Morgan Stanley

Beyond the Mid-Term Elections: A Post-Election Legislative Outlook

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Introduction

On Election Day, United States voters spoke with unmistakable certitude. Republicans rode an anti-incumbent, anti-Washington and Tea Party-driven wave to retake the House after four years in the minority, netting at least 61 seats, easily clearing the 39 needed for control. With several states too close to call as of Wednesday morning, the Senate will remain in Democratic hands. However, Republicans also managed significant gains there as well, netting at least 6 seats to reduce the Democratic advantage to 51-47, with 2 races still undecided as of Wednesday morning. This watershed election heralds a return to a divided government where Democrats and Republicans will be forced to deal first with each other if they are indeed going to deal with America's problems.

After the existing Congress completes business in the November/December "lame duck" period, the 112th Congress will take the reins in January. The conventional wisdom is that a divided Congress will produce very little in the way of legislative accomplishment. However, the inherent risk in doing nothing is a weak legislative record on which to run for re-election. President Obama and Congress will surely be mindful of this, as the 2012 election looms. That risk is even more pronounced in the current environment where the electorate clamors for solutions.

Thus, it is quite possible that after the dust settles and the two sides have had time to stake out their positions in the new Congress, both parties may realize that to govern effectively, they must agree on something. While agreement is likely to remain elusive in many areas where the chasm is simply too wide to bridge, limited compromise could be found in a few areas, including energy, tax, trade and immigration.

This report provides a look ahead, introducing the new leadership team that will likely control the houses of Congress, previewing the "lame duck" legislative period, and examining the issues that will drive the agenda in 2011 and beyond.

Changes at the Top: New Leadership in the Next Congress

Next year, the congressional stage will feature new faces in many leadership positions, including influential committee chairmanships. The changes this year will be particularly stark as Republicans, after several years in the minority, have their turn to run the House and control the agenda. While intra-party leadership elections, decided by the parties' respective steering committees, will not take place for several weeks, the following are the most likely scenarios.

Incoming members are expected to appoint Rep. John Boehner (R-OH) to be Speaker of the House. As his second in command, Republicans will likely promote Rep. Eric Cantor (R-VA) to be their new Majority Leader. Sen. Harry Reid (D-NV) managed to win a closely contested race in Nevada, and should continue as Majority Leader of the Senate.

House Ways and Means Committee – Michigan Congressmen Dave Camp is expected to lead the House Ways and Means Committee and chart the agenda in the areas of taxes, trade, health care and Social Security. He is expected to push proposals to lower taxes on business and expand trade. Given the focus on the deficit, particularly the growing cost of entitlement programs, he will be tasked with coming up with new ways to reduce spending.

House Budget Committee – With much of the election focus on government spending, the budget Congress produces will need to demonstrate a clear path to deficit reduction. Wisconsin Congressman Paul Ryan is expected to lead the House Budget Committee and will likely put forth a budget document that significantly reduces government spending.

House Financial Services and Senate Banking Committees – As discussed further below, the banking committees will both have new leaders to steward housing reform and *Dodd-Frank Act* implementation. Rep. Spencer Bachus (R-AL) will likely sit atop the House Financial Services Committee, replacing Rep. Barney Frank (D-MA). The Senate Banking Committee, having lost Sen. Chris Dodd (D-CT) to retirement, will be chaired by South Dakota Senator Tim Johnson.

House Oversight Committee – Rep. Darrell Issa (R-CA) will likely take control of what portends to be an important committee in the 112th Congress, House Oversight and Government Reform. With commentators predicting that Republicans will challenge the Administration with scrutinizing government oversight, the aggressive and dogged Issa will be in a unique position of power.

Common Ground or Scorched Earth: Will the Parties Come Together?

With the House having turned over to Republican control and the Senate Democrats losing their strong majority, the legislative landscape will certainly shift after this election. In the House, where a single-vote majority passes bills, the Republicans should be able to muscle through legislation at will, assuming leadership can keep rank-and-file members in line. Look for a quick, aggressive thrust to pass deficit-reduction measures and follow through on commitments outlined in their "Pledge to America." In the Senate, where the filibuster threat necessitates a 60-vote supermajority to pass controversial bills, Democrats will find it difficult to leverage their bruised-but-not-dead majority. In contrast to the current Congress, where a 59-seat Democratic caucus has generally been able to lure one or two moderate Republicans to cross the aisle and vote with Democrats, Senate leaders will not have this luxury with a significantly reduced majority.

Accordingly, for Congress to pass legislation in 2011 and 2012, both parties must be prepared to engage in real compromise. But will they be so willing? While party strategy is still being developed, we find it highly unlikely that Democrats and Republicans will quickly come together in a "kumbaya" type moment in Q1-2011 or even Q2-2011.

For their part, Republicans most likely will be eager to stick to the ideological roots that drove them to victory. Moreover, Republicans may feel particularly aggrieved at the manner in which Democrats have conducted business the past four years, and may likely be slow to relinquish this bitterness.

At the same time, President Obama and Democrats have little incentive to immediately move to the center (assuming they are ever going to). While 2012 beckons, the President is not yet in full campaign mode. The economy will be defining in the next election, and the President may opt to let liquidity measures and any further quantitative easing play out first, hoping there are legitimate signs of recovery by the second half of the year for which he can take credit. Should Democrats compromise immediately with the Republicans, and should the economy then recover, it would be harder for Obama to take full credit.

This suggests that we will see partisan acrimony and gridlock dominate at least the first half of 2011. By late 2Q-2011 or 3Q-2011, Obama's 2012 campaign will be in stride; we will have greater clarity over the direction of the economy; and the President will, at this point, be faced with the "bank left or move to the center" decision. Which direction he chooses at that point remains to be seen, but it is unlikely that he will commit much sooner than that. It would appear that the attempt to reach a deal on the many open questions around tax reform will pose the first big test.

November/December: Finishing Business in the "Lame Duck" Session

The legislative process in election years is often marred by calculated actions by both parties to score political points, creating gridlock during the months just prior to the election and precipitating a post-election session to complete action on a long list of legislative issues. With the election now over, Congress will need to approve funding to keep federal agencies running, consider an extension of unemployment insurance, and address a handful of more discreet priorities. However, the biggest item of unfinished business is a package of business tax provisions and the well-publicized 2001 and 2003 tax cuts on marginal rates and investment income.

Absent action by Congress and President Obama before year-end, significant changes to the individual tax system will occur on December 31, 2010. Failure to act would allow tax rates across the board to increase, including a rise in the top tax rate from 35% to 39.6%; a capital gains tax hike to 20%; and a nearly three-fold increase in the top tax rate on dividend income. The estate tax would return at rates over 55% and a low $1 million exemption. In addition, Congress has yet to provide relief from the growing effects of the stealth Alternative Minimum Tax (AMT), notwithstanding actions in prior years to enact a routine "patch" to limit the number of taxpayers that it ensnares. Failure to enact an increase in the AMT exemption levels could potentially subject over 20 million additional taxpayers to the AMT.

Resolution of the tax debate could take several different directions in a post-election environment. The divergent positions of the two sides make a long-term solution nearly impossible, increasing the odds of a short-term fix. Thus, two options seem most likely. Congress and the White House either agree to a short-term fix to temporarily defer the issue – mostly likely resulting in a one-year extension of all the 2001 and 2003 tax cuts – or fail to pass a final bill amidst the disagreement, leaving the issue for the next Congress to deal with in 2011. Both options have the effect of perpetuating the uncertainty that continues to hinder markets and the economy. The sheer size of the issues and continued divisions in government favor enactment of temporary measures, such as a short-term extension of both the business tax extenders and the 2001 and 2003 tax cuts.

Taxes/Budget

As noted above, the future of tax policy in 2011 is largely dependent on the outcome of the vote in the next few weeks on the 2001 and 2003 expiring tax provisions. Assuming Congress extends, even temporarily, the tax cuts, the new Congress will shift attention to the deficit and the fiscal state of the government's books. A central Republican theme during the campaign was spending and the size of government. One thing to look for is the report of the President's deficit reduction commission due out by December 1. While it is unlikely the Commission will garner enough votes to make formal recommendations, it is expected to lay out several options for reductions in spending, entitlement reform (such as Social Security) and reform of the tax code. Given the fiscal situation, the Commission's options on spending, combined with the work of others, could form the basis for some bipartisan action on austerity measures. The need to compromise will likely keep any final product modest, but it will at least provide a step toward addressing the growing fiscal imbalance.

Looking beyond the budget, there is bipartisan support for making the tax code more efficient and effective in stimulating economic growth. While large scale reform of both the individual and corporate tax rules is unlikely, incremental steps could be taken. If Congress is looking to do something to please the business community with a focus on economic growth, efforts to reduce the tax burden on employers by reducing the corporate tax rate would be well received. President Obama has called for 100% expensing of business investment in new assets. Republicans could add to this proposal and develop a package of tax changes aimed at simulating additional investment and job creation. The challenge will be in finding enough areas in the tax code to lessen the impact of a rate cut on the deficit. It is a tall order, but something that Republicans may look to act on in the next Congress.

Energy

Energy policy over the past two years has been dominated by one issue – cap and trade. On the heels of a significant victory in 2008, President Obama and congressional Democrats felt emboldened to move aggressively on a new energy and climate agenda. Relatively early in 2009, Speaker Pelosi strong-armed through the House of Representatives a sweeping energy bill with cap and trade as its core policy achievement on a closely divided vote. The controversial bill languished in the Senate where Majority Leader Reid, a committed supporter of cap and trade, could not find the votes to bring the bill up for consideration. Moreover, the Senate was unable to pass any energy legislation due to the political calculation that moving an energy bill stripped of cap and trade would sit poorly with Democratic supporters. Thus, even bipartisan proposals sit without action, seemingly held hostage to a controversial cap and trade proposal.

The new reality in Congress and the Republican takeover in the House may be the catalyst that finally allows the Senate to attempt to move a more modest, bipartisan energy bill. Much of the work has been done on such a bill. The Senate Energy Committee produced a bipartisan bill without cap and trade that contained many proposals ranging from a renewable energy standard to oil and gas exploration and transmission sitting. Of course, the new Congress will not take up the prior bill, but it can serve as a starting point and an example of what is possible. Either side could insist on partisan and extreme positions, potentially derailing an energy bill once again. But energy policy has split

more on geographic and industry lines rather than on pure political ones, making deal making less obvious but possibly more likely. Thus, there is room at the table for the members of Congress with interests in exploration of traditional fuels, expansion of renewable energy sources, nuclear power and other ideas to form a coalition strong enough to get the votes. Action in the area could also be accelerated by outside events, such as a spike in oil and gas prices, blackouts or another environmental accident.

Trade

When asked to clarify his position on trade, President Obama states he is "pro-free trade, as long as it is fair." While he has made positive statements about the Doha Development Round and pending Free Trade Agreements (FTA) with South Korea, Colombia and Panama, he has not taken any meaningful steps to move these measures forward. The economy, health care reform, financial regulatory reform and other more urgent issues have taken priority.

During his first 18 months in office, trade was barely mentioned. Indeed, raising the trade issue in any way did not help build support; in fact, it antagonized critics (many of whom represent core Democratic constituencies, whose support the President needed to pass health care and other priorities) and compelled them to organize against the pending trade agreements. Instead of defending free trade, the White House strategy was to avoid the subject and initiate a series of goodwill gestures designed to neutralize opponents' arguments against free trade. Examples include: stepping up enforcement of existing trade agreements, passing health care reform, improving assistance for dislocated workers, shifting the focus from "free trade" to "export promotion," renegotiating pending FTAs to make them more favorable to U.S. workers and products, and including "Buy America" provisions in the stimulus bill. The conventional wisdom held that addressing the anxiety that underpins the hostility toward trade agreements first would help build a stronger foundation of support among key stakeholders for a more viable long term trade policy. The results of this strategy have yet to be seen, but given the economic and political environment, it is hard to argue that a different plan would have produced a better outcome.

Despite the difficult environment, President Obama has said he supports the South Korea FTA and wants renegotiations to be completed before he travels to Seoul for the next G20 Leaders Meeting later this month, and that he intends to submit the deal to Congress for a vote during the "lame duck" session. Several Republicans and Democrats reacted positively to this announcement. Current House Majority Leader Steny Hoyer (D-MD) has said that he supports the South Korea FTA and has argued that the Colombia and Panama FTAs should be considered at the same time.

Moving trade agreements through Congress requires strong leadership and tremendous personal capital on the part of the President. Senior member of the House Ways and Means Committee Kevin Brady (R-TX) has said, "If the President wants to lead, he'll have a willing partner in the GOP who can deliver those votes." Translation: the Republicans will do their part, but they will not carry all of the political risk associated with a difficult trade vote.

China Currency

Over the past two years, the U.S.-China trade relationship has come to epitomize the tensions surrounding trade and globalization generally. On September 29, 2010, the House of Representatives passed H.R. 2378, the *Currency and Fair Trade Act*, with broad, bipartisan support. Aimed at China, this legislation would alter U.S. countervailing duty law to make it easier to offset fundamentally undervalued currency as a subsidy that could lead to economic sanctions. The vote provided a way for members to demonstrate their frustration with China's currency policy and a host of other U.S.-China trade issues and their support for jobs and the U.S. manufacturing sector – critical messages for members facing difficult elections. However, shortly after the House vote, key senators signaled they would not bring the bill to a vote this year, and therefore the measure would have to be reintroduced next year. Nevertheless, Senator Schumer (D-NY), who has sponsored China currency legislation in the Senate, has stated that he will attempt to bring the House-passed bill to the Senate floor during the "lame duck" session.

The outlook for legislation this year remains unlikely – but the situation is very fluid. The threat of legislation has increased in the past few weeks given anti-China rhetoric on the campaign trail and lack of progress so far in international dialogue. Clearly, China currency is an issue where Democrats and Republicans could agree. While the White House has made it clear it prefers dialogue over legislation, most agree the President would be loath to veto a bill after stating publicly so many times that China's currency is undervalued and it hurts American workers. The outcome of the G20 Leaders meeting this month will be defining – if there is no forward movement on currency, the pressure for legislation will intensify, and both Democrats and Republicans will feel compelled to act.

Financial Services Overview

2010 was an intense year for the banking committees in Congress. The House Financial Services Committee ("HFSC") and Senate Banking Committee ("SBC") completed a legislative sprint of epic proportions by passing the *Dodd-Frank Act* in July, while simultaneously keeping one hand on the rudder to oversee the Administration's multifaceted triage of the economic crisis. And while the latter effort is ongoing, the coming year will be marked by a pivot – not only with respect to the makeup and leadership of each committee, but with regard to their agenda.

With new helmsmen in control (Republicans replacing Chairman Frank on House Financial Services, likely with lead committee Republican Spencer Bachus, and Democratic Senator Tim Johnson likely replacing the retiring Chairman Dodd in Senate Banking), responsibilities will shift to tackling the complex redesign of housing finance and presiding over regulatory implementation of the *Dodd-Frank Act.* In a more divided 112th Congress, Republicans and Democrats in each chamber will be forced to either navigate these contentious issues with greater cooperation or risk further devolution into stagnant, partisan bickering. While little legislative action beyond a handful of hearings is expected in the "lame duck" session, here is a look at the major issues those committees will seek to address in 2011:

Housing Finance

In September 2008, in response to deteriorating market confidence and faced with the impending threat of systemic destabilization, President Bush placed Fannie and Freddie into conservatorship, erasing any doubt about the nature of the federal backstop for the two GSEs. While the move was perhaps necessary to avoid contagion, untangling the conservatorship will be only one of many issues facing the newly minted Congress as it wades into complex and partisan waters of housing finance reform.

Republicans and Democrats in the HFSC and SBC have spent the better part of the decade wrestling with GSE reform, with little to show for the effort. The issue will be front and center in 2011 after Congress made the strategic decision to avoid encumbering the *Dodd-Frank Act* with the albatross of housing reform. Although *Dodd-Frank* included an array of mortgage origination provisions – including a requirement to verify a borrower's income and assets and ability to repay a loan, restrictions on prepayment penalties, and increased liability for originators – it failed to address core housing finance policy changes or the fate of the GSEs. That decision probably enabled the bill to find the slim majority it needed for passage, but it only delayed the inevitable.

Stakeholders and lawmakers have already released a variety of policy proposals expressing a range of alternatives for the future of housing finance. These proposals lay out competing visions on the extent to which the federal government will be involved in the housing market, including the role of the GSEs; what particular model should be adopted; whether an explicit or implicit federal guarantee should exist; and the future of the securitization markets. The mortgage bankers, the realtors, the securities industry, consumer rights groups and academics have all joined the chorus of wide-ranging solutions.

At the same time, the Obama Administration and Congress have begun to lay a foundation for 2011 action through a series of fall congressional hearings and an August conference at the Treasury Department. We expect the hearings to continue into 2011, initially to evaluate the merits of the various proposals, then to drill down in a more focused direction and, ultimately, to promote and move a specific legislative vehicle. The Obama Administration has indicated that it will release a comprehensive proposal for reform of Fannie and Freddie by January 2011, and House Democrats may release a initial concept draft prior to that (although having relinquished legislative control, the imperative may evaporate).

Regardless of the precise timing, housing finance will be a contentious issue that will likely devolve into a protracted political blame game prior to any productive resolution for the markets. With an eye toward the 2012 election, Republicans and Democrats will use the issue to tie the other to the root of the financial crisis. Accordingly, a final solution may not materialize until well into 2011, if not later.

Dodd-Frank Act Implementation

While housing will drive much of Congress' financial services agenda, residual *Dodd-Frank Act* issues will take up a significant amount of time as well. First, the HFSC and SBC are each tasked with oversight of the many agencies that will be writing rules under the Act. Specifically, Congress must preside over rulemaking from the CFTC and SEC on derivatives and the FDIC on resolution authority, the creation of a new systemic-risk regulator and a Consumer Financial Protection Bureau, the imposition of stricter capital and other macro-prudential rules, and more robust investor protection rules by the SEC (including a likely fiduciary duty for brokers and possible changes to mandatory arbitration), among others.

Embedded within this authority is the ability to set both the oversight agenda and the underlying tone. Chairmen Johnson (SBC) and Bachus (HFSC) will tailor their levels of scrutiny as each sees fit, which may prove particularly relevant for the Republican Bachus, who will spearhead his party's dissection of a bill that few in his party voted for and many tried to amend during passage. Accordingly, Republican control of the House gives them a useful lever to exert pressure and influence over the rule writing process, even if indirect and at the margins.

Second, we expect that the next Congress will move a bill to make "technical corrections" to the *Dodd-Frank Act*. Drafted hastily and amended quickly, the Act is littered with non-substantive errors that require further editing by Congress. While it is highly unlikely in the face of a Democratic Senate and a looming presidential veto that House Republicans will be able to repeal sections of the law with which they disagree, the technical corrections bill could provide Republicans with a means for making still meaningful changes. Should a technical corrections bill be taken up by the House in 2011, expect some spirited debate about what corrections are, in fact, technical in nature.

The appropriations process will serve as a final *Dodd-Frank Act* implementation flashpoint, as House Republicans may seek to limit critical funding needed by regulatory agencies. To address the significant responsibilities vested by the Act, the SEC has said it needs to hire 800 additional personnel. The CFTC has also argued for a significant resources increase to execute its derivatives rule writing authority, and other regulators face similar pressures. Republicans at odds with large swaths of the Act may see an opportunity to delay and frustrate implementation, and holding the gavel at House Appropriations may provide the means.

Oversight of SEC Activities

The SEC will continue its more aggressive approach under the stewardship of Chairwoman Mary Schapiro in 2011, and Congress' financial services committees will need to find time to keep a watchful eye over non-*Dodd-Frank* rulemaking at the SEC. The SEC continues to review market structure issues, including high frequency trading and dark pools. The Commission's interest is particularly acute in the wake of its May 6 Flash Crash report, and it can be expected that the SEC will seek further refinement and extension of its circuit breaker pilot program. Couple this with the myriad other issues facing the Commission, including short selling, SIPC reform, 12b-1 fees, and others, and the HFSC and SBC will have a full plate of SEC oversight.

Health Care

Of all the issues in this year's election, health care seemed to generate the most emotional debate. Democrats gambled on enacting a massive health care reform bill that has consistently generated negative results in the polls. It might be said that the one issue the electorate spoke to on November 2, beyond the economy, was opposition to the new health care law. Republicans campaigned on its repeal, and there is no doubt they will attempt to fulfill that campaign promise. However, repeal is not going to happen while President Obama occupies the White House. Republican options range from cutting off funding for many of the new initiatives to making targeted changes to the law, such as striking the individual mandate or the tax penalty for not buying insurance.

Immigration

Immigration reform remains a top priority for President Obama and many members of Congress from both parties, but efforts to legislate have faltered, and tensions among the various factions deepened during the 111th Congress. Immigration was a dominant issue in national and local campaigns, and it will continue to be leading up to the 2012 elections.

The day before Congress adjourned for the mid-terms, Senator Robert Menendez (D-NJ) introduced a broad immigration overhaul bill and pledged to bring it to the floor during the "lame duck" session. Republicans were dismissive and called it a calculated move designed to rally Hispanic voters ahead of the election (Sen. Menendez is chairman of the Democratic Senatorial Campaign Committee, which is responsible for electing Democrats to the Senate). While Republicans and Democrats agree the immigration system is broken and unsustainable in its current form, compromise will be difficult, especially after many members tacked right in an effort to fend off anti-immigration challengers. Legislation is unlikely to move forward this year, but is possible in the 112th Congress. The window for action will be short, and if legislation is not completed by the first half of 2011, it becomes highly unlikely.

A successful outcome will depend on Republicans and Democrats working together. Critics of past reform efforts complained the measures did not address illegal immigration adequately. Republican support will also depend upon strong border security. Any compromise measure that could attract support from all sides would have to address undocumented workers (how to keep companies from taking advantage of them) and provide a pathway to citizenship. In addition, the business community has advocated for reforms that would facilitate high-skilled immigration. The business community's views will weigh heavily in this debate, as its support will be needed to pass legislation.

Conclusion

Though Republicans now control the House, and their gains in the Senate will severely limit Democrats' ability to move legislation in that chamber, Republicans do not have the votes to override presidential vetoes or pass bills without serious compromise. Therefore, any successful legislation will require trilateral negotiations between the President, the Democratic Senate and the Republican House.

For all practical purposes, the 2012 presidential campaign will begin November 3, and this reality will surely impact the legislative agenda in the 112th Congress. In order to win re-election, President Obama will need to adjust his legislative priorities and change the way he interacts with Congress. The Iowa caucuses are 15 months away and Obama must begin to re-shape his presidency at a time when the momentum is moving in favor of Republicans. His options are limited. Obama could continue to press his agenda knowing it will be voted down, and then run against Republican obstructionism. Alternatively, he could find common ground with Republicans and establish his credentials as a pragmatic centrist. The result will either be gridlock or a vastly different legislative agenda, underscoring the import of Election Day 2010.

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