Economic Research:

The U.S. Midterm Election Matters--Just Maybe Not So Much To The Economy

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U.S. CHIEF ECONOMIST

Beth Ann Bovino

New York

(1) 212-438-1652

bethann.bovino@spglobal.com

U.S. SENIOR ECONOMIST

Satyam Panday

New York

+ 1 (212) 438 6009

satyam.panday@spglobal.com

Key Takeaways

- Regardless of the midterm election outcome, the U.S. economy will continue the momentum built in 2018, although growth may slow as the fiscal stimulus fades in 2019.
- The gridlock in Washington we have noted previously will likely continue, with little change to protectionist trade policies or the tax bill passed earlier this year.
- The midterms may determine the opportunity for infrastructure and immigration to be areas of limited compromise.
- In our view, an employment-based immigration approach would be a boon to the economy, though deporting low-skilled workers may result in losses down the road.
- This will come as the fiscal deficit likely widens to over $1 trillion by 2020, according to S&P Global Economics. Congress needs to pass further funding legislation by Dec. 7 in order to avoid a partial government shutdown this year--and later face the challenge of dealing with the debt ceiling in 2019.

With party officials on both sides of the political aisle looking to motivate voters down the stretch of what has been a highly contested midterm-election campaign, there's a lot at stake.

Unless you're looking at it from an economic viewpoint.

All 435 seats in the House of Representatives are being contested, with the Democrats needing to add 23 seats to gain a majority. In the Senate, Republicans hold a two-seat margin (with the two independents caucusing with Democrats), but only 35 of the chamber's 100 seats are up for grabs on Nov. 6--and only nine of those 35 are held by Republicans, and all in states that President Donald Trump won in 2016.

But, regardless of whether the Democrats can flip one or both chambers of Congress or Republicans hold onto their slim majority, economists at S&P Global expect the near-term economic effects to be muted. Momentum in the world's biggest economy remains solid, and we expect GDP growth above-trend this year and next, underpinned by the strong labor market, still-bullish consumer confidence, and favorable manufacturing sentiment (see "Fewer Tricks, Plenty Of Treats For The U.S. Economy," published Oct. 2 on RatingsDirect).

While we recognize their fallibility, current polls indicate a small chance that Democrats can mobilize enough ballot-goers to take both chambers, and a similarly slim opportunity for Republicans to hold the House. Thus, using a baseline expectation based on polls of the Democrats gaining a majority in the House and Republicans retaining their majority in the upper chamber, we believe the gridlock on Capitol Hill we've alluded to previously will continue. Gridlock does not mean the economic boat will capsize, though it will likely increase uncertainty around fiscal deadlines.

With that in mind, President Trump will likely continue to rely on executive actions to support his agenda ahead of the 2020 run for the White House. Trade policy--specifically the tariff dispute with China--will continue to be the focus, and further moves seem highly likely after the midterm elections. Similarly, the president's push for deregulation in a number of industries looks set to continue.

While a divided government may mean that legislation has a significant chance of hitting roadblocks, the president and Congress may feel pressure to produce some tangible legislative results ahead of re-election in 2020. One would be efforts to improve U.S. infrastructure. President Trump has already proposed a "Legislative Outline for Rebuilding Infrastructure in America," while House Democrat Minority Leader Nancy Pelosi has recently pushed for infrastructure funding, suggesting that there is some room for compromise. In addition, limited immigration reforms may represent another potential opportunity for compromise, given bipartisan support to resolve the standoff on the Deferred Action for Childhood Arrivals (DACA) immigration program over the proposed border wall.

The Possibilities--and Pitfalls--For Policy

To be sure, a unified government carries a greater possibility of policy progress--if not new, potentially landmark, legislation. Still, we believe either outcome--a divided Congress or the status quo--is unlikely to produce a clear change in the nation's fiscal policy ahead of the 2020 presidential election.

Any repeal of the Tax Cuts and Jobs Act of 2017 seems unlikely, in our view, regardless of the outcome of the election. While there may be some room for change in the tax code, a significant expansion seems unlikely, particularly in a divided government. It also seems doubtful that the government will authorize another discretionary spending increase as large as the one that Congress passed earlier this year, unless economic growth decelerates sharply.

Meanwhile, with the tax package having a smaller effect on growth than what was expected by the White House and policymakers, the focus for many lawmakers has shifted to the growing federal deficit, which is likely to reach $1 trillion (and roughly 5% of GDP) by 2020. This increases the chances of another partial shutdown of the federal government next year, as does Congress's need to pass further funding legislation by Dec. 7 in order to avoid a partial government shutdown this year. Only seven of the 12 appropriations bills for 2019 were approved in September, pushing additional funding debates after the midterms. Then, in 2019, Congress will need to address the need for another suspension or increase in the debt ceiling. While we expect common sense to prevail, the debate will likely get louder as the March deadline draws near.

Trade Trials And Tribulations

The direct economic effects of the U.S.'s tariff dispute with China have been limited, but that could change if the countries wind up in a full-blown trade war. President Trump has already said he's ready to slap tariffs on all American imports from China--not just the $250 billion now subject to levies of 25%. Our assessment of a scenario in which the U.S. steps up its protectionist measures by placing tariffs of 25% on all nonfuel imports from China (with China responding in kind) shows that the direct effects would shave roughly one-third of a percentage point off U.S. GDP growth per year on average in 2019-2021 (see "Global Trade At A Crossroads: It's Hard To See Any Winners In A U.S.-China Trade War," published Sept. 5). We've lowered our growth forecast for this year to a (still-solid) 2.9%, from 3.0% in our June forecast, and we expect the economy to expand 2.3% next year.

Because of China's large trade surplus with the U.S., Beijing can't respond dollar-for-dollar. But officials say they're poised to impose retaliatory tariffs on a wide range of U.S. goods, which include many targeted at states the President won in 2016. Either way, other restrictions (such as those on cross-border investment) may have a bigger effect than the tariffs themselves.

Meanwhile, the U.S.-Mexico-Canada Agreement (USMCA) to replace the North American Free Trade Agreement (NAFTA) will likely see a vote next year, and a divided government could make this a rocky process. Either way, the USMCA is significant mainly for what it avoids--sweeping trade restrictions and likely economic damage to the three countries involved. We believe its effects will be modest in most cases, raising the cost of some cars and SUVs sold in the U.S., but not materially changing the web of economic interdependence among the three North American countries (see "USMCA, NAFTA's Successor--It Could Have Been Worse," published Oct. 8).

Finally, policy areas such as health care could grab the spotlight in the next Congress. However, even a political battle akin to the attempt to overhaul the Affordable Care Act last year won't likely be enough for us to make material changes to our macroeconomic forecast. On the other hand, a significant infrastructure-spending package--which members of both parties support, though perhaps not enough to forge a breakthrough--could help lengthen what has been a historic expansionary period. (Though it's unclear how adding a significant number of jobs during an already tight labor market would play out.)

As it stands, headline unemployment is at 3.9%, and, perhaps more importantly, wage gains have finally picked up. Historically high job openings and a "quit rate" (an important measure of the strength of the jobs market) showing American workers increasingly comfortable with leaving their jobs point to a sustained pickup in wage growth--an important factor for an economy primarily driven by consumer spending.

Immigration Policy Has The Potential To Be A Boon Or A Hindrance To Growth

All of this comes as the president expands his rhetoric on immigration, most recently with his plan to end birthright citizenship for children born to undocumented immigrants. (A number of legal experts argue that such a move would be unconstitutional, given the provisions of the 14th Amendment.)

From an economic standpoint, S&P Global agrees that moving the needle toward an employment-based approach to immigration would likely increase the number of skilled working-age people in the U.S., and that an influx of young, skilled labor would spur economic growth, reduce the federal deficit, and help offset the deleterious effects of an aging American population.

In 2014, we estimated that such a change could add more than three percentage points to real GDP in the first decade and more thereafter (see "Adding Skilled Labor To America's Melting Pot Would Heat Up U.S. Economic Growth," published March 19, 2014). Inversely, sharply cutting immigration could put the U.S. on the path to even slower rates of economic growth. With the baby boomers retiring, we at S&P Global already see U.S. potential growth rate, out 10 years, at just 1.8%. This would make it worse.

In addition, undocumented workers hold roughly 5% of U.S. jobs and account for about 3% of private-sector GDP, so, according to an study by according to a November 2016 study by economists Ryan Edwards and Francesc Ortega of Queens College, the deportation of these people would lead to significant cumulative economic loss of roughly $5 trillion in the same period (not including the costs of deportation). Given unauthorized immigrants account for a far higher share of the total workforce in agriculture, construction, and leisure and hospitality, these industries will be hit the hardest.

An election outcome that leads to a change in one or both chambers would likely throw a large hurdle in the way of the president's push for legislation that sharply curbs immigration. However, there is also potential for limited compromise on immigration as the 2020 elections appear on the horizon.

According to the 2013 cost estimate by the Congressional Budget Office (CBO) and the staff of the Joint Committee on Taxation, the Senate's immigration reform proposal (S.744) would generate changes in direct spending and revenues that would reduce federal budget deficits by $56 billion over 2014-2018 and $197 billion over 2014-2023, but this considers all the provisions of the bill, not just legalization. The CBO estimated that the bill would reduce total deficits by about $840 billion over the next 20 years because the increased taxes paid by immigrants--both new immigrants and current undocumented workers who convert from undocumented to legal status--would be larger than the bill's increased costs, in part because the Senate bill includes substantial benefit reductions for immigrants converting from undocumented to legal status. Increases in immigration would improve Social Security's finances, according to a Social Security Administration Trustees' report.

Regardless of the midterm election outcome, we see the U.S. economic engine continuing to hum along. While there may be challenges presented that slow it, we believe the world's largest economy will continue its path of growth and expansion in 2018 and 2019.

Writer: Joe Maguire

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