BAILIWICK NEWS

Reporting and critical analysis of State College public affairs

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Tensions about cutting services, raising taxes, or both, likely to rise during 2017 budget cycle.

By Katherine Watt

This is the first in an intermittent series on the State College municipal budget process and the Centre Region Council of Governments (COG) regional budget process, which unfold annually between September and December.

Introduction

Population and income changes over the last 40 years have intensified financial challenges for State College, especially since 2005.

Specifically, real estate tax revenue has flattened because the Borough is built-out. Earned income tax revenue has flattened because high-income residents have fled from the urban core to the surrounding suburban townships, replaced by low-income Penn State student residents. The cost of providing health care and pensions to public employees has far outpaced inflation, and repeatedly deferred maintenance of existing infrastructure has raised future maintenance costs by allowing decay to advance.

The State College budget must be examined in conjunction with the COG budget, because many services that could be provided at the municipal level are provided by COG, and some services COG needs are provided by the Borough.

These two budgets also interrelate extensively with the Centre County budget, the other municipal budgets in Centre County, and state and federal budgets and regulations.

One key point that will be explored throughout the series is the relationship between perceived abundance (debt-fueled economic growth) and administrative complexity, and between actual scarcity of tax revenue and administrative simplification.

Bailiwick News takes the position that the initial community response to a contracting or steady-state (stagnant) economy and declining or flat tax revenue will likely be a brief push for greater collaboration in an attempt realize efficiency gains. However, political tensions exacerbated by scarcity will eventually force simplification to prioritize meeting basic community needs with tangible community resources. We anticipate dissolution of regional collaborations, reduction of programs and services, and reallocation of now-regional jobs and financial resources up to the County level, over to the municipal level, or out to privately-funded agencies.

Numbers in Broad Context

The State College budget is prepared by the department heads and Borough Manager Tom Fountaine, and submitted to Borough Council for review and authorization. Borough departments include administration, including tax collection; police protection; planning and zoning; and public works (primarily road maintenance and refuse collection).

The COG budget is prepared by the agency heads and Executive Director Jim Steff, and submitted to the COG Finance Committee and then the General Forum for review and authorization. COG agencies include parks and recreation programs; library services; planning; code enforcement; firefighting and emergency management services.

Although this series will not cover local school taxes and budgets, or Penn State budgets, it's helpful to put the State College and COG budgets in context. The 2016 State College budget, approved by Borough Council in December 2015 and now in effect, included total planned 2016 expenditures of roughly $42 million. The total approved COG budget for 2016 was roughly $21 million. The total approved Centre County budget for 2016 was just over $75 million.

Approved 2016 State College Area School District budget expenditures were just under $147 million, roughly four times larger than the State College budget. The Penn State University 2016 budget (covering operations at the University Park campus and the commonwealth campuses) was $4.89 billion. The State College budget is less than 1% of the Penn State corporate budget.

Of the $42 million State College budget, the General Fund portion was just over $25 million, and the remaining $17 million included the "proprietary funds." Proprietary funds are programs operated by the Borough, intended to be largely self-supporting by paying for services and maintenance costs through user fees. Examples include the Parking Fund, the Sanitary Sewer Fund and the Refuse Collection Fund.

The total State College contribution to the COG 2017 proposed budget is currently projected to be $1,564,373, toward a total COG budget of $24.3 million.

Income Trends

State College Manager of Financial Services Dwight Miller reported in his 2015 Financial Trend Monitoring Report that "urban core communities" like State College currently have only three legislatively-authorized sources of tax revenue: real estate taxes assessed on property, earned income taxes assessed on residents' income, and realty transfer taxes assessed when property changes hands. In recent years, State College has also made an effort to increase sales of Borough staff services to other entities to develop another revenue stream.

Real estate taxes are paid by property owners, currently 16.4 mills, or $16.40 for every $1,000 of assessed value.

State College real estate tax revenue is flat for two main reasons. First, 41.5% of the property in the Borough is tax-exempt, because it's owned by Penn State and other exempt organizations. The second reason is the Homestead Exclusion Act, passed in 2006, which excludes qualifying homeowners from paying real estate taxes up to $25,000.

Real estate revenue is also declining as a proportion of the budget because State College is "built-out." As the construction boom has played out in recent decades, fields and forests suitable for conversion to housing, commercial uses and roads have become more scarce. Urban State College is so built-out that for the last few years, public officials have changed zoning laws to allow high-rise development – to build "up" rather than "out," through the Fraser Centre, the Metropolitan, the Rise, and a handful of upcoming projects. The suburban townships are now pressing hard against regional growth boundaries, looking to build in sensitive ecosystems that were once deemed off-limits, especially for groundwater protection.

Earned income and net profits taxes are paid at a 1.3% rate by wage-earning residents: employees through withholding and self-employed individuals through their net profit reports. Non-residents who meet certain criteria are also taxed, although at a lower rate.

Earned income tax receipts are declining, especially over the last decade, as adult residents with high incomes have moved out of the urban core to suburban townships, and been replaced by low income college students. Between 2000 and 2010, the proportion of 18-24 year olds as part of overall population increased from 65% to 71%.

Expense Trends

Publicly-funded budgets are mostly public employment programs. Sixty to 70% of local taxes pay for wages, salaries, health care and pensions for the government employees who provide services like tax collection, police protection, library administration, road paving and plowing, water and sewer pipeline repair and replacement, park maintenance, and so on.

These are jobs that cannot be outsourced to other countries to reduce or eliminate health care and pension expenses. They're family-supporting jobs, and also community-supporting jobs. Through government employees who also live in the COG municipalities, most of the tax dollars they earn as income also support local businesses or local branches of national chains such as farms, grocery stores and restaurants; health care providers; home improvement stores and contractors; and car dealerships.

Three main cost pressures are confronting State College, and two of them are labor costs.

The first is defined-benefit pensions for employees and retirees hired before 2012, when the Borough switched to a defined contribution program for all new hires.

In 2004, pension contributions cost less than $200,000. In 2016, they were $1,450,000, according to a "Budget 101" presentation available at the Borough website.

In a September 2015 audit, the 2014 money-weighted rate of return for the general government employee pension plan was 6.58%; for the police pension plan it was 6.54%.

A May 2016 audit reported that the 2015 rate of return for the general pension plan was -0.54% and for the police pension plan was -0.52%; both funds lost money that year, along with most pension funds across the country.

This is a national problem. Sophie Baker reported in a Jan. 25, 2016 article at pionline.com that "analysis of the 219 portfolios in Bank of New York Mellon's universe shows an average 2015 investment return of -0.08."

On Sept. 22, 2016, Elizabeth Campbell Bloomberg at the *St. Louis Post-Dispatch* reported that "public plans had a median increase of 1 percent for the year ended June 30…A reversal of fortune doesn't seem imminent. The Fed's decision to hold the benchmark lending rate between 0.25 percent and 0.50 percent has depressed yields on mortgages, corporate bonds and other fixed-income securities."

According to Assistant Borough Manager Roger Dunlap, for 2016 so far, through June 30, the returns for both State College plans were 2.82%. However, in 2014 and 2015, the projected contributions from taxpayers to the pension funds were calculated using an "actuarial assumption" of a projected 8% rate of return.

Under defined benefit plans, local taxpayers are on the hook to make up shortfalls in investment income, which is why municipal contributions have been rising, and why plans across the country are severely underfunded. The degree of shortfall increases dramatically with every incremental decline in the investment rate of return, and so far, no projections have been prepared with an actuarial assumption of a 2% or lower rate of return.

The second major cost driver is health insurance for public employees. In 2005, health care cost the Borough $1,316,621. In 2015, it cost $3,428,254. The increase was significantly higher than general wage growth and officially-reported inflation over the same period.

The third major cost driver, especially looking forward, is the anticipated expense to repair and replace aging infrastructure, including buildings and water and sewer lines. Many past Borough Councils have postponed capital improvement projects to redirect resources to pay operating costs, but the physical aging process cannot be put on hold.

Income-Expense Gap

As a result of these economic forces – most well beyond the direct control of local leaders – for nine of the last 10 years, Borough Council has adopted structurally imbalanced budgets in which expenses were greater than income. The gaps have been filled with one-time revenue sources, including use of general fund reserves.

In December 2015, Borough Council passed the first structurally balanced budget in ten years, covering 2016.

Borough finance staff are now projecting that financial business as usual, including structural imbalances, will lead to a projected $728,123 budget gap for 2017, rising to $3,538,000 by 2021.

They are recommending two small policy changes for Council to begin addressing the predicament.

The first staff recommendation is that Council adopt a structurally balanced budget policy, which would reinforce pressure on future Councils to cut services, raise taxes, or both, rather than further defer hard decisions by using one-time revenue sources.

The second staff proposal is to change the policy that currently sweeps all excess General Fund reserves above 12% of projected expenditures at the end of the year, into the Capital Projects Fund automatically, without Council review. Staff are recommending that this and future Councils take responsibility for making case-by-case choices about how to allocate future available funds to meet high-priority needs.

Borough Council will be discussing these issues at regular and work sessions throughout October and November.

CRITICAL ANALYSIS

These are not temporary trends. These are structural predicaments many decades in the making that will continue to inflict economic pain for the rest of our lives.

The global economy, yoked to central banks, has become a system for transferring paper wealth up the income scale and inflating asset bubbles, at the expense of real wealth in the form of local material economies. Contrary to government propaganda uncritically echoed in national media outlets, since roughly 2005, the American economy has been in a depression for all but the top 1% of the population.

To look at just one example of government lies, the headline (U3) unemployment rate in August 2016 was 4.9%, but it does not count working-age people who have given up looking for work (short-term discouraged) or are employed part-time but would prefer full-time. The U6 rate, including those people, was 9.7% in August 2016.

However, short-term discouraged people drop off the U6 count after one year. When long-term discouraged are counted, the August 2016 unemployment rate is 23%. (ShadowStats.com)

Job loss, and resulting flat or declining household incomes, are fighting a losing battle against rapidly rising costs for housing, health care, child care and education.

In parallel, flat or declining municipal tax revenues are fighting a losing battle against rapidly rising costs for health care and pensions for public employees providing public services.

Young local leaders in their thirties and forties are among the first wave of adult children and grandchildren against whom all the borrowing of the last 40 years has been done, in some cases by the older local leaders now in their sixties and seventies.

The deferred bill is now coming due.

Meanwhile, the state and federal governments, from whom unfunded mandates and limitations on municipal taxing authority come, have lost legitimacy in recent years, especially through government shutdowns caused by their own budgeting failures. State and federal contributions have dropped and are likely to keep dropping, yet legislatures are not working quickly to authorize additional local taxes, including those that would help tourist communities like State College, such as alcohol pour taxes, hotel taxes, and recreation taxes.

At some point, the local political and financial benefits of explicitly refusing to meet unfunded mandates may outweigh the risks, and the local risks of municipal and regional governments attempting to meet mandates by filling funding shortfalls with local tax increases may outweigh the benefits.

Federal and state pressures aside, until roughly 2005, it made fairly good sense to hitch local budgets to new construction and increased population: rising property values increased real estate tax revenues, and rising incomes increased income tax revenues.

Times have changed. The traditional claim that increased population, regardless of income level, offsets increased costs to provide basic services for the added population, is wearing thin. After the point of diminishing returns – arguably 2005 – the addition of more people and built structures has led to a net loss locally in terms of degraded natural resources and rising program expenses.

In other words, it’s become increasingly difficult to maintain the infrastructure we’ve already built and the service programs we’ve already set up. So it’s time to stop adding new infrastructure and programs, focus on taking care of what we’ve got, and draw clear distinctions between public needs for essential services including clean water and police protection – and public desires.

This means elected and appointed officials need to scale down public expectations and manage the public anger and disappointment that can be expected in response.

Management staff in State College and COG seems to understand the bind, and its implications. A SWOT analysis conducted among State College department heads over the summer included in the top five strengths that “employees have strong pension and benefits package” and that the “borough offers a wide range of services.” In the top five weaknesses, managers listed: “tendency to take on more projects and work than we have the capacity to complete” and “limited diversity in revenue sources.”

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