's 65 data centers based on significant benefits of scale. It is these companies who pay the bulk of the data center personal property taxes in Loudoun County. In most instances, these companies have short term leases (three to five years). Prior to the expiration of their contracts, companies have the ability to evaluate the costs of their capital-intensive operations. They also have the flexibility to relocate their server and equipment to lower cost markets that now offer aggressive incentives (such as personal property tax exemptions) and subsequently lower net taxes. These markets include Atlanta, Georgia; Charlotte, North Carolina; Cheyenne, Wyoming; Colorado Springs, Colorado; Des Moines, Iowa; Omaha, Nebraska; Portland, Oregon; Quincy, Washington; Salt Lake City, Utah; and Tulsa, Oklahoma. If Loudoun County cannot compete effectively with these markets, the County risks losing technology companies and the positive net tax revenue that comes with them.

The high proportion of expenditures that go to equipment for companies in the data center industry means that they have to pay close attention to personal property rates, and the personal property tax is generally by far the largest of the taxes data centers pay to the County. The power infrastructure, fiber, and other key locational attributes of Loudoun County have been key prerequisites for attracting data centers, but it is critical to maintain personal property rates at a competitive level to retain and grow this industry. Further information from DED is included as Attachment 3.

During the development of the FY 2018 or FY 2019 budget, the Board may want to consider taking a closer look at the personal property rate in relation to future revenue potential from retention of data centers in the County. Staff from DMB and DED will continue to monitor both the market factors and the revenue trends in this area. It should be noted that each cent on the personal property tax rate for computer equipment is estimated at approximately $369,000 in FY 2018.

County Government estimated Local Tax Funding Increase: The budget development process has just begun on the County side, and as such, the magnitude of budget requests and base budget increase requirements are preliminary or unknown. A few specific increases are anticipated: continuation of merit pay increases and the planned opening/staffing of new county facilities; specifically Phases 2 and 3 of the Dulles South Multipurpose Center, the Brambleton Library, and the Kirkpatrick Fire Rescue Station. Opening of new facilities is estimated at approximately $8.1 million at this time. Additional budget requests will likely need to be considered to maintain service levels that coincide with increased population and other driving factors such as mandates.

As the County continues to add as many as 11,000 new residents per year, demand for services continues to increase. Maintenance of current service levels each year results in additions to the budget both in terms of operating funding and staffing. DMB will continue to work with departments to assess the resources needed to maintain current service levels as well as areas where it may be beneficial to enhance services to align with Board priorities. As Board priorities and direction are discussed, staff has and will continue to return to the Committee during the budget development period with more specific impact and needs for FY 2018 and seek guidance from the Committee and Board that can be weighed against resource availability as revenue forecast confidence increases.

The areas in which staff has identified potential service level issues or policy issues which will affect the FY 2018 budget are: human services, specifically in the areas of substance abuse and domestic violence and in the staffing of and workload associated with the delivery of basic safety net programs; in public safety concerning staffing levels required to maintain service and open new facilities as well as several expansions to existing safety programs; internal support services, such as procurement, grants management, communications and administrative services, necessitated by rapid growth of the County workforce in the professional and direct service delivery areas; information technology services associated with recent upgrades or replacements of every major information system used by the County as well as rapid changes in the technology industry.

In addition, the County has embarked on a classification and compensation study, which will likely result in changes to the existing structure that will have an implementation cost. Planning for this should occur as part of both the FY 2018 and FY 2019 budget processes. This list is not exhaustive and more of these types of concerns will likely be put forward by departments during the FY 2018 budget process.

County/Schools CIP-CAPP-Debt Service Needs and prior use of fund balance: It should be noted that expenditure requirements for funding the approved Capital Improvement Program (CIP), Capital Asset Preservation Program (CAPP), and Debt Service needs and prior use of fund balance are traditionally covered by new local tax funding before applying the 66 percent – 34 percent split of local tax funding between LCPS and the County. FY 2018 is an amendment year for the CIP and as such, large scale changes are not expected. However, as staff continues to develop the Proposed CIP and as the capital needs of the School System become clearer, it is possible that the capital and debt local tax funding needs could change, effecting local tax funding availability for both County and LCPS operating expenditures.

Schools estimated Local Tax Funding increase: Estimates on school shortfall figures in the scenarios discussed above are based on the FY 2018 Preliminary Fiscal Outlook memo provided to the School Board by Superintendent Williams dated August 9 and are subject to substantial revision. The memo referred to the potential of an additional $94.1 million of new expenditures relating to increased enrollment, new schools, step and other compensation increases, VRS requirements, health care cost increases, and fleet related expenditures. It also referred to costs of other potential initiatives that the School Board might prioritize, i.e. Vision 20/20 and expansion of full-day kindergarten to seventy-five percent. To offset some cost increases, LCPS is anticipating up to $19.8 million of additional state revenue in FY 2018 due to new enrollment. Factoring in the potential additional state and other revenues brings the LCPS estimated local tax funding increase to $74.3 million over the current year.

In total, $27.1 million of fund balance was used in FY 2017. For FY 2018, at the current tax rate of $1.145, new revenues for the schools are estimated at $31.1 million, based on the current local tax funding split ratio of 66 percent for LCPS and 34 percent for County Government. It should be noted that this split is applied to “net new” local tax funding which results after accounting for new debt service and capital needs and the prior use of fund balance in the FY 2017 budget. With an increased local tax transfer and OPEB need estimated at $74.3 million, the estimated shortfall for LCPS would be $43.2 million. If the tax rate were reduced to the estimated equalized rate of $1.135 the estimated new revenue for LCPS would be $26.3 million, making the shortfall $48.0 million.

FISCAL IMPACT: Staff is currently working with each County agency to develop budget requests that will then be evaluated and prioritized during staff's internal review process. Committee and Board guidance obtained throughout the process through discussions of service levels, staff identified policy issues and Board priorities is and will continue to guide staff in the review and refinement of budget requests for FY 2018. Under the current revenue estimates, each cent on the real property tax rate is worth approximately $7.3 million of revenue in FY 2018. Additionally, any reduction in the rate from the current $1.145 would also result in a reduction in current year revenue associated with the second half collection, thereby reducing available fund balance in FY 2017. At this time, no use of FY 2016 General fund balance is included in the shortfall figures in this item. Staff anticipates bringing the year-end closeout to the Committee in December and the Board in January. The County Administrator will likely recommend at that time that some portion of the remaining FY 2016 fund balance be reserved and forwarded for use in the FY 2018 budget for one-time expenditures such as capital costs.

ALTERNATIVES: The Committee may wish to change its guidance from previous years or add additional conditions or guidance direction for the County Administrator.

DRAFT MOTIONS:

1. I move that the Finance Government Operations and Economic Development Committee recommend that the Board of Supervisors direct the County Administrator to prepare the Proposed FY 2018 Budget at the **current real property tax rate and provide options that would reduce the tax rate to the estimated equalized real property tax rate**.

AND

I further move that the Finance/Government Operations and Economic Development Committee recommend that the Board of Supervisors direct staff to analyze the personal property tax rate on computer equipment in relation to Loudoun's data center market and return to the Committee with information in advance of the FY 2019 budget development process.

OR

2. I move the Finance/Government Operations and Economic Development Committee recommend that the Board of Supervisors direct the County Administrator to prepare the Proposed FY 2018 Budget ____.
(*alternatives and/or budget options*)

OR

3. I move an alternate motion.

ATTACHMENTS:

1. FY 2018 Preliminary Fiscal Outlook Memo presented by Loudoun County Public Schools dated August 9, 2016
2. FY 2018 Budget Outlook and Guidance FGOEDC Item 18 – July 12, 2016

3. Business Personal Property Tax Comparison of Top Data Center Markets – Memo from the Department of Economic Development

LOUDOUN COUNTY PUBLIC SCHOOLS
BUSINESS & FINANCE - ASSISTANT SUPERINTENDENT'S OFFICE
21000 Education Court, Suite #309, Ashburn, VA 20148

TO: Dr. Eric Williams, Superintendent

FROM: Leigh Burden, Assistant Superintendent, Business & Financial Services

SUBJECT: FY18 Preliminary Fiscal Outlook

DATE: August 9, 2016

The FY18 budget development process has already begun. Although it is too early to provide firm data for FY18, staff have attempted to provide some broad projections so that everyone has an early understanding of the potential needs of LCPS for FY18. Preliminary details about expenditure and revenue projections follow. Also, there are three key points that must always be emphasized when providing early projections:

- this information is only to illustrate potential expenditures;
- these are not recommendations—thus these items may or may not be included in the FY18 Superintendent's Proposed Budget; and
- the sum of the potential expenditures identified in this memo should not be interpreted as a recommended change in the budget.

Preliminary Expenditure Information

ENROLLMENT GROWTH

Enrollment *up to $26.7 million*

- Enrollment projections for FY18 are not yet completed and will be largely based on the September 30, 2016 actual enrollment. New enrollment projections will be developed in October and will most certainly change from the enrollment projections used in this calculation. But for now, the CIP projections developed in October of 2015 for FY18 show 80,700 students—an increase of 2,035 students or about 2.6%.

- At the FY17 cost per pupil (CPP) $13,121, LCPS would need $26.7 million in additional funds to maintain current service levels. However, adjustments to this calculation are anticipated due to potential economies of scale—each additional student does not typically cost the full average CPP; but with the lack of more current data, a conservative approach is most prudent.

New Schools *$1.8 million*

- The Commonwealth's Standards of Quality (SOQ) requires a variety of support positions based on the opening of new buildings. SOQ support positions include principals, guidance counselors, secretaries, librarians, and assistant principals. Custodians are an example of another position type allocated per building. There are also the non-salary costs of utilities and insurance. For FY18, we will provide support positions for Brambleton Middle School as well as provide early staff for a new Elementary School, a new Middle School and the High School Academy opening the following year. The total additional cost is $1.8 million. (See attached.)

SALARIES & BENEFITS

Step Increases *$17.8 million*

- Step increases for all eligible employees' average about 2.2%. Note employees at the top of the scale do not receive step increases. The cost of step increases for all those eligible is $17.8 million. Each 1% salary increase costs approximately $8.1 million.

Teacher Salary Adjustment *$9.1 million*

- These funds are identified for continued restructuring of the Teacher Salary schedule to increase competitiveness—particularly for mid-career teachers—and to make further progress toward the School Board's Strategic Plan Goals.

Other Compensation *$2.9 million*

- Other compensation includes potential initiatives for employees not eligible for step increases, such as modest one-time payments for employees at the top of the scale, and market/scale adjustments and/or reclassifications for administrative, classified and auxiliary scale staff members.

VRS *$10.0 million*

- Virginia Retirement System (VRS) contributions are expected to increase significantly due to a planned increase initiated by the General Assembly. Estimates are based on VRS rates for K-12 employees identified in the second year of the Commonwealth's Biennium Budget.

Healthcare *$8.0 million*

- Healthcare costs and other employee benefit programs also are expected to increase 10% or about $8 million. AON consultants/actuaries are currently reviewing claims to determine a better estimate for cost increases for FY18. In October, they will complete their work and make recommendations as to premium increases and/or plan design changes. Information regarding the recommended changes as well as the status of the self-insurance fund will be provided to the School Board at that time.

ENHANCEMENTS, RESTORATIONS & REALLOCATIONS

Vision 20/20 Initiatives *$4.0 million*

- This item is a placeholder for potential Vision 20/20 initiatives or resources needed to implement selected objectives of the School Board's Adopted Strategic Plan.

Full Day Kindergarten *$5.0 million*

- Expanding this program to 75% will require additional funding. Analysis is being performed to determine the cost of expansion using existing facilities and the cost of expansion with new classroom space.

Restorations *$1.0 million*

- Items reduced as part of budget reconciliation in previous years are often reinstated in later years. Initiatives to restore Middle School Deans and Tech Assistants were proposed for FY17, but not funded. These items will likely be requested in FY18.

OTHER OPERATIONS & MAINTENANCE

Fleet *$7.8 million*

- The fleet management plan is currently underway. No new buses were purchased in FY16 and the replacement plan was deferred. Preliminary estimates show that an additional $7.8 million will be needed for buses and other fleet vehicles in FY18.

Textbooks & Digital Learning Resources *unknown*

- LCPS is currently conducting an assessment of textbooks and digital learning resources to determine the division's future needs.

Potential expenditure increases for FY18 are summarized below.

Preliminary Expenditure Information	**Amount**
Enrollment Growth	up to $28.5 million
Salaries & Benefits	$47.8 million
Enhancements, Restorations, Reallocations	$10.0 million
Other Operations & Maintenance	$7.8 million
Total	**up to $94.1 million**

It should be noted that providing a preliminary fiscal outlook has its disadvantages, primarily due to unanticipated items not yet considered. All major expenditure drivers have been included, but a new need could still arise that has significant budget impact.

Preliminary Revenue Information

Federal/Miscellaneous/Carryover Revenue *Minimal Change*

We expect minimal changes to Federal/Miscellaneous revenue and no change to Carryover funding.

Local Funding *Unknown*

We do not have any preliminary projections as to what the local funding levels might be at this time. Typically the County releases its first projections in October. However it should be noted that the Board of Supervisors Finance Committee was briefed on the economic outlook by County staff in July 2016. No recommendations were proposed and LCPS potential needs were not mentioned.

State Funding *up to $19.8 million*

State funding for FY18 is somewhat known at this time as the Commonwealth utilizes a biennium budget. Thus, we have FY18 estimates for State funding, albeit those projections will likely change with the late December introduction of the Governor's Proposed Budget. LCPS generally gets additional funding from the State to address new enrollment. Using the current formulas results in as much as $19.8 million in new funding.

Potential revenue increases for FY18 are summarized below.

Preliminary Revenue Information	**Amount**
Local Funding	Unknown
State Funding	up to $19.8 million
Federal Revenue	Minimal change
Miscellaneous Revenue	Minimal change
Carryover Funding	No change
Total	**up to $19.8 million**

Please contact me if you have questions.

ATTACHMENT (REVISED 8/10/16)

Brambleton MS	FTE	Amount
Assistant Principal	1.0	$127,325.00
Dean	2.0	$182,754.00
Secretary	1.0	$69,182.00
Custodian	4.0	$212,844.00
Librarian	1.0	$91,377.00
Library Secretary	1.0	$47,785.00
School Nurse	1.0	$65,103.00
Teacher Aides	2.0	$101,166.00
Technology Resource Teacher	1.0	$93,552.00
Computer Lab Aide	1.0	$47,785.00
Insurance & Utilities		$304,000.00
Custodial Uniforms		$870.00
Machinery, Supplies, and Equipment		$41,000.00
Maintenance Agreements		$7,900.00
Total	**15.0**	**$1,392,643.00**
ES (1/2)		
Principal	1.0	$71,726.50
Secretary	1.0	$34,591.00
Total	**2.0**	**$106,317.50**
MS (1/2)		
Principal	1.0	$76,048.50
Secretary	1.0	$34,591.00
Total	**2.0**	**$110,639.50**
HS - Academy		
AET Director	1.0	$161,017.00
Secretary	1.0	$69,182.00
Total	**2.0**	**$230,199.00**
Grand Total	**21.0**	**$1,839,799.00**

Date of Meeting: July 12, 2016

#18

BOARD OF SUPERVISORS
FINANCE/GOVERNMENT OPERATIONS & ECONOMIC DEVELOPMENT COMMITTEE
INFORMATION ITEM

SUBJECT: **FY 2018 Budget Outlook and Guidance**

ELECTION DISTRICT: Countywide

STAFF CONTACT: Tim Hemstreet, County Administrator
Erin McLellan, Department of Management & Budget

PURPOSE: The purpose of this item is to begin the planning process for and discussions of the FY 2018 Proposed Budget. This item is the first in a series of items that will be coming before the Finance/Government Operations and Economic Development Committee (FGOEDC) and the Board of Supervisors (Board) throughout the budget development process.

BACKGROUND:

In July each year, the FGOEDC begins a discussion of priorities and areas of focus for the annual budget development process that staff will spend the summer and fall considering and bringing back to the FGOEDC to gain further direction and guidance. Initial budget guidance from the FGOEDC, which generally includes tax rate parameters as well as identification of Board priorities, is received in the fall and is subsequently confirmed by the Board in January. January guidance allows the Board to consider its budget guidance after the prior year-end closeout is reported in December or January as well as the schools budget request, and to receive a more up-to-date financial outlook.

The planning for FY 2018 has begun with staff in preparation for this guidance. It is anticipated that the first set of forecasts on the estimated available revenue in FY 2018 will be provided to the Committee at its October meeting and the full Board at the second business meeting in October, at which time the County and School Division will be anticipating guidance from the Board on financial and policy parameters as well as priorities that will guide staff in shaping the Proposed Budget.

Board direction on priorities will assist staff in prioritizing and refining the large number of requests that are elevated through the internal County Government budget development process. An early discussion of priorities or focus areas for the upcoming year will allow Department of Management and Budget (DMB) staff and County Administration time to work with departments to determine current levels of service or deficiencies in areas that the Board has targeted and to develop issue discussions that can return to the Board during budget development for more clarity and refinement.

In the absence of Board direction on priorities, staff will likely prioritize those areas in which known current service level challenges already exist and need to be addressed through adjustments to the budget or through a reallocation of resources from another area of the County Government. In addition, a focus on Board priorities, regardless of potential new funding availability, allows the Board to lead budget development forward in a strategic way that will provide both direction on potential enhancement areas if new funding is available or potential reduction areas if new funding is not available. As priorities are discussed and refined through the summer and fall, staff confidence in revenue and expenditure forecasts will concurrently increase and further refinement of the priorities can be tied more closely to funding availability.

ISSUES: There are currently several areas in which staff has already identified issues that are affecting departments' abilities to maintain current or required service levels. The issues discussed below are likely not a complete list of the service level deficiencies or challenges that will be explored during the FY 2018 budget development process.

In order to establish a framework to monitor these issues going forward and provide departments with measures and benchmarks by which to tell their service story to the Board and the public, staff is considering the creation of department service plans. Service plans would describe the current or required level of each of a department's service lines, the measures and metrics associated with those services, as well as potential enhanced levels of service. Service plans were used in the early 1990s (and some are still maintained in some form) by the County to show how changes in population and demand are tied to resource levels. These plans provided a guide by which base budget adjustments to maintain current service levels could be anticipated and justified. Service plans also assisted the Board both in times of revenue availability to enhance services as well as when revenue was reduced to determine priorities for funding. The process of re-establishing service plans could begin during FY 2017 with the larger departments and/or those that have significant service maintenance issues. Service plans take a significant amount of time to develop and as such service plans for all departments would likely not be accomplished until the beginning of the FY 2020 budget development process; however, beginning with larger and/or service level challenged departments would ensure that the most critical service plans would be in place for the FY 2019 budget development process.

Current Service Level Areas of Concern: Below is a brief description of current service level challenges and areas in which staff will likely be bringing forward budget requests in FY 2018.

1. Department of Family Services – Caseloads in several units within the Department of Family Services, most notably Benefits and Child and Adult Protective Services, have increased over the last decade as population has grown, resulting in some of the highest caseloads per case worker in the region. Although the Department has received some new positions in these strained units over the last few years, relief has not been achieved due to continual vacancies, additional state and federal mandates, and case complexities that require greater staff time and effort. Some progress has been made specifically in the Benefits caseloads, although relief has not been fully achieved. It is unclear at this point if the addition of more staff will actually have the effect of decreasing caseloads or if maintaining filled positions is challenging due to the pay Loudoun is able to offer in these positions compared to other jurisdictions. It is likely that increased staffing may well benefit overall workload.

2. Department of Mental Health, Substance Abuse and Developmental Services (MHSADS) – Similar to other jurisdictions, the County has experienced a surge in drug-related overdoses from heroin and other opioids in recent years. Drug addiction and overdoses have created challenges in service delivery for the County's health and welfare departments as well as its public safety departments. As part of the FY 2017 Adopted Budget, the Department received additional staffing for the Adult Detention Center, where clinicians address both serious mental illness and substance abuse disorders within the County's detention facility. This enhancement to MHSADS' service level will help to address the prison population's substance abuse challenges, but more resources and a strategically constructed, interdepartmental program are required by the Department to tackle the countywide epidemic beyond the filter of law enforcement. Effective

July 1, 2016, the central point of entry for services definition expanded to include the population with developmental disabilities in addition to intellectual disabilities. MHSADS is responsible for assessing service needs and waiver eligibility for the county population with developmental and intellectual disabilities the service impacts of this change will need to be further explored during budget preparation. In addition, demand for services such as employment and day support, services for infants and toddlers with developmental delays and for psychiatry (which have been extremely difficult to procure) and outpatient therapy services have continued to increase and stretch the department's resources.

MHSADS requires additional infrastructure to support services. In recent years, MHSADS business operations has increased span of human resource functions, including duties related to on boarding staff, employee relations, FMLA management, and ongoing recruitment activities for hard to fill positions. The MHSADS budget and finance branch has absorbed complex reimbursement functions with rules that are more restrictive and diverse across payer sources. The department requires appropriate support staff to assure provision of services to the individuals for whom the mandate exists and to monitor compliance with federal, state and local regulations.

3. Department of Transportation and Capital Infrastructure – Beginning in FY 2019, all local gasoline tax revenue will be diverted from County uses to the Washington Metropolitan Area Transit Authority. Local gasoline tax supports $9.1 million of a total $21.3 million for the County's transit operations, including Metro Connections, long-haul service, and local fixed route service. While the County must begin the process of weaning its operations off local gasoline tax, further discussion is needed on the strategy for addressing this funding gap, which could include the identification of new revenue sources or a reduction/discontinuation of some services.

4. Department of Fire and Rescue (LCFR) – In FY 2015 the Loudoun County Combined Fire Rescue System (LC-CFRS) was created to better integrate career and volunteer fire and rescue efforts in the County. Despite an aggressive volunteer recruitment program, the need for additional career staffing has dominated budget discussions over the last several years. There are two reasons for this. First, increases to career minimum staff has occurred at several station locations in order to keep up with service delivery demand brought on by population growth and development within the County. In some instances, this increase has been planned and budgeted to ensure the availability of new personnel coincident with the opening of a new station or service. In other instances, career staffing has been requested on an emergency basis, usually the result of a crisis situation where the number of available volunteer personnel is insufficient to ensure shift coverage of apparatus.

   Second, as these staffing requests are addressed, additional new staffing, known as "hybrid staffing" have been added to ensure the maintenance of minimum daily staffing levels when personnel take leave, attend mandatory training, recover from injuries, fulfill military duty or separate from County employment. Hybrid staffing is based upon the concept of a staffing factor, which simply means for each individual employee is hired, a percentage of another FTE is needed in order to build the sufficient reserve of employees needed to "back fill" vacancies caused by the factors listed above. From 1999 to 2010, LCFR did not use a staffing factor (as is done nationwide) to compute the total number of employees needed, thus hybrid staffing is still "catching up." As the pressures on the LC-CFRS have grown, available hybrid staffing has often been overtaken by emergency staffing requests where volunteers can no longer guarantee coverage and the need to address vacancies due to the limited flexibility of filling positions through recruit schools. As a result of not being able to have a true hybrid staffing model, overtime usage by the Department has increased. Prior to FY 2016, the overtime budget for the Department was not routinely increased as staffing increased; this has resulted in another significant pressure on the personnel budget of the Department. The Department does not carry a large number of vacancies at any given time, so its ability to absorb overtime costs is limited. Staff will be analyzing the LCFR staffing factor to assist in determining the appropriate levels of overtime budget needed for maintenance of the Department's current level of service as well as ways in which overtime can be mitigated. In the meantime, LCFR continues to experience budget and staffing needs related to new facilities, i.e., the opening of the Kirkpatrick Farms station.

5. Department of Finance and Procurement – The Department of Finance and Procurement is responsible for the acquisition of goods and services for all County departments and agencies as well as for capital projects. The Procurement Division's staff of five contracting officers and one senior buyer are responsible for handing over 600 active contracts and processing new solicitations. This workload increases as the County Government grows, adding and expanding service levels and capital projects, as well as when more departments choose to provide their services through contracts rather than in-house staff. During its June meeting, the FGOEDC engaged in a discussion related to the procurement process for capital projects, and staff indicated at that time that additional resources for the Procurement Division would allow the County to better manage active contracts and new solicitations and keep pace with the current level of demand from the organization.

6. Department of Information Technology – The growth in the number of County users and facilities coupled with rapid changes in technology and major system upgrades and replacements have resulted in year-over-year increases in the operating budget of the Department of Information Technology. Staff expects that increases to the base budget of the Department will be required in FY 2018, similar to the last few years, to fund existing contracts for licensing and hardware/software maintenance as well as to maintain replacement schedules and provide support services to the organization. In addition, there are a few larger technology related decisions or costs (some as a result of recently implemented enterprise systems) that will likely affect the FY 2018 budget. Continuing costs associated with implementation of the County's ERP system and the new Computer Aided Dispatch (CAD) system including software and hardware maintenance, offsite hosting (ERP only) and ongoing contractual services will affect upcoming budgets. Additionally, both the County's primary and secondary data centers are located in facilities that are aging. This presents a significant risk to ongoing County operations. Staff is investigating opportunities for moving both the primary and secondary centers to data centers with a local presence as well as additional U.S. presence for disaster resiliency. The County will also need to consider its options for the upgrade or migration of Microsoft Office as the time approaches to either re-institute the County's enterprise license or move to Office 365, which is a cloud-based option. Both options have fiscal and operational impacts that will need to be examined. Staff is currently developing an RFP for a County-wide technology staffing review that will help inform the decisions necessary to ensure that currently implemented and upcoming/future technology related needs are staffed, operated and financed in the most effective and efficient way. This information may be available for the development of the FY 2018 budget.

Other Challenges and Service Gaps: There are other concerns that are known at this time and, though they are not necessarily affecting current service levels, they are creating gaps in the County's ability to continue to improve internal support of service delivery. Additionally, some of the items listed below could be associated with Board priority areas. This list is not exhaustive and more of these types of concerns will likely be put forward by departments during the FY 2018 budget process.

- General Government:
  - Grants management and coordination – Currently the County lacks resources that can be completely dedicated to diversifying the County's revenue streams to relieve pressure on local tax funding. One area that the Board has begun to identify and that staff has seen an increased need for is in grants identification, application and coordination. This need was raised through the internal budget process last year however greater needs existed dealing with maintaining current service levels, and as such, this request was not included in the Proposed Budget. Pressure from departments for assistance in this area has increased the level of importance of this need. Staff will continue to assess the need for dedicated grants resources and some level of funding and staffing may be included in the Proposed Budget.
  - Maintenance of current infrastructure – Three issues are present with current County infrastructure: 1) the County is beginning to experience the needs associated with aging facilities (one example is described above regarding Information Technology), ; 2) the growth of County population and subsequently the growth in County Government has presented a space issue; and 3) even though approximately 80 percent of the Department of General Services' services are provided through outsourcing, as facility needs increase, the need for staff to effectively manage contractors and perform immediate triage has also increased. Existing staff will not be able to maintain the current level of service and quality control due to the increase in facilities and increased maintenance demand of the aging infrastructure. The Department of General Services is currently developing a space plan that will come to the Board for approval, but financial implications exist associated with the need for more space as well as the need to renovate existing space to fit new needs and address needed safety and security upgrades. The County's (and the School Division's) Capital Asset Preservation Program (CAPP) budgets are also proving to be less than adequate to keep up with the needs that arise from both aging facilities and the growth in number of facilities around the County. These issues may exert pressure on the budget development process for FY 2018.
  - Classification and Compensation Study and potential future impacts – In FY 2017 the Board considered expenditures related to a comprehensive study of the County's classification and compensation system. The first phase of the study has begun at Board direction with current FY 2016 budgetary resources; however, the second phase of the study will also require resources, and staff will be looking to identify fund balance in FY 2017 for this purpose. The larger issue, however, will be how to fund changes in the system long term. Staff anticipates that recurring funds will need to be set aside as part of the FY 2018 and FY 2019 budget processes so that when and if the Board chooses to make changes to the classification and compensation of County employees adequate resources will already be built into the personnel budget. Human Resources has indicated that the fiscal impact of any potential changes is unknown at this time; however, staff will continue to analyze the potential of building up a backstop that would prevent a large swing in personnel budget needed in a single year.
  - Management and coordination of public affairs and communications – The public affairs and communications functions of the organization have been identified in previous budget discussions as a potential vulnerable area. The Office of Public Affairs and Communications within the Office of the County Administrator has only 7.80 FTE. The Office handles the bulk of routine and emergency public information and communication

activities, digital communication platforms, constituent services, accessibility services, Board and Planning Commission broadcasting operations, and media interactions for the entire County Government. In addition, the Office coordinates countywide internal communication activities with all departments. On average, the Office responds to thousands of requests for service from the public and county departments each month. The Office continues to examine ways to gain efficiencies by decentralization of some of these functions, particularly through the public safety agencies as well as by leveraging modern communication technology; however, a strong need still exists in the overall management of this function. It is possible that requests may be renewed in this area in the coming budget development process.

- Human Services

  - Domestic violence –Several years ago, a number of county and state agencies created the Domestic Abuse Response Team (DART) to target domestic violence issues. The team is composed of front-line staff and mid-level managers and meets monthly to review cases and to identify service gaps. They are guided by the DV Steering Committee which is composed of department directors of the thirteen agencies in the County that comprises the County's domestic violence system. The Steering Committee meets quarterly to address any policy issues and/or any problem areas raised by DART. The Coordinated Community Response (CCR) and both groups have the strong and active support and participation of the two Juvenile and Domestic Relations Court Judges. The efforts of these combined individuals and agencies over the last decade have resulted in many improvements to Loudoun's response to domestic violence crimes, including re-written policies and procedures, training for law enforcement and other responding personnel, dedicated DV court dockets, automatic 60-day review hearings for all DV probationers to report on probation compliance, the recent institutionalization of a lethality assessment protocol (LAP) (which is a nationally recognized evidence-based strategy to help prevent domestic homicides) and other changes. However, the number of domestic violence calls continues to rise and there have been several recent homicides in which a number of agencies such as Family Services, the County Attorney's Office and the Child Advocacy Center played significant roles in the safety, protection and placement of surviving children. Staff of the Juvenile Court Services Unit indicate that there is an increase in domestic issues in one-parent families and in violence towards parents. If this issue becomes one of the identified issues under the Board's strategic plan, additional resources may be evaluated in the area.

  - Health Department Local Administration – Staff is currently beginning to study a potential recommendation to shift from state administration of the Health Department to local administration. The Health Department currently consists of both state and county employees and a state budget, local budget and cooperative (shared) budget. This means that the Health Department has many State and County positions performing the same job. Additionally, Loudoun County provides funds that remain in Loudoun outside of the cooperative budget to fund 28 County employees and associated non-personnel costs. As a result, Health Department staff is responsible for maintaining and complying with dual State and County technology systems, and human resource, procurement and payment policies and procedures. This can result in duplication and administrative inefficiencies which may have an impact on service provision. Additionally, this creates personnel related challenges because of differences in compensation and Fair Labor Standards Act (FLSA) determinations between State and County employees performing the same function. Transition to local administration would likely have a fiscal impact that would need to be discussed with the Board.

  - Non-Profit Funding – During the FY 2017 budget process, the Board identified the area of the County's support to non-profits as a discussion that would be included in the FY 2018 process. The Board has directed a needs assessment that will likely be conducted during the early fall. Findings from this study may impact the level of funding or mechanism of funding for non-profits.

- Public Safety

  - During FY 2016, the Sheriff's Office has been piloting a Body Worn Camera program. The cameras are being piloted to be utilized as a tool to improve law enforcement interactions with the public, build community trust, strengthen accountability and transparency, and increase the safety of sworn personnel. This program currently utilizes 45 cameras in field operations. Further discussion of the policy, legal, operational and cost implications of expansion of this program will likely be an issue the Sheriff will bring forward during the budget process. As the Sheriff's Office evaluates its ability to move forward with this as well as other technology programs (including the new CAD system, eCitation devices, and in-cruiser systems), it is anticipated that the Sheriff's Office will request positions to manage and implement department technology projects, systems, and maintenance.

  - Currently staff from the Sheriff's Office, Animal Services, and Fire Rescue are working on a consolidation of the emergency dispatch functions under one office. If this public safety improvement is implemented there may be a potential fiscal impact related to the standing-up of this function. Staff will continue to work on this project and bring any needs through the budget process if necessary.

- Opening and Operation of Planned Infrastructure Projects – There are approximately six new/renovated capital facilities projected to begin operations in FY 2018. These facilities will require approximately 139.19 FTE and $11.4 million of net operating expenditures in the FY 2018 budget. New facilities requiring operational resources include the Brambleton Library, Dulles Multipurpose Center Phases II and III, Kirkpatrick Fire and Rescue Station, Public Safety Firing Range, Ashburn Sheriff's Substation, and Stone Ridge Park and Ride Lot.

- Internal Administrative Support – As was the case in FY 2017, maintaining current service levels may require administrative and other support positions. Over the last decade, with such high population growth year over year, most of the focus of adding positions in the budget process has been around positions that are more operational in nature and more direct service oriented. As programs have expanded to keep up with population growth, internal support of those programs has sometimes been secondary. In FY 2017, several administrative support positions were approved which further supports the County's ability to maintain current services to citizens.

In addition to the service level and other issues raised above, there are economic pressures that will also affect the development of the FY 2018 budget. The following is a current outlook that staff will continue to monitor and update during the process. The current economic outlook is very similar to the one presented last year (with the exception of a slightly improved real property picture for FY 2018), namely continued slow economic growth for the current and next two years.

World Economy: The International Monetary Fund (IMF), the Organization for Economic Cooperation and Development (OECD), and the World Bank have lowered their prior projections of global economic growth for 2016; and they project only modest improvement at best in 2017. A survey of their analyses indicates the following:

- Worldwide economic output grew at about 3.0 percent in 2015. Expected growth in 2016 ranges from 2.4 percent to 3.2 percent, and growth in 2017 is expected to be only slightly better.

- Low commodity prices and outflows of financial capital are adversely affecting many developing economies (e.g., Brazil, Venezuela); and China is attempting to reduce its reliance on exports to expand its economy (now among the largest in the world) in favor of domestic consumption. This transition is occurring in the presence of a huge excess of debt-financed industrial capacity, which has contributed to volatility in Chinese and global financial markets.

- None of these organizations is predicting that a global recession will occur over the next two years, but all acknowledge the major risks to the current outlook. One of those risks is the recent United Kingdom decision to exit the European Union. Thus far, the main consequence of this action has been increased volatility in financial markets. However, if businesses delay planned investments in new plant and equipment until the future trade arrangements between Britain and the EU are clarified, an economic recession could result.

U.S. Economy: The June 2016 Wall Street Journal survey of U.S. economic forecasts shows average expected real GDP growth in 2016 of 2.0 percent (compared to 2.6 percent projected six months ago). The same survey shows average expected growth in 2017 and 2018 of 2.3 percent and 2.2 percent, respectively. None of the survey participants is projecting an economic recession within the next year, but they estimate the chances of such an event to be 1-in-5 as compared to 1-in-10 a year ago. Following are brief summaries of major segments of the national economy:

- *Housing Market:* Since the 2008-2009 recession, the rates of both household formation and homeownership have declined significantly from pre-recession levels. Consequently, sales of existing homes and construction of new homes fell sharply after the recession, which was triggered by the collapse of housing prices and a sharp decline in mortgage lending. Sales of existing homes sales are now close to the 5.3 million per year value that preceded the housing bubble[1]. However, construction of new homes in 2016 is running at an annual rate of 1.2 million units, an increase of about 11 percent over 2015 but well below the 1.5 million per year pace associated with the traditional rate of household formation. The June 2016 Wall Street Journal survey calls for a 7 percent increase in new home construction to 1.3 million units in 2017. Home ownership is the single, largest determinant in preventing families from becoming impoverished.

- *Labor Market:* Although the increase in May 2016 was a disappointing 38,000 jobs, payroll employment continues to increase, and the U.S. unemployment rate declined to 4.7 percent.

[1] Sales of existing units rose from 5.3 million in 2001 to more than 7 million units in 2005 as the U.S. Housing market over heated. (Source: HUD, Historical Data Table 7 from the National Association of Realtors)

However, the May jobs number was impacted by the Verizon strike. Meanwhile, the Labor Department reports that the number of job openings in April was 5.8 million, a very high number. In addition, the Labor Department's index of inflation-adjusted compensation per hour for the first quarter of 2016 was nearly 2 percent higher than it was a year earlier. The June Wall Street Journal survey projects that monthly job growth in 2016 will average 155,000, which is below the 199,000 pace in the December 2015 survey.

- *Financial Markets:* Since last August, financial markets have exhibited increased volatility in asset prices. The August episode coincided with a large correction in the Chinese stock market and the revaluation of China's currency. The latest dip in U.S. equity markets followed the UK vote to exit the European Union. Nevertheless, both the DOW and the S&P 500 stock indexes remain at high levels; and U.S. interest rates are still at historically low levels, as the Federal Reserve's monetary policy remains accommodative to support further improvement in the labor market.

State and Local Economy: The state and local economies are exhibiting faster job growth in 2015 versus the previous two years now that federal discretionary spending has stabilized after declining for several years. Highlights of the state and local economic environments are summarized below.

- *State Revenue Outlook:* April 2016 payroll employment in Virginia was 2.1 percent higher than in April 2015. However, the Department of Finance reports that General Fund tax receipts for the first 11 months of FY16 are running 1.9 percent above year-ago levels versus an expected increase of 3.2 percent. Lower than expected payroll withholding and sales tax revenue are the two largest contributors to the shortfall. The June 2016 presentation by the Secretary of Finance cited employment data showing that much of the recent growth in Professional and Business Services ("PBS") employment in Virginia was disproportionately in "Administrative and Support" jobs, which tend to be lower paying (http://sfc.virginia.gov/committee.shtml). The data also suggested that the higher-paying PBS job categories are experiencing low rates of wage increase[2]. June revenues of $2.4 billion would be required to meet the fiscal year budget estimate, which is $300 million or 14 percent above the revenues realized in June 2015. By July 4, if the Comptroller determines that revenues from the three principal sources—individual withholding, corporate income tax, and sales tax—are more than 1 percent (or $169 million) below the budget estimate, the Governor will be required to re-forecast the budget outlook for FY17 and report results to the General Assembly by September 1.

- *Unemployment:* Loudoun County's unemployment rate continues to rank among the lowest in Virginia and nationwide. In April 2016, the unemployment rate in Loudoun was 2.0 percent below the national rate. April 2016 unemployment rate was 2.7 percent in Loudoun, as compared to 3.9 percent in Virginia and 4.7 percent nationally. This statistic may be somewhat misleading

[2] Payroll employment figures represent a tally of jobs irrespective of whether the jobs are full-time or part-time. If recent increases in payroll employment are more heavily skewed towards part-time employment, the impact of job growth on household income will be diminished.

as underemployment remains a significant issue in contrast to high housing costs for both ownership and rentals.

- *Job Growth:* The latest available data on payroll employment within Loudoun extends through December 2015. In the fourth quarter of 2015, there were 8,775 (or 5.8 percent) more payroll employees in the County than were here in the fourth quarter of 2014. This compares to growth of only 1.5 percent in 2014 versus 2013. Almost 40 percent of these additional jobs were in the Professional and Business Services category, which increased by 3,400. (Some of this increase could be due to professional services required by the two large construction projects currently underway in Loudoun—the Silver Line and the Panda-Stonewall Energy project). 2015 fourth-quarter payroll employment in the Washington, DC, region also exhibited an increase of 2.2 percent. The improving employment picture should bolster the local housing market.

- *Residential Real Estate Market:* Dulles Area Association of Realtors (DAAR) reports a 6.8 percent increase in the number of closed sales of existing homes in Loudoun during the first five months of 2016 as compared to the same period a year ago. DAAR characterizes the current market as a seller's market since active inventory is lower than it was a year ago, and the May median days on the market of 11 was 9 days fewer than for May 2015. The median sale price in May 2016 was also up 2.5 percent versus a year earlier, the ninth consecutive month of price gains. Although median sale price is not a perfect indicator of the overall annual rate of market appreciation, the reported upward tendency supports the current expectation of modest price appreciation in 2016 in the FY 2017 Adopted Budget[3]. New home construction measured on a 12-month moving average basis increased fairly steadily from the fall of 2010 to a peak of roughly 400 units per month in January 2014. Since then, the pace has lessened to about 300 units per month since early 2015. This pace is sufficient to meet the currently projected growth in the number of households during 2016 and 2017, but continued improvement in the regional economy and job market could generate some additional demand from individuals who have delayed purchasing a home. However, permitting activity in the first four months of 2016 is actually running slightly below the 300 per month rate.

- *Commercial Property Market:* In 2015, Loudoun realized approximately $690 million of new investment in commercial and industrial real property, following $580 million in 2014. These amounts are significantly higher than the average annual value of $290 million experienced during 2011-2013. Investment in commercial and industrial property appears to be holding steady with substantial contributions by data center development. The County currently has 9 million square feet of data center space either currently in operation (approximately 6 million square feet) or slated to be developed. In addition, although technically classified as public utility property, construction has begun on Panda Energy's $640 million Stonewall Power Project. Once

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[3] The annual real property assessment must assign a value to all of the approximate 124,000 residential properties in the County. The several thousand homes which are sold in a given year may not be a representative sample of all residential properties in the County, so the behavior of the sample average price or median price may over- or understate the countywide average rate of appreciation, which is assumed to be 1 percent in the FY 2017 Budget.

completed this facility should increase the value of utility property in the County by nearly 40 percent.

FISCAL IMPACT: As the County continues to add as many as 11,000 new residents per year, demand for services continues to increase. Maintenance of current service levels each year results in additions to the budget both in terms of operating funding and staffing. The revenue outlook currently being developed by staff appears at this point to be similar to the position the County was in at this time last year; however, at this point in the planning process staff confidence in the revenue forecasts is relatively low. A forecast of expenditure needs in FY 2018 is also under development at this point. DMB will continue to work with departments to assess the resources needed to maintain current service levels as well as areas where it may be beneficial to enhance services to align with Board priorities. As Board priorities and direction are discussed, staff will return to the Committee over the coming months with more specific impact and needs for FY 2018 and seek guidance from the Committee and Board that can be weighed against resource availability as revenue forecast confidence increases.

DATE: 09/30/16
SUBJECT: Business personal property tax comparison of top data center markets
TO: Tim Hemstreet, County Administrator
FROM: Buddy Rizer, Executive Director

Northern Virginia has become the largest data center market in the world, currently representing 30 percent of the entire U.S. Market. The majority of the facilities are located in "Data Center Alley" in Loudoun County where more than 70 percent of the world's internet traffic passes through Loudoun's infrastructure on a daily basis. According to the Commissioner of the Revenue, Loudoun receives in excess of $100 million dollars a year in local tax revenue. Additionally, the benefit/cost ratio for the data center industry is currently 9.5 in Loudoun County, meaning that for every $1.00 the county spends in services for the Data Processing, Hosting, and Related Services sector, the cluster provided approximately $9.50 in tax revenue to Loudoun County. And, because data centers pay high wages – $105,942 per year on average in 2014 – they also have a disproportionate impact on state income tax revenue; by far the largest source of revenue for Virginia state government.

While Loudoun remains a world class location for data centers, it is no longer a cost-effective solution for companies looking to co-locate, or lease space in such facilities. When Virginia enacted its data center sales and use tax exemption in 2009, only seven other states offered such incentives. Today, over half of all states offer incentives for data centers and most of those states now offer additional incentives that are more competitive than Virginia's.

A major driver of local tax revenue are not just the data center building shells, but the servers and other equipment that are inside them. This is where Loudoun is most vulnerable in its data center market. Approximately ninety percent of the data centers in Loudoun County are colocation facilities that rent space to technology companies of all sizes. In fact, more than 3,000 technology companies are hosted inside of Loudoun's 65 data centers based on significant benefits of scale. It is these companies who pay the bulk of the data center personal property taxes in Loudoun County. In most instances, these companies have short term leases (3-5 years). Prior to the expiration of their contracts, companies have the ability to evaluate the costs of their capital-intensive operations. They also have the flexibility to relocate their server and equipment to lower cost markets that now offer aggressive incentives (such as personal property tax exemptions) and subsequently lower net taxes. These markets include Atlanta, Georgia; Charlotte, North Carolina; Cheyenne, Wyoming; Colorado Springs, Colorado; Des Moines, Iowa; Omaha, Nebraska; Portland, Oregon; Quincy, Washington; Salt Lake City, Utah; and Tulsa, Oklahoma. If Loudoun County cannot compete effectively with these markets, the County risks losing technology companies and the positive net tax revenue that comes with them.

During its 2013 session, the Virginia General Assembly added data center computer equipment and peripherals to the list of property types eligible, on a county-by-county basis, for a tax cut (HB1699).

Why is it important to track business personal property tax rates of top data center markets?

The primary taxes that businesses pay to Loudoun County each year are on real property, gross revenue (for the Business Professional Occupational License tax, BPOL) and business tangible personal property such as furniture, machinery, and computer equipment. Businesses in target clusters such as aerospace, aviation, and especially data centers are very capital-intensive and the value of their equipment means they are subject to much higher business personal property taxes (BPPT) than businesses in industries that require less investment in capital equipment.

The high proportion of expenditures that go to equipment for companies in the data center industry means that they have to pay close attention to BPPT rates,[1] and the BPPT tax is generally by far the largest of the taxes data centers pay to Loudoun County. The power infrastructure, fiber, and other key locational attributes of Loudoun County have been key prerequisites for attracting data centers, but it is critical to maintain BPPT rates at a competitive level to retain and grow this industry.

This research compares BPPT liability for computer equipment (the primary BPPT that applies to data centers) in Loudoun County to other locations that are top markets for data centers.[2] The tax liability is a product of the tax rate and the depreciation schedule (see Table 1). Tax rates and depreciation schedules for computer equipment for locations that are top data center markets are compared in Tables 2 and 3.

What is Loudoun County's tax rate on equipment in data centers?

The business personal property tax (BPPT) rate for computer equipment is $4.20 per $100 of assessed value, with an assessment factor for depreciation of 0.5 in the first year and 0.4 in the second year, down to 0.1 in the fifth and subsequent years. This means that a business pays a $2.10 tax the first year after equipment is purchased, $1.68 in the second year, and so forth as shown in Table 1.

[1]"The Economic and Fiscal Contribution that Data Centers Make to Virginia," Northern Virginia Technology Council, http://www.nvtc.org/documents/advocacy/NVTC__DataCenter_Report_011316_final_lowres.pdf
[2]Areas with concentrations of data centers can be identified at Datacentermap.com

Table 1: Business personal property taxes in Loudoun County

Years since purchase	Assessment Factor	Annual BPPT tax paid per $100 of purchase value of equipment	Total BPPT taxes paid per $100 of purchase value of equipment
1	0.5	$2.10	$2.10
2	0.4	$1.68	$3.78
3	0.3	$1.26	$5.04
4	0.2	$0.84	$5.88
5	0.1	$0.42	$6.30
6	0.1	$0.42	$6.72

How does the Loudoun County tax rate compare to the rate in other top data center markets?

Loudoun County has a higher tax rate on computer equipment than all other top data center markets in the United States. Accounting for differences in the depreciation schedules set forth by local governments shows that it may not have the highest overall BPPT liability for a given amount of investment, but it is among the highest. A more precise calculation of total BPPT liability per amount invested would require knowing the number of years computer equipment is used such that it remains subject to the BPPT.

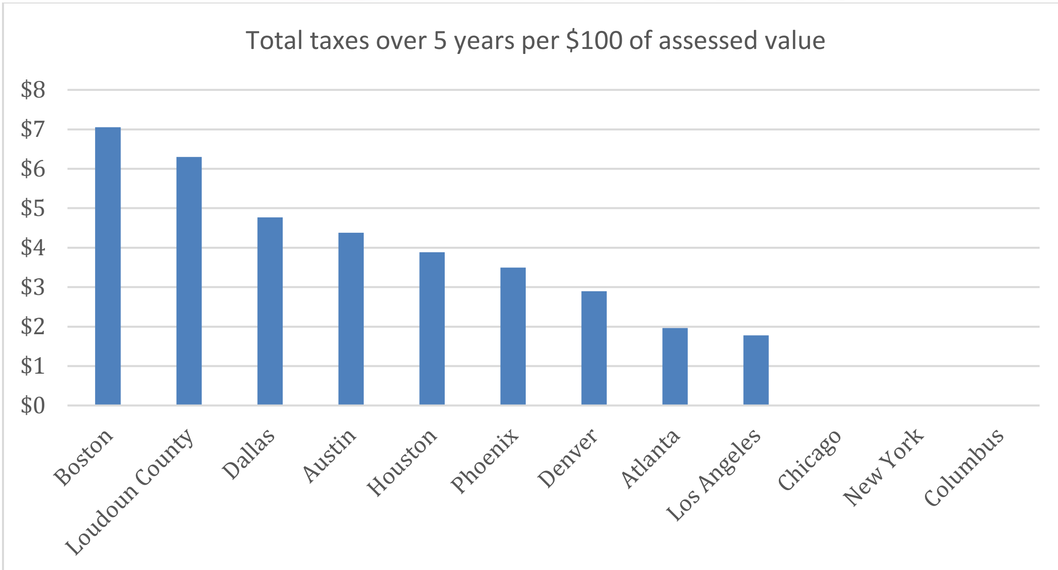
Table 2: BPPT rates for computer equipment in top data center markets

Location	BPPT Tax Rate ($ per $100)	Percent comparison to Loudoun County
Loudoun County	$4.20	-
Atlanta*	$1.14	-73%
Austin*	$2.50	-40%
Boston	$2.68	-36%
Chicago**	$0.00	-100%
Columbus, OH**	$0.00	-100%
Dallas*	$2.74	-35%
Denver	$2.26	-46%
Houston*	$2.54	-40%
Los Angeles*	$1.25	-70%
New York**	$0.00	-100%
Phoenix*	$3.18	-24%

*There are minor variations in the BPPT rate depending on specifically where the business is located, as there are different rates assigned to tax districts for water and sewer, emergency services, and schools within the city or county. The numbers shown are estimate of average BPPT rates.
**Illinois, Ohio, and New York have no BPPT.

Table 3: Comparison of BPPT rates for computer equipment over 5 years

Location	BPPT rate ($ per $100)	Depreciation Factor					Total BPPT taxes over 5 years per $100 of assessed value	Percent comparison to Loudoun County
		Year 1	Year 2	Year 3	Year 4	Year 5		
Loudoun County	$4.20	0.50	0.40	0.30	0.20	0.10	$6.30	-
Atlanta	$1.14	0.67	0.54	0.31	0.10	0.10	$1.97	-69%
Austin	$2.50	0.71	0.49	0.30	0.17	0.08	$4.38	-31%
Boston	$2.68	0.85	0.69	0.52	0.34	0.23	$7.05	12%
Chicago	$0.00	NA	NA	NA	NA	NA	$0.00	-100%
Columbus, OH	$0.00	NA	NA	NA	NA	NA	$0.00	-100%
Dallas	$2.74	0.75	0.56	0.28	0.10	0.05	$4.77	-24%
Denver	$2.26	0.50	0.36	0.22	0.13	0.07	$2.90	-54%
Houston	$2.54	0.68	0.44	0.28	0.10	0.03	$3.89	-38%
Los Angeles	$1.25	0.54	0.39	0.24	0.15	0.10	$1.78	-72%
New York	$0.00	NA	NA	NA	NA	NA	$0.00	-100%
Phoenix	$3.18	0.50	0.30	0.20	0.10	0.00	$3.50	-44%



What other information about business personal property taxes should be considered?

Studies comparing personal property taxes by state have found Virginia to have the highest BPPT, both per capita and as a percent of tax revenue collected by local governments within the state.[3] There is a national trend towards reductions in BPPT, which local governments have recognized as a disincentive for investment in capital equipment and a policy that tends to cause businesses that make large investments in equipment to locate in places with lower taxes. BPPT results in greater economic distortions in the market and a more negative impact on economic growth than taxes on real property. BPPT taxes are largely invisible to individuals, as the tax expense is generally passed on to consumers in the form of higher prices, but they are significant for businesses - especially businesses in capital-intensive industries like data centers.

Loudoun County is currently receiving a very significant stream of tax revenue thanks to the recent investments in high-cost computer equipment in data centers. While we have succeeded in attracting this investment, keeping the BPPT rate at $4.20 per $100 for computer equipment may be a less favorable policy than a more competitive rate, considering the lower BPPT rates in other locations and the trend of increasing sensitivity to BPPT rates in the data center industry. If the rate remains substantially higher than other locations, it could cause Loudoun County to miss out on new business investment and put at risk the current base of customers.

[3] "States Moving Away From Taxes on Tangible Personal Property," Tax Foundation study by Joyce Errecart, Ed Gerrish, Scott Drenkard. http://taxfoundation.org/article/states-moving-away-taxes-tangible-personal-property