Political Parties and Macroeconomic Policies and Outcomes in the United States

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Containing inflation at politically acceptable rates of unemployment has been the most important macroeconomic policy problem confronting American political authorities for several decades. In a democratic political system, macroeconomic policies are rarely, if ever, motivated by apolitical Golden Rule norms; rather they are conditioned, at times, decisively, by political forces. In this paper I analyze one important source of political influence on postwar macroeconomic policies and outcomes in the United States: the differing economic goals of the political parties.

I. Party Constituencies, Voter Priorities, and Party Goals

In American national politics, the core constituency of the Democratic party consists of the down-scale classes, who primarily hold human capital and bear a disproportionate share of the economic and broader social costs of extra unemployment. Up-scale groups form the core constituency of the Republican party; they hold financial capital and absorb the greatest losses from extra inflation. For this reason Democratic voters generally express greater aversion to unemployment and less aversion to inflation than Republican voters (see my forthcoming book, chs. 3–6, and the studies cited).

Differences in the economic interests and revealed preferences of the parties' core constituencies are reflected in the pattern of policies and outcomes observed under Democratic and Republican presidential administrations. Democratic administrations have been more likely than Republican ones to pursue expansionary policies yielding lower unemployment and extra growth, but running the risk of higher inflation. Republican administrations typically weight the problem of inflation more heavily. Consequently, they have more readily and more vigorously pursued disinflationary policies, and in general they have been more cautious about stimulating aggregate demand and employment.

In what follows I use stylized theoretical models to obtain econometric estimates of the party cleavages just described. The analysis here is brief and confined to unemployment outcomes and monetary policy under the parties. Elsewhere I use the same framework to analyze real output and fiscal policy and develop the story in greater detail (see my book, chs. 8–10; for an earlier analysis, see my 1977 article).

II. Unemployment under the Parties

The impact of the Democratic and Republican parties' different economic goals on the time path of unemployment may be evaluated by the following stylized model. Both have different unemployment targets, U^T, that are constrained by, and therefore tend to vary, around a "normal" or benchmark unemployment rate, U^N. The unemployment target prevailing during Democratic presidential administrations is lower than the corresponding target during Republican administrations, which is represented by the (quarterly) U^T equation

$$(1) \qquad U_t^T = \beta_0 + U_t^N + \beta_1 Dem_{t-1},$$

where *Dem* is a binary variable equal to +1 during Democratic administrations and 0 during Republican administrations; U^N is set equal to Robert Gordon's (1984) calculation of the natural unemployment rate; and the party hypothesis requires $\beta_1 > 0$. The *Dem* term appears with a one-quarter lag because the unemployment target reflected in

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current policies is based on the party in power during the previous period.

Given behavioral lags in policy formulation, institutional lags in policy implementation and, most important, structural lags in the response of the economy to policy actions, presidential administrations cannot achieve their economic objectives immediately. Therefore, administrations are able to adjust the observed unemployment rate, U, to their preferred rate, U^T, only partially each period. The adjustment mechanism is

$$(2)\quad U_t - U_{t-1} = \phi_1\left(U_t^T - U_{t-1}\right) + \phi_2(U_{t-1} - U_{t-2}) + \beta_2\, Shock_{t-1} + e_t,$$

where $0 < \phi_1, \phi_2 < 1$, and e is a well-behaved disturbance.

Hence, policy-induced changes in unemployment from one quarter to the next are capable of closing only a fraction (ϕ_1) of the gap between the current target and the actual unemployment rate observed for the previous period. The remaining right-hand side terms in (1) add a bit more realism to the adjustment model. Additional structural inertia in the time path of unemployment is accommodated by the lagged rate of change term. Fluctuations in unemployment due to shocks exogenous to the domestic political economy, notably the energy price hikes of 1973–74 and 1979–80, are represented by the variable *Shock*, which is equal to the percentage point rise in the price of imported oil, weighted by the net share of oil imports in *GNP*.

Substituting (1) into (2) and solving for U_t yields a nonlinear second-order estimating equation for the time path of unemployment:

$$(3)\quad U_t = \phi_1\beta_0 + (1 - \phi_1 + \phi_2)U_{t-1} - \phi_2 U_{t-2} + \phi_1 U_t^N + \phi_1\beta_1 Dem_{t-1} + \beta_2 Shock_{t-1} + e_t.$$

Estimation results for equation (3) in Table 1 show that the coefficients of all terms have the anticipated signs and satisfy conventional statistical significance levels. The rate of adjustment of unemployment to party targets (ϕ_1) is on the order of 7.5 percent per period, but it is perturbed by structural inertia from the lagged rate of change (ϕ_2). The estimate of the β_2 parameter indicates that each unit rise in the *Shock* term initially increased the unemployment rate by about 0.3 points, after a one-period lag. However, the *Shock* variable reached peak values of 1.6 in 1974:3 and 1.5 in 1980:1, and dynamic calculations suggest that the energy price shocks ultimately raised unemployment about 2 percentage points above U^N in 1975 and again in 1980.

For my purposes here, the most important parameter is β_1 (*Dem*), which estimates the magnitude of the cross-party difference in unemployment targets and, therefore, the impact of sustained changes in party control of the presidency on unemployment outcomes, after all lags of adjustment. In the unemployment equation, the estimate of β_1 is approximately -2.0, which implies that after adjustment lags, unemployment tends to be about 2 percentage points lower under the typical Democratic administration than under the typical Republican one. Alternatively, this estimate is theoretically consistent

TABLE 1—ESTIMATES OF THE PARTY CLEAVAGE MODELS FOR UNEMPLOYMENT AND MONETARY POLICY, 1953:I TO 1983:II[a]

	Unemployment Rate (U) Equation (3)	$M1$ Growth Rate (m) Equation (6)
α		1.31
		(0.55)
β_0	0.843	
	(0.550)	
δ		−0.875
		(0.270)
φ_1	0.076	0.638
	(0.020)	(0.085)
φ_2	0.561	
	(0.072)	
β_1	−2.11	−1.97
	(0.94)	(1.04)
β_2	0.313	
	(0.090)	
$c_1 + c_2$		0.432
		(0.148)
Adj. R^2	.963	.361
SE of Regression	0.322	2.73

[a] Estimated standard errors are shown in parentheses.

with (and empirically indistinguishable from) the idea that the parties have different ideas about the "normal" or "natural" unemployment level, and this prompts them to pursue different unemployment targets.

The estimated values of ϕ_1 and ϕ_2, which define the rate at which actual outcomes are adjusted to party targets, indicate that the unemployment equation is stable, and that convergence to equilibrium values is nearly complete after 16 quarters, or one presidential term. Hence, if we take all parameter estimates at face (point) values, and assume that U^N now lies between 6 and 6.5 percent, the results indicate that the typical contemporary Democratic administration will aim for (and, after one term, achieve) an unemployment rate just above 5 percent, as compared to a target rate just above 7 percent for the typical Republican administration.

III. Monetary Policy under the Parties

Thus far I have tried to show that the partisan stripe of presidential administrations has significantly affected unemployment outcomes in the postwar American economy. However, policy authorities do not control directly macroeconomic outcomes; they control macroeconomic policies. Monetary policy is easier to maneuver in the short run than fiscal policy, and it is more decisive: the impact of fiscal initiatives are largely dissipated unless monetary growth rates are accommodating. Although the Federal Reserve has considerable formal autonomy under American institutional arrangements, it's insulation from political direction is largely illusory. Numerous studies have concluded that the administration's macroeconomic goals are what drive Federal Reserve policy behavior, as contrasted to Federal Reserve policy rhetoric (the evidence is summarized in my book, ch. 1). This view underlies the theoretical framework presented below.

Letting m denote the (annualized, quarter-on-quarter) percentage growth rate of the $M1$ money supply, we have the target equation

$$(4) \qquad m_t^T = \alpha_0 + \delta\left(U_t^T - U_{t-1}\right) + cp_t^*,$$

where p^* denotes the "ongoing" inflation rate (of the implicit *GNP* deflator), and the party cleavage hypothesis requires $\delta < 0$. Hence, the money supply growth rate target of an administration is proportional to the gap between its unemployment target (U^T) and the actual unemployment rate (U) observed for the previous quarter. When unemployment is above the target, administrations seek to close the gap by pushing the Fed to raise the money supply growth rate (relative to the inflation rate). The reverse is true if the gap between U and U^T goes the other way. The monetary growth target is also conditioned by the ongoing inflation rate, p^*, since movements in the real money supply are what move unemployment and real output. If administrations (and, more directly, the Federal Reserve) are indifferent to inflation, c (the coefficient of p^*) should be in the vicinity of 1.0. If c is less than 1.0, monetary policy goals do not fully accommodate inflationary trends, which implies that unemployment goals may be adjusted upward in order to fight inflation.

The adjustment-to-target equation for the money supply growth rate is

$$(5) \qquad m_t - m_{t-1} = \phi_1\left(m_t^T - m_{t-1}\right) + e_t,$$

where $0 < \phi_1 < 1.0$. This adjustment function includes no lagged (inertia) terms because, in principle, the money supply growth rate can be brought into line with party targets quickly. Substituting (4) into (5) (and recalling that U^T is given by equation 1) and solving for m_t, yields the nonlinear estimating equation

$$(6) \qquad m_t = \alpha + (1-\phi_1)m_{t-1} + \phi_1\delta\left(U_t^N + \beta_1 Dem_t - U_{t-1}\right) + \phi_1 cp_t^* + e_t,$$

where $\alpha = \phi_1(\delta\beta_0 + \alpha_0)$, and other terms are as defined previously.

The results for equation (6) are reported in the second column of Table 1. The estimate for δ is about 0.9. After lags of adjustment, nominal $M1$ therefore tends to grow nearly point-for-point with deviations of unemploy-

ment from the party targets. The estimate for the speed of adjustment (ϕ_1) of m to m^T is 0.64 (that is, 64 percent per quarter). As would be expected, this is much larger than the corresponding rate of adjustment of U to U^T.

From the point of view of a political analysis of the American economy, the most important parameter, as before, is β_1, which distinguishes the monetary targets and, hence, the unemployment targets of Democratic and Republican administrations. The β_1 point estimate is -2.0; almost identical to the estimate in the unemployment equation. Since the estimates of β_1 in the m and U equations were obtained independently, their near equivalence is strong evidence in favor of the party cleavage model.

However, monetary policy has also responded to the "ongoing" inflation rate (which is measured by annualized, quarter-on-quarter inflation rates lagged one and two periods). The coefficient of p^* (the sum $c_1 + c_2$) is significantly less than 1.0. Consequently, real money supply growth rates, which, as I noted earlier, are what affect unemployment (and real output) movements, have been constrained by inflation rates. (Regressions not reported here reveal that the inflation sensitivity of monetary policy does not vary with the party controlling the White House.) In fact, the estimation results imply that if inflation is high enough relative to the gap between actual and target rates of unemployment, the real money supply turns negative which, after a lag, would tend to yield rising unemployment (and lower future inflation). But unemployment, inflation and (lagged) monetary growth rates are mutually endogenous, and this complicates formal analysis of the model's long-run properties.

IV. Discussion

It is not possible to say from the econometric evidence whether the inflation sensitivity of monetary policy represents relaxation of unemployment goals by presidential administrations or "independent" anti-inflation activity by the Federal Reserve. However, since the unemployment model is essentially a reduced-form equation in which the policy variables have been solved out, we may gain more information about the impact of inflation on operative unemployment goals by entering lagged inflation variables directly into the U^T function, which amounts to estimating equation (3) after adding terms of the form: $\phi_1 \Sigma c_j p_{t-j}$, $j > 0$.

Taking this approach, which circumvents some of the feedback problems noted above, produces estimates of Σc_j that are uniformly positive and range in magnitude between 0.08 and 0.15, but that invariably are not significant at the usual test levels. One might conjecture from such results that there is some tendency for the parties' unemployment goals to be raised on the order of one-tenth of a percentage point per point of sustained inflation. Despite the absence of firm statistical evidence, a conclusion along these lines is surely sensible. After all, even the Democratic party's core constituency dislikes inflation, although less so relative to unemployment than Republican supporters.

Moreover, if the normal or benchmark unemployment variable used in the unemployment model, U^N, is a true natural rate, then unemployment held below U^N indefinitely would yield hyperinflation (which, assuming an unbounded Phillips curve, is what the estimates for equation (3) imply would be the case under a prolonged run of Democratic administrations), and unemployment held above U^N indefinitely would yield hyperdeflation (which is the steady-state result for equation (3) under the Republicans). Since neither party has held the presidency for more than two terms in succession in the postwar (estimation) period, such unrealistic long-run results do not weaken the validity of the model for party regimes of the duration actually observed. Nonetheless, it must be remembered that party cleavages are over the relative emphasis give to macroeconomic problems. A typical administration of either party will ultimately respond to a dominant macroeconomic problem, even if it requires distasteful actions inconsistent with usual priorities.

Yet, postwar electoral history shows that the Democrats have been more likely than the Republicans to get into difficulty with the voters by pursuing overly ambitious unem-

ployment goals creating extra inflation. The Republicans, on the other hand, have more frequently suffered electoral setbacks because of their enthusiasm for disinflationary bouts of economic slack. In an era when elections have increasingly turned on economic performance, such "overshooting" may help explain why neither party has managed since World War II to hold the presidency for more than two consecutive terms.

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