City of Alexandria, Virginia

MEMORANDUM

DATE: AUGUST 25, 2011

TO: THE HONORABLE MAYOR AND MEMBERS OF CITY COUNCIL

FROM: BRUCE JOHNSON, ACTING CITY MANAGER

SUBJECT: UPDATE ON FEDERAL DEFICIT REDUCTION ACTIONS, CREDIT RATING AGENCY ACTIONS AND INDIRECT EFFECTS ON THE CITY

In an August 1, 2011, memorandum to City Council titled "Direct Effects of Federal Debt Ceiling Crisis and Deficit Reduction Issues on the City," staff focused on the City's direct exposure in the event that a failure to raise the debt ceiling led to temporary federal liquidity issues and/or the downgrading of the nation's credit rating; and/or a debt ceiling/deficit reduction agreement included significant cuts in federal aid to local governments.

This memorandum serves three purposes:

- It provides an update on the debt ceiling agreement adopted by Congress and the President to reduce the federal deficit;
- It discusses actions taken by the credit rating agencies to date; and
- It discusses, as promised in the previous memorandum, the indirect economic and fiscal effects on Alexandria of potential credit rating downgrades and the federal deficit reduction plan adopted as a *quid pro quo* for raising the debt ceiling.

A third separate memorandum will present the arguments we plan to use with the rating agencies to defend our current AAA/Aaa ratings.

EXECUTIVE SUMMARY: This memorandum presents City Council with a cautious outlook that paints a picture of considerable uncertainty and the risk of potential significant long-term fiscal impacts if the worst case scenario turns true. The indirect effects described in this memo could pose challenges for the years ahead. However, most of these indirect effects would be delayed and become apparently only beginning in FY 2013. Of course, the magnitude of the impacts will depend greatly on the type of expenditure reductions taken by the federal government and the response of the economy. Certain options may impact the Washington area more than others that would be more spread out over the entire nation.

During the recession, City Council made the difficult short- and long-term changes needed to balance the budget and ensure long-term fiscal stability, with reserves at or above fiscal guidelines. As a result, the City has sufficient liquidity and budgetary flexibility to address these fiscal challenges head on. It also has demonstrated the ability to make adjustments in spending and revenues to balance the budget quickly and decisively. Staff will closely monitor budgetary and economic indicators to anticipate the severity of any longer-term effects and prepare options to respond to them in a timely fashion, whether during the regular budget cycle or mid-year as in FY 2009.

Our immediate recommendation is going to be to keep any surplus generated in FY 2011 from lower-than-budgeted expenditures and higher-than-previously-anticipated revenues as a reserve for future contingencies that may arise from either national economic or federal budget political uncertainties. The size of that additional surplus will be known shortly.

DEFICIT REDUCTION: On August 2, Congress passed a $2.1 trillion increase to the debt ceiling and a deficit reduction, which includes:

- Immediate 10-year discretionary spending caps for federal agencies (both defense and non-defense) that are expected to cut close to $1 trillion over the next decade. (These caps call for reductions of about 4.0 percent in discretionary federal programs initially, gradually increasing to 8.8 percent by FY 2021. See Table I.);
- The creation of a bipartisan, bicameral committee tasked with planning an additional $1.5 trillion in deficit reduction over 10 years through expenditure reductions, tax increases or both by the end of 2011;
- Automatic reductions of $1.2 trillion split evenly between defense and non-defense spending (excluding Social Security, Medicaid and low-income programs) and effective in 2013 that will be triggered if the committee fails to reach agreement by the end of this year.

Table I: Deficit Reduction Effects
(Budget Authority by Federal Fiscal Year, in Billions)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-2021
Adjusted March 2011 Baseline	1,087	1,109	1,134	1,159	1,186	1,218	1,251	1,285	1,319	1,353	12,099
Proposed Caps	1,043	1,047	1,066	1,086	1,107	1,131	1,156	1,182	1,208	1,234	11,260
Effects Relative to Baseline	-44	-62	-68	-73	-79	-87	-95	-103	-111	-119	-840
Percentage Change	-4.0%	-5.6%	-6.0%	-6.3%	-6.7%	-7.1%	-7.6%	-8.0%	-8.4%	-8.8%	-6.9%

Additional budget reductions made by the bipartisan, bicameral committee established through this plan would not take effect until federal FY 2013 and cannot be predicted based on current information. It is important to note that these "cuts" from current services represent a slowdown in the anticipated rate of increase for federal spending, not a decline in total spending. While federal spending may still increase over the ten year period, the spending increase would be slightly less than the rate of inflation meaning a real dollar reduction in the buying power of federal spending. Also, the exact cuts by federal departments and programs will not be decided until the appropriations process runs its often delayed course. So, it may not be until the spring of next year that we know the specifics of federal FY 2012 budget reductions or the late winter of next year or spring of 2013 when we know the reductions for federal FY 2013.

In addition to what is included in this agreement, it is important to note that the agreement does not include renewal of the payroll tax holiday or federal unemployment benefits, both of which are set to expire at the end of calendar year 2011. These two programs are expected to provide $150 billion in economic stimulus in calendar year 2011, which may not be available in 2012 if these programs are not renewed in separate legislative action. President Obama's administration has indicated that, after Labor Day, it will propose countercyclical fiscal actions to spur the economy and job growth.

CREDIT RATINGS: In the coming weeks and months, City staff will be working with Moody's (and perhaps S&P if necessary) on its review of the City's bond rating. No immediate changes are expected in our ratings.

On August 5, Standard & Poor's (S&P) downgraded the nation's credit rating from the top AAA rating, which the U.S. has held since 1917, to S&P's second highest rating of AA+ and has indicated that a second downgrade is possible if the congressional deficit reduction committee does not meet its November deadline. On August 18, S&P announced that it may lower municipal credit ratings in November, after the deficit commission and/or report deadline. In light of recent statements by S& P affirming that "U.S. public finance is among the most stable and predictable in the world," there is a significant probability that many AAA-rated municipalities may keep their top ratings despite the nation's lowered credit rating.

On August 2, Moody's Investor Services announced that it had reaffirmed the nation's Aaa rating but assigned it a "negative outlook." On August 4, Moody's announced that the Commonwealth's Aaa credit rating had been reaffirmed but assigned a "negative outlook" as well due to the state's dependence on federal jobs and spending. Moody's also announced that the City of Alexandria's Aaa credit rating, along with those of the six other Aaa-rated Northern Virginia jurisdictions, is among the 161 local government credit ratings reaffirmed at Moody's top Aaa rating but assigned a "negative outlook" because of these localities' indirect and direct financial and economic relationships with the federal government. This current rating action was based on the characteristics that these local governments shared **as a group** and will be followed by separate case-by-case reviews of each affected jurisdiction within 90 days of the announcement.

On August 16, citing the nation's "pivotal role in the global financial system and the flexible, diversified and wealthy economy that provides its revenue base," Fitch Ratings affirmed the nation's AAA credit rating and stated that it did not anticipate a downgrade in the near future. Regarding state and local ratings, Fitch has stated that they "are not capped by the U.S. rating, reflecting their extraordinary autonomy, discrete powers and responsibilities, and possession of their own independent taxing authority." To date, the City has not felt the need to receive a third bond rating from Fitch; although that could change.

In spite of S&P's downgrade, Treasury yield rates have fallen to historic lows, due primarily to volatility in the stock market and domestic and international investors viewing U.S. Treasuries as "safe haven" investments. The S&P downgrade could contribute eventually to increases in future borrowing costs for both the nation and private borrowers which may have a trickle-down effect on municipal borrowing rates. This outcome is unlikely at this time. Potential downgrades to the Commonwealth's and City's credit ratings may negatively affect future borrowing costs more quickly, although only modestly as there is not much difference between AAA and AA-rated bond interest rates, all other things being equal, and some institutional investors may ignore downgradings that were based on political and economic theory rather than actual experience.

INDIRECT EFFECTS: The federal government and credit rating actions described above will have various short- and long-term indirect effects on the City's economy, budget and financial condition, which this memorandum will cover in seven broad categories: general economic conditions; revenues from the Commonwealth; direct federal government employment and spending; property values and taxes; business and consumer demand; effects on hotel revenues; and social services expenditures.

Alexandria-based national real estate forecasting firm Delta Associates (whom often works with Dr. Stephen Fuller at GMU) recently issued a report (Attachment I) on the impact of federal spending on the Washington, D.C. regional economy and concluded that the likely future federal reductions, while having a negative impact on the regional economy, would result in a tempering of the rate of growth of the economy and would not trigger a decline in the region's economy. While this seems optimistic, its source is credible and, even if it is overly optimistic, means that any decline is likely to be small instead of material.

For quick reference, Attachment II provides a summary guide to select revenue categories and the risks posed to collections/receipts. Attachment III provides a historical comparison between federal spending and certain select indicators.

General Economic Conditions

At this time, economists from JP Morgan Chase and Deutsche Bank estimate that the discretionary spending caps, combined with the expiration of the payroll tax holiday, federal unemployment benefits and American Reinvestment and Recovery Act programs, will reduce 2012 GDP growth by 1.5 percentage points. A loss of 1.5 percentage points of growth in 2012 could stall or reverse the economic recovery. The City's local economy generally fares better than the regional and national economies during economic crises; however, if the federal deficit reduction plan and program expirations induce a second "double dip" recession, the City can expect across-the-board negative impacts on revenues.

Revenues from the Commonwealth of Virginia

Since the Commonwealth can withdraw funding at any time, cutbacks could occur within 2012; however, since budgetary effects on the Commonwealth are likely to be staggered, the most serious funding decreases, if they occur, can be expected in FY 2013 or later. Revenues from the Commonwealth can be indirectly affected in two ways: State budget cuts due to federal budget cuts or increased borrowing costs from a credit rating downgrade and decreased federal pass-through revenues. Table II shows budgeted FY 2012 revenues from the Commonwealth for the City and the Schools.

Table II: Commonwealth Revenues

Type of Funds	Amount	Percentage of All Funds Budget
City Intergovernmental	$43.5 million	6.2%
City Grants	$21.7 million	3.1%
Total City	**$65.2 million**	**9.3%**
Schools Intergovernmental	$26.5 million	11.4%
Schools Grants	$ 3.3 million	1.4%
Total Schools	**$29.8 million**	**12.8%**

In addition to the funds above, the City and the Schools receive federal pass-through revenues ($4.1 million and $11.3 million, respectively) that are passed through Commonwealth agencies before being allocated to the City and may be further reduced as a result. In the event of cutbacks in Commonwealth funding to the Schools, the School Board would need to work with City Council to resolve any budgetary issues that may arise. Attachment III has more details on Commonwealth revenues received by the City.

Direct Federal Government Employment and Spending

Three groups will bear the brunt of cuts to direct federal government employment and spending: City residents employed by the federal government; City workers employed by the federal government and City federally-dependent organizations; and City businesses and organizations that receive federal dollars.

City Residents

There is no specific data available for the number of City residents who work in federally-dependent businesses and organizations. However, according to a June 2011 report from George Mason University, federal spending accounts for 35 percent of the gross regional product of the Washington Metropolitan Area, so cuts to federal spending depending on how the cuts are structured could have a significant impact on the regional labor market in which City residents compete for jobs.

Table III shows the role that federal employment plays in the total personal earnings[1] and income[2] of City residents, based on 2009 data[3].

[1] Earnings include contributions for8 government social insurance, wage and salary disbursements, supplements to wages and salaries and proprietors' income.

[2] Personal income includes earnings, rental income, personal dividend income, personal interest income and personal current transfer receipts, minus contributions for government social insurance.

[3] Federal Bureau of Economic Analysis; Statistical methodology determines the earnings and personal income of Alexandria residents by adjusting at a gross City-wide level for net earnings and income of those people who live and work in neighboring jurisdictions. The federal civilian and military employee earnings and income represent workers in Alexandria, not necessarily Alexandria residents. Those figures are not adjusted for place of residence separately but only as a part of a gross City-wide adjustment of all earnings and income.

Table III: Federal Employment

	Amount	Percentage of City Total
Personal Earnings	**$2.8 billion**	**28.3%**
Civilian	$2.2 billion	22.1%
Military	$0.6 billion	6.2%
Personal Income	**$2.4 billion**	**22.3%**
Civilian	$1.9 billion	17.4%
Military	$0.5 billion	4.9%

*Source: Bureau of Economic Analysis

Federal budget cuts could lead to staff reductions at federal agencies, federal contractors and other organizations that receive federal funds (such as nonprofit organizations, healthcare facilities and hospitals). These staff reductions could result in a decline in City residents' total personal income, which would be partially offset by pension payments, unemployment and other income replacement programs. However, if past history is a guide, federal agency headquarters staff reductions are likely to be minimal with a focus on attrition and slower position growth in lieu of layoffs. This decline could translate to a decrease in consumption-related tax revenues, an increase in tax delinquencies for newly unemployed residents, and an increase in demand for social services.

City Workers

It is unlikely that cuts to federal spending alone will result in substantial declines in current City employment levels, but there may be some effect. According to Virginia Employment Commission (VEC) data for the fourth quarter 2010, the federal government civilian employment (excludes uniformed military) currently represents 13,816 or 14.4 percent of all jobs in the City. Since the City is expected to gain an additional 6,400 federal employees in calendar years 2011 and 2012 as Mark Center opens, federal employment may make up as much as 19 percent of City employment by the end of 2012, and will certainly greatly offset any federal employee reductions. Fortunately, the U.S. Patent and Trademark Office (PTO), which employs approximately 8,000 or 58 percent of the 13,816 federal employees currently working in the City, is fee-funded and therefore, may be largely unaffected by federal budget cuts. In fact, PTO has been planning on expanding its workforce to handle a substantial patent applications backlog. Excluding PTO, federal employment now makes up 6.6 percent of City employment. We have no specific data on the number or percentage of City workers who are employed by federally-dependent businesses and organizations.

As shown in Attachment III, the City's employment levels have been fairly resilient to significant declines in federal spending[4] in Alexandria in FY 2008 and FY 2009.

While non-residents who work in the City do not pay most City taxes, they do tend to dine, shop and park in the City. So, reductions in the Alexandria based federal work force could result in a

[4] Federal spending includes grants, contracts, and salaries and wages. Grants include funding for both public and private entities.

loss of consumption-related tax revenues as well as parking meter and garage receipts. The City may also experience increased public transportation costs to offset revenue losses from decreased fare collections.

City Businesses and Organizations

Cuts to federal contracting, grants and subsidies will translate in decreases in business-related tax revenues, but these affects can be expected to be delayed. For-profit City businesses that receive federal funds are sources of business license (BPOL) taxes and business personal property (BPP) taxes. BPOL taxes in FY 2012 are estimated to be $31.8 million or 4.6 percent of the budget; BPP taxes are estimated in FY 2012 to be $16.9 million or 2.5 percent of the budget. Federally-funded not-for-profit organizations are generally exempt from BPOL taxes, but most do pay BPP taxes.

Since BPOL taxes are based on gross receipts from the prior calendar year and current federal contracts could be expected to continue for some time before winding down, the City should not experience any significant decline in BPOL revenues until FY 2013 and subsequent fiscal years. BPP taxes are based on the assessed value of all business personal property located in the City as of January 1 of the current calendar year, so FY 2012 revenues will not be affected as much as FY 2013. However, if federal budget cuts discourage federally-dependent businesses and organizations from purchasing new machinery and equipment, the City can expect BPP collections for FY 2013 and subsequent years to be affected. We do expect the ongoing uncertainty of the federal budget situation to have a dampening effect on federal contract awards, amendments and renewals in FY 2012. This will negatively impact all City business tax categories in FY 2012 to an unknown degree.

The three categories above reflect the primary indirect effects that can be expected from federal budget cuts. The categories that follow reflect secondary indirect effects that can be expected if the anticipated effects above take place **and/or** other potential economic factors, such as a credit crisis spreading to the U.S. from Europe, come into play and exacerbate overall financial and economic conditions.

Property Values and Taxes

Real property taxes produce the lion's share of City revenues, comprising $321.7 million or 57.6 percent of the City General Fund Budget. Real estate transactions on which assessments will be based are already set for the first half of FY 2012, so there will be very limited impacts on the next year's assessments. It is unlikely that the current real property value trajectory will change much prior to January 1 or fully offset calendar year 2011 increases that have already occurred in the market place. Declines in real estate values, if they occur, may not occur until calendar year 2013 or later. Historically, real estate assessments lag changes in economic trends. As an example, although the real estate market correction began in 2006 and worsened in 2007, City real estate assessments on taxable properties remained flat between 2007 and 2008 and declined by only 2.1 percent in calendar year 2009. Assessments dropped significantly (7.7 percent) in calendar year 2010 but were up by 2.6 percent at the beginning of this calendar year. In the

FY 2012 budget, staff forecasted that real property assessments would increase by 2.73 percent in 2012. Early indications are that real estate assessments will exceed that forecast.

The downgrade of the nation's credit rating could lead to higher interest rates and lower property values, but only in the long term. The immediate impact on interest rates of both the credit downgrade and economic uncertainty generally has been a "flight to safe haven investments" that has driven yields on U.S. Treasuries and other high grade bonds downward to historic lows. These lower interest rates have driven mortgage rates to their lowest recorded levels in turn. The Federal Reserve has also recently indicated that it plans to hold interest rates low for two years into 2013. By itself, that should keep the real estate market healthy. The risks to the City's real estate market now appears to be more from (1) a European banking and credit crisis spreading to the U.S. or (2) a major shift of secondary mortgage market away from Freddie Mac or Fannie Mae without adequate alternatives being in place. Changes in the "jumbo" mortgage caps could also have a negative impact. If such a crisis did fully develop in Europe and spread to the U.S., the effects could be higher monthly payments on variable rate mortgages, which could lead to decreased sales that would weaken the market and suppress real estate assessments. More worrisome would be the proposed elimination, phase out or capping of the home mortgage interest deduction, which, if enacted by the federal deficit reduction "Super Committee" and Congress, would certainly negatively impact home values.

Higher interest rates could also make auto loans more expensive, weakening the automobile market and suppressing the vehicle assessments upon which personal property taxes are based, but the effect would be delayed. Taxes on personal vehicles total $16.7 million or 2.4 percent of the FY 2012 budget. Assessments for calendar year 2011 are already set and it is unlikely that 2012 assessed values will show a decrease. Therefore, the City will probably not experience a decline in personal property assessments until at least calendar year 2013, affecting FY 2014. As an example, although the last recession began in FY 2008, vehicle personal property tax assessments did not decline until FY 2010.

Since real estate and personal property taxes are based on assessed value, without any change in tax rates, the City could then expect lower real estate and personal property tax receipts. However, if and/or when real estate and vehicle personal property values do stagnate or decline, City Council has the option of increasing tax rates to mitigate any effect on tax receipts.

Since recordation taxes are more sensitive to variable market conditions, declines may begin during calendar year 2012 (second half FY 2012 or first half FY 2013). However, at the moment, recordation tax revenues have not been affected. The City's recordation tax rate is limited to a portion of the Commonwealth's rate, so City Council would not have the option of increasing the tax rate unless the General Assembly permits a higher tax rate. However, since estimated recordation tax receipts for FY 2012 total $3.8 million and are only 0.6 percent of total City revenues (All Funds Budget), any declines should not have any significant effect on City finances.

Business and Consumer Demand

Higher interest rates and economic insecurity would place downward pressure on demand and by extension, consumption-related tax revenues, business license tax revenues, and business personal property tax revenues. If interest rates rise due to economic turmoil abroad or at home or, in the long term, the federal credit rating downgrade, both businesses and consumers can expect to face higher borrowing costs for bank loans and credit card purchases. Economic insecurity and a lack of confidence may also lead both businesses and consumers to cut back on spending. As explained earlier, the effect on FY 2012 business license and business personal property tax revenues, if any, would probably be very slight; however, the City could experience a larger dip in these tax categories in FY 2013 under certain circumstances. Consumption-related taxes, such as sales taxes ($24.2 million or 3.5 percent of the budget) and restaurant meals tax revenues ($16.3 million or 2.4 percent of the budget), would be affected sooner and could begin declining within FY 2012.

Hotel Revenues

The Alexandria Convention and Visitors Association estimates that 30 percent or more of the City hotel business is dependent on federal government-related activities. So, any drop in the federal government per diem and/or drop in government sector demand for hotel/motel rooms would affect hotel revenues. The City's transient lodging tax, which is paid by federal contractors but not federal employees (if the federal government directly pays), is 6.5 percent of the total amount of the room rental charge plus $1.00 per room per night. Therefore, decreased room rates could lower receipts from the portion of the transient lodging tax assessed on room rental charges. There is already some indication that this is happening; however, the effect thus far has been to slow the rate of year-over-year growth in transient lodging tax receipts rather than to actually decrease receipts.

Social Services Expenditures

Any layoffs within the federal government or federally-dependent industries could increase demand for social services by City residents. Any potential "double dip" recession, whether or not related to federal spending cuts, would have a far greater impact on demand for social services. If federal budget cuts are large and/or focused on social service programs, demand could be expected to increase even further. Social services programs are funded by a combination of City, state and federal funding. Cutbacks in federal or state social services expenditures, combined with increased demand, could require the City to find alternative funding sources, cut back on planned non-benefit expenditures, modify program eligibility requirements, or deny services once programs have reached their budgetary limits. Pressure will also exist to replace a decline in federal reimbursements in whole or in part.

ATTACHMENTS:

Attachment I: Delta Associates' Report on The Federal Budget and Its Impact on the Washington Metro Area
Attachment II: Revenues and Risks
Attachment III: Historical Federal Spending Comparisons

cc: Department Heads and Constitutional Officers
Chair and Members, Budget and Fiscal Affairs Advisory Commission
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