Looking Back on 2008 and Anticipating the Challenges of 2009

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Congress dedicated most of its time and energy in 2008 to the growing economic crisis gripping the country. Congressional hearings and legislative activity on the failures of the capital markets and the financial regulatory system, the housing crisis, and the demise of long-standing financial institutions were held on nearly a weekly basis. This included specific hearings and legislative efforts to assist state and local governments and the municipal bond market. As President Barack Obama has noted, the economic turmoil did not happen overnight, nor will the economic recovery. Therefore, it may take well into 2009 — or longer — to measure the success of the recovery initiatives from 2008. Below is an overview of these efforts and their impact on state and local governments.

HOUSING

Throughout 2008, Congress pursued avenues of assistance to homeowners and communities. After several months of negotiations between House and Senate leaders and the White House, the president signed the Housing and Economic Recovery Act (Public Law 110-289) into law on July 30, 2008. A comprehensive measure hailed as landmark legislation, the new law includes provisions that are of critical importance to states and local governments.

The law makes available $3.92 billion in Community Development Block Grant (CDBG) funds to cities and states to assist communities that are significantly affected by rising rates of vacant properties as a result of foreclosures. The block grant funds can be used to purchase, rehabilitate, or demolish these abandoned properties in order to stabilize neighborhoods and stem the losses in property values of neighboring homes. The funds are to be distributed by the Department of Housing and Urban Development and allocated to communities based on state and local home foreclosure percentages, the number of homes financed by subprime mortgage loans, and the number of homes in default on existing loans.

Other parts of the new housing law that are significant to the state and local government community include provisions authorizing state housing finance agencies to issue an additional $11 billion in housing bonds, which would fall outside of the private activity volume cap. The funds raised can be used to refinance some subprime loans, provide loans to first-time home buyers, and finance the construction of low-income rental housing. The law also repeals the alternative minimum tax (AMT) on all housing bonds, which could save state and local governments between 60 and 65 basis points on their issuances because they would no longer have to offer higher interest rates to compensate investors for the interest lost to the AMT. Finally, the new provides a new credit enhancement for bond issuers by allowing Federal Home Loan Banks to extend

letters of credit to their member institutions for tax-exempt bonds.

EMERGENCY ECONOMIC STABILIZATION ACT

Members of Congress quickly recognized that the enactment of comprehensive housing legislation was but the first stop on the road to economic recovery. As the economic crisis continued to spiral to downward, Congress turned its attention to initiatives that would kick-start the nation's credit markets. Relief came in the way of a $700 billion rescue measure signed by the president on October 3, 2008. The Emergency Economic Stabilization Act of 2008 (Public Law 110-343) was intended to help stabilize the financial markets and ease the credit crisis plaguing private companies and state and local governments.

At the heart of the measure is the creation of the Troubled Asset Relief Program (TARP), which was initially intended to focus on rescuing the financial industry by allowing the Treasury Department to purchase distressed assets linked to mortgage-related securities. However, soon after Congress initially appropriated the first $350 billion for TARP, Treasury Secretary Henry Paulson reversed course and used the funds to infuse capital directly into banks instead of purchasing troubled assets. Specifically, the Treasury invested $125 billion in large banks and investment banks and $125 billion in regional banks, and provided $40 billion in emergency aid to insurer AIG. Some of the TARP balance has also been used to help consumers by providing assistance to companies that issue credit cards, provide student loans, and finance auto purchases.

President Obama and his economic advisors are working with Congress on the release of the remaining $350 billion in TARP funds, which would be used to: allow consumers, states and municipalities, and small businesses easier access to capital; strengthen oversight of the TARP program; help homeowners avoid foreclosure by reducing mortgage payments and changing bankruptcy laws; limit executive compensation at firms that receive government funds; replace governments funds with private investments; and possibly create a new facility that would provide a funding backstop to the state and municipal government debt market and help alleviate the state and local credit crunch.

The act also increases the FDIC deposit insurance limits from $100,000 to $250,000 through 2009, although no special provisions were provided for municipal deposits. The FDIC also announced unlimited insurance coverage, through 2009, for non-interest-bearing checking and transaction accounts participating in the FDIC's Temporary Liquidity Guarantee Program.

Finally, the act addresses many outstanding tax issues of interest to state and local governments. These include: allowing state and local sales taxes to be deducted on federal returns through 2009; increasing the alternative minimum tax exemption for 2008; extending through 2009 a provision that permits homeowners who do not itemize their income tax deductions to take a standard deduction for state and local property taxes; and extending through January 2013 a 2007 law permitting homeowners to refinance their mortgage and pay no taxes on any debt forgiveness they receive.

PENSIONS AND RETIREMENT

Further recovery assistance came toward the very end of the year when President George W. Bush agreed to sign the Worker, Retiree and Employer Recovery Act (Public Law 110-458) into law on December 23, 2008. The new law makes technical corrections to the Pension Protection Act (PPA) of 2006 and offers sponsors of private-sector defined benefit plans relief from the funding requirements of the PPA that were to take effect in 2009. Democratic lawmakers argued that the legislation was needed to address the crisis many pension plans were facing due to assets lost as a result of the tremendous market volatility in recent months.

The Bush administration originally opposed the measure, arguing that continued underfunding of pension plans could lead to increased claims against the Pension Benefit Guaranty Corporation. However, President Bush noted that he would put his reservations aside to sign the measure after recognizing that in the current economic environment, the benefits of the legislation outweighed his concerns.

Another significant provision of the new law is the relief it provides from required minimum distributions in 2009. Lawmakers included this provision to assist retirees who would otherwise be required to take withdrawals from their retirement accounts after having suffered significant losses in account value. Under the act, 401(a), 401(k), 403(b) and 457(b) plans will not require minimum distributions for people who reach age 70-1/2 during calendar year 2009.

The legislative relief from the minimum distribution requirements applies only to calendar year 2009. However,

many members of Congress continued to say they wanted the Treasury Department to adopt regulations providing relief for calendar year 2008 as well. In mid-December, the Treasury announced that it would not waive the minimum distribution requirement for 2008, citing the difficulties involved in achieving a simple and equitable solution by the end of the year, and noting, in particular, that there would be cases in which some retirees had already taken their distributions, while others had not. In response, 61 Democratic and Republican members of Congress signed a letter urging the president to direct the Treasury to "immediately waive" the minimum required distribution rules for 2008.

Several other provisions of the Worker, Retiree and Employer Recovery Act provide relief to the public sector. They include:

- Amending the Age Discrimination in Employment Act (ADEA) to clarify that governmental defined benefit plans may credit interest at rates above the market rate of return if the governmental plan's interest rate was set by federal, state, or local law.
- Clarifying that eligible retired public safety officers may exclude up to $3,000 of their retirement benefits from federal income tax if the money is directly deducted for health insurance or long-term care premiums, whether the plan providing the coverage to the public safety officer is insured by a third party or self-insured.

THE CASE OF DAVIS V. KENTUCKY

States and local governments received a welcome respite from the turmoil beginning to overshadow the municipal bond market with the United States Supreme Court's May 2008 decision in the case of *Davis v. Kentucky*. At issue in this case was whether states violate the U.S. Commerce Clause when they tax a resident's out-of-state municipal bond interest while at the same time exempting in-state, tax-exempt bond interest from taxation. A vast majority of states implement this differing tax policy, making the decision in this case quite significant.

In a 7-2 decision, the court ruled that states do not violate the U.S. Commerce Clause by exempting taxation on in-state municipal bond interest while taxing interest on out-of-state municipal bonds. Specifically, the Court held that because issuing bonds is a traditional government function, and because setting different tax policies does not constitute economic protectionism, there is no violation of the dormant commerce clause. The opinion also states that invalidating a century-old taxing practice would cause "financing for long-term municipal improvements to change radically," noting specifically that the hardship would be borne by smaller municipal bond issuers, which benefit from single-state municipal bond investment funds that are currently available to investors.

A GLIMPSE INTO 2009

As President Obama and members of the 111th Congress take their place in the nation's capital, the primary focus continues to be economic recovery. In particular, President Obama and congressional leaders have set their sights on enacting an $825 billion economic stimulus package by mid-February. President Obama hopes that this stimulus package, which is now being referred to as the American Recovery and Reinvestment Plan, will create 3 million jobs through infrastructure and other program funding, as well as tax credits and changes to tax laws. For states and local governments, in particular, the measure will likely include funding for infrastructure projects such as roads, transit, schools, and housing; greater assistance for Medicaid costs; direct state fiscal relief; and changes in the tax code to spur greater demand for municipal bonds. According to state and local elected leaders, these additional funds should help mitigate some financial burdens as they struggle to balance their budgets and provide essential services while facing a deteriorating tax base, increased foreclosures, and staggering pension and health-care obligations.

CONCLUSION

Following the passage of the stimulus plan, President Obama will unveil his first budget, which will set his administration's priorities for the year. Just as in the stimulus plan, the president's budget is likely to include many provisions of assistance and interest to state and local governments. The Government Finance Officers Association, together with our partners in other state and local government associations, is prepared to work on behalf of our members to ensure that the new administration and Congress are aware of our priorities as well as our interest in facilitating greater cooperation between the federal government and state and local governments. ❚

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