

Themes on the Economy®

Handicapping Post-Election Year Policy Shifts

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Facing the Inevitable

As McCain and Obama slug it out to differentiate themselves from each other and the current administration, the reality of a growing federal budget deficit, weak economic conditions (and prospects that the economy could deteriorate further), and a widening income gap make certain policy shifts inevitable.

This report takes a look at the two candidates and how they differ from each other, the economic and political realities that the next president is likely to face, and what those realities suggest about the outlook for public policy over the next four years. Some things, like increased regulation, higher overall tax rates, and constraints on government spending are inevitable, regardless of who gets elected and what they have promised.

Obama vs. McCain*

Obama and McCain differ in race, age, their views on the role that government should play in the economy, diplomacy, and the intersection between faith and government:

- If elected, Obama would be one of the youngest presidents in history, joining ranks with Bill Clinton and John Kennedy; McCain would be one of the oldest presidents in history, joining rank with Ronald Reagan.
- Obama is a first-term senator, and has relatively little experience with foreign affairs; McCain is a four-term veteran of

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the Senate, and well-known for his tours abroad, particularly in the war-torn Middle East.

- Obama, whose father is from Kenya, would be the first African American elected to the White House; McCain, who comes from a long line of U.S. Naval academy graduates, has ancestors who served in the Confederacy and on the staff of General George Washington.
- Obama was a child during the Vietnam War and has never served in the military; McCain is a military veteran, with 22 years in the Navy, including 5-1/2 years as a prisoner of war in Vietnam.
- Obama opposed the U.S.-led invasion of Iraq; McCain supported the invasion and the Bush strategy for a surge in troops today. (Both candidates, however, support an increase in troops in Afghanistan, where the real war on terror is being fought.)
- Obama is open to negotiations with rogue world leaders, such as the president of Iran; McCain holds a hard

Worse Before It Gets Better

Real GDP grew at a 1.9% rate in the second quarter, double the pace of the first quarter, but still disappointing given the dismal growth seen earlier in the year. Tax rebates provided a marginal offset to rising prices at the pump and kept consumer spending afloat; the trade deficit narrowed; and government spending accelerated slightly. Construction also continued to post gains, which helped to offset the ongoing decline in residential construction activity.

Prospects for the second half of the year are not as good. Consumer spending is expected to weaken as the tax rebates play out. The only hope is lower energy prices, which could mitigate the size of the decline in consumer spending in the fourth quarter. The contribution from trade is also expected to dissipate as growth abroad weakens. However, equipment spending is expected to pick up, as businesses rush to take advantage of tax incentives for equipment purchases before year-end, and inventories are so low, they have nowhere to go but up. Separately, the drag from housing is expected to dissipate but not reverse until well into 2009. On net, real GDP is expected to rise at a dismal 1.0% in the third quarter and contract by -0.5% in the fourth quarter.

A Pause in Monetary Policy. The Fed is expected to remain on the sidelines as it continues to juggle the somewhat competing priorities of stabilizing financial markets and stimulating the economy, with higher rates of inflation. The fed funds rate is forecast to remain at its current 2% level through the end of the year. The Fed is expected to start raising rates in March 2009. The fed funds rate is expected to end the 2009 at 3.5%, still low relative to history.

line against negotiation with Iran, insisting instead that the U.S. use economic sanctions to get Iran to capitulate on nuclear arms. Both candidates, however, oppose a military strike against Iran as the Bush administration has threatened in recent months.

- Obama wants universal healthcare and is willing to raise taxes on the wealthiest Americans to help pay for a costly new program; McCain, who voted against prescription drug benefits for the elderly under Medicare, is more cautious on raising taxes to fund an expansion of government. The policies of both candidates, however, will result in significantly larger federal budget deficits.
- Obama sees higher energy prices as an incentive to go green and free ourselves from our dependency on fossil fuels; McCain offered to try to lower gas prices by temporarily suspending the 18% federal tax on gasoline over the summer. Both candidates, however, now support increases in off-shore drilling.
- Obama has reassured blue collar workers by making unionization easier (something that Wal-Mart vehemently opposes); McCain was hurt in Michigan, but helped in other states during the primaries, by talking tough to the UAW—he acknowledged what others refused to admit, that the jobs being lost in the state were not coming back.
- Obama excels as an orator, attracting large crowds when he speaks; McCain does better in small venues, speaking off the cuff and without a script.
- Obama tends to support more populist (protectionist) policies on trade; McCain endorses free trade. In an odd twist of fate, however, Obama has raised more funds from wealthy donors and Wall Street than McCain.

On net, Obama is seen as more of a traditional Democrat, but has moved further to the middle in recent weeks on issues of foreign policy, energy conservation, and taxes. This has raised criticisms of flip-flopping by the McCain camp and infuriated those at the left within the Democratic party. McCain, on the other hand, appears to have moved more to the right, despite his reputation as a moderate in the Senate. This shows itself in: promises

to appoint conservative Federal and Supreme Court judges; opposition to gay marriage (which he probably shouldn't have discussed on "The Ellen DeGeneres Show"); and the extension of the 2003 tax cuts, which he initially voted against because of concerns about the size of future federal budget deficits.

The number of people willing to publicly declare their party allegiance has surged, mostly in favor of Democrats. The mix within the parties, however, is still extremely heterogeneous, and no one is quite sure how people will vote in the secrecy of the voting booth. (How far have we really come on the issue of race?) There is also the battle over Independents who are turned off by talk of tax hikes and big government by Obama, and the support of the Iraq War and empowerment of the religious right by McCain.

The election is too close to call, with McCain significantly narrowing the margin between himself and Obama in recent weeks. This is probably because of renewed tensions with Iran and McCain's perceived edge in foreign relations over Obama. One can only hope it is not attributable to negative ads against Obama by the McCain. The McCain campaign spent an estimated 60% of its total advertising budget on a commercial that compared Obama, a Harvard Law grad, with Britney Spears and Paris Hilton. (Too bad nobody checked to see whether the Hiltons had contributed to McCain's campaign – which they did – before they slammed Paris. Oops!)

A Reality Check

The realities facing the next president are not pretty:

- The economy is expected to get worse before it gets better, which will up the pressure for additional stimulus. A growing federal budget deficit, however, will limit the extent to which Congress and the next administration can stimulate the economy via lower taxes or increased spending.
- The Fed is likely to tighten in 2009, which will further limit the stimulus that the federal government can provide to the economy, at least at the start of the next president's administration.
- Commodity prices, particularly energy, are expected to remain "unacceptably" high, even as they fall from recent peaks. This will up the pressure for a more comprehensive energy policy, including increased drilling in the U.S. and research on alternative energies. It could also open the door to ending some agricultural subsidies, which remain ridiculously large.
- The income gap is expected to further widen, with falling home prices inflaming the sense of being left behind among middle- and lower-income households. This is likely to worsen the backlash against globalization and make free trade pacts even harder to negotiate.
- Restraints on immigration are expected to exacerbate labor shortages in key low- and high-skill industries, such as agriculture and information technology.
- Baby boomers are expected to reach retirement age, without the necessary funds to retire.
- The Millennials—those born since 1980—are coming of age and beginning to vote. They don't ever expect to get a social security check, and don't trust big business or big government. They do, however, believe in the American Dream, with a large number of them betting that they will become wealthy entrepreneurs.
- The 2003 tax cuts are set to expire, which is likely to trigger a class war, and force policymakers to seriously reconsider the feasibility of earlier cuts for the wealthy.
- The Alternative Minimum Tax will need to be repaired instead of just patched.
- The push to increase regulations of both goods (toys from China) and financial institutions will intensify.
- A shortfall in defense spending, particularly on protective gear and healthcare benefits for the troops, is expected to buoy defense spending (and limit spending increases in other sectors) regardless of our actions in Iraq. This is to say nothing of the need to increase our presence in Afghanistan.
- And, Democrats are likely to gain an even larger majority in Congress regardless of who is elected president.

This could affect White House appointments, which were stalled by the Democrats in Congress during the Bush administration.

Facing the Inevitable

As a result, some things will be inevitable next year, regardless of who becomes the next president:

- Taxes on the wealthy will rise as policymakers struggle with the need to raise revenues in the face of a worsening income gap. Persistently weak economic conditions, however, are likely to limit the magnitude of any initial tax hikes—those fearing a 50% top tax rate can rest assured that won't happen, at least in the near-term.
- Many of the loopholes on taxes for corporations are expected to be closed, including those that allow hedge fund and private equity profits to be taxed at the nominal 15% capital gains rate, but overall corporate tax rates are expected to be lowered. This will bring the U.S. more in line with corporate tax rates in other countries (it is embarrassing when France has lower corporate tax rates than we do), and should provide some offset to the drag created by an increase in tax rates on the wealthy. (The wealthiest Americans tend to earn the bulk of their income either directly or indirectly from the performance of corporate profits.)
- Current retirees will get social security, but the qualifying age for future retirees will be delayed, and benefits will be means-tested so that the bulk of funds can be channeled to middle- and lower-income households. Incentives to save will also be enhanced. So far, however, most people have been too cautious in the allocation of their investments in their 401k plans to ensure sufficient funds for retirement.
- Spending is expected to be prioritized, with social and conservation programs taking a back seat to defense spending, given bi-partisan support for such increase, and the growing burden created by Medicare and Medicaid.
- Universal healthcare is expected to be abandoned and replaced by efforts to better pool the risks of consumers, so

that they can buy cheaper coverage than is currently available. There will also be a push to subsidize disaster insurance for the working poor and expand the use of less expensive or free clinics. The goal will be to slow the rate of increase in the cost of healthcare, which is projected to put even more upward pressure on Medicare and Medicaid spending than demographics.

- Free-trade agreements are expected to be negotiated more on a piecemeal basis with individual countries and the U.S. instead of large block agreements with regions. This will diminish the role that the U.S. plays in leading market reforms the world over, but will not stop the progress of globalization. It also suggests that the politics between individual countries will play a larger role in trade agreements going forward.
- Regulation is expected to intensify, largely in response to the sub-prime debacle and resulting credit crisis. There is also a move to better regulate the quality of imports, which isn't surprising given recent problems with imports from China. And, the temptation by Congress will be to regulate for conservation and greener technologies, given the limits on spending.
- Agricultural subsidies are likely to be rolled back in response to record commodity prices and the need to shift spending elsewhere in the budget.
- Immigration is expected to open up slightly for the lowest skilled workers, given the need for laborers to pick crops and work in some of the least attractive jobs. The U.S. is expected to remain hostile, however, to increases in immigration. The limits on the most skilled and educated of immigrants is a particular loss, given the contributions to both profits and tax revenues those individuals could make to the U.S.
- Energy policy is expected to be revisited. The emphasis appears to be shifting away from conservation and alternative fuels, however, toward increased domestic oil production. Indeed, much of the burden of conservation and the shift to green technologies is expected to be shouldered by state and local governments, which are already well

ahead of the federal government in securing more efficient and inexpensive energy.

On net, regulatory burdens, taxes, and spending are all expected to rise in the near-term. The federal budget deficit will continue to grow, as spending problems are not likely to be addressed until after the 2012 elections. Protectionism will be held at bay by downplaying free trade with individual trade negotiations instead of more broad-based treaties. Free trade and immigration have become convenient scapegoats for globalization, which has probably played as large a role as poor education in displacing workers in recent years.

The Bottom Line

Vote your preference in November. Do not expect either candidate to actually be able to deliver on his pre-election promises given the political reality of an economy that is likely to get worse before it gets better. It is also unlikely that the next president will make it past his first term given the challenges that he will face. (Of course, two terms do not exactly guarantee that a president will do what is needed, given our experience over the last seven years.)

Indeed, it would be wise for the next president to focus more on policy than on his prospects for re-election in 2012, but that may be optimistic given the length of presidential campaigns. I am already fatigued by the current campaign, and the candidates haven't even named running mates yet. I have to give my respect to those running, however, as they have shown extraordinary stamina. Let's hope that they show as much strength as leaders as they have as candidates.

*Many of the insights on the similarities and differences between Obama and McCain were taken from an article in the *Chicago Tribune*, by Mark Silva on June 8, 2008, titled "Obama vs. McCain: A Study in Contrasts."

Mesirow Financial Economic Forecast (Numbers as of August 8, 2008)

	2007(A)	2008	2009	2008:1(A)	2008:2(A)	2008:3	2008:4	2009:1	2009:2	2009:3
National Outlook										
Chain-Weighted GDP	2.0	1.5	1.4	0.9	1.9	1.0	-0.5	1.6	2.1	2.4
Personal Consumption	2.8	0.8	0.3	0.9	1.5	-1.4	-1.4	0.5	1.0	1.8
Business Fixed Investment	4.9	3.9	1.3	2.4	2.3	3.1	3.0	-1.1	0.9	1.0
Residential Investment	-17.9	-20.7	-7.4	-25.1	-15.6	-15.0	-17.1	-9.4	0.1	7.3
Inventory Investment (billions)	-2.5	-28.3	0.6	-10.2	-62.2	-19.4	-21.4	-5.5	-1.2	2.6
Net Exports (billions)	-546.5	-404.1	-331.5	-462.0	-395.2	-386.1	-373.0	-354.8	-334.3	-325.3
Exports	7.5	8.6	5.7	4.5	11.9	7.1	6.0	5.3	4.3	3.5
Imports	1.7	-1.7	1.0	-2.0	-6.3	2.5	2.0	0.9	0.1	2.4
Government Expenditures	2.1	2.3	2.0	1.9	3.4	1.6	2.0	2.1	1.9	1.8
Federal	1.6	4.3	2.8	5.8	6.7	1.6	3.0	2.9	2.6	2.4
State and Local	2.3	1.2	1.5	-0.3	1.6	1.6	1.4	1.7	1.5	1.4
Final Sales	2.4	1.7	1.1	0.9	3.9	-0.7	-0.5	1.0	1.9	2.2
Inflation										
GDP Deflator	2.7	2.2	2.2	2.6	1.1	2.4	3.0	2.7	1.8	1.6
CPI	2.9	4.5	2.8	4.3	5.0	6.1	2.6	2.3	1.9	1.7
Special Indicators										
Corporate Profits*	-2.0	1.1	7.1	-1.5	-5.7	-2.7	1.1	4.3	6.7	5.1
Disposable Personal Income	2.8	1.1	0.5	-0.1	11.3	-8.3	-3.3	3.0	2.3	1.8
Housing Starts (millions)	1.34	0.94	0.86	1.05	1.02	0.87	0.83	0.83	0.84	0.88
Civilian Unemployment Rate	4.6	5.5	6.4	4.9	5.3	5.8	6.0	6.2	6.4	6.5
Employment	0.8	-0.6	-0.5	-1.5	-0.5	-0.5	-0.8	-0.5	-0.5	-0.1
Vehicle Sales										
Automobile Sales (millions)	8.0	7.3	8.0	7.5	7.7	7.0	7.2	7.3	7.6	7.9
Domestic	5.5	4.7	5.1	5.0	5.0	4.4	4.5	4.7	4.9	5.2
Imports	2.5	2.6	2.7	2.4	2.7	2.6	2.7	2.6	2.7	2.7
Lt. Trucks (millions)	8.6	6.5	6.2	7.9	6.6	5.5	6.2	6.3	6.2	6.2
Domestic	7.1	5.4	5.0	6.5	5.3	4.4	5.2	5.1	5.0	5.0
Imports	1.5	1.2	1.2	1.4	1.2	1.0	1.0	1.2	1.2	1.2
Combined Auto/Lt. Truck	16.6	13.9	13.9	15.4	14.3	12.4	13.4	13.6	13.8	14.1
Heavy Truck Sales	0.4	0.3	0.4	0.3	0.3	0.3	0.2	0.3	0.4	0.4
Total Vehicles (millions)	16.9	14.2	14.5	15.6	14.6	12.7	13.6	13.9	14.2	14.5
Interest Rates/Yields										
Federal Funds	5	2 ¹ / ₄	2 ³ / ₄	3 ¹ / ₈	2 ¹ / ₈	2	2	2	2 ⁵ / ₈	3 ¹ / ₈
10-Year Treasury Note	4 ⁵ / ₈	4	4 ⁵ / ₈	3 ⁵ / ₈	3 ⁷ / ₈	4 ¹ / ₈	4 ¹ / ₄	4 ³ / ₈	4 ⁵ / ₈	4 ³ / ₄
Prime Rate	8	5 ¹ / ₄	5 ³ / ₄	6 ¹ / ₄	5 ¹ / ₈	5	5	5	5 ⁵ / ₈	6 ¹ / ₈
Corporate Bond AAA	5 ⁵ / ₈	5 ³ / ₄	6 ¹ / ₄	5 ¹ / ₂	5 ⁵ / ₈	5 ⁷ / ₈	5 ⁷ / ₈	6 ¹ / ₈	6 ¹ / ₄	6 ¹ / ₄
Exchange Rates										
Yen/Dollar	118	110	112	105	105	109	110	110	111	110
Dollar/Euro	1.37	1.47	1.40	1.50	1.56	1.54	1.51	1.49	1.45	1.43

A= Actual

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, \$ figures reflect adjustment for inflation.

*Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change. Totals may not add up due to rounding. In 2005, GDP was \$11,049 billion in chain-weighted dollars.

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