WSJ.com THE WALL STREET JOURNAL. ONLINE

OTHER FREE FEATURES

Republicans' Tactical Edge
Conventional wisdom is overlooking some significant tactical advantages that Republicans have on their side in the election, which could be enough to save at least some imperiled seats.

Corn Is Booming as Ethanol Heats Up
Corn prices are up nearly 55% since September, fueled by the booming ethanol industry. But the trend is bruising livestock farmers and has Wall Street fretting over profits at food manufacturers.

In Web Video Spoofs, Candidates Get Remixed
A new variety of Web video is emerging this election season: political parodies that interweave campaign footage with segments from popular movies, TV shows and songs.

See More Free Features

Go to WSJ.com's Home Page

BROWSE WSJ.com
FRONT SECTION PAGES

- News
- Technology
- Markets
- Personal Journal
- Opinion
- Weekend & Leisure
- Health
- Media & Marketing
- Asia
- Europe
- Americas

Free Dow Jones Sites
MarketWatch
CareerJournal
OpinionJournal
StartupJournal
RealEstateJournal
CollegeJournal

ECONOBLOG

How Much Do Election Shakeups Affect the Nation's Economy?

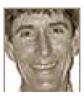
November 3, 2006

As the midterm elections loom, Congress watchers expect Democrats to pick up seats in both the House and the Senate and perhaps take control of both houses. While economic and pocketbook issues such as the minimum wage and the Bush tax cuts have played a part in stump speeches, it remains to be seen whether any major policy changes are in the offing. Still, it's instructive to take a step back and see what changes in party control have meant for the U.S. economy in the past.

The Online Journal asked Mark Thoma, associate professor of economics at the University of Oregon and an economics blogger, and Justin Wolfers, an assistant professor of economics in the business and public policy department at the University of Pennsylvania's Wharton School, to discuss the research on the topic and share their own views on how much -- or little -- a change of control in Congress could affect the U.S. economy.

What do you think? Share your comments on our discussion board.

* * *



Mark Thoma writes: In the last 30 years, a considerable amount of work has been devoted to an area of economics known as "political business cycles." Researchers in this area look at the relationship between electoral outcomes -- the outcome of elections and the economic policies of the party in power -- and the subsequent performance of the economy.

Broadly stated, there are two kinds of research on political business cycles. One type watches how the parties that win elections -- or are in control -- affect the performance of the economy. (For an overview of seminal work in this area see this paper by Allan Drazen. Also, see more recent papers here, here and here.)

The other class of research looks at the question from the opposite side. These researchers study how the performance of the economy helps decide which party wins an election. (For a good grounding in this type of work, see some important papers here and here.)

Here are some large research findings as summed up by Drazen:

• Inflation -- In the U.S., there is evidence of a post-electoral increase in inflation prior to 1979, but no evidence thereafter.

> **Mark A. Thoma** is an associate professor of economics at the University of Oregon. He joined the UO faculty in 1987 and served as head of the economics department for five years. His research involves the effects that changes in monetary policy have on inflation, output, unemployment, interest rates and other macroeconomic variables, and he has conducted research in other areas, such as the relationship between the political party in power and macroeconomic outcomes. Thoma blogs daily at Economist's View. He received his doctorate from Washington State University.
>
> **Justin Wolfers** is an assistant professor of economics in the Business and Public Policy Department at the Wharton School. He is a visiting scholar with the San Francisco Federal Reserve, a research fellow with the National Bureau of Economic Research, and a research affiliate of the Institute for the Study of Labor in Bonn, Germany, and the Centre for Economic Policy Research in London. Dr. Wolfers earned his Ph.D. in economics in June 2001 from Harvard University. His research covers labor economics, macroeconomics, political economy and behavioral finance.

• Monetary Policy -- There is evidence of a pre-electoral increase in money growth rates from 1960 to 1980, but none thereafter. Money growth, or the percentage change in money supply, is an important measure of monetary policy prior to 1980, when the Fed started to focus on the federal-funds rate as the main monetary policy tool. There is no evidence for the U.S. of an electoral cycle in the federal-funds rate.

• Spending on Programs -- There is evidence of pre-electoral increases in government transfers (such as food stamps, Social Security and other cash payments) and other fiscal policy spending. This appears strongest before 1980.

• Output -- There is a clear partisan effect on economic activity, with real GDP being significantly higher under Democrats than Republicans in the first half of their terms. There is no significant pre-electoral increase in aggregate economic activity, meaning there is no evidence for pre-election manipulation of the economy.

Drazen also summarizes empirical work on the second kind of research, focusing on how the performance of the economy helps to determine who wins an election. Aggregate economic conditions before an election, specifically per capita output or income growth (and to a lesser extent inflation), have a significant effect on voting patterns.

TODAY'S MOST POPULAR

1. The New Word in Home Sales: 'Canceled'
2. Berkshire Earnings Quadruple
3. Idiocy Has Never Looked Smarter In 'Borat'
4. Cardinals Dream of Arizona
5. MarketBeat: Chelsea's New Job?

A robust finding in the political business cycle literature is the last item on the first list, stating that output tends to be higher in the first half of Democratic administrations. If this is true, then it might be expected that the stock market performs better when Democrats are in power. Evidence in favor of this hypothesis comes from this 2003 paper by Pedro Santa-Clara and Rossen Valkanov, "The Presidential Puzzle: Political Cycles and the Stock Market." In the paper, the authors look at excess returns, i.e. returns over and above the returns on Treasury bills, using data from 1927 through 1998. Their estimates show that returns are, on average, 9% higher when Democrats are in power. (See this chart of returns by political party from University of California, Berkeley professor Hal Varian's description of the paper). They note that much of the difference in returns arises from smaller firms performing much better under Democratic administrations.

Precisely why this is the case is difficult to answer. And the paper doesn't come to any strong conclusions about the driving force behind the difference in returns. Nor does it explain why the difference persists, though it does rule out a few plausible reasons for these findings. Whatever the reason for the difference in returns, the evidence suggests that returns are distinctly higher under Democratic administrations. Therefore, if you are an investor, you may want to hope for the continued reemergence of the political left and for a Democrat to win the next presidential election.

But before we get our hopes up too much, I suspect Justin may want to comment further on how much confidence we should have in these results.

* * *

Justin Wolfers writes: Mark has done a wonderful job in summarizing the current state of the knowledge about the link between elections and economic outcomes.

What are the key differences between Democrats and Republicans? Democrats seem to care more about unemployment. Not surprisingly then, the election of Republicans seems to presage economic recession.

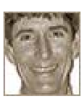
But as an occasional contributor to that literature, let me take up the role of part-time cynic. A very real difficulty with this research is that we have more researchers than we have elections. This means that just about any correlation in the data is likely to get highlighted by someone -- whether it is due to luck, or real differences between the parties.

Do I believe that Democrats are better for growth than Republicans? Probably. But do I believe that this difference is big enough to keep causing recessions? I'm less sure. And how much can we extrapolate from presidential elections to thinking about the effects of a midterm election? The effects are probably even weaker.

More recently, we have seen another sharp difference emerge between the parties: their approach to fiscal policy. There was a time when we assumed that Democrats were the "tax-and-spend" party that inherited a Keynesian philosophy, while the Republicans followed neoclassical textbooks and believed in balancing the budget. Yet the deficit rose sharply under Reagan, again under Bush (41), declined under Clinton, and is once again a real concern under the current administration. Indeed, in recent research, Erik Snowberg, Eric Zitzewitz and myself document the fact that bond yields rose sharply on news that Bush was re-elected in 2004, as typically happens when investors expect the deficit to rise. (Click here for the summary.)

Finally, perhaps the lens of "left" versus "right" is not the most important factor in these midterm elections. Rather, we are facing the choice of unified versus divided government. In this context, the question is whether a Democratic House is likely to impede good government or provide a useful check on bad government. In my next post I'll return to some useful recent experiments that might help us figure out the likely effects.

* * *



Mark Thoma writes: First, let me highlight the work Justin and his colleagues have done on how stock returns vary by party, because the research overcomes a difficult problem in the political business cycle literature of sorting out the direction of causality between election outcomes and economic outcomes. This is accomplished by finding a "natural experiment" in the 2004 presidential election that is able to identify with some certainty the particular variable that changes first and hence drives changes in other variables.

But, as the authors acknowledge and discuss, there are still problems with sorting out the reasons for the observed differences between the parties. This applies generally in this research, not just to their paper.

In particular, when we see differences in economic outcomes for the two parties, we don't know if those results are due to expected policy changes -- such as reducing taxes on dividends – or an expectation that real GDP will be higher or lower under a particular administration. For instance if stock returns improve, it could be due to the expectation of favorable policies or it could be due to the expectation that the economy will improve and profits will jump. So it's hard to pinpoint what actually drives these results researchers observe.

That is, we can't tell if returns rise because investors expect favorable treatment, or because they expect a booming economy. My suspicion is that much of the difference in stock returns is due to the expectation of favorable treatment rather than the expectation of enhanced economic activity, and the behavior of the Bush administration has done nothing to dispel this notion.

But before moving on, I should note that Robert Reich, secretary of Labor under the Clinton administration, says we're both nuts. He believes that stock returns have nothing at all to do with the party in power. Though he is in agreement with Justin on fiscal policy, Reich writes:

"Anyone who thinks the market reacts to who's in charge of Congress or even the White House doesn't know economics and is blissfully ignorant of politics. The truth is, there's not much politicians can do to stimulate or retard the economy. Tax policies have a marginal impact, at best. Bill Clinton raised taxes and the market went up. George Bush cut taxes and the market went up. Supply-siders think tax rates are a big deal. They're wrong ... Deficits do matter because large ones can spook the market into fearing the Fed will raise interest rates to counteract the inflationary tendencies of big deficits."

And, for a bit more on this topic, see Market Gains by President/Congressional Party, which finds that returns are higher when Democrats are in power, though the study should be interpreted cautiously.

* * *

Justin Wolfers writes: There's nothing better than letting the other guy describe one's own research. And Mark did a terrific job. As he says, our research suggests that the stock market expects returns to capital to be about 2% higher under Republicans than under Democrats. We interpret this in much the same way that Mark does: It may well reflect different expectations about how Republicans treat capital versus labor.

And more to the point, this effect is pretty small. So perhaps our findings are also consistent with Robert Reich's view. The exciting thing about our approach is that we use past "experiments" to try to predict the future. And as we look forward to these midterm elections, it's worth thinking about what we can learn from some of these past experiments. Let me highlight two in particular.

In 1994, the political landscape was similar to today, in that one party controlled both houses and the White House. Of course it was obviously different in the sense that the Democrats were at the helm.

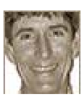
On the eve of that year's midterm election, the Iowa Electronic Markets rated Republicans a 75% chance to take the Senate and a 20% chance to take the House. For the 2006 election, I'm tracking the odds on www.intrade.com, and the situation is roughly analogous. The latest odds suggest that the Democrats are a 70% chance to take the House, and a 30% chance to take the Senate. So if we follow the 1994 script in 2006, and we move from united government to divided government in 2006, what can we expect?

The answer is: Surprisingly little. Financial markets barely moved in response to the 1994 election surprise. That is, financial markets pretty much expected "more of the same."

Seema Jayachandran's research (available here) analyzes another neat natural experiment: In May 2001, Sen. Jim Jeffords' decision to leave the Republican Party and begin voting with the Democrats handed them control of the Senate. What happened? In response, average Democrat-supporting firms saw their stock rise by 0.1%, while average Republican-supporting firms saw their stock fall by 0.4%. This yields a net decline of about one quarter of a percentage point. That is, even if the effects of the White House are small, the average effects of losing control of the House or Senate are even smaller.

Still, these averages hide the fact that some sectors will do a lot better with a Democratic house than others. (This is a theme also explored in recent work by Brian Knight and Andrea Mattozzi.) And all of this leads to the conclusion that perhaps we need to be talking not just about the aggregate effects on the economy, but also distribution: Who will be the winners, and who will be the losers?

* * *



Mark Thoma writes: Justin provides a nice lead-in to a different aspect of how economic outcomes differ by party: Changes in the distribution of income. Over the last several decades, income inequality in the U.S. has been increasing as most of the gains from economic growth have gone to those at the very top of the income distribution. (The best source of research and data on changes in income distribution over time comes from the work of Thomas Piketty and Emmanuel Saez).

The degree to which changes in inequality can be attributed to changes in economic policy according to the party in power, or economic factors such as a skill-based wage premium, is currently the source of much debate in economics, and there are strong advocates on both sides. (See Greg Mankiw versus Paul Krugman and more details from Krugman.)

A 2004 paper by Larry Bartels at Princeton University looks at this issue and finds some surprisingly strong differences in income distribution according to which political party is in power.

As Bartels notes, prior to his work, most explanations for changes in the distribution of income were based upon economic rather than political explanations. For example, one story for the change in inequality is based upon the idea that "skill-based technical change" has made educated workers more valuable in the workplace and this has allowed more educated workers to achieve higher income gains than those with less education. However, the fact that most of the gains have been at the very top of the income distribution rather than for the much larger group of college-educated workers undermines this explanation (this is Paul Krugman's 80-20 fallacy).

Bartels provides strong evidence that political factors are a significant source of rising inequality. He finds that families at the top of the income distribution, those at the 95th percentile, fare equally well under Democratic and Republican administrations.

But families at the lower end of the distribution, those at the 25th percentile, have realized four times as much income growth when there is a Democratic president.

Why the difference? As Justin noted earlier, "Democrats seem to care more about unemployment," and there is evidence that unemployment is lower and output growth is higher when Democrats are in power -- this is one of the regularities noted in the opening post. Bartels's explanation for the partisan differences in inequality is that "both unemployment and GDP growth have much stronger effects on income growth at the bottom of the income distribution than at the top." Thus, while the issue is not yet fully settled, this research provides strong evidence that the party in power affects the distribution of income, particularly at lower income levels.

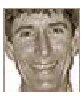
* * *

Justin Wolfers writes: Let me follow Mark in trying to think about the drivers of inequality, but once again try to focus this on likely consequences of the midterm elections.

What are the main poverty-fighting tools available to the federal government, and how will the election change things? The minimum wage is obviously particularly relevant to the growth of the "working poor", and the current $5.15 minimum has not changed since 1997. It seems likely that congressional Democrats -- were they to win a majority -- would use it to try either to raise the minimum wage or to force the Republicans to deal with voter discontent on the issue. Yet even if there are changes, the consequences may not be so large, as many states have instituted more generous minimum wage laws.

Taxes are obviously the other really important tool for affecting inequality of living standards. And the opportunity for the Democrats to effect real change here can't be understated. One way the Republicans have disguised the total cost of these tax cuts is by passing them with a 10-year sunset clause. But the prospects of a hostile House may well mean that the assumed renewal of these changes will be a harder fight. And I suspect that this is probably good news for those at the bottom of the income distribution. We are facing tough fiscal times, and returning to a more progressive tax system will surely mean that those at the bottom of the income distribution will bear less of the burden.

* * *



Mark Thoma writes: Since Justin has already touched upon how the elections might change economic policy and affect income inequality, and since I agree with his analysis, let me end my part with a discussion on another topic -- whether the Federal Reserve has manipulated monetary policy in response to political pressure, i.e. whether there is any evidence for "political monetary cycles." In the U.S., we have decided that the Federal Reserve should enjoy a substantial degree of independence from the rest of government. One of the reasons for this is specifically to avoid having monetary policy manipulated to serve the political ends of the party in power rather than the best interests of the public. Thus, it would be disappointing to learn that there is evidence the Fed manipulates the money supply according to political considerations.

One reason I wanted to end with this is that one of the regularities noted in the first post suggests that the Fed did, perhaps, manipulate the money supply around elections prior to 1980. There is evidence of a pre-electoral increase in money growth rates from 1960 to 1980, but none thereafter. There is no evidence for an electoral cycle in the federal-funds rate. This is based, in part, on work by in 1987 by Nathaniel Beck and in 1989 by Kevin Grier, who found that there are cycles in the money supply that coincide with election cycles, a result that is suggestive of political manipulation by the Fed. This could be from the Fed actively intervening in the economy before elections to influence the outcome, or from a bias toward easy policy in the run-up to elections to avoid being blamed for affecting the outcome of the election should a downturn occur.

But further examination of Beck's paper and subsequent work by others suggests that to the extent that there are coincident cycles in the money supply and elections, they are not caused by active intervention by the Fed. As Beck explains, fiscal policy is the source of the variation: "While there is a cycle in the money supply, ... [t]he monetary cycle disappears when fiscal policy is held constant. It appears as though the Fed passively accommodates fiscally induced political monetary cycles, but does not actively cause such cycles."

This was been reinforced by later work including Jon Faust and John Irons in 1996. In their summary, they write: "Political economists often find large effects of political variables and often attribute the effects to manipulation of the Fed ... We find almost no support for the hypothesis that political effects on the macroeconomy operate through monetary policy and only weak evidence that political effects are significant at all."

Independence of the Fed is important. What's best for the economy in the long-run may not serve the short-run interests of the party in power, and it's reassuring that there is little solid evidence of that the Fed manipulates the money supply for political purposes.

* * *

Justin Wolfers writes: I'm glad that Mark has raised the issue of the link between politics and monetary policy. Indeed, it's worth broadening the issue a little further. While there is some quite convincing evidence that electoral machinations affect the economy, the open question remains: Why? Or how? That is, we see evidence that election cycles appear correlated with macroeconomic outcomes, but we tend not to see much evidence that macroeconomic levers are shifted around election time.

On the fiscal side, I think that the reason is simply obfuscation. Keeping track of the federal budget is a task of nightmarish complexity, and politicians are a pretty crafty bunch. So I wouldn't be surprised if there were more manipulation on the fiscal side than we mere economists can observe.

But on monetary policy, I think it is very difficult to believe that there is any political influence operating on the Fed. Sure, Alan Greenspan may have been willing to lend the Republicans his credibility during testimony on non-monetary matters, but it is nearly impossible to make the case that monetary policy was eased to help them win an election. Indeed, Greenspan was consistently reappointed by both Democrats and Republicans! And the current Fed chairman, Ben Bernanke, has shown himself to be quite committed to the Fed's political independence. Thankfully, we seem to be in a situation that the main managers of the business cycle have risen above the political fray.

Finally, let me conclude with what I think the biggest impacts of Tuesday's election will be:

1. While not much will change in aggregate, this aggregate will hide a lot of microeconomic turmoil. Divided government will reduce the ability of Republicans to deliver favors for their friends. And you can probably guess who the winners and loser will be.

2. The politics of Iraq will change. My own research with Eric Zitzewitz (available here), suggests that our policy in Iraq is a much more important economic factor than the usual left-right squabbles. Indeed, it may well explain a lot of our current economic malaise.

3. The main effect of this election is that it will change the political status quo for future elections. If the Democrats win the House, this gives them a lot of hard-to-defeat incumbents for future elections, raising the possibility of united Democratic government in 2009. (David Lee's research on incumbency effects in congressional elections suggests that today's election victory confers substantial benefits in future elections.)

And the major puzzle that I currently see? The past two years have clearly been terrible for Republicans, with Iraq deteriorating, Katrina undermining the public trust, and corruption scandals aplenty. And consequently their chances of keeping control of the House have fallen precipitously (Intrade.com charts here). But the real surprise? Prediction markets tell us that the odds of Republicans winning the White House in 2008 remain virtually unchanged. Neither the incumbency advantage coming from victory in the 2004 elections, nor the subsequent declines in Republican fortunes have shifted the odds (chart: here), and the 2008 Presidential election remains a coin flip.

Stay tuned: It looks like Tuesday will be a long night. And when the counting ends, the two-year campaign for the White House begins.

What do you think? Share your comments on our discussion board.

Write to Matt Phillips at matt.phillips@wsj.com