Memo to: Oaktree Clients

From: Howard Marks

Re: Growing the Pie

A few weeks ago, we were pleased to announce a partnership with Brookfield Asset Management that created an alternative investment manager with one of the broadest slates of strategies and greatest asset totals. And what question did I get? "Will there still be memos?" Well, here's your answer.

* * *

One thing I'm not happy being right about is the tenor of the current debate over our economic system. Most of my January memo, *Political Reality Meets Economic Reality*, was devoted to fretting over the rise of populism from the left and the resulting anti-capitalist sentiment, and it has risen further since.

I mentioned legislation that had been introduced to appropriate some of corporations' cash and governance rights for workers, as well as a proposal for a higher income-tax bracket for top earners. Since then we've seen additional suggestions covering a wealth tax, higher estate taxes and, in New York City, a tax on *pieds-à-terre*. Clearly companies and wealthy individuals are being viewed by some as attractive political targets and good sources of incremental revenue.

One of the main reasons behind populism's ability to stir people is the favorable reception its rhetoric receives. "They have too much." "We've been short-changed." "The system's rigged." "They got where they are by cheating." "The rich don't pay their fair share." **Sound bites like these find receptive audiences among people who are unhappy with their lot, whereas detecting the error in these statements requires an insight, sense of history and understanding of economics that many people lack.**

What's Going On?

In the January memo, I set forth my view that in the last 10-20 years, the rising economic tide had stopped lifting all boats. In addition, major social and economic trends contributed to increases in economic inequality. These developments, I said, were largely behind the rise of populism.

Ray Dalio and Bridgewater actually beat my memo by two days, publishing on January 28 an excellent note titled *Populism + Weakening Economy + Limited Central Bank Power to Ease + Elections = Risky Markets and Risky Economies*. I was particularly drawn to the following passage:

> Disparity in wealth, especially when accompanied by disparity in values, leads to increasing conflict and, in the government, that manifests itself in the form of

> populism of the left and populism of the right. **As a rule, populists of the right (who are usually capitalists) don't know how to divide the pie well, while populists of the left (who are usually socialists) don't know how to grow the pie.** [Emphasis added]

Populism of both the right (behind Donald Trump) and the left (behind Bernie Sanders) played a big part in the 2016 presidential election season. It's the latter that's my subject here.

In my January memo, I argued at length that capitalism can be credited with much of what made the United States what it is today. **In short, to borrow Ray's terminology, the capitalist system achieved this by creating the biggest pie: the largest total GDP in the world and one of the highest per-capita GDPs.** And only capitalism is likely to cause the pie to continue to grow. The failure of non-capitalist systems to produce economic growth and prosperity is well documented.

Obviously, however, when the pie is divided up under capitalism, not everyone gets the same-sized piece. That's the idea underlying the following line in Winston Churchill's speech in the House of Commons on October 22, 1945:

> **The inherent vice of capitalism is the unequal sharing of blessings . . .**

As with so many things, Churchill said it best. Under capitalism we're likely to see bigger slices of the pie go, for example, to those who are smarter, more talented and more hardworking, but also to those who are luckier or born into wealth. The first three of these explanations are generally considered valid, the fourth is not, and people fight about the last. **The gains produced by capitalism are inseparable from – actually they derive from – the opportunity for those who are smarter, more talented and more hardworking to end up with bigger slices of the pie.** On the other hand, no one considers it inherently desirable that lucky people do so also. And many think the benefits of inheritance should at least be watered down (although generally not the benefactors or beneficiaries).

And what do the "populists of the left" want? For the most part, "fairer" and more equal outcomes. They say relatively little about expanding the pie but more about fairness in how it's apportioned. That's why Churchill went on from the above to add:

> **. . . The inherent virtue of Socialism is the equal sharing of miseries.**

When we look around the world, we see countries that have stressed equal sharing of the pie and others that have cared more about expanding the pie. The equal sharers include Cuba, North Korea, Venezuela and the USSR, while the expanders, in addition to the U.S., include South Korea, Hong Kong and Singapore. In which group of countries do people generally live better? In which group would you rather live?

Today, many people apparently fail to understand the role of capitalism in creating the wealth that Americans share. Others may feel the capitalism that got us here may have been fine in its time but isn't needed anymore; thus, we should shift our attention to more equal distribution instead. And a last cohort may consider equal sharing more important than the creation of more prosperity.

Socialism superimposes socio-political considerations on an economic system, such that equality is elevated relative to self-interest and individual motivation. Capitalism omits that emphasis. In this

context, last month Charlie Munger called my attention to China's agricultural history following the death of Mao Zedong in 1976. The following excerpts are from a 1986 paper in the *Journal of International Affairs* regarding the then-recent agricultural reforms in China. This'll be a long slog, but I think it's worth studying how China transitioned from the "equal sharing of miseries":

> The long-term (1957-1978) growth of cereal output just kept up with the expansion of the population. Over this period, China actually was becoming more dependent on imported grain to feed its population. . . . By 1978, about 30 million urbanites, roughly 40 percent of the population of China's municipalities, were dependent on imported cereals. The performance of most non-grain crops was even less impressive. . . . The slow growth of farm output, not surprisingly, was accompanied by extraordinarily modest growth of peasant income. . . .
>
> By 1978 an apparent consensus had been reached at the highest levels of the Chinese Communist party that the painfully slow growth of agricultural output was caused . . . by certain inefficiencies of China's collective production structure, the loss of productivity resulting from the promotion of local self-sufficiency, the curtailment of rural marketing and the disincentive of relatively low prices for farm products. Beginning in 1978 the Central Committee endorsed a series of sweeping reforms that addressed each of these problems. Collectivized agriculture . . . was replaced with a system of household farming in which the land was divided among existing households. . . . Decisions on cropping patterns and the quantities of fertilizers and other inputs to be used are now made by each household rather than by team and brigade leaders. . . . Peasants are now encouraged to specialize and produce for the market rather than being forced to be self-sufficient. Comparative advantage cropping has been encouraged by reopening rural markets . . .
>
> These reforms . . . have led to an unprecedented pace of growth since 1978. Grain output, for example, had grown from 305 to 407 million metric tons, an average annual rate of almost 5 percent, well over twice the historic rate of 2.1 percent achieved between 1957 and 1978. . . .
>
> The official jettisoning of the policy of local cereals self-reliance, encapsulated in the Maoist slogan "Take grain as the key link," and the reopening of rural markets have stimulated an upsurge of production of non-cereal crops. . . .
>
> The unprecedented growth of agricultural output also has been accompanied by substantial growth in real farm income. . . . Average per capita farm income in current prices rose from 134 yuan in 1978 to 355 yuan in 1984. . . . The gains derive not only from the growth of farm output . . . but also from the substantial expansion of rural non-farm employment and income. . . .
>
> Although decollectivization has provided the incentives for improved productivity growth, it has created . . . significant and partially unanticipated adverse consequences. . . . Over the longer run it is not clear how the local labor-intensive maintenance of existing irrigation systems will be sustained. . . . The current system appears almost certain to have an adverse effect on the distribution of income in rural areas and may lead, ultimately, to significant rural unrest. . . . Another seemingly

> unanticipated consequence of the demise of the collective system is the impaired delivery of rural social services. State budgetary funds for rural health-care and primary-school education always have been limited. Most of these programs . . . were financed by collectively accumulated welfare funds. . . . A final unanticipated consequence of the reform is its budgetary impact. While the higher farm quota prices the state introduced along with decollectivization have contributed significantly to greater incentives and productivity for peasant producers, the financial burden to the state of these incentives has mounted far more rapidly than expected. [Nicholas R. Lardy, "Agricultural Reforms in China"]

The Chinese experience described above tells the whole story in eight short years: deregulation and decontrol; free enterprise and the profit motive; increased flexibility and choice; the benefits of specialization; and the allocation of resources via the free market. The results: vastly increased production, but also greater inequality and reduced government services. **In other words, you can't have it all. Most people lived much better because of the reforms, whereas under the prior system everyone had it the same, but most people lived far less well. Which was fairer?**

Capitalism doesn't know about or care about fairness in the sense of equal sharing. **What it considers fair is the proposition that people who have greater ability or work harder should be able to earn more.** That potential, it says, provides incentives for hard work and rewards those who achieve, ultimately resulting in a better life for almost everyone. The story of China – just like that of America – shows that it works.

A Case in Point: We Like Our Pie the Way It Is

One of the biggest stories in the business world over the last two years was Amazon's search for a location for another headquarters. A total of 238 cities, towns and other entities submitted proposals, trumpeting their merits as a possible location for HQ2 and, in many cases, offering financial inducements.

The big news came last November, when Long Island City in Queens, New York was chosen for Amazon's expansion, as was Northern Virginia. The parameters in Queens included a $2.5 billion investment on Amazon's part; approximately 25,000 new Amazon jobs (plus the likelihood of thousands more in construction, local infrastructure and support businesses); $27 billion of projected incremental state and city tax revenues over the subsequent 25 years; and $3 billion returned to Amazon over that period in the form of tax credits and subsidies.

The deal's supporters were elated. But opposition soon began to form, and, on February 14, Amazon pulled out.

> The plan fell apart in the face of a backlash over public subsidies, resentment of the covert process in which the city and the state negotiated the deal, and concern about its neighborhood impact. (*The New York Times*, February 22)

Labor unions that would want to organize Amazon's operation opposed the deal because of Amazon's policy of resisting unionization (although, unsurprisingly, the bargain was supported by unions for construction workers and others anticipating expanded work opportunities).

Politics reared its head, of course, especially when the State Senate Majority Leader nominated Michael Gianaris, who represents Long Island City, to the obscure Public Authorities Control Board, which had the power to thwart the project. According to the *New York Post*, Gianaris opposed the subsidies and was "miffed" at not having been consulted by the mayor and governor when the deal was negotiated. Some say his nomination, while never effective, was the nail in the deal's coffin.

Finally, populist rhetoric injected resentment into the process, as per an article in *The New Yorker* magazine of November 17:

> Richard Florida, the urban-studies theorist, told [writer Anand Giridharadas] that Amazon's HQ2 competition "captures the zeitgeist of early 21st century American late capitalism." He added, "The very idea that a trillion-dollar company run by the world's richest man could run an *American Idol* auction on more than two hundred thirty cities across the United States (and Canada and Mexico) to extract data on sites and on incentives, and pick up a handy three billion dollars of taxpayer money in the process, is a sad statement of extreme corporate power in our time" . . .
>
> Alexandria Ocasio-Cortez, the [then-]representative-elect of New York's Fourteenth Congressional District, which spans parts of the Bronx and Queens, criticized the deal on Twitter. "The idea that [Amazon] will receive hundreds of millions of dollars in tax breaks at a time when our subway is crumbling and our communities need MORE investment, not less, is extremely concerning to residents here," she wrote . . .
>
> Reached by telephone on Thursday, Ocasio-Cortez called the Amazon deal "dressed-up trickle-down economics." "What we're seeing here is a complete public cost for a private corporate benefit," she told me. "When you give a three-billion-dollar tax break to the richest company in the world, that means that you're giving up our schools. You're giving up our infrastructure. You're giving up our community development." In other words, there is an opportunity cost to luring the world's richest man by letting him free-ride on the public services that other New Yorkers must pay for.

Although the majority of New Yorkers supported the deal in polls, the combined forces in opposition were sufficient to turn Amazon away. In a statement, the company said:

> For Amazon, the commitment to build a new headquarters requires positive, collaborative relationships with state and local elected officials who will be supportive over the long term.

That doesn't sound unreasonable.

But Amazon's decision not to go forward was cause for victory celebrations on the left. City Councilman Jimmy Von Bramer said:

> Even when we were faced with the richest man in the world and the richest company in the world, we did not buckle. Amazon doesn't need our $3 billion . . . (*New York Post*, February 15)

And Rep. Ocasio-Cortez tweeted the following:

> Anything is possible: today was the day a group of dedicated, everyday New Yorkers & their neighbors defeated Amazon's corporate greed, its worker exploitation, and the power of the richest man in the world.

In other words, the response from the "progressive" left was that Amazon could take those jobs and shove them.

I don't mean to single out Ocasio-Cortez, and I have nothing against her. But she is the most prominent spokesperson for the approach that so troubles me, and what she says exemplifies that which I want to resist. Here's what *The Washington Post* (owned by Amazon's Jeff Bezos) said in a February 21 article titled "Alexandria Ocasio-Cortez is an economic illiterate — and that's a danger to America":

> Case in point: Last week, Ocasio-Cortez celebrated the tanking of the deal negotiated by her fellow Democrats in which Amazon promised to build a new headquarters in Long Island City, New York, right next to her congressional district. Amazon's departure cost the city between 25,000 and 40,000 new jobs. Forget the tech workers whom Amazon would have employed. Gone are all the unionized construction jobs to build the headquarters, as well as thousands of jobs created by all the small businesses — restaurants, bodegas, dry cleaners and food carts — that were preparing to open or expand to serve Amazon employees. They are devastated by Amazon's withdrawal.
>
> Ocasio-Cortez was not disturbed at all. "We were subsidizing those jobs," she said. "**Frankly, if we were willing to give away $3 billion for this deal, we could invest those $3 billion in our district, ourselves, if we wanted to. We could hire out more teachers. We can fix our subways**. We can put a lot of people to work for that amount of money if we wanted to." [Emphasis added]

She entirely misses the point. **There was no $3 billion sitting in a city bank account, waiting to be spent on either subsidies for Amazon or enhanced services for New Yorkers. The $3 billion going to Amazon wouldn't have represented a diversion of resources from other potential uses.** It consisted entirely of contingent future payments: the part that would be kicked back to Amazon from the taxes it would pay, the balance of which could be used to support infrastructure or services. **No Amazon, no $3 billion paid out** (and no $24 billion of net taxes received by the city and state). Ocasio-Cortez either (a) completely misunderstood the deal she was criticizing or (b) overlooked the facts in favor of rhetoric calculated to play on resentment and scare up votes. Which explanation would you consider preferable?

A lot of readers enjoyed the story in my January memo about the ten men who drank beer in a bar every night, with each paying according to his ability. (It was included as an appendix. Nancy missed it the first time through; I hope you didn't.) When the grateful bar owner took 20% off their collective tab, the ten disagreed over how the reduction should be divided up, since most of it appeared likely to go to the richest man (who'd been paying most of the bill). In their anger, the other nine men beat up the tenth. He didn't come back after that, leaving the nine unable to afford their daily beer. **They sure showed him!**

And likewise, New York showed Amazon! They beat Amazon up, and it's not coming back. If you look back at the politicians' statements above, you'll see they're all about resentment of Amazon's (and Bezos's) wealth and how unwarranted the subsidies were. But there was no mention of the lost potential jobs or what's good for New York's economy or, more importantly, for its people. New York had a great chance to expand the pie, and the populists of the left found a way to scuttle it.

Another example of channeling resentment toward the rich is the *pied-à-terre* tax that's been proposed in New York City. The tax was inspired by a money manager's purchase of a $238 million apartment as a second (or possibly third) home. It would impose a levy on houses and apartments worth more than $5 million that aren't primary residences, on the grounds that the owners benefit from their homes' New York location without paying New York income tax. But is it smart?

Absentee owners pay real estate tax even though they use few city services. And when they come to town, their spending contributes to the economy. Do they really abuse the city? And the new tax would exacerbate the current glut of high-end homes by turning away some of the potential purchasers for whom they were built. *The New York Times* (March 24) says ". . . the tax is one small way to make New York City a little fairer." It also mentions the political palatability of a tax on wealthy absentee owners. But given that the obvious effect will be to depress the market for homes and diminish employment in a broad range of related industries, does it make economic sense?

The rhetoric of the far left plays on resentments and differences, and it's easily swallowed. But the policies are more likely to equalize the sharing of misery than to expand blessings, however unequal.

* * *

About 50 years ago, an older friend described for me what he felt made America great:

> When the worker in Britain sees the boss drive out of the factory in his Rolls Royce, he says, "I'd like to put a bomb under that car." But when the worker in the U.S. sees the boss drive out of the factory in his Cadillac, he says, "Someday I'll own a car like that."

Today, too few Americans feel they might own that Cadillac. Taken to the logical extreme, that has the potential to bring the American miracle to an end. **Thus, business should do all it can to arrest the trend toward stagnant and unequal incomes . . . not just to be fair or generous, but to assure perpetuation of the system that got us here.**

Capitalism is the most dependable route to prosperity. And it has to be responsible capitalism. **The solution can't lie in turning away the Amazons of the world, imposing extra taxes on Cadillacs or otherwise shrinking the pie.**

April 1, 2019

Legal Information and Disclosures

This memorandum expresses the views of the author as of the date indicated and such views are subject to change without notice. Oaktree has no duty or obligation to update the information contained herein. Further, Oaktree makes no representation, and it should not be assumed, that past investment performance is an indication of future results. Moreover, wherever there is the potential for profit there is also the possibility of loss.

This memorandum is being made available for educational purposes only and should not be used for any other purpose. The information contained herein does not constitute and should not be construed as an offering of advisory services or an offer to sell or solicitation to buy any securities or related financial instruments in any jurisdiction. Certain information contained herein concerning economic trends and performance is based on or derived from information provided by independent third-party sources. Oaktree Capital Management, L.P. ("Oaktree") believes that the sources from which such information has been obtained are reliable; however, it cannot guarantee the accuracy of such information and has not independently verified the accuracy or completeness of such information or the assumptions on which such information is based.