Memo to: Oaktree Clients

From: Howard Marks

Re: More on Repealing the Laws of Economics

Last September, I wrote a memo titled *Shall We Repeal the Laws of Economics?* in which I described economies as organic entities that operate on their own pursuant to some underlying laws. The best known is the law of supply and demand: in general, people will buy more of something as the price goes down and produce more of it as the price goes up. Another has to do with incentives: in general, people will allocate resources (such as their labor) to the activities for which they will be best rewarded. These and the rest of the rules are straightforward, and it doesn't take a Ph.D. to understand them. In fact, they're part of human nature.

But governments sometimes want outcomes different than those a free-functioning economy will produce. To that end, they enact rules and regulations designed to override the laws of economics. Some governments even go so far as to adopt socialism or communism, creating economies where government commands take over entirely from the laws of economics.

Rent Control

A prime example discussed in my September memo was rent control. When demand for apartments exceeds supply, it's only natural that rents will rise, perhaps eventually to the point where people who live in a given location can't afford to continue doing so. But elected officials typically want to preserve neighborhoods. They want their constituents to be able to continue renting apartments in their districts and not lose out to others who can pay more. To deliver on this aspect of constituent service, they pass laws to limit rent increases. Now people who otherwise couldn't afford to live in the jurisdiction can do so. Those tenants are happy, and that makes the elected officials happy, as happy constituents tend to vote for incumbents.

But not everyone is happy. Landlords are unhappy about not being able to charge the full rent they could charge in a free market, so they stop investing in their apartments and sometimes take them off the market. Developers who might be interested in building new apartments refrain from doing so out of concern that they won't be able to earn a sufficient return. Also unhappy are people who would like to live in that location and can afford to pay market rents but are unable to find vacant apartments because they're occupied by people paying below-market rents.

There are at least two things wrong with this situation. **The first is that governments are choosing winners and losers, rather than letting market forces do so.** In the case of rent control, the people who occupy apartments (and potentially political incumbents) are the winners, but landlords, developers, and people looking for apartments are the losers. The elected officials enacting rent control will say they're only trying to produce fairness for existing occupants, but they're obviously treating others unfairly.

In addition, there are negative implications for society overall. Tenants living in rent-controlled apartments enjoy a very valuable asset: a bargain-priced place to live. But there's no way to monetize that asset; they can only enjoy the benefit by continuing to live there. For this reason, they tend not to move, reducing mobility for themselves and everyone else. Rent control also discourages the upgrading of existing apartments and the construction of new apartments, so the housing stock fails to keep up with the needs of the community in terms of both condition and quantity. In other words, **governments can limit the rents landlords can charge for their apartments, but they can't make developers build new ones.** These things can reduce overall societal welfare and interfere with the movement of resources to the use where they're most productive.

Fire Insurance in California

Most unfortunately, earlier this year, in the aftermath of the Southern California wildfires, we witnessed an extreme economic consequence of overriding the laws of economics. When fires decimated the communities of Pacific Palisades and Altadena, thousands lost their homes, including a dozen Oaktree employees. On top of the severe disruption of all aspects of their lives, many of them are suffering extremely negative financial consequences. This is because many were uninsured or underinsured, often as a result of actions taken by California insurance regulators.

Most of California's government is firmly under the control of the Democratic party, which generally leans toward a high level of activism in general and intervention in economic matters in particular. Notably, because the Democrats hold a super-majority in the state legislature and have little fear of potential Republican opponents, Democratic elected officials don't have to moderate their behavior to pass legislation or hold on to their seats. And just like the support for rent control – there's a lot of that in California, too – the government sought to help out homeowners by limiting the premiums companies could charge for fire insurance.

In a sign of the times, I'll let my new (and AI-powered) editorial assistant, Perplexity, fill you in on the background. I've simplified the format and added emphasis, but I haven't changed a word. What follows below is pretty close to what I would have produced in an hour or two:

> Before the devastating fires of 2025, California's fire insurance market was already in a state of crisis, shaped by a combination of regulatory constraints, insurer withdrawals, and mounting wildfire risk.
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> Insurers were prohibited from using forward-looking catastrophe models to set rates for wildfire risk. Instead, they were required by law to base their rates on historical average losses over the previous 20 years. This approach became increasingly problematic as wildfires grew more frequent and severe, making historical data a poor predictor of future risk. Regulations also prevented insurers from raising premiums to reflect increased reinsurance costs, further limiting their ability to price policies according to actual risk.
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> Major insurers began withdrawing from the California market or ceasing to write new policies in fire-prone areas. Chubb stopped writing new policies for high-value homes in 2021, Allstate followed in 2022, and State Farm, the state's largest home insurer, stopped writing new policies in 2023. In 2024, State Farm announced non-renewals for over 70,000 policies statewide, including thousands in high-risk areas like Pacific Palisades and Altadena, just months before the 2025 fires. Other insurers, including Tokio Marine America and its subsidiaries, also exited the market in 2024.
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> Homeowners who managed to keep their policies often faced dramatic premium hikes. For example, some saw their annual premiums rise from $4,500 to $18,000. As a result, many property owners either lost coverage or could not afford to insure their properties, leading to

widespread underinsurance. **By the time of the 2025 fires, fewer than a quarter of affected properties were insured against fire.**

The state-backed FAIR Plan, intended as a last-resort insurance option, saw a surge in enrollment as private insurers withdrew. However, FAIR Plan coverage is limited and more expensive than private insurance, often requiring supplemental policies to achieve adequate protection. The FAIR Plan's exposure to wildfire risk increased dramatically, raising concerns about its solvency in the event of another catastrophic fire season.

California law provided for a mandatory one-year moratorium on non-renewals and cancellations of residential insurance policies in areas affected by a declared state of emergency. This protection applied after major wildfires but did not prevent insurers from withdrawing or refusing to renew policies before such emergencies were declared.

The regulatory approval process for rate changes became increasingly slow, with the average time for approval rising from 157 days (2013–2019) to 293 days (2020–2022). This lag contributed to insurer frustration and market instability.

As Perplexity notes, insurers were told they couldn't price fire policies to reflect increases in the frequency and severity of forest fires. Likewise, they couldn't raise prices to pass through the higher premiums their reinsurers were charging based on the increased frequency and severity.

If a $5 million house has a 1% probability of burning down in a given year and the insurance regulator says you can only charge $25,000 per year for a fire policy, what will you do? (Note: I didn't need Perplexity to tell me the insurance company faces an expected payout of $50,000 on that policy: 1% of $5 million.) The answer's simple: you don't write that policy.

The lesson here is the same as with rent control but rendered much more graphic by the catastrophic fires. **Just as with rents, you can limit the price insurers can charge for coverage, but you can't make them provide coverage at that price.** In this case, governmental efforts to enforce a non-free-market solution deprived many of access to insurance, ultimately bringing misery to thousands.

Anything Else? Oh Yes: What About Tariffs?

That's 2½ pages of prologue leading up to my main topic: tariffs. As we've had two months since "Liberation Day" on April 2 to think about them, I'm going to attempt a complete discussion (and also try to stay objective and apolitical).

First, what is a tariff? According to Merriam-Webster, it's "a schedule of duties imposed by a government on imported or in some countries exported goods." In other words, it's a tax. The exporting company, the exporting country, or the importing company might choose to pay some or all of the tariff, but only if they're willing to spend money to maintain their market share in the importing country. Otherwise, the tariff will be paid by the end-consumer in the form of a price increase.

Why is the U.S. raising tariffs? The reason for President Trump's pro-tariff stance is no doubt his long-held conviction that our negative trade balance in goods (the amount by which our imports exceed our exports – $1.2 trillion in 2024) is proof that foreign countries are ripping us off. As he puts it, "we're losing $5 billion dollars a day on trade." I'll leave aside my insistence that international trade isn't a rip-off in itself – it's literally a fair trade since the exporting country gets the money, and the importing country gets the goods it desires. I'll also overlook the U.S.'s $290 billion positive trade balance in 2024 in services – things advanced countries would tend to sell, such as financial, communication, and information services, along with intellectual property.

What are tariffs meant to achieve? On April 9, in my memo *Nobody Knows (Yet Again)*, I guessed at President Trump's goals in enacting them as follows:

- support U.S. manufacturing
- discourage imports
- encourage exports
- shrink or eliminate our trade deficit
- make supply chains more secure through onshoring
- deter unfair trade practices aimed at the U.S.
- force other countries to the negotiating table
- generate revenue for the U.S. Treasury

As I also wrote, every one of these eight goals is desirable in itself and something tariffs should bring about. Essentially, raising the cost of imported goods – and that's what tariffs do – should be a step in all these directions. The important question in economics is what other effects there might be.

Let me digress a minute for a primer on trade. Assume there are two countries with a wall between them. In Country A, workers make $100 an hour and a car costs $50,000. In Country B, workers make $50 an hour and the same car costs $35,000. Because there's no cross-border trade, all remains well and good. But if the wall comes down, some enterprising businessperson will ship cars from Country B to Country A, where they'll sell like hotcakes at a price of $36,000 (adding in $1,000 for transportation). **Highly unequal wages and prices – examples of what economists call disequilibria – can't persist if things like labor and goods are mobile. That's trade at work.** Thus, over time, workers will move from Country B to Country A for the higher wages. That will cause wages in Country A to come down (more workers available) and wages in Country B to go up (fewer workers available) and, eventually, Country B's cars to no longer be cheaper. **Tariffs are like the wall posited above. They impede foreign competition, enabling domestic manufacturers to sell their products even if they represent an inferior bargain.**

Let's say we accomplish the first two goals listed above, both of which are among the foreseeable results of what's called "protectionism," because tariffs protect domestic industries from encroachment from abroad. If imports are rendered more expensive by tariffs – or if they're banned altogether by trade barriers – domestic manufacturers face reduced competition from imports. That's good for domestic manufacturers and their workers, but what else happens? First, prices might rise; there are already reports of domestic manufacturers raising prices under the umbrella of higher import prices. Second, they may begin producing inferior goods because they don't have to compete against imports. Third, because they don't have to worry about competition from low-paid workers in foreign countries, domestic workers are able to form strong labor unions and demand high wages, further adding to the cost of domestic goods. **Thus, consumers pay more than they would if imports were unconstrained, and the volume of exports may actually decline, since domestic producers might become globally uncompetitive.**

Is the U.S. Right to Raise Tariffs?

When I was a boy, the phrase "foreign car" was practically an oxymoron. The first two Volkswagens came to America in 1949. They were among roughly 7,500 cars imported that year, representing only

0.03% – that's three one-hundredths of a percent – of all cars sold in the U.S. But in 2024, according to a fact sheet published by the White House in March, half the 16 million vehicles sold in the U.S. were imports, and they included 500,000 Volkswagens (usimportdata.com). Why?

There were a number of reasons for the success of the foreign manufacturers, including quality, engineering and marketing, but one main reason was that consumers concluded that cars made in the U.S. were more expensive than foreign cars but not correspondingly better. (My first car, an Oldsmobile Cutlass, cost $3,200 in 1965, and a Volkswagen Beetle cost just half as much.) U.S. auto workers were able to command higher wages than those paid in Germany or Japan, plus a unique fringe benefit package including lifetime medical care, which was said in 2008 to amount to $1,900 per car. This represented a tremendous competitive burden. Sales of cars made in the U.S. were brisk until the rise of international trade brought imports to our shores, at which point the imports imposed economic reality upon the Big Three U.S. auto makers, with their higher cost structures and dated products. (It must be noted that Volkswagen's success in penetrating the U.S. market is said to have been aided by subsidies from the German government.)

The result was lost sales for domestic producers and the movement of production overseas. Could this have been avoided? Only if U.S. workers were willing to work at wages comparable to those paid to workers in other countries. Otherwise, the movement of jobs to foreign countries was probably inevitable. U.S. automakers could have responded to the new foreign competition by improving quality or boosting productivity, but it's unlikely they would be able to offset their higher cost structures in the long run.

Niall Ferguson, the British economic historian, did an excellent podcast on April 10, just after the new tariffs were introduced. In it, he said:

> Every single economy that industrialized, from the late 18th century through the 19th century into the 20th century, reached a peak at some point along the way, roughly when the per capita GDP reached $40,000 [presumably in today's dollars], after which manufacturing as a share of employment declined. And the decline is essentially identical for all developed economies, as people move out of working in factories and move into service-sector jobs, which are less physically demanding and require more education. So that happened everywhere. It wasn't just in the United States. . . .

In other words, progress takes countries up the curve from subsistence to prosperity, and along the way they transition from agriculture- to manufacturing- to service-based economics. The success of the U.S. economy caused many of its workers to leave the manufacturing sector. As a result, only 8% of our non-farm jobs are in manufacturing today, down from about 30% in 1950. According to Ferguson's research, that probably didn't have much to do with the automobile industry in particular or with unfair trade practices applied by other nations. And it's probably not because people couldn't find jobs in manufacturing: according to the Bureau of Labor Statistics, there are about 400,000 job openings today in U.S. manufacturing, and no one's rushing to fill them.

It stands to reason that a country cannot pull ahead of others in terms of per capita income and standard of living and expect to continue as mainly a manufacturing economy. And neither can we return to being one. Here's more from Niall Ferguson:

> We cannot go back to the 1950s, or for that matter to the 1910s, not socially, and not economically. There is not a world in which these policies could lead to the reindustrialization of

> the United States, because it is way more expensive to do manufacturing in this country than it is to do it practically anywhere else . . .

It can be appropriate for a government to decide that certain goods should be made domestically and certain industries should be protected.

- The obvious example is when national security is at stake. We might conclude that our military shouldn't buy defense materiel abroad, since we don't want to be dependent on foreign suppliers, especially those in countries that could be antagonists. If you need further persuasion, Joe Nocera wrote this in a May 6 article in *The Free Press* titled "The Intellectual Godfathers of Protectionism":

  > If there was any doubt that America had put its security at risk in allowing the Chinese to take over so much manufacturing, COVID put it to rest. A closer look showed that the US needed China to build its ships, to gain access to rare-earth minerals, to export its semiconductors and literally thousands of other necessary products. . . . [Quoting Rana Foroohar], "People finally woke up to the fact that 80 percent of our supply chain had been outsourced to our biggest strategic rival."

- A tariff also might reasonably be enacted to protect an iconic industry that's important to national identity. The Swiss might want to bar imports of white cheese with holes in it, just as the French might prohibit importation of white wine with bubbles.

- Lastly, tariffs might well be applied against countries that employ unfair trade practices, such as subsidizing their domestic producers and denying foreign companies access to their markets. Tariff hawks assert that other countries have been doing things like this for years, leading to our massive trade deficit.

Governments can opt to levy tariffs in cases like these, even if they interfere with the operation of the free market. The argument we heard before the so-called Liberation Day was for "targeted tariffs" that would be applied selectively to accomplish these goals. But that's different from taxing all goods from all countries. Governments can't require everything to be made at home without consequences. Indeed, given that the U.S. is bigger and richer than most other countries, isn't it inescapable that we'll buy more from other countries than they'll buy from us?

Tariffs are, primarily, an effort to cause goods to be made domestically even when equivalent foreign goods are cheaper or better (or both). Governments can make that happen by erecting barriers that keep foreign goods out or make them more expensive. That protects domestic industries and domestic workers, but at the expense of domestic consumers (and global welfare). **That's a tradeoff – the kind of thing free markets require and leaders who would mandate economic outcomes would prefer to ignore.**

<u>Any Other Laws We Can Dispense With?</u>

I'll now leave the subject of repealing the laws of economics to comment briefly on our elected officials' willingness to ignore them. I'll discuss two examples.

The first relates to fiscal discipline. In short, the U.S. government habitually spends more than it takes in, and I think this is one of the very worst things going on in our country. As I mentioned in *Nobody Knows*

(Yet Again), the U.S. is able to do this because to date the world has given it virtually unlimited credit at particularly low interest rates. The result has been fiscal deficits in 41 of the last 45 years and trillion-dollar-plus deficits in all of the last five. If your brother-in-law behaved this way, you'd call him irresponsible.

Economist John Maynard Keynes said in the 1930s that if an economy is growing too slowly to produce the needed jobs, the government should engage in deficit spending. By doing so – putting more into the economy through spending than it takes out in taxes – it stimulates economic growth and thus job creation. And then, when prosperity is restored, the government should run a surplus – spending less than it takes in – and pay down the debt. Today, U.S. politicians from both parties are in the habit of spending without regard to the deficit, and the part about surpluses and paydowns has been forgotten. In fiscal year 2024, for example, **the U.S. ran a deficit of roughly $1.8 trillion, or 6.4% of GDP, in a time of prosperity**.

If we continue to borrow and add to the national debt every year at a rate that exceeds the growth of GDP, the interest bill at a constant interest rate will take up a bigger and bigger percentage of the budget, adding to future deficits and debt. The interest bill will compound as a percentage of GDP, and so will the debt. We already spend more on interest each year than on defense. And the interest bill will soar further if rates rise in the future – whether in response to inflation or deterioration of the U.S.'s creditworthiness – and maturing low-rate debt has to be replaced in a higher-rate environment. How long can we increase debt faster than GDP?

No one can say when, but it makes sense to assume we'll eventually reach a point at which our credit is no longer unlimited and our interest rates are no longer so low. As Warren Buffett said at the May 3 Berkshire Hathaway annual meeting:

> We're operating at a fiscal deficit now that is unsustainable over a very long period of time. We don't know whether that means two years or 20 years, because there's never been a country like the United States. But you know, this is something that can't go on forever . . . and it has the aspect to it that it gets uncontrollable at a certain point.

Fixing this won't be easy, as Buffett went on to say, because we've developed bad spending habits and leaders have pandered to voters by keeping taxes low. There are only two possible parts to the solution: curtail spending and/or expand revenues. No one wants to be taxed higher, and no one wants to see the programs they benefit from reduced. **Because what's required is austerity, all aspects of which are unpleasant, few people in Washington genuinely pursue a solution.** President Trump tried to cut "waste, fraud and abuse" through Elon Musk and his Department of Government Efficiency, but the potential savings went from $2 trillion to $1 trillion and ended up in the low hundreds of billions of dollars at most, which is a relatively immaterial amount.

At the same time, the House of Representatives has passed a bill that would extend tax cuts that were enacted in 2017 and supposed to end this year. Extending them would significantly increase the deficit relative to what it would be if the cuts were permitted to expire as scheduled. In addition, the bill includes some quirky revenue reducers, such as exempting overtime pay and tips from taxation and increasing the standard deduction for senior citizens. The non-partisan Congressional Budget Office estimates the bill will add an aggregate $2.4 trillion to the deficit over the next 10 years. How could the House have passed a bill in May 2025 that neither raised taxes nor cut spending? The rejoinder, as usual, is that the bill – and especially the tax cuts – will stimulate the economy, causing the deficits and the debt to shrink as a percentage of GDP. I think it's fair to say this tactic hasn't worked to date.

We're simply not tackling our deficits. We're not implementing meaningful spending cuts or tax increases. **The idea that spending shouldn't exceed revenues is completely out the window. George F. Will listed nine tenets of progressivism in a May 28 article in *The Washington Post*, and one was as follows: "limitless borrowing from future Americans to fund today's Americans' consumption of government goods and services."** I think that absolutely nails the thinking that guides all of Washington, with the exception of the rare true fiscal conservative.

The same is true with regard to the funding of Social Security. Our Social Security program was designed as a pay-as-you-go program, not a funded endowment that spins off benefit payments like a pension fund. Your tax payments are used to pay benefits to people who are retired, and in the same way, your benefits in retirement will come out of taxes paid by those working at that time. In the past, when many people were working relative to the number who had retired, tax receipts exceeded benefit payments, and the surplus accumulated in the Social Security Trust Funds.

Today, the problem is that the number of workers paying into Social Security has fallen relative to the number of retirees taking out. In addition, retirees are living longer, but workers aren't paying taxes longer. Thus, tax revenues coming in have fallen relative to benefit payments going out, and they are insufficient to pay benefits. The difference is made up by drawing from the Trust Funds.

The math is simple: there are x dollars in the Trust Funds, and they earn interest at Treasury rates. By projecting growth in the number of workers and retirees, benefit payments and life expectancies, you can estimate with some confidence the year when, in the absence of corrective action, the Trust Funds will be exhausted. That year is 2035. At that point, either (a) benefit payments will have to be cut so that they equal tax receipts (and it's estimated that receipts will be sufficient to pay only 79% of the promised benefits) or (b) the shortfall will have to be paid from the general U.S. government budget, further adding to the deficit. **Nothing in this paragraph is conjecture.**

There are many options for solving this problem. They include the following:

- raise the Social Security tax rate
- increase the amount of earnings on which Social Security tax is paid (the current cap is $176,100)
- raise the retirement age
- shrink retirement benefits
- reduce the cost-of-living adjustment
- apply a means-based test, phasing out benefits as a retiree's income rises

The problem is that all the above would be wildly unpopular with voters. It's assumedly for that reason that the two political parties have one thing they agree on: "hands off Social Security." Thus, it hasn't been dealt with in over a decade. What would happen to executives in your organization who turned a blind eye to such a foreseeable problem?

The members of the Baby Boomer generation to which I belong – people born between 1946 and 1964 – are unusually numerous, disproportionately affluent and probably above average in tendency to vote. Thus, they have significant political influence, having cast 38% of the votes in the 2020 presidential election. All the Boomers are in or near retirement, and no politician wants to antagonize them. Thus, elected officials can't stand the political heat associated with fixing Social Security, so they punt. As a result, the insolvency of the Social Security Trust Funds is sure to occur only ten years or so from now.

Let's get personal. I started getting Social Security when I turned 70, the latest possible opportunity, and I now receive $4,612 per month. **That's ridiculous: I and other wealthy Boomers shouldn't get Social**

Security benefits. As with the national debt, the problems associated with Social Security will be left for our descendants to deal with. **This is a matter of serious generational equity that deserves attention but doesn't receive it.**

Our elected officials may believe the status quo can be maintained forever, or more likely they count on being out of office by the time the wheels come off. But certainly, they're not facing up to reality. The behavior in Washington with regard to both the fiscal deficit and the precariousness of Social Security remind me of the tale of the guy who jumped off the 20-story building. As he passed the 10th floor, he said, "So far, so good."

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When allowed to function, the laws of economics provide incentives that encourage innovation, productivity and efficiency, creating prosperity and optimizing overall welfare. For example, globalization delivers the benefits of "comparative advantage," under which each country produces the things it can make better and cheaper and, as a result, consumers everywhere enjoy the best possible combination of quality and price. In the process, workers in the producing nations receive the highest possible pay for their labor.

And when insurance companies are permitted to pursue business and price policies as they choose, market competition will yield the best possible solution in terms of coverage that's available and fairly priced.

Of course, optimizing overall welfare is different from ensuring that all individuals prosper. Workers in a country that lacks comparative advantage may lose their jobs or see their wages decline if not protected by tariffs and trade barriers. And buyers of insurance may pay more for coverage than they would if insurance commissioners limited premiums.

The only way to strive for universal prosperity and "fairness" – no winners and losers – is for government to mandate it. But the efforts to do so have never been successful, as described above and in *Shall We Repeal the Laws of Economics?* It didn't work for the Soviet Union, and it didn't work in shielding homeowners from the economic impact of the California wildfires.

The much better way is for governments to allow markets to operate freely and deal with undesirable side effects. Examples include making sure a safety net gives workers who lose their jobs income support and retraining, as well as making sure companies and countries don't engage in improper, anti-competitive practices. Choosing to limit effects in this way may involve tradeoffs, with costs that a society can reasonably decide to bear.

The bottom line on all the above is that free-market economies don't produce perfect solutions, but efforts to significantly control them make things much worse. There can be no solution that gives everyone what they want. All things considered, however, the laws of economics lead to the best solutions that can be attained.

June 18, 2025

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