

POLITICAL PULSE

Speaker Pelosi

Thursday, October 12, 2006
 Donald Luskin

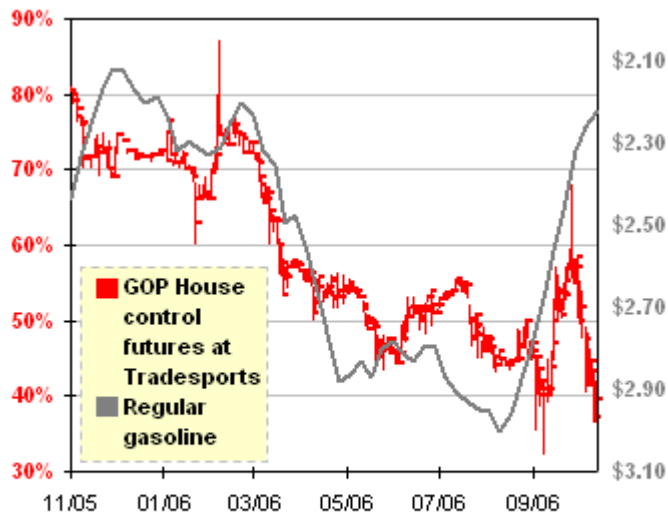
Long-term, the GOP losing congressional control may be best for growth.

We noted several weeks ago that it looked as though falling gasoline prices were improving the Republican party's poor chances of holding on to its majority in the House of Representatives in the upcoming election (see ["Immaculate Consumption"](#) September 19, 2006). But the scandal surrounding representative Mark Foley now seems to have turned the tide decisively against the GOP. Gasoline prices have continued to fall, yet the futures contracts on House control traded at Tradesports.com now give GOP victory a probability of only 40% (through the long history of political betting markets in the United States, a probability of 40% or less within a month of an election has been a highly reliable indicator of coming defeat). Traditional bottoms-up handicapping, such as the *Cook Political Report*, show a horribly lopsided number of competitive races facing Republican incumbents, with a number of races already leaning Democratic. So we reaffirm our earlier strategic view (see ["Foreshocks"](#) September 7, 2006) that the GOP will lose control of the House of Representatives in November -- although the Democratic margin of control will probably only be on the order of three or four seats; the GOP is likely to hold the Senate, though its majority is likely to be diminished by two or three seats.

Update to strategic view

CONGRESS CONTROL: The Republican party will lose control of the House of Representatives by a narrow margin. It will retain control of the Senate by a narrow margin. Absent a Democratic sweep so vast that it reveals an anti-growth mood among the electorate -- or a substantial GOP upset that affirms a pro-growth mood -- no likely outcome ought to have a large effect on markets one way or the other.

[\[see Investment Strategy Dashboard\]](#)



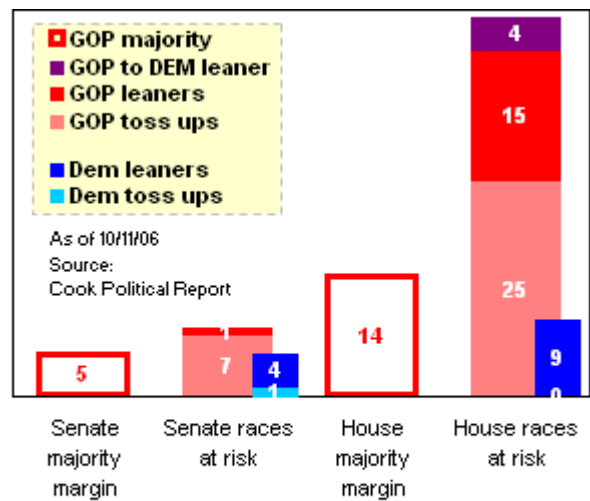
**GOP CHANCES TRACKED GAS PRICES
 -- UNTIL THE FOLEY SCANDAL**

We have to think that markets have already discounted something along these lines. It would take a Democratic sweep of unexpected dimensions, or a substantial GOP upset, to move markets much. As things stand now, other than extending the 2003 tax cuts on dividends and capital gains this year, the GOP hasn't done much for pro-growth policy. Even Democratic control of both houses of Congress probably wouldn't result in the enactment of much anti-growth legislation. The Democrats are unlikely to gain a sufficient majority in the Senate to overcome GOP filibusters or presidential vetoes. The risk will remain just what it has been all along under GOP control -- populist runaway trains like Sarbanes

Oxley, and just plain bad ideas like the Medicare prescription drug benefit. Some further thoughts:

- Long-term, the GOP losing control of Congress could be the best thing for growth. A loss could refocus the GOP on better meeting the needs of its pro-growth base, resulting in a deeper focus on reducing spending, taxes, regulation and trade barriers.
- Crunch time for pro-growth policy will be 2010, when the 2003 tax cuts on dividends, capital gains and personal income all expire. The GOP losing Congress now may be its best hope for controlling it -- and the White House -- after the 2008 election, when the tax cuts will have to be extended. A Democratic House, with flamboyant left-liberal Nancy Pelosi as its speaker -- leading various anti-Bush witch-hunts backed by subpoena power -- could galvanize conservatives for the 2008 election. It would give the GOP the opportunity to demonize Pelosi as a taste of what Hillary Clinton would be like as president.
- In the near term, the pro-growth battleground will be the extension of the Alternative Minimum Tax "patch" for tax-year 2007, necessary to keep more than 5 million Americans from being subject to far higher personal income tax rates. Republicans have never had much enthusiasm for "patching" AMT, or reforming it for the long term, as it primarily affects residents of blue states with high state and local tax rates. Democrats, on the other hand, have always seen it as the one tax on "the rich" that they can enthusiastically oppose. Thus, in this one case at least, Democratic control of Congress would improve the near-term prospects for pro-growth policy.

What if the GOP manages to hold on to congressional control? One senior congressional source has suggested to us a reason why this might be better for growth than many might expect. The Democratic strategy has been to oppose any and all GOP initiatives with near-unanimity, to make the GOP seem ineffective in the eyes of its own base. This has been difficult for certain Democrats who have gone along with it for the sake of the party, despite their own personal inclination to support particular GOP initiatives. For example, many Democrats publicly support repeal of the death tax, yet voted against it. If the GOP manages to hold on to Congress despite such sacrifices, pro-growth Democrats might vote their consciences in the next session. GOP pro-growth initiatives such as death tax repeal might get a second -- and better -- shot.



JUST TOO MANY COMPETITIVE RACES FOR THE GOP

BOTTOM LINE: A narrow GOP defeat in the House, and narrow continuing GOP control in the Senate, is likely already discounted in markets. A Democratic sweep of unexpected scope could be an unexpected negative, as it could reveal not simply disgust with particular politicians or a particular party, but a broader move away from the preference for pro-growth policies. Similarly, a substantial GOP upset could be an unexpected positive by revealing a move toward the preference for growth policies. Across these two unlikely outcomes there is a negative skew -- sad to say, but even if the electorate revealed hitherto unknown preferences for pro-growth policies, it's not at all clear that the present crop of Republicans would do much about it. **TM**