2015 Legislative Update:
The Republicans Take Over

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For the first time since just after the beginning of the Obama Administration, Congress convenes in 2015 with both houses held by the same party. As the Republicans take over, they are seeking the appropriate mix of confrontation and collaboration to move legislation and satisfy two factions within their party.

Most Republican members of the House – along with some notable Senators such as Ted Cruz – tend to identify with the more conservative wing of the party. They are willing to pass legislation Obama is likely to veto, thereby highlighting the differences between the parties as the country heads toward the presidential election in 2016.

In contrast, most Republican Senators identify with the more moderate wing of the party. To win their state elections, they had to court independent voters by showing willingness to compromise. Those Senators are more likely to seek accommodation with the Administration, at least on limited bipartisan measures.

For his part, Obama's actions suggest that he remains skeptical of compromise with the Republicans. Rather, he will continue to use his executive power as broadly as possible (some assert beyond what is possible) to implement his social agenda. His obstinacy could thwart efforts of the moderate Republicans to enact legislation and embolden the more conservative (confrontational) party wing. Also having the potential to thwart compromise is the emergence of a newly vocal wing of the Democratic Party (led by Senator Elizabeth Warren) that feels moderate Democrats are not doing enough to further progressive social policy.

It didn't take long after the election for all of these dynamics to be on display. Frustrated with Congress' inability to act, Obama in November issued an executive order relaxing the nation's immigration enforcement policy. Conservatives within the Republican Party, incensed at what they viewed as presidential overreaching, pushed to delay a bill appropriating funds needed to keep the government running, hoping to force the President to rescind his order (which he vowed not to do). The moderate wing of the Republican Party – while also generally disagreeing with the President's action -- feared that a government shutdown would hurt the Republican's standing before they even had the chance to take over the Senate. Ultimately Congress agreed to fund most of the government through September 20, 2015. The exception was the Department of Homeland Security (which handles much immigration policy implementation); Congress funded DHS only through February 27, 2015, setting up another showdown early next year. At the last minute, Progressive Democrats also joined the fray, opposing (without success) an ancillary provision in the final funding bill that weakened Dodd-Frank banking rules.

As this kerfuffle makes clear, split government is alive and well for at least the next two years. Congress is likely to enact most legislation only when faced with a "forcing event" that compels action to ward off a patently unwanted result (such as a default on U.S. debt). Below I discuss some of the legislative goals of the Republican Congress as well as the forcing events likely to compel action. Throughout I have tried to highlight how the various initiatives would affect particular sectors or industries, either favorably or adversely.

Budget and Government Appropriations

The Republicans are hopeful of passing a budget for government operations beginning in October 2015. That alone would be an impressive accomplishment, as Congress has been unable to agree on a federal budget heretofore during the Obama Administration. The federal budget deficit declined markedly in 2014, easing some of the strain in devising a near-term budget. Longer term, entitlement spending (primarily Social Security and Medicare outlays) remains a significant problem. Nonetheless, it is likely asking too much to expect Congress and the Administration to agree on entitlement reform in the next two years.

Congress and the Administration will have to address defense spending. A bipartisan agreement reached in 2013 implemented "sequestration" spending cuts – across the board cuts in discretionary federal spending (that is, spending other than entitlements). Sequestration imposes deeper and deeper spending cuts over ten years (eight years remain outstanding). Under the bipartisan agreement, half of the sequestration cutbacks are cuts in defense spending. Congress will have great difficulty squaring those cuts with the additional costs the U.S. will incur as it intervenes in crises in Russia, the Middle East, and Africa. Raising taxes or shifting spending from domestic priorities is unlikely to garner bipartisan support, which means that additional federal borrowing is likely.

Trade

Obama is seeking Congressional permission to finalize the Trans Pacific Partnership ("TPP"), a twelve nation free trade pact with countries in the Asia-Pacific region. TPP would lower tariffs, establish guidelines on patents and copyrights, and level the competition for international companies that compete with government-backed businesses. If finalized, it would establish the world's largest free trade zone. The goal is to boost U.S. exports to Asia to counter increasing competition from China.

Free trade apparently makes for strange bedfellows. Most Congressional Republicans support the TPP as fostering global commerce and enhancing U.S. company exports. Most Congressional Democrats oppose the agreement as detrimental to U.S. labor by opening up labor competition overseas. Last term, Senate Democratic leadership – the President's desire notwithstanding -- refused even to allow a vote on the TPP.

Finalization of the TPP would help U.S. multinational companies that can benefit from increased Asia sales or less expensive Asian labor.

Affordable Care Act (Obamacare)

One of the Republicans' first actions almost certainly will be to pass a bill repealing the Affordable Care Act. Just as certainly, the President will veto that proposed legislation.

The greatest threat to the ACA comes not from Congress but from the Supreme Court, which has agreed to hear yet another important challenge to the law. The ACA provides premium subsidies to families with income below a designated threshold (currently around $95,000 for a family of four) who buy insurance on a state "exchange" (website). The law assumed each state would establish its own exchange, but in fact only fourteen states did so. In the remaining 36 states, the exchange is operated by the federal government (*healthcare.gov*).

Specifically, the ACA provides that an eligible insured receives a premium subsidy when buying insurance on an exchange "established by a state." Challengers to the law are asserting that those buying insurance on the federal website are not doing so on an exchange "established by a state" and thus are ineligible to receive a subsidy. If the Supreme Court accepts that argument, it would cripple the law as subsidies are a crucial component of the effort to provide health insurance to all Americans. The Supreme Court is likely to issue its opinion in June of this year. If the Supreme Court agrees with the challenge, *sectors and companies who get a boost from the ACA could see that benefit quickly evaporate.*

Putting aside the court challenge, beginning in 2015 employers with 100 or more employees must begin providing insurance to all full time employees or pay a penalty for failing to do so. Congress might seek to change the definition of "full time employee" from more than 30 hours a week to more than 40 hours to ease employers restricting part-time employee hours. *Such a change would benefit the service industries.*

There might also be a bipartisan effort to repeal the medical device tax, a funding mechanism for the ACA that has proven unpopular. The issue there will be how to replace the lost revenue. *Repealing the tax would be a boon for the medical device sector.*

National Energy Policy

Energy policy might be the one area where a comprehensive bipartisan agreement is possible. Each side has goals it wishes to achieve, and neither side appears implacably opposed to the other side's initiatives.

For their part, the Republicans want federal approval of the Keystone pipeline, more drilling on federal lands, more offshore drilling, and fewer restrictions on energy exports. The Administration wants more incentives for alternative energy, such as wind and solar. A comprehensive energy compromise could achieve all those ends.

There is one sticking point. Last year the EPA issued proposed regulations restricting greenhouse gas emissions from power plants. Most Republicans vehemently oppose the regulations, which they view as exceeding the EPA's authority, increasing energy costs, and hurting employment. The Administration is determined to go ahead with the rules.

The parties will need to set that dispute aside to reach a compromise on energy policy. If they can do so, though, *legislation could be a boon to the energy sector.*

Tax Reform

Both the Administration and the Republican leadership have expressed a strong desire to pursue tax reform. That effort will be spearheaded by Paul Ryan, the former vice presidential candidate who takes over as chair of the House Ways & Means Committee.

Both Republicans and Democrats agree that tax reform cannot result in a loss of revenue to the government. (The Administration and many Congressional Democrats believe reform actually should *increase* federal tax revenue.) Thus the tax reform process involves lowering the tax rate and recouping the lost revenue by eliminating or curtailing deductions and exemptions, including perhaps many that we've come to rely upon. The mortgage interest deduction and tax-exempt interest on bonds are possible examples. Most of these items have strong support from particular industries or groups, making it difficult for Congress agree on changes to them.

It is early for definitive predictions, but my guess is that individual tax reform is probably too heavy a lift for Congress. In the polarized environment of Washington, it is hard to see Congress agreeing on such controversial proposals as taxing municipal bond interest or limiting charitable contribution deductions. It appears that high individual tax rates are here to stay.

I have a bit more hope for corporate tax reform. The United States has the world's highest corporate tax rate, a disadvantage that has prompted U.S. businesses to move operations (and jobs) overseas. More recently, we've seen companies -- Burger King is a prominent example -- moving their *headquarters* overseas to escape U.S. taxes (a process called "inverting"). There is bipartisan consensus that a reduction in corporate tax rates is needed to encourage companies to keep operations and jobs here.

As on the individual side, to maintain revenue neutrality a significant drop in the corporate tax rate must be accompanied by elimination or curtailment of deductions upon which particular industries rely. Such items could include oil and gas depletion allowances, LIFO accounting (important to the retail industry), accelerated depreciation (important to the manufacturing sector), and asset based taxes (anathema to the financial sector).

Thus, corporate tax reform is likely to produce winners and losers, affecting sectors across the economy. The progress of corporate tax reform will be an important consideration for investors and financial advisors to take into account. We will keep you informed as this process moves forward.

Forcing Events

In addition to the above initiatives, Congress faces a series of deadlines in 2015 where it must enact legislation or face undesirable consequences. These deadlines include:

- Homeland Security funding (February 27)
- Debt ceiling (March 15)
- Medicare “doc fix” (March 28) (preventing a drastic decline in Medicare reimbursement rates for doctors)
- Highway funding (May 31)
- Export-Import Bank authorization (June 30)
- Government funding (September 30)
- Tax extenders (December 31) (preventing expiration of a number of desirable tax provisions)

Of these, the one to watch initially is the need to raise the debt ceiling. After March 15, the United States will be unable to borrow additional money. The government will limp along for a few months without borrowing using tax receipts and funds it does not otherwise need immediately, but come next summer Congress will need to raise the debt ceiling to prevent the U.S. defaulting on its outstanding debt. (If the U.S. cannot borrow, it cannot pay interest on its debt outstanding.)

In the final analysis, Congress is not going to allow the country to default on its debt. But past experience shows that the looming deadline may produce a showdown, as Republicans demand concessions in return for raising the debt ceiling and the President holds fast to his position that the ceiling is not a negotiable item. As the deadline approaches and Congress bickers, markets tend to get nervous. *I have long said that a market decline over concern about Congress' impending failure to act is a buying opportunity*. Congress *will* act – likely at the last minute – at which point the market will recover. It is incumbent on investors and financial advisors to keep these “forcing events” in mind as investment opportunities.

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