The Tennessee Advisory Commission on Intergovernmental Relations

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MEMORANDUM

TO: Commission Members

FROM: Lynnisse Roehrich-Patrick
Executive Director

Lynnisse

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SUBJECT: Federal Action on the Budget—Potential Effects on Tennessee

Dr. Reuben Kyle will provide information on the effects of federal action on the budget, including an overview of the factors that result in the fiscal "cliff." He will explain the various tax increases and the effect from the Budget Control Act of 2011, including the sequestration process.

For some time now, political leaders and the press have been warning about the fiscal "cliff" the country is facing because of the combination of federal tax increases and budget cuts set to occur in January 2013. The tax increases result from several looming events, including current US law requiring federal income tax rates to revert on January 2, 2013, to those in place before the cuts of 2001-2003, which would raise rates for most taxpayers. At the same time, the temporary payroll tax cut will expire, increasing every wage earner's taxes, capital gains taxes will rise, and many other changes will take place. One estimate is that, as a result of all these tax impacts, a typical middle-income household earning about $50,000 per year would incur a $1,750 tax increase.

These changes in tax laws confront us because when the individual income tax rates were changed in 2001, the Congress set a time limit on the life of these new rates. They were to expire in 2010, but given that the country was just beginning to recover from the worst recession in 80 years, the Congress pushed that date back another two years, to the end of 2012. In the case of the payroll tax, the cut was part of the President's stimulus bill passed in 2009 as a temporary measure to ease the impact of the recession.

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 in many federal programs. The Congressional Budget Office (CBO) estimates that the combination of the two sets of changes will reduce the federal budget deficit by $607 billion, approximately 4% of gross domestic product (GDP), from 2013 as compared with 2012. In other words, the immediate effect will be to reduce US GDP by about 0.5% in inflation-adjusted terms according to the CBO. By way of comparison, the recent recession reduced GDP by 3% from 2008 to 2009. Other estimates of the impact on GDP and economic growth are for an even greater reduction.

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 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 Federal Funds Information for States (FFIS), a subscription service created by the National Governors Association and the National Conference of State Legislatures, says that "OMB currently estimates 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."

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 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. However, beyond the period covered by the continuing budget resolution, the 2011 Budget Control Act calls for a total of nearly one trillion dollars to be cut through FY 2021 that averages about $109 billion of cuts per year.

Examples of the estimated impact of the sequester on Tennessee are listed in the attached document. 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 by most citizens to some degree.

Federal Action on the Budget—Potential Effects on Tennessee

- 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.
- 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.

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