

## Election Euphoria Collides with Economic Reality

**President Bush has won a clear-cut election victory. Now comes the hard part—managing an economy that has become increasingly out of balance. Household saving is unsustainably low, the current account deficit unsustainably high, and budget deficits are now chronic. The road is likely to be bumpy because it will be difficult to engineer smooth, offsetting adjustments**

Republicans are euphoric about the election rout—**R**outturn—not only an outright majority in the presidential contest, but also gains in the House and Senate. Soon that euphoria will collide with an economy that has become increasingly out of balance.

President Bush's economic priorities will be to make permanent the tax cuts enacted during the first term and to pursue reforms of Social Security and the tax system. Although the Bush administration is likely to succeed in making the tax cuts permanent, partial privatization of Social Security and moving toward a consumption-based tax code will prove much more difficult. The deterioration in federal finances is an obstacle, leaving little, if any, room for maneuver.

### How the Election Was Won

Despite late polls showing Senator Kerry gaining ground, President Bush was reelected by 3.5 million votes. The electoral vote was closer, but key victories in the battleground states of Ohio and Florida put President Bush over the top.

The key for the Bush campaign was its superior voter identification and turnout program. For the first time in recent memory, more Republicans voted than Democrats. In addition, an exit poll revealed that 22% of voters identified moral values as the most critical issue in the election—more important than any foreign policy issue or any domestic issue debated over the course of the campaign. President Bush won 80% of those voters most concerned about

cultural issues, and we would expect this to influence the political dynamic on Capitol Hill and at the White House.

President Bush's victory was not the only good news for Republicans, who increased their majorities in Congress. The GOP expanded the number of Senate seats under its control from 51 to 55, for a 55-44-1 margin, and expanded their House majority to 231-200-1, with three races still undecided. The key victory for the Republicans was former Congressman John Thune's win over Senate Democratic Leader Tom Daschle in South Dakota. Nevada Senator and Assistant Democratic Leader Harry Reid is expected to assume the top Senate Democratic leadership post.

No matter who replaces Daschle, Democrats, having lost the White House and both houses of Congress by wider margins, will be divided over how to deal with President Bush's agenda. Party moderates advocate a more conciliatory tone while liberals will argue for a more combative approach. Regardless of the approach, the new Senate could bolster President Bush's chances of passing a number of his initiatives in the areas of healthcare, energy, and reform of government-sponsored enterprises (GSEs).

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## A Bumpy Ride

President Bush is likely to face a challenging economic environment during his second term. Most importantly, the US economy has become increasingly out of balance. The private household balance and the current account balance have both continued to deteriorate.

Moreover, these imbalances are not sustainable. With inflation and interest rates no longer falling, returns on financial assets and housing will be much lower. This means that the current low saving rate will be inadequate to keep the household net worth-to-income ratio from declining over time. As this becomes evident to households, the saving rate will rise and consumption will fall as a share of GDP.

The current account deficit is unsustainable because it implies an explosive rise in US net foreign indebtedness. If the current account deficit were to stabilize at 5% of GDP, net foreign indebtedness would climb to around 100% of GDP.

Unwinding these imbalances smoothly will be difficult for four reasons. First, the factors that drive household spending and saving behavior are different from the factors that affect the current account deficit. Thus, it would take good luck to unwind these two imbalances smoothly at the same pace.

Second, there are barriers to unwinding the trade imbalance. In particular, China has been unwilling

to revalue its currency against the US dollar. With other Asian currencies pegged to China's, this has made it difficult to facilitate a large downward adjustment in the value of the dollar. Public pressure by the US government on China is probably counterproductive because Chinese policymakers do not want to be seen as caving under US pressure.

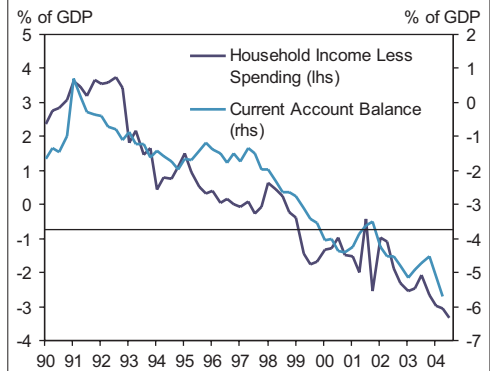
Third, the attention of the Bush economic team appears to lie elsewhere. The economic priorities of the second term are to make the tax cuts permanent, partially privatize the Social Security system, and pursue tax reform. After arguing during the election campaign that the economy is doing well, the need to work to unwind the imbalances does not appear to be a top priority within the Bush administration.

Fourth, the Bush administration's job will be complicated by the need to appoint a new person to head the Federal Reserve Board. Chairman Greenspan's term as governor expires in January 2006. By law, he cannot be reappointed to another term. In the past, new Fed chairmen have often been accompanied by volatile financial markets. Financial markets have tended to be volatile during the first year of Arthur Burns, Paul Volcker, and Alan Greenspan's tenures.

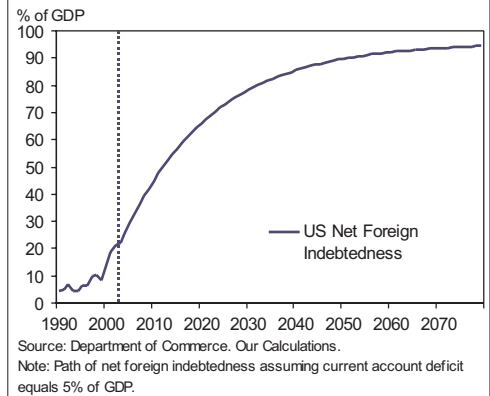
## Tax and Entitlement Policy

With Republicans increasing their margin in the Senate, the Bush administration should be successful in making the first-term tax cuts permanent.

**Household and Current Account Deficits Continue to Deteriorate**



**Net Foreign Indebtedness Unsustainable**



The major implication of this will be to worsen the long-term budget outlook. If one also assumes that defense spending will stay at around 4% of GDP, discretionary domestic spending will rise at about 2% in real terms, and the Alternative Minimum

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Tax will be altered to keep the proportion of taxpayers subject to the AMT constant, then we estimate that the cumulative budget deficit will total \$5.5 trillion over the next ten years compared to \$2.3 trillion for the most recent Congressional Budget Office projection. After that, the outlook worsens as entitlement spending soars.

In terms of Social Security reform and tax reform, the Bush administration still faces an uphill battle. For Social Security reform there are two obstacles. First, Democrats will fiercely resist partial privatization because they view this as ‘the camel’s nose under the tent’ on the way to full privatization.

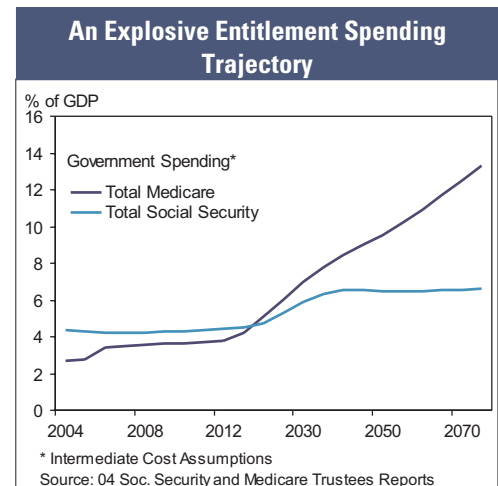
If Social Security were partially privatized, support for the system from higher-income households would probably erode. That is because the current Social Security

system contains a strong income redistribution element in the calculation of benefits, with high-income households subsidizing the benefits of lower-income households.

In contrast, if a portion of payroll taxes were instead diverted into separate individual retirement accounts, the cross-subsidization of these monies would end, lifting expected returns for higher-income households. Relative to the current system, privatized accounts are a better ‘deal’ for high-income households. Because a taste of this could undermine support for Social Security, any proposal to partially privatize Social Security is likely to encounter fierce Democratic resistance. Since it would take 60 votes to cut off a filibuster in the Senate, the Republicans’ 55-vote majority is not sufficient to ensure passage.

Second, partial privatization of Social Security would drive up the deficit over the next few decades as the diversion of payroll taxes into private accounts reduced Federal government revenue.

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Depending upon the precise parameters of the plan, partial privatization could increase the ten-year cumulative budget deficit by \$1 trillion to \$2 trillion.

Tax reform is also a priority. The notion is to shift the tax code toward a consumption-based tax (e.g., VAT or national sales tax) rather than continue to rely on income taxes for the biggest proportion of government revenue. The major obstacle to reform here is the budget situation. If large budget deficits necessitate that tax reform be revenue-neutral, then reform will necessarily create losers as well as winners. In particular, a consumption-based tax system will not be viewed with favor by seniors.

An alternative that might meet with greater success would be a backdoor approach—continuing to expand the scope and scale of tax-deferred saving accounts. The greater the proportion of household saving that resides in tax-deferred accounts, the closer the US would be to a consumption-based tax system, though at some budgetary cost.

### The Legislative Agenda Will Shift

In contrast, a bigger Senate majority should make some other legislative priorities more attainable:

**Health Care:** President Bush proposes to make premiums paid for health savings accounts (HSAs) tax deductible, in order to expand their use. While we do not expect any large spending proposals—budget deficits limit Bush’s options, and Congress

has already spent more than most conservatives would have liked on the Medicare drug benefit—we do expect Bush to press for this change. HSAs would not substantially reduce the number of uninsured, but they could have a beneficial impact on healthcare inflation if widely adopted. Pharmaceutical firms and other healthcare providers are likely to be spared any major legislative changes over the next two years.

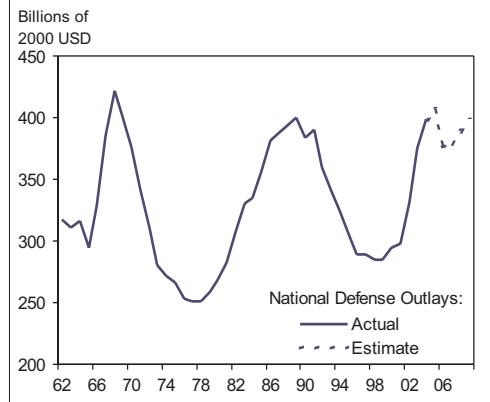
**Energy:** Passage of a comprehensive energy bill and separate legislation permitting oil exploration in the Arctic National Wildlife Refuge (ANWR) in Alaska is now within reach. Both, however, are focused on long-term supply issues and, therefore, would have little short-term impact on energy prices.

**Defense:** Budget pressures from continued operations in Iraq and Afghanistan will likely persist, pushing up total defense spending for at least the next few years. However, spending on procurement and R&D may come under pressure over the medium term, as Capitol Hill becomes more sensitive to budget deficits.

**GSEs:** Tighter regulation of Fannie Mae and Freddie Mac has been on the Republican Congressional agenda for several years. With Republicans more comfortably in control of Congress and the White House, the likelihood of increased regulation or changes in capital requirements is clearly higher.

**Legal Reforms:** While as much a political as an economic issue, legal reforms (class action litigation

**Defense Spending to Remain Near Post War Highs**



reform, asbestos, and medical malpractice) would have an effect on several industries and the companies that insure them. All three issues will be pushed forward next year; class action reform stands the highest chance of passage. ■

For more detail, please see our *October/November US Pocket Chartroom: The Tough Road Ahead*, 8 November 2004.