MuhlenkampMethods
For the Intelligent Investor
Answers to questions you may not even know you have.

Muhlenkamp's Musings on Economics

This essay was originally published in Muhlenkamp Memorandum *Issue 3, January 1988. More observations were added in October 1996. Themes include free will and the government, the effects of inflation and recession on spending patterns, the effects of investment on the economy, and the effect of income taxes on work incentive.*

Economic Maxims

"There is No Free Lunch."—Milton Friedman

Therefore, everything consumed must be produced. Every dollar spent must be earned.

Prices are set by the (potential) buyers.

No person or company can make you buy their product (only government can do that). Unless the product and price attract a buyer, there will be no purchase.

Organizations don't exist; only people exist.

An organization is just a number of individuals who have some common interest(s).

We are all volunteers.

We cannot be effectively coerced into doing what we don't want to do. We can be prevented from doing what we want to do.

Observations

1. People are diverse in talent, skills, desires, and interests. No matter how you write the rules, 10% of the people will fail. But the rules must be written for the 90%. The 10% can be treated as exceptions.

2. We cannot spend ourselves rich. We can only earn and invest to become rich.

3. People have three working speeds:

- They work for someone who can't/won't fire them, typically government.
- They work for someone who can fire them, typically a business.
- They work for themselves.

4. People have four spending modes:

- Spend their own money (money they've earned) on themselves (private economy).
- Spend money they've earned on someone else (private charity).
- Spend someone else's money on themselves (see the Senate office building).
- Spend someone else's money on someone else (government programs).

5. Inflation is much more detrimental to the long-term prosperity of people than is recession. When in a recession, people work harder, spend less, and are more careful about the expenditures they do make. This is a self-correcting mechanism. In inflation, the incentive of people is not to work harder, but to speculate; not to borrow less, but to borrow more; not to spend less, but to spend more.

Farmers in the 1970s perceived it in their best interest not to plant corn but to borrow more money to buy more farmland. People working a 40-hour job found it in their best interest to borrow more money and buy a bigger house. We engendered a belief that you can spend yourself rich and, as long as interest rates were well below inflation, it worked.

This was done at the expense of the savers of the world. As long as people were willing to take 5¼% interest on their savings, others were able to borrow at 7½% (pretax) and buy houses that appreciated by 10%. This worked fine for borrowers, but it didn't do much for savers.

Then savers got smart and raised interest rates. The tables turned, and they remain turned today. Savers can now earn enough on their savings to offset inflation, pay the taxes, and have a penny or two left over. Today, borrowing a lot of money to buy a big house is a losing proposition. From 1965 to 1980 it was a winning proposition. Yet, that fact educated a whole generation in the belief that they could spend themselves rich. You cannot spend yourself rich, individually or nationally.

6. The economy is not strengthened by spending; it is strengthened by investment. My grandfather farmed with horses. One hundred years ago, two-thirds of the American public were farmers, and they farmed with horses. We live much better than they did with a lot less effort, not because they spent a lot, or because we spend a lot, but because people invested time and effort (or in lieu of that, they invested savings) in ideas ranging from Ford's car and tractor to McCormick's reaper and Edison's electric power. Today we benefit from these investments. If those people had spent their money (after all, wine, women, and song have always been available), we would not have these items today.

Mr. Singer, who invented the sewing machine, when asked why, said, "For the money." We are taught today that greed is a negative emotion. In some ways, greed is great. It makes a person very easy to motivate. I am grateful that Mr. Singer was greedy. It allows me to wear much better and cheaper clothing than my great grandfather did, because he was reliant on my great grandmother and her fingers and needle and thread for everything he wore.

Further Observation

You can force people to put in their time, but you can't force them to do anything useful. Any nonmarket economy is evidence of this. If you want the ultimate description of how much time can be spent doing little useful work, read Aleksandr Solzhenitsyn's *A Day in the Life of Ivan Denisovich*.

I have an uncle who is a farmer. A few years ago he toured Russia. When he returned, he told me it was no surprise to him that Russia had economic difficulties. He observed 11 people baling hay and, in his words, "doing the work I do with two." I commented that he thought of them as farmers. He said, "Yes, of course." I noted they were working not for themselves, but for the government.

Another Observation

The following is an excerpt taken from an article entitled "When Economics Rises above Politics," by David R. Henderson, in The Wall Street Journal, *October 9, 1996.*

> The Royal Swedish Academy of Sciences awarded the Nobel Prize in economics to . . . William S. Vickrey . . . and James Mirrlees.
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> Mr. Mirrlees . . . was an adviser to the British Labor Party. In 1971 he published an article in which he took as a given that the government should redistribute income from rich to poor. Making reasonable assumptions about people's skills and earning power, and taking account of tax rates' effect on the incentive to earn, Mr. Mirrlees used some heavy mathematics to calculate the top marginal tax rate the government should impose on high-income people. Any guesses about what he found? Was it 83%, the top rate in Britain at the time? Perhaps 70%, then the top U.S. rate? Not quite. The top marginal tax rate, concluded Mr. Mirrlees, should be no more than about 20%. Moreover, he found that the marginal tax rate should be that same 20% for everyone. In short, the optimal tax structure, said this left-wing economist, is what we now call a flat tax.

> Mr. Mirrlees was stunned by his own result. "I must confess," he wrote, "that I had expected the rigorous analysis of income taxation in the utilitarian manner to provide arguments for high tax rates. It has not done so."
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> Mr. Vickrey, in an article in the *Palgrave Dictionary of Economics*, wrote that the marginal tax rate on the highest-skilled person in society should be zero. . . "There is no point to deterring him from earning the last dollar of income, since if he does not earn it there will be no revenue from it." Arthur Laffer couldn't have said it better. . . Mr. Vickrey wrote [in 1964]: "There still remains the fact that money income from gainful work is subject to an income tax while imputed income from leisure is not taxed. . . . Accordingly, an income tax tends to make individuals choose leisure in preference to gainful work to an uneconomical extent.

Folks, my conclusions aren't novel or new, but they require politicians to relinquish some of our tax money and therefore some of their power. And politics is all about power.