April 1, 2013

The Dilemma of Wealth Disparity

> *…the top 1% of Americans earn more income than the bottom 50%, and the wealthiest 400 Americans own more wealth than the next 150 million Americans combined.*
>
> - Senator Bernie Sanders (Independent from Vermont) [1]

Wealth disparity continues to increase at a rapid rate in the United States and, as it becomes more widely recognized, is becoming a divisive and contentious issue. Should this trend of increasing inequality continue, the social and economic consequences may become more divisive yet, and even perilous for future generations.

Due to wealth's profound compounding effect, it is amassed disproportionately. Concentrated, pooled wealth tends to be invested into more conservative cash flowing bonds, real-estate and dividend paying stocks. Stagnated wealth does not flow into new dynamic businesses which stimulate economic growth and prosperity. The velocity or circulation of money, and thus productive economic activity is reduced. The result of our current tax structure has reversed the "trickle down" theory of Andrew Mellon, to a "flood up" reality benefiting the wealthy. Is the current goal of our economic system to increase the standard of living for all, or to reward the few at the expense of the many?

What is the significance of this wealth compounding effect (U.S. dollars) for the marginal wage earner (4th & 5th quintiles), the average median wage earner (2nd & 3rd quintile), the wealthy, (1st quintile), and the super rich (top 1%), and what are the implications and relevance to our domestic and global society with regards to the compounding effect of wealth and household income?

The April 15, 2013, Forbes article "A Billionaires Map" estimates the Walton family, scions of the world's largest retailer, Wal-Mart, increased their 2012 net worth by **$3.1 billion** for an estimated total of **$119 billion.** (Sam Walton's children were gifted Wal-Mart stock at an early age, transferring ownership and avoiding high estate taxes at Sam's death.) Forbes reports, there are 442 billionaires in the U.S.

Warren Buffett's estimated personal net worth of **$54.6 billion** increased by **$1.1 billion** in 2012 according to Forbes. Buffett, a brilliant individual, intelligent investor, and a noble man, estimated the future annual percentage growth of Berkshire Hathaway will be about 12% compounded annually. According to him, Berkshire's book value compounded at 19.7% annually from 1965-2012, as reported in the 2012 Berkshire Hathaway annual report. Assuming a 12% annual growth in the future book value, the value of Buffett's net worth would double in six years to **$109.2 billion**.

Buffett understands the ***"eighth wonder of the world,"*** and the "*magic"* of compounding. ("Compound interest is the ***'eighth wonder of the world'***. He who understands it, earns it… he who doesn't… pays it."- Albert Einstein.) He utilizes the established tax laws and economic benefits written into law by the U.S Congress. Therein lies the dilemma. As an ardent admirer of Buffett, and owner of Berkshire Hathaway, clients and I have benefited from his brilliant investment ability, as well as the current tax structure of our economic system. This is not about Buffett; it is about the construction of our laws to disproportionately benefit the super wealthy!

How does this political influence translate to the living standards and wealth creation of the individual citizen? (Sales tax, income tax, real-estate rent / property tax, employment tax, local user taxes, payroll, social security, workers' compensation, etc. are normally paid by all employed individuals when applicable.)

[1] Congressional Joint Economic Committee meeting, October 4, 2011

It can be argued that this political influence has lead to a collapse in the living standards and wealth creation of individual citizens.

Table 1: US Household Income and Spending, July 2011 – June 2012, BLS

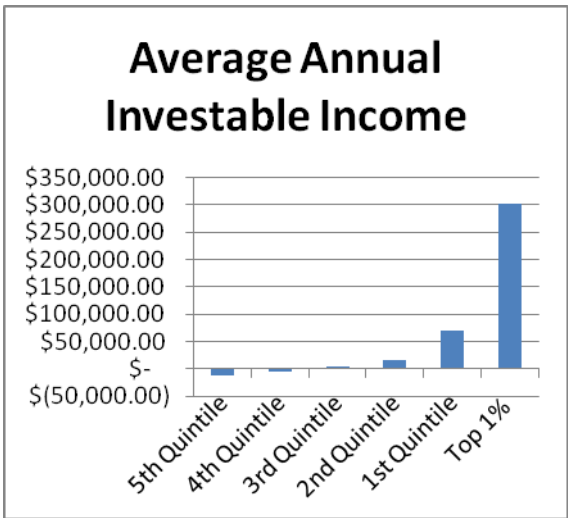
Family of 4	Average Pre-Tax Income	Non-Discretionary Expenses	Income Surplus/Deficit	Total Expenses	Investable Income♦
5TH Quintile	$ 10,000.00	$ 18,500.00	$ (8,500.00)	$ 22,000.00	$ (12,000.00)
4TH Quintile	$ 28,000.00	$ 26,300.00	$ 1,700.00	$ 33,000.00	$ (5,000.00)
3RD Quintile	$ 47,000.00	$ 34,100.00	$ 12,900.00	$ 43,000.00	$ 4,000.00
2ND Quintile	$ 75,000.00	$ 46,300.00	$ 28,700.00	$ 59,000.00	$ 16,000.00
1ST Quintile	$ 168,000.00	$ 77,200.00	$ 90,800.00	$ 98,000.00	$ 70,000.00
Top 1%	$ 717,000.00‡	$ 330,000.00◊	$ 387,000.00◊	$ 416,000.00◊	$ 301,000.00◊

♦ Investable income is calculated as Total Income – Total Expenses
‡ Dunn, Alan. "Average America vs. the One Percent", Forbs, 3/21/2012
◊ Estimate based on the 1st Quintile % of income.

4th & 5th Quintiles (Bottom 40% of Households)
A family of 4, with annual earnings of **$23,550** is at the federal poverty level in the United States. These wage earners make less than they can be expected to live on even if they never spend money on anything but what they actually need to survive[2] . They have no ability to accumulate assets or save money[3]. In this family both adults MUST work, and possibly more than one job. **Even then, the family must rely on food stamps and welfare benefits in order to survive.** They will never benefit from wealth compounding in any form.

3rd Quintile (Middle 20% of Households)
A family of 4, with annual $47,000 gross earnings (an experienced teacher with a masters degree, for example). **Saving enough for retirement is unlikely.** The benefit they gain from compounding is negligible.

Top 1%
Basic living expenses are irrelevant; however, the ability to have discretionary savings and compounding of wealth is significant!



The issue we face as a nation is the **control** of Congress by wealthy and powerful special interest groups. These special interest groups have influenced the laws to such an extent that they effectively control the political and economic system. The United States now has a **plutocracy**, a powerful and select number of individuals and corporate executives, some of whom are placing their corporate and personal interests before the needs of the common good. President Eisenhower, a conservative Republican, warned in his 1960 farewell speech of the dangers of a "military and industrial complex." Today the influence of financial and industrial executives, and individual plutocrats, has become a dangerous economic and political fact! Eisenhower's vision is now a reality!

[2] Table 1, Income Surplus/Deficit column.
[3] Table 1, Investable Income column.

Example:
One egregious example of a special interest group buying off politicians through political "contributions" is the tax rate (carried interest) for hedge fund managers. Congress and our President passed a law allowing wealthy hedge fund managers to be taxed at a 15% carried interest rate vs. the 35% ordinary federal income rate for the average wage earner. A hedge fund manager capturing capital gains of 1 billion per year earns 84 million in gains in just the first year. (Table 2)

Table 2:

	HEDGE FUND MANAGER	
TAX RATE		15%
PRE-TAX INCOME	$	1,000,000,000
NET INCOME	$	850,000,000
LIVING EXPENSES	$	1,000,000
INVESTABLE INCOME	$	849,000,000

In this way, tax loop-holes, tax free real-estate exchanges, tax-free exchange funds (for equities) and similar laws, solicited by special interests and enacted by Congress, and signed into law by Democratic and Republican Presidents, are at the foundation of this political perversion.

The dilemma at hand is how to responsibly address tax laws and regain control of a Congress which has been unduly influenced by special interest groups (corporate, individuals, and families) for over 100 years. As a representative body, Congress has written laws which unduly benefit their powerful and wealthy supporters. How can the uninformed and unorganized electorate restructure the political system in order to provide the economic incentive, personal initiative, opportunity, creativity and ambition we now enjoy, and concurrently reduce the increasing gap of wealth disparity the current system has created?

Additional facts!

In 2011, Doug Short wrote[4] that

> "**In real terms, households in the bottom quintile earned less in 2009 than they did in 1989—twenty years earlier."** i.e. the growth in household expenses exceeded the income growth of those households in the lowest quintile.
>
> **"In the top quintile, the annualized income growth increased… 84% during the same period**… The lack of sustained growth in household incomes is no doubt a major factor in the general decline in consumer confidence over the past decade."

Chairman Ben Bernanke, has observed that wealth disparity has been increasing since the 1970's, and that it is a real concern and something that we should address as a society.[5]

This is not the first time wealth disparity has been an issue for the United States. Republican President Teddy Roosevelt addressed the issue over 100 years ago. The observations and conclusions of Roosevelt are as relevant today as they were at the turn of the 20th Century. Roosevelt provided solutions for income inequality after observing the injustice, greed, and corruption during the Gilded Age of John D. Rockefeller, J. P. Morgan, Andrew Carnegie, Cornelius Vanderbilt and Andrew W. Mellon. Can we as a society learn from the wisdom and experience of our elders?

Clearly, the dilemma of wealth disparity and economic inequality cannot continue at the current pace. The American plutocracy now in place must be willing to redistribute their enormous wealth. This wealth was created by individual initiative, and the opportunity was provided by our economic and tax system. The laws and system were structured to a large degree, by special interest's political and economic influence. Is there a fair, beneficial, and rational way of accomplishing this redistribution? For America, economic inequality and wealth disparity may be the most critical social issue of the 21st Century!

- *Roger L. Johnson*

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[4] Short, Doug. "U.S. Household Incomes: A 43-Year Perspective." www.dshort.com 13 Sep. 2011.
Online at : http://advisorperspectives.com/dshort/updates/Household-Income-Distribution.php

[5] For more on this subject, please read:

- Domhoff, William G. "Wealth, Income, and Power." September 2005. Sociology Dept., University
- Dunn, Alan. "Average America vs the One Percent", March 21, 2012. Forbs
  Online at: http://www.forbes.com/sites/moneywisewomen/2012/03/21/average-america-vs-the-one-percent/