

# MuhlenkampMethods

For the Intelligent Investor

Answers to questions you may not even know you have.

## Prosperity

*This essay was originally published in Muhlenkamp Memorandum Issue 52, October 1999. In this essay, Ron points out that for prosperity to be consumed, it must be produced. So if we want to enjoy the “good life” that comes with prosperity, we need to understand how prosperity is produced. What motivates the worker to work? What motivates the employer to hire the worker? How do we protect these incentives so that our economy continues to grow?*

I want to discuss how we produce prosperity. In this regard, the past 30 years have been fascinating.

### Defining “Prosperity”

What does “prosperity” mean to you?

When I ask this question, people respond in terms of a better lifestyle, home, car, or vacation; a secure retirement; funding college education; and so on. But these responses describe how we consume prosperity. I believe we can’t consume prosperity unless we produce prosperity.

In the 1970s, we had stagflation. Stagflation is a combination of low growth (stagnation) and high inflation. According to the economic theories I was taught in the late 1960s, this wasn’t supposed to happen. Inflation was supposed to be a result of too much growth. Low growth was supposed to result in lower inflation or deflation. So, stagflation wasn’t supposed to happen—but it did.

In the 1980s and 1990s we had accelerating growth and declining inflation, along with huge federal budget deficits. When Ronald Reagan proposed the tax cuts that resulted in budget deficits, conventional economic wisdom argued that the increased federal borrowing would result in higher interest rates, a crowding out of commercial borrowers, and a declining economy. It didn’t happen; interest rates fell, and the economy expanded for nearly 20 years. What went right?

In the 1970s we had 10% inflation and a progressive federal income tax rate structure with a top tax bracket of 70%. Inflation of 10% meant that each individual needed 10% more money each year just to maintain his/her standard of living. The progressive tax rate meant that if you received a 10% raise



(pretax), your taxes went up 20%. (The numbers are straight from the tax tables of 1979.) A 70% tax rate meant that after a certain level it didn't pay to work (and produce).

## All Work, No Pay?

One day in 1980, I was visiting a couple of clients who are doctors. They had set up pension and profit-sharing plans, but they also had a plethora of other plans, including salary deferral, and so on, each of which was designed to minimize or defer their tax bill. I finally asked them how much of their time they spent being doctors and how much of their time they spent deferring taxes. They said they spent about a day per week deferring taxes. So, here you have two highly intelligent, highly trained individuals who spent four days a week doing something useful and one day a week producing nothing, simply because of their high tax bracket.

The 70% tax bracket fed a tax shelter industry that funneled money into areas that were tax-favored rather than economically productive. And we got a glut of boxcars, barges, and "see-through" (empty) office buildings. Meanwhile, my friends who were farmers concluded that the way to get ahead was not to grow more food, but to borrow more money and buy more land. My suburban friends spent some of their working hours planning how to borrow more money and how to buy a bigger house. At about this time, a friend of mine who taught at Duquesne University sketched the following scenario based on a five-day work week:

- Monday, you pay 10% in taxes on your earnings.
- Tuesday, you pay 20% in taxes on your earnings.
- Wednesday, you pay 30% in taxes on your earnings.
- Thursday, you pay 40% in taxes on your earnings.
- Friday, you pay 50% in taxes on your earnings.

How many of you would come to work on Friday? Over the years, I have asked several thousand people this question. I used to get 2%-5% of hands going up. Lately, I'm getting zero. People are telling me that, at a 50% tax bracket, they will quit working. And you don't have to be an adult to come to this conclusion.

In the early 1980s, when my daughters were in their early teens, I hired them to keypunch for me. I paid them \$5 an hour when they could make only \$2.50 an hour babysitting. After watching their money



go to early-teen things that I considered frivolous, I suggested that, henceforth, they should not spend half of what they earned working for me. But the next time I asked them to work, they were unavailable, and the next. I finally had to remove the restriction in order to get the work done. My early-teen daughters were unwilling to work under a 50% tax rate (as perceived by them) even though the net to them was as great as they could earn elsewhere.

I believe the reason we had high unemployment in the 1970s is simply that it didn't pay to work. Certainly there were people looking for jobs, nearly all of whom would not have been in the 50%-plus tax brackets. It would have paid for them to work, but it didn't pay a businessperson to hire them. Aside from the income taxes, there was a raft of other penalties.

When I hired my first full-time employee in 1981, I had to fill out seven different forms and pay seven different taxes. My friends who were running small businesses told me I was crazy to hire employees instead of temporaries. Yet few politicians seem to understand that taxing the employer is not conducive to creating jobs. The exception was Ronald Reagan.

In 1983, Ronald Reagan lowered the top tax rate to 28%. It paid businessmen to earn the incremental dollar, so they started hiring. Unemployment has fallen ever since. George H. W. Bush and Bill Clinton raised the top tax rate to 39.6%. Depending on the state and local rates, most people face an additional 3%–8% in taxes. So we are once again flirting with the 50% rate at which people tell me they will quit working.<sup>1</sup>

<sup>1</sup>I believe the lowering of tax rates in 2001 is an important step in keeping people below the nonworking threshold, but the lower rates are temporary.



## Working: It's Not Just a Paycheck Anymore

Meanwhile, there is another dynamic that has changed in the past 30 years. If you work in a union shop, seniority (length of tenure) gives you preference on certain things. Thirty years ago, seniority gave a worker preference in working overtime (which pays one and a half or two times the hourly rate). Today, seniority still gives preference, but it is viewed as the right to not work overtime.

My father worked all the overtime he could. When I worked in a union shop for a couple of summers, I worked all the overtime I could. It was a chance to earn more money. Recently, I had a conversation with a man who has a tool and die shop in Vandergrift, Pennsylvania. I asked him if he has trouble getting employees. He said it isn't too bad. He pays less than Allegheny Ludlum (the big local mill), but people want to work for him because there is no compulsory overtime. Let me repeat. He can pay less because he has no compulsory overtime (which would allow employees to earn one and a half or two times the normal rate). Given similar choices, people have reversed their preference! What is going on?

I believe that many people no longer work just for money. While this may seem to contradict my earlier argument, I think the answer is a bit more subtle.

My parents and their peers, who lived through the Depression, were willing to work long hours and live cheaply to make things better for their children. People in Japan who survived the war were willing to work long hours and live cheaply to make things better for their children. When my son, Tony, was in Korea, he wrote home to say, "Dad, these people work 60 hours a week and live in rabbit hutches." My observation is that people who have been truly poor (without food, clothing, and shelter)—or who fear being truly poor—will do almost anything to avoid it. But those who have always had the basics, and take them for granted, have much different incentives.

Once you are able (or believe you are able) to take food, clothing, and shelter for granted, the willingness to work additional hours becomes a direct tradeoff between leisure time and additional goods or services. And it involves not just the hours of work, but also all the other facets of working, from a sense of challenge and satisfaction to the social and human aspects. Working becomes not just a means to feed and clothe yourself and your family; it also becomes a way to foster a sense of purpose and self-esteem. I know a lot of people who find purpose and self-esteem in their work. I don't know any who have found it in the party circuit.

One interesting aspect of the current U.S. economy is that many of the goods and services we now consume were unheard of just a generation ago. We use the word "need" to describe goods and services



our parents viewed as luxuries and our grandparents never dreamed of. It has become apparent that there is no limit to the goods and services desired by the consumer, which means that there is no limit to GDP per capita from a demand or consumer perspective. The only limit to GDP per capita is what that same consumer is willing to produce.

If we want people to choose to work and produce increasing amounts of discretionary goods and services, we, as employers, must compensate employees in ways that are meaningful to them, not just in salary but also in the work environment.

## Encouraging the Employer

At the same time, if we want people to choose to employ others and to produce increasing amounts of discretionary goods and services, we, as citizens and voters, must allow employers to earn returns that are meaningful to them, not only in money but in freedom from excess regulation.

If we raise taxes on employees, they're likely to quit working. If we raise taxes on employers, they're likely to quit hiring. And the margin of incentives is slim. In our economy, profit to payroll averages 6 cents on the dollar.

For my employee to take home \$1, it costs me \$1.84 (including the 401[k] contribution), which means that he or she has to produce \$1.95 to provide me with the 6%. (For an update, see our essay "The Trouble with Government Spending.") I believe much of the prosperity of the past 20 years rides on that 6% margin of profit.

As Abe Lincoln said, "You cannot help the wage earner by discouraging the wage payer."

