SQUIRE PATTON BOGGS

THE STATE OF THE UNION IN 2015

WHAT TO EXPECT FROM THE 114TH CONGRESS

JANUARY 21, 2015

“[THE PRESIDENT] SHALL FROM TIME TO TIME GIVE TO
THE CONGRESS INFORMATION OF THE STATE OF THE UNION,

AND RECOMMEND TO THEIR CONSIDERATION SUCH MEASURES
AS HE SHALL JUDGE NECESSARY AND EXPEDIENT;”

Article 2, Section 3

U.S. Constitution

INTRODUCTION

Last night, President Barack Obama delivered his sixth State of the Union Address before a joint session of the 114th Congress. Given six years to the day of his first Inaugural Address, this was his first address to a Congress under Republican control. Arguing that the "shadow of crisis has passed," he focused the bulk of his speech on his domestic agenda for his last two years in office. As he has done in recent weeks, the President again called on Congress to find common ground on a host of issues that would help create jobs and boost wages for middle-class Americans.

Speaking on behalf of the Republican Party in the GOP address following the President's address, Senator Joni Ernst (R-IA) said there is much that can be achieved by the President and the new Republican-led Congress to create jobs, boost American manufacturing, and increase wages if the two parties work together. Bipartisan support exists in Congress for removing trade barriers, reforming the tax code, and building the Keystone pipeline, Senator Ernst noted, calling on the President to work with the new Congress to make them happen.

In this analysis, we explore three areas of potential compromise that would have significant, long-term value for the country: taxes, trade, and transportation. Seven deadlines requiring congressional action will undoubtedly have an impact on the willingness of Members to work within their own caucuses and across the aisle. We look first at the political environment in which the debate will occur, and then review those looming dates on the calendar.

Potential Areas of Agreement

To put the next two years in context: In the six years he has been in office, the 111th, 112th, and 113th Congresses found common ground with President Obama on roughly the same number of bills produced by the 80th Congress alone, the "Do Nothing Congress" against which Harry Truman campaigned in 1948. In those six years, President Obama vetoed only two bills. In the past two weeks, the White House has already identified seven bills that the President would veto if presented to him. With confrontation already emerging between the President and Republicans over issues such as the Keystone XL pipeline and immigration, are we facing two more years of gridlock in the 114th Congress?

We don't think so. In fact, we are optimistic that Congress and the President can reach agreement on many issues, including on at least two of the three major "t" issues: trade and transportation, with a potential on the third: taxes. For the President, these would be legacy-building accomplishments. What's in it for Republicans?

Republicans, in particular in the Senate, have reasons to offer an olive branch, not least to show the American public in the run-up to the presidential elections in 2016 that they can govern. The 2014 Senate races were run in states that naturally favored Republican candidates, including several states in which Democratic incumbents were facing electorates that had voted for Mitt Romney by double digits in 2012. By contrast, Democrats will clearly be on offense in 2016, when 34 seats will be contested. Many Senate races will be fought in states much more historically receptive to Democratic candidates. In addition, the party will have the benefit of a Presidential race turnout model that boosts Democratic prospects in close races. Of the 34 Senate seats up in 2016, 24 feature Republican incumbents while just 10 Democrats will be up for re-election. Unlike in 2014, none of the 2016 Democratic Senators up for re-election hail from states that President Obama lost in the 2012 election. By contrast, Republicans must defend six seats in states that President Obama carried in 2012 (Florida, Illinois, Iowa, New Hampshire, Ohio, Pennsylvania, and Wisconsin) and two he carried in 2008 (Indiana and North Carolina).

In this environment, many Senate Republicans will likely wish to demonstrate to their constituents that they can work with Democrats to move legislation forward that can be signed into law. No longer a party in control of only one chamber, the onus now is on Republicans to change the narrative of a "Do Nothing Congress" to one of a "Do Something Congress." Since they remain six votes short of the 60 votes needed to overcome even a threatened filibuster by Democrats, Senate Republicans will need to reach across the aisle to move legislation in which they have an interest. Moderate Senate Democrats thus will soon be in a position to shape the outcome of legislative debates. Congressional Republicans will no doubt consider using the Budget Reconciliation process, which requires a simple majority in both chambers, to advance major legislative priorities. (But given the limitations inherent in this procedural option, they may find that their options are limited.) Lacking 67 votes in the Senate, Congressional Republicans cannot expect to overcome presidential vetoes if they go too far.

History shows that the last two years of a lame duck President can be productive, even for a President facing a Congress controlled by the other party. Presidents Ronald Reagan, Bill Clinton, and George W. Bush, the last three Presidents to serve two four-year terms, successfully worked with Congress to enact significant legislation or to otherwise achieve landmark initiatives in their final two years in office. President Reagan, for example, pushed back against conservatives in his base to negotiate an important arms reduction treaty with the Soviet Union that eliminated the threat of intermediate-range nuclear missiles. Notwithstanding opposition from his party, President Clinton reached agreement with China to normalize trade relations between our two countries.

Even though he did not enjoy as much success as Reagan and Clinton, President Bush found common ground with Democrats on a major energy bill, the last "all of the above" energy bill to clear Congress, and signed into law legislation that was essential to dealing with the fallout of the collapse of Lehman Brothers, when the world economy also was at risk.

President Obama will face similar opportunities, such as working with Republicans in Congress to secure enactment of Trade Promotion Authority, which we think is essential for his Administration to conclude major trade agreements across the Atlantic (Transatlantic Trade and Investment Partnership or "TTIP") and across the Pacific (Trans-Pacific Partnership or "TPP") for the benefit of the nation as a whole. Although the President devoted much of his remarks about tax reform to the individual side of the ledger, fundamental tax reform on the corporate side of the ledger might be within reach, but as we point out below a "corporation only" reform package would present difficult issues. If realized, that goal could pay dividends for decades. Finally, there is a real need to address the impact of "sequester" on future spending options, especially the adverse impact sequester will continue to have on military readiness. Beyond these more contentious issues, Congress and the White House should be able to reach agreement on a new surface transportation bill, an aviation funding bill, and other bills that historically have enjoyed bipartisan support, such as education reform legislation.

While opportunities for bipartisan cooperation clearly exist, hurdles remain. A key dynamic will be the President's ability or inability to build legislative coalitions needed to move bills through Congress, as well as the willingness of moderate Senate Democrats to work with Senate Republicans irrespective of the President's position on issues. Last night, for example, the President called on Congress to raise taxes for wealthier taxpayers and large financial institutions in order to provide tax cuts for middle-class Americans, a position that may be popular with liberal Democrats but will make it harder for moderate Democrats to find common ground with their Republican colleagues committed to achieving fundamental tax reform. Moreover, relations between the White House and key legislators in Congress have deteriorated to a low point, which the President appears to have acknowledged last night in reaching out with suggested areas of compromise and offers to work with Congress. Barring a major change in approach by either side in 2015, McConnell and Boehner will likely continue to face challenges in securing support from their Members for initiatives seen as accommodating the priorities of a president who has been unwilling to accommodate the priorities of their constituents. Moreover, the two leaders will face the continuing challenge of finding common ground given the large, conservative House majority and the narrower, more constrained Senate majority.

Notwithstanding the skepticism about whether these hurdles can be overcome, we remain optimistic. In December, we saw a glimpse of how legislators could work together for the benefit of the American public. If there is hope for the millions of Americans who feel disenfranchised by both parties, it's the fact that on probably the biggest vote of the last Congress—to pass a funding bill to keep the government running—a centrist-bipartisan group was able to come together and vote to make government work. That's an encouraging sign for all Americans and could be a brighter path for the future of the 114th Congress.

Seven Dates to Watch.

February 2. The President will submit his budget, much earlier than in prior years. In it, he will lay out his spending priorities, as well as signal the areas in which he hopes to reach agreement with Congress beyond taxes, trade, and transportation.

February 28. The short-term funding bill for the Department of Homeland Security expires. The House has already approved a bill to extend funding for the balance of the fiscal year, but the version it adopted will not likely get much support in the Senate, let alone become law. As approved by the House, the new funding bill would block the Administration from carrying out the President's immigration reform executive orders promulgated late last year.

March 31. The so-called "Doc Fix" needs to be extended if physicians are to avoid a steep drop in Medicare reimbursement rates. Last March, for the 17th time since 2003, Congress adopted yet another short-term "fix," in this instance a one-year extension of current law, and then only because the House leadership moved the bill by voice vote when no Tea Party Members were on the floor to object. This year, the House will likely need to face the issue head on.

March 31. By the end of March, the federal government could reach the end of its capacity to borrow, which would require a further increase in (or suspension of) the debt ceiling. The date is not fixed, as with the expiration of the "doc fix," since the date on which the Treasury would be unable to borrow depends on a variety of factors, including tax receipts and its ability to implement "extraordinary measures" to extend its borrowing authority. (With the use of such measures by Treasury, the effective deadline could be July or as late as September.) The leadership of the Senate and House have made it clear that Republicans will not allow the government to default, and thus will undoubtedly find a way to extend current law this spring, in time to avoid the default precipice. The House and Senate will put significant energy between March and May into passing a budget resolution for the coming fiscal year. While it is unclear at this time what the contours of this budget blueprint will be, it is a near-certainty that the resolution will assume an increase in the debt limit later in 2015.

May 31. The Highway Trust Fund will become insolvent unless Congress has done something to top it up. The account funds improvements to the nation's infrastructure: bridges, roads, and public transit. The looming deadline could trigger an intra-party fight among Republicans, pitting those who support federal funding against those who believe States should be principally responsible. As further explored below, Congress will separately be debating a longer-term funding bill and potential sources of financing, including whether Congress should increase the gas tax that historically has been the principal source of revenues in the fund, especially now that crude oil prices have fallen so substantially in recent months.

June 30. The Export-Import Bank's charter will expire unless reauthorized. Before a provision to arm Syrian rebels overtook the debate on passing a stop-gap funding bill, the rift over Ex-Im funding left that measure in doubt. In this Congress, House Republicans opposed to extending the Bank's charter will have a cleaner shot at forcing major changes or killing it out right.

September 30. The Federal Aviation Administration authorization (as well as funding for the entire government) will expire on the eve of the new fiscal year. Congress must act to ensure continued funding for the nation's air transportation system. Issues will likely include how to protect the air traffic control system from annual budget uncertainties and accelerate NextGen technology, increasing the Passenger Facility Charge, and recurring debates over funding for small and rural airports and relaxing limits on long-distance flights going in and out of Reagan National Airport in Washington, DC. Authorizations for the popular Children's Health Insurance Program and Child Nutrition program also are set to expire on this date, along with the normal appropriations bills that keep the federal government operating.

Other developments that may shape the policy year ahead for Congress and the President include an expected ruling by the U.S. Supreme Court in June in *King v. Burwell*, on the constitutionality of the federal subsidies that are a critical component of the Affordable Care Act (ACA); a possible push by the President and bipartisan leadership of Congress for passage of a formal Authorization of Military Force (AUMF) against the global ISIL terrorist force; and the June 1 expiration of the Foreign Intelligence Surveillance Act (FISA), the statute that authorizes federal law-enforcement and anti-terror agencies to engage in wiretapping and other forms of electronic surveillance.

About Squire Patton Boggs

As a firm with deep public policy roots, we are proud of our ability to help clients exercise a right enshrined in the U.S. Constitution by petitioning their government. We have been at it since 1965, when Jim Patton encouraged a young White House aide named Tom Boggs to help him build a different kind of law firm, one that understood that all three branches of government could provide solutions to challenging problems. By combining political know-how, legislative experience, and substantive knowledge of the law, they had a vision for helping clients achieve success.

Last year marked a historic transition for our public policy practice, as we joined with our colleagues at Squire Sanders to form Squire Patton Boggs and dramatically expand the capabilities we offer our clients. From a boutique firm with an international focus in 1965, we have evolved today into a true global firm with 44 offices in 21 countries, including a presence in capitals around the world where major policy decisions made today could affect your business tomorrow. Today, we have the ability to address your business objectives worldwide. We look forward to using our broader capabilities to do so in Washington with the 114th Congress and throughout the world.

COMPREHENSIVE TAX REFORM

Fundamental tax reform has been on the agenda for years, but the effort to enact a comprehensive bill has not gained meaningful traction beyond proposals put forward by leading Members of Congress and the Administration. In the last Congress, the chairs of both the Senate Finance Committee (Senator Max Baucus) and the House Ways and Means Committee (Representative Dave Camp) tabled a series of options and proposals, particularly in the business tax area. In 2012, the Obama Administration expressed support, in principle, for moving forward with business tax reform. In the end, however, the necessary bipartisan support for a package proved lacking as, for example, key Senators could not agree whether a reform package should raise net revenues for other spending programs and deficit reduction or be "revenue neutral" with any revenue from closing "loopholes" being used to finance further tax reductions.

With Republicans now in control of the Senate as well as the House, what are the prospects for action on comprehensive legislation? Senate Majority Leader McConnell recently noted that "[d]ivided government is the perfect time to do tax reform." The new chairmen of both congressional tax writing committees—Senator Orrin Hatch (R-UT) and Representative Paul Ryan (R-WI)—appear committed to the tax reform effort. Indeed, there has been increasing discussion in many quarters that fundamental tax reform could emerge as another viable opportunity for bipartisan cooperation—perhaps even the enactment of final legislation—in 2015 and 2016. Moreover, the appointment of cross-party tax reform working groups within the Senate Finance Committee suggests that Republicans recognize the need to achieve a bipartisan consensus for tax reform to move forward, particularly in the Senate.

Fundamental reform will also require the commitment of the President and his active participation in, and support for, the give and take of the reform process. The hopes of tax reform proponents that the President would do precisely that, and do so in a bipartisan fashion, were drawn into question in some quarters by the President's decision to use his State of the Union speech last night as the vehicle to propose some $320 billion in new taxes, aimed largely at investment income and large banks, with revenues raised by these new taxes dedicated principally to a new or expanded series of tax credits and incentives ostensibly directed to middle income taxpayers.

Specifically, the President would increase the top capital gains tax rate to 28 percent and eliminate the provisions of existing law that provide for a stepped-up tax basis on inherited assets such as real estate, stock, and securities. In addition, the President would impose a 7 basis point fee on the liabilities of roughly 100 of the largest financial institutions. The President would use the revenue generated from these tax proposals to "better support and reward work" through the creation a new "Second Earner Credit," expansion of the Earned Income Tax Credit and child care tax benefits, and streamlining of education tax incentives.

Additionally, the revenue would be used to reform retirement tax incentives and expand savings opportunities, while also helping to pay for the President's recent proposal to make two years of community college free to all students.

Republicans already have rejected the proposals. It remains to be seen whether they will be a deterrent to tax reform or merely represent an effort by the President to make certain that his proposals are "on the table" when the bargaining that is an inevitable part of the legislative process begins in earnest. Even if the latter proves to be the case and the President becomes an active participant in a bipartisan tax reform effort, there will be, as illustrated below, many hurdles to overcome.

Any serious effort at fundamental tax reform will require Congress and the President to tackle and resolve a great many issues. A major threshold issue is whether to limit the tax reform effort to "corporate" tax reform. Given that the U.S. corporate tax rate is among the highest in the world, there appears to be an emerging consensus that a reform package should broaden the corporate tax base and use the resulting revenue savings to reduce the corporate tax rate. While the Administration generally has supported a corporation-only approach, last night the President emphasized proposed changes to the individual side of the ledger, with explicit calls to use the code to make it more progressive, in part as a means to provide greater relief to the middle class.

A piecemeal approach to tax reform is appealing to many given the absence of a comparable consensus on how the individual income tax system should be reformed, but such an approach is complicated by the fact that, with the rise of new forms of business organizations, such as limited liability companies, and other factors, an increasing portion of business income is reported on individual rather than corporation income tax returns. Given the emerging consensus that the U.S. corporate tax rate, which is among the highest in the world, should be reduced, a reform package that addresses only corporations could well result in different tax burdens being imposed on substantially the same types of economic activity. For this and other reasons, and in contrast to the apparent position of the President, Finance Committee Chairman Hatch appears inclined, as illustrated by the discussion in his recent tax reform working paper, to addressing both business and individual tax reform issues at the same time. It remains to be seen, however, whether with his State of the Union proposal to repeal the carryover basis rules for inherited property, the President will have placed individual tax reform more squarely on the tax reform agenda. If that proves to be the case, the absence of a consensus on a path to individual tax reform could slow the tax reform process.

Within the business sector, a second major issue that must be confronted is how to address international tax issues. Unlike many if not most of the members of the Organisation for Economic Co-operation and Development, which have adopted a *territorial tax system*, the United States taxes U.S.-based businesses on their worldwide income. This fact, plus the high (by international standards) U.S. corporate tax rate is believed by many to the prime cause of the spate of inversion transactions and to provide incentives for new businesses to organize and maintain their headquarters outside the United States. Although the adoption of a "pure" territorial system is unlikely and would certainly continue to be opposed by the President, there may be room for a "middle ground" approach such as that recommended in the prior Congress by Representative Camp. As in the Camp proposal, however, even a middle-ground proposal, such as limiting the tax on income from international operations to nominal amount (such as 5.25 percent as some have proposed), will necessarily be accompanied by anti-abuse provisions intended to prevent artificial shifting of business activity (or assets such as patents and other intellectual property) to locations outside the United States. Efforts to combine a reduction in the corporate tax rate with movement toward some form of territorial system could lead to consideration of other provisions intended to preserve the corporate tax base, such as those tabled by former Representative Camp with respect to ability of certain types of corporations to avail themselves of the tax benefits available to certain types of entities such as real estate investment trusts.

Any comprehensive approach to business tax reform will also likely address so-called *earnings stripping transactions* in which multi-national businesses based outside the United States use intercompany debt to reduce the U.S. tax on their U.S. operations. The expressed concern is that U.S. subsidiaries of foreign-based businesses may owe a particularly high (some would say "excessive") amount of debt to their foreign affiliates in order to generate large U.S. tax deductions that erode the U.S. corporate tax base. This area is considered particularly ripe for action given the use of such transactions by former U.S. businesses following inversion transactions and the fact Republicans and Democrats alike appear concerned that the current rules on earnings stripping are inadequate.

Hurdles to fundamental tax reform will not be limited to those initiated on Capitol Hill or in the White House. Lowering tax rates and using base-broadening measures to generate the revenue savings necessary to support those lower rates, will necessarily produce "losers" as well as "winners." For example, capital-intensive businesses may favor more generous depreciation allowances for plant and equipment while businesses in other sectors of the economy may prefer rate reductions to "tax preferences." A split within the business community could slow, or perhaps derail, the tax reform process.

Finally, the tax code has attracted the attention of those who would use tax reform to finance other priorities and needs such as the significant revenue shortfall in the Highway Trust Fund. As a result, both the Administration and some in Congress have looked to the possible use of one-time measures that may be included in a tax reform package as a source of financing highway-related infrastructure spending. For example, Representative Camp proposed that U.S.-based multinationals be subject to tax at a reduced rate on their historic earnings from international operations over an eight-year period, with the revenue diverted to the Highway Trust Fund.

Whether fundamental tax reform is completed in 2015-16 and thus becomes part of the President's legacy or, as many have suggested, must await the outcome of the 2016 presidential and congressional elections, remains to be seen. What now seems certain, however, is that 2015 and perhaps 2016 will be a period of intense activity related to taxes generally and tax reform in particular. If fundamental tax reform is not enacted in the current Congress, positions taken by key congressional and administration participants in the legislative process during 2015-16 on more than a few issues, may well inform the decisions made on those issues by the Congress that will convene in January 2017.

TRADE POLICY

With Republicans now in control of the Senate President Obama may find more support for his trade policy agenda. Last night, the President urged Congress to give him the authority to advance his trade policy agenda as a means of creating jobs. The Republican Party traditionally supports pro-business free trade policies, and Senate Republicans are expected to be stronger proponents of free trade in the 114th Congress. Though some House Republicans, particularly those elected as part of the Tea Party movement, and liberal Democrats have expressed concern about the lack of congressional involvement in free trade negotiations, House Republicans are generally supportive of renewing the "fast-track" Trade Promotion Authority (TPA) necessary to implement any signed trade agreements by sending them to Congress for an up-or-down vote, without subjecting them to normal procedures such as amendments and filibusters. That said, the Obama Administration will still need to increase its engagement with House and Senate Republicans and moderate Democrats to ensure passage of TPA renewal in the 114th Congress. With a narrow majority in the Senate, Senate Republicans may need to agree to incorporate certain labor and environmental provisions generally viewed more favorably by Democrats in order to secure enough votes to pass TPA.

Trade Promotion Authority (TPA) Renewal.

Although the Obama Administration has stated that it does not believe it needs renewal of the TPA to reach final agreement on the Trans-Pacific Partnership (TPP) or the Transatlantic Trade and Investment Partnership (TTIP), its negotiating partners have argued that they cannot view any U.S. offers as final offers without TPA since otherwise Congress would have the ability to amend the agreement. As Chairman of the Senate Finance Committee, Senator Orrin Hatch would prefer for Congress to pass TPA before the Obama Administration reaches final agreements on TPP and TTIP. House Ways and Means Chairman Ryan will host a hearing on the U.S. trade policy agenda with U.S. Trade Representative Michael Froman on January 27. The event will likely push the momentum forward for the President's broader trade agenda, including TPA. But the President's push for fast-track authority faces dissent from within his own party. A group of congressional Democrats, led by Representatives Rosa DeLauro (D-CT) and Louise Slaughter (D-NY), planned to host a press conference today to highlight democratic opposition to TPA. So, the fight has just begun.

Trans-Pacific Partnership (TPP).

TPP completion is intricately intertwined with bilateral talks between the United States and Japan on market access in automobiles and agriculture, and the two countries have yet to come to an agreement. Moreover, TPP countries are still working to narrow down remaining issues, including addressing non-conforming measures, financial services, e-commerce, localization of servers, intellectual property, and rules of origin. While negotiators had hoped to complete the agreement before the November 2014 Asia-Pacific Economic Cooperation meetings in Beijing, TPP now will likely be concluded this year. This timeline should give the Obama Administration time to push for passage of TPA first.

Transatlantic Trade and Investment Partnership (TTIP).

Initially, the U.S. and EU set an ambitious goal of concluding TTIP by the end of 2014, but it has become clear that deadline was untenable. Since its launching in 2013, the U.S. and EU have participated in seven rounds of formal negotiations. At the most recent round, the EU tabled a proposal for a sanitary and phytosanitary (SPS) chapter, as well as papers on automotive and chemical regulatory sectors. Much of the momentum and outlook for TTIP had been stalled by elections on both sides of the Atlantic, but especially in the EU, as candidates focused their efforts on protecting their domestic base. TTIP is not expected to be concluded until at least 2016. Therefore, Congress is likely to devote more attention to TPP in the near future.

TRANSPORTATION AND INFRASTRUCTURE

Transportation and infrastructure issues promise to be a prominent part of the 114th Congress, which faces the need to extend or reauthorize the nation's surface transportation and aviation programs, with funding and policy challenges involved in each. Passenger and freight rail safety reauthorization will be on the agenda, along with legislation addressing key commercial and competition issues for the nation's railroads. With this range of issues on the agenda, the 114th Congress is shaping up to be both busy and highly consequential for transportation and infrastructure stakeholders.

The surface transportation program is at a crossroads. The 114th Congress may prove decisive in setting the future direction for federal investment in the nation's highway and mass transit systems. Since 2008, incoming revenue into the Highway Trust Fund (HTF), primarily from the gas tax, has been insufficient to support authorized expenditure levels and is continuing to lose ground. The federal gas tax, which is set at a fixed 18.4 cents per gallon, has not been increased since 1993. At the same time, increases in fuel efficiency and changes in driving patterns have led to decreasing gas tax revenue, resulting in an ever-widening gap between revenue and authorized spending levels.

With the Highway Trust Fund (HTF) again facing insolvency, Congress enacted legislation on July 31, 2014 to transfer $10.9 billion from the General Fund to the HTF to maintain current funding levels through May 31, 2015. Since 2008, Congress has transferred approximately $67 billion from the General Fund to the HTF to maintain its solvency. Together with the funding patch, Congress extended the most recent two-year authorization, the 2012 Moving Ahead for Progress in the 21st Century Act (MAP-21), until the end of May.

Only months after being sworn in, the 114th Congress will confront the need to reauthorize or extend the federal surface transportation program and the fundamental question of how to pay for it. The most recent Congressional Budget Office (CBO) projections indicate that $22 billion in new revenue will be needed to extend the program for an additional two years through the end of FY2016, $52 billion will be needed for a four-year reauthorization through FY2018, and $85 billion in new revenue will be needed for a six-year reauthorization through FY2020. The question of how to pay for the surface transportation program, in turn, is inextricably tied to the question of what to fund and what the federal role in transportation investment should be.

This large and growing structural deficit, coupled with serious questions about the political viability of further General Fund transfers, brings the surface transportation program to a potential inflection point. The 114th Congress and the Obama Administration face three fundamental choices for the future of the program: (1) increasing the gas tax or raising dedicated new revenue from other sources; (2) reducing spending to align with available revenue, and deciding what to fund within the revenue constraint; or (3) continuing the General Fund transfers and short-term policies that have sustained the program since 2008. There is also certain to be increasing debate over "devolution"—in essence, reducing or substantially eliminating the federal gas tax and federal role, and devolving the financing and administration of surface transportation program to the states.

In many ways, MAP-21 was a transitional bill, setting the stage for these decisions ahead. Responding to the constrained funding environment, MAP-21 focused on maximizing the value of existing resources. It expanded innovative financing opportunities, increasing funding for the Transportation Infrastructure Finance and Innovation Act (TIFIA) low-interest loan program nearly tenfold. It broadened tolling opportunities and took steps to facilitate public private partnerships (PPPs). It streamlined the environmental process to accelerate project delivery and encourage innovative delivery methods. Most significantly, it took steps to define and prioritize systems that are in the federal interest, targeting over 60 percent of highway funding to an expanded National Highway System consisting of the nation's most important highways; and requiring the designation of a Primary Freight Network consisting of the nation's most significant freight corridors. In short, MAP-21 could provide the framework for moving the program forward largely intact with additional revenue or the beginnings of a blueprint for fundamentally refocusing the federal role to operate within available HTF revenues.

Although there has been renewed discussion of a gas tax increase, this option continues to face steep political hurdles. While some key Republican Senators have indicated that they are open to considering it, Speaker Boehner, Ways and Means Chairman Ryan, and Transportation & Infrastructure Chairman Bill Shuster (R-PA) have indicated that a gas tax increase will not pass the House. Senate Finance Committee Chairman Hatch, while open to it, has said it is highly unlikely.

One option for raising revenue for transportation is through tax reform, linking the two pieces of legislation as Speaker Boehner has proposed and the President urged last night. The Obama Administration's budget proposals and $302 billion surface transportation reauthorization proposal, the GROW AMERICA Act, called for generating revenue through "pro-growth business tax reform," but did not provide further details. Dating back to the so-called Super Committee process, the bi-partisan "Gang of Six" proposed maintaining the current gas tax but raising $133 billion over ten years for transportation as part of comprehensive tax reform.

There has been particular focus in Congress on "repatriation," or tax changes that would encourage or require companies with overseas income to repatriate it to the United States, with resulting tax revenues used to fill the shortfall in the HTF. Former House Ways and Means Chairman Camp included a mandatory repatriation proposal in his comprehensive tax reform draft as part of the transition to a new corporate tax system, which Administration officials said was in the "same zip code" as their thinking.

Many other ideas have emerged, but each faces challenges. There have been various proposals to link transportation and energy revenues, either through expanding domestic oil and gas drilling and devoting the new revenues to transportation (a Republican proposal from the 112th Congress); or new taxes on oil sales (a Democratic proposal from the 111th Congress). Others have proposed indexing the gas tax for inflation or converting the current fixed per-gallon tax to a percentage sales tax. There does not appear to be any political will for converting to a mileage-based fee or Vehicle Miles Traveled (VMT) tax, although many experts point to the VMT as the most sustainable solution.

The other fundamental choice is to reduce spending to align with HTF receipts. There is a view that if additional revenue cannot be raised, the federal program must live within its means and investment should be refocused on the areas of greatest federal interest and with the greatest importance to the nation's economic competitiveness.

Proponents of this view generally call for available revenues to be bolstered through further expansions in innovative financing, tolling and PPPs; and for federal requirements to be further streamlined to reduce costs and provide states with maximum flexibility. Indeed, under any scenario, there is broad consensus that federal transportation policy should take steps to facilitate and expand PPPs and innovative finance. Leading up to his State of the Union remarks, the President announced infrastructure proposals to provide greater opportunity for private investment in public infrastructure projects, including a new type of bond—a Qualified Public Infrastructure Bond—that extends the benefits of municipal bonds to PPPs. There is also broad support for tolling in connection with adding new highway capacity and for High-Occupancy Toll (HOT) lanes, but tolling existing, general-purpose lanes on the Interstate remains divisive.

Notwithstanding the challenge of identifying funding sources, there will be significant pressure to avoid large-scale cuts to transportation spending. Without additional revenue, however, spending would have to be cut by more than 30 percent to stay within available HTF balances. Influential stakeholders have strenuously opposed such cuts in the past. Construction projects and jobs would be affected in every state and district. Further, while many in the transportation sector are hopeful about expanded innovative financing, PPPs, and the use of tolls, there is also a broad consensus that these mechanisms only work for a limited number of projects and are a supplement to—and not a substitute for—base system revenues.

In any scenario, there are likely to be voices calling for an end to dedicated HTF funding for mass transit. Of the 18.4 cent-per-gallon gas tax, 2.86 cents is dedicated to the Mass Transit Account to support $8 billion in annual HTF outlays for transit. While the House has generally been less supportive of funding for urban transit systems, the debate over MAP-21 confirmed there is a fundamental core of bi-partisan and bi-cameral support for dedicated transit funding. At the same time, there are signs of increasing interest in finding ways for transit users to contribute to a financing solution, and proposals for new transit user fees could emerge as part of the debate.

Ultimately, the fundamental question facing the 114th Congress is whether and how to raise additional revenue, followed by the question of what the federal program will look like under the various constraints. With the change of party control of the Senate, we expect there to be a more fundamental and concerted debate about the future of the HTF that will give voice to the different options and alternatives outlined here. At any funding level, the Republican-controlled Congress is likely to favor accelerating the direction and reforms in MAP-21 and will likely seek to prioritize investment in the higher order systems, further streamline the environmental process, and make greater use of tolling, innovative financing and PPPs.

Chairman Shuster and Senate Environment and Public Works Chairman Jim Inhofe (R-OK) favor a six-year reauthorization. Chairman Inhofe has been quoted as saying his top priority is to "pass a fiscally responsible, long-term transportation bill that builds upon the reforms in MAP-21, better coordinates funding needs with private and state partners, and eliminates wasteful spending."

After years of short-term policies, the next Congress could well prove decisive in setting the future direction for the nation's highway and transit policy. At the least, the future of the surface transportation program is shaping up to be a key point of focus. With the current extension expiring at the end of May, the 114th Congress will confront these issues along with a window of opportunity for major legislation before the next presidential election.

SQUIRE
PATTON BOGGS