Federal Outlook and Impact on Virginia

November 21, 2024

Outline

1. Introduction
2. Overview of Federal Funds and Virginia Specific Discussion
3. Federal Tax Policy Outlook and Update Related to TCJA
4. Key Takeaways and 2025 Session Outlook

Introduction – Federal Outlook and Impact to Virginia

- With a single-party controlled government, the following could impact Virginia:
  - Tariffs
    - Increasing tariffs on goods imported into the United States - possible inflationary impact.
  - Tax Changes/Extension of the Tax Cuts Jobs Act (TCJA)
    - TCJA extension is not likely to result in significant changes to state revenue; however, additional tax policy actions may result in lost revenue.
  - Immigration
    - Possible impact on labor markets, especially in certain job sectors, and prices.
  - Federal employment downsizing or relocation (~193,000 federal jobs in Virginia)
  - Changes to federal discretionary and mandatory programs (includes smaller grants and larger programs like Medicaid)

Topic and Panel Introduction

Meet the Panelists

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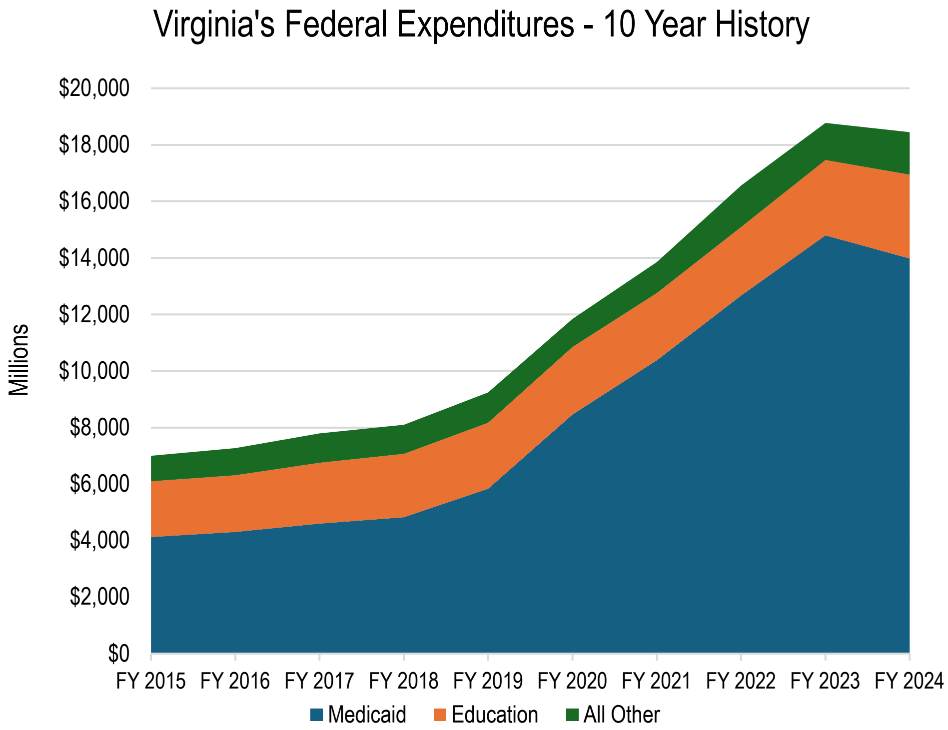
Federal Funds and Virginia

Virginia’s Federal Expenditures Have Grown Substantially

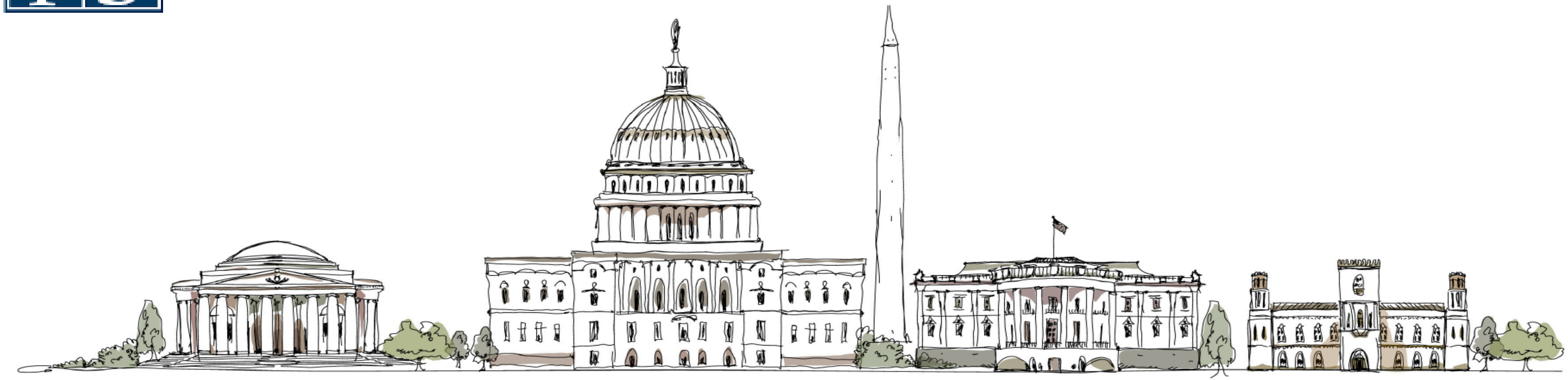


- Virginia's federal spending has increased from $7.0 billion in FY 2015 to $18.5 billion in FY 2024, an increase of 264 percent.
- Medicaid's share of federal spending in Virginia has increased from 59 percent in FY 2015 to 76 percent in FY 2024.
- The expansion of Medicaid in FY 2019 is the main reason for Medicaid's increased share.
- Federal transportation funds make up approximately 17 percent of Commonwealth Transportation Fund revenue.

Federal Government May Consider Changing Medicaid Program

- Previous discussions on reducing federal costs of the program typically have included changing the program to a block grant.
- The Congressional Budget Office has provided the following options to reduce federal Medicaid costs:
  - Establish caps on federal spending;
  - Limit state taxes on health care providers; and
  - Reduce federal Medicaid matching rates.

Source: Congressional Budget Office report on "Options for Reducing the Deficit“, published March 2, 2023.

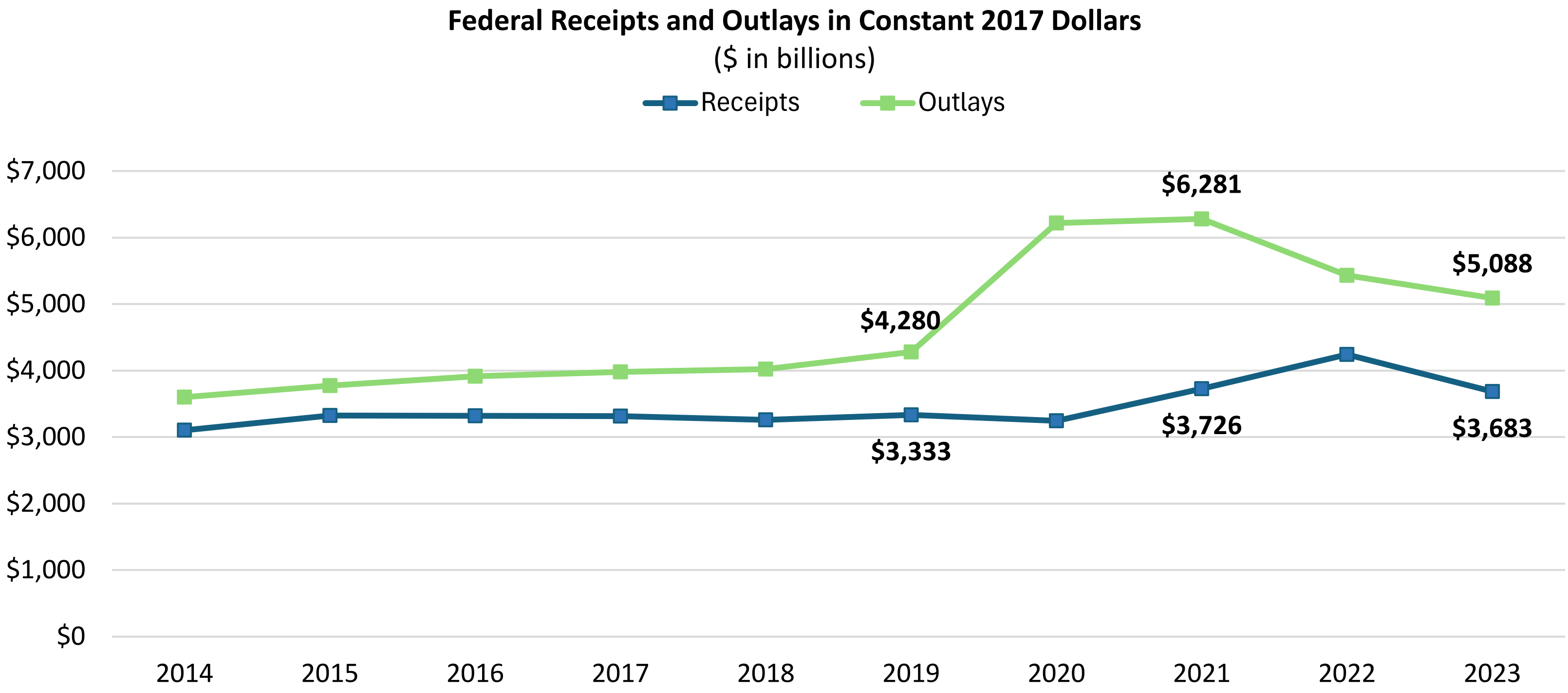


The Post-Election Landscape

Federal Funds Information for States
ffis.org

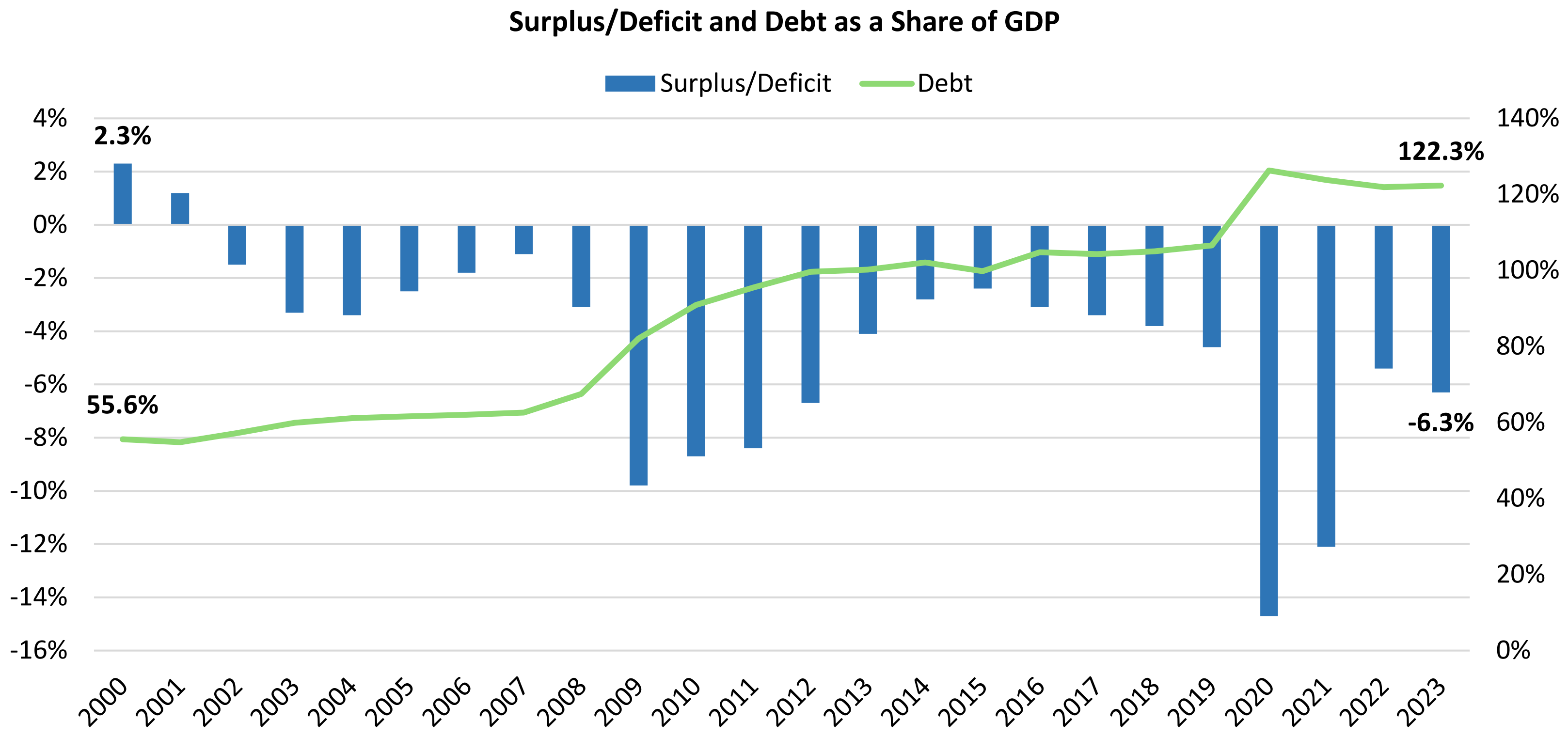
Virginia Senate Finance & Appropriations Committee
November 2024

Federal revenues and outlays are misaligned



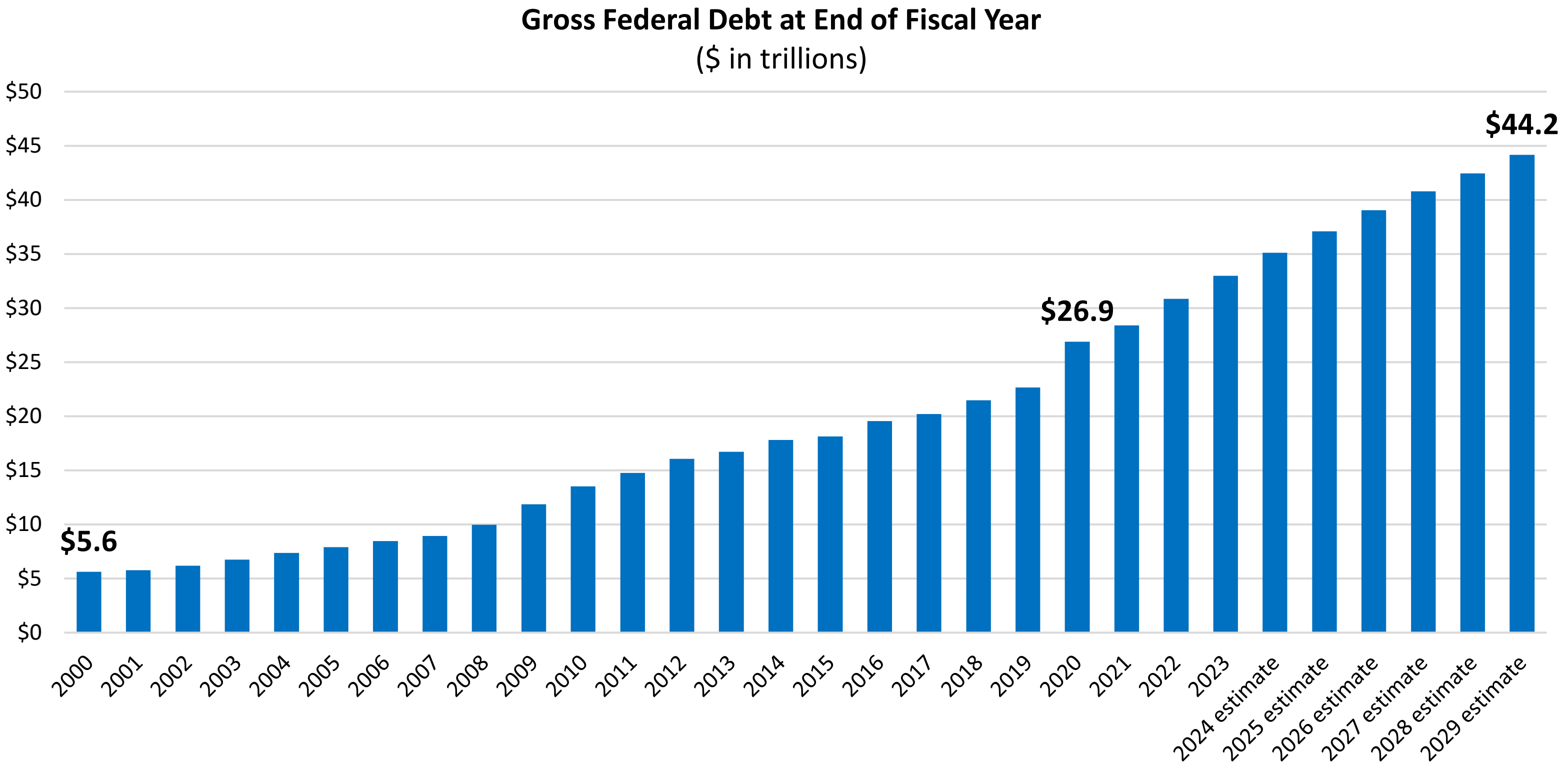
Source: FY 2025 President's Budget, Historical Table 1-3

Deficits are large and debt is growing



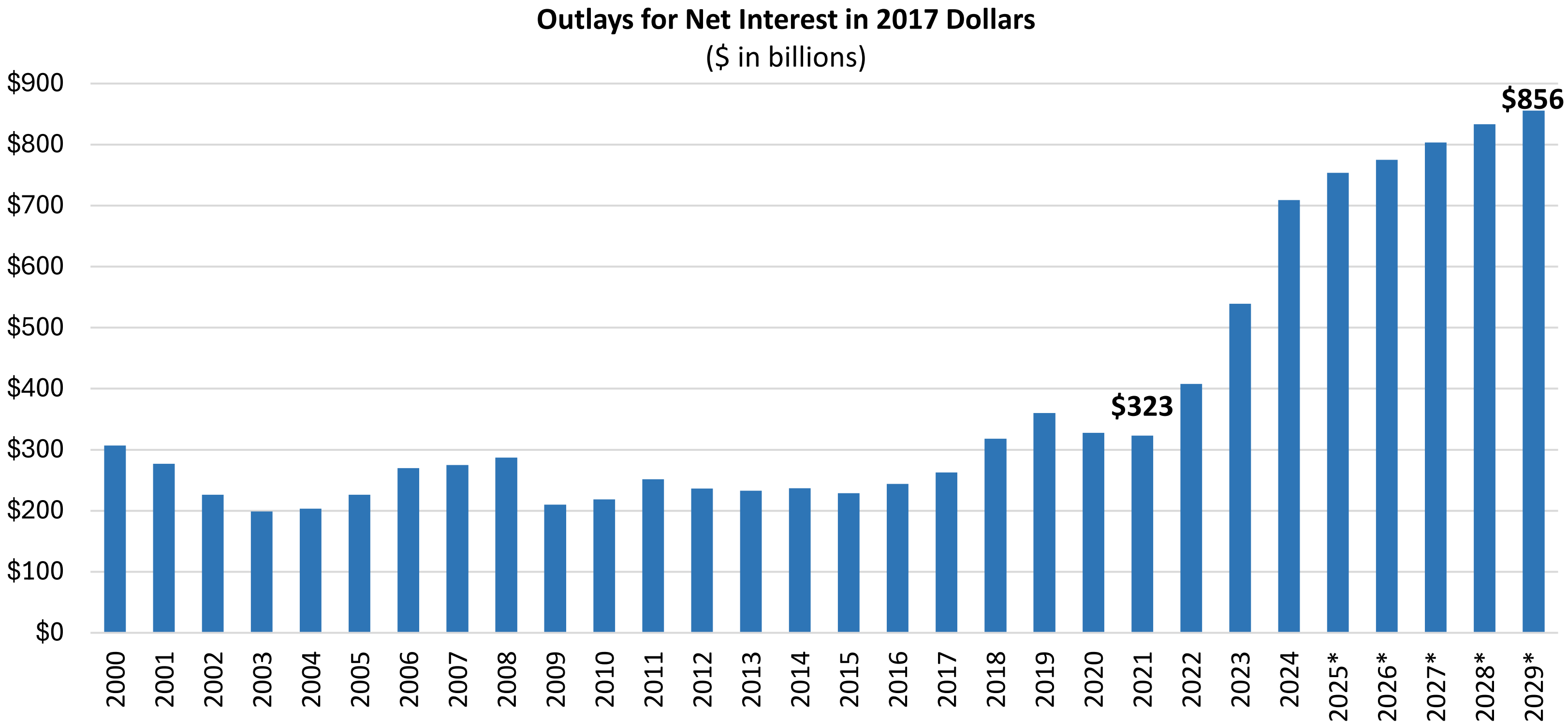
Source: FY 2025 President's Budget, Historical Tables 1-3 and 7-1

Another perspective on debt



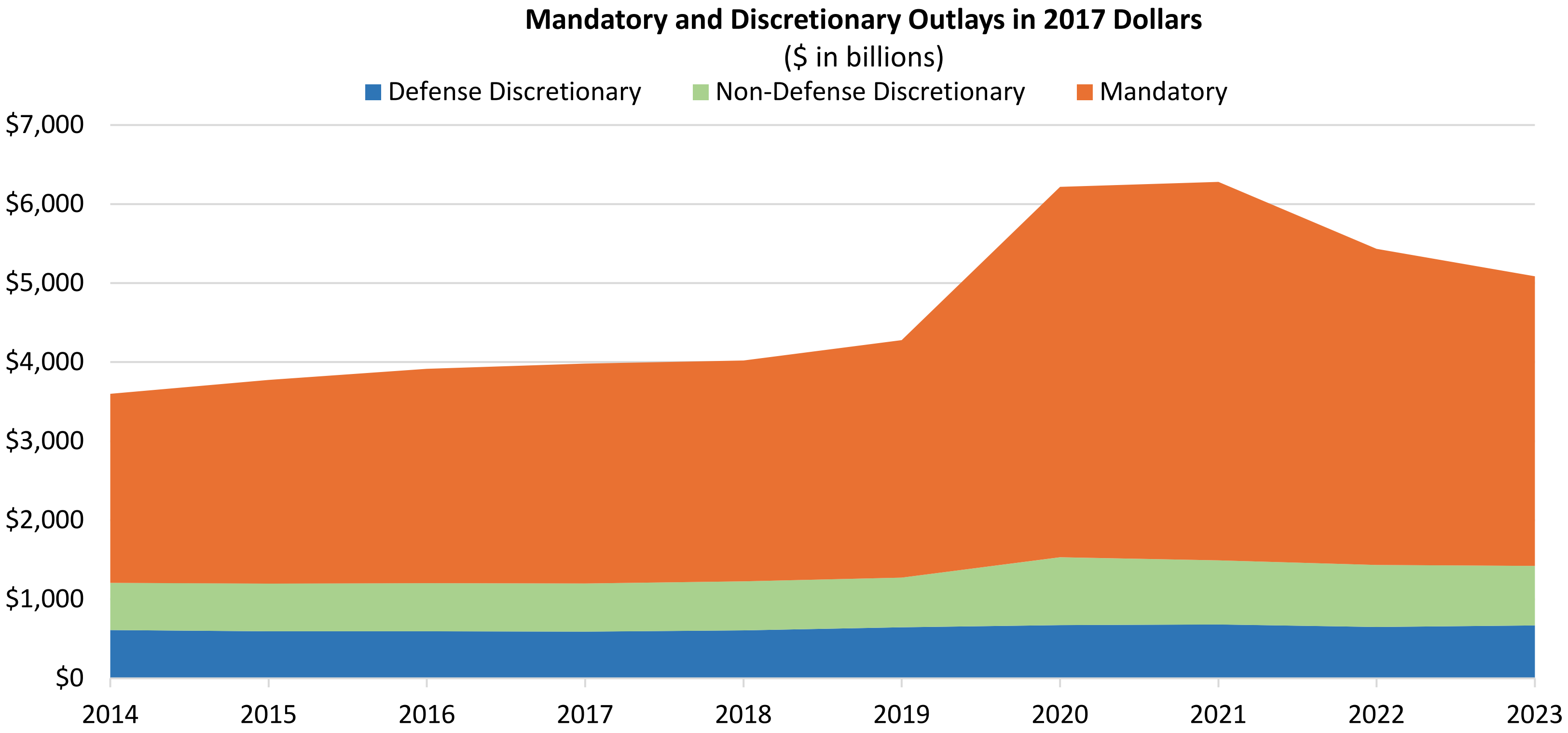
Source: FY 2025 President's Budget, Historical Table 7-1

Interest on the debt is now rising rapidly



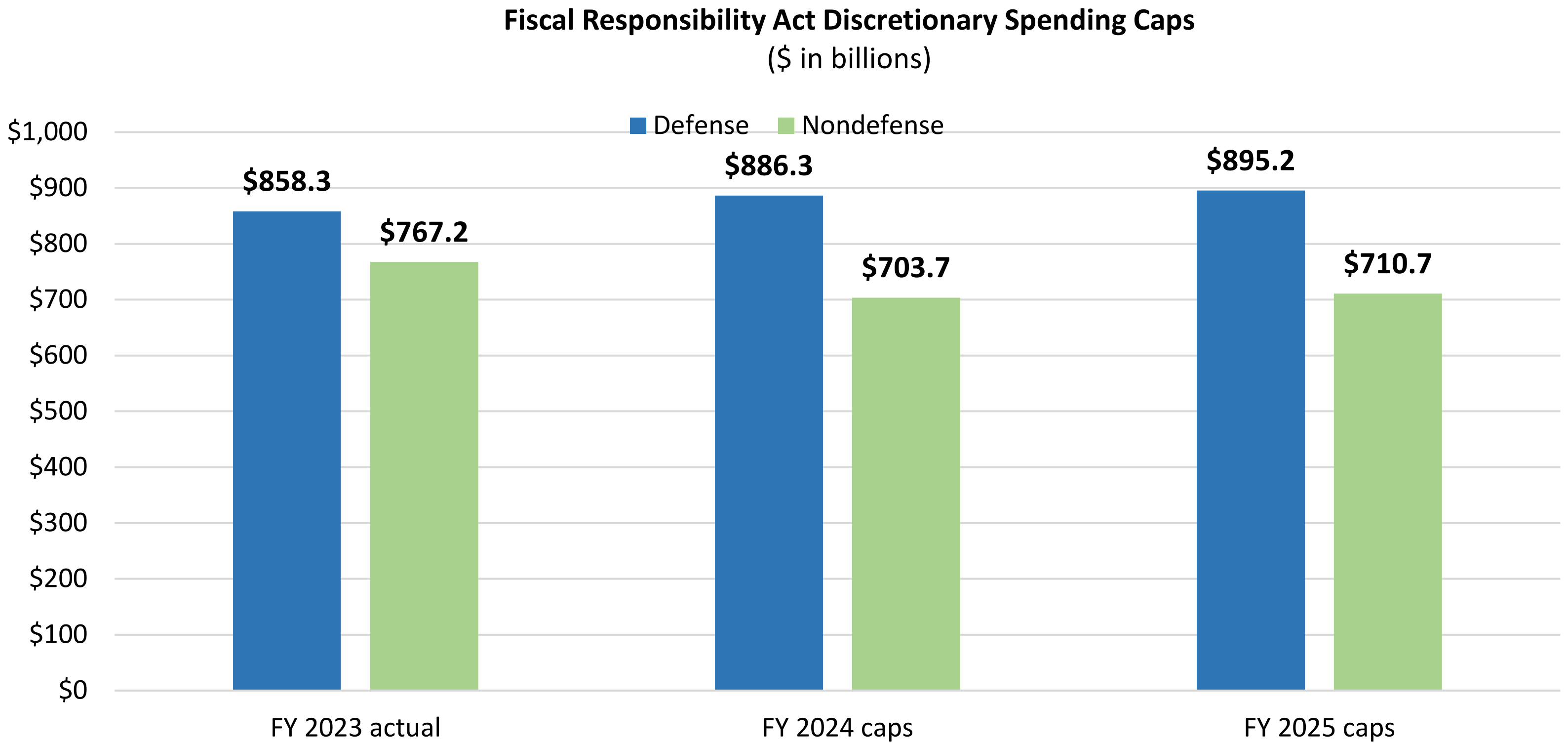
*Projections in president's FY 2025 budget

What’s driving spending growth



Source: FY 2025 President's Budget, Historical Table 8-2

FY 2025: Fiscal Responsibility Act recap



Source: Congressional Budget Office

Post-Election: lame duck session questions

- Will Congress finalize FY 2025 appropriations?
- Will it pass another CR into next year? (Current CR expires December 20)
- Will there be a shutdown?
- House and Senate bills are far apart, but something like a full-year CR would be a compromise that would allow Congress to wrap things up.
- Bipartisan support is needed to get appropriations enacted.

January and beyond: reconciliation

- Will likely be used
- Used to change tax policy and mandatory programs (but not Social Security)
- Affordable Care Act?
- Not used for discretionary programs
- Expedited process allows simple majority in Senate
- Opportunity to do it twice: FY 2025 and FY 2026

January and beyond: annual budget process

- FY 2026 budget process will begin late
  - Rescind unobligated balances: IIJA, IRA funds
  - Eliminate grant programs
  - Propose reconciliation to address tax policy, mandatory programs (including Medicaid, SNAP)
  - Outside of reconciliation, need bipartisan support to pass discretionary appropriations

January and beyond: debt limit

- Has historically been a catalyst for significant budget reforms: Budget Control Act of 2011, Fiscal Responsibility Act
- Suspension ends January 1, 2025; could be several months before it needs to be addressed
- Underlying fiscal condition will inform this debate, but politics will play a key role

January and beyond: past themes

- Controlling entitlement spending
- Eliminating and consolidating programs
- Measuring results
- Trading flexibility for funding
- Focusing on work and employment

How these things inform the state/federal fiscal relationship

- Things that suggest big changes
  - A new political landscape
  - Federal fiscal condition
  - Robust state balances
  - Lack of state solidarity
- Things that support the status quo
  - Mandatory programs can be hard to change (but reconciliation makes it much easier)
  - Discretionary spending is relatively modest, and programs may have powerful constituencies
  - Grants to state and local governments are an efficient fiscal stimulus in the event of a recession

Questions?

- **Get the latest updates** by joining the email list.

    Email eableman@ffis.org (Ethan Ableman)

- **View publications** at ffis.org.

    Contact eableman@ffis.org for login help

- **Follow-up questions?**

    Contact Marcia Howard: mhoward@ffis.org

Federal Tax Policy Outlook and Update Related to TCJA

Federal Tax Policy Outlook

- The individual provisions of the Tax Cuts and Jobs Act (TCJA) expire at the end of CY 2025.
  - Virginia's standard deduction increase and refundable earned income tax credit also expire at the end of CY 2025.
- It is now expected that TCJA provisions will be extended in 2025.
  - If TCJA was not extended, the GF revenue loss would be $216.6 million in FY 2026 and $560.5 million in FY 2027.
  - Debate will likely focus on which provisions to extend, additional changes, and how to pay for tax policy.
  - To extend the expiring individual TCJA provisions, the Congressional Budget Office projects the federal deficit to increase $4.5 trillion over the 2025-34 period.*
- President-elect Trump stated that he supports excluding tips and overtime earnings from federal income tax, uncapping the state and local tax deduction, and imposing tariffs.

* Source: Congressional Budget Office report on "Budgetary Outcomes Under Alternative Assumptions About Spending and Revenues", published May 8, 2024.

Virginia Impact from Federal Tax Changes

- Virginia generally conforms to federal definitions of income with some exceptions (e.g., limitation on itemized deductions, medical expense deduction), which allows taxpayers to calculate their Virginia tax liability without different rules and definitions.
- In 2023, the General Assembly adopted rolling conformity, allowing Virginia to conform to federal tax changes as soon as enacted by Congress.
  - Legislative guardrails would deconform if the federal provision +/- GF revenue by more than $15.0 million, or if the cumulative impact of conformed provisions +/- GF revenue by more than $75.0 million and allows conformity if the action extends a federal provision to which Virginia has already conformed.
  - To date, rolling conformity legislation has not been implemented.
  - **Rolling conformity may generate large revenue variations and potentially create structural imbalance in an adopted budget.**

Impact to Virginia of TCJA Extension

November 21, 2024

Background - TJCA & Virginia Response

Tax Cuts and Jobs Act of 2017 (TCJA)

Major Provisions of the TCJA with a Virginia Revenue Impact*

Individual Provisions	Business Provisions (Permanent)
Increase in Federal Standard Deduction (↑)	Interest Deduction (↑)
Mortgage Interest Deduction (↑)	NOL Rules (↑)
Other Itemized Deduction Changes (↑)	Amortization of Research Expenses (↑)
Limitation on Losses for Noncorporate Taxpayers (↑)	Repeal Domestic Production Activities Deduction (↑)
	Repeal of Certain Like-Kind Exchanges (↑)
	Limitations on Fringe Benefits (↑)
	Increase IRC 179 Expensing (↓)
	Simplified accounting rules for small businesses (↓)

**Parentheticals indicate impact to Virginia revenues (increase or decrease)*

Virginia Tax

Virginia Tax Policy Changes to Address TCJA

2019 Tax Policy Changes

- During the 2019 session, the General Assembly enacted a tax policy package to address the TCJA, which incorporated the following*:

Individual Provisions	Business Provisions
Increase in State Standard Deduction by 50 percent (from $3k/$6k to $6k/$12k) (↓) (Expires after TY 2025)	Deduction for 20 percent of interest deduction disallowed under TCJA (↓) (Permanent)
One-time $110/$220 individual tax rebate (↓)	Subtraction for global intangible low-tax income ("GILTI") taxed under the TCJA (↓) (Permanent)
Deconformed from State and Local Tax Deduction Limitation for Real and Personal Property Tax (↓) (Permanent)	
Deconformed from Overall Limitation on Itemized Deductions Suspension (↑) (Permanent)	

**Parentheticals indicate impact to Virginia revenues (increase or decrease)*

Virginia Tax Policy Changes to Address TCJA

Post-2019 Tax Policy Changes

- In 2022 and 2023, the General Assembly enacted further tax policy changes*:

Tax Policy	2022 Tax Policy Change	2023 Tax Policy Change
Virginia Standard Deduction	Increase in State Standard Deduction (to $8k/$16k) (↓) (Expires after TY 2025)	Increase in State Standard Deduction (to $8.5k/$17k) (↓) (Expires after TY 2025)
Virginia Pass-Through Entity Tax	Created Pass-Through Entity Tax ("PTET") to workaround the federal $10,000 SALT limitation (revenue neutral) (Expires after TY 2025)	Made technical changes to PTET to workaround the federal $10,000 SALT limitation (revenue neutral) (Expires after TY 2025)
Virginia Earned Income Tax Credit	Made Virginia's Earned Income Tax Credit partially refundable (↓) (Expires after TY 2025)	No tax policy change

**Parentheticals indicate impact to Virginia revenues (increase or decrease)*

Potential Impact Going Forward

Expiring Federal TCJA Provisions

Provisions Scheduled to Expire that Impact Virginia Revenues

- Enhanced Federal Standard Deduction (indirect impact)
- Repeal and Limitation of Itemized Deductions, including:
  - Limitation for Charitable Contributions
  - Mortgage Interest Deduction
  - Casualty loss, wagering, and miscellaneous itemized deductions
- Other Provisions:
  - Treatment of Moving Expenses (Deduction for Employers/Exclusion for Employees)
  - Exclusion for Student Loan Discharge Due to Death or Disability
  - Repeal of Exclusion for Employer-Provided Bicycle Commuter Benefits
  - Loss Limitation for Noncorporate Taxpayers (expires December 31, 2028)

Expiring Virginia Provisions

Virginia Provisions Set to Expire December 31, 2025

- Virginia Standard Deduction:
  - Currently $8,500 for individuals/$17,000 for joint filers
  - Set to revert to $3,000/$6,000 beginning in TY 2026
- Virginia Earned Income Tax Credit
  - Currently partially refundable (20% nonrefundable EITC or 15% refundable EITC)
  - Refundability set to expire beginning in TY 2026
- Pass-Through Entity Tax (PTET):
  - Currently set to expire beginning in TY 2026
  - No change to overall tax collections, but could impact timing of revenues

Rolling Conformity

- Virginia generally conforms to the Internal Revenue Code, which simplifies the state tax system by using the federal definition of income as the starting point of the Virginia return
- From 2002 until 2023, Virginia was a fixed date conformity state, meaning that Virginia conformed to the IRC as of a specified date and had to enact legislation each year to advance the date of conformity
- In 2023, the General Assembly adopted rolling conformity legislation, which automatically conforms to federal tax law changes under specified thresholds:
  - No more than $15 million/provision
  - No more than $75 million annually
- Federal tax legislation exceeding these thresholds requires action by the General Assembly in order for Virginia to conform

Timeline of Events

Federal budget introduced

Winter/Spring 2025

Potential Federal Action:

- Extend provisions in their current form (no VA revenue impact)
- Modify TCJA provisions and/or make additional changes (potential VA revenue impact)

Congress will need to act on budget and/or any extension legislation

Virginia Conformity:

- Extension of existing provisions adopted automatically
- Virginia Tax to provide estimates of any additional changes

If Congress acts, Virginia to respond accordingly

Potential Virginia Action:

- Extension of Virginia provisions would require legislation
- Federal changes > \$15m/\$75m require legislation to conform

Potential Revenue Impact

- Virginia provisions (standard deduction, EITC, and PTET) are set to expire after TY 2025
  - Tied to a specific date and not Congressional extension of the TCJA
  - As a result, Virginia would need to take legislative action to extend these provisions
- Extension of all federal and VA provisions assumed in official General Fund revenue forecast
  - Impact of other federal changes depends on specific Congressional action
- Virginia revenue impact if Congress extends the expiring federal provisions but does not extend the Virginia provisions:

Expiring Provision*	FY 2026	FY 2027	FY 2028	FY 2029	FY 2030
Virginia Standard Deduction Increases	$557.2	$1,161.0	$1,169.8	$1,192.5	$1,215.8
Virginia Earned Income Tax Credit Enhancements	$59.6	$123.2	$122.5	$124.1	$126.1
Total	**$616.8**	**$1,284.2**	**$1,292.3**	**$1,316.6**	**$1,341.9**

**Amounts in millions; preliminary estimates provided by Chainbridge Software, LLC to reflect the Virginia revenue impact if temporary federal provisions of the TCJA were allowed to expire. General Fund Revenue Forecast currently assumes extension of expiring federal and state provisions.*

Other Potential Federal Tax Policy Changes

Other Potential Federal Tax Policy Changes

Business Taxes

- Lower the corporate income tax rate from 21% to 20%
- Lower the corporate income tax rate to 15% for companies that make their products in the U.S.
- Eliminate the green energy subsidies in the Inflation Reduction Act (IRA)
- *Federal rate changes, tax credits, and excise taxes do not generally have a direct impact on Virginia tax returns*

Other Potential Federal Tax Policy Changes

Individual Income Taxes

- Exempt tip income from individual income – *approx. loss of $70m annual VA impact (based on national data from the Committee for a Responsible Federal Budget)*
- Exempt Social Security benefits from individual income and payroll taxes – *already exempt from Virginia taxation*
- Exempt overtime pay from individual income and payroll taxes – *approx. loss of $220m-$305m annual Virginia revenue impact (based on industry data from BLS)*
- Increase the federal Child Tax Credit – *no impact to Virginia returns*
- Remove or modify cap (e.g., increase to $15k-$20k) for state and local tax (SALT) deduction (likely part of TCJA extension) – *no direct Virginia impact because Virginia deconforms from the SALT cap, but could impact PTET*

Key Takeaways and 2025 Session Outlook

Key Takeaways and 2025 Session Outlook

- Federal debt is expected to reach $44.0 trillion by October 2029. Interest expenses are expected to almost triple by 2029 prior to additional tax or spending decisions.
- Federal spending is largely concentrated in mandatory programs (Social Security, Medicare, and Medicaid), which are difficult to restrict without major reforms.
- States generally are in a stronger fiscal position and federal policymakers may modify federal grants and other discretionary spending.
  - Federal debt may constrain federal fiscal stimulus in response to a future recession.
- Federal tax changes can impact Virginia taxable income and revenue if actions modify limitations, definitions or exempt income from federal taxable income.
  - General Assembly will need to evaluate federal changes and then determine appropriate response to Virginia tax policy.
- Due to rolling conformity, Virginia may conform to certain federal tax policy changes without the General Assembly considering impacts to taxpayers or the general fund.
  - May generate large revenue variations and potentially create structural imbalance in an adopted budget.