Romney’s Party Isn’t Fiscally Responsible

By Betsey Stevenson & Justin Wolfers - Oct 8, 2012

Presidential candidate Mitt Romney says he will get the U.S. government’s finances in order and make life better for business. It’s a classic Republican pitch, but to what extent does it correspond to what he might really do as president?

Not so much, if you believe -- as Republicans traditionally do -- in the wisdom of markets.

One way to assess the benefits of Republican presidencies is to look at how markets have responded to them over the years. The most reliable method is an “event study,” which analyzes the response of market prices to rapid shifts in the likelihood of a Republican in the White House. Fortunately, history has blessed us with many such natural experiments.

Let’s take the 2004 election as a particularly stark case study. In the middle of Election Day, flawed exit-poll numbers suggested that John Kerry would win in a landslide. For the next few hours, financial markets believed that there would be a Democrat in the White House. Then, by late evening, the votes were counted, and it became clear that President George W. Bush, the Republican, had won re-election.

The incident is a social scientist’s dream. It led financial markets to believe that the country was switching from a Republican to a Democratic administration -- a shift in beliefs that was completely unconnected to other factors, such as specific political promises or the state of the economy.

Market Response

So how did markets respond? Yields on government bonds were lower during the brief period in which a Democrat was expected to be president, suggesting investors believed the Republican would increase the national debt -- a move that, all else being equal, should push up interest rates. Indeed, the debt rose sharply in the following years under President Bush.

This reaction has been typical in recent decades: A study of similar events over previous election cycles -- by economists Justin Wolfers, Erik Snowberg and Eric Zitzewitz -- found that since 1980, bond yields have tended to rise on news that a Republican will be elected. The pattern held last week, when interest rates on government bonds increased slightly after Romney’s strong performance in the first
presidential debate.

This record suggests that markets believe the modern Republican Party has abandoned its historical commitment to fiscal responsibility. They have been right: Presidents Gerald Ford, Ronald Reagan, George H.W. Bush and George W. Bush all presided over a rising national debt, in many cases despite reasonably strong economic growth. By contrast, before the last recession, debt has fallen as a share of gross domestic product under every Democratic president since at least Harry Truman.

It wasn’t always this way. For much of U.S. history, investors in U.S. government bonds were largely unresponsive to political news. Only when the national debt rose for the first time in a generation under President Ford did they start paying attention.

What about the stock market? The same study found that stocks typically rise a percentage point or two on news that a Republican will be elected. The effect, while small, has been quite consistent over the past 120 years. The implication is that equity investors believe that Republicans will provide a slightly better climate for businesses, at least for those listed on the stock market.

The difference is small, and the equity market’s optimism about Republicans doesn’t necessarily mean investors believe they will be better for the economy or jobs. Higher share prices might reflect the expectation that Republicans will favor capital over labor, big business over small, current companies over future entrants, or shareholders over bondholders.

**No Reward**

More important, investors’ preference for Republicans generally hasn’t been rewarded after presidents take office. Looking at data since 1927, a separate study by economists Pedro Santa-Clara and Rossen Valkanov found that the stock market rises more strongly under Democratic presidents. True to this pattern, the Standard & Poor’s 500 Index has gained more than 80 percent during the tenure of President Barack Obama.

None of this tells us that Romney will blow out the budget deficit, or that stockholders are cheering for him to win. It does, however, suggest that his clearly articulated plan to cut tax rates, coupled with vague promises to make up the lost revenue by eliminating unnamed deductions, should be viewed with some skepticism.

For Republicans as a whole, the record is clear: Anyone who persists in believing that they have been the more fiscally responsible party is swayed by rhetoric, not reality.

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