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To: The Honorable Scott Walker
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From: Mike Huebsch, Secretary
Department of Administration

Subject: Potential Impacts of Federal Debt Ceiling Situation on Wisconsin

As you are aware, the President and Congress are currently in discussions regarding an increase to the federal debt ceiling and various fiscal concerns surrounding that issue and the federal budget deficit generally. Per your request, the Department of Administration (DOA) gathered input from state agencies regarding possible impacts on federally-funded programs. A summary of the federal debt ceiling issue, the accounting of federal revenues in the state's budget and potential agency impacts are summarized below.

Federal Debt Ceiling

The federal government typically spends more each year than the revenue generated under the current tax structure. This annual and on-going deficit is financed through the issuance of debt. Current federal law places an overall limit on the amount of debt that the federal government has outstanding at any one time. An increase in this "debt ceiling" requires authorization by Congress.

If the debt ceiling is not increased, the federal government will have insufficient resources to pay obligations already incurred, including interest payments on bonds. This latter situation constitutes default on the full faith and credit of the United States. Bond rating agencies have stated that a default will result in a downgrade of US debt, which would have significant ramifications in financial markets and for the underlying ratings of state-issued and municipal debt.

In the event that no further debt can be secured by the federal government, the US Treasury may be forced to prioritize payments. Some reports state that this could reduce cash flow for certain parts of the federal budget by as much as 50%. Neither the US Treasury Department nor the Office of Management and Budget has issued any directives or instructions regarding prioritization of payments. However, the Bipartisan Policy Center indicates that if priority was given to interest on US government securities, Social Security benefits, Medicare/Medicaid, Defense vendor payments, and unemployment insurance benefits, then payments would have to stop entirely for military and federal salaries and benefits, Education, Food and Nutrition Services, Temporary Assistance to Needy Families (TANF), Labor, Justice, Energy, Health and Human Services, Federal Highway and Transit, Environmental Protection Agency, Internal Revenue Service refunds, Small Business Administration, and Housing and Urban Development.

<u>Federal Revenues and Wisconsin</u>
Federal revenues make up approximately 29% ($9.3 billion) of the Wisconsin state budget on an annual basis. Top programs include Medicaid, UW federal research grants and student financial aid, transportation, TANF block grant funds, child care and child welfare services funding, low-income energy assistance, workforce training, and community development block grants.

Federal revenues are considered a part of the state's general fund for accounting purposes and Wisconsin has sufficient cash in the short-term (at least three months) to continue to fund federal obligations if desired, due in part to the recent issuance of an operating note and the ability to inter-fund borrow, until the federal debt limit issues are resolved by the President and Congress. Depending on the duration of the situation at the federal level, DOA might have to implement a payment prioritization plan under the statutes.

A default by the federal government may have broader implications for the state's debt management program by increasing the cost of bonds and potentially compromising certain elements of existing bond indentures (e.g., investment of bond security proceeds, etc.). Moody's recently announced that five AAA-rated states had been placed on credit watch due to the disproportionately high impact of federal revenues on those state's economies and finances. Loss of the US AAA rating could also affect 7,000 top-rated municipal credits. A rise in interest rates could also occur if a default results in dislocation and concern in global credit markets. State revenue collections could be dramatically affected if federal default results in further economic deterioration and return to a recessionary situation.

All states, including Wisconsin, utilize State and Local Government Series Treasury obligations (SLGS) to serve as investments in escrows to pay off refunded state bonds. It is necessary for these escrows to be funded by AAA-rated securities to defease the refunded bonds. A downgrade of US securities leaves the legal status of these escrows in question. The implications of these potential changes are uncertain.

Another area of concern is the direct subsidy provided to bonds issued by states and municipalities under the Build America Bonds program. Under this program, rather than provide a tax-exemption on the interest of publicly issued debt, the federal government pays a subsidy to the issuer. The current debt limit situation could result in these subsidies being delayed, which could impact the state's capital improvement, clean water, and transportation funds.

State agencies that manage federal programs continue to monitor communications from federal grantee agencies regarding specific instructions concerning prioritization of federal payments or reductions in funding.

Responses from Key Agencies

Administration – could affect over $350 million (including $200 million in ARRA funding) in federal low income heating assistance and weatherization programs, including grants to all 72 counties, 7 tribes and 20 weatherization agencies; $24 million of housing funding for homeless shelters and residential repair contracts could be affected, and home purchase and rental contract closings could be postponed; justice assistance funding of nearly $140 million for the 2008-2010 funding period related to a variety of programs including law enforcement training, a portion of funding for the Fusion Center, and equipment for first responders could be affected; and programs provided by the Coastal Management and National Community and Service Board could also be impacted.

Children and Families – primary federal programs include Title IV-E child welfare services, TANF, Child Care Development Block Grant, and Community Services Development Block Grant. The larger programs (e.g., TANF, child care and portions of Title IV-E) have a GPR match or maintenance of effort requirement that would allow continuation of services in the short term. Certain federal grant programs (e.g., Community Services Development Block Grants, and sub-grants from the state Department of Health Services) may be more immediately affected since these have either local matching funds or do not have corresponding state fund match requirements.

Health Services – the primary potential area of impact are Medicaid programs, with $350 million in federal support each month. If the state decides not to provide temporary cash flow assistance to these programs, payments might have to stop to a variety of providers. Those most reliant on federal funding include nursing homes, Family Care managed care organizations and home health, personal care and related activities. Funding for FoodShare and Women, Infants and Children (WIC) nutrition supplement program have been received for August and September. Supplemental Security Income (SSI) and Caretaker Supplement benefits could be affected, although there are GPR maintenance of effort requirements that provide some flexibility in the short term; eligibility determination for these programs could be affected by a reduction in federal revenues.

Programmatic impacts of any suspension of payments could be severe. Recipients of long-term care services may have to turn to nursing homes for assistance; providers in rural areas that are heavily dependent on federal funding might have to close, forcing recipients to travel longer distances to receive necessary care (e.g., renal and kidney dialysis facilities). Quality Assurance activities (e.g., inspections of nursing home facilities) could also be affected.

Military Affairs – could eventually affect funding for 394 of 420 state positions in the department, totaling $17 million on an annual basis. Programs supported by federal funds include building maintenance and utilities, emergency management grants, military facility construction, disaster payments to local governments and the Challenge Youth Academy.

Natural Resources – could affect $77.9 million of federal natural resource development and environmental protection funding. Key programs include reimbursement to communities for cleanup of contaminated sites, sport fish restoration, nonpoint source pollution abatement efforts, forest fire assistance and prevention, and Great Lakes restoration activities.

Public Instruction – could affect some or all of $761 million of federal aid for local education programs. Key programs include Title 1 services, Individuals with Disabilities in Education Act (IDEA), and school lunch.

Transportation – no significant impact is expected in the near term (two to three months); the situation is somewhat uncertain due to the differing views of the interaction between the federal Highway Trust Fund and the federal general fund. Over 80 percent of federal funds to DOT are used for highways.

University of Wisconsin System – could affect student financial aid and result in lower enrollments; federal research grants could be affected resulting in potential reductions and layoffs to 5,300 FTE federally-funded positions; could reduce federal indirect revenue that supports other activities on UW campuses.

Veterans Affairs – the state's veterans homes are heavily dependent on per diems paid by the federal government to residents (approximately $6 million per month); veterans assistance programs that support 162,300 monthly recipients may also be affected; and construction projects (primarily at the veterans homes) could also be impacted if federal reimbursements are held in abeyance.

Workforce Development – payment of unemployment insurance is expected to be a priority for the federal government; programs that could face interruption include Workforce Investment, Trade Adjustment Assistance, National Emergency Grants, Disabled Veterans Outreach, Work Opportunity Tax Credits, Bureau of Labor Statistics, and Vocational Rehabilitation.

The Department of Administration continues to monitor the federal debt ceiling situation and will provide updates as events dictate.