An unprecedented partisan divide in economic expectations occurred following President Trump’s election. Such sharp and sustained partisan divergences are not predicted by theories of rational expectations since all parties have access to the same economic information. Most other social sciences, in contrast, have adopted a more inclusive view, accepting that a significant relationship exists between people’s partisan views and their economic expectations. Importantly, the more insular views of economics are of relatively recent origin. It has only been since the closing days of the 19th century that economics shed the name “Political Economy” to become a distinct discipline, primarily due to the influence of William Stanley Jevons and Alfred Marshall. As we all know, change does not come quickly in academia, as it took another one hundred years for Glasgow University, where Adam Smith once taught, to finally change the name of its department from political economy to economics at the close of the 20th century. It is not that economics dismissed the importance of politics as a cause of economic behavior, but that the discipline held that rational interpretation of potential economic policies would ultimately converge across all economic agents. Distributional issues, perhaps the core determinant of economic policy preferences, were dominated by concerns about how to best maximize economic growth in the last half of the 20th century. Only recently have distributional issues gained prominence, and represent a significant commingling of partisanship and economics. Indeed, income inequality, immigration, and trade policies are now considered as much political as economic issues. Moreover, in an era of secular stagnation and income inequality some people have turned from economic markets toward government programs as the best means to enhance their living standards. The distributional issues sparked by secular stagnation and income inequality are likely to perpetuate sustained partisan differences in economic expectations.

There are two important elements of this thesis: first, that the partisan differences are due to fundamental concerns about distribution and not simply a temporary reaction to a surprising election result; and second, that the partisan differences in expectations influence economic behavior and do not simply represent political posturing. In most past presidential elections the winner was widely expected in advance, giving consumers a substantial amount of time to gradually adjust their economic expectations. In sharp contrast, Trump’s election was not anticipated in advance; moreover, he proposed many controversial economic policies. At the time of this writing, it has been more than six months since his election, and the partisan divergences in economic expectations have not narrowed. While it is impossible to determine what length of time qualifies as temporary, at present it must remain an open question whether a fundamental change has occurred or whether it has resulted from a much longer “temporary” but transitory response—perhaps lasting as long as Trump’s entire term in office.

More data are also needed to determine whether the partisan differences in expectations cause real differences in economic behavior. People who expect the economy to fall into recession act differently than people who anticipate robust economic growth. If people’s expectations were dominated by political rather than economic factors, would people still make the same important economic decisions based on those expectations? If so, will spending pullbacks be offset by stepped up spending, so that across all consumers the average expectation still has predictive power? Another hypothesis is to anticipate that people know the difference between partisan views and economic reality and act accordingly. This assumption, however, requires that people
knowingly hold two sets of economic expectations: one set they publically share (and are captured in surveys), and another private set of expectations that are used to guide their own behavior. While this may seem unlikely, surveys have long guarded against what has been termed in the methodological literature as “socially desirable responses.” If people do maintain distinctive private and public personas, the survey data on economic expectations may no longer determine their economic behavior.

Partisan differences in economic expectations are not unique, however. The data from the University of Michigan surveys have long found that expectations among age, income, and education subgroups permanently differ. Theory suggests that people with high work skills, for example, anticipate a much lower unemployment rate that those with low job skills. The data for unemployment expectations among respondents with different education levels significantly differ in mean levels, and these means mirror the actual differences observed by the Department of Labor’s official surveys. The same differences have been observed across age groups, which have also consistently mirrored the official statistics. As is well known, correlations rather than means dominate the explanatory power of econometric models. Despite the mean differences, inter-correlations of unemployment expectations are very high across demographic subgroups. This pattern of differing mean levels but very high inter-correlations holds for most other economic expectations as well. It may well be that partisan differences in expectations will also be highly correlated over time despite their mean differences. Partisanship would then be mainly reflected by mean differences similar to most other demographic variables, but leave the predictive power of econometric models unchanged. Unfortunately, only mean partisan differences are now available, so this issue must also await more data to be resolved.

Partisan Differences in Economic Expectations

The most basic first step is to provide evidence that consumers have adopted drastically different expectations about prospects for the national economy. Chart 1 plots the timeseries of the Index of Consumer Expectations from the early 1960’s to April of 2017. The chart plots the three-month moving averages of the survey results. I have also noted in the right hand margin how the last point in the series is decomposed by self-identified party affiliation. Compared with the overall average of 86.7, the Expectations Index among Democrats was just 58.9, while among Republicans it was 118.4. Note that self-identified Independents had an Index score of 89.3, barely different from the overall average. It is of some interest to note that Independents formed the largest group, accounting for 41% of all respondents; Democrats accounted for 32% and Republicans 27%. In the two-party system in the U.S., Independents effectively act as a centrist party, to which the winning presidential candidate must appeal. Perhaps the most central point is that the wide divergence of
the Democrat and Republican parties define the result as partisan.

While influence of partisanship on people’s expectations of the future course of the economy may not be surprising, it would be entirely another thing if people used “alternative facts” to describe the current state of the economy. In that case, the data would become unbelievable, and the analysis would heavily depend on psychological explanation of the existence of outright misperceptions. The Index of Consumer Sentiment is composed of two main sub-indices: the above noted Expectations Index, and the Current Economic Conditions Index, shown in Chart 2. The timeseries for the Current Conditions Index indicates no significant partisan difference in how consumers perceive current economic conditions. The University of Michigan surveys include many other questions on both expectation for wages, inflation, unemployment, interest rates, and so forth, as well as many additional questions about the current state of the economy. All exhibit the same pattern of a partisan impact on expectations and nearly identical results for current conditions across political parties.

Most readers are familiar with the ecological fallacy: it represents a logical error that equates inferences about the behavior of individuals from data on groups of individuals. The University of Michigan surveys are well suited to make the correct inference since the samples represent a rotating panel of respondents. The Michigan survey interviewed the same person in June, when both candidates for the presidency were known and in December, the month following the election. The right hand panel on Chart 4 shows that among identical respondents, those who self-identified as Democrats scored 24.1 points lower on the Expectations Index in December than in June, while Republicans raised their score by 50.5 Index-points from June to December, a gap of 74.6 points. Income expectations were expected to be 1.3 percentage points lower by Democrats and 2.3 percentage points higher by Republicans. Net changes in unemployment expectations were 47 points less favorable in December than in June for Democrats but 91 points more favorable among Republicans. There is no question that the election of Trump caused Democrats to become more pessimistic and Republicans to become more optimistic about future economic conditions.
This reversal in expectations was quite large. Each of the Presidents identified in Chart 4 took office after a member of the opposite party held the office, but none of them caused nearly as much change in economic expectations as Trump. Note that the change data covered exactly the same six-month period from June to December in each case. The total difference between Democrats and Republicans following Trump’s election was a statistically significant 74.6 points, compared with insignificant changes of just 17.2 points for Obama, and 16.5 points for Reagan. The same difference was true for personal income expectations and expected changes in unemployment. Unfortunately, the Michigan surveys has only rarely asked the question on party affiliation—in only 44 months out of a total of nearly 500 months, or just 8% of the time, with most of these occurring in the past decade. Since it hardly ever mattered, it wasn’t regularly measured.

An indication of the partisan extremes, Chart 5 includes the Michigan measures of unemployment expectations and the official Bureau of Labor Statistics measure of unemployment. Since the surveys measure the expected change in unemployment during the year ahead, the official data was converted to year-to-year changes in the unemployment rate. The data show a remarkably robust relationship between prior expectations and subsequent actual changes in the unemployment rate, that is until following the election of Trump. As on prior charts, on the right margin I have indicated the breakdown of expectation by party affiliation. There are two notable aspects: the first is the extreme divide between the two main parties, which was already mentioned. The second is the unreasonableness of unemployment expectations on the part of Republicans. The April 2017 unemployment rate was just 4.4%, matching the 2007 low. If the decades old relationship between expectations and realization still holds, the Republican expectations are off the chart and indicate a negative unemployment rate. The current situation has some complications, including a relatively low labor force participation rate and a more inclusive unemployment measure that includes discouraged and marginally attached workers, the U6 measure, which stood at 8.6% in April 2017. Even the Independents expect the unemployment rate to fall to an extraordinary low rate, but not a negative one. Importantly, I did not use this example to indicate that it was only Republicans that held unreasonable expectations. As will be shown, Democrats are also too extreme in their pessimism.

**Presidential Administrations**

The prior analysis of the impact of presidential elections on economic expectations was restricted to how individuals immediately changed their economic expectation upon the election of a new president. The following analysis is based on all surveys that included the question on party affiliation within each president’s term in office (the data exclude the November surveys in election years when ballots were cast). The months included in this analysis are as follows: 6 months under
the Reagan administration (3,091 cases), 9 months under the G. W. Bush administration (4,387 cases), 24 months under the Obama administration (11,043 cases), and 3 months under the Trump administration (1,169) cases. Since differences in the mean level of the Index of Consumer expectations mainly reflect business cycle developments, a more accurate determination of the partisan impact is reflected by the differences for each political party from the overall monthly mean. The same procedure was followed for the other measures that will be introduced shortly.

The data for the Expectations Index are shown in Chart 6. Republicans held more favorable expectations during the Reagan, Bush, and Trump administrations, who were all Republican presidents. During the Obama administration, Democrats held more optimistic expectations. The partisan gap, defined as the difference between Democrats and Republicans, showed an insignificant difference between the Reagan and Bush administrations, and was only slightly higher, although of the opposite sign, under President Obama. In sharp contrast, the partisan gap was over twice as large and highly significant under the Trump administration.

What could explain the extraordinary partisan divide under the Trump administration? All people have access to the same news about economic conditions as well as potential changes in economic policies. Theories of rational expectations would typically assume that these information sources would lead people to adopt similar economic expectations. To be sure, there is an extensive literature in political science and sociology of partisan differences in economic expectations. The differences have been generally small, although significant, and largely ignored by economists. The current partisan impact on economic expectations exhibited by consumers (as well as business firms) suggests that selective perceptions of economic developments and economic policies must be involved.
The University of Michigan surveys regularly ask respondents whether they have heard of any recent changes in the economy, and if they have, to explain in their own words what they have heard. At the most general level, the responses are divided into favorable and unfavorable developments. The data in Chart 7 shows the results by party affiliation as deviations from the overall monthly survey levels. Under the Reagan and Bush administrations, the differences were quite small, but in the expected direction with net references to positive developments higher among Republicans. The partisan divide on perceptions of the economy doubled under the Obama administration, and then again doubled under the Trump administration. Indeed, virtually all of the economic news reported by Republicans centered on positive developments, mainly references to employment and economic policies. The opposite was true of Democrats.

When the economic developments were restricted to news about jobs, only small partisan differences were found under the Reagan and Bush administrations (Chart 8). For the Obama and Trump administrations, the partisan divide on news about jobs was nearly identical, although Democrats were more positive under Obama, and Republicans more positive under Trump. Indeed, the net references to jobs were nearly equal but in opposite directions for both Democrats and Republicans—Democrats went from +9 to -10, and Republicans went from -14 to +14.

News about changes in government economic policies showed no partisan divide under Reagan or Bush; indeed, positive references to the economic policies of Reagan and Bush were made by respondents regardless of party affiliation (see Chart 9). The data for President Obama showed that Democrats held much more favorable opinions of economic policies, while Republicans were as likely to express negative as positive views. In the first several months of the Trump administration, the partisan divide was significantly higher, with Democrats just as negative about prospective economic policies as Republicans were positive. Whereas most respondents coalesced to support the policies of Reagan, Bush, and Obama, no such consensus has yet emerged under Trump.
Impact of Question Wording

What is the best method to assess people’s opinions about potential changes in economic policies as well as its impact on employment? I have implicitly suggested that open-ended questions are superior in that they measure what is of most concern to the respondent without any prompting. However, closed-ended questions are much more common in consumer and business surveys. These questions ask respondents to consider a specified topic and answer in terms of specific pre-defined answer categories. The University of Michigan surveys includes both types of questions about the government economic policies and the availability of jobs. Chart 10 shows the change in responses from the 3rd quarter of 2016, prior to Trump’s election, to the 1st quarter of 2017. Across all households, the open-ended question on news heard changed from -13 to +13 and the fixed-response question changed from -17 to +12. Questions on jobs, changed for the open-ended question from -2 to +12, and for the fixed-response question from -9 to +20. The implication is that both types of questions yield similar results.

Also shown in the same table are the results by education and party affiliation. By party affiliation, the data indicate a somewhat larger change for the fixed-response questions than the free-response questions, but both question types indicate the same enormous partisan divide. Note, however, that the partisan divides from last year’s 3rd quarter to this year’s 1st quarter are confined to those with less than a four-year college degree. While the divide among college educated respondents remained very low and insignificant, the change among those with less education significantly declined, with positive net changes across both question types. Again, the net changes were somewhat larger for the question on jobs with the fixed-response categories. This suggests that those with relatively low job skills, as proxied by education, were the most affected by Trump’s election.
Jobs as a source of the Partisan Divide

While the partisan divide on economic policy is largely identified with the Trump presidency, the gap on jobs between Democrats and Republicans was just as strong under Obama, suggesting that job availability is a more longstanding cause of the partisan gap. One indirect method for testing this hypothesis is to observe the trends over time in references to jobs. We have already seen that the level of education was highly related to job references, with only the college educated not seeing job availability as a crucial economic issue. The data in Charts 11 and 12 show the time trends in the open-ended and the fixed-response question on jobs. Note that prior to the recent decade, the response trends for those with a high school education or less, some college, and a college degree had shown nearly identical trends. In the past ten years or so, references to jobs by college educated respondents were consistently more favorable than among the other two education groups. Since Trump’s election, the largest gains were recorded by the two lower education groups, although the college educated also became more positive. The relatively lower references among the less than college educated may also factor into the decline in the labor force participation rates of prime age workers. Also note that despite the more positive views of jobs by the college educated, the timeseries movements were largely in lock-step with the other education groups; that is, although the mean was higher, the correlation across education groups was still high.

Public Policy Preferences

The most striking elements of the current partisan divide are differences in economic policy preferences. In the July to October surveys, respondents were asked about four central issues: trade, immigration, income inequality, and Social Security. The questions were phrased to be clearly focused on the topic but avoided any suggestion about specific policies. The response scales for all questions were in terms of how it would impact the overall economy. For example, “Would more trade
or less trade with other countries be better for the U.S. economy?”

Chart 13 shows the responses to all four questions, with the titles indicating the wording. More trade with other countries was seen as better for the economy by 60% of all consumers; just 21% thought less trade would be better. Nearly a majority (48%) thought the overall economy would be helped by higher taxes on the wealthy to reduce income inequality. Nearly two-thirds favored higher taxes rather than reduced Social Security benefits. Perhaps the biggest surprise was that just 21% thought that the economy would benefit if immigration was increased compared with 37% who thought it would be better for the national economy if immigration was reduced.

Chart 14 shows these policy preferences by party affiliation. Little difference was found on trade preferences: 67% of Democrats and 56% of Republicans thought more trade was better for the domestic economy. All of the other policies showed significant differences across parties. It should also be noted that when policy preferences were controlled for the respondent’s age, education, and income, significant party differences were still present for every policy except trade.

At least two-thirds of Democrats favored trade, higher taxes to reduce inequality, and higher taxes to support Social Security and Medicare; it could reasonably be inferred that Trump opposed all of these positions. More Republicans opposed than favored higher taxes to reduce inequality, benefit cuts rather than increased taxes to support entitlement programs for the elderly, and reduced immigration, all with the aim of strengthening the domestic economy. While these differences in policy preferences are consistent with the positive economic expectations of Republicans and the negative expectations of Democrats, none of these programs would have a substantial impact on the economy and so could not justify the extreme positions observed. Nonetheless, they would have an impact on the margin for the economy as well as on specific individuals.

Prospects for the Partisan Divide

Perhaps the most discussed issue is whether the partisan divide is simply a reaction to Trump, with the gap immediately narrowing either after his agenda is deemed unpassable even by his own party, or when his party loses control of congress after the mid-term elections, or after his term in office is complete. Such speculation is all the rage among DC political pundits. There are more fundamental economic issues, however, that created the gap and will maintain the partisan
divide in the future. The prime economic issues responsible for the persistence of the partisan divide are secular stagnation and income inequality. Since the Great Recession, the average annual growth rate in the U.S. economy has been about two percent, and increasing income inequality over the past several decades has meant that lower and middle income households have faced stagnating or even declining market incomes. It is only natural that these households have sought the government’s help to secure greater financial support and to redress the distribution of income and wealth. The only group that has avoided stagnating incomes and high employment levels has been the college educated in the top income quintile. To be sure, these households have not benefitted as much as those in the top 1% or top 0.1%. Nonetheless, the upper middle class have enjoyed continued growth in their incomes. Since it is highly improbable that either secular stagnation or income inequality in the U.S. will disappear anytime soon. As a result, consumer expectations are likely to continue to be influenced by partisan views based on distributional concerns.

Does the rising importance of partisanship in the determination of consumer expectations mean that the data will become less useful for predicting behavior? Not necessarily. The University of Michigan surveys record regularly differential expectations across population subgroups. Subgroups defined by age, income, and education typically display differences in their expectations. For example, unemployment expectations are seen quite differently among respondents with low compared with higher education, and these differences reflect differences in the unemployment rates of these different subgroups published by BLS. Life-cycle theory indicates that young people receive larger income increases than older workers. Despite these mean differences across demographic subgroups, the timeseries correlation remains very high. Econometric models typically discount mean differences and rely on correlations to produce their forecasts.

Differences across age groups in the Index of Consumer expectations are shown in Chart 15. The charted data include only three age groups so that the differences are legible. Note that the gap between the top and bottom income terciles is largest at the peaks and the gap virtually disappears at troughs. Also note the closing of the gap among age groups since Trump was elected, with the closure due to the oldest respondents. The data at the bottom of the chart is for a more detailed breakdown of age into five groups. Despite the gap of 18.0 Index-points over the 1978 to 2017 time period, all five age subgroups maintained extraordinarily high inter-correlations from 0.93 to 0.96.
The same analysis was performed for the division by income subgroups in Chart 16, with the same general conclusions: wider gaps at the peaks, and closure at the trough. The data at the bottom of the chart indicate that the mean difference between the top and bottom quintiles was 17.9 Index points. The timeseries inter-correlations were quite high, ranging from 0.91 to 0.97. The smaller gaps in recent years may well be due to an economy that had only advanced by 2%.

If political party affiliation had a similar impact, showing differences in mean levels and high timeseries inter-correlations, it would not affect predictive accuracy of econometric models. While the current gap is larger that the historic gaps by age and income quintiles, the larger Trump gap occurred near peak levels, and data suggest that the gaps were the largest around past peak levels. Whenever the party in office is replaced by the other party, there may be a transition period where the data is in flux, but the emerging trends could be just as highly inter-correlated as under the prior administration; that is, the means may reverse, but the timeseries correlations would remain high, preserving its predictive power. Needless to say, these questions will only be answered by the collected data in the months and years ahead.

**Political Economy**

An essential element of “political economy” was its foundation in moral philosophy. Today’s issues concerning the appropriate distribution of income and wealth as well as taxation and entitlements also depend on moral foundations. The modern discipline of economics must more fully accommodate how the distributions of these important facets of the political economy affect economic behavior and wellbeing.