The Midterm Elections: How Will This Affect Your Finances?

On Election Day, November 7, 2006, voters handed congressional leadership to the Democratic Party, ushering in a shift in the balance of power in Washington, D.C. The election results have left many people wondering how the new political landscape will affect the financial markets, the economy, and tax policy.

It's important to point out that these election results are by no means unprecedented. Since World War II, the average loss for a second-term president's party during his sixth year in office has been 29 House seats and 6 Senate seats.[1] While Congress will be controlled by Democrats, the White House is still under Republican control and the president has veto power.

Many economists believe that having power split between the two major parties may actually help the economy. As one expert put it, "The market actually likes the executive and legislative branches under different leadership, as it reduces any damage coming out of Washington."[2] Investors might not have to worry that a dramatic piece of legislation will negatively affect the stock market.

In January 2007, when the new Congress convenes, the agenda is likely to shift to such issues as the minimum wage, Medicare, stem-cell research, interest rates on college loans, and immigration. Eventually, Congress will need to address the tax cuts implemented in 2001, which expire at the end of 2010. Here's a review of some of the pending issues.

Minimum Wage
The minimum wage has been unchanged since 1997, when it was raised to $5.15. An attempt to raise the level to $7.25 failed in June 2006, yet several states have increased the minimum wage to above the federal level.

An increase in the minimum wage has the potential to affect consumers and investors in several ways. However, there will still be a debate about how an increase in the minimum wage will affect companies and the economy.

Taxes
Many of the tax programs implemented over the past five years are currently scheduled to expire at the end of 2010. Without congressional intervention, income taxes will revert to their pre-2001 levels, eliminating the lowest tax bracket and raising the remaining brackets. Capital gains and dividend taxes will also revert to their pre-2001 levels. If this happens, dividends will be taxed as ordinary income and long-term capital gains will be taxed at a maximum 20% rate.

As a result of the 2001 tax law, the top federal estate tax rate has been falling and the applicable exemption amount has been increasing, resulting in fewer Americans being subject to federal estate taxes. In 2010, for one year only, the federal estate tax will be fully repealed, but it will return in 2011 at pre-2001 levels unless Congress intervenes. Congress tried but failed to eliminate the tax permanently in 2006 (the House approved the measure in 2005, but the plan was rejected by the Senate in 2006). It's likely that further attempts will be made in the future, although they will face more opposition from Democrats.

Over the past several years, Congress has passed temporary measures designed to help keep middle-income taxpayers beyond the reach of the alternative minimum tax (AMT), which was established over 30 years ago to help prevent the rich from using their wealth to avoid paying income taxes. Because the AMT is not indexed to inflation, the number of Americans who are subject to it grows every year. Members of both parties agree that the tax is unfair to many middle-class Americans, and thus AMT reform is likely to be an issue in the future.

Social Security

Experts have been warning that Social Security will be operating in a deficit situation in 2017 and will have to begin tapping trust funds to pay benefits. According to the Social Security Administration, trust funds will be exhausted in 2040, at which time Social Security will not be able to meet all its obligations. Reform efforts in the past have stalled, but look for this to be a major issue in the next two years as various new solutions are proposed.

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In 20 of the last 30 years, the government has been divided. From an historical perspective, there has been little difference in the productivity of Washington with a divided government. Over the last 16 years, two of the most productive legislative sessions occurred in 1995–1996 with a GOP-controlled Congress and the Clinton administration, and in 2001–2002 with a Democrat-controlled Senate and the Bush administration.[3] And in the 1990s when each party controlled a branch of government, the country experienced the longest economic expansion in U.S. history.

When the 101st Congress convenes in January, the federal government will be taking a close look at several key issues that affect Americans. With that in mind, you might see this as an opportunity to take a fresh look at key issues in your own financial life.

Sources:

1) *National Review,* November 2006
2) CNNMoney, November 2006
3) *Time,* November 6, 2006