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CITY COUNCIL REPORT

POLICY AGENDA

TO: David Cavazos
City Manager

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ITEM:5

THRU: Ed Zuercher
Assistant City Manager

FROM: Jeff DeWitt
Chief Financial Officer

Mario Paniagua
Budget and Research Director

Karen Peters
Senior Executive Assistant to the
City Manager

SUBJECT: FEDERAL TAX AND LEGISLATION IMPACT ON CITY

This report provides updated information on the impacts to the City of Phoenix from *The American Tax Relief Act of 2012*. Additionally, information is provided on potential impacts to City programs from future spending cuts under sequestration, estimated to be as much as $13.5 million. Other potential impacts being watched include the municipal bond market and the general economic conditions due to the uncertainty surrounding actions in Washington, D.C.

BACKGROUND

As a result of the Budget Control Act of 2011, Congress was faced this past December with a set of circumstances affecting the federal budget that is commonly referred to as the "fiscal cliff." On or around January 1, 2013, approximately $500 billion in tax increases and $200 billion in spending cuts were scheduled to take effect.

On January 1, 2013, after the White House and Congressional leaders failed to form a "grand bargain" that would address all the elements of the fiscal cliff, Congress cleared a mini-fiscal cliff package (*The American Tax Relief Act of 2012*) that extends current tax rates for most Americans; delays the automatic spending reductions – also known as sequestration – for two months; and fixes a number of expiring tax and spending provisions. The Senate passed the deal brokered by Vice President Biden and Senate Minority Leader McConnell (R-KY) by 89-8 and the House voted 257-167 for passage.

Since the deal only provides for a two-month delay in sequestration, coinciding with the expiration of the current Continuing Resolution on March 27, the Congress and the Administration must address both FY 2013 and long-term automatic cuts under sequester while having to address the problem of hitting the debt limit in late February or early March.

It is expected that entitlement reform, which was not included in the fiscal cliff deal, will be on the Congressional agenda this year as Republicans push hard for both spending cuts in discretionary and entitlement programs in dealing with the debt ceiling.

When the debt limit is reached depends on how much the federal government actually spends and taxes in the coming weeks. Most analysts think the next debt ceiling increase will be necessary around February 2013, and would need to be between $730 billion and $1.25 trillion in order to avoid reaching the debt ceiling for all of 2013. Even so, raising the debt ceiling between an additional $1.3 billion and $2.2 billion would be needed again in 2014.

THE AMERICAN TAX RELIEF ACT OF 2012 DETAILS

Tax Policy Changes:

- **Capital Gains and Dividends:** Made permanent – 15 percent top capital gains and dividends rate up to $400,000 (singles), $450,000 (married); 20 percent rate for both above threshold.
- **Estate Tax:** Created permanent extension of current policy on portability and unification with a $5 million exemption indexed to inflation and a 40 percent top rate.
- **Personal Exemption Phaseout (PEP) and Limitation on Itemized Deductions (Pease):** Adopted permanent relief from PEP and Pease under $250,000 (single), $300,000 (married).
- **Alternative Minimum Tax (AMT):** Permanently indexes AMT to inflation. The AMT was intended as a baseline tax for high earners, and if the AMT was not indexed to inflation, it would have impacted a number of middle-class taxpayers if not "patched" before next year.
- **Marginal Rates:** Created a permanent extension of current policy up to $400,000 for singles, $450,000 for married couples.
- **Tax Extenders:** This is the catch-all term that is used for tax breaks that need to be extended regularly. The Act adopts the package reported by Finance Committee in 2012, with a 2-year extension through 2013.
- **Temporary Payroll Tax Cut:** Allowed to expire, which raises the employee portion of Federal Insurance Contributions Act (FICA) or Social Security tax from 4.2 percent to 6.2 percent. The employer contribution remained at 6.2 percent.
- **Bonus Depreciation:** 1-year extension of 50 percent Bonus Depreciation.
- **Stimulus Tax Credits:** 5-year extension.
- **Deduction Cap:** There is no cap on deductions.

Spending Policy Changes:

- **Debt Limit:** No increase in the debt limit. It remains at $16.394 trillion.
- **Sequestration:** Sequestration is delayed for two months and paid for with a reduction in discretionary spending cap for 2013 and 2014, and expanding eligibility for Roth conversion.
- **Community Living Assistance Services and Support (CLASS) Act:** CLASS Act entitlement repealed.
- **Doc Fix:** One-year extension paid for by reducing Medicare spending. This policy, passed by every Congress for 15 years, but lapsing at the end of 2012, reverses temporary cuts that Congress passed as a deficit reduction measure in 1997. The cuts require that growth in provider payments not exceed growth in GDP.
- **Unemployment Insurance:** One-year extension of current extended weeks of Unemployment Insurance.
- **Farm Bill:** Provided for a one year extension of the Food, Conservation, and Energy Act of 2008 at no additional cost to the taxpayer.

POTENTIAL ECONOMIC IMPACT

The January 1, 2013, expiration of the temporary cut to the FICA, or Social Security payroll tax, will have a negative fiscal impact on the national and local economy. The increase will result in reduced wages for consumers to spend on home purchases and discretionary items such as retail goods, restaurant and bar sales, auto purchases, and amusement-related activities. All of these types of purchases have a direct correlation to City sales tax revenues.

To further compound the problem, any reductions in federal spending would eventually create a negative impact to businesses and federally sponsored public programs in Arizona. Specifically, in order for companies and federally funded programs to absorb the decreases in federal funding, reductions will likely be made in staffing levels resulting in job losses, less spending on commodities and materials, and reduced wages and investment. A 2012 study conducted by George Mason University in Virginia estimates that Arizona would lose nearly 50,000 jobs due to the federal cuts at risk in sequestration.

These actions will reduce resources available for spending and will negatively impact the local economy and city revenues.

INCOME TAX EXCLUSION FOR MUNICIPAL BOND INTEREST

One of the revenue enhancements still on the table is restricting or eliminating the income tax exclusion of municipal bond interest.

Taxing municipal bond interest would immediately increase borrowing costs for state and local governments by as much as two percentage points, which translates into a 25 percent increase in infrastructure costs over time. This would cause a significant decrease in infrastructure spending by states and municipalities, further slow the economic and jobs recovery nationally, and cost taxpayers and ratepayers billions of

dollars in higher interest costs each year. Even the possibility of altering the tax treatment on outstanding municipal bonds such as a 28 percent cap – essentially a retroactive tax – creates uncertainty and would have adverse effects on governments needing to access capital markets.

This uncertainty would have a chilling effect on infrastructure investments and jobs. The estimated $40 billion annual cost of the municipal bond interest exclusion leverages $400 billion in new infrastructure projects annually. Eliminating the exclusion would have far-reaching adverse and unintended consequences affecting jobs and infrastructure.

Over the next 12 months the Finance Department has plans to refinance debt for the Aviation, Transit, Water, and Wastewater funds with projected long-term savings of more than $140 million. The current low-interest-rate markets and high-quality credits ratings made these saving possible. If the tax exemption on municipal bonds is removed, interest rates will increase to a level that these refinancing savings would largely be eliminated. Even moving to a 28 percent cap on interest deductions is expected to reduce these savings by more than $35 million in the current market.

The U.S. Conference of Mayors and the National League of Cities have expressed to the White House and Congress that cities and towns oppose any limits to this critical tool.

SEQUESTRATION AND ITS IMPACTS

The term sequestration has been adopted by Congress in recent years to describe automatic spending cuts that are triggered by specific circumstances. Last August, bipartisan majorities in the House and Senate passed, and the President signed, the Budget Control Act of 2011 (BCA) creating a framework for reducing federal spending and raising the nation's debt ceiling in order to avoid default on the federal government's loan obligations. Specifically, the BCA called for spending cuts to occur in two phases. The first round happened as part of the Fiscal Year (FY) 2012 appropriations process. To find the second round of cuts - $1.2 trillion over the next 10 years - the BCA called for the creation of a Joint Select Committee on Deficit Reduction, a bipartisan committee of 12 members selected by the respective majority and minority leadership in the House and Senate.

Under the law, the Joint Select Committee, which became known as the "Super Committee," had until November 23, 2011, to reach agreement on the additional cuts and to refer this package of cuts to Congress for consideration. Sequestration was to take effect in January 2013 if the Super Committee failed to reach agreement on the second round of cuts.

These across-the-board cuts would be applied equally to non-defense and defense discretionary spending over the next ten years, with both categories being cut by a total of $54.7 billion each year. Overall, sequestration would result in a 9.4 percent cut in defense discretionary spending and an 8.2 percent cut in non-defense discretionary spending. Sequestration would also impose cuts of two percent to Medicare.

Transportation programs funded by the Highway Trust Fund, Social Security, Medicaid, and civil and military employee pay are exempt from sequestration.

Last November, after months of negotiations, Super Committee Co-Chairs Representative Jeb Hensarling (R-TX) and Senator Patty Murray (D-WA) announced that it was impossible for the Committee to reach agreement.

A report released by the White House Office and Management and Budget (OMB) estimated the impact of sequestration on more than 1,200 budget accounts, including programs important to cities and towns. They estimated that:

- The Community Development Fund, which includes the Community Development Block Grant, would be cut by $279 million; it is currently funded at $3.4 billion.
- The Choice Neighborhoods program would be cut by $10 million; it is currently funded at $120 million.
- The Home Investment Partnership Program (HOME) would be cut by $82 million; this program is currently funded at $1 billion.
- Department of Justice State and Local Law Enforcement Assistance Grants would be cut by $92 million; these grants are currently funded at $1.12 billion.
- The Community Oriented Policing Services (COPS) Program would be cut by $13 million; this program is currently funded at $162 million.
- Environmental Protection Agency State and Tribal Assistance Grants, which includes funding for the Clean and Safe Drinking Water State Revolving Funds, would be cut by $293 million; these grants are currently funded at $3.56 billion.
- The Department of Labor Training and Employment Services account, which funds job training programs, would be cut by $262 million; it is currently funded at $3.192 billion.
- FEMA State and Local Programs, which include Urban Area Security Initiative grants and the State Homeland Security Grant program, would be cut by $183 million; these programs are now funded at $2.2 billion.

Sequestration would also impact the subsidy bond market. According to the OMB's estimates, rebate payments on subsidy bonds authorized for FY 2013 would be reduced by 7.6 percent, totaling $255 million for the $181 billion in Build America Bonds issued between April 2009 and December 2010. A cut now will leave issuers on the hook to make the full interest payments without having budgeted for the money. However, most general obligation bond issuers budget to pay full debt service without accounting for receipt of the interest subsidies and most revenue bond issuers did not pledge the subsidies to bondholders. Instead, they use the subsidy to offset debt service costs once the subsidy is received.

Even if the proposed cut is not enacted, OMB giving voice to the possibility of retroactively reducing the federal subsidy will likely have a chilling effect on any future credit bond program.

CITY OF PHOENIX PROGRAMS

The total potential impact to the City of Phoenix under the on-going federal budget and debt limit debate is unknown. Direct federal aid to cities is only part of the potential loss. The sequestration in current law would force automatic cuts of 8.2 percent in non-defense discretionary programs that the City manages, such as Community Development Block Grants, COPS grants, numerous Human Services programs, and workforce training grants.

Another unknown is how the State of Arizona will react to cuts. Many federal grants are directed to the State, which then passes the funds to the City.

Listed below are summaries prepared by the Human Services Department, Neighborhood Services Department, Housing Department, and Community and Economic Development Department on potential impacts of sequestration under current law. These estimates do not account for the impact of potential tax cuts.

Human Services Department

Head Start Programs – As a result of sequestration, the City would lose $2,235,550 of its $27,262,819 grant. This would result in the loss of services for 253 Head Start children and 25 Early Head Start children. In addition, approximately 30 staff positions would no longer be funded.

Low Income Home Energy Assistance Program (LIHEAP) – As a result of sequestration, the U.S. Department of Health and Human Services has released 90 percent of the LIHEAP appropriation under the current Continuing Resolution (CR), which will expire March 27, 2013. This release results in a 34 percent cut, amounting to $3 million, affecting approximately 6,000 households per year compared to federal FY 2010.

Community Services Block Grant (CSBG) – As a result of sequestration, the City's CSBG allocation would be reduced by approximately $115,000, impacting over 200 low-income vulnerable households.

Social Services Block Grant (SSBG) – As a result of sequestration, the City's SSBG allocation would be reduced by approximately $54,000 of the $659,055 annual grant. This would impact the ability to provide services including emergency financial assistance and information and referral to 100 low-income vulnerable households.

Older Americans Act – As a result of sequestration, the City's Area Agencies on Aging (AAA) funding allocation would be reduced by over $209,000, impacting the ability to provide nutritionally balanced home-delivered meals to seniors and disabled adults. The loss of funding would reduce nearly 30,000 meals affecting more than 200 seniors. In addition, reduced funding of AAA throughout the state would impact their ability to provide services that include legal assistance, housekeeping and bathing services, and the ability to resolve long-term care issues.

Temporary Assistance to Needy Families (TANF) – As a result of sequestration, the City's TANF allocation would be reduced by over $87,000, impacting the ability to provide services including emergency financial assistance, and information and referral to over 153 low-income vulnerable households.

Homeless Emergency Assistance and Rapid Transition to Housing (HEARTH) Act - Sequestration would result in a decrease of $110,400 in Emergency Shelter Grants funding the City currently allocates for community based homeless programs, including the Watkins Emergency Shelter. Funding for homeless services at both the Watkins shelter and those to be funded from the pending Request for Proposals will be impacted. In total, an estimated 70 homeless clients would not receive services as a result of sequestration. Furthermore, sequestration would also result in community agencies receiving less federal funding from the Maricopa Association of Governments Continuum of Care funding and thus these agencies would be unable to provide critical services for homeless individuals, families, and unaccompanied youth.

Family Advocacy Services (FAC) – Sequestration would result in a decrease in funding to the FAC's community partners that provide counseling and long-term case management services. If there is a loss of these FAC-based partners, an estimated 445 victims of domestic violence will not receive long-term case management and 968 victims of domestic and sexual violence will not receive counseling service.

Neighborhood Services Department

Community Development Block Grant – Phoenix estimates that it will lose another $1.3 million (8.4 percent) of its FY 12-13 CDBG allocation as a result of sequestration. This will raise the total loss of federal funds to date to 37 percent and will have devastating impacts on services and the ability to leverage resources, as reflected in the following selected impacts:

Services to Vulnerable Populations
Total Potential Cuts for Phoenix: $170,000

- 850 elderly or disabled persons will lose basic human services such as transportation to medical care, home delivered meals, dental care, services to the blind, physical therapy, or homelessness prevention.
- 3,600 at-risk youth or children will not receive life-skills counseling, tutoring, day care services, or after-school nutrition. Programs providing outreach services and subsistence to youth living on the streets will have to curtail operations.
- 7,200 homeless persons including youth, elderly, and veterans will find themselves without shelter or food especially during the hot summer months or cold winter months.
- 150 children affected by domestic violence in their homes will not be able to find temporary emergency shelter.
- 250 tenants at-risk of eviction or homelessness or living in inhumane conditions will not be able to obtain counseling on tenant rights or basic assistance.

Housing Services for Low Income Residents
Total Potential Cuts for Phoenix: $600,000

- 120 families, elderly, or persons with disabilities will not receive emergency housing repairs such as air condition unit and water/sewer line replacements, plumbing repairs, or housing rehabilitation such as roof repairs and elimination of hazardous electrical or structural conditions in homes. Persons with disabilities will have less access to resources for ramps, roll-in showers and grab bars, and basic home modifications. Special needs populations will have fewer opportunities for affordable housing.

Business Technical Assistance and Neighborhood Commercial Rehabilitation
Total Potential Cuts for Phoenix: $122,000

- 4.5 jobs are estimated to be lost as a result of fewer resources for providing technical assistance to needy small businesses. The CDBG Management Technical Programs (MTA) provides specialized professional services to struggling small businesses to enable them to expand, resulting in the creation of jobs. Fewer resources will also be available for the EXPAND loan program for start-up businesses and for the neighborhood commercial revitalization façade program which is very effective in revitalizing businesses and neighborhoods in targeted areas.

Neighborhood Revitalization
Total Potential Cuts for Phoenix: $178,000

- 5,200 fewer graffiti sites will be painted over or removed. There will also be less paint and tools available to volunteers to help clean up their communities.
- 895 fewer homes with property maintenance problems will be issued notices of correction and provided information on property maintenance resources. This will lessen the ability of neighborhood associations to combat blight and the negative effects of the foreclosure crisis.
- 4,400 residents in target areas will not receive neighborhood revitalization services including organized community clean-ups, community safety programs, information and referral services, block watch, and crime prevention.

Public Facilities, and Improvements and Infrastructure Projects
Total Potential Cuts for Phoenix: $60,000

- Ten public facility, parks, or infrastructure projects will have their funding reduced which may jeopardize the viability of some of these projects. Food banks, community centers, and non-profit groups serving seniors, disabled, youth, and domestic violence victims rely on these funds for renovation and repairs to their centers. Older areas of the City rely on CDBG for improvements to aging parks and infrastructure.

Program Management and Administration
Total Potential Cuts for Phoenix: $170,000

- Two jobs and operating expenses are estimated to be lost as a result of sequestration, reducing resources available to properly monitor projects to assure completion of goals in compliance with applicable regulations. The cuts will reduce the operating infrastructure needed to efficiently manage programs and generate the partnerships/leveraging needed for program success.

Housing Department

Sequestration would have a devastating impact on housing programs the City administers for low-income families. The proposed 8.2 percent reduction in funding would have the following affect on Housing Department programs:

Public Housing Programs – Proposed reductions represent an 8.2 percent reduction in Public Housing Operating Subsidy funds, or about $656,000. Last fiscal year the Operating Subsidy was offset (reduced) by $3 million to force use of operating reserves. Nationally, the offset was almost 20 percent of the Operating Subsidy for all PHAs. Under a CR or sequestration, the national Operating Subsidy will be drastically cut, perhaps even to about 70 percent of the needed funds. If the offsets are directed to housing authorities with reserves as they were last year, then combining the Phoenix offset and sequestration, the City could see a 45 percent cut in its operating subsidy, or $3.7 million. The operating reserves on-hand would be completely depleted. There is no off-setting decrease in compliance and service mandates.

Capital Fund Program (CFP) – Continued cuts to Capital Fund Program dollars makes it nearly impossible for the Housing Department to make the necessary capital improvements to its aging housing stock. The Housing Department would be forced to continue to defer maintenance and only address a few repairs amongst a variety of competing needs.

Section 8/Housing Choice Voucher Programs (HCV) – An 8.2 percent reduction in Section 8 Housing Assistance Payments (HAP) funding is a reduction of $3.6 million or 407 units. While the department currently has a substantial reserve in place, estimated HUD funding for FY 2013 would only be enough for 5,319 units while current voucher leasing is at 5,526 units. This represents a shortfall of funding for 643 units. At the end of 2012, HAP reserves were projected to be $5 million. It will take only 10.5 months of operations at the current level to exhaust the HAP reserves that support the City's HCV recipients. Proposed options for managing such a cut would be to discontinue issuance of vouchers, thus reducing voucher issuance by 24 families per month, or denying any requests for rental increases from Section 8 landlords. With approximately five approvals granted a month, ranging between $50 and $100, ceasing rental increases could save up to $3,000 over a six-month period. Additionally, aggressively terminating families for non-compliance instead of working with them could realize more than $150,000 over a six-month period. Ultimately, it could be necessary to terminate families in the program to balance the program costs and maintain a necessary reserve

for emergencies. Administrative fees are currently prorated at 80 percent and this proration is expected to continue through 2013. If sequestration is also applied the administrative budget will be impacted by a 25.9 percent reduction, or a shortfall of $74,163 per month.

Community and Economic Development Department

Workforce Investment Act (WIA) funding is formula-based (Adult, Dislocated Worker, and Youth). Estimated reductions to the Phoenix Workforce Connection programs as a result of pending sequestration are based on current allocation amounts as follows:

SEQUESTRATION IMPACTS TO THE CITY OF PHOENIX	Current Allocation	8.2% Reduction	Reduced Allocation
Adult	$ 3,122,342	($256,032)	$ 2,866,310
Dislocated Worker	$ 4,091,119	($335,472)	$ 3,755,647
Rapid Response	$ 433,177	($ 35,521)	$ 397,656
Youth	$ 3,413,647	($279,919)	$ 3,133,728
TOTALS	**$11,060,285**	**($906,944)**	**$10,153,341**

Possible impacts to the Phoenix Workforce Connection system could include:

- Adversely impact the number of customers receiving services;
- Adversely impact the ability to meet the increased need for support services for customers;
- Jeopardize the number of One-Stop Center sites currently operated with WIA funds;
- Possible loss or reduction of the number of Adult Program and Youth Program Subcontractors;
- Jeopardize the services provided to businesses;
- Jeopardize the One-Stop System's ability to increase training in high-wage, high demand occupations (for example, 82 fewer people will receive training and the workforce training budget will be reduced by approximately $480,000);
- Further reduce the ability to maintain equipment for self-service customers;
- Significantly reduce the overall amount and scope of services provided to businesses and individuals through the One-Stop system.

TOTAL POTENTIAL SEQUESTRATION IMPACTS TO CITY DEPARTMENTS

Human Services	Approximately $ 5,810,950
Neighborhood Services	Approximately $ 2,600,000
Housing	Approximately $ 4,256,000
Community and Economic Development	Approximately $ 906,944
TOTAL	**Approximately $13,573,894**

RECOMMENDATION

Staff continues to monitor federal policy changes and their impacts to the City. This report is for information and discussion; no Council action is requested.