Income and Wealth

David Parker Essays

Volume One

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INTRODUCTION

Income and Wealth

For an individual, the most fundamental of all economic goals is financial independence—freedom from worrying about the state of the economy, from following the news every day, from producing a product or making a profit. Financial independence is possible for anyone because there is no relation between earning a living and acquiring assets, no relation between income and wealth. An employee at McDonald's making minimum wage can become financially independent within ten years.

Consider Andrew Carnegie: A young immigrant from Scotland, in 1848, without money or contacts, within a few years of arrival in America had acquired most of the nation's steel mills. Alone in his room, he read voraciously about the laws of money and economics. Pacing his library, sending a few telegrams, he applied what he learned. Soon afterward and for the rest of his life, Carnegie, the richest man in America, arguably in the world, even today, spent his time giving that money away, building and endowing the nation's public libraries, for one.

Consider my grandfather: An immigrant from Austria, in 1938, who had to leave everything behind, paced the house. Until my grandmother couldn't stand it any longer and told him to go out and do something. He came back with four movie theaters.[1]

For Carnegie as for my grandfather there was no relation between the wealth they acquired and the income they had. Their wealth did not come from savings but from investment, the purchase of assets with leverage, when possible, borrowing up to 100 percent of value.[2] (Most people purchase with their savings as a down payment and borrow the balance, but professional investors will borrow the entire amount—the leveraged buyout.)

It is not a coincidence that Andrew Carnegie and my grandfather made their money in America; the opportunity is here, the result of the certainty of this country's social, political and economic freedom, precisely what attracts creative, ambitious and entrepreneurial people.[3]

John D. Unruh, Jr., in *The Plains Across, The Overland Emigrants and the Trans-Mississippi West, 1840-60*, states that "the importance of privation, bravery, creativity, determination to solve problems of danger… [are those] characteristics that drained Europe of much of its vitality and made the U.S. an empire extending from coast to coast." To Unruh, those characteristics have not yet been bred out of American culture.[4]

Carnegie and my grandfather applied the laws of money and economics to acquire assets. But they also had business experience. In *The Empire of Business*, a series of lectures in 1902 at Columbia University, Carnegie states emphatically that preparation for business means to start at the bottom and learn everything.[5] To Carnegie, those wishing to make a fortune are wasting their time going to college. Professional sports are the analogy today. Certain careers start when one is young, when the body and mind are agile. In exchange, success comes quickly, leaving a lifetime afterward for study.[6]

My first experience with the idea that there may be no relation between income and wealth came as a child. I read in the newspaper about the death of an old waiter at the St. Francis Hotel in San Francisco, that it was discovered he had amassed a fortune and I remember thinking, “How was that possible? Waiters don’t earn a lot of money.”

My second experience came at my first public school teaching assignment. I regularly dropped by to talk with the school custodian at his tiny office, listen to Pavarotti, debate his claim of the superiority of Italian over French cuisine and to sense his joy at coming to work at dawn so he could turn on the heat and talk with early arriving students and teachers. It never occurred to me until he revealed it that he was not working for the money, that he owned four apartment buildings from which he derived ample cash flow.

McDonald’s

So, like the custodian, and probably the waiter, why can’t a young couple working at McDonald’s at minimum wage become financially independent in seven years? Because at minimum wage, it takes ten years.[7] It works like this:

If an employee at McDonald’s earns $10.00 an hour,[8] ten hours a day, six days a week, that’s $600 per week. If the spouse also works at McDonald’s, the $600 becomes $1,200, times four, $4,800 a month, $57,600 a year. For ten years, the two employees save half of what they earn: $28,800 a year.

At the end of each year that $28,800 savings is invested as a down payment on a $150,000 asset, say, a one-third interest in a $450,000 residence. At the end of ten years, ten such $150,000 assets, each appreciating at 4% per year, will be worth $1,872,856, and will generate $93,746 annual cash flow, a 39% annual rate of return on total cash invested of $288,000 ($28,800 times 10). The spreadsheet below shows equity build up for Asset No. 1:

Asset No. 1

Year No.	Cash	Loan amount	Original investment	4% Appreciation (compounded)	Asset value end of year	Annual loan amortization (4% int/30-yr)	1% Cash flow
1	$28,800	$121,200	$150,000	$6,000	$156,000	$2,134	$1,500
2		119,066		6,240	162,240	2,221	1,560
3		116,845		6,489	168,729	2,311	1,622
4		114,534		6,739	175,468	2,406	1,687
5		112,138		7,018	182,486	2,504	1,754
6		109,634		7,299	189,785	2,606	1,824
7		107,028		7,591	197,376	2,712	1,897
8		104,316		7,895	205,271	2,822	1,973
9		101,494		8,210	213,481	2,937	2,052
10		98,557		8,539	222,020	3,057	2,134
							18,003

The owners' equity in Asset No. 1 is the value of the asset at the end of year ten: $222,020, less the ending loan balance of $98,557, plus the total cash flow $18,003:

$222,020
\- 98,557
\+ 18,003
$141,463

At the end of ten years, the equity in Asset No. 2, purchased one year later, is the value of Asset No. 1 built up through year nine. The equity in Asset No. 3 is the value of Asset No. 1 up through year eight. Asset No. 4 through year seven, continuing to Asset No. 10 through year one:

Total value of the assets:

Asset No. 1	$222,020
" 2	213,481
" 3	205,271
" 4	197,376
" 5	189,785
" 6	182,486
" 7	175,468
" 8	168,486
" 9	162,240
" 10	156,000
	$1,872,856

Total value of the loans:	Total value of the cash flows:
$ 98,557	$18,003
101,494	15,869
104,316	13,817
107,028	11,920
109,634	10,023
112,138	8,199
114,534	6,495
116,845	4,758
119,066	3,136
121,200	1,576
$699,043	$93,746

At the end of ten years, the owners' equity is the total value of Assets 1 through 10, $1,872,856, less the total value of the loans, $699,043, plus the total value of all the cash flows, $93,746.

$$\begin{array}{r} \$1{,}872{,}856 \\ -\ \ 699{,}812 \\ \underline{+\ \ \ \ 93{,}746} \\ \$1{,}267{,}559 \end{array}$$

If our McDonald's couple then sells their ten assets and purchases a single $1,267,559 asset that earns 4% interest per annum, their yearly income will be $50,702. (Or, if they keep the ten assets, the return is the same.)

The young couple no longer need maintain their Spartan lifestyle (living on $28,800 a year). Now they can live on their annual cash flow of $50,702 a year. They are financially independent.

Of course, $50,702 a year is minimal financial independence. Yearly income could be greater under other circumstances: if the couple each earned twice minimum wage, $20.00 an hour; or worked twice as long, 20 years (because they couldn't keep up the Spartan lifestyle); or were active in the management and development of their real estate so that the value of the real estate increased at more than four percent a year. The point: even at minimum wage, it's possible to acquire enough assets so that wealth is no longer a function of income, rather, that income is a function of wealth.

For a more accurate (and surprising) accounting of the above example, see Appendix B.

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SOME ECONOMIC PRINCIPLES

Timeless Rates of Return

Again, a principal theme of this book is that there is no relation between income and wealth, between earning a living and acquiring assets. The idea derives from the natural laws of money and economics.1

One such law is the Efficient Market Hypothesis: *in a competitive economy, all investments produce the same rate of return*. What this means is that it's not important what investment you make; it's important only that you make an investment.

Throw a dart at the stock market page; buy whatever company it lands on. That company will produce the same rate of return as any other. Why? Because in an efficient market, whenever a stock produces an above-market return, buyers rush to purchase it; within seconds, its price rises such that its return is again equal to the others. Observe traffic backed up on a freeway; when one lane starts to flow, cars move over to that lane, and, right away all lanes are moving again at the same pace. No need to invest in a different lane; profit is zero.

Hidden, then, in the Efficient Market Hypothesis is the fact that not only do all investments produce the same rate of return, but that in the long run, all profit is zero. Why? Because basic rates of return are not profit. They are the time value of money—historically one to two percent for savings, two to three percent for mortgage lending, three to five percent for venture capital. When a rate is higher, risk is higher.[2]

But what about high income, even unconscionably high income? That also has nothing to do with a rate of return: *high income is entrepreneurial compensation*, that portion of a firm's total revenue generated by a particular individual. In professional sports, athletes, no differently than CEOs are paid a portion of the revenue they personally generate—perhaps two percent of that revenue.[3] The high compensation, however, does not last. It comes at the early stages of a product and drops off as the creative entrepreneur starts to generate less income. At that time the entrepreneur may leave, and the replacement CEO has but one function: *to slow down the rate at which the firm is losing market share*.

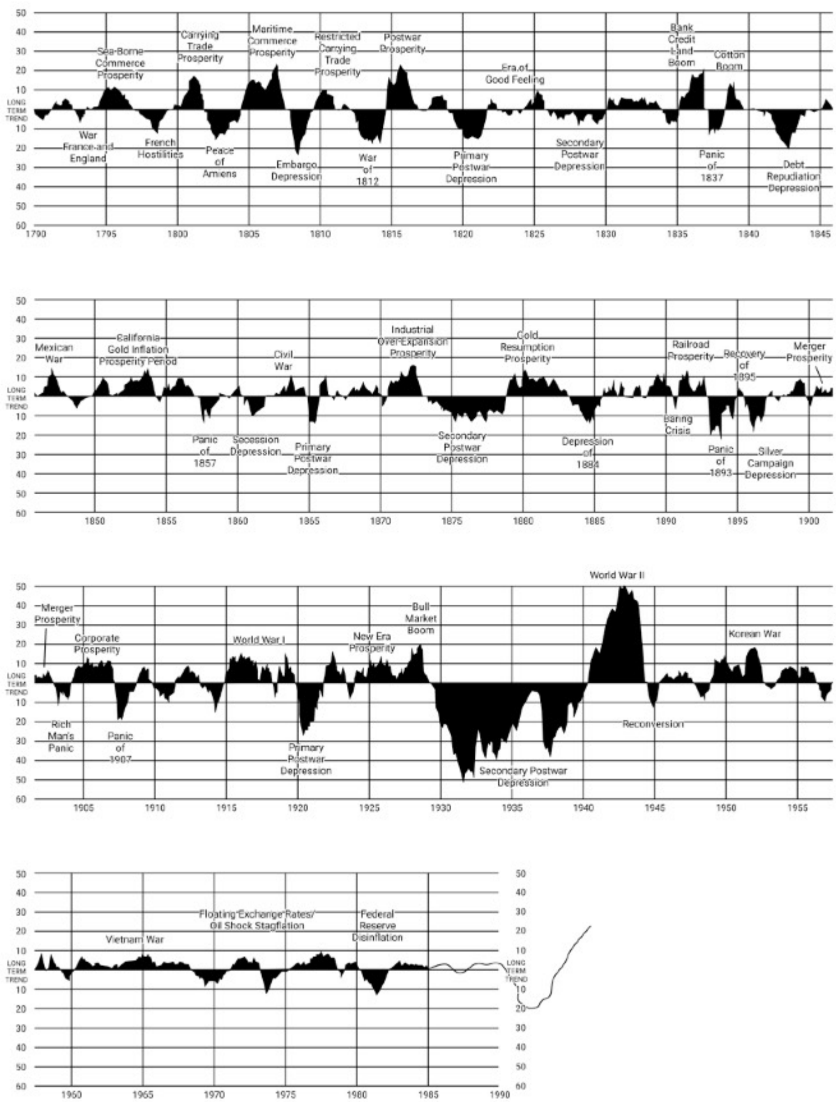
So, why are some CEOs paid $100 million a year? The only answer is supply and demand. Market reality is that few people are capable of holding a large corporation together. [See Appendix D, "Entrepreneurial Mindset."] The natural law of demand, that *price is a function of demand*, forces their compensation to be bid up. It may take a $100 million a year to entice a multi-millionaire to give up those mornings at the country estate reading *Essays* of Montaigne, setting up childrens' birthday parties in the afternoon, or what comedian Jerry Seinfeld calls "Gone Out, Left Family" (GOLF).

The correct insight is that wealth does not come from salary: *wealth is a function of acquiring assets through the use of leverage*—purchasing an asset with a down payment, borrowing the balance—*the* reason someone on a modest salary can (at that salary level) be as financially independent as someone on a high salary.[4]

Another important principle is that not only are rates of return timeless, but that rates of return are not profit. Every cost increase to business, therefore, adds to those rates. Taxation and regulation, the cost of solving social and economic problems through the political process, *has* to be passed back to the consumer. Unfortunately, that inefficiency leads to anti-competitive business behavior, for example, to large corporations with their low long-run-average-costs absorbing the added costs and then buying up the smaller firms that cannot. Thus, the consequence of legislation such as Sarbanes-Oxley and Dodd-Frank is that they push businesses to become too-big-to-fail, to become monopolies, and the nation to become a corporate state. The corporate state, socialism from the right, is a handful of corporations picked to carry out government policy (like in the 1930s and '40s in Italy, Germany and Japan). Watch out, then, when large corporations pretend not to want regulation. Like Uncle Remus' Brer Rabbit, they will yell, "Oh, whatever you do, please, please, don't regulate us!" [5]

Government intervention in the economy has to be accounted for: it disturbs real rates of return—the time value of money at risk—and disturbs the market's self-correction process—its natural ability to adjust to price change. Producers see rising price signals as a genuine increase in demand for goods and services, and so, increase production.[6] Once they realize the price increase was an adjustment to taxation and regulation, that it was artificial—inflation, artificial demand—and that they are holding unsold inventory, they will halt production. Hello, recession.

With recession, however, other problems arise: unemployment, and Keynesian pressure on government to do something about it, to stimulate demand through deficit spending. Years later, when everyone realizes that those interventions had no effect, to the contrary, that it was taxation and regulation that caused the recession, that along with belt-tightening, the solution should have been to reduce taxation and regulation, *then* the recession will turn around.[7] The following timeline of the U.S. economy glaringly reveals that government intervention in the 1930s greatly prolonged the Great Depression. The huge black mass that marks the 1930s' Great Depression, the only huge black mass, also marks the only economic downturn in which government intervened. The 1930s recession, about to end in 1933 (before any of the New Deal programs kicked in—see the large gap in that black mass after 1935), because of government policy that restricted the money supply and curtailed international trade, turned into the Great Depression. The Depression continued until 1942, and would have continued another ten years had it not been for World War II.



Was it the massive spending for World War II that ended the Depression? Yes, but only because the timing was right: it came at the end. At the onset of a depression, massive government spending is useless: depressions and recessions are free-market phenomena that must run their course.[8] Recessions are the result of an overexpansion of credit, a natural human phenomenon that, like a wound to the body, cannot heal faster than nature allows. Only at the end of a healing period might massive injection of vitamins have an effect.[9] See “Keynesian Economics” below.

However, before a discussion of Keynesian economics—economics based on the belief that a modern economy must have a governmental component, that social workers and politicians should be given a say—one must understand that to Keynesians it doesn’t matter that an advanced industrialized economy is too complex to be managed (in that no one can possibly manage 300 million people making decisions encompassing billions of interacting bits of information per second), or that individuals in a free society prefer to make those decisions for themselves. Keynesians are more interested in principles of social justice and wealth redistribution, and in the “benefits” of deficit spending. They are not interested in the adverse consequences (think European socialism). They are not interested in the economic principles that make it possible for a McDonald’s employee to become financially independent. Why? Because Keynesian economics is not economics; it's social policy; it’s wealth redistribution.[10] Wealth as a function of acquiring assets, *that’s* economics. Financial independence from acquiring assets through leverage, *that’s* economics. McDonald’s, *that’s* economics.

Economics – Personal Finance

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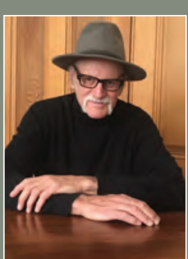

David Parker taught music to thousands of public elementary students in San Francisco for more than 40 years. During that time, he also became a successful real estate investor and serious writer on political economy. He has written five books and has had two essays published in Pacific Southwest Academy Journal of Law and Business.
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