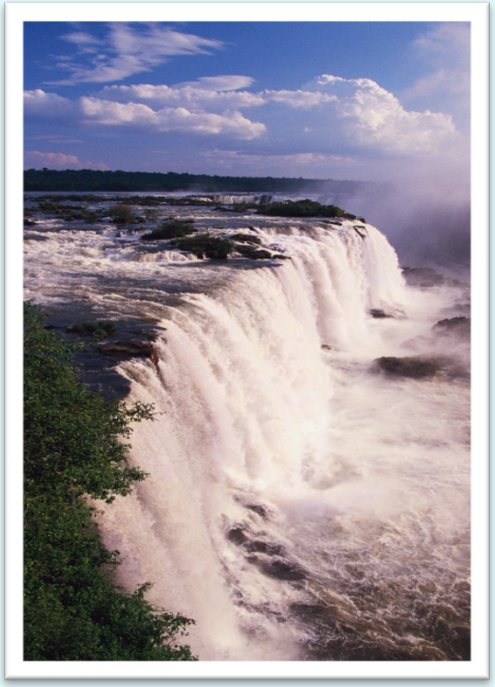
Virginia's Fiscal Cliffs



VIRGINIA LOCAL GOVERNMENT MANAGEMENT ASSOCIATION

JUNE 20, 2013

GEORGE MASON CENTER FOR STATE & LOCAL LEADERSHIP

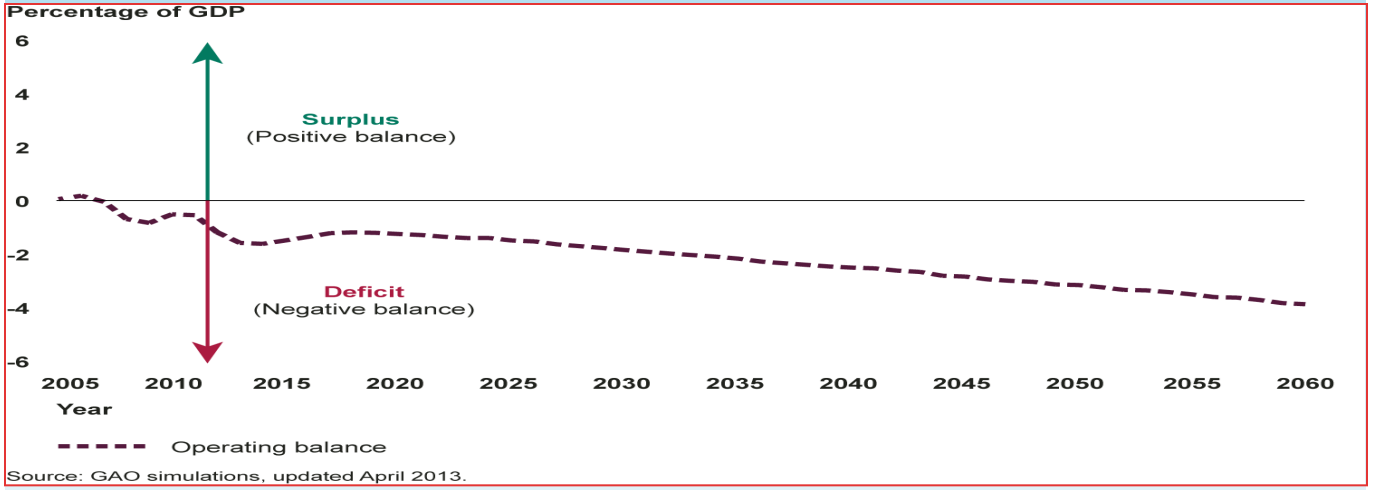
Why it Matters

- Likely consequences of pressure to address the federal deficit and renewal of debt ceiling debate that led to the downgrade of U.S. debt August 2011:
  - Diminished U.S. transfers to the Commonwealth and local governments
  - Arbitrary cuts to key federal programs that disproportionately affect Virginia's economy
  - Potential federal tax changes that could adversely affect state and local revenues
  - Expiration of long-term unemployment insurance may also indirectly increase demands on local and state governments – when people get less help from the federal government, they may end up placing greater strains on local and state government social services

- ***All this means the ongoing series of fiscal cliff s in 2013 and the sequester triggered in March for the next decade could have significant credit implications for state and local issuers***

Why it matters to you

THE STATE AND LOCAL GOVERNMENT SECTOR CONTINUES TO FACE NEAR-TERM AND LONG-TERM FISCAL CHALLENGES WHICH ADD TO THE NATION'S OVERALL FISCAL CHALLENGES.



Source: GAO simulations, updated April 2013.

Fiscal Cliff Timeline

- **Late November – December 31, 2012: Debt Limit Reached, temporary extension enacted (kicking the can down the roado**
  - Absent legislation to raise the debt ceiling, the federal government will default
  - Such a default would eliminate the Treasury's authority to borrow, in effect putting the federal government into bankruptcy
  - It would affect the federal governments ability to make payments to local governments, states, Social Security recipients, etc.
  - Therefore, it would trigger credit rating downgrades for states and local governments—especially in Virginia where there is such a significant presence.
  - The refusal of the House of Representatives in 2011 to vote to increase the debt ceiling triggered the Budget Control Act that created the Fiscal Cliff and led to multiple Virginia local government downgrades.

Fiscal Cliff Timeline

- **January 1, 2013: Fiscal Cliff**
  $661 Billion Impact for Calendar Year 2013
  - **Expiration of 2001, 2003 and 2009 tax cuts ($281 billion)**
    - Commonly referred to collectively as the "Bush" tax cuts
    - Includes tax rate reductions on individual income, capital gains, dividends, estates and gifts, as well other exemptions, credits, and deductions
    - Extended for two years in 2010
    - Estimated that if full package of tax cuts is allowed to expire, taxes will rise by an average of about $1,600 per household next year (Tax Policy Center)
  - **Expiration of payroll tax holiday ($115 billion)**
    - Temporary measure intended to promote economic growth first enacted for 2011 and then extended for 2012
    - Temporarily reduced employee's Social Security payroll taxes from 6.2 percent to 4.2 percent on approximately their first $110,000 of wages.
    - Estimated that if allowed to expire, taxes will rise by an average of about $700 per household next year (Tax Policy Center)

Fiscal Cliff Timeline

- **Deadline to address tax extenders and business depreciation ($75 billion)**
  - Tax extenders: host of targeted tax breaks for businesses – most notably, the research and experimentation tax credit – and individuals that historically have been renewed each year.
  - Some expired at the end of 2011, but many recipients retain the expectation that they will continue to be extended
  - Business depreciation: Over past two years, business owners permitted to take 100% bonus depreciation for purchases of tangible assets (deduct entire value of those assets from their profits for tax purposes in the year of purchase)
  - If policymakers do not act before the close of this year, these businesses and individuals will not be able to take advantage of the provisions when they file taxes in 2013

Fiscal Cliff Timeline

- **Expansion of Alternative Minimum Tax (AMT) ($40 billion)**
  - Minimum tax intended to ensure that upper-income taxpayers do not pay "too little" in income taxes as a result of various deductions, exemptions, preferences, and credits in the code
  - Not automatically annually adjusted for inflation, so if Congress fails to renew the "patch" that fills this purpose, 27 million more Americans will have to calculate and pay the AMT on their 2012 tax returns
- **Expiration of extended unemployment benefits ($34 billion)**
  - Congress temporarily extended amount of time laid off workers could collect unemployment benefits due to recession
  - Under current law, workers can collect for as many as 93 weeks, depending on their state of residence and its unemployment rate
  - If allowed to expire, up to 26 weeks of benefits will be provided to unemployed workers in most states

Fiscal Cliff Timeline

- **Imposition of Patient Protection and Affordable Care Act (ACA) taxes ($24 billion)**
  - Some new ACA taxes scheduled to take effect in 2013
  - For individuals with wages of more than $200,000 ($250,000 for joint filers), Medicare payroll tax rate will increase by 0.9 percentage points on wage income above those thresholds
  - Entire 3.8% Medicare tax will be applied to “net investment income” above those same thresholds
  - Some other smaller provisions will begin in 2013 as well
- **Expiration of Medicare "Doc Fix" ($14 billion)**
  - Medicare Sustainable Growth Rate (SGR): formula used to calculate fees paid to physicians by Medicare and Tricare
  - “Doc Fix”: annual delay of scheduled fee reductions enacted by Congress each year for last decade. Now wide gap between SGR formula and current fees
  - If Congress allows “doc fix” to expire, it will result in an immediate 27% cut in physician payments

Fiscal Cliff Timeline

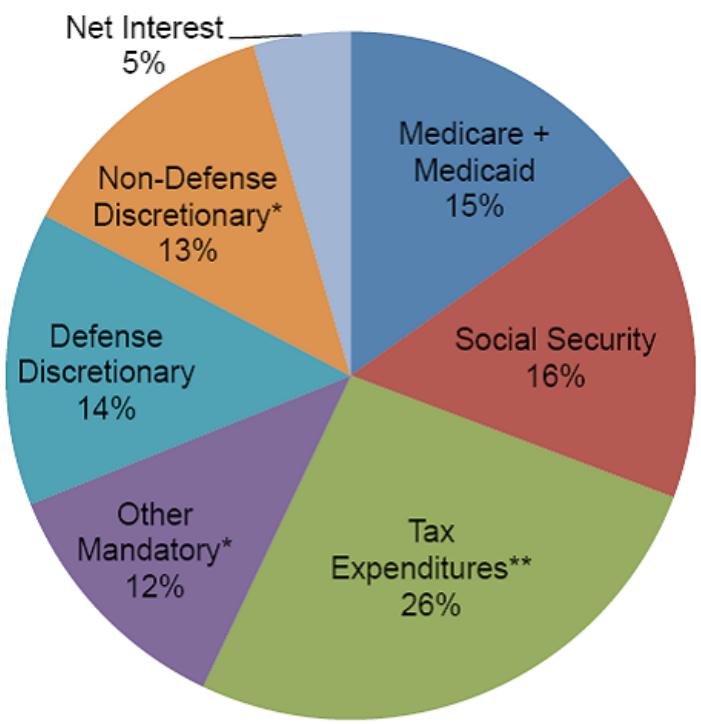
- **January 2, 2013**
  - **Imposition of sequester cuts ($78 billion)**
    - Budget Control Act of 2011 formed a congressional "super committee" instructed to agree on at least $1.2 trillion of deficit reduction
    - Failsafe included automatic cuts to defense and non-defense spending that would be implemented if super committee did not meet its target
    - Across-the-board cuts went into effect in March—and will remain in effect for ten years absent congressional legislation that waives or postpones them
    - Estimated cuts to discretionary agency budgets for the latter three-quarters of Fiscal Year 2013 (i.e., January-September): 13% for defense and 11% for non-defense (BPC)
    - Some mandatory spending programs, such as subsidies to farmers, will be cut by 10%, and starting in February, payments to Medicare providers, private Medicare Advantage plans, and Medicare drug plans will be reduced by 2%. The sequester also applies to interest payments to municipalities with Build America Bonds.
- **January 2, 2013: 113th Congress Convenes**

Federal Debt & Municipal Downgradings

ON FEBRUARY 4, 2013, THE PRESIDENT SIGNED H.R. 325 TO SUSPEND THE U.S. DEBT LIMIT UNTIL MAY 19. BECAUSE THE FEDERAL GOVERNMENT IS NOW UP AGAINST THE REINSTATED DEBT LIMIT, TREASURY HAS AGAIN COMMENCED USE OF EXTRAORDINARY MEASURES, INCLUDING THE SUSPENSION OF THE PURCHASE OF STATE & LOCAL SECURITIES.

IT NOW APPEARS THAT, ABSENT NEW FEDERAL LEGISLATION TO RAISE THE DEBT CEILING, THE U.S. GOVERNMENT WOULD BECOME INSOLVENT AND DEFAULT ON ITS DEBTS AND OBLIGATIONS AT THAT TIME. SHOULD CONGRESS NOT ACT IN A TIMELY MANNER, JUST AS IN AUGUST OF 2011; IT IS LIKELY THAT OVER 1,000 STATES AND LOCAL GOVERNMENTS WOULD RECEIVE CREDIT DOWNGRADES.

Show Me the Money



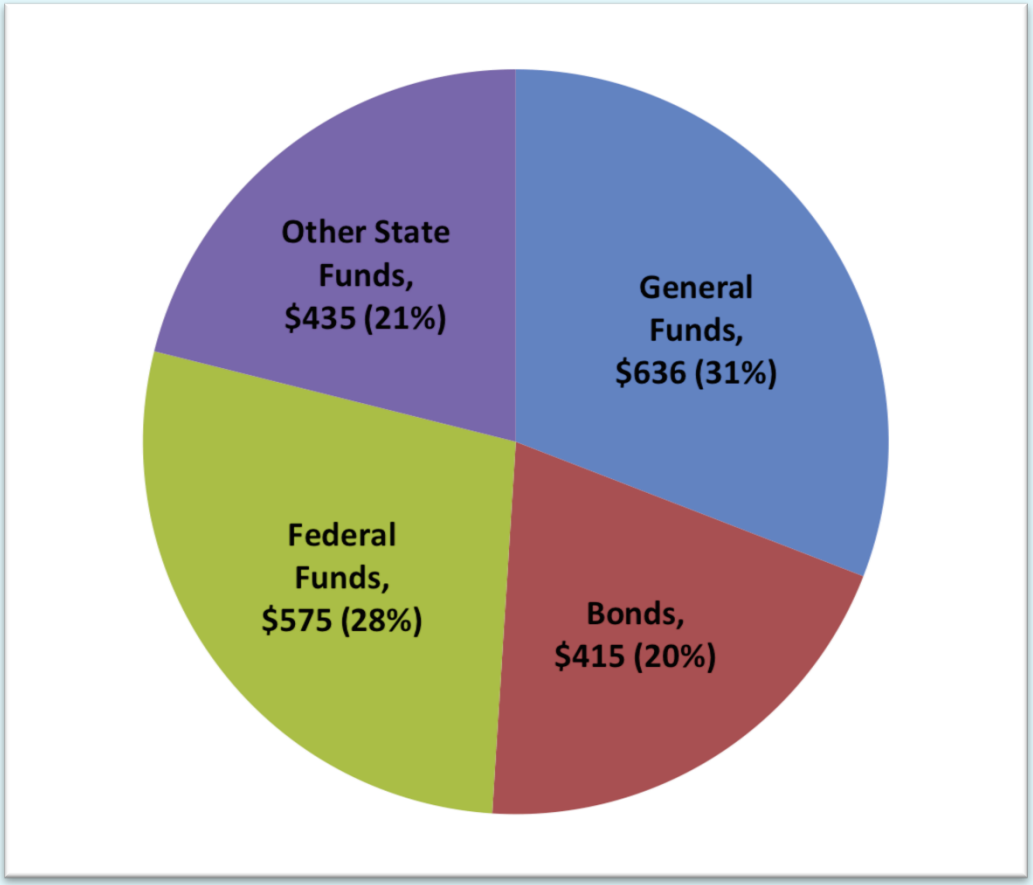
*Some defense-related spending, such as veterans' benefits and military retirement, fall into these categories.

** There is a significant amount of spending that occurs through the tax code in the form of provisions that are commonly referred to as tax expenditures.

Source: Congressional Budget Office (CBO) Budget and Economic Outlook (January 2012), Joint Committee on Taxation

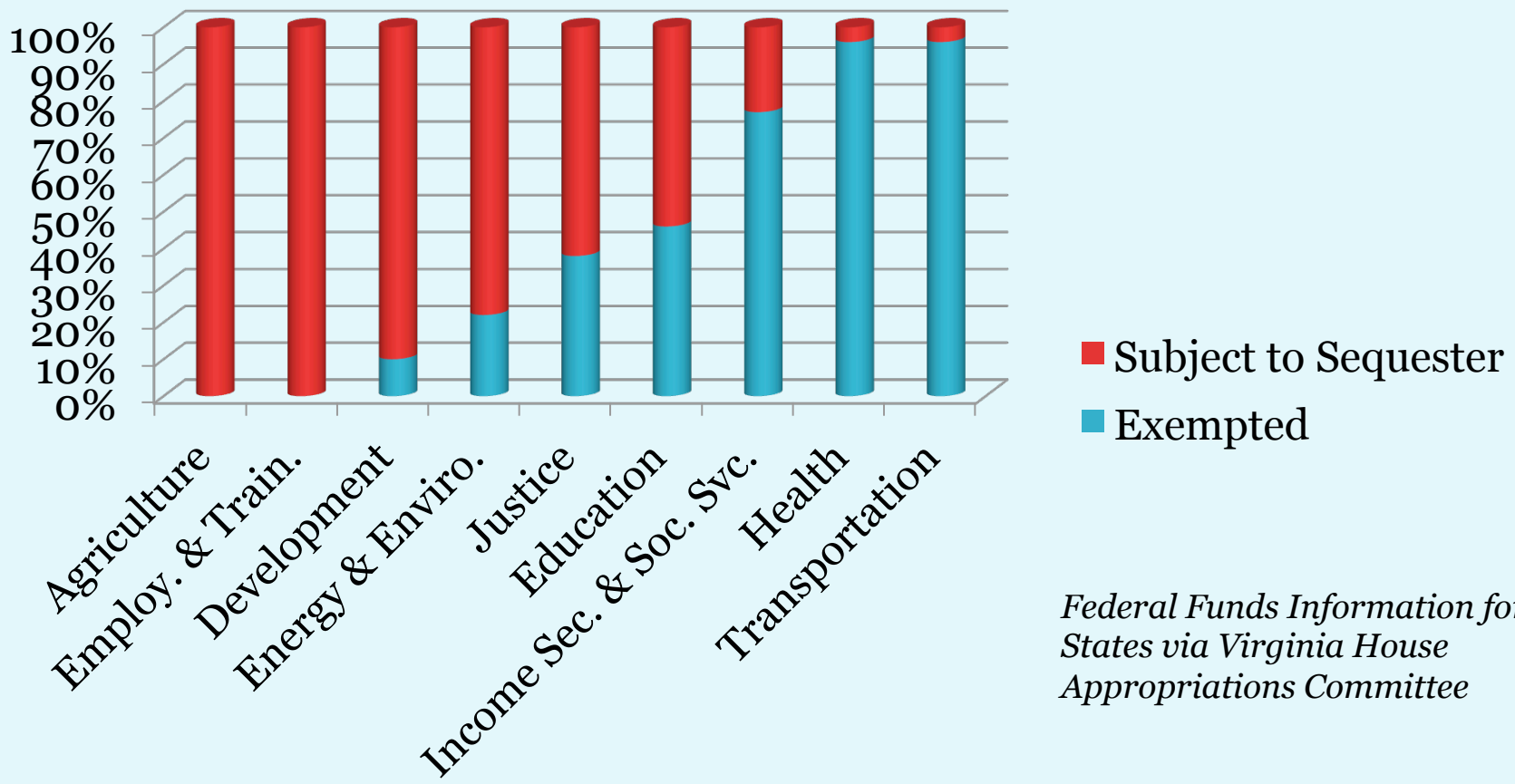
Federal expenditures: The biggest and fastest growing part of the federal budget, deficit, and debt: The Complete Budget Picture in FY 2012
(Bipartisan Policy Center June 2012 report)

Indirect Danger



State expenditures by funding source

Virginia's Share of Grants in Aid Subject to Sequester



Federal Funds Information for States via Virginia House Appropriations Committee

Will the Federal Government Be Open on October 1st?

The Senate is not expected to consider any FY 2014 spending bills until mid-June. The House and Senate are operating under different discretionary budget authority totals, $967 billion in the House and $1.058 trillion in the Senate. The Senate assumes sequestration is replaced while the House maintains it, but shields defense-related spending from the full BCA-mandated spending cuts.

Marketplace Fairness Act

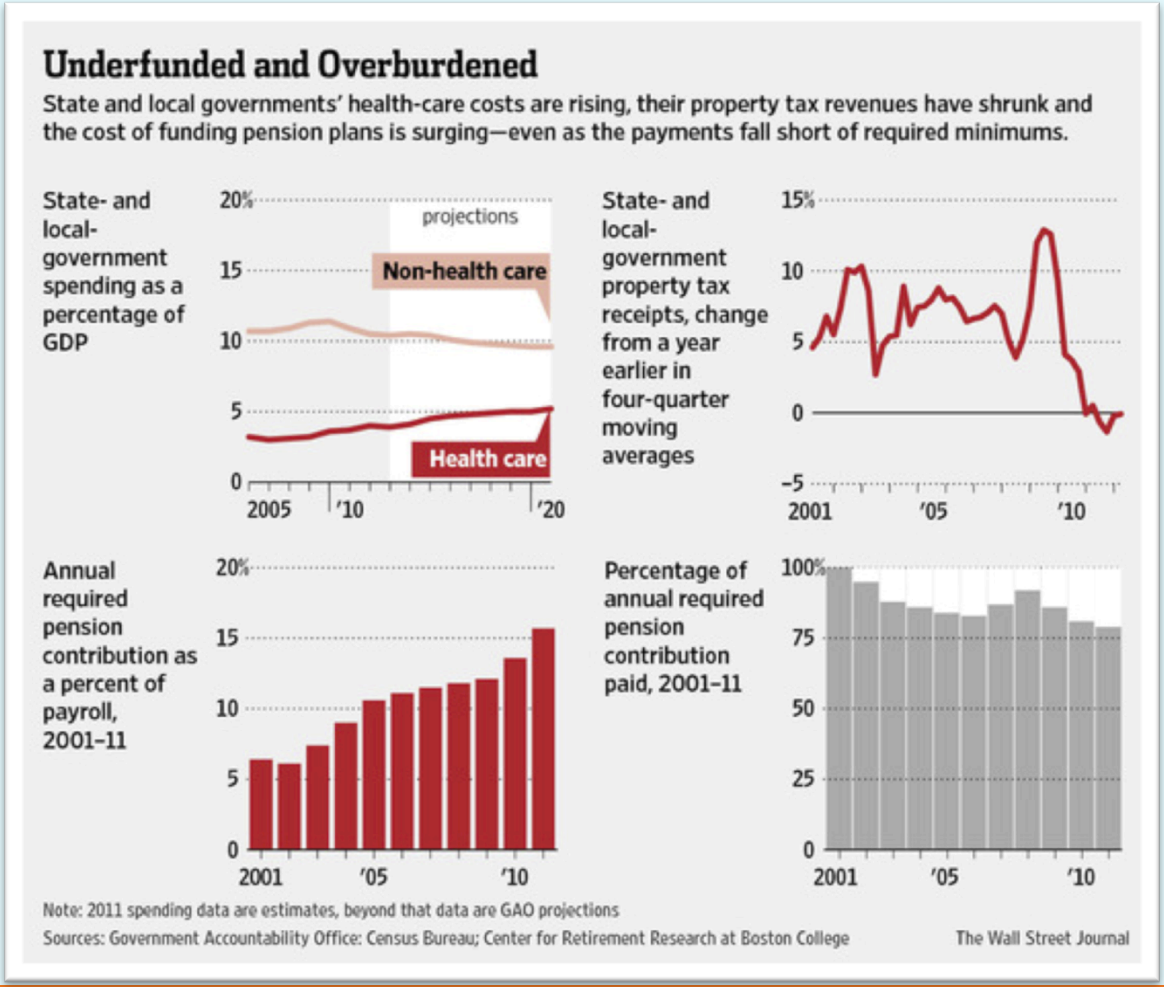
THE U.S. SENATE LAST MONTH PASSED AND SENT TO THE HOUSE THE MARKETPLACE FAIRNESS ACT, FEDERAL LEGISLATION WHICH WOULD ALLOW FOR THE COLLECTION OF VIRGINIA SALES AND TAXES ON OUT OF STATE OR INTERNET SALES. THE FATE OF THE LEGISLATION IS NOW BEFORE U.S. REP. BOB GOODLATTE (VA-6TH). THE LEGISLATION:

- IS SUPPORTED BY 72% OF VA. BUSINESS LEADERS
- WOULD ENABLE SOME 404,100 VA. RETAIL JOBS TO COMPETE ON A LEVEL PLAYING FIELD
- WOULD BRING IN $442.7 MILLION IN NEW ANNUAL STATE AND LOCAL SALES TAX REVENUES TO THE COMMONWEALTH
- WOULD ADD SIGNIFICANT NEW RESOURCES FOR VA'S NEW TRANSPORTATION LAW

Tax Implications for Virginia

- Virginia's House Appropriations Committee notes the Commonwealth is the largest per capita recipient of federal procurement spending of any state
  - Concern about reduced tax revenues and employment from federal spending cuts

“Underfunded and Overburdened”



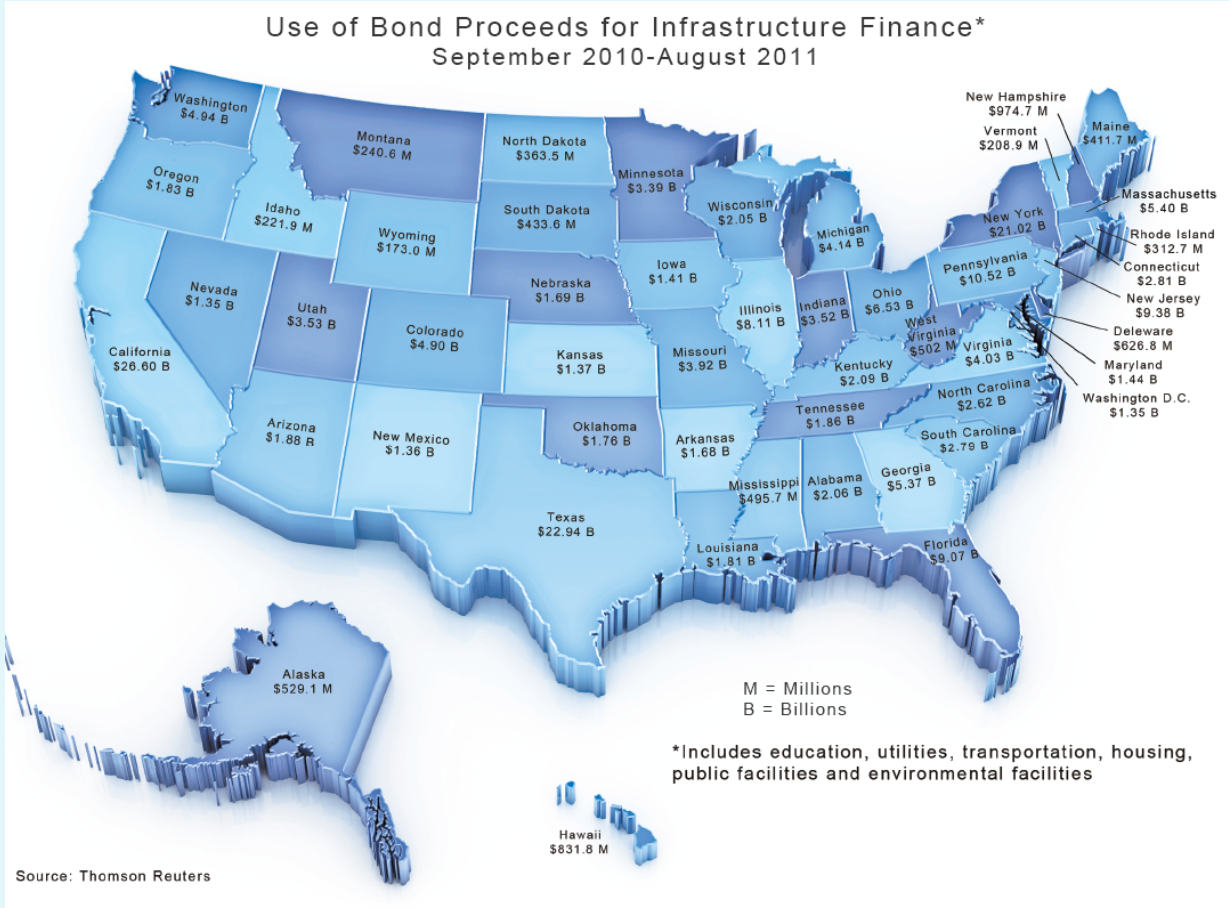
The Physical Cliff Next Time

"Today, our motto is more like 'Millions in insurance payouts for new hardwood floors but not a cent for infrastructure.' Of course, our national discussion of the 'fiscal cliff' facing the U.S. government at end of 2012 isn't going to include anything as radical as looking at return on investment. How could it, when the country doesn't even do a capital budget that treats investments as a separate category? Instead, we're going to slash this program and spare that one based on which interest groups yell loudest – and which groups have contributed the most to the politicians who are best placed to influence the decisions. Maybe someday – after another devastating natural disaster or two in other parts of the country – the United States might invest in ways to prevent damage to its infrastructure – or even in improvements to existing infrastructure. But listening to the closing days of this election, I'm not counting on that happening anytime soon." Jim Jubak

What's it mean for my city?

- Federal tax reform likely in 2013
  - Growing apprehension about the debt and deficit
  - House passed Pathway to Job Creation Through a Simpler, Fairer Tax Code Act to set up an expedited process
    - Would reduce individual and corporate tax rates, eliminate the Alternative Minimum Tax, and end special-interest tax breaks
    - Bill provides no analysis of potential impact on state and local tax revenues
  - Many municipal bond issues will be considered as part of that process, just as happened in 1986
- Local governments sought approval for about $37 billion of borrowings in the elections
  - 45% less than 2008; Sharpest drop in six decades for a presidential election year
  - "There is a reluctance to commit to new ongoing spending given the uncertainty of revenue." (Tracy Gordon, state and local-finance economist, Brookings Institution)

Use of Bond Proceeds



The Peril of Federal Tax Reform

- Two deficit/debt reduction commissions addressed federal tax reform last year: Bowles-Simpson and Domenici-Rivlin
  - Bowles-Simpson neither included anyone representing or experienced at state/local level, nor addressed impact of its recommendations on local governments
  - Domenici-Rivlin, co-chaired by former Mayor of Albuquerque, Sen. Pete Domenici (R-N.Mex.), included both former state and local elected leaders and carefully considered potential revenue effects on local and state governments
- Because state individual and corporate income tax systems are piggy-backed onto federal code, any federal changes have significant consequences for state (and local) revenues; revenue systems are intertwined — as is authority to issue debt.

Bowles-Simpson Proposals

Commission/Task Force	Proposals	Treatment of Bonds
National Commission on Fiscal Responsibility and Reform (i.e., Bowles-Simpson)	• Achieves nearly $4 trillion in deficit reduction by 2020 • Proposes more than four dozen ways to cut outdated programs and increase economic competitiveness by making government cut and invest rather than borrow and spend • Reduces deficit by 2.2% of GDP by 2015 • Reduces tax rates, abolishes AMT, and removes many tax expenditures (including mortgage interest deduction) • Reduces debt to 50% of GDP by 2024 and 40% by 2037 • Proposes major overhaul of Social Security to ensure solvency	• Eliminates tax-exempt interest treatment for all new municipal bonds • Replaces tax-exempt bonds with direct subsidy bonds

Administration Proposals

Commission/Task Force	Proposals	Treatment of Bonds
Obama Administration FY 2013 Budget Proposal	• Plan focuses on increases in taxes on the wealthy • Proposes cuts in future spending on defense and Medicare • Social Security is not addressed • Proposes $3.6 trillion in deficit reduction by 2021 offset by $447 billion in deficit increases (spending and tax cuts) for a net deficit reduction of $3.2 trillion • If all measures are implemented, deficit would be 2.3% of GDP by 2021	• Recommends limiting value of exemption for interest on municipal debt to 28% • Unclear whether grandfathering of current bonds would be allowed • Makes permanent the Build America Bonds program with a lower subsidy rate

Municipal Capital Financing over the Cliff

The general approach of the experiment was to assume the repeal of a number of the largest tax expenditures under the individual income tax as identified in our publication, *Estimates of Federal Tax Expenditures for Fiscal Years 2011-2015*, (JCS-1-12), and use the resulting revenue raised to reduce the statutory rates of the individual income tax while also repealing the individual alternative minimum tax and the PEP and Pease limitations. The result was to be approximately revenue neutral over the 10-year budget period, 2013-2022.

The experiment would make several changes to present law. These changes include: (a) repealing the individual alternative minimum tax; (b) repealing the overall limitation on itemized deductions and personal exemptions for certain taxpayers; (c) repealing all itemized deductions; (d) taxing capital gains (and dividends) as ordinary income; and (e) repealing the interest exclusion on State and local bonds issued after December 31, 2012. No transition relief would be provided under any repeal.

Thomas Barthold, Chief of Staff,
Congressional Joint Committee on Taxation