The Stakes in the Romney-Obama Contest

By Knowledge@Wharton *Wed, Sep 26, 2012*

Expect big changes next January? Think again. While the candidates' economic philosophies and positions are dramatically different, divided government will prevent either from bringing his version of Morning to America, predicts a Wharton School professor.

To hear the two candidates tell it, the U.S. presidential election offers a dramatic choice on the economy: Vote for me, each says, if you want a robust recovery; pick my opponent, and we'll plunge back into recession.

But regardless of who wins, important economic factors will remain facts of life. Millions of American homeowners are "underwater," owing more than their homes are worth and weakening the consumer demand that is key to the economy. Employers, even if they are flush with money, won't hire more workers until they need them—when demand rises or appears ready to.

The debt crisis in Europe resists a quick solution, and deficits and overhanging debt in the U.S. are too big to be whittled down very fast. These deficits will compete for federal revenue that could stimulate the economy through more spending or cuts in taxes.

Given the size of these problems, what is the most likely economic landscape to emerge after the election if President Barack Obama, a Democrat, wins, or if Republican challenger Mitt Romney wins?

Three Wharton faculty members say that, either way, the future is likely to look much like the present, for several years at least. "The notion in the political debate is that if you just do something a little bit differently, things will get much better. But it doesn't work like that," says Wharton finance professor Franklin Allen.

"It seems to me that one of the most depressing things about this campaign has been that it's more or less tit-for-tat, gotcha issues that have emerged, rather than any serious talk about what [the candidates] are going to do [regarding] the looming problems with the economy," says Wharton finance professor Richard J. Herring.

Whoever he is, the next president will face an immediate economic crisis, including the "fiscal cliff," tax increases and deep spending cuts that will kick in automatically unless Congress and the White House can agree on an alternative. The cliff is a result of a standoff in 2011 over raising the debt ceiling. "I think once the election's over, that's going to be the big issue," says Allen.

What if the Democrats, who support tax increases on the wealthy, and the Republicans, who do not, cannot agree, and the automatic provisions kick in? "I think it's quite likely that would lead to recession," Allen states, predicting that tax hikes and cuts in government spending would reduce gross domestic product by about 3%.

While both candidates say their policies would speed job creation, the problems run too deep to be resolved quickly, Allen adds. “It’s become a much more serious problem than we have ever had in this country before,” he says, arguing that many of today’s unemployed will remain so unless they are retrained, a lengthy and expensive process that he says is currently inadequate.

Indeed, according to Allen, the current economic problems are unique in American history. The clearest analogy is Japan, which has been struggling for many years. What’s the solution? “I don’t think anybody really knows,” Allen says.

A divided government

Obama proposes a continuation of the policies of his first term, which included efforts to stimulate the economy through federal spending and modest tax reductions focused mainly on people with low and middle-class incomes. He would allow the Bush-era tax cuts to lapse for people earning more than $250,000 a year, but would keep them for people earning less. He would stay the course with his health care overhaul—the Patient Protection and Affordable Care Act, or Obamacare—and would keep most of the regulations imposed on the financial services industry after the financial crisis.

Romney’s most dramatic economic proposal is to reduce tax rates even below the Bush levels in effect today, while making up for the lost revenue by eliminating some unspecified deductions and tax loopholes. Romney wants to repeal parts of Obamacare and many of the financial regulations. He would loosen environmental regulations and, compared to Obama, place heavier emphasis on exploiting coal and oil.

While the candidates’ economic philosophies and positions are dramatically different, neither is likely to engineer a sweeping policy change, says Herring. The reason: divided government.

Polls predict a close election, with neither contender’s coattails long enough to ensure massive wins by his party’s congressional candidates. The odds thus seem to favor a continued division in government, with neither party getting a veto-proof majority in Congress or a filibuster-proof super-majority in the Senate.

“We have to recognize the fact that whoever wins isn’t going to get a huge, sweeping mandate to do whatever they want,” Herring says. Severe problems undermining the economy are therefore likely to remain unsolved, including the decay of roads, bridges and other infrastructure, debt problems, the eventual insolvency of Medicare and American students’ lagging educational achievements compared to other developed countries.

“The question is, what are they going to do on the margins?” Herring asks.

Federal tax policy is, as most agree, far too complex and confusing, Herring says. But neither candidate is likely to have the mandate it would take to change this, given the vested interests that would resist. While Romney, who has emphasized tax overhaul more than Obama, says he would strip out many deductions and loopholes, he has not said which ones, but has indicated he would not go after popular ones like the income tax deduction on mortgage interest.

‘The worst possible consequence’

The presidential campaign has also focused on two health care issues with significant impact on the economy: Obamacare, the 2010 law that overhauled medical insurance, and Medicare, the financially troubled health care entitlement program for the elderly.

Obama considers the Patient Protection and Affordable Care Act his greatest achievement and has promised to preserve it, while Romney wants to repeal much of it and replace it with a plan that he has not fully detailed. With a continuation of divided government, Obamacare will likely survive, Herring predicts. “Romney has not clearly articulated a workable alternative, though heaven knows we don’t really understand the thing we’ve got.”

From an economic perspective, a key problem with Obamacare as written, says Herring, is the requirement that businesses with 50 or more workers provide health insurance. That has dampened the creation and growth of small businesses, which are the primary source of new jobs, he argues. Unemployment stands at just over 8%.

In the long run, problems with Medicare will have more economic impact than issues surrounding Obamacare, says Mark V. Pauly, professor of health care management at Wharton. By providing insurance to the previously uninsured, Obamacare will “give you a clean conscience,” he jokes, “but Medicare will clean out your bank account. So, from an economic point of view, Medicare is much more consequential.”

Both issues, Pauly says, create uncertainties that weaken business confidence, which in turn helps stifle economic growth. Many business people favor the Republican promise to repeal Obamacare, but worry about what would come next, while Obamacare’s business mandates are a known quantity for now. “If Republicans win and I’m a business providing health insurance, I have a hard time knowing what to expect,” Pauly notes.

In a similar way, Republicans have a more aggressive plan for reducing the Medicare funding shortfall by subsidizing participants who would shop for health insurance on the free market. But polls show that many Americans worry they would then end up shouldering more of their own health care costs in retirement, so it is unclear Republicans would push for all the changes they have proposed even if they swept the election.

On the other hand, says Pauly, Democrats have yet to propose a clear plan for preserving the current Medicare system for the long term, making the outlook unclear for future beneficiaries. “That kind of uncertainty, in the short run, is about the worst consequence of all the debate about health care,” he says.

Divided government would also make it difficult, if not impossible, to resolve problems with the 2010 Dodd-Frank financial reform law, which has business-dampening features like heavy reporting requirements to multiple agencies, Herring says. One of that law’s key goals was to prevent the need for future bailouts of financial services companies deemed “too big to fail,” but there are serious questions about whether the Dodd-Frank safeguards would work, he adds.

The stock market, after plunging in 2008 amid the financial crisis, has recouped nearly all of its losses. But

Herring notes that a key factor in this rebound was the Federal Reserve's efforts to keep interest rates low. Stocks may not do as well after these efforts end, as they must at some point. "We're clearly relying much too much on monetary policy," he says. "The Fed has basically been turning cartwheels" to bolster the markets and economy.

The alternative—better fiscal policy to reduce the danger from factors like the federal government's huge deficits and debt—seems unlikely given divided government, according to Herring. As things stand now—and are likely to stand after the election—major problems like the deficits, debt, growing health care costs and eventual insolvency of Medicare will be kicked down the road to be dealt with later, after they have become worse and the solutions more costly, he predicts. "If we actually wait until there's no choice, it's going to be very painful."