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City Manager's Office

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Betsy Shotwell

SUBJECT: SEE BELOW

DATE: December 11, 2012

Approved

Date 12/13/12

SUBJECT: PATTON BOGGS UPDATE ON U.S. FISCAL CLIFF CRISIS

INFORMATION

Attached is a special update from City's Federal lobbyist firm of Patton Boggs on the fiscal cliff negotiations. As referenced in the November 30, City Manager's Weekly Report: "Sequestration and the "Fiscal Cliff," Patton Boggs financial services and tax policy team is providing updates on the negotiations.

Betsy Shotwell

BETSY SHOTWELL
Director, Intergovernmental Relations

Attachment: Patton Boggs LLP: Fixing the Debt: Update on U.S. Fiscal Cliff Crisis 12/10/12

PATTON BOGGS LLP

FIXING THE DEBT: UPDATE ON U.S. FISCAL CLIFF CRISIS

December 10, 2012

RECENT EVENTS

- On Sunday, the President and Speaker Boehner met face-to-face for the first time in over three weeks. Following the meeting, the White House and the Speaker's office released identical statements that declined to offer specifics of what was discussed, but indicated that the lines of communication remain open.
- Republican leadership publicly remains steadfast in their refusal to raise top marginal income tax rates, while the President has drawn a bright line, insisting on up-front tax rate increases for upper income earners.
- The White House is refusing to negotiate until Republicans relent on immediate marginal tax rate increases for top earners, even though House Republican leadership publicly stated last week that they will support $800 billion in tax revenue in tax reform next year.
- A confident President Obama is also digging in on the debt ceiling, stating that it cannot be used as leverage in any forthcoming negotiations. Some Democrats are going so far as to suggest the President invoke the 14th Amendment and unilaterally raise the debt ceiling. White House Press Secretary Jay Carney, however, has ruled out this maneuver. Still, the President has warned Republicans that he will not engage in another round of negotiations over the fiscal cliff in January, stating that the Congress must break its habit of using the debt limit to exact additional reforms.

WHERE WE STAND: THE FORMAL PROFFERS

In a December 3 letter to the President, House Republicans submitted their counteroffer to the White House's fiscal cliff proposal. The Republican proposal offers $2.2 trillion in new revenues and spending cuts – roughly $500 billion more than the amount proposed by the President. House Republicans reach the $2.2 trillion figure through: (i) $800 billion in new revenues in the course of tax reform to be completed in 2013; (ii) $300 billion in discretionary spending savings; (iii) $600 billion in savings from mandatory healthcare programs; (iv) $300 billion from other mandatory spending; and (v) $200 billion through revisions to the Consumer Price Index (CPI) inflation calculation method, providing for a chained CPI.

From the White House, in the days following the November 29 meetings between Treasury Secretary Geithner and Republican leadership, more specifics on the Administration's initial $1.6 trillion proposed tax increase and spending reductions (and stimulus spending program) were released. Per Administration officials, $1.6 trillion of net tax increases would occur in two steps: (1) the first trillion up front by virtue of allowing all of the upper-income Bush tax cut provisions to expire on earned and investment income, along with changes to the estate tax, with (2) the remainder in a tax reform process to be completed by August 1, 2013.

The White House proposal includes a host of corporate revenue raisers. While the corporate policies have long been part of the President's budget proposals, they were not previously part of fiscal cliff discussions. Specific targets include: reforming the international tax system (raising $150 billion), repealing Last In First Out (LIFO) accounting ($75 billion), repealing certain oil and gas preferences ($30 billion), reinstating Superfund taxes ($20 billion), changing the tax treatment of financial and insurance products ($17 billion), and taxing carried interest as ordinary income ($13 billion).

Administration officials have told the press that the proposal would accomplish $600 billion in spending cuts and reforms to mandatory programs — half of that from Medicare. The White House plan provides that entitlement reform would occur by August 1, 2013. Further, the Administration proposed delaying the sequester until August 1, 2013, using that date as a means to press Congress to action on tax and entitlement reform.

THE CHATTER

"[T]he president has adopted 'a deliberate strategy to slow-walk' our economy right 'to the edge of the fiscal cliff.'"

- Speaker Boehner, December 7, 2012

- Throughout last week, Congressional Republicans loudly rejected the Administration's framework as a non-starter, arguing that: (i) the proposed tax increases are way too high, front loaded, and raise marginal rates; (ii) the extent of the proposed entitlement reform is insufficient and lacking in detail; (iii) the proposed new spending provisions are intolerable; and (iv) the proposal to permanently raise the debt ceiling is a non-starter.

- Treasury Secretary Geithner reaffirmed that the Administration is prepared to "go over" the fiscal cliff rather than accept a deal that does not include higher tax rates on the top 2 percent of earners. Specifically, in response to a question about whether the Administration is willing to go over the cliff, Secretary Geithner responded: "Oh, absolutely. We don't see a way of doing it that makes any sense or has any political viability without rates going up."

- On Friday, Speaker Boehner accused the White House of wasting another week, reiterating that Republicans offered a "serious proposal, based on testimony of President Clinton's former chief of staff [Erskine Bowles]." The Speaker urged the President to respond to this offer with a plan that "can pass both chambers of the Congress."

- Last week, at an event sponsored by the Campaign to Fix the Debt, Senate Finance Committee, Chairman Baucus (D-MT) indicated that he is working on a plan that combines new revenue, spending cuts, and a long-term, comprehensive deficit solution. No plan details or specifics were provided, with Baucus deferring to the negotiations currently underway between the White House and House Republicans. However, Baucus later told reporters that a "plan B" is in the works.

- From the House, Ways and Means Committee Chairman Dave Camp (R-MI) added that "[i]t is outrageous that the President and Treasury Secretary would prefer to drive this country back into a recession instead of working with Republicans on tax reform – tax reform that can and will raise the revenue they are demanding."

Both sides continued to posture, with little progress being made last week. However, in these final days of December, there still remains a possibility for successful compromise.

While speaking to a group of CEO's last week, the President suggested that a deal to avert the fiscal cliff was possible within a week. "Another way of putting this is we can probably solve this in about a week. It's not that tough, but we need that conceptual breakthrough," the President said. The goal still appears to be a roughly $4 trillion deficit reduction agreement, which is the level necessary to stabilize the debt to GDP ratio at roughly 3 percent moving forward and is viewed by many as a sign to the markets that Congress and the Administration are serious about tackling long-term debt. However, any agreement will likely count as savings the $2 trillion pocketed last year by virtue of enactment of the Budget Control Act.

In terms of the structure of a possible year-end compromise, the shape of a deal still appears to likely follow the contours of what has been suggested publicly in the past – a down payment on deficit reduction drawn from both tax increases and mandatory spending reductions, coupled with greater measures to follow next year through fundamental tax and fundamental entitlement reform. Assuming such a deal materializes; expect to see an extension of the Bush tax cuts for most taxpayers, with some form of tax increases on certain upper-income taxpayers.

As recent events suggest, however, it remains to be seen whether a combination of the Republicans' position of limiting deductions (and possibly exclusions) and the President's position of marginal rate increases will prevail. Many believe the solution to the existing impasse lies somewhere between current tax rates and Clinton-era rates, coupled with caps on certain tax preferences. However, in exchange for a possible 37 percent top rate with a limitation on tax preferences for upper-income individuals, Republicans will demand significant entitlement reform, spending cuts, and tax reform. In that regard, Republicans continue to maintain that there must be spending cuts included in any year-end deal. (Programs that could be under consideration for purposes of a down payment include SNAP, Medicare means testing, and perhaps further Medicare reforms.) And, others suggest that certain economic stimulus items should be included, such as unemployment insurance and an extension of (or some alternative to) the current payroll tax.

In-line with stages proffered by the Administration's current proposal, the construct of any deal will likely contain a process for expedited action next year for both tax and entitlement reform, with an agreed upon revenue target for tax reform and an agreed upon savings from mandatory spending (mostly entitlements). Presumably, Senate Finance and House Ways and Means will be tasked with filling in a broad structure, though some working parameters might be outlined in advance (again, the magnitude of the up-front savings could be relatively small or very large depending on a final negotiation). Should tax and entitlement reform fail to be signed into law within a time certain, it is unclear whether there would be legislative trigger or "backstop" to compel action next year, aside from reversion to current law, and what such a trigger might look like.

Any deal on this scale will likely include a debt ceiling increase, along with the assorted priorities that Congress still needs to address for 2012 and 2013 (e.g., AMT patch, tax "extenders," doc fix, Medicare extenders, etc.). However, these pieces are not likely to move this year absent a deal of some sort that averts the fiscal cliff, as their fates are linked to broader negotiations.

Finally, it is highly probable that a deal will also delay the spending sequester, but it remains unclear whether that would be paid for with revenue and/or spending cuts over and above the "down payment" or whether additional pay-fors will be used to pay for a delay.

FOR MORE INFORMATION

For up to-the-minute fiscal cliff updates, please contact a member of the Patton Boggs Tax Policy team:

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