Memo to: Oaktree Clients

From: Howard Marks

Re: Economic Reality

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*Addendum, June 13: There's been a lot of response since the memo that follows was originally published on May 26. In the discussions that have ensued, I realized that I should have led with something like this:*

> ***Ultimately, economics is the study of choice.*** *Because choices range over every imaginable aspect of human experience, so does economics. . . .*
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> *How do individuals make choices: Would you like better grades? More time to relax? More time watching movies? Getting better grades probably requires more time studying, and perhaps less relaxation and entertainment. Not only must we make choices as individuals, we must make choices as a society. Do we want a cleaner environment? Faster economic growth? Both may be desirable, but efforts to clean up the environment may conflict with faster economic growth. Society must make choices. . . .*
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> *We would always like more and better housing, more and better education – more and better of practically everything.*
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> ***If our resources were . . . unlimited, we could say yes to each of our wants – and there would be no economics. Because our resources are limited, we cannot say yes to everything. To say yes to one thing requires that we say no to another. Whether we like it or not, we must make choices.***
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> ***Our unlimited wants are continually colliding with the limits of our resources, forcing us to pick some activities and to reject others.*** *Scarcity is the condition of having to choose among alternatives. (Macroeconomics Principles, Libby Rittenberg and Tim Tregarthen. Emphasis added)*



*Because of the above, we make economic choices every day. Everyone knows choices like these are inescapable.*

*Everyone, that is, except for politicians. The politician promises better grades and more leisure time. A cleaner environment and faster economic growth. That's what caused me to write the memo:* ***in politics and government – unlike the real world – the word "or" often goes out the window, replaced by "and." No choices are necessary.***

*A few months ago I saw a cartoon featuring caricatures of two primary opponents. Under one it said "bulls**t" and under the other it said "free s**t." There's bound to be a lot of the former in any election season, but economics tells us the latter is unrealistic. I wrote this memo to help readers understand why.*

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In 1977, responding to the difficult energy outlook brought on by the Arab Oil Embargo, President Jimmy Carter created the position of Secretary of Energy and chose James Schlesinger as America's first "energy czar." Previously Schlesinger had served as Chairman of the Atomic Energy Commission, Director of Central Intelligence, and Secretary of Defense, and in his early days he taught economics at the University of Virginia. I was tickled by a story – undoubtedly apocryphal – about his days in academia that made the rounds when Schlesinger was in his new energy post.

As the story went, Schlesinger was such a convincing evangelist for capitalism that two students in his economics class decided to go into business after graduation. Their plan was to borrow money from a bank, buy a truck, and use it to pick up firewood purchased in the Virginia countryside, which they would then sell to the grandees in Georgetown. Schlesinger wholeheartedly endorsed their entrepreneurial leanings, and they proceeded with great enthusiasm. From the start of their venture, the former students could barely keep up with the demand.

Thus it came as quite a shock when their banker called to tell them the balance in their account had reached zero and the truck was about to be repossessed. They contacted Schlesinger, and he listened attentively as they recounted their experience: they had, in fact, been able to acquire vast amounts of wood for $50 a cord, and they'd been able to sell all they had for $40 a cord. How could they be broke? Where had they gone wrong? Schlesinger puffed on his ever-present pipe and said: "The answer's obvious: you need a bigger truck."



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While it certainly wasn't the case with Schlesinger (despite what the above tale suggests), most ordinary citizens don't have what it takes to figure out what is and isn't economically feasible. Since we're in the midst of election season, with promises of cures for our economic woes being thrown around, this seems like a particularly appropriate time to explore what can and can't be achieved within the laws of economics. Those laws might not work 100% of the time the way physical laws do, but they generally tend to define the range of outcomes. It's my goal here to point out how some of the things that central banks and governments try to do – and election candidates promise to do – fly in the face of those laws.

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When I was in high school, one of my buddies convinced me to take a class in accounting. I found the double-entry bookkeeping we learned to be logical, symmetrical and unambiguous. After accounting I moved on to economics, and I found it equally logical. The die was cast for my career in business.

Like the lesson of the Schlesinger story, the rest of economics is also pretty straightforward, and its laws are quite reliable. If you buy for $50 and sell for $40, you won't make money . . . period (or stay in business long). That reminds me of a joke I used in "bubble.com" in January 2000, one my father told me roughly 60 years ago:

> "I lose money on everything I sell."
> "Then how do you stay in business?"
> "I make it up on volume."

For those of us in the business world, economics defines reality. (You may think you've heard me poke at it, but what I deride is economic forecasting, not economics. There's a big difference.) The realities of economics are the subject of this memo. My primary methodology will be to describe ways in which people (and especially politicians) tend to propose things that conflict with economic reality, and explain why they're unlikely to work.

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Let's start with central banks' attempts to achieve monetary stimulus. When central banks want to help economies grow, they take actions such as reducing the interest rates they charge on loans to banks or, more recently, buying assets ("quantitative easing"). In theory, both of these will add to the funds in circulation and encourage economic activity. The lower rates are, and the more money there is in circulation, the more likely people and businesses will be to borrow, spend and invest. These things will make the economy more vibrant.

But there's a catch. Central bankers can't create economic progress; they can only stimulate activity temporarily. GDP, or national output, can be seen roughly as the amount of labor employed times productivity, or the amount of output per unit of labor. In the long term, these things are independent of the amount of money in circulation or the rate of interest. The level of economic activity is determined by the nation's productiveness.

Central bank actions can encourage or accelerate economic activity, but they can't create economic activity that otherwise wouldn't occur. Much of what central banks do consists of making things happen today that otherwise would happen sometime in the future. It's not clear that the effects are long-lasting or anything more than an acceleration of events within the confines of a zero-sum game. What is beneficial, however, as Professor Randall Kroszner of the Chicago Booth School of Business wrote me, is the fact that:

> [Central banks] can help to prevent a complete financial meltdown and the negative economy-wide externalities associated with a financial collapse. In these circumstances, and if done appropriately, their actions can do more than just move up future production to the present by helping to avoid economic activity losses due to a panic.

In the old days, when cars often failed to start, there were fluids we could squirt into the carburetor to get them going. But they weren't fuel for long-term operation.

For example, lending people money can enable them to buy things today that they otherwise mightn't have bought until later (if at all). If a consumer buys a boat today with money made available through a low-interest loan, that's a boat he won't buy next year. Lending people money doesn't alter their lifetime incomes, meaning consumers may buy fewer boats later, when the loans have to be repaid, causing disposable income to contract.

**So far, as the last seven years show, (a) central banks haven't been able to generate the growth they hoped for and (b) the impact of each successive jolt of stimulus seems to have been less powerful.**

Rather than believing central banks can make economies more productive, it's my bottom line that there's a naturally occurring growth rate for each economy, and that rate dictates the long-term output, not central bankers' actions.

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What have the following places had in common in recent years: China, Ireland, Spain and Arizona? The answer's simple: large numbers of empty new homes. In the last decade-plus, governments and central banks chose to encourage economic growth in these jurisdictions by making financing readily available for construction. This can do wonders for an economy . . . as it did in these cases in the years leading up to the crisis of 2007-08.

Construction increases the demand for labor, building materials, support services and ancillary businesses. There's only one catch: easy financing – especially if sufficient to cover 100% of costs – can encourage developers to create space for which there's no demand. The process of creating unsalable homes, unneeded office space and uneconomic infrastructure adds to GDP in the short run but burdens the countries' financial systems, especially the institutions that make the loans to builders. In the end, the bad loans stay with the banks, perhaps necessitating bailouts.

Another example can be seen in the case of Sainty Marine, a Chinese state-owned enterprise that recently made headlines by becoming China's first listed company to file for bankruptcy. Sainty Marine first bought and sold ships and then transitioned into shipbuilding, acting on contracts that – unlike elsewhere in the industry – were entered into without the benefit of financial guarantees. It needed financing in order to build those ships, and got it from state-owned banks. **But when a state-owned bank lends money to a state-owned shipbuilder, who's making business-like decisions? Who worries about issues like whether there'll be charters for the ships and whether owning them will be profitable?**

The point is that mistakes like overbuilding are always possible – but they're much more likely to occur if no one's making decisions on an economic basis. If lending personnel are making loans without a direct stake in their repayment, they're less likely to say "no" to weak loan applicants. And if borrowers won't be affected by a failure to repay loans, which of them will decline offers of financing?

Not all loans work. And when they don't work, both the lender and the borrower are usually affected. As someone once said, "bankruptcy is to capitalism as hell is to Catholicism." **When the parties involved aren't motivated by profit or worried about loss, good economic decisions are unlikely to be made.**



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Riding to work the other day, I heard about protests occurring in France. Workers were complaining about potential changes in labor regulations that would make their jobs less secure. In brief, French workers like it the way things are: they can't be pushed beyond 35 hours a week, and employers' ability to terminate them is subject to a drawn-out, torturous and uncertain program. They also like their lengthy vacations and the extensive benefits provided by the state. **The question is where the ability to pay for above average benefits will come from if neither the hours worked nor the productivity per hour is above average.** Governments and regulations can't produce prosperity.

In the current campaign, Bernie Sanders has called for free health care and free public college education for all. And all the candidates have sworn to protect the current level of Social Security benefits, which are sure to render the system insolvent absent other changes. Benefits like these have to be paid for. This can be done either out of "current earnings" – a share of GDP (i.e., tax revenues) – or through borrowings. But governments can't create out of thin air the means with which to make disbursements. In that way they're not so different from households or businesses.

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One way some governments think they can pull off the miracle of providing more is by raising taxes on the rich. After all, the rich have – by definition – more money than they need: everyone else gets by on much less.

"Populism" has been a strongly rising element in politics over the last decade. It primarily means drawing class distinctions and claiming to be on the side of the common man. This often comes down to playing on the resentment of the lower-earning majority toward the wealthy minority. Populism is a particularly strong force in the U.S. presidential election now underway, fed by economic dissatisfaction among the working class due to the effects of globalization, job outsourcing, and technological progress with which some haven't kept up. "Outsider" or non-establishment candidates in both parties – Donald Trump and Bernie Sanders – are having a lot of success telling voters the economy isn't working for them and appealing to resentment toward those who are doing better. Now even Hillary Clinton is saying of the wealthy and powerful, "The deck is stacked in their favor . . . my job is to reshuffle the cards."

Taxes are the main instrument for politicians to put class resentment to work. Many eventually resort to an old saw: "We're not out to soak the rich. We just want them to pay their fair share." I discussed this subject at length in "It's All Very Taxing" (November 2011). In my view, however, (a) there's no way to determine what the fair share is, (b) there are only the opinions of self-styled experts on this subject, and (c) "fair share" always seems to come down to "more than they've been paying."

**It makes sense to assume that most democratic societies eventually will reach the point where the majority views the top tier as a cash cow available for unlimited milking. "Let's hit them for a little more; there's nothing they can do about it." But the truth is, this "tyranny of the majority" is an unhealthy development.** First, society does better when able members have strong incentive to contribute. Second, upward aspiration and mobility will be constrained when taxes become confiscatory. Finally, taxpayers aren't necessarily powerless in the face of rising tax rates.

That brings me to an article that appeared in *The New York Times* on April 30, entitled "One Top Taxpayer Moved, and New Jersey Shuddered." It concerns the impact of rising rates on taxpayer behavior, starting from the fact that New Jersey's biggest single earner had moved to Florida. (New Jersey has raised its top income tax bracket from 6.37% in 1996 to 8.97% today, whereas Florida doesn't have a state income tax.)

> "If you're making hundreds of millions of dollars and you're paying close to 10 percent to the state of New Jersey, you do the math," said John Bramnick, the Republican leader in the New Jersey Assembly. "You can save millions a year by moving to Florida. How can you blame him?" . . .
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> In New York, California, Connecticut, Maryland and New Jersey, the top 1 percent pay a third or more of total income taxes. Now a handful of billionaires or even a single individual . . . can have a noticeable impact on state revenues and budgets. . . .
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> In California, 5,745 taxpayers earning $5 million or more [or only 4/100s of a percent of the 13.6 million returns filed] generated more than $10 billion of income taxes in 2013,

> or about 19% of the state's total, according to state officials. "Any state that depends on income taxes is going to get sick when one of these guys gets a cold . . ."

While not everyone would change their residence to reduce their taxes, some will. Remember that seven of the 50 states do not tax their residents' incomes. **Thus the bottom line on this – I think the good news in terms of fiscal responsibility – is that states have no choice but to think of taxpayers as mobile. If you raise the top tax rate by 10%, you won't collect 10% more taxes from them.** A surprisingly large number of the people Nancy and I meet in New York have their residences in Florida. That's a reflection of economic reality – and should restrain the tendency to excessively tax the rich.

The U.S. is one of only a tiny number of countries whose citizens are taxed on all their worldwide income, regardless of where they live or where their income is earned. Thus, Americans don't have a good way to escape federal income taxation by moving abroad. (Technically, they can leave the U.S. tax system by paying the taxes that would be due if they were to sell all their assets and realize all the appreciation to date. But they also have to surrender their citizenship and sacrifice frequent visits to the U.S., and the number of people willing to do all this is limited.)

Citizens of almost every other country have an easier way to respond when the "soak-the-rich" movement arrives (see the big earners who moved away when France enacted a 75% top rate a few years ago). **Thus most governments are aware that while they can raise tax rates on people of means, in most cases they can't make them sit still and take it.**



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**Another way national governments can make it easier to accomplish their financial goals is by printing money. But flooding the market with more currency debases the value of the currency.** They can increase people's nominal incomes, but eventually they'll find their fatter wallets don't contain any more spending power than they used to.

In "The Limits to Negativism" (October 2008), I discussed the fact that in Weimar Germany, the government took the 1,000 mark note and over-stamped it "One Million Marks." But it still only bought one goat.

> The mark fell from 60 to the U.S. dollar in early 1921 to 320 to the dollar in early 1922 and 8,000 to the dollar by the end of 1922. It's hard to believe, but according to Wikipedia (user-maintained and perhaps not always the most authoritative):
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>> In December 1923 the exchange rate was 4,200,000,000,000 Marks to 1 U.S. dollar. In 1923, the rate of inflation hit 3.25 x $10^6$ percent per month (prices double every two days).
>>
>> One of the firms printing these [new 100 trillion Mark] notes submitted an invoice for 32,776,899,763,734,490,417.05 (3.28 x $10^{19}$, or 33 quintillion) Marks. [That's not a misprint.]

The great advantage for governments in creating inflation lies in the ability to meet obligations with debased currency. That was the motivation behind Germany's hyperinflation in the 1920s – to make it easier to cover expenses and debts denominated in Marks.

Today most nations want to see inflation. That would reduce the "real" value of their national debt and ease repayment in real terms. Treasuries and central banks have tried to encourage inflation by cutting interest rates and increasing the amount of money in circulation. Quantitative easing, for example, consists of the Fed using newly printed dollars to buy outstanding debt; this should increase the amount of money in circulation and thus raise the dollar price of goods. Voilà: inflation.

But governments' efforts have been strikingly unsuccessful and, so far, inflation is MIA. Inflation is a mysterious (and, I think, largely psychological) phenomenon. **The U.S. government couldn't figure out how to stop it in the 1970s, and the nations of the world can't find a way to start it today.** Classically, inflation has resulted from (a) "demand pull" – too many buyers for a fixed supply of goods, or (b) "cost push" – rapid increases in the costs of production. Neither of these causes is in evidence today. Thus inflation is quite feeble, and that's disappointing to countries that would like to pay their debts with cheaper currency.

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A related tool for national economic betterment consists of another route toward currency debasement: devaluation. A nation can increase its ability to deal with the rest of the world by adjusting its currency's rates of exchange.

Let's say the U.S. wants to increase its exports of manufactured goods. One way to do this is to make the goods cheaper. But what if the dollar costs of manufacturing can't be reduced? In that case, why not just reduce the amount of foreign currency it takes to buy a dollar's worth of goods?

For example, let's say the selling price of a U.S. widget is $100, and there are 10 Ruritanian kopeks to the dollar. Thus a widget costs 1,000 kopeks in Ruritania. Say we change the exchange rate to 8 kopeks to the dollar. Now that widget costs a Ruritanian buyer only 800 kopeks. The number of dollars the U.S. seller receives is unchanged, but the number of kopeks the Ruritanian buyer has to pay for a widget is reduced by 20%. Sales of U.S. widgets to Ruritanians skyrocket.

Of course, while a weaker currency makes a country's exports more competitive, it also means its citizens have to pay more of their home currency to buy imports. **So, as in the case of the other things under discussion here, there's no free pass. There's little a country can do in terms of policy actions to improve its situation that (a) doesn't have negative ramifications and (b) will enhance the long-run outlook in the absence of fundamental improvement in economic efficiency.**

And, by the way, here's another wrinkle: you can't just devalue your currency; you can only devalue it **against another currency**. What happens when multiple countries want to devalue at the same time? China tries to devalue the yuan versus the yen, but Japan tries to devalue the yen relative to the yuan. This is called "competitive devaluation." **The one thing we can be sure of is that every country can't simultaneously devalue versus all the others . . . try as they may.**

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This discussion of devaluation and exchange rates leads eventually to the entire issue of globalization and international competition. Globalization is one of the most important and influential topics today, and it is shaping economic progress and political discourse.

Let's go back to the early post-World War II period. The U.S. mainland was physically and economically intact – having been spared from combat – while Europe and Japan had been decimated. U.S. corporations were performing strongly, and the prosperous U.S. consumer was the source of powerful demand. In most fields, American products were the best in the world. "Imported cars" were essentially non-existent, and the television sets, hi-fis and appliances our parents (or grandparents) bought were produced here. Even our clothing was made in America.

In this very positive economic environment, consumers, producers and workers all thrived, and in most regards, Americans enjoyed the highest standard of living in the world. Now that is in doubt, and this has become a main issue in the presidential campaign. Here's how I put things in "What Worries Me" (August 2008):

> One of the reasons for our high standard of living is the fact that Americans have been paid more for doing a given job than everyone else. This was fine as long as (a) the U.S. enjoyed the benefits listed [earlier], and (b) significant barriers protected the status quo. But why should this go on? How can it go on?
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> Think about two cities. City A has more jobs than people, and city B has more people than jobs. Initially, people in city A – where labor is relatively scarce – will be paid more for doing a given job than people in city B. **The key to their continuing to earn more is the existence of barriers that prevent people from moving to city A.** Otherwise, people will move from city B to city A until the ratio of people to jobs is the same in both cities and so are the wages. **Among other things, geographic inequalities are dependent on the immobility of resources.**
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> For much of the last century, barriers kept our pay high. Other countries' output wasn't as good as ours. Some lacked investment capital, and some were decimated by war from time to time. Perhaps they didn't possess our ability to generate technological advancements or our managerial skills. High transportation costs, tariffs, prejudices (when I was a kid, "Japanese transistor radio" was synonymous with "low quality") or legal restrictions (e.g., keeping foreign airlines from competing freely in our markets) may have protected American wages. International trade wasn't what it is today. But all of these things can change over time, and it's hard to see how the earnings supremacy of U.S. workers will be sustainable. . . .

In 1949 we saw the arrival of a little car called the Volkswagen Beetle. It was odd, with its rounded shape and the engine in the back, but boy was it cheap: roughly $1,300. The quality of foreign cars was initially the subject of skepticism, but over time quality improved, the superior price/value bargain overcame cultural resistance, and the share of car sales going to imports grew.

Two Volkswagens were sold in the U.S. that year, then hundreds, and then many thousand. Soon Japan started to send over the Toyota, Datsun (now Nissan) and Honda, and they were successful, too. To put their success into perspective versus those two Beetles in 1949, in 1981 the Japanese automakers entered into a "voluntary restraint agreement" limiting the number of cars they could bring into the U.S. to 1.68 million per year. More recently Korea began sending cars to the U.S. Today foreign brands account for more than 55% of car sales in the U.S. market. Of course a good part of the success of imports has been related to lower costs. (A substantial number of the "foreign brand" cars sold in the U.S. today are actually made here, but in non-unionized plants at total labor costs including benefits that average \$10/hour, or \$250/car, less than the U.S. carmakers' unionized plants. In the past, when foreign cars were actually made abroad, the cost differential was much more dramatic.)

**U.S. automakers' market share was destined to decline if foreign cars were some combination of better and cheaper. And when it did, U.S. autoworkers' income and standard of living had to start to equalize relative to those building better-value-for-the-money cars abroad.** Trade barriers, high transportation costs, a strong union and inertia kept the U.S. worker ahead as the 20th century wore on, but eventually reality caught up with the industry.

Here's an example: the autoworkers' union had bargained for excellent benefits for auto workers, and according to the Economic Policy Institute:

> In 2005, there was a gap of \$3.62 between the average hourly wage of \$27.41 at Ford and \$23.79 for [foreign-owned plants]. When fringe benefits, legally required payments, pension benefits, retiree health care, and other post-employment labor costs are added in, the gap grew to \$20.55 (\$64.88 versus \$44.33).

There was a limit on the ability of U.S. automakers to sell cars burdened with substantial benefit costs while foreign car costs included much less for benefits. **The bottom line is that, in a globalized world, if people in country A will work for less than those in country B, there are only four possibilities for manufacturers in country B:**

- **charge a higher price for the same product and lose market share,**
- **charge the same price for the higher-cost product and enjoy smaller profit margins (or even suffer losses),**
- **charge the same price for an inferior product (this probably can't be done for long), or**
- **get the government to erect trade barriers on imported goods, such as a tariff that equalizes selling prices or a quota that restrains competition.**

Thus the operating and financial condition of U.S. automakers deteriorated such that, during the Global Financial Crisis, General Motors and Chrysler declared bankruptcy (enabling them to cut costs and shed benefits), and Ford underwent a thorough restructuring with the same result. Workers' more modest contracts since then have, of necessity, caused their relative standard of living to decline. This is an example of the reasons behind the working class's current discontent.



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**Of course, this leads me to the idea that probably did more than any other to set the wheels in motion for this memo: "we'll bring back the jobs."** One of Donald Trump's most emphatic promises is that he will respond to America's loss of manufacturing jobs to other nations by causing goods to be made here again. Bernie Sanders opposes free trade and argues we must "develop trade policies which demand that American corporations create jobs here, and not abroad." Are these actionable positions?

(A minute for an aside: U.S. manufacturing employment of 12.3 million workers is down 37% from the peak of 19.5 million reached in 1979. So when did the value of manufacturing output hit its peak? The answer may surprise you: **today!** The current level of U.S. manufacturing output is in the vicinity of the all-time high and roughly double the 1979 level. Twice the output with less than 2/3 the workers means output per worker has more than tripled. Thus, if we were producing today's output at the 1979 level of productivity, we'd be employing 25 million more workers! So while we've lost 3.2 million jobs to China since 2001, for example, we've lost many times that to improvements in productivity. **Perhaps if the government wants to preserve jobs it should just outlaw productivity gains.** That thought reminds me of the early-19th-century Luddites, English textile workers who were unhappy about industrialization and banded together to destroy labor-saving factory machinery. Of course, history shows it's hard to hold back economic progress by edict or force of will.)

Let's assume it's possible to manufacture high-labor-content goods like cellphones much more cheaply in China than in the U.S. (not an unreasonable assumption, since the average manufacturing worker in China makes less than $9,000 per year). And let's assume the resulting cost to deliver a cellphone to an American retailer is $100 if made in China versus $150 if made in the U.S. In that case, a Trump or Sanders administration would have the following choices:

- forbid imports of cellphones, requiring that they be made in the U.S. at a cost of $150,
- find Americans willing to work at Chinese wages, bringing the cost down to $100, or
- impose a trade tariff on Chinese imports that equalizes the U.S. retailer's cost for phones at $150.

I'm not aware of any other possibilities. The first probably isn't feasible in this day and age. The second is equally unlikely, since few Americans are likely to elect to do the tedious work involved, and the Chinese wage of less than $5 per hour would violate our federal minimum. That leaves the third option: tariffs. And, in fact, Mr. Trump has said he would impose a 45% tariff on Chinese imports, 35% on Mexico, and various tariffs on goods from other countries. Here are some of the problems with that:

- First, such tariffs are probably barred under trade agreements that are in place. To impose them, we would have to abrogate those agreements.
- We have to wonder about retaliatory actions – wouldn't other countries impose offsetting tariffs on U.S. exports that would further harm our manufacturing base? As *The New York Times* wrote on May 3, "starting a trade war might be cathartic for workers who have lost jobs, but it is unlikely to create a lot of factory work."
- What would happen to our ability to refinance our perpetually growing national debt if China, our biggest creditor, decided one day it wasn't quite as eager to participate in new Treasury financings?
- What would rising barriers do to one of the main motivations behind the broadening of U.S. trade agreements since World War II: preventing conflict?
- **Finally, but most simply, what American wants to pay 50% more for a cellphone than he does today?**

What we have here is a reminder that "economic common sense" isn't so common. Have the voters who think it's a great idea to "bring back the jobs" thought about what goods manufactured at U.S. wages – or tariffs designed to bring the cost of Chinese goods up to those levels – would do to their cost of living? I'd guess not. **How will the interests of the 3.2 million Americans estimated to have lost their manufacturing jobs to China be balanced against the hundreds of millions who would have to pay considerably more for imported goods? Not an easy question.**

Quotas, tariffs and subsidies are all ways for countries to protect industries that can't hold their own against international competitors without these things. Thus they're a good example of ways in which policy decisions can lead to distortions. **Since the industries for which tariffs and subsidies are**

**established are, by definition, industries that can't compete without them, for these things to be enacted, someone has to make a decision that (a) these industries should be kept afloat and (b) consumers of these industries' goods should be prevented from paying the lower prices that would prevail if consumers had easy access to goods from abroad, free of tariffs.**

Do we want to subsidize our farmers, or do we want to allow Americans to buy cheap crops from abroad (and let the farmers go out of business)? Leaving aside strategic national considerations, do we want to protect the jobs of those who work in industries where the U.S. is uncompetitive, or do we want to allow U.S. consumers as a whole to minimize their cost of living? **In each case, it's one or the other . . . but not both.**

The bottom line, as with so many of the things I'm discussing here, is that economic laws cannot be ignored or magical solutions willed to appear. While it's far from the entire explanation, the main reason the U.S. has lost manufacturing jobs to foreign countries is that people there are willing to work for much less. **In this globalized world, that means Americans can't enjoy both the high-paying manufacturing jobs they used to have <u>and</u> the low-cost goods they've been buying of late. The imposition of tariffs can't solve that conundrum.** As long as American workers demand wages higher than people elsewhere, they're unlikely to manufacture much for the rest of the world, or for themselves, either. This is an incredibly clear example of how economic reality makes it hard to find easy solutions to difficult problems.

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While on the subject of wages, it's appropriate to mention the minimum wage. The U.S. government first established a federal minimum wage of $0.25 an hour in the Fair Labor Standards Act of 1938. It has been raised 22 times since then and now stands at $7.25. At the state level, there's a patchwork of regulation. A few states don't have a minimum wage. Some have minimums that are below the federal level. Many states use the federal minimum, and a bunch have minimums higher than the federal level.

Just this year, however, increases in the state minimum to $15 (with exceptions) have been enacted in California (by the end of 2021, from $10 today) and in New York (by the end of 2018-19, from $9 today). As the wages of the lowest-paid workers increase, where does their newfound prosperity come from, and what will be the effects?

The debate over increasing the minimum wage is loud and inconclusive . . . and mainly a matter of ideology. Conservatives and business interests are sure an increase in the minimum wage will be disastrous for both business and workers. If higher wages drive up selling prices vis-à-vis competitors who face lower labor costs, business and jobs will suffer. If selling prices and non-labor costs are unchanged, there's a fixed pie to be divided up (between workers' wages and business owners' profits). Thus, if you mandate higher pay per worker and the owners' slice remains the same, the wage slice of the pie by definition will cover fewer recipients; the result is job losses. And if instead you take the higher wages out of the owners' part of the pie, fewer businesses will start up, and some might close, again resulting in job losses.

Liberals and labor organizations, on the other hand, insist there will be no material impact. For example, according to a study from the National Employment Law Project, following most of the 22 federal increases since 1938, job formation didn't slow from what it had been. And in the few cases where it did slow, the increase took place in recessionary times, so maybe it wasn't the result of the wage increase.

In between these polar positions (neither of which is probably completely right), there are lots of things to think about:

- What's right for undifferentiated businesses (think fast food) in a high-minimum-wage state abutting one where the wage is much lower?
- Is the same minimum wage right for all businesses in a given state regardless of their varying degrees of labor-intensiveness?
- Is the same minimum wage right for all businesses in a state regardless of their profitability? And what about non-profits like hospitals, with their heavy reliance on low-cost labor?
- Is the same minimum wage right for all parts of a state regardless of the differences in their economic vibrancy and cost of living?
- And is a benign job-formation-impact history relevant given that we're now talking about increases of 50-100%, large changes relative to history, and given that the U.S. no longer has all the growth potential and competitiveness that it did when the prior increases took place?

Senator Sanders has said he'll enact a $15 minimum federal wage. Is it possible that $15 is an appropriate minimum for all regions, states and cities? (It's interesting to note in this regard that the proposed changes in New York and California treat New York City differently from Rochester, and Los Angeles differently from Bakersfield.) And if a single minimum wage isn't right for every location, what government commissariat will perform the impossible task of setting the right minimum for each one?

I don't mean to decide the minimum-wage issue here, but rather to say it's not an easy subject. **It seems unlikely that you can make everyone better off just by mandating a higher wage.** Some businesses will become less successful or non-viable. Business formation may be discouraged. The breakeven cost for further investment in automation will decline. (Headline from today's *Washington Post*: "Ex-McDonald's CEO says raising the minimum wage will help robots take jobs") Some workers may lose their jobs or fail to get jobs. Remember, governments and regulators don't create wealth, they only redistribute it. Their impact is largely a zero-sum game except in the longest-term sense.



* * *

As an avowed "democratic socialist," Bernie Sanders expresses hostility toward business, especially the financial sector – "The business model of Wall Street is fraud" – and he sounds like he'd go pretty far to regulate the economy. For instance, he's said he will break up the big banks (without much mention of how).

Rather than go into all the economic laws his policies violate, I'll simply ask some questions I consider relevant:

- What has been behind the United States' progress to the top of the world's economic heap? (If he doesn't attribute a lot of our success to the capitalist, free-market system, then we disagree.)
- Where are the countries that have thrived under control economies? How about the U.S.S.R. and East Germany? (Didn't the ability to watch the former East Germany and West Germany side-by-side provide a good controlled experiment?) How do average folks live in Cuba, Venezuela and Vietnam? Why is China continually increasing its use of free-market techniques?

How about an example of central economic control in action? Here are some excerpts from an article about Venezuela that appeared in *The Atlantic* of May 12, 2016 (I've added some emphasis and reordered the paragraphs):

> A case in point is the price controls, which have expanded to apply to more and more goods: food and vital medicines, yes, but also car batteries, essential medical services, deodorant, diapers, and, of course, toilet paper. **The ostensible goal was to check inflation and keep goods affordable for the poor, but anyone with a basic grasp of economics could have foreseen the consequences:** When prices are set below production costs, sellers can't afford to keep the shelves stocked. Official prices are low, but it's a mirage: The products have disappeared.

**Here's a shocker: you can set prices for goods, but you can't make people produce them.** That sounds a lot like economic reality.

These ineffective – or counterproductive – price controls were only one part of a huge economic mess. How did it arise?

Not long ago, Venezuela – "a seemingly modern, seemingly democratic nation just a few hours' flight from the United States" – was wealthy and a good place to live.

> Sitting atop the world's largest reserves of oil at the tail end of a frenzied oil boom, the government led first by [Hugo] Chavez and, since 2013, by [Nicolas] Maduro, received over a trillion dollars in oil revenues over the last 17 years.

But then it saw the beginning of:

> The experiment with '21st-century socialism' as introduced by . . . Chavez, a self-described champion of the poor who vowed to distribute the country's wealth among the masses, and instead steered the nation toward the catastrophe the world is witnessing under his handpicked successor Maduro . . .
>
> In the last two years Venezuela has experienced the kind of implosion that hardly ever occurs in a middle-income country like it outside of war. Mortality rates are skyrocketing; one public service after another is collapsing; triple-digit inflation has left more than 70 percent of the population in poverty; an unmanageable crime wave keeps people locked indoors at night; shoppers have to stand in line for hours to buy food; babies die in large numbers for lack of simple, inexpensive medicines and equipment in hospitals, as do the elderly and those suffering from chronic illnesses.

This is the fate that has befallen a once-wealthy and once-modern nation operating under central economic control. Shall we give it a try?

*   *   *

For me, the bottom line on economic reality is that, in the short run, governments theoretically have the ability to:

a) **accelerate economic activity**, bringing forward to today otherwise-future activity,
b) **make life better for one group of citizens at the expense of another** (e.g., the rich versus the poor), and
**c)** **encourage one form of activity versus others** (e.g., investing for capital gains versus investing for dividends).

**One could view these things as potentially helpful policy tools, or as actions that distort the workings of the economy. By definition, they are designed to accomplish results that wouldn't occur if the market were left free.** Perhaps not all the goals are truly desirable, and some may cease being considered desirable after they've been enshrined in law, possibly because of unintended consequences. Some issues – for example, the question of whether income on capital should be taxed higher or lower than income from labor – are just a matter of opinion based largely on political point of view. Some actions taken may be nothing more than patronage and rewards for voter loyalty.

In contrast to the above list of things governments can do to affect economies, there's a significant list of things they can't do.

a) **They can't create much net growth, wealth or prosperity through stimulus alone.** A certain quantum of wealth is produced by an economy. It can be moved around, but governments can't increase it magically.
b) **They can't make everyone better off simultaneously.** For the most part they can only take from one group to give to another. An example is the ability to improve the fortunes of workers in an endangered industry through import tariffs that raise prices for the industry's customers.
**c)** **There aren't many actions they can take that won't have repercussions for people other than the ones they're intending to benefit, and second-order consequences for everyone.** France can enact regulations that protect current jobholders by making it difficult to lay them off, but those same regulations will deter entrepreneurs and owners from starting or expanding businesses and hiring new employees.
d) While governments can provide incentives and nudge people in a given direction, **they can't make economies (or the people in them) perform as desired**. For example, in the 1990s the Japanese government tried to stimulate consumption by mailing out checks (something that's referred to today as "helicopter money"). But its conservative citizens put the money in the bank rather than spend it, turning the government's action into a classic case of "pushing on a string."

**Fundamental improvements – intelligent changes in investment incentives, the tax system or infrastructure, for example – can increase the slope of the growth curve and provide substantial net long-term benefits for a society (although not necessarily for every individual member). Short-term fixes simply cannot create wealth out of thin air.** I'll close with something Winston Churchill said, with some additions of my own: "We contend that for a nation to try to tax [or stimulate or devalue] itself into prosperity is like a man standing in a bucket and trying to lift himself up by the handle."

May 26, 2016

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