Memo to: Oaktree Clients

From: Howard Marks

Re: Shall We Repeal the Laws of Economics?

For months, I've been saving up clippings for a memo on the above topic, but favorite subjects such as risk, debt, and uncertainty repeatedly jumped the queue, delaying my intended memo until the U.S. election season got into full swing, making it compelling.

Like me, you've undoubtedly noticed that politicians ranging from former President Trump and Vice President Harris to down-ballot candidates are back to making promises that ignore economic reality. Trump's call for tariffs and Harris's attack on grocery profiteering are merely two examples of proposals that would impose costs the candidate ignores (in Trump's case) or that fail to reflect a meaningful understanding of the problem (in Harris's case). My purpose, of course, is not to promote or dismiss either candidate, but rather to illustrate that there is no "free lunch" in economics, despite candidates' assertions to the contrary.

The Background

In 2016, with an unusually clamorous presidential election in full swing, I published two memos that strayed from investing into the world at large, called *Economic Reality* and *Political Reality*. The first explained that economics is largely the study of how we make choices – how people allocate finite resources among the available options. The second stated that in politics – and especially in the land of campaign promises – there's no such thing as finiteness. As I wrote in *Political Reality*:

> I've always gotten a kick out of oxymorons – phrases that are internally contradictory – such as "jumbo shrimp" and "common sense." I'll add "political reality" to the list. The world of politics has its own, altered reality, in which economic reality often seems not to impinge. No choices need be made: candidates can promise it all. And there are no consequences. If something might have negative consequences in the real world, politicians seem to feel free to ignore them.

I followed those two memos with one in 2019 entitled *Political Reality Meets Economic Reality*. **Its main thrust was that politicians can promise whatever they want regarding the economy, but they won't be able to deliver if their promises fly in the face of economic reality because, ultimately, the laws of economics are incontrovertible. Free economies are driven by self-interested decisions made by millions of producers and consumers, employers and employees, and savers and investors. Governments can pass laws designed to encourage or even compel behavior, but in general they can't mandate economic outcomes. There are so many moving pieces and second-order consequences that governments generally can't engineer both prosperity and the specific economic outcomes that policymakers may seek.**

History is littered with command economies that didn't succeed. There's proof for this that includes the "control group" required by the scientific method. Eighty years ago, Korea was a single country. Then, following World War II, it was split in two, obviously with similar people, geography and resources: South Korea (under U.S. influence), and North Korea (under Soviet influence). Since then, South Korea has operated as a capitalist democracy and North Korea as a communist dictatorship. There's little

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reliable economic data regarding North Korea, but according to the CIA's *Worldbook*, its GDP in purchasing power terms is estimated at $2,000 per person versus $50,000 in South Korea. North Korea's citizens are described as impoverished, but at least it doesn't have a border problem, since nobody's trying to sneak in. There are political differences (democracy versus dictatorship) in addition to the economic ones, but **I think it's fair to say capitalism has won**.

In discussions of economic systems, I usually ask people what they think has been responsible for the economic preeminence the U.S. has enjoyed since the end of World War I, and thus for its citizens' higher average standard of living. Are Americans smarter? Harder working? More deserving? None of the above. I'm confident it's because of our historical embrace of the free-market system and capitalism.

The incentives provided by free markets efficiently direct capital and other resources where they'll be most productive. They prompt producers to make the goods people want most and workers to take the jobs where they'll be most productive in terms of the value of their output. And they encourage hard work and risk taking. The result is a higher standard of living for society in general, but certainly not everyone benefits to the same degree. Thanks to the way incentives interact with people's different abilities, some people do considerably better than others. Some also prosper thanks to good luck and/or inherited advantage, rather than innate ability. **The free-market system doesn't necessarily produce "fair" outcomes in all circumstances, but economic systems designed to do so generally don't provide the incentives needed to encourage economic productivity for the collective good. That's what accounts for their record of failure.**

On August 15, the media reported that the next day, Vice President Harris would announce her economic policies. The bulk of the attention went to her promise to ban price gouging in the grocery industry. "Grocery prices … have jumped 26 percent since 2019, according to Elizabeth Pancotti, director of special initiatives at the Roosevelt Institute, a left-leaning think tank" (*The Washington Post*, August 15), and many voters say inflation is their greatest concern. For this combination of reasons, Harris's targeting of grocery prices is entirely predictable. (Ironically, August 15 was also the day U.S. inflation was reported to have fallen below 3% for the first time since March 2021.) I'm certain, however, that this falls under the heading of simplistic economic solutions that are designed to appeal to voters but are unsoundly based and likely to fail.

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What Is Price Gouging?

Price gouging is generally defined as sellers taking advantage of market power or temporary supply/demand imbalances to raise prices to levels that otherwise wouldn't prevail. And food prices did rise significantly in 2021 and 2022, leading to suspicion of food retailers. But might there be reasons for the price increases other than a malevolent decision to gouge on the part of sellers? Here are a few possibilities:

- When the pandemic began in March 2020, most people stayed home and cooked their own meals, significantly increasing the demand for groceries and depleting inventories.
- The production system was disrupted, with inputs in short supply or in the wrong places relative to the needs. This led to the much-discussed "supply-chain problems." Too few goods – when coupled with too much money chasing them – constitute the classic reason for inflation.
- The federal government sent taxpayers massive amounts of Covid-19 relief. Many more people received benefits than had been hurt financially by the pandemic. Those people came out ahead, capturing trillions of dollars for future spending.

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- When the Delta variant of Covid popped up in mid-2021, people again stayed home and shrunk from contact with others, spending more on goods and less on services than they otherwise might have. Demand for goods was strong as a result, outstripping the limited supplies and causing prices to rise.

Profit margins in the supermarket industry are low – about 1% to 2% of sales – and that changed only a little in 2021-22. So, was there gouging? And if gouging is the explanation for the price increases, why did it occur in those years, rather than sooner? Again, might today's high prices be explained by something other than gouging? *The New York Times*, rarely a defender of capitalism, wrote the following on August 15:

> Researchers from the Federal Reserve Bank of Kansas City reported last year that rapid job growth in the U.S. economy, and the wage increases that came with it, were major contributors to rising grocery prices.

A number of factors contributed to the increase in food prices, many of them linked to the macro economy. **But the bottom line is that conditions allowed food sellers to raise prices, and they did so.**

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Is Raising Prices Wrong?

The above is the key question. Definitions of price gouging invariably include words like "unfair," "excessive," and "exorbitant." These are subjective terms that are open to judgment and debate. The propriety of behavior with regard to these words is usually in the eye of the beholder. The seller's highly reasonable price increase is the customer's gouging. The difficulty of defining gouging reminds me of those who say, "we're not out to soak the rich; we just want to make them pay their fair share in taxes." I'm far from saying the rich shouldn't pay their "fair share," but what's the standard for a fair share, and who gets to set it? **In the same way, who determines whether prices are fair, and how?**

When a supermarket raises the price of a necessity like bread, is that gouging? The answer is that it's complicated, and that's what makes it hard to regulate prices fairly.

- If the farmer pays more for fertilizer and labor and then charges the baker more for wheat, can the baker fairly pass that on to the supermarket in the form of a higher price for bread?
- If the baker raises the price he charges the supermarket for bread, is it wrong for the supermarket to pass on the increase to the consumer?
- If the supermarket's employees demand higher pay, can it offset the increase by raising the prices of the things it sells?
- If demand increases because a hit TV show popularizes sandwiches, is it wrong for people in the supply chain to take advantage and charge more for bread?

In a free market, prices are determined by supply and demand. Is it wrong per se for providers of goods and services to raise prices in response to reduced supply or increased demand? A few examples should make clear the complex nature of this question.

- Uber applies "surge pricing" during rush hour, when more people want rides. Is that an unfair practice? If the government says Uber mustn't do so, that will make rides available at prices below what some people would pay and deprive drivers of the full fare they could otherwise collect. And the rate the drivers would then receive might not be high enough to justify the time

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they'd spend stuck in traffic, meaning fewer drivers would be available to handle the peak demand and people needing rides would remain unserved. **Is that preferable?**

- If 1,000 tickets for a Taylor Swift concert are put on sale at $100 and 3,000 people line up to buy them, what's the message? Simple: they're too cheap! Would it be unfair for the concert promoter to raise the price until there are just 1,000 people in line? Few people would say so. But if instead the price remains at $100 and the first 1,000 people buy them all, that leaves unmet demand, in which case those who bought the tickets would be able to resell them for more than $100. The profit would go to the resellers, who got their tickets at a price that was too low. Is that fair? **Wouldn't it be fairer if the ticket prices were raised and the increment went to Tay Tay, reflecting the full value her fans put on her labor?**
- In 2021, when people wanted to leave their city apartments, and homes and building materials were in short supply, home prices shot upward. If you owned a home worth $400,000 in 2019 and asked $500,000 for it in the post-pandemic environment, was your behavior immoral? **Should the government prosecute people who asked more for their homes?**
- Lastly, when the economy sprung back to life in 2021 and there were multiple job openings per unemployed worker, making higher salaries attainable, workers were able to tell the boss, "I can get a higher salary down the road. If you don't give me a raise, I'm leaving." Should the government limit wage increases at a time when employees have an edge in negotiations? In the fall of 2023, the United Auto Workers union took advantage of the bargaining power caused by the tight labor conditions to extract from Ford "an 11% wage increase in the first year, and total 25% increase in wages over the 4.5 year contract, a $5,000 ratification bonus and a cost-of-living adjustment." (Wikipedia) **This was a huge package. Did it represent gouging?**

Each of these examples shows one party taking advantage of supply/demand conditions to charge more for the thing they have to offer. But certainly, their actions aren't illegitimate. They're simply examples of how markets work.

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The alternative would be to have the government decide who should prevail in each case. Should it be the Uber driver or the passenger; the concertgoer or the performer; the homeowner or the homebuyer; the worker or the employer? Many have a knee-jerk tendency to sympathize with the passenger, concertgoer, homebuyer, and worker, as it's easy to care less about the person who's profiting: the driver, popstar, homeowner, and employer. **But if the government puts its thumb on the scale in favor of one party or the other, it distorts the workings of the free market and keeps it from functioning efficiently on behalf of society overall.** More on this later.

There are forms of seller behavior that are clearly wrong. These include collusion, price fixing, and predatory pricing designed to drive competitors out of the market. But laws prohibiting these behaviors are already on the books. Additional laws designed to prohibit and punish price increases that someone *views* as unfair, excessive or exorbitant – as opposed to being the result of improper conduct – are sure to prove difficult to enforce and counter-productive.

<u>Would a Law Against Price Gouging Work?</u>

Just as history is full of failed command economies, it also shows the ineffectiveness of attempts to regulate prices. In 1974, when the OPEC oil embargo set off inflation that made life difficult for millions, the U.S. government countered by distributing "WIN" buttons, standing for Whip Inflation Now. I still have mine, but neither it nor the voluntary consumer actions that were supposed to follow were enough to keep inflation from reaching 13.5% in 1980. The buttons were derided, with some skeptics wearing them upside down, according to Wikipedia. "Worn that way, 'NIM' stood for 'No Immediate Miracles,' 'Nonstop Inflation Merry-go-round,' or 'Need Immediate Money.' "

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There's more recent experience with price controls, in Venezuela. Here's what I said about it in *Economic Reality*:

> 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. (*Atlantic Monthly*, May 12, 2016, emphasis added)
>
> **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.

This is an example of the fact that officials may believe they can control economic developments with a stroke of the pen, but they'll be thwarted by second-order consequences that complicate the effort.

There's nothing wrong with trying to bring down the cost of necessities. However, the best way to do this is to encourage additions to supply. Another way is to not overstimulate demand by injecting excessive liquidity into the economy. **Mandating lower prices is generally the least effective way to get them.**

This is a good time for me to cite the economist's adage that "the best solution for high prices is high prices." This isn't a joke; far from it. In general, high prices mean demand is strong relative to supply. Eventually, those high prices will encourage producers to produce more and consumers to consume less, and the depressant impact on prices from both directions is obvious. We see this all the time in the oil market, for just one example.

A government bureaucracy set up to regulate the price of food is very unlikely to succeed and almost certainly would have adverse effects. So, are there no benefits we can count on from price controls? I can think of one: thousands of new (albeit unproductive) jobs in that new bureaucracy. As Jason Furman, a relatively liberal economist, said of Harris's anti-gouging efforts, "This is not sensible policy, and I think the biggest hope is that it ends up being a lot of rhetoric and no reality."

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Another Case in Point: Rent Control

The issue that first suggested this memo several months ago was rent control, something I've had personal experience with, having lived in an apartment that rented for $92 a month in 1956, when I was ten.

The federal government implemented rent control during World War II so that, with few new apartment buildings being built and breadwinners away fighting the war rather than earning their normal wages, families wouldn't be priced out of their apartments. Rents on New York City apartments were frozen at 1943 levels. This was probably a good idea under the unusual circumstances of wartime, but the program wasn't dismantled afterwards, and it still governs some apartments that were built more than 80 years ago. And rent regulation still plays havoc with the supply and demand for New York City apartments.

In general, New York City rent control limits rent increases on apartments so long as they're occupied by people who were tenants in 1971 or relatives who lived with them. The law was enacted to protect the occupants at the time, but apartments have been passed down at controlled rents to people who didn't

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necessarily live in them in 1971. Fewer and fewer people are still around who satisfy the above criterion, so this form of rent regulation is winding down.

Newer regulations continue in force under the rubric of "rent stabilization." One example is Mandatory Inclusionary Housing, which has been explained to me as follows: if you want to build an apartment building and need some zoning relief – and virtually all projects do – you must agree as follows:

- A percentage of the apartments will be "affordable."
- Tenants for affordable apartments must earn incomes well below the average in the area.
- The maximum allowable rent will be set based on a percentage of tenants' income.
- Rent increases upon lease renewal will be regulated, usually at a few percent per year.

Most would agree that it's laudable to encourage the creation of new affordable apartments, but this particular method of doing so has the related effect of increasing the cost of apartment construction. Probably everyone would be better off if there were simply more new apartments built every year.

The bottom line is that rents for the majority of New York City apartments remain subject to one form of control or another and are unlikely to ever become fully deregulated. As a result, the incentives to build new apartments are limited, and between 2002 and 2017, for example, the growth in the number of rental apartments in New York City was only 0.3%, per year.

Improvements in regulated apartments are also regulated. Expenditures on improvements are limited to a very small amount in any 15-year period, and the investment can be recouped only through an increase in the monthly rent equal to a tiny percentage of the cost of the improvements. Thus, making improvements is generally uneconomic:

> Many landlords do not fill their vacant rent stabilized units, as the operational and renovation costs may exceed the legal maximum rent. As of 2022, there are roughly 20,000 vacant rent stabilized apartments in New York City. (Wikipedia)

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Might there be something wrong with a system where (a) there's strong demand for apartments but (b) it's more profitable to keep apartments vacant than rent them out? **Apartments aren't much different from bread or toilet paper. Officials can limit the price people have to pay, which is popular with consumers, but other than in the most dictatorial jurisdictions, they can't force suppliers to produce goods for sale at the regulated prices.**

As I've tried this year to keep up with articles about New York's apartment situation, I've noticed that the following factors are usually listed as discouraging apartment creation: (a) a lack of tax incentives and subsidies, (b) resistance to construction of affordable apartment buildings in the suburbs, and (c) high interest rates (albeit the last one can't be used to explain the low level of apartment construction in the 2010s). **What struck me most was the absence of any mention of the impact of rent regulations.**

A February 9 article in *The New York Times* particularly piqued my interest. The article reported that the percentage of New York City rental apartments that were "vacant and available" had fallen to 1.4%, the lowest since 1968. It went on to say, "Housing experts consider a healthy vacancy rate to be somewhere around 5 to 8 percent." So why are so few apartments vacant? It comes down to supply and demand:

a) As in the example of Taylor Swift tickets, **they're simply too cheap**. That means demand is strong and apartments don't sit vacant.

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b) Also, because rents are kept too low, **would-be builders can't achieve attractive returns**, meaning there are few additions to supply. (I also imagine that if apartment builders could earn an acceptable return on investment, they'd have to worry about new regulations expropriating it.)

As mentioned earlier with regard to prices in general, if demand for apartments is strong and supply is restricted, the result should be rents that rise, encouraging landlords to add to supply. But market forces aren't allowed to freely function in New York City; the laws of economics have been blunted by regulation. The February 9 article included the following statements (and this is from *The New York Times*, again usually not the capitalist's friend):

> The answer is that developers generally can't make returns for building apartments that are competitive with the returns on other forms of investment. . . .
>
> Housing experts estimate that the number of homes the city needs to build is in the hundreds of thousands.
>
> So far, however, the city and state have not made moves that could accelerate enough housing development to solve the crisis. . . .
>
> [Governor Kathy] Hochul said in a statement that the survey was "the latest reminder that we can only build our way out of this crisis."

But it's interesting to note that the "moves" that are described as having the potential to lead to "building our way out of this crisis" always emphasize government-provided subsidies and incentives, never allowing the free market to set rents.

A person in favor of this arrangement would argue that it maintains affordability and diversity. **What it means in purely economic terms is that some people who couldn't afford to live in New York City if rents were set by free-market forces are able to live there if they're lucky enough to secure an apartment with regulated rent. But other people who would like to live in New York City and can afford higher rents can't do so because there are no apartments for them.** And lastly, landlords that have apartments that are somehow unregulated can command higher rents than would be the case if additions to the supply of apartments weren't being discouraged. It's a matter of personal philosophy whether this is good or bad. But clearly, the laws of economics and the actions of free markets aren't at work in New York City. Someone in government is making the decisions.

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I'll end this discussion with a comment Jason Furman made about grocery prices:

> Mr. Furman . . . said . . . if prices do not rise in response to strong demand, new companies may not have as much inclination to jump into the market to ramp up supply. (*The New York Times*, August 15)

By the way, as part of her August 16 economic package, Harris said she would prohibit landlords who own more than 50 apartments from raising rents by more than 5% for two years. That may or may not be a good idea, but it's certainly not going to encourage increased investment in apartments.

Regulatory Miscellany

There are so many examples of governmental attempts to ignore or override the laws of economics that it's daunting to think of cataloging them, but I must discuss a few here, and their shortcomings:

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- Another component of Harris's economic program is a plan to **give first-time homebuyers $25,000 to help with down payments**. Certainly, it's hard these days for young people to come up with the cash needed to become homeowners. The problem here is that giving a million would-be buyers $25,000 each, or $25 billion in all, would almost certainly result in an immediate increase in home prices, eliminating much of the hoped-for benefit from the program. Easy: that can be prevented by passing a law that prohibits current sellers from raising home prices in response to enactment of the program. But what about homes that will come onto the market in the future? Simple: enact another law that says you can't ask more for your home than you would have if the program didn't exist. Try enforcing that one.

- When he was president, Donald Trump enacted tariffs on goods from China to counter trade practices he considered unfair. Now, he promises **a 10% across-the-board tariff on imports**. Those tariffs might discourage imports, stimulate domestic production, and reduce the U.S.'s chronic trade deficit. But they'd likely be paid by consumers of imported goods, as manufacturers and exporters are unlikely to absorb a tariff if they can pass it on. For many years low-cost imports have held down inflation in the U.S. and enabled Americans to enjoy an attractive standard of living. Broad new tariffs are likely to be the equivalent of price increases for American consumers. And the tariffs – and those imposed by other nations in retaliation – would hamper globalization, which benefits the global economy by letting people in each nation do for the world what they're best at.

- Trump's policy proposals also include **extension of his expiring 2017 tax cuts and a panoply of new ones**. There's something for everyone, with tax cuts for corporations and individuals, including ending the taxation of tips, Social Security benefits, and overtime pay. The Penn Wharton Budget Model estimates that in 2026, the plan would reduce taxes by $320 for the average person in the bottom income quintile and $47,220 for those in the top percentile. Even without factoring in the latest proposals, like exempting overtime pay, these actions are projected to increase the national deficit by $5.8 trillion over the next decade, or $4.1 trillion after incorporating their potential stimulative impact on the overall economy (so-called "trickle-down effects"). Other than that possibility, there's no suggestion the cuts would be paid for.

- California is a Petri dish for so-called "progressive" economic ideas. In 2022, the state legislature passed a bill creating a council comprised of industry representatives and restaurant workers to set wages in the fast-food industry. Faced with a threatened industry-financed referendum to repeal the law, legislators modified it to mandate **a minimum hourly wage of $20 for fast food chains of more than 60 restaurants**. The new law only took effect in April, so it's too early to assess its impact. Press accounts, however, are replete with accounts of restaurants closing, employees being laid off or having their hours reduced, employers investing in labor-saving technologies, and substantial price increases for the consumer. Although "mom and pop" restaurants are not required to pay the new minimum wage, predictably many have been forced to match the mandated rate to retain their employees, meaning the protection legislators intended for small restaurants may be illusory. That's how the laws of economics work.

- Similarly, California passed a law mandating a **$25-an-hour minimum wage for workers in the healthcare industry.** But more recently, according to *The Wall Street Journal* of May 27, officials realized that it "would cost the state $4 billion more a year owing to higher Medicaid costs and compensation for workers at state-owned facilities" and so they delayed the benefit of the law with respect to those workers. Shocking here is the idea that you can't give money to someone without getting it from someone else, and California taxpayers might not enjoy the state directing more of it to healthcare workers, especially given the current budget deficit.

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- If there's one thing both parties agree on, it's **"hands off Social Security!"** Retirees present and future want their monthly payments, and they want the rules left as they are. The leaders of both parties have agreed to this. It's just that it can't work. Social security is a contributory program analogous to insurance, and it works through a trust fund. Workers pay in via taxes and retirees get checks. But the number of retirees drawing benefits has been growing relative to the number of active workers paying in, and, if nothing is changed, the fund is sure to become insolvent through an inexorable mathematical process. There are many levers that could be pulled to restore Social Security to health, but nobody wants to pull them, since doing so would displease someone (that is, displease some voters). The options include (a) raising the Social Security tax rate, (b) raising the ceiling on the earnings on which tax is paid, (c) reducing benefits, (d) limiting cost-of-living adjustments, (e) raising the retirement age, (f) limiting the number of years for which retirees can collect, and (g) means testing would-be recipients. None of these is considered acceptable. Everyone just wants their checks as promised.

  It doesn't take a degree in economics to know what happens when people spend more than they bring in. (Only in political reality might someone expect a different outcome.) However, we don't hear a word from politicians or elected officials about making the changes that are necessary to keep the Social Security trust fund from insolvency. The government can switch Social Security from a self-funded program to a government-funded benefit, of course, and at first glance, the change appears to be mainly semantic. But depleting the trust fund and paying benefits from the Treasury would add further to the already-troublesome deficit, the national debt, and the annual debt service, which would feed back to further increase the deficit and debt.

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That leads me to a topic I'm asked about all around the world: the U.S. government's deficit and debt. I answer that they're an embarrassment. Oaktree is privileged to manage money for several countries that have sovereign wealth funds, not national debt. Some countries put windfalls into a lockbox, like Norway's oil revenues or the proceeds from the privatization of Australia's telephone company. And many other countries live within their means simply because they have to – they don't have the luxury of printing unlimited amounts of money without precipitating a devaluation. But the U.S. habitually runs deficits, spending more than it takes in. Our last surplus came in 2000, at the end of the Clinton administration. Today, for the first time, simply the annual interest on our national debt exceeds the Defense Department budget. Yet neither party is willing to address the deficit or stand for balanced budgets. Our congress rarely submits a budget at all, no less a balanced one. **This is irresponsible behavior we wouldn't tolerate in our own organizations.**

The U.S. acts as if it has a credit card with no limit on the balance and no requirement to pay it down. It does so because it's been able to get away with it thus far, and our governing officials lack the will to spend less than they can. We don't hear much these days about Modern Monetary Theory, the view popularized in 2020 that "for countries in control of their currencies, deficits and debts don't matter." Nevertheless, our government still acts as if this theory is valid.

In the 1930s, John Maynard Keynes posited that when an economy is growing too slowly to produce the needed jobs, the government should increase spending to stimulate demand, even if that means running a deficit and covering it by borrowing. And then, when prosperity resumes and the jobs are there, it should spend less than it takes in, running a surplus and using it to repay the debt. All good, except for that last bit: the part about surpluses and debt repayment has been forgotten.

The truth is, deficits encourage the economic growth that most people enjoy, and spending more than the government takes in permits officials to give away "free stuff," thereby gaining votes. **But doing this**

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perpetually requires ignoring the laws of economics, running up debts in the apparent belief that they'll never have to be paid. Can it go on without end? We'll see, but I would think not.

What Are the Common Threads?

The actions and proposed actions described above, like the questions beginning at the bottom of page three, all have certain elements in common.

- The goals usually seem commendable on the surface: cheaper goods and services, and more equal outcomes. But, given the way things work in economics, they usually have second-order consequences that are uncontrollable and unhelpful.
- At their core, they're all questions of "who gets what?" There's no possibility of money appearing from out of the ether; there are just choices regarding who pays in and who gets something out. It's a zero-sum game.
- The goals are often populist, with legislators and regulators picking winners and losers. They usually fashion their actions as protecting the downtrodden little guy from the rapacious big guy. Most anti-free-market regulations incorporate size criteria, meaning they only apply to supermarkets, not corner grocery stores; landlords with a lot of apartments; medical facilities of a certain size; and restaurant chains, not independents. In this context, we should note what President Biden said at the Democratic National Convention in August: "I'm proud to have been the first president to walk a picket line and be labeled the most pro-union president in history." Are employees per se more deserving of protection than employers? Without employers, where would people get jobs? Regardless, they do serve as convenient targets for politicians.
- The rhetoric surrounding these matters is often alarmingly classist and divisive. Here's part of a typical note I received from a candidate last month: "Even with inflation lowering [sic], food prices still seem sky-high. It's another sign of corporate greed hurting . . . consumers. CEOs shouldn't be lining their pockets with record profits while families struggle to put food on the table or pay for medications." In this kind of environment, "profit" is a dirty word, and "greedy corporations" are ripe for suspicion and regulation.
- Finally, elected officials have a habit of exempting themselves from impact. Thus, it's interesting to observe that California's minimum fast-food wage doesn't apply to restaurants in government facilities. What official wants to suffer the wrath of an employee forced to pay more for lunch?

One of the most important characteristics of the laws of economics is that they apply to everyone. On the other hand, attempts to negate those laws are usually designed to affect some parties differently from others. Whenever this is the case, those in charge are picking would-be winners and losers. Not a great idea in a "free society."

Fundamentally, government subsidies and economic regulations amount to encouraging actions that people wouldn't take on their own. In other words, these actions wouldn't happen in a free market. Mandates like these should be examined critically. Some may stem from officials' Solomonic decisions and desire for a fair society. Others are probably the result of a philosophic bias in favor of redistribution. And still others are just a matter of currying favor with voters.

For many career politicians, the first order of business is getting elected and reelected. Elected officials' tinkering with the economy is often designed to appeal to voters. Then there's the added benefit of getting officials off the hook, since they can redirect blame for politically undesirable developments to "bad actors," such as powerful corporations and greedy landlords. Finally, economic regulations can

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provide temporarily palliative outcomes, with the negative side effects coming only in later years, when the officials who enacted them have left the political stage.

Free Markets or Controlled Markets? That Is the Question

Governments don't make a product, create value over and above the cost of the inputs they employ or – other than through their spending – contribute to GDP. They collect (or print) money with one hand and distribute money and services with the other. They collect taxes from taxpayers and incur debts in the name of future taxpayers. Then they pay out money for benefit programs, salaries, capital expenditures, and subsidies. **Policymaking is about who will pay in and who will receive the benefits.**

Governments don't strive for profits, meaning the people who run governments get a free pass on efficiency. Corporate management teams that fail to produce a product worth more than the inputs – aka make a profit – won't last long. But governments aren't expected to do so, and as a result, there's no easy yardstick for quantifying a government's effectiveness, like profits do for a business.

Governments do play essential roles that may have nothing to do with profits or value added.

- They provide things people can't provide for themselves, such as defense, healthcare, police and fire services, education, infrastructure, and response to emergencies, both physical (floods, tornados, and pandemics) and economic (recessions and hyperinflation).
- They also provide safety nets for those who would otherwise suffer. There are extensive differences of opinion over how much of this governments should do, and those differences underly one of the biggest disagreements between the U.S. political parties.

Beyond necessities, how far should a government go to even out its citizens' incomes and quality of life? Doing so is one of the reasons why governments take from some to give to others as described above. **But it must be acknowledged that each step in this direction – as opposed to requiring people to fend for themselves – is a step in contravention of free-market forces, with consequences.**

- Darwin described the way species are strengthened through what is known as "survival of the fittest." It works, and species evolve upward. But this is, by definition, a cold-blooded process through which the strong thrive and the weak perish. Good for the whole of the species, but not for every member.
- Likewise, the collective economic welfare of a society is maximized by the operation of the free market. In the process, some people do better than others – preferably, but certainly not always, the most talented, hardest working, and most deserving. Only in the most rose-colored (and ill-fated) systems is it not accepted that some people will do better than others. But the differential has expanded a great deal of late, and there is a growing debate as to "how much better" is fair and acceptable.

The choice is clear based on the evidence provided by history: (a) efficient free market economies with their incentives and uneven outcomes or (b) command economies with their uniform outcomes and sub-par performance. On page two, I wrote the following:

> The incentives provided by free markets direct capital and other resources where they'll be most productive. They prompt producers to make the goods people want most and workers to take jobs where they'll be most productive in terms of the value of their output. And they encourage hard work and risk taking.

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In contrast, if markets are made less free – that is, if they're forced to follow government edicts rather than the laws of economics:

- capital and raw materials will be directed to places other than where they'll be most productive;
- producers will fail to make the things people want most, and instead will make things the government thinks people should have;
- workers will be assigned to work where they'll produce less than they otherwise might; and
- hard work and risk taking won't take place as much, since the rewards for doing those things will be capped and, in some cases, redirected to people who didn't do the work or take the risk but whom those in control deem deserving.

Incentives and free markets are essential for a high-functioning economy, but their existence assures that some members of the economy will do better than others. You can't have one without the other.

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China

At this point you might ask, "But what about China? The Chinese economy isn't free to operate pursuant to the laws of economics, but it's doing well." We think of China as a "communist country," replete with state-owned enterprises, industrial policy, and five-year plans. And yet, China's GDP has grown at nearly 9% per annum for the last 45 years, and in 2010 it became the world's second-largest economy. How could that be?

As it turns out, much of China's economic success is attributable to a vibrant private sector. I've been visiting China for nearly 20 years and, especially during my early visits, I struggled to comprehend the logic that permits the coexistence of the collective ideology with private enterprise. Certainly, those are "strange bedfellows." A visit to Xiamen, China earlier this month for the China International Fair for Investment & Trade reminded me of this conundrum. Regardless of the explanation, the fact is that China's economy relies heavily on the dynamic private sector. In the summer of 2022, Edward Cunningham of the Harvard Kennedy School used a popular formulation to describe it:

> China's private sector is often summed up with a combination of four numbers: 60/70/80/90. Private firms contribute 60% of China's GDP, 70% of its innovative capacity, 80% of its urban employment and 90% of new jobs.

And the government recognizes this. On March 13, 2023, CNN reported on a statement from Chinese Premier Li Qiang:

> "For a period of time last year, there were some incorrect discussions and comments in the society, which made some private entrepreneurs feel worried," Li said Monday. "From a new starting point, we will create a market-oriented, legalized and internationalized business environment, treat enterprises of all types of ownership equally, protect the property rights of enterprises and the rights and interests of entrepreneurs."

Certainly, this represents a triumph of pragmatism over ideological purity. It's a clear example of accommodating to economic reality rather than trying to override it.

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My first step toward understanding the workings of the various economic systems came in junior high school in the late 1950s, when I read George Orwell's *Animal Farm*. Orwell wrote it in 1945 as a thinly veiled critique of Russia and communism/socialism. That book taught me most of what I needed to know about free markets versus command economies. If you haven't read it, or if you read it so long ago that you can't remember what it says, I suggest you pick it up.

In the allegory of *Animal Farm*, the animals took over the running of the farm. For me, the key lesson emanates from the motto they painted on the barn wall, borrowed from Karl Marx: "From each according to his ability; to each according to his needs."

What an idealistic statement! It would be great if everyone produced all they could, with the more able members of society producing more. And it would be great if everyone got what they need, with needier individuals getting more. But, as the animals on the farm soon learned, if workers only get to keep what they need, there's no incentive for the more able among them to put in the additional effort required to produce a surplus from which to fill the needs of the less able. **The great challenge, of course, is to strike the proper balance: to take enough from the successful in the form of taxes to fund services, government programs, and wealth transfers without eroding their incentive to work or encouraging them to seek out low-tax jurisdictions.**

What I discuss above are the economic facts of life, and some of their ramifications may be less than ideal. But idealists' wishes don't govern economies; these realities do. Foremost among them are the power of incentives and the influence of supply and demand. The rules must be respected; they can't be ignored, wished away, or overridden without consequences.

Anyone who thinks it's better to live in a centrally planned economy that prefers evenly distributed benefits over free markets hasn't studied history (or read *Animal Farm*). It may sound good in theory, but it has never worked. The laws of economics will always win out eventually. Nations can respect them and reap the associated benefits, or they can try to contravene them and pay the price in terms of underperformance. **In the world of politics, there can be limitless benefits and something for everyone. But in economics, there are only tradeoffs.**

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