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CLIENT MEMO

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The Fiscal Crisis in Washington: Who is Really to Blame?

– An Alternative Perspective –



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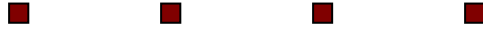
We also attempt to identify and explain significant new theoretical developments in economics and finance, developments that render the world less counter-intuitive. After all, Einstein was right: Good theories are good *because* they work better.

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The Tool of Fools

Once, while watching a Sunday morning TV show, I rebutted the argument of a pundit via a series of sarcastic remarks — after all, ridiculing others can be fun. My wise father was watching the show with me and reprimanded me by pointing out:

“Woody, sarcasm is the tool of fools. Better to convince people of your views by the powers of thought than by sarcastic put-downs.”

Fast forward to what is transpiring in Washington today. In the Sunday *New York Times* of October 6, columnist Maureen Dowd ridiculed in every way possible the views and behavior of that clique of House Republicans who now hold the nation hostage. Her predictably sarcastic op-ed piece was accompanied by a cartoon depicting a future New York City and the Empire State Building in a terribly dilapidated that. The cause? Why the behavior of obstructionist Republicans, of course. Ms. Dowd was writing on behalf of the vast majority of pundits and indeed of American citizens appalled by what has been going on in Washington.

But might there be something to be said for those Republican views? Might today’s consensus as to who is to blame for today’s fiscal distress be off base? If so, might this explain the level of vitriol we are observing in Washington? Let’s delve deeper.

Visit from the Chief Economist of Mars

To answer these questions, consider the following thought experiment. Suppose the American Economics Association invites the Chief Economist of Mars to visit Earth and to prepare a report on how we are doing — a report complete with recommendations on how to improve the lives of Earthlings. Martians are brilliant (as we all know) and their Chief Economist will exhibit the kind of incisive, unbiased, cut-to-the-quick analysis exhibited here on Earth by Singapore’s founding father Lee Kuan Yew — and by virtually no one else. [Anyone doubting this assertion should read *Lee Kuan Yew* edited by Graham Allison and Robert Blackwill, MIT Press, 2013.]

What would the Martian’s report card say, in brief?

Case of Emerging Markets: His principal conclusion would be that emerging markets can effectively choose long-run growth of 6% versus 3% according to whether they instill a *respect* for the rule of law as well as enforce laws on the books; whether they have “inclusive” as opposed to “exclusive” economic institutions; whether the ideal of perfect competition is taken seriously and is enforced; and whether emerging economies trade fairly with other nations, or not. Broadly speaking, the eminent Martian economist concludes that corruption is the arch-enemy of growth, and the extent of corruption will mirror the extent to which these four requirements of economic success and political stability are taken seriously. The eminent economist will remind us that this last observation is a theorem — not an opinion — to be found in the literature of “optimal mechanism design” carried out here on Earth.

Case of Developed Economies: In this case, the Martian’s report would identify two different threats to future prosperity. First there is the risk that the US (and indeed all OECD governments) will fail to rein-in the growth of entitlement spending. To be sure, the economist will express sympathy with the need for the state to step in and assume the role of *in loco parentis* for elderly and needy people, a role historically and traditionally played by the extended family — until today. The economist will also express sympathy for the incentives of politicians seeking re-election: they buy votes by legislating ever-expanding welfare state benefits to voters — benefits that end up being unaffordable. Yet understandable as such behavior may be, the end result is to mortgage the future and thus sow the seeds for the kind of social and political instability we are now seeing in the nations of Southern Europe.

The Martian's second recommendation will be for the US and all other OECD economies to check the power of *special interest groups*. This power grows exponentially as nations mature and get rich: it results in the adoption of counter-productive policies in the Capitol. Drawing upon the path-breaking research of the late Mancur Olson, Jr. (an Earthling), the economist reminds us of the great paradox underlying the institutionalization of special interest groups: **K Street** in Washington ends up lined with the lobbying offices of every possible "special interest group" in the nation — except for one group which happens to be the largest and most important group of all: the citizenry. The light in their office is off — no one represents them.

New Perspective on Today's "Obstructionist" Politics

The current stalemate in Washington is thought to stem from a refusal by recalcitrant Republicans to permit ObamaCare to go into effect — to be "funded" as it were. This was the conventional wisdom until the writing of this essay. Just now, the Republicans are focusing much less on ObamaCare than on the more general issue of "fiscal reform." Yet this shift in emphasis does not amount to very much. All along, those hard-core Republicans who have been so opposed to ObamaCare were opposed to it *because* the healthcare reform act represented a degree of welfare state expansion that threatened the American Dream itself. Their main concern has always been to curtail the growth of government.

But wait: Isn't runaway welfare state spending the very issue that the Chief Martian Economist, Lee Quan Yew, and most OECD economists have identified as being the gravest possible threat to the future? And are not President Obama and leading Democrats the ones who "won't put welfare state spending on the table" — even at the eleventh hour before a debt crisis? If so, then who are the *true* obstructionists here? Whose behavior should we be most concerned about? Why are Republicans alone singled out for ridicule? In brief, the true problem in Washington is that the Democrats will not even discuss (much less reform) what is by far the gravest threat confronting the nation.

Why Such Acute Gridlock? Why A Debt Ceiling Threat?

Traveling around the world, I am often asked why the two sides of the US Congress are as divided as much as they are:

“What explains the enormous gulf between your two parties?” they ask.

The answer to this question is that, when the stakes in a dispute become very large, both sides in a negotiation dig their feet in and end up playing a game of chicken. During most of my lifetime, while there were always policy disagreements across the aisle, the issues at stake and the associated disagreements were rarely so great as to engender today’s level of gridlock. That is to say, the issues were such that, with some leadership by a Lyndon Johnson or a Ronald Reagan or a “Tip” O’Neill, heads could be banged together and a compromise could be worked out. The contentious issue of the Vietnam War between 1968 and 1974 was an exception here, and two presidents arguably fell from office because of it.

In today’s context in Washington, there are two problems that make a Clinton-style compromise very difficult to achieve:

First, there is virtually no leadership from President Obama or from the heads of the Houses of Congress.

Second, the principal issue at stake is absolutely fundamental and neither side is willing to compromise on it. This issue is whether the welfare state continues to expand as it has for half a century, or whether it will be curtailed. *Retaining welfare state extravagance is the gold standard of the Democratic party, just as reforming it is the gold standard of most Republicans — not merely Tea Party extremists.*

From this standpoint, what is perhaps surprising is that *only* 50-odd Republican members of the House have adopted the take-no-prisoners stance that they have. Conversely, what is *not* surprising is that this intense minority is willing to risk both a government shutdown *and* a debt ceiling crisis. They have only one credible threat strategy available to them, and given the intensity of their beliefs, it is understandable that they are using it. Of course, this is not to condone their behavior.

Prospects for a Debt Ceiling Crisis and a Prolonged Shutdown

– A Game Theory Perspective –

The political crisis in Washington can be modeled as a multilateral bargaining game played between three players: right-wing Republicans; moderate Republicans, and Democrats. What will be the outcome? What might game theory say about the outcome of such a conflict? Two things come to mind.

Relative Threat Strategy Power: John Nash, Jr. first taught us to analyze the prospective outcomes of bargaining games by taking into account the *relative* threat power of the antagonists. In the present case, the Democrats hold the cards because if the Republicans *do* stand pat and a debt ceiling crisis results, the damage done to the Republicans will be much worse than that done to Democrats. This is true for two reasons: Not only will the Democrats be able to credibly blame Republicans for single-handedly causing the crisis, but worse, Republicans may well lose control of the House and continue to be a minority in the Senate. This would be a terrible price for the party to pay, and as the countdown continues, moderate Republicans are likely to abandon the right wing's cause. This suggests that a compromise will soon be reached, one in which the Republicans buckle.

“Mistakes Equilibria”: Above and beyond the role of relative threat power, a bargaining game can be analyzed in terms of the number of players involved (and hence the number of coalitions that can form) as well as in terms of the information structure of the game.¹ The fundamental theorem in this regard stems from the work of the two Nobel laureates John Harsanyi and Reinhard Selten. They taught us that, the *fewer* the number of players (and thus the fewer the coalitions that may form) and the *more* “complete” the information structure is, then the *more likely* it is that a compromise will be reached.

The present game of chicken is a three-person game as identified above, and it is a game of complete information in that all the players know both the preferences and the options of the others.² According to theory, this makes it likely that a compromise will be reached, obviating the need to utilize threat strategies. In the case of a game with four or more players (where many more coalitions can form and where the players do not know each others' preferences

¹ If there are n players, then there will be $2^n - 1$ possible coalitions of the players.

² More formally, all players know each others' utility functions and strategy sets.

and options very well) misunderstandings will most likely occur leading to an unintended “mistakes equilibrium.”

Two Examples: The game that led to the outbreak of World War One is a game of this second variety. There were five empires with blurred and overlapping interests, and myriad possible coalitions between the British, the French, the Russians, the Prussians, and the Austro-Hungarians. Misunderstandings were legion, and “tripping” into war was nearly inevitable. In the opposite direction, the Cold War was essentially a two-person game of complete information. The US and the USSR knew each others’ preferences and options, and there were no coalitional complications. The outcome? No shots were fired over five decades.

To conclude, the game being played on Capitol Hill is a one with few players, with only two coalitions, and with nearly complete information. It is thus *likely* that a compromise will be reached — at least on these theoretical grounds. Likely does not mean certain!

What Would the Founding Fathers Have Thought of Today’s Gridlock?

The readings of Madison in particular suggest that the Founding Fathers would have been somewhat dismayed by what is transpiring — especially so by the lack of any leadership. However, they would have known in their wisdom that, however fractious the process of negotiations may be, it nonetheless represents democracy at work. And this untidy process is vastly superior to the alternative mode of conflict resolution usually adopted throughout human history: a military coup to settle differences. This should give us all something to think about! So should the fact that the concerns of Republicans are better grounded than is the lack of concern of today’s Democrats. The Martian says so.