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Change: Part 2 - The Electorate Strikes Back

This election marked a defining moment for the political and economic landscape in the US. It closed a chapter in the story of when and how government should act both in a crisis and afterward. The electorate has written the first page of the next chapter. How it will read from here is subject to speculation in which we are happy to engage. The President has acknowledged the reality of a shift in the balance of power in Washington. He is confronted with choosing between tacking to the center through pragmatic interaction with Republicans or holding his ground under the umbrella of partisan politics as espoused by the Democratic leadership. Tough choice. This week's announcement of his support for a compromise on deferring tax increases for two years indicates his partiality for the pragmatic over partisanship. How this will be received in certain quarters should provide a bit of drama before year's end and provide a clue as to whether key decision-makers on both sides of the aisle also move toward the center to govern or remain in election-mode with their parties' leadership. The recovery of the US economy hangs in the balance.

The Electorate Speaks but What Are They Saying?

That's the question being tossed around by pundits and politicians in the aftermath of an election that, years from now, could be viewed as historically significant. Some compare this to the mid-term election of '94 where a Republican Congress and Bill Clinton forged a prickly alliance to attack the budget deficit. Others see this as the beginning of a shift in the political firmament similar to what preceded the election of Ronald Reagan. Alas, we see no Reagan, or Clinton for that matter, among those who currently aspire to the office. Among the terms used to describe the result of November's costliest election ever are: Repudiation, Mandate, Endorsement. They are none of the above and all of the above: It just depends on who you ask and what their agenda is. What we are sure of is that the blind pursuit of an ideology-based agenda by the party in power has ground to a halt. While we think that's good for the country, there's no guarantee that what follows will be any better for the economy.

We're hopeful that the cultural divide between parties can be bridged but are realistic about the polarization of their respective leaderships. R leaders envision the US as a free-enterprise driven meritocracy where government plays a limited role. D leaders embrace the concept of a social-democratic state where government plays a much larger role in managing the economy and mandating an ethic of social justice within the private sector. The former embraces capitalism, the latter a modified version of socialism. Obviously, we are unapologetic capitalists so it's no surprise that we were pleased with the outcome of the election. If you ask us, we don't view the election as a mandate for a reopening of the Republican playbook. We see this election sending the message that no party should control both Congress and the White House if their intent is to put party before country in the pursuit of their agenda. **Both parties are guilty of the uncontrolled expansion of government borrowing and spending for the benefit of their respective constituencies. Both have now suffered for it at the polls. We hope they heed the message that is being delivered.**

The First Test

Who do you believe better utilizes capital, the government or the private sector? If efficiency and productivity are the benchmarks, the private sector wins in a landslide. It's the engine for growth in every economy. According to some sources, government spends somewhere around $1.25 for every dollar it takes to fund its operations along with entitlements, social programs, and, unfortunately, the occasional war. It can be argued these benefit everyone so we don't deny the need for government, especially in a crisis, and don't object to paying taxes to fund essential services.

The problem arises when government sees itself as a growth industry in the absence of a crisis. It competes with the private sector for capital, using the ultimate weapon: its taxing power.

It doesn't take a genius to figure out that there is a tipping point out there on the horizon where unchecked taxation and inefficient utilization of capital by government will constrain the private sector to the point of killing the engine of growth. The only option left is to borrow to maintain a false sense of prosperity. Case in point: Greece. They and other profligate Euro-zone economies serve as a lesson to the rest of the world about what can happen when government can't embrace self-discipline. History is littered with empires that have fallen because of unbridled self-indulgence. It's most often the result of a subtle, decades-long cultural shift but it can also be intentionally self-inflicted as seen in the Cloward-Piven strategy that has attracted the interest of those politicos who see government as the answer rather than the question.

The bi-partisan Deficit Commission took up the challenge and proscribed steps to preempt the economic crisis that will befall us if we continue down our present path. Europe has chosen to embrace austerity in meeting its challenge. We have chosen to use stimulus to pave our way to recovery. The Commission borrows from both in crafting a solution. In short, it calls for less government borrowing and spending and slightly higher, but reasonable taxation. Sounds simple: shared sacrifice. Unfortunately, in this case the rubber meets the road on the way to Washington where money is sent to burn and good ideas go to die. Most agree the Commission took the national debate on the deficit to a higher level. Unfortunately, that also took it over the heads of policy-makers in Washington. In this week's tax compromise everybody got something they wanted, except the Deficit Commission. The president and Republican leaders have agreed upon a plan that, in essence, is a $600 billion stimulus package. It will defer the Democrat tax increases *and* extend long-term unemployment benefits. And who pays for it? Your grandchildren.

The need for more stimulus and quantitative easing at the present time is debatable. The need for higher taxes at this moment is not: they would forestall a strong recovery. Unfortunately, the compromise didn't call for a prioritization of programs and cuts in non-essential spending. That would have been a nice first step and one that could make reasonable tax increases down the road more palatable to taxpayers. This was a squandered first opportunity to legitimize the Commission's recommendations. We hope it's not the first of many. **We'd give this first test of post-election Washington a solid "D".**

2011: What Mode of Operation Will Government Choose?

We hope to see the rise of pragmatism (a la 1994) in government next year. It's time to abandon the political theater and migrate from election to governance mode. Without a doubt, the election marked a shift in the balance of power *between* the parties. We think this week's compromise on taxes could eventually lead to a shift *within* the parties. The Democratic leadership has remained intractable on the far left as the President reached across the aisle. Tea-partiers have chided Republicans for abandoning their principles and vow to soldier on at the opposite extreme right. If the current condition persists, we could well see gridlock for the next two years as each party postures and jockeys for position. However, the intra-party discord could marginalize the extremists within each party if the president, Blue-Dog Democrats, and moderate Republicans find their voice to communicate across party lines to craft big solutions to big problems.

It's too early to make a detailed forecast of what we think will happen next year but we're cognizant of the risks ahead. We believe state and local governments will be confronted with their own sovereign debt crisis. They will be forced to confront their deficits immediately and should look to the Deficit Commission's blueprint for a solution. We expect to see municipalities cut or eliminate programs, layoff public employees and rewrite collective bargaining agreements. Failure to address the deficit at the federal level carries a much greater risk. The current tax package served to poke a slumbering giant: The Bond Vigilantes. They are the buyers of US debt and we rely on their good graces. Rates have kicked up in response to this poke. One poke too many could awaken them and send our budget spinning out of control with a spike in our cost of borrowing that would derail our recovery.

Managing the deficit is the biggest obstacle to regaining our economic footing and mounting a sustainable recovery. We're hopeful that Congress can find their way to implement change that sends the message that the Deficit Commission's recommendations will be followed and that the private sector, not government, is the growth engine of our economy. It would inject a much-needed dose of certainty and confidence into the economy and the global markets.

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