The Fiscal Cliff

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- The "fiscal cliff" refers to the combination of tax increases and budget cuts that would take effect on January 2, 2013 if current law remains in effect.
- According to the CBO 51 tax provisions expired in 2011 and 18 will expire in 2012. Tax changes would include:
    - The expiration of cuts in personal income tax rates that were passed in 2001 and 2003 which would raise rates for almost all federal tax payers.
    - Expiration of the 2% Social Security tax cut paid by employees
    - Expiration of the Alternative Minimum Tax "patch" that has saved many taxpayers from the provisions of that tax passed decades ago.
    - An increase in the estate tax
    - Increased tax rates on long-term capital gains
    - Plus a number of other tax provisions
    - The estimated tax bill for a family with income of between $40,000 and $60,000 would rise by nearly $2,000.
- The second half of the "cliff" comes from the Budget Control Act of 2011, which requires that if no deficit reduction plan is agreed on by December 31, 2012, automatic budget reductions will impose across-the-board reductions of many federal programs.
    - Budget reductions are made under a *sequestration* process created by the Congress in 1985, by the Balanced Budget and Emergency Deficit Control Act of that year, mandating across-the-board budget cuts for federal programs with a specified set of exempted programs.
    - The current bill provides that roughly half the cuts will come from defense expenditures and half from non-defense expenditures.
    - The 2011 Budget Control Act calls for a total of nearly one trillion dollars to be cut through FY 2021, which averages about $109 billion of cuts per year.

- An interesting analysis of the present situation by Susan K. Urahn, director of the Pew Center on the States, is offered in the latest issue of *Governing the States and Localities*.
    - She points out that as a result of the Great Recession states have lost $97.8 billion in revenues over the period 2008 to 2010. That amounts to 12% of state revenues.
    - At the same time, the demand for state services has increased.
    - On average about $1 of every $3 in state revenues come from federal grants and that average hides a wide variation from state to state.
        - For example, Mississippi gets about 50% of its revenue from federal grants while Virginia only gets about 25% of its revenues from such grants.
        - Tennessee gets between 40% and 45% of its revenues from federal grants, according to the article.
    - States will be impacted not only by the possible loss of grants but also by changes in the federal tax code.
        - Thirty-six states plus the District of Columbia link their tax rates to federal tax rates.
        - Tennessee may avoid that problem since we do not have a broad-based income tax.
    - The point of the article is that while states are impacted by changes in federal fiscal policies, and in this case the "fiscal cliff," there is little opportunity to include state and local governments in the discussion of these policies.
        - One lost opportunity mentioned is the demise of the Advisory Commission on Intergovernmental Relations at the federal level.
- Analysis of the sequester's effects is complicated by the Congress's September 2012 passage of a continuing resolution extending the budget deadline for fiscal year 2012-13.
        - The resolution allows the federal government to continue to operate until March 27, 2013.

        - It calls for a 0.612% across-the-board increase for most federal programs.
        - As a result, even with the sequester, funding for some federal programs will increase while funding for others will decrease.
- The actual size of the budget cuts will only be known at the end of the calendar year, but several estimates have been made based on different assumptions about the across-the-board percentage.
    - The White House Office of Management and Budget (OMB) prepared an analysis of the impact of the sequester using "a 9.4% cut for defense discretionary programs, a 10.0% cut for defense mandatory programs, a 7.6% cut for mandatory programs, and an 8.2% cut for nondefense discretionary programs."[1]
    - The Federal Funds Information for States (FFIS), a subscription service created by the National Governors Association and the National Conference of State Legislatures, released impact estimates for each state based on the OMB assumptions about the cuts.
        - The FFIS estimates that 28 of the 40 programs most important to states will require across-the-board cuts; only 18% of funds are covered.
            - They estimate that in those 28 programs, states could lose $5.3 billion.
                - In the 12 programs exempt from the sequester, funding could increase by $12.9 billion.

- Examples of the estimated impact of the sequester on Tennessee include
    - Women, Infants, & Children (WIC) -$8.9 million
    - Title 1, Grants to Local Education Agencies -$21.4 million
    - Vocational Rehabilitation Grants -$3.2 million
    - Special Education -$18 million
    - Career and Technical Education—State Grants -$1.8 million
    - Child Care and Development Block Grants -$4.0 million
    - Child Support Enforcement -$2.8 million
    - Head Start -$10.5 million
    - Community Services Block Grants -$1 million
    - Unemployment Insurance-State Administrative -$3.2 million
    - Low-Income Home Energy Assistance -$4.2 million
    - Surface Transportation Program -$1.4 million
    - Subtotal for Tennessee -$95.3 million

- In addition, the Department of Defense reductions in Tennessee are estimated at $320 million.

- The law requires that the cuts be made to each covered program, project, and activity so that agencies will have virtually no discretion when applying the cuts.
- OMB's analysis gives the estimated cuts to more than 1,200 budget accounts, everything from Senate and House staff salaries to military intelligence.
- The pain will be felt in virtually every sector of government and ultimately most citizens to some degree.

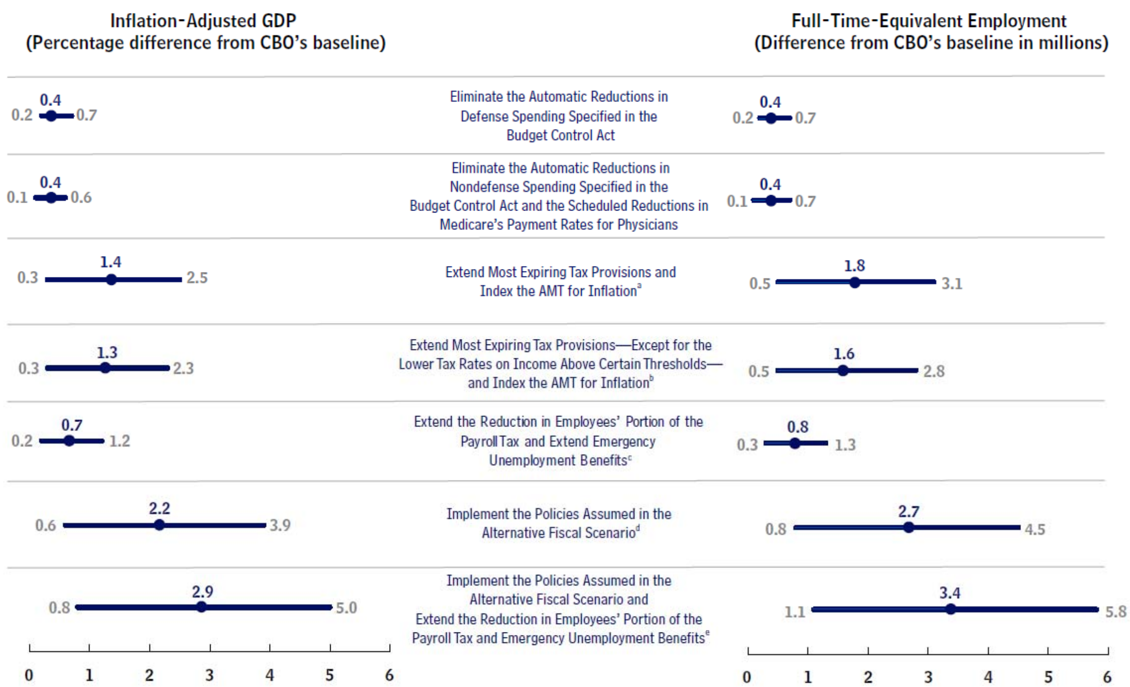
Federal Funds as a Percent of Total State Expenditures, FY 2011

Rank	State	Percent	Rank	State	Percent
1	South Carolina	50.0%	27	North Carolina	34.4%
2	Mississippi	48.4	28	New York	33.7
3	Oklahoma	45.5		**U.S. Average**	**34.1**
4	Tennessee	45.1	29	Nebraska	32.9
5	Michigan	44.8	30	Iowa	32.8
6	South Dakota	44.2	31	Colorado	31.0
7	Alabama	43.5	32	Nevada	30.9
8	Pennsylvania	42.8	33	Maryland	30.5
9	Idaho	42.8	34	Utah	29.6
10	Missouri	41.6	35	Minnesota	29.5
11	Louisiana	41.1	36	Illinois	28.8
12	California	40.2	37	Wisconsin	28.6
13	Indiana	39.2	38	New Jersey	28.0
14	Vermont	38.6	39	Oregon	27.9
15	Montana	38.6	40	Washington	26.3
16	New Mexico	38.5	41	Kansas	26.2
17	Kentucky	38.2	42	Ohio	23.9
18	Texas	38.0	43	Virginia	23.2
19	Rhode Island	37.2	44	Alaska	22.8
20	Maine	36.7	45	Hawaii	22.8
21	Georgia	36.3	46	Delaware	22.0
22	North Dakota	36.2	47	Wyoming	21.6
23	Arizona	35.9	48	West Virginia	21.6
24	New Hampshire	35.7	49	Connecticut	12.3
25	Florida	35.5	50	Massachusetts	7.2
26	Arkansas	34.6			

Source: National Association of State Budget Officers, "State Expenditure Report."

Figure 1.

Estimated Economic Effects in the Fourth Quarter of 2013 of Eliminating Various Components of Fiscal Tightening Scheduled for Fiscal Years 2013 and 2014



Source: Congressional Budget Office.

State Rainy Day Fund Balances as a Percent of State Expenditures, FY 2012

Rank	State	Percent	Rank	State	Percent
1	Alaska	213.2%	26	Mississippi	1.8%
2	Wyoming	47.6	26	Virginia	1.8
3	West Virginia	20.0	28	North Carolina	1.5
4	North Dakota	18.2	29	Kentucky	1.3
5	Texas	14.0	29	Maine	1.3
6	South Carolina	13.1	29	Nevada	1.3
7	Nebraska	12.1	32	Illinois	1.0
8	Iowa	9.9	33	Ohio	0.9
	U.S. Average	**8.8**	34	Washington	0.8
9	New Mexico	8.7	35	New Hampshire	0.7
10	Louisiana	8.0	35	Oregon	0.7
10	South Dakota	8.0	37	Hawaii	0.5
12	Colorado	6.5	38	Indiana	0.4
13	Delaware	5.1	39	Alabama	0.0
14	Utah	4.8	39	Arizona	0.0
15	Rhode Island	4.7	39	Arkansas	0.0
15	Vermont	4.7	39	Connecticut	0.0
17	Maryland	4.5	39	Idaho	0.0
18	Massachusetts	4.2	39	Kansas	0.0
19	Minnesota	3.9	39	Montana	0.0
20	Missouri	3.1	39	New Jersey	0.0
21	Michigan	2.9	39	Oklahoma	0.0
22	Tennessee	2.7	39	Pennsylvania	0.0
23	New York	2.3	39	Wisconsin	0.0
24	Florida	2.1	50	California	-2.0
25	Georgia	1.9			

Source: National Association of State Budget Officers, "Fiscal Survey of States."

[1] Federal Funds Information for States (FFIS) www.ffis.org