



HEARD ON THE HILL: COMMENTARY FROM THE 51ST WASHINGTON CONFERENCE

Summary

- Various policy decisions over the last five or so years have created the current low-growth and high-debt environment.
- The debt ceiling debate will provide Republicans with the greatest opportunity this term to change the direction of government spending.
- The negative economic outlook leading up to the 2012 election, combined with the incumbents up for reelection, creates a great chance for pro-growth policy come 2013.

The mission of Laffer Associates annual Capitol gathering has always been to keep our clients informed through intimate exchanges with some of the people shaping the policies affecting their portfolios. Over a three-day period, our attendees enjoyed individual discussions with some of the nation's premier lawmakers as well as expert political and financial analysis from Beltway and Wall Street pundits. Each and every one of the speakers was a real pleasure.

The wide variety of speakers afforded us an in-depth and firsthand look at a range of topics that are currently of the utmost concern to everyone in Washington D.C.. Particularly given the pace of change in D.C. and the seemingly ever-increasing role of the government in the economy, the perspective was invaluable. There was an intense focus on the policies of this administration and Congress, what further goals they may have for this year and how the new Republican majority in the House is affecting that dialogue. The topics *du jour* included the out-of-control budget, the looming breach of the debt ceiling, the effects of ObamaCare, the potential for pro-growth reform and the 2012 election. While there remain a number of substantial issues on the table, for the first time in several years there is hope for pro-growth legislation in the not-too-distant future.

Debt Ceiling

Republicans believe that the president and Treasury are going to try to scare them into agreeing to raise the debt ceiling, but they are committed to receiving something in return, particularly drastic reductions in spending. The Republicans acknowledge that there could be nasty consequences in the bond market in the event of a technical default, but they are more focused on the negative effects of continuing to run up the national debt. Accordingly, their goal in the House is for one dollar in spending cuts for every dollar the debt ceiling is raised.

For the first time, the White House seems to be hearing the Republicans on the need for spending cuts to accompany any increase in the debt ceiling. While we were in Washington, the president called all of the GOP Senators to the White House to discuss the debt ceiling issue. During that meeting, he said for the first time that all entitlements were on the table for the debt discussion. On the Republican side, tax increases are not on the table.

It should be acknowledged that there is a fair amount of disagreement in the Republican ranks on the debt ceiling. Some members are adamantly opposed to raising the debt ceiling at all, some will raise it only if they receive large concessions in return from Democrats and some will argue in favor of spending cuts but believe at the end of the day the debt ceiling must be raised and won't threaten actually bumping up against the ceiling. A number of Republicans are also worried about the potential political fallout from a shutdown, and others believe that they have to honor the budget because they voted for the Continuing Resolution that acts as the FY2011 budget. These disparate views of the urgency of the debt situation lessen the likelihood of major concessions from the Democrats in return for an increase in the debt ceiling, but the most likely outcome remains somewhere near one dollar in spending cuts for every dollar the debt ceiling is increased—it's just unclear how concrete the cuts will be (e.g., whether they are "promised" cuts or legislated cuts by changing eligibility for entitlements or eliminating certain programs) and how long the time period will be during which those cuts take place.

The Republican House

The Republicans in the House believe strongly that they are lone protectors of the American public from continued statist, anti-growth policies. They are united behind pro-growth policies and all speak to the virtues of supply-side tax reform, spending restraint, sound money, reduced regulation and free trade. It really is a remarkable juxtaposition compared to when they last were in power during the George W. Bush presidency. This passion was evident in their body language, their talking points and also in their votes (e.g., every House Republican voting to repeal ObamaCare). Further, they all express

great confidence in their leadership—confidence that the leadership will set the right policy agenda, hold the membership together on tough votes and work hard to maintain and grow the GOP majority in the House.

The one area where it is clear there is some disagreement within the ranks is over just how far to push on the pro-growth agenda right now. On one hand, there are outspoken members who believe they were elected to change the status quo, who want to make changes now and who are pushing the leadership to set its sights higher on each policy item. On the other side are members taking a more strategic approach, essentially saying, “We’re doing the most we can with control of one of the three branches of government; the time to be really aggressive is 2013 when we should have control of at least one more branch of government.” We’ve already seen those two sides battle a bit in the discussions on the 2011 budget, and we’ll continue to see it as an issue during any major policy discussions in advance of the 2012 election.

2012 Election

The following quote from Congresswoman Michele Bachmann (R - Minnesota), although a bit more forward than some in her predictions, pretty much summed up the feeling of Republicans:

I really believe that in 2012, everything is in place for us to have the triple crown. I do think we can take 60 seats in the Senate, and I really believe that we can take the White House. We’ve got a lull in job creation, slow economic growth and astronomical (and still rising) gas prices. President Obama’s plan hasn’t worked, and people will respond to this. We cannot afford an establishment candidate who is not bold. We need to tell the American people the truth that we need to reverse direction in the White House. It’s about saving this country right now. That’s where we’re at, and that message is how we’ll win.

On the Democratic side, there has been a shift toward central planning. The Republicans want to emphasize the power of individuals and the role of freedom and incentives in job creation and production, of equality of opportunity over equality of outcomes. The Republicans truly believe that if they stick to their principles on economics they will win out on ideas. The key in their view is simply putting out their ideas and articulating them as compared to the ideas and principles of the Democrats.

At present, some Republicans are worried that they don’t have a great candidate for president, while others believe that the candidate doesn’t matter as long as the ideas are correct, especially given the circumstances. For instance, for the unemployment rate to be under 7.5 percent on Election Day, we need an average monthly growth of approximately 275,000 jobs from now through October 2012, which is a tough task. In addition to the poor economy, the policies under the first two years of the Obama administration—ObamaCare, bailouts, stimulus, etc.—are largely unpopular.

Meanwhile, President Obama’s advantage is not in his record or ideology but rather in his personality, his technology and his demography. He will lose the white vote, but minority populations are growing rapidly across the U.S. and in a number of large states, including California, Texas and Florida. In order to win in 2012, President Obama will need to again win the female vote, the minority vote and the youth vote.

The House should remain handily in GOP control following the election. In the Senate, though, there are 23 Democrats (or independents who caucus with the Democrats) and only 10 Republicans up for re-election. The GOP seats are all fairly safe, while McCain won 10 of the 23 Democratic seats in 2008. The Democrats also have a number of retiring members among those 23, and a number of the states moved more toward Republicans in the 2010 election.

Republican Budget

The House Republicans have put forth a budget that reduces spending over the next decade by \$6.2 trillion. The big changes in the budget are repealing ObamaCare, moving Medicare to essentially a voucher system and block-granting Medicaid. Defense spending is cut in-line with what the Democrats would suggest; non-security discretionary spending is cut, as are things like farm subsidies. Social Security reform is not yet a part of this budget.¹

Democrats are critical of the plan for a number of reasons. They do acknowledge that some of the spending cuts and some of the restructuring of government will have support, but also believe that the budget is lacking in specifics. The Democrats also believe that there are a number of spending items, loopholes and tax expenditures that, when push comes to shove, the Republicans will be unwilling to give up, which will cause the whole budget to crumble. Indeed, some Republicans are skeptical that their fellow members will be willing to cut military spending and farm subsidies, both of which will have to go to bring Democrats to the table on entitlement reform.

ObamaCare

It used to be that states regulated healthcare. We now are moving that power to the federal government in the belief, according to this administration, that Congress and Washington are now going to make our healthcare system more efficient,

¹ “The Path to Prosperity: Restoring America’s Promise.” *budget.GOP.gov*. <http://budget.house.gov/UploadedFiles/PathToProsperityFY2012.pdf>
Please source all citations according to AP style

less costly and with better coordinated care for seniors.² The law is enormously complex, creating at least 159 new programs and bureaucracies and granting the Secretary of Health and Human Services approximately 2,000 new powers.³

Now, to many observers it is incomprehensible to add in all of this new government bureaucracy and expand the rolls of government-provided healthcare by 32 million people and still claim that the bill reduces the deficit.⁴ Well, the bill was scored in such a fashion because the budget period scored includes 10 years of taxes but only six years of spending. Finally, if the government-run healthcare program in Massachusetts is any indication, healthcare services will also be less readily available. At the same time, Food and Drug Administration testing has become more stringent, such that the number of medical devices and new drugs approved by the FDA each year has dropped substantially over the last 10 years.

Accordingly, repealing ObamaCare is the top goal of many Republicans. Indeed, every Republican in the House has already voted for repeal. The Senate is trickier, as it will require 60 votes to avoid a filibuster, so many Senators are focused on addressing specific issues step-by-step. Meanwhile, the bill has been declared unconstitutional by two courts and will eventually make its way to the Supreme Court, with a decision on whether the individual mandate is constitutional likely to be rendered sometime in the summer of 2012. Given the current makeup of the Supreme Court, it is likely to be a 5-4 decision that will swing on the vote of Justice Kennedy. His record suggests the decision really could go either way, although declaring the entire bill unconstitutional as Jude Vinson did in Florida is a highly unlikely outcome.

Medicare

The Republicans are being demagogued for the Paul Ryan proposal, with the Democrats saying Republicans want to end Medicare. The proposed budget means-tests Medicare for those currently below 54 years of age, but does not change it for those above that age.⁵ From a strategic position, the Republicans possibly could have waited until after the 2012 election to make the point that you literally cannot balance the budget or get the debt under control without addressing Medicare (due to the demographic shift and the inflation in healthcare services). Instead, they chose to address the issue now, and many feel they are paying the political price for it. However, many Republicans countered that their town hall meetings were stunning successes, with big crowds approximately 80 percent in their favor.

Spending

A number of Republicans would like to see a constitutional amendment put in place to limit spending as a percentage of GDP. Unfortunately, that takes at least two years to get ratified across the country and another five or so years to implement—right now we probably don't have the luxury of seven years to solve our spending problem. So, there are a number of proposals on the table to control spending. For instance, Senator Bob Corker and a group of bi-partisan co-sponsors have put forward the CAP Act, which would lower spending over 10 years from 24.6 percent of GDP to a binding cap at 20.6 percent of GDP, the historical average over the past 40 years.⁶ The administration and liberal groups like *MoveOn.org* are very outspoken in their dislike for this bill, but it would be a vast improvement over the status quo.

Objective observers of the budget look at three big areas where spending needs to be cut in order to eventually achieve a balanced budget: 1) entitlements, 2) the military and 3) federal aid to the states. Most people know about the first two, but few people realize that the federal government now spends approximately \$600 billion annually on functions that used to be, almost exclusively, state and local issues: K-12 education, public housing, urban transit, etc. That number has especially increased under the administrations of George W. Bush and Barack Obama.

Tax Reform

A number of speakers mentioned the tax delta between the U.S. corporate rate of 35 percent and the average international rate of about 20 percent. This presents American companies operating abroad with a major tax penalty when they repatriate earnings to the United States. Accordingly, we heard talk of some form of tax holiday on repatriated earnings, as well as talk of more comprehensive corporate tax reform. The latter would entail a broadening of the base, by eliminating various loopholes, credits and tax expenditures, and a lowering of the rate, to somewhere between 20 percent and 28 percent, in order to be revenue-neutral on a static basis. Both Republicans and Democrats thought there was a possibility of getting corporate tax reform during the current session. While individual tax reform is part of the budget discussions, it is unlikely to see any movement on that before the 2012 election because the Republicans and Democrats are much further apart on what would be acceptable on individual income taxes.

² For a full description of the bill and its negative effects, see Grace-Marie Turner et al, *Why ObamaCare is Wrong for America: How the New Health Care Law Drives Up Costs, Puts Government in Charge of Your Decisions, and Threatens Your Constitutional Rights*. Broadside Books, 2011.

³ For a graphic representation of the complexity of the health care bill, visit:

http://www.jec.senate.gov/republicans/public/index.cfm?p=CommitteeNews&ContentRecord_id=bb302d88-3d0d-4424-8e33-3c5d2578c2b0

⁴ While we believe that the bill increases the deficit, that is really beside the point. The bigger issue is that government provided health care distorts incentives, separating consumers from the purchase decision, and leading to overconsumption and higher costs. For more, see Laffer, Arthur B., and Wayne Winegarden. "The Health Care Wedge and the Economy." Laffer Associates, August 27, 2009.

⁵ For the full Republican budget, see "The Path to Prosperity: Restoring America's Promise." *budget.GOP.gov*.

⁶ <http://corker.senate.gov/public/index.cfm?p=the-cap-act>

Monetary Policy

Several Republican speakers wished to repeal the Humphrey-Hawkins Act, which gives the Federal Reserve a dual-mandate of price stability and maximum employment, and instead have the Fed focus solely on price stability following a specific rule. This is far down their current list of priorities, but could become a policy plank if the GOP retakes the Senate and the presidency.

Two-Year Budgeting

A number of speakers touched on instituting a two-year budgeting process as a means to control government spending. The process would entail one year spent putting together a budget for the next two years with the next year spent on oversight. In theory, this could lower costs on the front end by allowing for larger and longer-term contracts. Then in the non-budgeting year Congress could look at the existing rules and regulations to determine what needs to change, shortened, repealed, etc. The process is already employed with varying degrees of success in several states and seems to have some support at the federal level, although it is unlikely to be seen anytime soon.

Trade Policy

The Republican speakers were generally disappointed that three negotiated free trade agreements (FTAs)—those with South Korea, Colombia and Panama—remain pending. Their goal is to see all three passed before August, and they are considering tying them all together to be voted upon as a group.

On the Democratic side, the New Democratic Caucus is a group of 43 members who are generally pro-trade. Given their support, and nearly unanimous Republican support, the Panama and South Korea FTAs should be approved by August. The administration is trying to push through some changes in the Colombia FTA, and afterwards it's possible, although unlikely, that it becomes law. The Panama and South Korea FTAs look more certain to become law.

Foreign Policy

With the United States recently having entered Libya and killed Osama bin Laden, foreign policy was a hot topic at the conference. A number of people addressed the lack of apparent rationale for entering Libya—arguing that we were not threatened by Gaddafi, the U.S. had no real interests at stake in Libya and the president did not receive approval from Congress for engaging. It was suggested that the reason the administration went to the United Nations for approval rather than to Congress was because they wanted to let the coalition determine the mission rather than vice versa.

Meanwhile, our relationship with Pakistan is viewed as strategically important given their geographic location, but obviously strained given the way the bin Laden assassination unfolded. It was suggested that the biggest potential problem with Pakistan is having them as a failed state and thus directly or indirectly supporting terrorists; that instead we should acknowledge that the country is evolving at its own pace and can't be exactly what we would like right away.

Energy Policy

The administration is largely focused on expanding the supply of green energy and has even commented that it would like to see the price of electricity rise in order for Americans to consume less energy. Consistent with those goals, the Environmental Protection Agency is using the Clean Air Act as grounds to regulate carbon emissions, making it almost impossible to build new coal-fired plants. The Republicans will continue to push for more energy exploration, whether drilling in the Gulf, on public land or in Alaska, and working against excess regulation, but are having trouble making any progress given the current balance of power in Washington.

States

While the big story of the conference was the federal debt, many state capitols are faced with a similar reality of a current deficit and huge unfunded liabilities in public pension funds. The amount spent on retired teachers, policeman, firefighters, etc. is astronomical, and it's really putting pressure on state operating budgets. There are struggles coming up, such as the one we witnessed in Wisconsin this spring, over whether states are to be run for the benefit of the taxpayers or of the public employees. When thinking of fairness on these issues, remember that in recent years the average public sector wages, including benefits, has soared past average private sector wages. The states that are slow to deal with this issue are going to experience serious budget crises down the road.

National Labor Relations Board

A great number of automobile companies have built factories in right-to-work states, mostly in the Southeast. There are many plants, and now there are tens of thousands of suppliers too. Congressman Lamar Alexander (R - Tennessee) highlighted the fact that right-to-work legislation enables states to attract business investments and differentiate themselves from other states. Tennessee went from having almost zero auto jobs, and now auto jobs account for approximately one-third of the state's manufacturing jobs. Congressman Tim Scott (R - South Carolina) echoed Alexander's statements, noting his attempts to defund the National Labor Relations Board's (NLRB) ability to sue private companies. In fact, the 22 right-to-work states have outperformed the 28 non-right-to-work states in a number of areas over the last decade.⁷

⁷ Laffer, Arthur B., and Stephen Moore. "Boeing and the Union Berlin Wall." *The Wall Street Journal*, May 13, 2011.

Table 1

Right to Work vs. Force Union State 10-Year Performance

	2000-2009 GSP Growth	2000-2009 PI Growth	Q499 - Q409 PI per capita Growth	2000-2009 Pop Change	Domestic Migration as % of 2009 Pop	4Q99 - 4Q09 Payroll Change	2010 Unemployment Rate
RTW average	54.6%	53.3%	43.2%	11.9%	2.9%	4.1%	8.5%
Non-RTW average	41.1%	40.6%	39.4%	6.1%	-0.7%	-0.6%	9.0%
U.S. Average	47.0%	46.2%	41.1%	8.6%	0.9%	1.5%	8.8%

Source: BEA, Census

Yet, the NLRB filed a complaint against Boeing to stop its construction of a plant in South Carolina, which is a right-to-work state, instead of in its home state of Washington, which is not a right-to-work state, saying that it was retaliation against the Machinists Union, which has been on strike. Essentially, if this complaint stands it will set the precedent that a company operating in a non-right-to-work state cannot expand into a right-to-work state, which would be a devastating precedent for growth in the United States and would likely send more manufacturing jobs offshore.

California

California is an example of a state gone totally awry. They have a \$15+ billion budget gap to fill this year, and each year we think they're out of gimmicks until they find another.⁸ They are in a debt spiral, though, with taxes already the highest in the nation, regulations crippling businesses and enormous unfunded pension obligations. Sooner or later something will give. One thing that won't give is a federal bailout—at least not if House Republicans have anything to say about it.

Meanwhile, California will be reapportioned this year by an independent commission that has no real ability to gerrymander. The initial maps should be drawn in June and final maps in August, with court challenges already expected. We believe this will likely shift a few seats in the California state house and in Congress toward Republicans because the state has been so gerrymandered in the past by the Democratic-controlled state government.

Tea Party

The Tea Party Caucus now consists of 60 Republicans in the House, and a great many more support the Tea Party ideals of fiscal responsibility, limited government and strict interpretation of the Constitution. That said, the larger power of the Tea Party seems to be in the electorate, which remains difficult for either the Republicans or the Democrats to understand fully. Republicans see the Tea Party as a movement of Republicans, Democrats, Independents and previously apathetic voters who are sick of watching politicians destroy our country. The Democrats, meanwhile, switch back and forth between saying that the Tea Party is controlling the Republicans and that the Tea Party has no influence.

Immigration

A number of Republicans in border states have seen the benefits of immigration firsthand. They have also witnessed the negative effects the typical party-line stance on the topic has on the party. They would like to see immigration reform that allows more immigration, but based on skill and education levels instead of family ties, in addition to a guest-worker program and a formalized path over time to deliver citizenship to those currently here illegally. While that policy line could likely gain a lot of Democratic support, there is not enough Republican support to get it done. Unfortunately, that means that other small fixes are bogged down in the entire debate. One example is the Staple Act, which would "staple" a green card to the Ph.D. degrees of American-trained graduate students in certain fields so that they can immediately become contributing members of the labor force. Another example would be increasing the number of H1B visas awarded each year. Both of these are pro-growth changes with bi-partisan support that won't happen because the politics around the entire issue is so fragmented.

Government Oversight Committee Investigations

The Government Oversight Committee is responsible for rooting out waste, fraud and abuse in the government. Actually finding inefficiency in the government is not hard. Instead, the hard part is convincing any administration to get rid of these programs. There is some frustration from the Committee that the current administration believes in transparency as long as they don't need to provide it, but the members are working tirelessly to fight back against waste, fraud and abuse in the stimulus, in executive orders and in actions taken during the financial crisis. However, rather than doing the analysis of the waste, fraud and abuse, the Committee is more focused on finding the lessons that need to be learned in order to make sure that excesses like this never happen again.

⁸ Vara, Vauhini. "California Legislature Passes Main Budget Bills." *The Wall Street Journal*, June 15, 2011.