Agincourt Capital Management, LLC

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Investment Update

"We all know what to do, but we don't know how to get re-elected once we have done it."
Luxembourg's Prime Minister Jean-Claude Juncker

The "prisoners' dilemma" is a classic study in economic game theory that is used to explain how decisions based on narrow self-interest can result in a worse outcome for those who could benefit from sticking together and cooperating. Here's the basic construct: Two people are arrested for a crime that they did, in fact, commit, but the police need the confession of at least one of the pair to wrap up the case. The prisoners are questioned separately, and each is offered a lighter sentence for "ratting out" the other. Now, the optimal solution, from the prisoners' collective perspective, would be for neither of them to talk to the police—if they could count on each other to keep quiet, the police's case would fall apart and each could walk away free. But since there is "no honor among thieves" (and human nature being what it is), each has the incentive to unilaterally break their silence and point the finger at the other guy, since keeping quiet while being ratted out means getting the stiffest punishment of all. The prisoners' dilemma predicts that a sub-optimal solution will always be reached in a world of "imperfect information" as the parties choose to defect rather than to stick together.

Out in the real world, away from the game theorists, the prisoners' dilemma is helpful in explaining, for instance, the difficulty of holding together cartels, such as OPEC, where individual members can make huge profits from unilaterally cheating on agreed-upon production quotas. In fact, OPEC has been far more successful than most cartels; despite long periods marked by rank cheating from stated quotas (and the Saudis' mostly accommodative stance) OPEC is the exception to the rule, having held together now for more than fifty years.

The debate regarding the future course of US fiscal policy, while not a perfect example of the prisoners' dilemma, appears to be at least heading in that direction, as both Republicans and Democrats seem destined to "sub-optimize" their collective choices.

To review, you'll recall that President Obama's successful 2008 campaign included promises of no increases in taxes for "middle class families." While the definition of middle class has been somewhat vague (it now appears that the dividing line is household annual income of $250,000 or less), he has been consistent in stating that he would let former President Bush's tax cuts on the top tax bracket expire (as we all know, essentially all of the tax cuts put in place back in 2003 are due to expire at the end of this year). Now both parties are trying to figure out the best way to position themselves in the debate.

In an ordinary year, both parties would likely look at the enormous budget deficit that has been brought on through years of profligate domestic spending, the war on terror, the fiscal stimulus programs (some would say "bailout," but we're trying not to use hot-button phrases) and the fact that tax receipts are at their lowest percent of GDP in decades and come to the conclusion that some combination of tax rate increases and spending cuts are in order. Newly-elected Conservative Prime Minister David Cameron has announced just that in England in recent weeks, proposing a 26% multi-year cut in overall government spending, combined with increases in the VAT, capital gains tax, and the implementation of a new banking tax. But here in the States, we are heading into mid-term elections, and that makes things considerably more complicated.

Adding to the complexity is the fact that the US economy continues to show signs of anemia. The colossal stimulus programs put in place in late 2008 and throughout last year have largely run off (except the Fed's near-zero interest rate policy and some unemployment benefit extensions and Federal transfers to states), and the economy is having trouble generating organic growth on its own. While this isn't surprising given the massive deleveraging of the consumer/housing/banking complex, the slow pace of the US economy is causing some policymakers to ask whether this is the right time to take on spending cuts and tax hikes.

As a result, the push by the President and most Democrats to let the top income tax bracket rise back to pre-2003 levels has lost considerable momentum, as certain economists (including Mark Zandi of Moody's, who has had the President's ear lately) have warned that raising taxes, even on the top earners, endangers our fragile economic recovery. With the US unemployment rate hovering in the 9.5% range, nobody whose livelihood depends on public opinion wants to be accused of obstructing economic growth. Republicans could use the stumbling of the Democrats to re-establish their leadership role on fiscal matters and propose a real, workable, tax overhaul and fiscal spending plan, but they, too, are focused on reelection and are playing it safe by insisting that all tax rates should remain at current low levels. For political reasons, the Republicans are content to watch the Democrats struggle with how to fix the tax code while waiting to see what changes the fall elections

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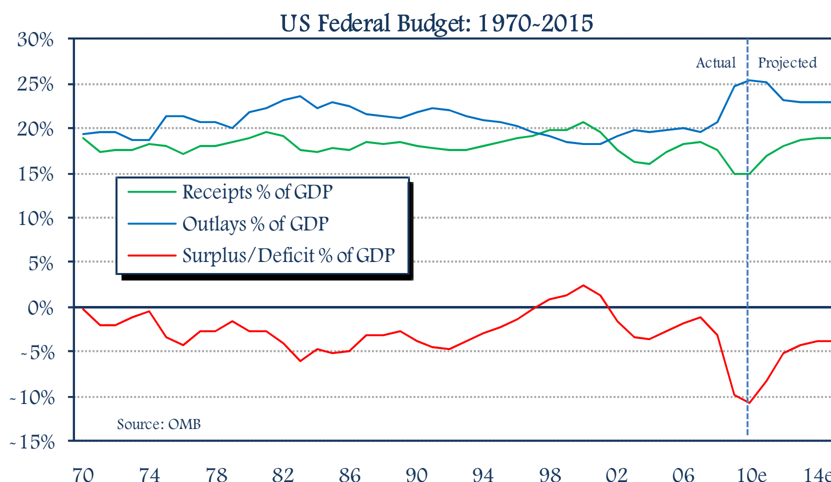
bring. It's conceivable that Congress and the President could bungle this issue completely this fall, allowing all the tax breaks to "sunset" back to pre-2003 levels (an outcome favored by former Fed Chairman Alan Greenspan).

The political posturing is not just frustrating to watch, but in this case, it's just plain dumb. As it turns out, making the difficult decisions and putting in place the appropriate policies to improve the US's fiscal imbalances will both help ensure the long-term health of our economy and may even help a politician get re-elected. Recent studies show that fiscal restraint does not necessarily lead to weaker economic performance. Economists at Deutsche Bank, compiling data for the past 40 years, showed that the US, Japanese, and Euro-area economies with structural budget deficits actually showed stronger economic growth (after a short delay) after putting in place more responsible fiscal policies, especially when those policies involved cuts in spending. This flies in the face of the Keynesian model, which predicts the exact opposite outcome.



Consumers and businesses act on their expectations of what the future may look like. Today in corporate America companies are sitting on piles of cash, at least partly due to the uncertainty of future US policies. The lack of clarity on future tax and spending policies (some of which may fall under the "regulatory" mantle) makes businesses reluctant to make sizable investments in people and capital equipment, while consumers, nervous about their own employment prospects, save more and spend less. This leads to a negative reinforcement loop that is harmful to economic growth. In contrast, Deutsche Bank found (based on a multiple outside studies, from 1990 to 2010) that economic expansions can and do regularly occur when consumers believe that their lifetime income will go up as a result of cutbacks in government borrowing, which has the effect of lowering interest rates for governments, corporations, and individuals.

Furthermore, the quote from Luxembourg Prime Minister Juncker at the top of page one is also, surprisingly, not supported by facts. A 1998 Brookings study by Alesina, Perotti and Tavares showed that governments of OECD countries who took decisive action to reduce budget deficits held up well both in popularity and in subsequent elections. More recent surveys in European public opinion polls further support this notion, while also indicating that voters there take a dim view of opportunistic deficit spending when used as a tool to get re-elected.

US voters are feeling no more charitable towards the management of our economy. An NBC-*Wall Street Journal* poll earlier this month showed a majority of Americans (52%) disapproving of President Obama's handling of the economy. There is clear discontent with the government spending money it doesn't have, while citizens cut back, do without and save more. The voting public wants the government to start working on solutions to our fiscal imbalances, and they're not seeing that happen.

What is "prisoners' dilemma-like" about the current situation is that both political parties have the opportunity to move towards a more-or-less optimal solution, yet neither is interested in cooperation; the result is likely to move us towards a far from optimal outcome. The President has a lot on his plate, but he and his party are in control, and his Treasury department should have developed a better plan than simply bumping up the top bracket. Republicans are no less culpable; after all, fiscal policy has traditionally been their strong suit. Rather than sticking with a status-quo tax code that has consistently fallen far short of generating sufficient tax revenue (20% of GDP should be the initial target for US Treasury receipts), the Republicans should take the reins and come out with a comprehensive plan to get us moving back towards a balanced budget.

But that will not happen this year. Ideally, after the election, Congress and the President (with recommendations coming in December from the bipartisan National Commission on Fiscal Responsibility and Reform) will begin working on true tax overhaul, developing the most efficient and effective way, clear of loopholes, special interests and social engineering policies, to pay for the Government that we all want. The Government we all want will, by necessity, not be able to produce all the things all of us want all of the time; tackling the necessary cuts in the budget must be made, too.

Either through cooperation or compromise, for the sake of our democracy, the people in Washington need to get it together and get our fiscal house back in order.