

POLITICAL PULSE

## A Lott for Markets to Think About

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**There are both big positives and big negatives that could emerge from the Lott crisis -- while we wait, there's big uncertainty.**

Sadly, events have vindicated our view -- expressed the morning following the election -- that investors should not get too excited about the prospects of **GOP** congressional control ushering in a new era of pro-growth policy (see "[Don't Get Swept Away by the Sweep](#)" Wednesday, November 6, 2002). We've now seen how the **Bush administration** intends to use its electoral mandate -- to put forward modest and poorly engineered stimulus proposals, and to select deficit-hawk big-business types to key economic policy posts. Now, on top of that disappointment, a layer of risk and uncertainty is added by the political implications of the imbroglio arising from **Senate Majority Leader Trent Lott's** comments at **Strom Thurmond's** centenary.

It's a blow to a market environment that was already suffused with discouragement and anxiety. We think it's now not too much to think that, in the immediate term, the playing out of the various scenarios by which the Lott controversy might be resolved could be the factor at the margin having the biggest impact on performance of markets ranging from equities and bonds to the dollar and gold. In fact, the Lott situation might well have played a role in the dollar's weakness late last week against foreign exchange and gold, exacerbating the weakened growth expectations attributable to disappointment with the Bush administration's personnel choices and thereby further dampening demand for dollar liquidity.

Let's try to think about the Lott situation the way **Deep Blue** would think about a chess game -- modeling all the branches of possible future moves, without necessarily having any feeling for exactly which one will end up getting played.

**LOTT STAYS AS SENATE MAJORITY LEADER** This is probably the worst outcome for prospects of substantive, pro-growth economic policy. Not only is a damaged Lott in a weakened position from which to argue for strong, incentive-oriented fiscal policy change -- or for anything else. But with Lott at the head of the **Senate Republican caucus**, the GOP will be even more vulnerable to class-based arguments on tax legislation. "Tax cuts for the rich" easily translates into "tax cuts for the white," and it can be safely assumed that the **Democrats'** class warfare propaganda machine will put be into high gear to drive home that message.

The class warfare argument against tax-cuts and other pro-growth policies is hardly new, and Republican senators have not been good at countering it in recent years. At one time long ago we might have been able to count on Lott to turn that argument on its head, making a **Ronald Reagan**-like case that the "rising tide lifts all boats" -- that the only way to bring real prosperity to minority communities is with fiscal policies that encourage capital formation to the greatest possible extent, ensuring that no group is left behind. Such an argument could note, for example, that the late 1990s boom touched off by the capital gains tax cut of 1997 brought the

black unemployment rate to its lowest levels in the post-War era. At one time, particularly during his tenure in **the House**, Lott was known as a true-blue supply-sider, standing side-by-side with **Jack Kemp** and the other key figures in the early development of the growth wing of the GOP.

But those days are long gone. Lott has been a major disappointment as a Senate leader in getting the best outcome possible for supply-side policies. He's often described as having all the best intentions, but being stymied by the realities of legislative politics. A strong leader, though, would at least make a point of doing his utmost to get his top priorities into law. All too often, though, Lott has proved himself much more willing to talk the talk than walk the walk.

As weak a leader as Lott has been, the particular nature of the controversy surrounding him now cannot help but make him far weaker. As **Hoover Institution** scholar **Shelby Steele** has argued, race relations are now the central focus of public morality, and the acid test of moral authority and legitimacy. Leaders who fail that acid test are unable to exert moral authority -- they cannot effectively lead. Steele points out that, in the 1950s, **Dwight Eisenhower** was quoted in the press as having used a particular racial slur -- *the N-word* -- on a golf course. It was handled as a minor embarrassment, and it soon passed. If he had been caught having an affair with a White House intern and then lied about it, he would have been driven out of office in a matter of weeks. In the modern era, **President Clinton** survived an impeachment over matters of sexual misconduct and lying about it. Steele invites us to imagine what would have happened if, during the impeachment process, a videotape had surfaced in which he was caught speaking the N-word to **Monica Lewinsky**? Surely then **George Bush's** opponent in the last presidential election would have been **President Al Gore**.

If Lott stays on as Senate majority leader, it will be in the weakened condition of a leader who has publicly failed the acid test of the morality of race relations. Other Senate Republicans will be similarly weakened by their acquiescence in Lott's leadership, no matter how many speeches they make condemning him. Such speeches would only make matters worse -- they would show a divided and distracted party, and they would document the party's hypocrisy by listing all the reasons why Lott should not be its leader. A party in that weakened condition would be at the mercy of its opposition's agenda. It would be all too eager to try -- in vain! -- to reclaim its lost moral legitimacy by compromising wherever possible.

Our Deep Blue analysis of the "Lott stays" branches of the chess tree are simple -- they are all very negative for economic growth. The "Lott leaves" branches aren't quite so simple, but they are more encouraging.

**LOTT LEAVES AS SENATE MAJORITY LEADER** If Lott leaves as majority leader, there is much more uncertainty, but at least some of the possible outcomes are quite good. The pivotal issues are who replaces him, how the GOP publicly explains the change, and whether or not Lott resigns from the Senate altogether.

We can construct a best-of-all-worlds result from Lott's leaving. A leading contender for Lott's post happens to be a very strong pro-growth advocate -- **Oklahoma Senator Don Nickles**. We said of him in a client report last month, "Nickles is a supply-sider who understands that deficits are the consequence of broader economic forces, not their cause, and appreciates the important incentive effects of marginal tax rates in shaping economic choices" (see "[Monetary Progress, Fiscal Stasis](#)" November 25, 2002). Nickles has already started the ball rolling. He spoke out against Lott's leadership in a television interview on Saturday, saying that "There are several outstanding senators who are more than capable of effective leadership and I hope we can have an opportunity to choose."

If a savvy supply-sider like Nickles gets the post, he could leverage the changed landscape into real, positive action. Indeed it's not too far-fetched to think that such a turn of events could even

overcome the disappointment, from the perspective of pursuing pro-growth policy change, of the Bush administration's selections of **John Snow** for **Treasury** and **Stephen Friedman** for the **National Economic Council**.

At the same time, for President Bush, the Lott imbroglio is a no-lose opportunity to once again snatch political strength from the jaws of crisis. As with the September 11, 2001 terrorist attacks, Lott's transgression presents Bush with a situation in which the highest possible costs are already sunk -- there's nothing to be gained or saved by doing anything but covering one's self in glory and taking the strongest possible opposing stand. Bush has already made on speech condemning Lott in no uncertain terms. By doing so, he is reaffirming the moral authority derived from his proper position on the public morality of race relations -- a position that has already been demonstrated in the most tangible possible way by Bush's appointment of African-Americans **Colin Powell** and **Condoleezza Rice** to the very top of the American power elite. It has been reported that both Powell and Rice have rebuffed requests from Lott to come to his defense.

Stay or leave, Bush wins personally by condemning Lott. But if Lott leaves as Senate majority leader, and if Bush and other Republicans use the opportunity to enhance their moral legitimacy, it could pay dividends to the party -- and the cause of economic growth -- for generations to come. The GOP could begin to emerge as the true voice of hope for the less privileged in our society, offering them not welfare or reverse-discrimination gimmicks, but instead, that most valuable of all entitlements: their right to carve out their own fortunes in an unobstructed and rapidly growing economy.

Our Deep Blue analysis favors the "Lott leaves" branches, then, provided that Lott's replacement is a pro-growth stalwart like Nickles, and that the GOP uses the opportunity to elevate its moral legitimacy. But there is one critical caveat. If Lott chooses to resign his Senate seat entirely if he's forced from the leadership, his replacement would be appointed by **Democratic Mississippi governor Ronnie Musgrove** -- and presumably he would appoint a Democrat. That would essentially mean a 50-50 Senate split. While the Republicans would still have the majority by virtue of **Vice President Cheney's** tie-breaker, it would leave their control vulnerable to a single defection to the Democrats. In fact, that could well put the Senate Republicans in the position of having to compromise pro-growth objectives in order to hold fringe elements of the caucus (such as **Rhode Island's Lincoln Chafee**) in the fold. **TM**