

Global Sage White Paper Series

The U.S.  
Mid-Term Elections:  
The Political Winds  
Have Shifted Again

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# THE U.S. MID-TERM ELECTIONS: *The Political Winds Have Shifted Again*

## EXECUTIVE SUMMARY

- The 2010 U.S. midterm elections were a major defeat for President Obama and the Democratic Party. As noted later in the documents, the Democrats suffered historic losses, including the loss of control in the U.S. House of Representatives, major lost seats in the U.S. Senate, defeats in Governors races, and the loss of nearly 700 seats in state legislatures across the country.
- According to most political analysts, the election was a referendum on Obama, his agenda, and the economy, and the results were seen as a repudiation of his government expansionist policies. The election results leave President Obama politically weakened and “his agenda dead.”
- Congress has recently returned to Washington for the “lame-duck” session of the 111<sup>th</sup> Congress, a two-three week session filled with important, must-do legislation. Among the critical near-term issues facing Congress are:
  - The fate of the Bush tax cuts and other key tax provisions
  - The passage of a continuing budget resolution funding government operations into next year
  - The extension of unemployment benefits
- Other issues that may see action during the lame-duck session are:
  - The China currency bill
  - The President’s START treaty
  - Immigration reform
  - Deficit reduction proposal will be received from the President’s Commission on Fiscal Responsibility and Reform
- At the heart of the political conflict in Washington is the fact that the two parties have largely diametrically opposed ideologies and priorities, and each feels they have a *mandate and a responsibility* to steer the country towards their own ideological goal. For the Democrats, it involves ensuring the implementation of the laws and reforms achieved in the past Congress. On the other hand, the Republican leadership is intent on rolling back the Obama agenda and reducing the role of the Federal Government. Since the Republicans do not have the ability to get their legislation enacted uni-laterally, they are charting a political strategy that includes, among other measures, greater public over-sight and transparency for all the groups and committees established and empowered by the Obama Administration to develop rules and regulations, Congressional investigations of mistakes and mis-deeds, House hearings on key issues and de-funding of the agencies and initiatives. The Republican leadership has already sent letters to the major agencies announcing their intentions.
- As a result, with Republicans controlling the House, and Democrats controlling the Senate and the White House, Washington is expected to be the scene of major gridlock for the next two years, with neither party able to impose its agenda on the other, and major legislation difficult to pass.
- All this will occur against the political backdrop of a weak economy, record (and unsustainable) U.S. deficits and the normal politics associates with the looming 2012 elections. In addition to the political jockeying for position in the race for the White House, the Democrats in the Senate are more exposed

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than the Republicans (23 Democratic Senate seats will be contested in 2012 versus only 10 Republican seats), and this will lead to uncertain behavior as incumbents look to their political survival in 2012.

- In this environment, spending on lobbying in Washington, D.C., has been accelerating in tandem with the proliferation of regulatory and rule-making bodies empowered by the new laws passed in the out-going Congress. Over the next two years, given the treacherous and difficult waters, understanding what is being contemplated by the various regulatory and rule-making bodies and having a voice in these debates is of paramount importance to our clients.

# THE U.S. MID-TERM ELECTIONS: *The Political Winds Shift Again*

The 2010 U.S. midterm elections were a major defeat for President Obama and the Democratic Party. Democrats suffered historic losses in the U.S. House of Representatives, lost seats in the U.S. Senate, had major defeats in Governors races, and lost nearly 700 seats in state legislatures across the country.

- In the House, Republicans picked up 63 seats, with one race still undecided; Republicans now hold a 242-192 advantage in the House.
- In the Senate, Republicans gained 6 seats, 4 seats less than the 10 seats needed to win control of the Senate, reducing the Democrats' advantage to 53-47 in the Senate.
- Republicans won 23 of the 37 Governors races, Democrats won 12 races, an Independent won one, and one is undecided. Republicans had a net gain of 6 Governorships, and now control 29 states while the Democrats control 19.
- Republicans won 125 Senate seats and 500 House seats in state legislatures, a total gain of 675 seats.

According to most political analysts, the election was a referendum on Obama, his agenda, and the economy, and the results were seen as a repudiation of his government expansionist policies. The election results leave President Obama politically weakened and "his agenda dead."

With Republicans controlling the House, and Democrats controlling the Senate and the White House, Washington is expected to be the scene of major gridlock for the next two years, with neither party able to impose its agenda on the other and major legislation difficult to pass. The recent discussion on extending some form of the "Bush tax cuts" illustrates how difficult the next two years will be.

## *House of Representatives*

Republicans won 63 House seats, the largest midterm win in 72 years, giving them a 242-192 majority in the next Congress. In the new Congress, Republicans will have their largest number of seats and their largest House majority since 1947. Democrats will have fewer than 200 seats and their least number of seats in 64 years.

Republicans won seats across the Midwest, the South, and the West, picking up 5 seats each in upstate New York, Pennsylvania, and Ohio, 4 seats in Florida, 3 seats each in Illinois, Virginia, Tennessee, and Texas, and 2 each in Indiana and Michigan. They won only 2 seats in New England and only 2 in the Pacific West.

## *U.S. Senate*

Republicans picked up 6 seats in the Senate, leaving Democrats with a 53-47 majority in the next Congress. Every Republican incumbent won, and Republicans held all their open seats. They defeated two Democratic incumbents (Lincoln and Feingold) and won four Democratic open seats in Indiana,

Pennsylvania, North Dakota, and Obama's former seat in Illinois. Republicans failed to win control of the Senate by narrowly losing four other races in Colorado, Nevada, Washington, and West Virginia.

It is important to understand, however, that despite not holding numerical control over the Senate, Republicans may actually have functional control of the Senate on many key issues. Twenty-three Democrats are up for re-election in 2012 (and only ten Republicans), and 13 of them are from states either won by McCain in 2008 or where Republican Governors won in 2009 and 2010. While in the last session of Congress, the Democrats votes largely as a block to pass filibuster-proof legislation, with so many Democrats up for re-election in 2012, many will probably look to their own political interests and vote with the Republicans on key issues, knowing that their votes will be largely political and symbolic, given the ability of the President to veto any legislation. This fact will give these Democrats "air cover" for their re-election runs. At least 5 to 10 of these Senators are potential votes for Republican proposals on many key issues.

### *Governors Races*

Republicans won 23 of the 37 Governors races, with Democrats winning 12 races, Republicans had a net gain of 6 Governors, picking up 11 new states while Democrats picked up 4 states and an independent won one. Republicans now control 29 Governors' mansions while Democrats control 19.

The Republican Governors wins will have major long-term implications. Republican Governors will be involved in the congressional re-districting process, which will draw Congressional districts for the next decade, and the Republicans should be able to protect and even expand the number of Republican House seats.

In addition, Republican Governors will be a powerful force in the 2012 Presidential race. Republicans won Governors races this year and last year in 11 states that Obama won in 2008—Florida, Iowa, Maine, Michigan, Nevada, New Jersey, New Mexico, Ohio, Pennsylvania, Virginia, and Wisconsin. Obama will have to win a number of these states back to win re-election in 2012.

### *State Legislatures*

Republicans won nearly 700 seats in state legislatures across the country, winning 125 state Senate seats and 550 state House seats. Republicans are now in total control of 20 states—with control of the Governor's mansion and state legislatures—twice as many as before the election. Democrats have total control of 10 states, with 15 states split. The increased control will further help Republicans in the re-districting process and the 2012 campaign.

### *Historical Perspective*

The President's party almost always loses seats in a midterm election. Since the end of World War II, the President's party has lost an average of 24 seats in the House and 4 seats in the Senate. Previous major losses include Clinton (54-8), Ford (48-4), Reagan (26-0), LBJ (48-3), and Truman (54-12).

The 2010 midterms were, however, the worst political route for Democrats in the House in 72 years, when they lost 72 House seats in 1938, two years into FDR's second term. For Obama, the 63 seats lost in the House was the worst defeat for a first-term President in 88 years, since Harding lost 76 seats in 1922.

Republicans won a majority of votes in the midterm elections by *nationalizing* the elections into a referendum on Obama and the Democrats, their ambitious agenda, and their failure to improve the economy. According to exit polls, voters were upset with Obama and Congressional Democrats for overreaching and overspending, for focusing on expanding government—the stimulus, health care reform, cap and trade—rather than fixing the economy and creating jobs. A majority of voters disapproved of the job Obama and Congress were doing, thought Obama's policies were hurting the country, and thought the Federal government should do less not more.

Republicans won a majority of men, women, independents, and seniors, as well as suburban voters, and voters who are high school and college graduates. The key voters were the independents, who voted for Republicans by a 59-41 margin, after voting for Obama by a 52-44 margin in 2008. Another key factor in the Republican win was the low turnout of the Democratic base. Young voters, African Americans, and Latinos all voted at a lower rate than in 2008. For the President, the challenge going forward will be to re-energize his base while winning back the independents who supported him in 2008 and abandoned him in 2010.

### ***Implications for 2011-2012 - Political Gridlock and Jockeying for Position for 2012***

President Obama is under intense pressure from Democrats to regain the legislative initiative and begin focusing on the economy and jobs. He has already begun to shaking up his Administration, bringing in new staff to the White House, including a new economic adviser, and appointing some new Cabinet members.

While many believe that the President will make a few moves towards the political middle to try to find some common ground with Republicans (e.g., what Clinton did), especially on critical issues such as the extension of the Bush tax cuts, but this will be difficult with Pelosi and Reid still in charge of Democrats in Congress. Instead, Obama will probably pursue a less ambitious agenda and seek instead to guard what he has already achieved. However, he will seek to work with Republicans on deficit reduction, tax-reform, education, and immigration, and seek incremental changes on energy and climate change.

Republicans will press ahead with what they see as their mandate from the election—cut spending, keep taxes down, reduce regulations, and repeal the health care bill. All of these initiatives could pass the House and stall in the Senate. However, some of the House-passed initiatives could be the basis for compromise legislation worked out by Democrats and Republicans in the Senate and the White House.

### ***The Lame-Duck Session - The Last Gasp of the 111<sup>th</sup> Congress***

Congress will return to Washington November 30 for the "lame-duck" session of the 111<sup>th</sup> Congress, a two-to-three week session filled with important, must-do legislation. The lame-duck session will be the last order of business for the Democratic House Majority led by Speaker Pelosi and for the Senate by Harry Reid. The session will include more than 100 members of the House and the Senate who will be leaving Congress either voluntarily or involuntarily at the end of the session.

Among the critical major near-term issues that are facing the lame-duck session include the fate of the Bush tax cuts and other key tax provisions, the passage of a continuing budget resolution funding government operations into next year, and an extension of unemployment benefits. Action may also occur on a number of other issues, including the China currency bill, the President's START treaty, a food safety bill, and immigration reform. The session will also receive a deficit reduction proposal from the President's Commission on Fiscal Responsibility and Reform.

## *Major Tax Issues*

The top priority for the President and Congress in the lame-duck session will be to resolve a number of major tax issues. With only a few weeks left in 2010, the Bush tax cuts are currently slated to expire, and millions of U.S. taxpayers have no idea what tax rates they will be facing on January 1, 2011, on individual income, capital gains, dividends, small businesses, many other businesses, and estates.

Four key tax issues need to be resolved in the next few weeks. If the lame-duck session cannot reach agreements on these issues, millions of individuals and businesses face tax increases of more than \$200 billion in January. The four major tax issues are:

- Extension of the Bush tax cuts of 2001 and 2003 for individuals, capital gains, and dividends
- The alternative minimum tax
- The federal estate tax
- Dozens of expiring tax provisions for individuals and businesses

Treasury Secretary Geithner has acknowledged that the failure to act on these major issues is "not a sensible way to run a country," and that "it would not be a responsible act of government to leave this level of uncertainty hanging over the country into next year." Most observers believe that compromise will be reached, with a temporary extension of all tax issues enacted within the next few weeks. However, with so little time left to act combined with an environment of political gridlock, there is a significant possibility that resolution to these critical tax issues will not be reached. Each is discussed in greater detail below.

### *"Bush Tax Cuts"*

The tax cuts enacted in 2001 and 2003 are scheduled to expire at the end of 2010. If no action is taken to extend these tax cuts, taxes will increase by \$200 billion in 2011 and by \$3.8 trillion over the next ten years. Individual tax rates will increase for all taxpayers, with the highest tax rate increasing to 39.6%. Capital Gains tax rates will increase to 20 percent and dividend tax rates will increase to 39.6%.

The President, under pressure from the Democratic leaders in Congress, continues to push for a permanent extension of the tax cuts for those with incomes under \$250,000, while Republicans continue to insist on a permanent extension for all taxpayers.

One possible compromise Democrats may offer would "decouple" the tax cuts, with a permanent extension for incomes under \$250,000 and a temporary extension for incomes above \$250,000. Another possible compromise would provide a permanent extension for all income under \$1 million. Both of these compromises are unacceptable to Republicans, who argue that no tax increases on anyone should be enacted in a weak economy.

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None of the proposals currently under discussion have enough support to be enacted into law. Democrats do not have enough votes to permanently extend the tax cuts for some and not for others, and Republicans do not have enough votes to permanently extend tax cuts for everyone.

The one potential compromise that could be acceptable to the President, many Democrats, and most Republicans would extend all of the tax cuts for one or two years. We believe that this compromise will be enacted this year.

### *Alternative Minimum Tax (AMT)*

Unless Congress acts this month, as many as 26 million taxpayers will be subject to the AMT for the first time on 2010 income, payable next April 15. Up until last year, Congress had passed a temporary “AMT patch” each year, holding the number of taxpayers affected by the AMT each year to about 4 million taxpayers. However, this temporary patch has expired and unless it is extended, 26 million taxpayers will be forced to pay an AMT on 2010 income.

### *Estate Taxes*

The Bush tax cuts of 2001 reduced the federal estate tax over a number of years, phasing it out completely in 2010. However, unless Congress acts this month, the estate tax will revert to pre-2001 levels in 2011, with a tax rate of 55 percent on estates in excess of \$1 million. The President has proposed setting the estate tax at 2009 levels, with a 45 percent rate and a \$3.5 million exemption. Republicans have proposed a 40 percent rate and \$5 million exemption, but would accept the 2009 levels.

### *Other Expiring Tax Provisions*

Dozens of tax breaks for individuals and businesses have expired or will expire at year-end. These provisions include the R & D credit, the active financing provision for financial services firms’ foreign earnings, and numerous energy tax incentives. Unless these provisions are extended, individuals and businesses face higher taxes in 2010 and 2011.

### *Carried Interest / Enterprise Value Tax*

House and Senate Democrats have been pushing legislation to raise the tax on carried interest and to establish an enterprise value tax as a revenue raiser to help pay for the tax extenders bill. However, Republicans are refusing to accept any revenue raisers and the tax extenders bill is not expected to include the carried interest/enterprise value tax.

### *Deficit Reduction Proposal*

The President’s National Commission on Fiscal Responsibility and Reform is due to release a deficit reduction proposal on December 1<sup>st</sup>. If fourteen of the eighteen members of the Commission reach agreement on the proposal, House and Senate leaders have pledged to allow the House and the Senate to debate the plan and vote on it in December.

A draft proposal was released by Commission co-chairs Erskine Bowles and Alan Simpson in mid-November. The Bowles-Simpson plan would reduce deficits by nearly \$4 trillion over the next ten years through discretionary and defense spending cuts, entitlement reforms, and tax reforms combining lower tax rates with a broader tax base.

The proposal has been criticized from both the left and the right and is not expected to be endorsed by the full commission and voted on by Congress. However, the elements of the plan could form the basis of deficit reduction negotiations between the White House and Congress in the years ahead.

### *China Currency Reform*

The U.S. Senate is under increasing pressure to allow a vote in the lame-duck session on a China currency reform bill.

The House passed a bill in September with bipartisan support, which would expand the authority of the Commerce Department to impose countervailing duties on imports benefiting from a country's undervalued currency. The bill is directed at "China's currency manipulation," according to the co-authors of the House bill.

The bill's Senate sponsor, Senator Chuck Schumer, pledged to push for a Senate vote in the lame-duck session, but a final decision has not yet been made.

The Obama Administration would prefer not to address the issue through legislation. However, Federal Reserve Chairman Bernanke's recent remarks criticizing China's strategy of currency undervaluation has increased pressure on the Senate to take up the bill.

### *Market Structure Hearings*

The Senate Permanent Subcommittee on Investigations (PSI) is planning a hearing December 1<sup>st</sup> on market structure issues, including high-frequency trading. The SEC, FINRA, and a number of market participants are expected to testify. The PSI has held a series of hearings this year on the financial services industry and the causes of the financial crisis, including the Goldman Sachs hearing last spring. The Subcommittee has also been investigating the role of traders in last spring's flash crash.

### *Implications For Financial Firms*

Spending on lobbying in Washington, D.C., has been accelerating in tandem with the proliferation of regulatory and rulemaking bodies empowered by the laws passed in the last session of Congress. Over the next two years, given the treacherous and difficult political waters, understanding what is being contemplated by the various regulatory and rulemaking bodies in Washington and having a voice in these debates is of paramount importance.



The **Global Sage** Public Policy Advisory Group is headed by Bruce Thompson, a Washington veteran with more than three decades of experience working on public policy issues in both the public and private sectors. Bruce has been deeply involved in every significant public policy debate involving the financial services industry. He was Head of the Merrill Lynch Global Government Relations Office for 22 years. Before that, he served at the Treasury Department as Assistant Secretary for Legislative Affairs under Don Regan and Jim Baker. Prior to Treasury, he worked in the U.S. Senate for seven years.

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