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Analysis of the Policies of President-Elect Obama

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Senator Barack Obama's electoral victory, complete with expanded majorities in the House and Senate, gives the Democrats control over the legislative and administrative processes for the first time since 1994. This has significant ramifications for the new Administration's policies to deal with the economic crisis, as well as domestic priorities on taxes, health care, energy, the environment, labor relations, and trade.

Today, President-Elect Barack Obama will shift to presidential transition following many months of campaigning. He will have just 77 days to assemble a cabinet, set critical priorities, and prepare a federal budget (which must be submitted to congress by February). Though he has not discussed it publicly, these plans are well underway. The Obama team is actively discussing potential Cabinet selections and will soon begin vetting resumes for the estimated 7,800 presidential appointee jobs which must be filled – 1,177 require Senate confirmation – and finalizing a comprehensive blueprint which will guide the incoming president through the transition.

While it is certain that the Obama presidency will mark a stark contrast from the Bush years, what remains to be seen is how much external factors like the economic crisis will impact his first 100 days and beyond. The following examines what we are likely to see under an Obama administration on an array of pressing issues.

Tax Policy: Storm on the Horizon

A fundamental component of the federal budget is the level of revenues or taxes, a finite resource that has implications on individuals, business and the broader economy. Historically, tax revenue as a percent of GDP has averaged around 18.1 percent. Under current projections by the Congressional Budget Office, revenues will grow to about 20 percent of GDP by 2012, the end of the next administration, absent additional action. A key issue before the next administration will be the appropriate level and composition of federal taxation. An examination of the ideas presented during the campaign by Senator Obama provides insight into the answer.

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There are two key drivers that will greatly impact the tax debate – the federal budget deficit and the expiration of the 2001 and 2003 tax cuts. Federal budget scorekeepers estimate the deficit for this year will be about $450 billion and could exceed $750 billion next year, after factoring in the recent cost of the economic rescue plan recently enacted. In addition, as the economy slows, predictions of future revenue collections will be revised downward, putting further pressure on the deficit and the level of revenues to run the government.

Against this backdrop is the fact that the current structure of the tax code is set to change dramatically as a long list of tax rates and tax credits will automatically expire December 31, 2010, creating a large built-in tax increase. Beginning in 2011, the following changes are set to occur:

- The top marginal tax rate for individuals increases from 35% to 39.6%
- The maximum long-term capital gains rate increases from 15% to 20%
- The top tax rate on dividend income increases from 15% to 39.6%
- The estate tax will be repealed in 2010 and then reappear in 2011 at pre-2001 high tax rates and low exemption levels
- Tax credits for children, education, and other incentives will expire or be reduced

Given these built-in changes, President Obama and Congress will face significant tax policy decisions. Underlying the decision process will be two competing philosophical views on the coming 2010 changes. Proponents of extending the 2001 and 2003 tax cuts argue that failure to act will "allow" a $1.5 trillion tax increase to occur. From a competing perspective, extending the 2001 and 2003 tax cuts would "cost" $1.5 trillion in lost revenue to the Treasury, highlighting the budgetary challenge of continuing the current tax structure into the future.

Faced with the reality of the current and projected fiscal pressures, Congress and President Obama are unlikely to agree on extending all of the expiring tax relief. Thus, the debate will center on prioritizing tax policies and engaging in a give-and-take exercise to find a tax structure that fits within the current fiscal and economic environment. Looking ahead, two overarching pressures will put opposing constraints on the outcomes – (1) the size of the deficit will limit the size and duration of any tax extensions or tax cuts and (2) a stagnant or recessionary economy in 2009 and 2010 will make it difficult to raise taxes too high or too quickly for fear of making the economy worse.

Tax Proposals

According to the Tax Policy Center, Obama's tax plan would cost $2.9 trillion over 10 years. Hidden within these numbers are proposals to raise taxes on business by either eliminating "corporate welfare," ending "incentives for companies to ship jobs overseas" or using "tax havens," and/or raising payroll taxes.

The incoming Obama Administration will need to decide which proposals to enact and which proposals to put aside as a new budget is crafted. One theme that is prevalent in the Obama plan is the clear distinction between tax reductions for lower- and middle-income Americans and tax increases for individuals making $200,000 or more and couples earning $250,000 or more. For these taxpayers, the Bush tax cuts would generally expire and they would see higher taxes in the form of additional payroll taxes and the phase-out of certain deductions.

The following chart outlines the various tax proposals Barack Obama announced during the campaign:

Barak Obama's Tax Plan

Business Provisions

Corporate Tax Rates	• No specific proposal to lower corporate tax rate • Provide a tax credit to employers that increase the number of employees in the United States; maintain U.S. headquarters; and provide certain benefits to employees
R&D	• Make permanent R&D tax credit
Health Care	• Provide a refundable tax credit of up to 50 percent of health insurance premiums paid by a small employer for health care for employees
Renewable Energy Production Tax Credits	• Make permanent the current tax credit for the production of electricity from renewable sources
Revenue Raisers/Tax Increases	• Tax offshore income and "tax haven abuse" • Codify economic substance doctrine • Tax publicly traded partnerships as corporations • Tax the "carried interest" income from investment partnerships as ordinary income rather than capital gain • Tighten rules on tax deductibility of executive compensation

Barak Obama's Tax Plan (cont'd)

Capital Gains	• Raise capital gains rate to 20% (from 15%) for individuals earning $200,000 or more ($250,000 for couples) • Eliminate capital gains for certain investments in a small business or start-up business
Dividends	• Raise tax rate on dividend income – from a top rate of 15% to top rate of 20%—for individuals earning $200,000 or more ($250,000 for couples)
Individual Provisions	
Marginal Tax Rates	• Make permanent lower income tax rates (10/15/25/28% rates) • Restore top rates of 36% and 39.6% (unclear what income level threshold new rates apply)
Phase out of Personal Exemption and Itemized Deductions	• Restore phase-out of personal exemptions and itemized deductions in 2009 and beyond (taxpayer earning $200,000 (single) or $250,000 (couple))
AMT	• Extend and index AMT exemption at 2008 levels (i.e., maintain current patch)
Savers Tax Credit	• Make the Saver's Credit refundable and change credit to provide a 50 percent match of the first $1,000 saved in a retirement plan
Tax Benefits for Families	• Make permanent $1,000 per child tax credit and marriage penalty relief • Expand Earned Income Tax Credit • Expand child and dependent tax credit
Seniors/Retirees	• Exempt from the first $50,000 of income received by a senior/retiree
Mortgage Tax Credit	• Provide a refundable "universal mortgage credit" equal to 10 percent of mortgage interest paid up to a maximum credit of $800 for taxpayers who do not itemize
Worker Tax Credit	• Provide a refundable tax credit of 6.2% of the first $8,100 in wages to offset the current payroll tax
Estate Tax	
Rates and Exemption Amount	• Freeze 2009 estate tax exemption and tax rate levels—$3.5 million exemption and 45% tax rate
Payroll Tax	• Subject incomes above $250,000 to payroll taxes. (The new payroll tax would be between 2% and 4% and paid by both the employee and the employer like the current Social Security tax. All income is already subject to the 1.45% Medicare tax)
Temporary Proposals to Address Economic Slowdown	• Eliminate the tax on unemployment insurance for 2008 and 2009 • Allow penalty free withdrawals from retirement accounts (limited to the lesser of 15 percent account balance or $10,000) • Provide employer tax credit of $3,000 per employee hired in 2009 or 2010 (credit would be refundable)

Observations on the Consequences of Obama's Tax Proposals

As with most policy decisions, there are winners and losers from changes to existing tax policy. An examination of the details of the tax proposal can provide some insight into who may benefit and who may see tax increases under the different tax policy changes outlined above.

- *Corporate versus Pass-Through Entities* – The current top corporate tax rate is 35%. Under the Obama plan, the top tax rate on pass-through income would increase to 39.6% or higher. Although corporate income is taxed twice (again when distributed as capital gain or dividend) the annual tax for pass-through entities could increase above that for corporations.
- *Domestic over International Businesses* – Senator Obama has proposed to "tax corporations that ship jobs overseas." Details of the proposal have not been provided, but multinational corporations could see a tightening or repeal of the current rules that allow tax on foreign earnings to be deferred until repatriated to the United States. This change would only impact U.S. multinational corporations that have earnings from foreign operations.

- *Cost of Capital* – Senator Obama would allow the capital gains rate to return to 20% and the top rate on dividend income to increase to 20%. Thus, the after tax cost of investments would increase. The shift to more and higher corporate dividend payouts would likely end with the increased tax on qualified dividends.
- *Cost of Labor* – Senator Obama would impose a new payroll tax (between 2% and 4%) on incomes above $250,000. The tax would be imposed on both the employee and the employer, increasing the cost of labor. However, some employers would qualify for the new worker tax credit (up to $3,000 per employee) for firms that are increasing their number of employees.
- *Housing Subsidy* – The proposed new universal mortgage tax credit of up to $800 for non-itemizers would further expand the various subsidies in the tax code for housing.

Financial Crisis/Economic Rescue

Obama envisions fiscal policy as a central tool for spurring the economy and blunting the coming recession. To build upon the first economic stimulus package passed in February 2008, Obama supports passage of a second stimulus bill to inject infrastructure and benefits-related spending into the economic engine (Obama did not vote on the final version of the first stimulus package). Obama has proposed a two-year, $175 billion total package, with:

- $25 billion in state relief, via a State Growth Fund designed to prevent cuts in state and local housing, education, health care, and heating assistance;
- $25 billion in infrastructure spending in the form of a Jobs and Growth Fund to prevent spending cuts in road maintenance and school repair; the Obama team estimates that this will save one million jobs;
- Extension of unemployment benefits, and a suspension of taxes on unemployment benefits;
- Tax credit of $3,000 per new worker hired, to stimulate employment;
- 90-day moratorium on foreclosures for homeowners making a good faith effort to pay off their mortgage;
- Bankruptcy reform to allow judges to modify a borrower's mortgage terms to make the loan affordable;
- For struggling families, permissible withdrawal of up to 15 percent of an individual's retirement account without early withdrawal penalty; and
- A program to lend federal money to cash-strapped state and local governments, in the model of the Treasury Department's Capital Purchase Program to troubled banks.

Obama proposes to pay for these expenditures with tax increases on families that earn over $250,000 per year and individuals earning over $200,000 (see taxation discussion above). He will also look to impose a windfall tax on oil companies and close certain corporate tax loopholes to offset the stimulus' price tag. Should Congress not act on a stimulus in a lame-duck session this fall, Obama will make his package one of his first priorities in 2009.

On housing reform, Obama seeks tighter regulation of mortgage lenders, greater transparency in the mortgage process and stricter enforcement of mortgage-related abuses. In 2007, Obama introduced the STOP FRAUD Act to increase penalties for mortgage fraud and provide additional protections for low-income homebuyers. Going forward, he will look to increase funding for federal and state enforcement programs, create additional criminal penalties for mortgage fraud, hold industry to greater reporting requirements, and expand disclosures to borrowers under existing mortgage laws. He also hopes to create a Home Obligation Made Explicit (HOME) score, to provide borrowers with a simplified, standardized metric to more easily compare mortgage products. Obama's mortgage reform approach will be decidedly more consumer protection-oriented than McCain's would have been, and would also include a 10 percent tax credit for 10 million mortgage borrowers who do not itemize

With respect to Fannie Mae and Freddie Mac, Obama has said very little as to what his plan is for these entities and how he might look to restructure them to bring them out of government conservatorship. Given their current condition and the other economic and financial regulatory problems the new Administration and Congress currently face, there is little expectation that the Obama Administration will look to take any aggressive action to change the present status of Fannie and Freddie any time soon.

Regulatory Reform

With seismic shifts in the federal government's approach to market intervention in recent months, the financial services regulatory landscape will be reshaped significantly in 2009 and beyond. Congress has clearly announced its intention to review the regulatory structure for the industry, and with Obama, it has a President with like-minded goals.

Obama's record on financial services regulation is rather limited, as his committee assignments during his senatorial tenure focused his sights elsewhere. However, Obama has echoed his colleagues' call for restructuring, announcing plans for expanded oversight of financial institutions that borrow from the federal government, transferring jurisdictional responsibilities, and improving transparency of investment firms.

Obama will also seek to streamline federal regulatory agencies, establish a financial market advisory group, and crack down on trading activities that he deems are manipulating the markets.

Regulatory reform will dominate the congressional banking agenda in 2009 and 2010, and large-scale regulatory changes are expected. The Treasury Department postulated its ideas for financial reform in March 2008 with its *Blueprint for a Modernized Financial Regulatory Structure*. This only set the table. The events of the past several months – market turmoil blamed in part on regulatory lapses, the federal government drastically increasing taxpayer risk with direct and indirect investments in troubled financial institutions, and the Federal Reserve significantly expanding access to its lending facilities – have radically altered the regulatory debate in Washington.

At a minimum, the Federal Reserve stands to augment its regulatory jurisdiction markedly. Whether through the Fed or another agency, Congress is likely to establish a systemic risk regulator to police the markets, and Obama has endorsed this approach. Other fundamental questions will be considered, including: how best to allocate responsibility for prudential/market stability/enforcement regulation of the markets; how best to regulate the activities of hedge funds and other investment firms that are largely unregulated today; how to regulate investment banking activities within commercial banking regulatory structures; and whether certain federal agencies should be merged in the interest of regulatory efficiency (e.g., SEC and Commodities Futures Trading Commission, or the Office of the Comptroller of the Currency and the Office of Thrift Supervision). The answers to these and related questions will go a long way in determining what our financial markets regulatory structure looks like for the next decade and beyond.

Credit Derivatives

In the wake of the Federal Reserve's intervention in AIG, and after the credit market seizure created by the Lehman Brothers collapse, Congress and the federal agencies are focusing on credit derivatives more so than ever before. This scrutiny will undoubtedly grow as we enter 2009.

Congress has held several hearings on credit default swaps during the subprime crisis, and leadership has indicated its interest in legislating a stricter approach to CDS in the 111th Congress. The bipartisan critique has largely centered on: how to improve CDS market transparency; how best to mitigate counterparty risk and systemic risk posed by outstanding CDS positions; how best to establish a clearinghouse(s) to facilitate clearing and settlement of CDS; whether CDS should be traded on-exchange; whether CDS contracts should be standardized; and whether CDS can and should be regulated as insurance products.

As with regulatory restructuring, neither the Obama nor the McCain campaigns had clearly articulated their positions on credit derivatives aside from sharpening their rhetoric as the election approached and the economy spiraled. Accordingly, Obama is largely a clean slate with respect to credit derivatives, although it can be expected that he will endorse aggressive action to increase transparency, at a minimum, and likely more aggressive efforts to enhance the infrastructure of, and place limits on, the CDS market.

Miscellaneous Business, Labor and Manufacturing

A handful of other commercial issues currently dominate the attention of lawmakers and federal officials – payday lending reform, credit card abuse, union elections, infrastructure improvements – and Obama has identified each as a priority in 2009.

In general, Obama supports a more consumer protection-oriented approach than McCain would have. A good example was the Obama campaign's focus on payday lending abuses. To protect lower-income individuals, Obama has announced his intention to cap interest rates on payday loans at 36 percent, while seeking to provide borrowers with clearer, simplified disclosures on loan fees, payments and penalties. He would encourage banks and credit unions to increase small-denomination, short-term consumer loans.

On credit card reform, Obama would look to create a rating system to enable consumers to evaluate the risk and benefits on every credit card, as well as a Credit Card Bill of Rights to deter unfair practices. He seeks to ban unilateral changes to card terms, prohibit interest on fees, require prompt crediting of payments, and to mandate that rate increases only apply to future debt. Obama has well-placed Democrat allies who have already laid the groundwork on this issue in the 110th Congress, so reform is likely.

Organized labor will see a significantly more receptive White House under Obama than in past years under President Bush. To wit, Obama has received grades of 100 percent from the AFL-CIO and 94 percent from the Service Employees International Union for his labor efforts in the Senate. Increasing the minimum wage has been and will remain an Obama priority. In the 110th Congress, Obama voted in favor of increasing the minimum wage to $7.25/hour. He has announced his intention to continue to seek minimum wage increases and will look to index the minimum wage to inflation.

To reverse the waning influence of unions in American business (union participation has declined from 24 percent of American workers in 1970 to 12 percent in 2006), Obama will look to enact the Employee Free Choice Act, a bill to make union organizing easier by eliminating the secret ballot from union elections. Most businesses have opposed the concept and other efforts to increase the role of unions. If successful, Obama's labor policies will drastically change the dynamic of labor relations that has characterized the past several decades in American commerce.

Obama will also look to create jobs and stimulate the economy through expanded manufacturing and infrastructure spending in

2009 and beyond. He would double funding to the Manufacturing Extension Partnership, which works with manufacturers to develop and implement new technologies that improve manufacturing efficiency. On transportation, Obama has said that "it is critically important for the United States to rebuild its national transportation infrastructure," including our roads, bridges, ports, airports and rail. He envisages a National Reinvestment Bank to expand federal transportation investments, paid for with $60 billion in federal funds over 10 years.

Trade

It is a well-established maxim that what candidates say about trade policy is not always what they do when elected, and this year is no different. It is obviously too early to tell how President Obama will carry himself on the world stage. Trade, however, is not likely to top the agenda for the first couple of years due to the urgency of other issues and the growing ranks of trade critics on Capitol Hill. Given the strong anti-trade mood in Congress, Obama is unlikely to initiate any sweeping trade liberalizing moves, especially considering that many incoming freshmen Democrats ran on anti-trade platforms.

More specifically, during the Democratic primaries, Obama called for a renegotiation of NAFTA with Canada and Mexico. There would be little, if any, pressure on Obama to keep this campaign promise since renegotiation is not a top priority for his supporters. Indeed, it is unclear how a settled NAFTA treaty could even be re-opened. He also opposed the Colombia FTA and South Korea FTA, so progress is unlikely next year, especially considering the expanded Democratic congressional majority.

Buttressing this theory, Obama softened his anti-trade rhetoric considerably once he secured the Democratic nomination. In recent months he has said he favors free trade in general, but that such agreements must include strong protections for labor and environment and that trade must be "free and fair for all." Importantly, such conditions are also critical for attracting more support in Congress. A top trade adviser to Obama and likely pick for the top job at USTR, Dan Tarullo, has stated that President Obama could be expected to devote more attention and resources to enforcing existing trade agreements. Democrats in Congress have been deeply critical of the Bush Administration for failing to enforce existing trade agreements, bringing less than half the number of cases to the WTO compared to the Clinton Administration. Tarullo has stated that Obama would consult closely with Congress on trade issues.

President-elect Obama has also expressed support for the successful conclusion of the Doha Round of multi-lateral trade negotiations, but the Obama campaign stated that the agreement must include benefits to workers and the poorest countries. Negotiations collapsed in July. While efforts are underway to revive them, hope for a breakthrough rests with China and India, which so far at least, do not appear to want a deal. Obama has also spoken about the importance of helping workers who lose their jobs as result of overseas competition, a shared priority of many members of Congress.

The bright spot on the trade agenda is that despite the recent slowdown in the global economy, US exports have been growing, which has cushioned the blow of job losses in other sectors of the economy. Policymakers on both sides of the aisle will be cautious about any proposals that threaten the benefits of free trade.

Energy

This past year, energy issues dominated much of the policy agenda as oil touched $150 per barrel and gas prices soared past $4.00 per gallon across the country. With both oil and gas prices in retreat as the economy hits the brakes, energy policy has lost its urgency. The new Obama administration will have many ideas and proposals in the energy arena, and the issue is sure to generate attention, but not much sweeping action.

We expect the Obama administration and new Congress to push for additional or more favorable incentives for renewable energy. In tandem with this effort will be moves to repeal or lessen incentives for oil companies as a means to shift from an oil based dependency to a renewable-focused economy. This transition is under way with long-term extensions of several tax credits and incentives for renewable energy. Further action could be accomplished through attempts to make these tax incentives permanent (such as a permanent extension of the production tax credit) or an expansion of direct subsidies for renewable energy through the Department of Energy.

Undoubtedly, the biggest issue will be climate change and a debate around enacting a "cap-and-trade" regime to deal with the problem. In 2008, the Senate debated cap-and-trade without passing a final bill. Given the state of the economy, next year will likely yield more talk without action. Under most iterations of a cap and trade regime, the cost of the system will fall on manufacturing and utility companies required to pay for carbon allocations. This cost will be too difficult to bear during a recession or fragile economy, regardless of the environmental benefits. Thus, until the economy recovers, it is unlikely that Congress will be able to enact a cap-and-trade regime.

Health Care

As polls suggested for months preceding the election, a primary concern on the minds of the American public is health care. This was another issue that painted a deep contrast between Obama and McCain. As a senator, Obama has voted several times to expand funding for health care programs, including the State Children's Healthcare Insurance Program (SCHIP), which Obama would use to increase health care funding for both children and certain adults, using proceeds from tax increases in other areas. In 2007, he voted in favor of allowing seniors to purchase cheaper prescription drugs from Canada and other developed countries.

Obama has given health care a central position in his domestic agenda for 2009. Seeking to expand coverage to many of the 47 million uninsured Americans, the Obama campaign trumpeted its health care plan that "provides affordable, accessible health care for all Americans, builds on the existing health care system, and uses existing providers, doctors and plans to implement." Central to the plan is a requirement that all children be covered (coverage would not be mandatory for adults), paid for with aforementioned tax increases on households making over $250,000. He would require employers to pay at least some of employees' health care costs.

Obama would require insurance companies to cover pre-existing conditions; seek to lower costs for business by creating a small business tax credit to help them provide insurance to employees; prevent insurers from overcharge doctors for malpractice insurance; establish a national insurance exchange that includes a range of private insurance options; and establish a tax credit program to allow low-income families to afford premiums. He continues to support lowering the cost of prescription drugs by allowing importation from other countries and by encouraging the use of generics.

Some of the highlights of Obama's Healthcare proposals include:

Expanding Access to Coverage

- Require all children, but not adults, to have health insurance
- Require employers to offer health benefits or to pay into a national insurance fund
- Expand Medicare and the State Children's Health Insurance Program
- Create a national health insurance exchange through which individuals and small companies could buy coverage from private insurance plans or a new government insurance option
- Provide people who are currently uninsured an unspecified tax credit to help buy insurance

Coverage for People With Existing Illnesses

- Require "guaranteed issue," prohibiting insurance companies from denying coverage or charging higher premiums to people who are sick

Controlling Costs

- Aim to improve prevention and management of chronic diseases
- Devote $50 million to promote health information technology
- Promote the use of generic drugs, instead of more expensive brand-name ones
- Reduce payments to private Medicare health plans

Improving Quality

- Support research into medical effectiveness and promotion of the best practices
- Foster more reporting of quality and price data
- Address health disparities for different racial and ethnic groups

Obama should get a quick and early victory in the health care area by expanding those covered by the SCHIP program. He also will look to bring down the eligible coverage age for Medicare to 55, expanding this program from the top down. The federal government's swelling balance sheet and focus on the credit crunch, however, will likely exhaust the actual and political capital that Obama will need to pursue his more ambitious health care plans. Although Congress will be generally sympathetic, it may be somewhat constrained by the realities of economic turmoil in the short to medium term.

Analysis

Obama's domestic agenda is clearly ambitious and will undoubtedly be an aggressive repudiation of the policies of the past eight years. It is an agenda heavily dependent on tax increases from higher-income earners, which should be supported by a like-minded Congress (see taxation discussion above). However, Obama's aspirations may be constrained by external factors beyond his control. Even with expanded Democratic majorities in Congress, the political reality is that the financial crisis will likely dominate his playing field, hampering to some degree his ability to tackle the other pillars of his domestic agenda.

As the federal government responds to the credit crunch and growing recessionary pressure, Obama will need to dedicate significant federal funding to expedite recovery, thereby siphoning money from other priorities and increasing pressure on the national deficit and debt. The final 100 days of the Bush administration have been a churning cauldron for the President and the markets, and Obama will quickly learn what it is like to go from the frying pan into the fire.

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