NATIONAL UNIVERSITY SYSTEM
INSTITUTE FOR POLICY RESEARCH

Policy Brief

FALLING OVER "FISCAL CLIFF" WOULD PUSH SAN DIEGO BACK INTO DEEP RECESSION

On December 31, 2012 a number of federal tax cuts will expire, including changes to income tax brackets and rates, changes to the Alternative Minimum Tax (AMT), special treatment for capital gains, increases in Earned Income Tax Credits and reductions in the "marriage penalty" for joint filers.

In addition, due to a Congressional budget impasse following the signing of the Budget Control Act of 2011, the federal government now faces the prospect of automatic across the board budget cuts ("sequestration") in a large number of domestic and defense programs.

While there seems to be a sense of urgency among federal policymakers, time is growing short to avoid what many are calling a "fiscal cliff." Closely divided government and deep ideological differences make resolution of this problem far from certain.

The National University System Institute for Policy Research (NUSIPR) examined three federal policy changes and estimated their impact on San Diego.

A) Using IRS and Bureau of Labor statistics, as well as tax models from the Tax Policy Institute, NUSIPR estimated the impact on San Diego County Taxpayers to the expiration of the "Bush-era" tax cuts as well as failure to "patch" the AMT to reduce its impact on middle-income taxpayers.

B) Using the Consolidated Federal Funds Report (CFFR), data from the Office of Management and Budget, and recent policy pronouncements from the White House, we estimated the impact of sequestration on non-defense federal spending in San Diego County.

C) Using data from the CFFR, Bureau of Economic Analysis, and the Bureau of Labor Statistics, we estimate the impact on defense expenditures in San Diego County. There has been relatively more specificity in this area, providing for a more accurate forecast of possible impacts on San Diego.

BOTTOM LINE:

A failure to reach resolution of these various policy positions would have a significant impact on the San Diego economy.

Tax Increase:	$ 2.8 to $3.5 Billion
Reduced Domestic Spending:	$ 481 Million to $761 Million
Reduced Defense Spending:	$ 1.1 to $1.7 Billion
TOTAL IMPACT OF THE FISCAL CLIFF:	$ 4.3 to $5.9 Billion

As way of context, in 2011 the San Diego economy grew an estimated 3.9 % or $6.7 billion. NUSIPR's current forecast is for Gross Metropolitan Product to grow in 2012 by 3.7 % or $6.5 billion. If no policy solution is reached in Washington, the net impact of the increases in taxes and decreases in spending would result in a return to recessionary contraction in the regional economy. Note that this does *not* take into account the degree to which federal spending would have a multiplier effect on the economy, likely understating the negative impact this dramatic and sudden reduction in spending would have on San Diego.

NUSIPR does believe that federal deficits are at levels that are unsustainable. However, a dramatic increase in taxes at the same time as a dramatic decrease in expenditures is likely to have such a shock on the economy as to send us back into recession.

Methodology

Expiration of Bush Era Tax Cuts

In January 2013 several significant tax cuts will expire, including reductions in payroll taxes, tax cuts tied to the stimulus such as increase in child tax cuts and the earned income tax credit and tax credits tied to promoting more sustainable forms of energy.

Also expiring, and the most debated, are the so called "Bush-era" tax cuts, a set of policies enacted in 2001 and 2003. They notably include cuts to marginal tax rates, increases in child tax credits, the ending of the so-called "marriage penalty" for joint filers and several other tax credits and deductions. At the heart of most of the debates over tax policy in Washington in 2012 has been whether to extend these cuts for all Americans, whether to limit their extension to families making less than a certain amount of adjusted gross income, or to allow them to expire.

To estimate the estimated impact in 2013 in San Diego County we used a model from analysis conducted by the Tax Policy Center, a joint project of the Brookings Institute and the Urban Policy Institute. They have calculated the average impact on households at different income levels from allowing the 2001 and 2003 tax cuts to expire and not extending the AMT "fix" for 2013. (Table T10-0133). We then mapped the income categories used by the Tax Policy Center onto an estimated distribution of household incomes for San Diego County. We then multiplied the average tax impact by an estimated number of households. This methodology resulted in a $ 2.8 billion projected impact on San Diego taxpayers from the expiration of the cuts.

The Heritage Foundation has conducted an analysis similar to the one we have for each Congressional district that existed PRIOR to 2010. For ALL of the tax cuts expiring at the end of 2012 they found an aggregate impact on the five congressional districts encompassing San Diego County of $6.14 billion. They also estimate that the Bush Era Tax Cuts and the AMT would comprise approximately 68% of the total amount. Excluding those parts of Riverside County that were part of the 59th Congressional district and the parts of Imperial County that are in the 51st district, the methodology used by Heritage indicates approximate a $3.8 billion impact on San Diego County. To err on the side of being conservative, we chose the lesser amount.

The United States has a progressive income tax meaning that the higher a taxpayer's household income the greater percentage of income, all other things being equal, is paid in the form of income tax. Thus changes in income tax policies typically have their greatest impact (both positive and negative) on higher wage earners. This is the case with discussions over the Bush Era tax policies. For example, 75% of the impact of the expiration of the tax would fall on San Diego households making more than $104,000. We estimate that those making between $104,000 and $168,000 would pay, on average, an additional $3,600 in federal taxes. For those San Diego households making more than more than $550,000, expiration of the tax cuts would see their taxes rise by more than $62,000 according to the Tax Policy Center's model. In contrast, for families making less than $21,200 expiration of the taxes would cause their tax liability to rise by only $45. We estimate that in 2013 San Diego will pay, in total $27.3 billion in federal taxes (includes payroll, estate, excise, and income taxes).

Finally, we do not attempt to calculate in this policy brief the indirect impacts on the economy as taxpayers cut back on purchases because of reduced after-tax income and as they took steps to alter their household incomes to reduce their tax burden (for example, by realizing capital gains in 2012 under lower rates than waiting until 2013 when the tax rate paid on capital gains by most taxpayers would increase).

Impact of Sequestration on Non-Defense Spending

Sequestration will significantly impact funding for non-defense federal programs and services that are used by everyday San Diegans, including public schools, national parks, and community health clinics. Popular programs such as Head Start and Job Corps are not spared from sequestration. Even departments for politically entrenched entitlement programs, which are mostly shielded from future reductions, will still be subject to "administrative" cuts which will likely result in longer processing times, greater backlogs of recipient claims, and fewer customer service representatives.

Important policy distinctions exist among federal expenditures that affect how we conducted our fiscal analysis. Non-defense federal spending in San Diego County is broken into two main categories – entitlements & discretionary programs. While generally most entitlement programs are exempt from sequestration, and discretionary programs are subject to it, this is not always the case. Under special rules set forth by Sections 255 and 256 of the Balanced Budget and Emergency Deficit Control Act of 1985 (BBEDCA), some government programs such as individual Social Security payments are exempt from sequestration, while other capital outlays, such as veterans' medical care, are subject only to 2% cuts, lower than the anticipated across-the-board figures.

To determine the impact of sequestration on non-defense federal spending in San Diego, NUSIPR first obtained the most current state-based financial data from the Consolidated Federal Funds Report (CFFR) website. San Diego County-specific records were then selected out from the database. We found that in 2010, $28.7 billion was disbursed for non-defense federal programs and services in San Diego County.

Among the largest federal entitlement programs in San Diego for 2010 included Social Security payments ($3.5 billion) and home mortgage insurance loans ($3.2 billion). Next, we labeled disbursements by federal agency and program using CFFR coding files. Countywide, federal expenditures are categorized under 154 unique agency budget codes and 407 program codes.

Individual expenditures were then divided (to the greatest extent possible) into five main categories: defense-related spending; non-defense discretionary spending; non-defense discretionary spending that is subject to Section 256 sequestration restrictions; non-defense discretionary spending that is exempt from sequestration under Section 255; and non-defense mandatory spending. Defense-related spending was removed from the sample. Remaining expenditures were adjusted to the estimated 2013 spending levels using categorical outlay growth figures found on the Office of Management & Budget website.

To estimate the range of sequestration cuts in San Diego, we conducted a literature review on the topic. The Center on Budget and Policy Priorities (CBPP) estimates that sequestration will result in an 8.4% across-the-board reduction in most non-defense discretionary programs, a figure which we used as the basis for our low-end for potential cuts. However, the Center for American Progress (CAP) notes that while the fiscal year 2013 begins on October 1, 2012, sequestration would not be implemented until January 2, 2013. As a result, CAP suggests some programs may have to increase their cuts to 11.3% - 13.3%, in order to achieve the total budget reduction within a nine month timeframe. Thus, NUSIPR adopted the 13.3% figure for our higher cut threshold. We project that non-defense expenditures in San Diego county will total $31.5 billion in 2013.

Impact of Sequestration on Defense Spending

The pending fallout from federal defense expenditures cutbacks will have particularly devastating impacts for San Diego. As the nation's largest metro area for military personnel, base operations, and income, San Diego has the most to lose from military spending cutbacks. The region also has significant defense contracting work totaling multi-$billions among private San Diego companies providing aerospace, shipbuilding, computers, electronics, communications, other R&D, services and supplies.

In total, defense spending directly accounts for 14% of San Diego's GDP. Including multiplier impacts from indirect and induced spending, the total approaches 25% or $1 in every $4 generated by the local economy.

If defense cuts occur across-the-board in 2013, proportional reductions in funding provided by appropriations bills will include funding of war costs and unobligated balances carried over from prior years. For 2014-2021, the cuts would occur through reductions on statutory caps of total defense funding as the Appropriation Committees decide how to allocate allowed funding.

In 2013, the one year in which the cuts affect already appropriated defense funding, the President is likely to exempt some or all *military personnel funding* from the sequestration (President Obama has indicated he will not allow personnel funding to be reduced). By the extent that option is implemented, cutbacks among other defense funding will necessarily be increased. Also shielded from "sequestration" are veterans benefits. This is particularly significant for San Diego because these two categories, military personnel and veterans benefits, account for substantial amounts distributed within the region. The total amount San Diego received in 2011 was $12.6 billion.

The Center on Budget and Policy Priorities (CBPP) estimates sequestration will result in a 9.0% across-the-board reduction of defense programs if military personnel funding is exempted, including war funding and unobligated balances. Only 7.0% would be cut if personnel funding is not exempt. The impact on San Diego, however, is actually greater if military personnel funding is not exempted because local base operations are so substantial.

If the 9.0% cutback of defense programs budget is equitably implemented across the defense budget, San Diego loses $1.1 billion. If personnel funding is not exempted, San Diego loses $1.7 billion. In 2013 we estimate that there will be $23.7 billion in DoD expenditures in San Diego County.