Weekly Market Commentary

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Washington's Dilemma

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Highlights

The "prisoners' dilemma" is the name of an example of game theory that illustrates why two parties might not cooperate, even if it appears that it is in their best interests to do so—much like the fiscal cliff debate in Washington.

Steps could be taken to mitigate the initial tax and spending impacts of temporarily going over the fiscal cliff to minimize the economic and market damage until a deal can be finalized.

Here's to the hope that this holiday season policymakers can find common ground and work together to resolve their differences, so investors are no longer held prisoner to Washington's dilemma.

The advance in the S&P 500, boosted by the latest three weeks of consecutive gains, is at risk if negotiations over the tax increases and spending cuts, known as the fiscal cliff, make no progress in the coming weeks.

The fiscal cliff negotiations between the two parties in Washington are reminiscent of a prisoners' dilemma. The "prisoners' dilemma" is the name of an example of game theory that illustrates why two parties might not cooperate, even if it appears that it is in their best interests to do so. It was originally created in 1950. The classic example of the game goes like this:

> Two people are arrested, but the police do not have enough information to convict them. The police separate and isolate the two, and offer both the same deal: if one testifies against his partner, and the other remains silent, the first goes free and the one that remains silent gets a one-year sentence. If both remain silent, they get the best outcome: both are sentenced to only one month in jail on a minor charge. But if each rats out the other, they each receive a three-month sentence. Each prisoner must choose either to betray or remain silent; the decision of each is kept secret from his partner until the sentence is announced.

1 The Prisoners' Dilemma

	Prisoner B stays silent	Prisoner B betrays
Prisoner A stays silent	Both serve one month	A serves 12 months; B goes free
Prisoner A betrays	A goes free; B serves 12 months	Both serve 3 months

Source: Albert W. Tucker 12/10/12

In the game, not cooperating with the other party seems like the best option—if you betray them you either get off free, or if they betray you too you get sentenced to only three months. The risk of staying silent on the hope that they work with you is just too high, since you could get a year in jail if they rat you out. In the game, the two parties almost always fail to work together as they pursue their own rational self-interests, even though they both know they would be better off if they did.

This is the situation in Washington right now in the negotiations over the fiscal cliff. The Republicans and Democrats know they can craft a better deal together, but the risk of making a serious offer that includes concessions that may not be met by a similar offer by the other side is too high.

If the Republicans give in and the Democrats do not, the Republicans get nailed with a terrible deal from their perspective and are likely to face primary challenges in 2014. In fact, right after Senate Republican Saxby Chambliss indicated his support for raising tax revenue if it were done in exchange for cuts to entitlement programs, two Republican candidates made it clear they intend to run against him from the right in 2014. Of course, this risk is the same for Democrats as well.

The odds are rising that a deal does not happen in 2012, risking at least a temporary jump over the fiscal cliff. In our *Outlook 2013*, we present our base case path of the economy and markets that includes a deal getting done — either late this year or early next year. It is possible we go over the cliff, but avoid crashing on the rocks below if a deal can be made in early 2013.

Steps could be taken to mitigate the initial tax and spending impacts of temporarily going over the fiscal cliff to minimize the economic and market damage until a deal can be finalized.

- Treasury Secretary Geithner has the authority to leave the IRS income withholding tables unchanged even if tax rates go up based on a section of the tax code that says the tables "provide such amounts to be deducted and withheld, as the Secretary determines to be most appropriate." This could mitigate the impact of the rise in both payroll and income taxes. If Secretary Geithner instructs the IRS not to change the withholding tables, as 2013 begins employers would not withhold any more in taxes from employees' paychecks than they do now, despite the higher rates going into effect.
- Even though the sequestered automatic spending cuts will go into effect at the start of the year, there is no reason why the roughly 10% across-the-board cuts to discretionary spending programs for 2013 must be made evenly during the year. Federal agencies can accelerate their spending in the first part of the year with the intention of relief as a result of a breakthrough on the fiscal cliff or make up for the cuts later in the year.

However, it is unlikely these steps would be taken unless it appeared the parties were close to a deal.

The prisoners' dilemma can tell us a bit about how two isolated parties may choose not to cooperate despite it being in everyone's best interest that they do. Of course, the difference from the game is that in Washington parties are not isolated. They merely choose to be.

Here's to the hope that this holiday season policymakers can find common ground and work together to resolve their differences so investors are no longer held prisoner to Washington's dilemma. ■

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INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.