

Memo to: Oaktree Clients
From: Howard Marks
Re: Political Reality

My last memo, in May, was on the subject of “Economic Reality.” Its goal was to describe the realities imposed by economics and point out the many ways in which governments and, especially, candidates for elected office ignore and promise to override them. Since then I have been struck by the way developments have moved economic reality to center stage. Of course, foremost among them has been the affirmative vote of June 23 on Brexit: whether the United Kingdom should leave the European Union.

I have no interest in writing a memo about Brexit itself. There’s a huge number of moving parts, too little past experience, too many varying opinions, and zero clarity on how the departure will be handled. There are many pundits out there telling us what the consequences of Brexit will be. The only thing I’m sure of is that most of them are wrong, and if I were to join their ranks, I’d probably be wrong, too.

Economic Reality: Choices and Consequences

The May memo described the ways in which economics defines and constrains reality in business, investing and everyday life. Economics establishes the rules of the game and the boundaries of the playing field, and these things can’t be ignored. They can be altered, but not without consequences.

The realities of economics are stark and consistent, but also logical. They aren’t absolute, like the laws of physics (e.g., gravity), but they reliably establish tendencies and limits. If the price of something goes up, the amount consumed is likely to go down. If wages rise, the number of people employed for a task is likely to decline. If tax rates go up, there’s likely to come a point at which there’s less incentive to work, and thus less output. If a government spends more, to pay the bills it has to either print money (which tends to be inflationary), raise taxes or borrow.

Shortly after publishing “Economic Reality,” I added a new section to the version appearing on Oaktree’s website, saying **economics is largely the study of choice**. If you only have \$10, do you want to buy a \$10 book or two \$5 hamburgers, or make a \$10 gift, or add \$10 to your savings? The only thing we know you can’t do is do them all. **Further, decisions and actions have consequences**. For example, spending can provide us with enjoyment, but it will also make us poorer.

Reality in Politics

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. If someone annoying, like a journalist or an opposing candidate, asks about potential consequences, it’s easy these days to misrepresent them or deny they exist. And if it turns out that costs or consequences were willfully

ignored, no redress is available: election victories based on unmet promises can't be rescinded, and candidates can't be sued over falsehoods on the stump.

In the addendum to "Economic Reality," I pointed out that candidates rarely talk about choice. Instead, they're likely to promise "all of the above." And rarely if ever do they mention the cost that will be attached to something, or the downside, as in "I'll give you A, but you'll have to give up B." I imagine page one of *The Politician's Handbook* must say "never deliver an unpleasant message."

In "What Worries Me" (August 2008), I wrote:

Imagine two candidates for president. One says, "I'm going to give you eight years of discipline and denial – of higher taxes and lower spending – but I'll leave the country in better shape." The other says, "I have a secret plan that will solve all of our problems without requiring any sacrifice on your part." Who do you think would win?

How about a real-world example? In 1984, Walter Mondale was the Democratic candidate for president, running against Republican incumbent Ronald Reagan. Mondale became famous for his candor in accepting his party's nomination:

Whoever is inaugurated in January, the American people will have to pay Mr. Reagan's bills. The budget will be squeezed. Taxes will go up. And anyone who says they won't is not telling the truth to the American people. . . . **Mr. Reagan will raise taxes, and so will I. He won't tell you. I just did.**

The result? Mondale lost in a landslide, with the popular vote of 59% to 41% representing the seventh-biggest percentage deficit in presidential election history. Far worse, of the 538 electoral votes, he won only 13 (the District of Columbia and his home state of Minnesota). That stands as the second-lowest electoral total for a presidential runner-up since 1824. **So much for the benefits of candor.**

Today many politicians promise to safeguard the Social Security system, but rarely do we hear anyone talk about (a) reduced benefits, (b) higher Social Security tax rates, (c) a higher ceiling on wages taxed, (d) delayed onset of benefits, or (e) means-testing for recipients. **And yet, either some combination of these or the insolvency of the system is an actuarial certainty.** Instead, we get the candidate's mantra: more for all, with no cost or consequences . . . and, in the case of Social Security, a complete absence of progress.

Brexit: Political Reality in Action

Being in Europe at the time of the Brexit vote gave me an opportunity to see the imperfections of political reality in action. I'll review a few:

- **The decision to conduct the referendum was a matter of political expediency** (defined as "the quality of being convenient and practical despite possibly being improper or immoral"). A schism in the Conservative Party between the pro-Europe faction and the Euro-skeptics (pronounced "skeptics") – as well as opposition from the UK Independence Party, or UKIP – threatened to hand Britain's 2015 election to the Labour Party. To put down this threat, Conservative Party leader David Cameron promised in 2013 to put the issue of membership in the European Union to a popular vote. We often see politicians paper over a problem with promises

today, preferring to put off the possible consequences until tomorrow (they seem to assume tomorrow will never come – see page 4). This is a very practical stratagem, since elected officials often leave office well before consequences appear, and at any rate, there's no consolation prize for losing an election, so a candidate might as well do everything he can to win.

- **Potential consequences are often overlooked or not understood.** Of course, the ramifications of a Brexit referendum couldn't be known in 2013; even now in 2016 no one knows what they'll be, although the decision to leave is a fait accompli. It was a glaring error to leave a decision of this importance and permanence up to a simple majority of those going to the polls. The referendum could have been structured so that a decision to leave required a supermajority of those voting, or a majority of registered voters (whether they voted or not). **Since neither of these was required, the decision was made to take the UK out of the EU** – possibly tearing the country asunder (e.g., Scotland may well secede from the UK, since it was tempted to do so before and strongly wishes to be part of the EU) – **because 37% of registered voters said that's what they wanted** (whereas 35% voted to Remain and the other 28% didn't vote).
- **The decision was likely influenced by factual inaccuracies and false promises.** For example, probably most importantly, "Leave" voters were told that exiting the EU would enable Britain to gain control over its borders and thus exclude immigrants. Further, voters were told the UK was sending £350 million weekly to the EU, and leaving would enable that to be spent on the National Health Service instead. Within days after the election, however, some of those who had made the promises admitted that (a) maintaining unfettered access to the European market – and its 500 million consumers – will probably make it impossible to close Britain's borders to immigrants from Europe; (b) the £350 million was a gross figure that ignored the money the EU sent back to subsidize British farmers, and the real net figure was closer to £200 million per week; and (c) no one really thought the whole savings could go to the NHS – maybe just "a good part."
- **It became clear soon afterward that winning the election and implementing the decision are two different things.** Britain soon saw that (a) no one had a plan for how the departure would take place and (b) implementing wouldn't be as much fun as campaigning. Thus:
 - David Cameron (who had urged a vote to "Remain") announced the next day that, since he wasn't the right person to engineer a departure, he would resign as Prime Minister and head of the Conservative Party.
 - Ex-London Mayor Boris Johnson, a leading Conservative agitator for Leave, who it was widely assumed would become the next Prime Minister, walked away after his unsuitability was made clear in something of a coup.
 - Jeremy Corbyn, the head of the Labour Party, whose tepid effort failed to reflect his party members' strong support for Europe, was the subject of a 172-40 no-confidence vote by the Labour members of the House of Commons.
 - The leader of UKIP, Nigel Farage, stepped down, saying he wanted his life back after many years of advocating for Britain's departure from Europe.

Thus, two weeks after the referendum, no one knew who would lead any of these parties. (Since then Theresa May has ascended, surprisingly quickly, as Prime Minister and head of the majority Conservatives.)

The English have a great expression: "a dog's breakfast." The meaning is simple: a complete mess. I think that's an apt way to describe the Brexit referendum.

To pull this part of the memo together, I can't overstate my appreciation for the way Thomas Friedman described the UK's situation in *The New York Times* on June 29:

A major European power, a long-time defender of liberal democracy, pluralism and free markets, falls under the sway of a few cynical politicians who see a chance to exploit public fears of immigration to advance their careers. They create a stark, binary choice on an incredibly complex issue, of which few people understand the full scope – stay or quit the E.U.

These politicians assume that the dog will never catch the car and they will have the best of both worlds – opposing something unpopular but not having to deal with the implications of the public actually voting to get rid of it. But they so dumb down the debate with lies, fear-mongering and misdirection, and with only a simple majority required to win, that the leave-the-E.U. crowd carries the day by a small margin. The dog catches the car. And, of course, it has no idea what to do with this car. There is no plan. There is just barking.

The Voting Booth

Now let's think about the nature of elections. In *The Intelligent Investor*, Ben Graham described the stock market as a weighing machine in the long run but a voting machine in the short run. What he meant by the latter reference was that in the short run, intrinsic value is often ignored and the stocks that do best are usually the ones capable of winning a popularity contest.

I believe that, over time, elections have become more like popularity contests. The successful campaign speech isn't one that does the best job of analyzing the challenges and supplying optimal solutions. It's one that most provides what people want to hear.

In business and investing, people invariably compare the benefits and costs of A against the benefits and costs of B. Then they select the alternative with the better expected net result (and hopefully one whose bad outcomes are survivable). A lot of mistakes may be made, and the process is sometimes misguided, but the effort to make good economic decisions is undeniably there. Decisions usually have clear consequences, and they are likely to become known before the people responsible depart.

In contrast, politicians tend to believe the best decision is the one that is most likely to lead to election or reelection. Responsibility for outcomes is highly diffused, and the results may only become clear years – or decades – after the elections are held and the decisions are made. Few voters have the ability to assess the reasonableness of candidates' promises, and – given the time lags mentioned just above – it can be difficult to judge candidates for reelection on the basis of their performance on the job.

Time for an aside: I don't claim that people in the private sector “do God's work.” But we generally pull together to work for the collective good when the incentives are aligned properly. While everyone at Oaktree wants to advance his or her own financial position, status and career potential, I'm certain they also want Oaktree and its clients to succeed, as that is a prerequisite for – and will be a prime contributor to – each individual's own success. In Washington, on the other hand, many elected officials (Republicans and Democrats alike) give the impression that the success of the government – and the country – takes a backseat to making sure that (a) they and their fellow party members are elected and reelected and (b) members of the other party aren't. To this end, some members of party A seem to consider it more important to ensure that party B is unable to claim any accomplishments, than it is that

party A actually gets something done. I saw a political advisor interviewed on TV, and when asked what makes a politician successful, he answered, “getting reelected by his or her constituents.” He quickly amended that to “getting legislation done,” but the message was clear.

The Quality of Debate

It’s only hesitantly that I use the above section heading to describe what I want to cover here. First, it seems there’s little of quality in political speech today, and second, I don’t see a lot of debate (in the sense of “a method of formally presenting an argument in a disciplined manner” – Wikipedia).

- Rather than organized point and counterpoint, voters today – certainly in the U.S. – are subjected to sound bites, insults and assertions that aren’t in response to anything. During a presidential debate in 2012 (which in retrospect seems so prim and well-mannered compared to today), one candidate – when told by the moderator that he hadn’t answered the question – said “you asked the question you wanted to ask; I answered the question I wanted to answer.”
- Unlike earlier years, there do not seem to be any rules governing what some people will say, or subjects that are off-limits.
- Some candidates seem to believe the truth is dispensable. In past elections, candidates could be heavily damaged if it could be shown that they’d said something inaccurate or untrue. This time around, the truth doesn’t seem to be accorded a universally high priority. According to PolitiFact, an independent fact-checking outlet, 28% of Hillary Clinton statements that they’ve checked are “Mostly False” or worse. In Donald Trump’s case, it’s an astounding 70%.
- In fact, it seems to me that, among certain portions of the electorate, there’s little concern for what’s said – just how it’s said. Over and over I hear people on TV say, “I like Trump because he tells it like it is.” They’re not necessarily commenting on his policies or the accuracy of his statements; more likely it’s his outspokenness and disdain for political correctness. In recent decades, it seems “this is someone I’d like to have a beer with” has taken the place of “this is the person who’s best qualified to lead the country.”

I’ve thought for the last year that the Republican primary “debates” had the feeling, more than anything else, of the professional wrestling matches I watched on television when I was a boy. Each wrestler had a persona that appealed to a certain segment of the crowd, and the fans of the villains would scream their support, faces contorted in rage. Dirty tricks and cheating didn’t push away these fans – in fact, these things just stirred their bloodlust. That certainly seems to be the case with some of today’s campaign moments. The parallels between politics and pro wrestling might even extend to attempts to rig the outcome. Just last month, the head of the Democratic National Committee was forced to resign because of staffers’ leaked emails proposing that it favor one candidate over another.

Ignoring Economic Reality

I listed above some of the false promises that led to the victory for “Leave” in the Brexit referendum. I also mentioned that there was a lot of backtracking on those promises in the weeks following the vote. Now I want to discuss a few questionable statements that have been made in the lead-up to the U.S. presidential election.

- **Some of Donald Trump’s most prominent economic pronouncements have been with regard to imports, job losses and the balance of trade.**
 - He says of China, “they’re killing us.” But trade is a two-way street. Barring unfair competition, when we run trade deficits – meaning we buy more from other countries than they buy from us – it’s for one main reason: they provide a better price/value proposition than we do. They sell products (and take jobs), but we get bargains. China isn’t “winning” in that case, and the U.S. isn’t “losing”: it’s a win for both countries. **Of course it’s also true that while the result may be positive for the countries overall, there still can be negative consequences for individuals. For example, people may lose their jobs because of cheap imports, and society should take steps to ease their loss.** I’ll return to this later.
 - Trump cites unfair competition from China as a main source of our loss of manufacturing jobs. As I pointed out in “Economic Reality,” however, in recent decades the U.S. has lost roughly ten times as many potential jobs to increased productivity, mechanization and automation as it has actual jobs to low-cost competition from China.
 - Trump blames part of China’s ability to sell cheap goods on the fact that it has held its currency artificially low versus the dollar. But it’s interesting to note that when China recently made its exchange rate less rigid, the yuan declined rather than rose, suggesting that perhaps it hadn’t been held artificially low.
 - As for economic reality, never has Trump said anything like this: “We may be able to increase manufacturing jobs by imposing protective tariffs, but that would require all consumers to pay higher prices for their purchases of goods from abroad.” What would the average American’s everyday shopping experience be if imported goods were barred, discouraged or heavily taxed?
- **Further, Trump doesn’t point out that, in response to the adoption of protectionist measures by the U.S., other countries could retaliate with increased tariffs on U.S.-made goods, costing some Americans their jobs.** Here’s what Moody’s Analytics says about his original economic agenda (I haven’t yet seen analysis of the plan he announced on August 8):

Broadly, Mr. Trump’s economic proposals would result in a more isolated U.S. economy. Cross-border trade and immigration will be significantly diminished, and with less trade and immigration, foreign direct investment will also be reduced. While globalization has created winners and losers in the U.S. economy in recent decades, it contributes substantially to the ongoing growth of the U.S. economy. Pulling back from globalization, as Mr. Trump is proposing, will thus diminish the nation’s growth prospects.

Trump’s campaign is mainly targeting people who fear being left behind by globalization, and ignoring the individual winners and positive overall effects (much as “Leave” campaigners did in the UK).

- **Trump claims his expertise and experience in business would enable him to put the U.S. economy on a better track.** Here’s Moody’s take on the original plan:

Mr. Trump's economic proposals will also result in larger federal government deficits and a heavier debt load. His personal and corporate tax cuts are massive and his proposals to expand spending on veterans and the military are significant. Given his stated opposition to changing entitlement programs such as Social Security and Medicare, this mix of much lower tax revenues and few cuts in spending can only be financed by substantially more government borrowing.

According to Moody's, Trump's program would cause the federal budget deficit to increase from \$640 billion today to \$3,151 billion in 2026 (rather than \$1,289 billion under current law), and federal government debt to increase from \$14 trillion today to over \$37 trillion in 2026 (versus about \$24 trillion under current law – all figures in 2009 dollars, adjusted for inflation).

- **Finally, I'll mention Trump's most unrealistic claim: that he could trim the federal debt by negotiating the ability to pay it off at a reduced amount.** He built his net worth in part by borrowing money and not paying it back, and he seems proud of his companies' repeated use of bankruptcy as a strategic tool. But Trump doesn't have an ongoing need to tap the world capital markets, as the U.S. does (he now operates under an asset-lite business model that emphasizes licensing fees rather than asset ownership; perhaps this is because his multiple defaults have caused the credit window to be closed to him). **The United States could refuse to pay its debts in full – that's called "rescheduling" or "default" – but we'd be unlikely to have the same access to the credit markets, and we would certainly cease to enjoy the benefits of a high credit rating and resulting low interest rates.**

As for my picking on Trump here: I'm quick to point out that Clinton has her own shortcomings as a candidate and potential president. Her use of a private email server while Secretary of State is just one prime example. And she has embraced positions, such as opposition to the Trans-Pacific Partnership and her promise of free public college at certain income levels, that seem intended simply to help her compete against Bernie Sanders in the primaries and win over his supporters in the general election. But I think it's fair to say that she hasn't been anywhere near as guilty as Trump of defying economic reality on the campaign trail, and that's my subject here.

The Sources of Today's Division

One prominent characteristic of the political arena today is the rise in discontent, much of it based on economics. The world is changing in ways that are uncomfortable for many, especially those lacking the ability to change with it. Here's some of what I wrote in "What Worries Me" (August 2008):

In many ways, including materially, Americans have enjoyed a wonderful standard of living over the last hundred years. Considering creature comforts such as housing, food, sanitation, healthcare, leisure and luxuries, ours may have been the highest standard of living in the world. That raises three questions:

- Why should we continue to enjoy the highest standard of living?
- Why should it continue to improve?
- And why should the rate of improvement outpace that of the rest of the world?

We often see poll results showing that increasing numbers of Americans doubt their children will live better than they do. We'd like them to, but why should they? Other than technological improvements which doubtless will continue to make life better for everyone, why should our standard of living improve monotonically? And improve relative to the rest of the world? Certainly the advantage in this regard can shift to other countries, just as it shifted to us in the past.

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 significant post-war competitive advantages and (b) significant barriers protected the status quo. But why should this go on? How can it go on?

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.

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 considered 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.** (Emphasis added)

Unfortunately, these 2008 observations, and especially the final sentence, proved to be on target. And the central issue – globalization of trade, or the opening of national borders for the free movement of goods – has raised serious issues and become a source of controversy in the current election.

The good news about free trade is that an overwhelming majority of economists believe it contributes to economic progress. For example:

A study by the Peterson Institute found that past trade liberalization laws added between \$7,100 to \$12,900 in additional income to the average household. A study by Peter Petri and Michael Plummer estimates that the Trans-Pacific Partnership, which Trump opposes and Clinton sort of opposes, would boost American incomes by \$131 billion. (David Brooks, *The New York Times*, July 1)

What's the source of these gains? They come primarily from specialization. When borders are closed, each country has to produce all the goods it needs. But when borders are open, each country will produce the goods it can make best or cheapest. Each will sell some of its output to other nations that can't make those things as well or as cheaply, and each will buy from other nations that which it can't produce as well.

There are good reasons for international specialization, and by and large Americans have benefited tremendously. Do we really want to produce T-shirts here and pay \$60 for something that now costs \$15? (Professor Gregory Mankiw, chairman of the Council of Economic Advisers under President George W. Bush, in *The New York Times*, July 15)

Clearly this process makes the overall global production system more efficient – everything is made where it can be done best – to the enrichment of all nations . . . but not all people. The benefits to date have been far from evenly distributed. In the U.S. they have gone overwhelmingly to those who are better educated and technologically adept or who own the companies that profit. Real incomes for people in the lower portion of the distribution have been stagnant at best, and the percentage of Americans participating in the work force – either employed or looking for a job – has declined.

As I described in 2008, Americans historically have been paid more than their counterparts around the globe. **This creates incentives to both manufacture abroad and automate at home.** (It also creates a condition that attracts immigrants – some illegal – who are willing to work for less.) Manufacturing employment is down a third since 1979, despite economic growth and increased manufacturing output. **Americans who lack education and thus are suited only for manual work** – who may have found jobs in agriculture a hundred years ago or in auto and appliance plants fifty years ago – **now face declining income trends . . . to some degree in absolute terms, and significantly when compared to (a) Americans with the education required for higher incomes and (b) the way things used to be, especially for their parents.**

In the past, in addition to the fact that incomes weren't so enormous at the top, the income gap was narrowed by the fact that people could do pretty well at the bottom. Millions of menial and blue-collar jobs were created as our economy expanded. Even without much education, people could enjoy the good things in life, including cars, TVs and vacations, along with good public school educations for their kids and the possibility that most of those kids would have better jobs than their parents. Which of those elements is equally true today? (“What Worries Me”)

I remember first becoming aware of income inequality – and certainly of unequal quality of life – during my first business trip in 1970, which was to Los Angeles. As a kid who grew up in Queens, New York, I had never seen anything like the verdant neighborhoods and beach communities of Southern California. Now the divergent trends in income are tearing at our society and influencing political events. A deteriorating income outlook and increasing income disparity have led to frustration, resentment, economic nationalism, protectionism and xenophobia among those affected.

As *The New York Times* put it on July 13:

In the years that followed [the mid-1990s], the number of immigrants living in the United States illegally would double and then triple before leveling off under the Obama administration around 11 million. Deindustrialization, driven in part by global trade, would devastate the economic fortunes of white men accustomed to making a decent living without a college degree.

The economic reality is that these trends – international specialization, automation, rising productivity, job losses, the need for education, and a feeling of hopelessness among those affected negatively – are real and powerfully influential. Whether we like them or not, they're here to stay. They're economic reality, and they cannot be ignored or refuted.

I'll move toward summing up on the causes of today's conditions by quoting from Thomas Friedman in *The International New York Times* of June 30. I think he did a great job of capturing the situation:

It's the story of our time: **The pace of change in technology, globalization and climate have started to outrun the ability of our political systems to build the social, educational, community, workplace and political innovations needed for some citizens to keep up.**

We have globalized trade and manufacturing, and we have introduced robots and artificial intelligent systems, far faster than we have designed the social safety nets, trade surge protectors and educational advancement options that would allow people caught in this transition to have the time, space and tools to thrive. It's left a lot of people dizzy and dislocated.

Friedman's statements appeal to me very strongly and remind me of *Future Shock*, a book written by Alvin Toffler in 1970. Toffler defined future shock – which he viewed as destabilizing our society – very simply: “too much change in too short a period of time.”

Arthur M. Schlesinger, Jr. discussed the results of economic decline and dissatisfaction in *The Politics of Upheaval* (cited in *The New York Times* of June 20):

The followers of the demagogues mostly came from the old lower-middle classes, now in an unprecedented stage of frustration and fear, menaced by humiliation, dispossession and poverty. . . . They came from provincial and traditionally non-political groups in the population, jolted from apathy into near-hysteria by the shock of economic collapse. . . . Old America [is] in resentful revolt against contemporary politics and contemporary economics.

These words do an excellent job of summing up current conditions. But Schlesinger, who died in 2007, obviously didn't write them for that purpose, but rather in 1960, to describe the Great Depression. The populism we're seeing today is not a unique phenomenon, but rather a standard occurrence in periods of economic difficulty. Populism has a record of giving rise to very destructive leaders and movements.

The combination of productivity improvements and foreign competition has been very hard on unskilled and semi-skilled labor – what's called “the working class.” **People employed in uncompetitive industries at the time globalization takes place are particularly disadvantaged.** Their incomes decline at a minimum, and they may lose their jobs and be unable to find new ones. Society should cushion the blow on these people. Here's one proposal:

Last March, the ranks of the incensed included 78 percent of Bernie Sanders's supporters and a whopping 98 percent of those backing Donald J. Trump.

More than half of voters – including 61 percent of Mr. Trump's supporters – feel they are not keeping up with the cost of living. Three quarters of Mr. Trump's supporters feel that life for people like them is worse than it was 50 years ago.

Some of this is due to irreversible forces. The days when white men kept an uncontested hold on political power, when young adults without a college degree could easily find a well-paid job, are not coming back. . . .

Last month, four academics – Jeff Madrick from the Century Foundation, Jon Bakija of Williams College, Lane Kenworthy of the University of California, San Diego, and Peter Lindert of the University of California, Davis – published a manual of sorts. It is titled “How Big Should Our Government Be?”. . .

The scholars laid out four important tasks: improving the nation’s productivity, bolstering workers’ economic security, investing in education to close the opportunity deficit of low-income families, and ensuring that Middle America reaps a larger share of the spoils of growth.

The strategy includes more investment in the nation’s buckling infrastructure and expanding unemployment and health insurance. It calls for paid sick leave, parental leave and wage insurance for workers who suffer a pay cut when changing jobs. And they argue for more resources for poor families with children and universal early childhood education. (*The International New York Times*, August 3, emphasis added)

This is a very liberal agenda, and many Americans would say the whole and many of its parts constitute undesirable government intervention. **What, then – if anything – should be done to arrest the trends described above?** If we don’t do something, it’s likely that the income and wealth gap will continue to grow; the downside of globalization will continue to be felt; and our political process will continue to be riven by widespread dissatisfaction.

Eduardo Porter, an economics columnist, summed up succinctly in *The New York Times* of May 25:

We shouldn’t try to stop globalization, even if we could. But if we don’t do a better job managing a changing world economy, it seems clear that it will end badly . . .

The trends discussed above – and resentment over experiencing them, fear of doing so, and anger upon seeing them at work in one’s community – have been big contributors to Trump’s popularity over the last year, and also to Sanders’s appeal to large numbers of Democratic primary voters. Similar sentiment played a big part in the Brexit vote to Leave and is on the rise in Europe. The issues won’t end with this year’s presidential election. Rather, I believe they are likely to prove long-lasting and difficult to resolve. They and the non-economic forces at play in this election are likely to have significant influence on U.S. politics for years to come.

The Implications for Politics in the Future

The historical alignment of the two main parties was quite stable for a long time. For most of my life, the Democrats have stood for “the working class”; a bigger and more active government; more taxation, spending and wealth redistribution; and more-liberal social policies. The Republicans, on the other hand, have been considered the party of big business and economically better-off Americans, and they have fought for free enterprise; smaller, less-activist government; lower taxes; a muscular defense posture and foreign intervention; conservative social policies; free trade; and supply-side (“trickle-down”) economics. The two parties – and their candidates and voters – generally have stuck to these ideologies.

I’ve seen the parties evolve from the above positions, but only modestly and gradually:

- The Democratic Party swung toward support for civil rights and became the primary party for non-whites. And when Bill Clinton's administration adopted a more centrist, less-liberal approach, it stood less for welfare and economic redistribution and was more sympathetic to big business and free trade.
- The Republicans, on the other hand, attracted rural whites antagonized by the Democrats' support for desegregation. The party became more motivated by religion, morality and personal freedom, more socially conservative, and less concerned with maintaining military strength and (outside of the Tea Party faction) shrinking government and reforming entitlements.

In the current presidential race, Donald Trump and Bernie Sanders – both outsiders to the traditional parties – have fared quite well thanks to support from millions of voters who are unhappy with the historic political arrangement and how it deals with today's conditions. Thus change appears to have accelerated, and there's talk of political revolution.

Given the events of 2016, the positions described above may well be realigned. There may be a party in the future built largely around:

- economic disadvantage and discontent,
- “cultural grievances” and disregard for political correctness, experts, establishments, and economic, social, political and media elites,
- fear of terrorism, xenophobia, law and order, nativism, protectionism, closed borders, and isolationism, and
- pragmatism and self-interest (national and individual) as opposed to philosophy and ideology.

The above factors, which Trump sums up as “America First” and “Make America Great Again,” may well rearrange or supplant the traditional positions of the parties. Depending in part on the outcome of the current election, it may turn out – as many people are saying – that the Republican establishment of the past has lost control of its party. Thus the party described above may be what today is called “Republican,” or it may be something brand new. While the Democratic Party establishment remains in control at present, Sanders shook it, assembling a substantial minority attracted to his socialist principles.

It is particularly intriguing to consider the possibility of a reshuffling of the historical blocs into three parties rather than two. Will a party of “the Dissatisfieds” be formed from today's Trump supporters to compete against both the Republicans and the Democrats? Might they be joined by Sanders supporters, with their own dislike of free trade, banks and big money; hostility toward elites and the Washington establishment; preference for economic redistribution; and disappointment with their economic prospects? Can the glue of alienation and dissatisfaction overcome these two groups' vast political, demographic and cultural differences? If Trump loses this year, will this group fade away or become institutionalized under the leadership of more conventional politicians? These things will become clear over time.

Here's a particularly provocative potential issue to consider: Our constitution calls for election of the president by a majority of the electoral college. But if there come to be three major parties, it's easy to imagine no candidate getting a majority. What happens then?

Few Americans may have known the answer a year ago, but I think many have begun to research it, and still more are likely to do so in the years ahead. I'll give you the answer: in the absence of an electoral majority, the president is chosen through a vote of the House of Representatives, with each state having

one vote. **Thus, theoretically, the 26 least-populous states – containing just 17% of America’s people and, by definition, almost none of its big cities – could choose the president.** For me, regardless of the political makeup of the House, the loss of proportional election is of great concern, particularly given the way the House is elected (see below).

My Prescriptions

I like and admire many of the politicians I meet – of both parties. I just don’t like the actions (or inaction) the system produces collectively. So I want to make it clear that my reservations about politicians in general are not as sweeping as I may make them sound above. Here’s what I said in “What Worries Me”:

Condemnation of politicians needn’t be universal. There actually are some I like. More than anything else, they’re marked by a spirit of bipartisanship. Rather than consider politics a blood sport in which the only important goals are to embarrass the other side and win elections, they want to solve our nation’s problems.

Nevertheless, despite the above, the bottom line is that I find myself more worried than optimistic (also from “What Worries Me”):

I confess that I feel the deck is stacked against government getting better. Less attention paid to newspapers and TV news, declining interest in national and international affairs, the rising role of the sound bite, generally shorter attention spans, a vanishing spirit of self-sacrifice, rising me-first-ism . . . where would optimism come from in this regard? We can hope, but I’m not that hopeful. The truth is that most people vote for the candidate who looks and sounds best in TV ads, who says what they want to hear, and who they think will put money in their pocketbooks today and brighten their lives tomorrow.

To the above I would add a very powerful force: the decline of balance in the media. Unlike the days of my youth, in which broadcasters operated under the “fairness doctrine,” today there are networks (as well as newspapers and websites) that act more like spokespeople for one party or the other than like impartial journalists. That enables people who follow election news through these outlets to hear only one party’s rhetoric and avoid all exposure to the other side’s case. This encourages extremism, widens the gulf between people and parties (the statistical evidence in this regard is compelling), and makes bipartisanship less likely.

Can the current political conditions be improved upon? Is the situation hopeless? While the economic and social trends discussed above won’t be easily altered, there are some “mechanical” fixes that could make our political process work better.

First, the drawing of district lines for elections to the House of Representatives should be de-politicized. Under the current rules, district lines are redrawn every ten years, after the census, by the party controlling each state’s legislature. That means they’re able to “gerrymander” the congressional map, drawing the lines so that opposition voters are concentrated into a small number of districts and allowing the party in power to win a disproportionately high number of House seats. Thus, for example, in the 2012 election in Pennsylvania, Democrats received 51% of the votes for the House of Representatives. But, thanks to the way the lines had been drawn by the Republican-dominated state legislature, that 51% majority was crammed mostly into a small number of districts, such that the Democrats won only five (or 28%) of Pennsylvania’s eighteen House seats.

As a result of gerrymandering, most House races are easy pickings for the party that drew the lines, and many that remain are equally easy pickings for the opposition party. Thus the vast majority of seats in the House are viewed as “noncompetitive”: **there’s only one party that can win.**

The outcome of 94 percent of House races is a foregone conclusion. **If this happened in any country but the U.S., we’d question whether it was a democracy.** (*Christian Science Monitor*, October 14, 2014)

For example, according to *The New York Times*, in the ten years prior to the enactment of the changes in redistricting and primaries described below, congressional seats in California were so safe that in 255 elections, only one shifted from the control of one party to the other.

If the lines for House districts were drawn by independent, non-political committees, I think House members would be less ideological and more likely to compromise, on average, and the process of governing would be less combative and more productive. This process is underway already in my former home state of California. Congressional districts were redrawn by an independent commission in 2011. Although it’s too early to judge the results, it appears that the new districts, which follow more natural geographic and demographic boundaries – combined with the new primary system described below – have created races that are more competitive and more inclined toward moderation.

Second, the structure of primaries should be reformed. As described above, district lines usually ensure that a given party will win each House seat. That means in a noncompetitive district, being nominated by the unbeatable party is tantamount to being elected. Thus the real contest today is in the primaries, which are likely to be won by ideologically-zealous candidates. This is so because (a) according to the website *fivethirtyeight*, in 2014 less than 15% of eligible voters participated in congressional primaries, (b) the few who do vote in primaries are likely to be the most motivated, and thus ideological, party members, and (c) gerrymandering has freed the candidate of the inevitable winning party from having to appeal to members of the other party or to independents. This combination encourages extremism.

The results might be different if the rules provided that (a) there’s only one primary, in which everyone can vote, and (b) the two top vote-getters in that primary – regardless of party – get to run in the general election. Thus, for example, both of the general election candidates for a House seat in a heavily Republican district could be Republicans, with no Democrat taking up space on the ballot in an election he has no chance to win. In that case, the more moderate of the two Republicans might pick up support from other moderate Republicans (when they turn out in greater numbers in the general election), as well as from Democrats, and be elected to Congress.

This “top-two primary” system is already in place in California, Louisiana and Washington, with the potential to elect moderates rather than extremists. According to *fivethirtyeight*, that’s exactly what happened in Washington’s 4th district in 2014. A “Tea Party hero” beat out a moderate Republican in the primary, 32% to 26%, while the leading Democrat got only 12% of the vote. In a state with separate Republican and Democratic primaries, the Tea Partier would have run against the Democrat in the general election and been a sure winner. But in Washington, the top two Republicans faced off, and the more moderate candidate won with support from moderate Republicans and some Democrats.

If more moderates won – as was much more common a few decades ago – it would be easier to imagine the two parties working together, producing compromise rather than gridlock. Some people think gridlock is more desirable than government action, but the way I see it, there are serious problems that need solving, and as long as the two houses of Congress are in the hands of extremists from

two different parties – or are both led by extremists from a party that's different from the one occupying the White House – solutions are unlikely to be found.

The third improvement would be a reduction in the role of money in politics. Money is everywhere in American politics, and the trends are negative in this regard.

- The 2012 presidential election cost a total of \$2 billion, and 2016's may dwarf that.
- The total amount spent on all federal elections in 2012 is estimated at \$7 billion.
- Virtually all the cash comes from private interests, rather than public funding as in some other countries. In addition to individual donors, corporations and unions can have great influence.
- Recent court decisions have made it possible for the amounts given to increase and harder for union members to refuse to share in their union's giving. Political giving has been interpreted to be a form of free speech, making it quite difficult to regulate.
- The lobbying industry has over 11,000 members and bills over \$3 billion per year.
- Every interest group has its paid lobbyists, especially the ones (like tobacco 50 years ago) that will only maintain profits if they can hold back reforms.

Elected representatives have to drum up contributions in order to fill their war chests. What politician can fail to support his big donors? Thus some may come to serve more as advocates than prudent policymakers.

Several years back I met a young man whom I decided to support in his first House race. When he called me the day after his election, I assumed it was to celebrate and thank me. But instead he asked for a contribution for his next race! With terms of just two years, Congressmen are never not running. This is only one example of the ways in which fundraising is too important in American elections.

I have a fourth suggestion, but fortunately it's one that is superfluous at the Federal level: **avoid the use of referendums to make decisions.** Wisely, the Founding Fathers omitted referendums from the process that governs the U.S. I like to think it was because they knew better than to leave big decisions up to a direct vote of the populace and were worried about "the tyranny of the majority," but it also seems they expected the referendums to occur at the state level.

It's interesting in the current context to note Prime Minister Margaret Thatcher's 1975 opposition to referendums (in defending membership in the European Union against its unpopularity):

Without the protections and definition afforded by a written constitution, referendums, she said, sacrificed parliamentary sovereignty to political expediency. In a system such as Britain's, that threatened minorities by trading liberal democracy for majoritarianism. "Perhaps the late Lord Attlee was right," she observed, "when he said that the referendum was a device of dictators and demagogues." (*Financial Times*, September 11, 2007)

We just cannot allow a simple majority of those who vote to directly decide important issues like Brexit. First, fewer people vote than we would hope, so decisions can turn on the wishes of a relatively small group. And second, many voters may lack the knowledge and analytical skills necessary for good decision-making. Consider the questions asked most often on Google in the UK in the hours after the Brexit polls closed: "What does it mean to leave the EU?" and "What is the EU?" Presumably many of the people asking these questions were the same ones who had just decided Britain's future. It might have been better if they had asked those questions before the vote.

* * *

I wrote this memo to explain what happened in the UK this year and what I think is happening in the U.S. I wanted to point out that politics rarely hews to economic reality; rather, it has a reality all its own.

The recent trends in income, wealth, trade and employment are causing a lot of dissatisfaction in the U.S. and Europe, and I expect them to have a strong impact on politics for years to come. **Widespread economic dislocation can cause voters to choose the wrong leaders. The U.S. is not exempt, and we must be highly vigilant in this regard.**

August 17, 2016

P.S.: Some readers may feel it's wrong for me to make any statements regarding the presidential candidates, and to criticize what I see as Trump's take on economic issues. Others may simply disagree with my views – but they are my views, and I hope you'll feel I have the right to express them. I've tried hard to stick to matters of economics and fact, rather than non-economic policy or programs, opinion or personal preference. I'm sorry if my statements cause unhappiness. Anyone who takes factual issue with anything I say here is welcome to let me know.

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