Confluence INVESTMENT MANAGEMENT

Weekly Geopolitical Report

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The Geopolitics of the 2020 Election: Part I

(NB: Due to the Memorial Day holiday, the next report will be published on June 1.)

In our geopolitical outlook for 2020,[1] our most important issue was the 2020 elections. In general, U.S. presidential elections are geopolitical issues because of America's hegemonic status. In an era where the U.S. is changing its position on hegemony, who resides in the White House may be unusually important. Therefore, foreign governments have an incentive to affect the outcome in November.

Due to the importance of this issue, we have written a five-part report, broken into nine sections. The sections are as follows:

1. *The Basics of Public Finance*: We look at the economics of public goods, the problem of free-riding and the role of the political process in allocation costs and benefits.
2. *Understanding the Electorate*: We examine the intersection of identity and class, which create groups, and introduce the Zeihan Grid to graphically show how they interact.
3. *Party Coalitions*: In a two-party system, parties are essentially coalitions of groups that change over time.
4. *The Incidence of Current Policy*: We show how the policies designed to dampen inflation have acted to harm the lower income classes.
5. *The Role of Social Media*: Media is always important to the political process and social media has changed how the parties act.
6. *Who will win?* We handicap the race between President Trump and VP Biden (spoiler alert—we are leaning toward Biden due to the current recession).
7. *Foreign Behavior*: This section examines the capabilities and leanings of major foreign nations with regard to swaying the election.
8. *The Base Cases*: We consider the outcome based on who wins the election.
9. *Ramifications*: We conclude with the likely market effects from the election.

The Basics of Public Finance

A key element of economics is the transaction. One party sells something to another party, who, on the opposite end of the deal, buys the product. In a free market with fully informed parties on both sides of the trade, it can be assumed that this is an efficient action—the seller receives from the buyer what both consider to be "fair." The seller gives up possession of the good and the buyer takes possession. A private transaction works because the good is separable; the buyer becomes the sole possessor of the product.[2] Put another way,

[1] *The 2020 Geopolitical Outlook*, 12/16/19

[2] This divisibility doesn't mean the transaction is perfect. There are two factors that can make a private transaction less than ideal, a condition economists refer to as "partial market failure." The first factor is called "externalities." Externalities occur when a private transaction has spillover effects that affect others not party to the transaction. A negative externality occurs when my private transaction has a negative impact on others. If I paint my house bright yellow and reduce the value of the homes around me, my purchase of paint

a market that doesn't fail is one where the private transaction captures all the costs and benefits.

When a market doesn't create conditions where all the costs and benefits are captured, it causes a situation that economists describe as "market failure." In the footnote, we describe a condition of partial market failure; the price and quantity don't fully capture all the costs and benefits. A classic example of full market failure is something called "public goods." A public good is one where the benefits are not divisible; if the good or service is provided to one consumer, all consumers can benefit and not necessarily harm the purchaser. Public goods have a particular issue, known as the "free rider" problem. If fire protection is provided, my residence is protected even if someone else pays for it. Thus, with a public good, there is no incentive for any individual to pay for it. Because public goods are plagued with the free rider problem, governments tend to provide them because they have the power of coercion. In other words, they can use force to make you pay your share through taxation.

Most people accept the public goods provided at the local level. A resident can see their property or sales taxes being used to provide police protection, schools or fire safety. Clearly, if one tried to divide fire protection, houses that refused to pay for it would put those who did at risk if a fire occurs. In other words, if the fire department refused to put out a fire for a home that was not "paid up," other homes that did pay could be at risk. Other public goods are divisible but still provided. A robust system of private education exists in America, but it is generally believed that we all benefit from a high baseline of education. Thus, public schools are common in most communities.

The ties to public goods at the national level can be less obvious. Clearly, national defense can't be divisible. If you have an army securing the border, you can't allow a citizen to be at risk of invasion while others are not. Once national security is provided, all benefit from it even if they don't pay for it. There are many other goods the government in the U.S. provides that don't necessarily benefit everyone equally. The services of the USDA mostly advantage farmers, but to some extent all benefit from greater supplies of food.

Still, the free rider problem is a serious impediment to the provision of government services. An individual has an incentive to receive goods and services from the government but get others to pay for it. A famous saying, attributed to Sen. Russell Long, describes this problem:

Don't tax you,
Don't tax me,
Tax that fella behind the tree…

The issue of the allocation of burdens and benefits goes beyond traditional public goods. Economists describe the costs and benefits of a policy as its "incidence." A famous example of this issue is the gold standard, where nations fixed the value of their currencies in terms of a specified

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generated a negative externality for my neighbors. On the other hand, if I invest in landscaping that beautifies my house, my neighbors may benefit because my purchase increased the value of their property. A second factor has to do with the idea of consumer surplus. The market-clearing price for a good includes buyers that would have paid more, but the seller doesn't get to capture that additional revenue if he sells to "all comers" at the market price. Sellers sometimes attempt to capture the consumer surplus through customer differentiation, that is, selling the same product to different buyers at different prices. A good example of this is "haggling at the bazaar."

amount of gold. If the balance of payments went into deficit, the deficit nation would have to engage in policies to reverse flows of gold back to the deficit nation. These were usually austerity policies—raising taxes and interest rates, cutting wages, etc. The costs of the gold standard tended to fall heaviest on debtors and labor, while the benefits went to the owners of capital. The gold standard was only effective under conditions of limited suffrage; when the owners of capital were dominant due to limited voting rights, they could impose austerity on labor, allowing policymakers to maintain the gold standard. After WWI, when voting rights expanded due to the sacrifices the general public made for the war effort, the gold standard tended to fail because the cost of adjustment could not be automatically assigned to labor.[3]

Although constituencies who argue for the provision of public goods or regulations (or relief from such) will attempt to couch their goals as "for the public good," for the most part, the goal is to get some version of Russell Long's ditty, to get some value from government for less than the cost of providing it. Often, the benefits of a policy go to only a few, while the costs are borne by such a large number that those bearing the costs are not willing to burden themselves with the lobbying effort to oppose it. This is a backdrop of how public goods and regulations are provided.

As the gold standard discussion shows, a good part of the allocation of costs and benefits comes down to power and influence. Those with power have the wherewithal to gain benefits or avoid the costs of policy. A key role of the political process is to sort out the demand for public goods and assign costs and benefits. In authoritarian governments, the leadership simply assigns the costs and benefits. In democracies, there is a complex system that develops around the allocation of costs and benefits. Democracies, in theory, can offer those with less power a degree of influence through the ballot box. However, in practice, the power of voting is usually curbed through politics and lobbying. For example, political parties can limit voters' choices and lobbying favors those who can afford to pay for its benefits. For those who lack power and influence, there are always fears that they will not benefit from policies but will also bear the burdens of providing them. For those with power, who tend to be a minority, there are always worries that democracy will devolve into mob rule and confiscate their assets and income.

Part II

Next week, we will cover sections two and three, namely, understanding the electorate and the role of political parties.

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[3] Simmons, Beth. (1994). *Who Adjusts? Domestic Sources of Foreign Economic Policy During the Interwar Years*. Princeton, NJ: Princeton University Press, pp. 22-25.