Eaton Vance on Washington

Andrew H. Friedman
Principal
The Washington Update

The Election Ends and the Lame Duck Begins

The election.

Billions of dollars spent, thousands of negative advertisements aired, scalding campaign rhetoric, a bitterly polarized electorate – and we ended up where we started: President Obama in the White House, a Democratic-led Senate and a Republican-led House of Representatives. Four more years of the same divided government.

Obama overcame great obstacles to win, having endured the highest unemployment rate of any president returned to office since the Great Depression. Indeed, he is only the second Democrat since that time to win a second term. And he is the first president in modern history to be re-elected with a smaller share of the vote than he received in his first-term election.

For the past eighteen months I have predicted unwaveringly that Obama would win, in large part because the Republican candidates in general – and Mitt Romney in particular – were having trouble connecting with the electorate. Romney was correct to make the economy the centerpiece of his campaign. But exit polls showed that many voters (particularly women and minorities) felt that Obama better understood and empathized with their concerns.

As much as the Republicans missed an opportunity to take the White House, their failure to take control of the Senate is almost more astounding. In that they were thwarted by their own Tea Party wing, which shunted aside a popular Republican incumbent in Indiana and put up a candidate in Missouri that fumbled the opportunity to oust an unpopular Democrat.

Will the next four years be different than the last four? History suggests there is a chance. Presidents spend their first terms worried about getting re-elected. They spend their second terms worrying about their legacy. In his second term, Ronald Reagan worked with a Democratic Congress to rewrite the tax code (the last time this has been done). Bill Clinton alienated members of his party to work with Congressional Republicans to craft welfare reform.

The “legacy” issue for a second Obama term is the federal budget deficit. In his first term, Obama paid lip service to reducing the deficit, but seemed to feel it was not a problem worth addressing. Yet, in an off-the-record interview a month ago, the President said that he intends to tackle the deficit early in his second term. Will he in fact do so, and will the Republicans join him in that effort or thwart it?

Any serious effort at deficit reduction requires reforming Social Security, Medicare and the tax code. My 2013 legislative updates will discuss what steps Washington might take, and how investors can prepare in particular for possible sweeping changes under tax reform.

The lame-duck session.

Since mid-2011, I have said that the real action in Washington will take place after the election, when Congress and the President must address the looming expiration of the Bush tax cuts. That time finally has arrived.

The dislocation caused by the tax cut expiration is joined with spending cuts slated to take effect as a result of last year's compromise to raise the federal borrowing limit. If both occur, the higher taxes and lower spending are projected to throw the economy back into recession for at least the first half of 2013. *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022, Congressional Budget Office (August 2012).* The financial community has dubbed this effect "the fiscal cliff."

In one of the presidential debates, Obama made an offhand comment that the spending cuts will not be permitted to take effect. But he did not elaborate. Washington may have difficulty deferring the implementation of the agreed-upon spending cuts without a suitable substitute plan. Standard & Poor's and Moody's have warned that a failure to implement the agreed-upon cuts will result in another downgrade in U.S. debt. *Moody's issues update on the outlook for the US government's debt rating: Budget negotiations key (September 11, 2012).*

As for the tax cuts, I believe it comes down to how strongly President Obama feels about what he says he wants to do. Obama's position is that the Bush tax cuts should expire for "wealthy" families, that is, for families with income above $250,000. The question, thus, is this: If Congress passes a bill that extends the Bush tax cuts for all Americans, will Obama veto that bill because included is an extension of the tax cuts for the wealthy? His advisors say yes: "The president … will veto any legislation that extends the unaffordable Bush tax cuts for the wealthiest in our country." *David Plouffe, senior adviser to President Obama, July 10, 2012.*

If President Obama sticks to that view, the Republicans will have a tough choice. Either they, too, refuse to take action in the lame duck Congress, in which case the Bush tax cuts expire and taxes next year go up across the board. Or, more likely, the Republicans agree to legislation that keeps taxes low on the middle class and they negotiate the income level above which taxes go up. For his part, the President has signaled a willingness to raise the income level for a tax increase to something above $250,000.

Obama believes that his re-election gives him a mandate to implement his tax plan. On Election Day, Speaker Boehner asserted that, by retaining the House, the Republicans received an equal mandate to oppose him: "With this vote the American people have also made clear that there's no mandate for raising tax rates." (More likely, Boehner's "mandate" is a manifestation of the adage that people hate Congress but love their congressman, believing the problem lies with all the *other* House members.)

The day after the election, however, Boehner struck a more conciliatory tone, saying that, although Republicans continue to oppose Obama's plan to raise tax rates, they are open to "increased revenue as the byproduct of a growing economy, energized by a simpler, cleaner, fairer tax code, with fewer loopholes, and lower rates for all." It is unclear if Boehner, in fact, is acceding to raising tax revenue as part of a tax reform process (presumably by eliminating deductions and exemptions), or is simply espousing the Republican mantra that the efficiency provided by a simplified tax code will stimulate the economy, producing more tax revenue as businesses grow. The latter argument has been a nonstarter with Democrats.

More likely, Boehner is trying to buy time. Expect him to follow up his remarks with a request that the President agree in the lame duck session to extend the tax cuts across the board to give Congress time to work on broad-scale entitlement and tax reform next year. If the President sticks to the position he's taken so far, he will reject such a proposal, instead allowing the reform process to work next year *after* tax rates have increased for the affluent.

Pragmatic Republicans are acknowledging the likelihood of such a tax increase. Congressman Tom Cole (R-Okla), a member of the House Budget Committee, concedes that, "This is a referendum on taxes. If the president wins re-election, taxes are going up [for the nation's wealthiest households]. There's not a lot we can do about that." (September 20, 2012).

Negotiations in the lame duck session could be complicated by the Republicans' "Norquist pledge" never to vote to raise taxes. Republicans could conceivably maneuver around that pledge by allowing the Bush tax cuts to expire at year-end without Congressional action, and then voting in January to *reduce* taxes back to 2012 rates for families under a certain income level. The results would be the same as if the Republicans had agreed to raise taxes above that income level in the lame duck session, but without their technically having voted for a tax increase. Such shenanigans would be unfortunate, as it would perpetuate the uncertainty over taxes beyond year-end.

One final point. Regardless of what happens with the Bush tax cuts, we already know taxes will increase in 2013. Under the health care reform law, beginning next year compensation income – income from work services – will be subject to an additional tax of 0.9%. And taxable investment income – e.g., interest, dividends, capital gains, rents, royalties – will be subject to an additional tax of 3.8%. (The additional tax on investment income will not apply to nontaxable income such as tax-exempt municipal bond interest or to amounts withdrawn from qualified retirement plans and IRAs.) Both of these new taxes will apply only to the extent a family's overall income is above $250,000 ($200,000 for individual taxpayers). With the Supreme Court's decision upholding the health care reform law, we now know *with certainty* these new taxes will go into effect, meaning that – regardless of what happens with the Bush tax cuts – taxes next year will be higher than they are now.

I've predicted that, given the uncertainty surrounding the fiscal cliff, the markets are likely to remain volatile even after the election. And, in fact, markets tumbled the day after the election, as investors began to focus on the fiscal cliff. This volatility is likely to continue as the parties spar in the weeks ahead, and rising capital gains tax rates could prompt investors to sell assets to lock in gains near year-end.

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Andrew H. Friedman is the Principal of The Washington Update LLC and a former senior partner in a Washington, D.C. law firm. He speaks regularly on legislative and regulatory developments and trends affecting investment, insurance and retirement products. He may be reached at www.TheWashingtonUpdate.com.

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Two International Place, Boston, MA 02110 800.225.6265 eatonvance.com
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