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Wealth and Income, and How Wealth Works

This material was originally part of an essay about wealth concentration and wealth management. People misunderstand what wealth is, and that mistake hinders seeing how capitalism works, works well or poorly, what is fair or unfair, and what to do. Regardless of who owns wealth, wealth should be well-managed so that it works toward the general benefit. We cannot expect any system of ownership and-or management to achieve an ideal of benefit for everybody but we can expect our system to work toward a practical realizable goal of general benefit. Some of this material is repeated elsewhere as needed.

From other essays, keep in mind that the income for most people is based on what difference he-she makes in the economy, that is, on how productive he-she is. This is true whether a person works for someone else or is in business for him-herself.

"Wealth" is how much a person owns and-or controls: material stuff, skills, knowledge, training, access to services, access to situations, reliable relations, favors owed to, and even reputation. It includes cars, TV sets, equity in houses, stocks, bonds, golf clubs, CDs, clothes, money under the mattress, money in the bank, jewels, art works, a lawyer on retainer, membership in a health club, membership in a health club that includes massages and tennis lessons, rights to a chair in a barbershop, rights to a pew in a church, having a tenured job, a reputation as a "cleaner" ("Pulp Fiction"), rights to profits from a movie, knowledge of calculus, and, sometimes, a diploma from a school.

"Extremes" are not the same as "distribution" or "unequal distribution". Suppose, in a group, 1 person has $1; 998 people have $50,000 each; and 1 person has $1,000,000,000 (billion). This group shows wealth extremes but not wildly unequal general distribution. In another group: 200 people each have $100; 500 people each have $10,000; 250 each have $20,000; and 50 each have $200,000. This second distribution is more unequal than the first although not as extreme. Just because a few people have vast wealth or suffer strong poverty does not necessarily mean the distribution of wealth is generally unequal or unfair. Economists have developed measures of equality or inequality in a distribution of wealth or income but I don't use them here. Although extremes are not the same as distribution, big extremes do tend to go along with unequal distribution.

"Income" is how much a person gets in new wealth in a period of time, usually per year. It is what the government taxes. For this essay, we need an idea a little different from what the state calls income. In many statistics, income is the total amount "in" minus total necessary expenses "out". If a person makes $100,000 per year in salary but has necessary living expenses of $60,000 then the person has a net income of $40,000. Some of the $40,000, the person might fritter away and some he-she might save to accumulate wealth. If a person has some money left over, what economists call a “positive income”, especially for a long run of years, the person can gains more and more wealth; the person accumulates wealth. For many Americans, necessary living expenses totally “eat up” wages, so these Americans do not have a positive income and do not accumulate wealth.

We have to be careful reading statistics to know whether “income” means “income in a place where income taxes are not very meaningful”, “income where taxes are significant”, “income before taxes without considering necessary living expenses”, “income after taxes without considering necessary living expenses”, and “income after considering both taxes and necessary living expenses”. Sources are not always clear. The American federal government considers income as what a person makes before taxes and other deductions such as FICA. Americans think of income as what remains after taxes and before necessary living expenses. To better understand concentration, some economists think of income as what remains after taxes and after necessary living expenses. When poor people in the Third World think of incomes in developed nations, they think of income before taxes and living expenses. They do not know about the high cost of living in developed countries and don’t consider taxes much because often they don’t pay taxes directly.

What makes up “necessary living expenses” is a big question that I do not address here.

Sometimes, spending on some necessary living expenses, such as payments to equity in a house, adds to cumulative wealth. Money spent on interest payments for the house does not. Money spent on food and medical care does not. Money spent on education might or might not.

For here (and I think for most statistics), think of income as after taxes and BEFORE necessary expenses. Think of some necessary living expenses as adding to accumulated wealth such as payments to equity on a house. I do not need to be fine-grained here so I do not sort it out in particular cases.

I do not explain “investment”. “Capital” differs from other stuff in that it allows a return, and the return can be the basis for profit and wealth accumulation. A car used for errands is stuff; a car used to deliver newspapers or pick up customers is capital. We can think of a savings account as more than mere stuff, we can think of savings as capital, because it is not money under the mattress but has been “invested” in a bank. If there are no fees to deduct, then the interest is the profit on money (capital) in the account. A painting is stuff if you buy it to enjoy it. It is capital if you buy it to sell it sometime. A CD collection is stuff if you buy it to enjoy it. It is capital if you use it for a small Internet business whether you originally intended to do that or not.

Suppose a computer programmer makes $80,000 per year, has necessary living expenses of $60,000 per year, and saves $20,000 per year. The $20,000 per year can contribute to wealth accumulation. We can consider it profit if we see it as a return on investment in education and on time-and-effort invested. It only matters that the salary can lead to accumulation of $20,000 per year. If he-she also invests the $20,000 per year so it earns additional interest, then we can think of the $20,000 per year as capital too, think of the interest as profit (the state taxes such interest like income and profit), and think the interest on the $20,000 also adds more to wealth accumulation.

Similarly, $1,000,000 invested in a small local bakery returns $200,000 per year; there are expenses of $130,000 per year; leaving a profit, or income, of $70,000 per year; not taking into account a normal salary for the owner-manager. If the owner-manager deserves $60,000 per year normal salary, then total expenses equal $190,000 per year ($130,000 + $60,000); leaving a profit of $10,000 per year. In business, profit is the usual basis for accumulation. If the owner-manager-as-representative-of-the-bakery makes $10,000 in "pure" profit (after standard salary) per year, then, after 10 years, the baker-as-guided-by-him-her has accumulated $100,000 in wealth. If the owner-manager also saves $10,000 per year from his-her normal salary, then together he-she accumulates $20,000 per year ($10,000 from pure profit as representative for the bakery plus $10,000 saved from salary). After 10 years, the owner-manager accumulates $200,000 in wealth. The state makes the owner-manager distinguish what goes to the bakery as a firm from what belongs to the owner-manager as part of salary.

$20,000 per year wealth accumulation is not too bad. Most Americans don't do that well; some few do very much better.

The regional supervisor of a business firm that owns and manages apartments makes $200,000 per year from which he-she saves $100,000 per year as the basis for investment and wealth accumulation. The owner of several local banks makes $1,000,000 per year, out of which he-she saves $800,000 per year as the basis for investment and wealth accumulation. The owner of a chemical manufacturing firm makes $10,000,000 per year, out of which he-she saves $9,300,000 per year as the basis for investment and wealth accumulation.

Income difference is not the same as wealth difference. Almost always, differences in wealth are much bigger than differences in income, and more stable than differences in income. Differences in income that don't seem big or important now can make big differences in wealth accumulation over time. They are what matter in thinking about impacts on the economy and society. The abilities to sustain income above needed expenses for long periods of time, and to reinvest accumulated wealth for more profit and accumulation, are what lead eventually to the great wealth accumulation of wealthy people and the even greater wealth accumulation of already-wealthy people.

The manger of Bank A makes $100,000 per year while the manager of Bank B makes $150,000 per year. They have similar expenses of $70,000 per year. At the end of 10 years, manager A has accumulated $300,000 while manager B has accumulated $800,000. The owner of several apartment complexes hires a person to manage them. The owner makes $1,000,000 in profit per year while the manager makes $100,000 above expenses per year. At the end of 10 years, the owner has accumulated $10,000,000 while the manager has accumulated $1,000,000. The manager buys a nice house, takes a wonderful vacation, and invests in a mutual fund. The owner buys more apartment complexes and hires another manager, and keeps doing that.

When comparing wealth, income, prices, etc. across time, we run into problems. Mostly, I ignore them. Inflation makes dollars worth less and raises money wages (but not real wages; see below) even when workers are not more productive, so a salary of $30,000 in 2015 is worth less in terms of "buying power" than a salary of $15,000 in 1980. Some prices rise faster than general inflation such as health care costs and housing. Some rise more slowly or fall such as the cost of computers and other electronic gadgets. I can't go into all this.

Suppose, in 1980, $500 bought a washing machine, but, now in 2015, it takes $1000 to buy the same washing machine. So $1000 now is the same "real" wealth as $500 then. Think of real income or real wealth in terms of what stuff (goods and services) it buys, not in terms of dollars. Dollars are only a way to assess what income or wealth buys. Dollar amounts are called "nominal" ("in name") amounts.

MORE ABOUT WHAT WEALTH IS AND HOW IT WORKS

Even now in the days of electronic finance, people tend to think of wealth as a big pile of money or big pile of precious metal. You can spend that heap however you want whenever you want. I think Warren Buffett has a vault somewhere full of silver. I am not sure what ratio of world wealth is in a "semi-liquid" form such as gold or silver, but not much, likely less than 1%. Buffett's pile of silver, if he has it, is only a small fraction of his total wealth. A pile of paper money would useless unless you could trade it (spend it) for real things that you can work with such as shovels, bulldozers, wires, computer code, hard workers, and smart workers.

It is better to think of wealth as the ability to get things done. A factory is wealth because it is a way to get things done. A piece of land is wealth for the same reason, even if we only use it to sit on to admire the sunset. A dollar is wealth because you could buy a bag of apples (or now, half an apple).

Although rich people can access money somewhat as non-rich people think of when they think of rich people sitting on a big pile of money, in fact, eventually, most money wealth rests on: material things such as factories, mines, land, farms, timber, and stocks of metal (less often gold than iron, vanadium, titanium, chrome, rare earths, etc.); products that have been made with raw materials such as cars and phones; ideas such as for a movie, book, or device; skills that went into making products and ideas; and the ability to hire people with skills. This is the wealth that people think of when they think of their house, car, business, and life insurance policy as wealth. Wealth also rests on the ability to get people to give you material goods and to do things for you, including think for you. That, in turn, can rest on your ability to get "liquid" wealth (money) to make deals. So we have to go from material goods to money wealth to see how things get done, and we have to see how rich people can make that move in ways that non-rich people usually can't.

It is easier to use $300,000 in money to get things done than to use a $300,000 house. It is easier to use $20,000 in cash to get things done than to use a $20,000 car unless all you want to do is run errands. When you have a lot of material stuff such as coal mines, factories, big buildings where smart people write computer code, research laboratories, and farm fields, you have two advantages. First, the hard stuff acts as a barrier against changes. The hard stuff is there, has value, and doesn't go away. Second, you can use the hard stuff to get money with which you can do things. You can borrow on it. It is the ability of the hard stuff to get you money to do things that makes it interesting as wealth. That makes it capital. I don't guess how much stuff you need before you cross a line and start thinking of it as capital rather than as simply stuff.

Even when banks and other financial institutions use money to get things done, now, they rarely use gold and they don't use paper as often as non-wealthy people think. They use ideas that get people to do things. They use the idea that they can pay people in electronic money to get people to do things. Again, it is the ability to get things done that makes electronic blips into capital and wealth.

What is important about getting things done is that we get the right things done, in the right amounts, by the right people, to the right people, for the right people, in the right ways. What is important about wealth is that it be managed properly for the general good. Just the fact that some people have more wealth than others does not matter if wealth in general is used for benefit in general, and nobody with skill and a good attitude goes hungry. The fact that some people have more wealth than others does matter if that arrangement of wealth causes the wealth to be misused, to lead to less general benefit, and especially if people with skill and a good attitude go hungry. Wealth does not have to be managed so that, in each case, wealth results in the greatest public good or even in any public good. Wealth only has to be managed so that overall the wealth results in much public good. We would like to get the most public good possible but that is not always practically available. We would like to avoid harm but we know sometimes some harm comes anyway.

Capitalism and managing wealth are like our legal system. Ideally we want pure justice. But we can't get pure justice directly. Instead, as an indirect method, we have the police, and we have competition between prosecutors and lawyers, and between lawyers and lawyers, from which competition we hope we get a close approximation to justice. We go after one thing not directly but indirectly using a method that we hope leads to best results. We don't expect perfect results. We adjust the system to get better results when we see bad results consistently. Some people have unusual ability due to natural skill or to training (they have a kind of capital). We hope they use their ability in the method to make the method work better to arrive at better justice. Even when they don't aim their ability that way, we have formed the system so it aims their ability that way anyhow, so the system uses them to get justice even when they don't care about justice. We cannot expect everybody to have equal ability and training (equal capital). Not only is equal ability and equal training impractical, but also it would do away with needed experts, and would overlook the opportunity to have people of unusual ability lead. We need a division between the large mass of ordinary lay people with small knowledge of the legal system (small capital) versus legal experts (large capital). We have found that works best. It can be terribly annoying but it does work best.

I can't specify a single goal for the economic system as for the justice system. Say the goal is prosperity, security, and the material means to pursue and safeguard freedom. We can't go after this goal directly either, so, instead, we use an indirect method to approximate the goal. We know we won't hit the goal perfectly but we hope our indirect method approaches as closely as possible, we can make corrections when we see flaws in the method, and we can make ad hoc corrections when we see some particular people who are victims of the system. We let people own stuff. Sometimes they own enough stuff so they have capital. We let people use their stuff as they wish, including investing it in the hope of getting more stuff. People compete for jobs and they compete in business. We hope that competition results in the best people getting the jobs and in the most adept people getting the most capital. People with capital use their capital to get more capital, and so on. Using capital this way leads to people in general having jobs, having security, and having the means to defend their freedom. We hope competition and owning leads to prosperity, security, and freedom, as closely as we can get. We accept that most people will have only moderate wealth and some people will have a lot of wealth. The fact that some people have a lot of wealth allows the system to do things that could not be done if the wealth were absolutely evenly divided (see below). We have fairly good evidence that this way does work and it works better than alternatives such as socialism, fascism, and theocracy. We know the capitalist way is not perfect. We correct the method (the rules for using capital) to make it work better, and we try to take care of ad hoc cases where people are hurt unfairly by competition and the amassing of capital. The indirect way can be terribly annoying but it does work fairly well.

In this description of capitalism as an indirect method to prosperity, security, and freedom, I said that we allow people to own stuff, and to own unequally, because to do so leads to the greatest good. That assessment is not quite true. People have a right to own stuff without necessarily any reference to the greatest good. We even have a right to own stuff in opposition to the greatest good. We do hope that the right to own stuff leads to the greatest good nearly all the time. There is no absolutely reliable way to reconcile all conflict between the right to own versus the greatest good, and I don't try here. Mostly in this essay I use the idea of "ownership as an indirect way to the greatest good" and I don't stress rights. That does not mean I don't know about rights. It doesn't mean that people who stress rights have a right to overlook greatest good. Both overlooking rights and stressing rights without feeling responsibilities are errors and both errors are unacceptable.

ON SHARING PRODUCTIVITY

Productivity in general has gone up but, among not-rich people, incomes in general have not gone up and wealth in general has not gone up. A worker-in-general is doing more but not getting more. All this is true but putting the issue in these terms biases any response. These terms confuse abstract averages with specific real processes. We have to be precise without using words to cover up in case workers are not getting something they deserve.

Saying "productivity in general went up" makes it seem like "productivity in general everywhere in every field by every worker consistently" went up. In that case, everybody makes more of a difference and everybody's income and wealth should go up. But that is not the case. Productivity in general in this sense does not go up directly. Only productivity in some particular arena goes up directly, such as dairy farming or video games. Then, only after benefits from an increase in productivity in that arena have spread through the whole economy, might productivity, incomes, and wealth in general go up. More productivity in one arena need not lead to more productivity in EVERY arena and to more productivity in general. Some arenas stay less productive, so incomes in those arenas should not go up much. Not every arena that increases its productivity leads to gains equally for everyone in the arena including workers, managers, and owners. Not every arena that benefits from more productivity in other arenas shares benefits equally with everybody in the arena including workers, managers, and owners. Not all arenas gain in productivity from increased productivity in other arenas. Not all arenas that do gain in productivity from increases in other arenas gain equally; some arenas gain more in productivity from changes in other arenas while some arenas gain less. Of course, changes that raise the productivity in one big arena do usually help productivity in other arenas and so do help general productivity; but, still, not in every arena and not in every arena equally.

Examples make this issue clearer. When computers get faster and cheaper, not everybody benefits right away and not everybody benefits equally. Those businesses that are most computer-intensive benefit the most and fastest, such as accounting, insurance, finance, some science, and Internet sales. Other industries that use computers benefit after a while but often not as much, such as health care, farming, chemical manufacture, and chain retail grocery sales. Some business benefits only a little or not at all such as fast food sales and janitorial services. When electricity first spread in the early 1900s, it did not benefit all business and workers equally and did not raise all incomes and wealth equally - or not at all. After decades, electricity was in almost every business, so we can say it did raise productivity in general, and did raise incomes and wages in general – but still not in every business equally. Bio-tech is likely to do the same. Bio-tech will change farming and medicine drastically but it won't affect computers and road building for a long time.

When change works its way through a particular industry first, then through some other particular industries, and then through most of the economy, it is NOT the case that all workers automatically reap all the benefits of increased productivity through increased wages. SOME increased productivity goes to workers, SOME goes to inventors, and SOME goes to owners. At first, owners get nearly all the benefits, and then the benefits cause some increase in income for workers. Over time, due to competition between firms in the field where the innovation began, much of the increase in productivity does tend to benefit workers in that field more. Then, again over time, some of the increase in productivity in this original field goes to benefit not only the workers and owners in this first field but generally through the economy; and much of that benefit eventually goes to workers. I don't explain here how these effects happen. How much goes to whom, when, and how is a big topic that I can't summarize here.

Productivity also works in reverse. Some industries become (comparatively) less productive, and so the profits and wages in those industries decline. The usual example is the horse-and-buggy industry after the automobile but more modern examples are the film industry or the land-line telephone industry.

So, what about changes in productivity since 1981? Where were they, who should get most benefit, do the benefits still remain primarily in the innovating industries or have they spread through the economy, which industries get more or which less as the benefits spread, what industries are left out, and so what industries should not have increased incomes and wealth? Again, these are topics too big for here. You can get a sense of the issue through some of the scenarios below.

The problems are that (1) we don't seem to be getting benefit even to the workers in particular fields with obvious innovations such as computers, plastics, and cell phones, and (2) we don't seem to be getting much general benefit even from changes that have spread through the economy and should have made for a general increase in incomes such as from plastics and computers. Owners do seem still to get most of the benefits. If electric production were invented-and-implemented now instead of 1910, then J.P. Morgan would get all the new wealth while workers get little; Henry Ford would get all the benefit from mass-producing cars while his workers and Americans in general get little.

It is hard to assess this situation accurately because of the background issues of increased costs, America entering the world economy, and the distorted domestic economy. Background problems could lead to higher money wages but not to increased real incomes for workers. These background problems would not affect owners as much, and so owners would still benefit. In this case, the gap is not due to a plot on the part of owners or corrupt politicians.

Recall that America once dominated the world economy but now is merely another large player. While America dominated, American business firms made unusual profits and American workers shared in the unusual profits. While not exact, it is fair enough to say American workers benefitted too much from an over-assertion of their productivity. In enough cases, the productivity of workers from other nations is growing faster than the productivity of Americans, has caught up to the productivity of Americans, or has surpassed us, as with Japanese and Germans in the 1970s and 1980s, and Chinese and Koreans after 2000. The productivity of American workers is increasing a bit if we compare American productivity now to before; but, even with small increases, the productivity of American workers might still lag behind increasing productivity elsewhere. Although American productivity now is somewhat more compared to America before, American productivity is still stagnant compared to the whole world. So real wages of American workers should not go up in the world arena and so should not go up here. If America had not increased productivity, we would have fallen more behind, like the Red Queen in "Alice in Wonderland" running faster just to stay put. Productivity gains in America are counteract a bit losses in comparative productivity in the world arena but maybe not enough so salaries should go up.

(To be fair: when I say "productivity", I have in mind something more complex than what most people think of as productivity. I have in mind "how much product is made (or service delivered) minus costs". Costs are high in America. High costs reduce American productivity and reduce gains in productivity compared to the world. We cannot reduce costs by making workers into slaves. We need to reduce costs.)

Although American workers are not gaining in real wages from increases in productivity, owners are gaining both from increases in productivity in America and the world. I don't explain here why.

Some kinds of labor will not be more productive and will not share much in productivity increases in other arenas, such as fast food work, janitorial work, general labor, and even some kinds of construction work. It would take a massive restructuring in how labor is used to make productivity gains with that kind of labor, and that kind of restructuring would result in huge losses of jobs. It is unlucky so many people now are in this kind of bad work, thus they are unable to share in gains in productivity and are so threatened by changes. It is unlucky that so many people now are incapable of finding more productive and better-paying work and so more able to share in increases in productivity.

The fact that so many Americans now do the kind of work that cannot increase its productivity much, and the kind of work that does not benefit from gains in productivity elsewhere, would lower the average gain from increases in productivity. They lower the average. That could make it seem as if Americans in general were not benefitting from increases in productivity, and American incomes in general were not going up, when, in fact, outside this group, workers were benefitting from increased productivity and incomes were going up. Is this the case? If we discounted all the people who can do only bad work and have only bad jobs, would the rest of the people be well-off enough? To answer this question fairly would require dipping into numbers more than this essay wants to do. Briefly, I think we cannot explain away stagnation by blaming it on people with no skills and bad jobs. They do lower the average but enough stagnation is left over after considering them so the middle class in general is still not gaining from productivity and so incomes still have not gone up since 1981. The problem is bigger than the group of people who can do only crappy work and can get only crappy jobs.

All this about productivity might be sad, and maybe even a bit unfair, but it can't be helped for a while. I don't know how long. It has been going on since 1975 and it looks to go on for ten more years. To really get at this topic, we have to put numbers on effects, which I can't do here. We have to figure out how over-valued American workers were before, how quickly foreign workers are catching up, how foreign workers might have surpassed American workers, how much any recent gains in American productivity might counteract the effects of losing out compared to other workers, how much owners gain from both domestic and world-wide industry, and how much owners gain from increases in both domestic and foreign productivity. That task is a challenge.

Distortion of the economy, rising costs, and America merging into the world economy contribute both to stagnant incomes and to workers not sharing in productivity. Workers not sharing in productivity adds to stagnation and-or stagnation adds to workers not sharing in productivity. Other factors contribute to workers not sharing in productivity and to stagnant incomes: legal, strategic, and tax advantages held by business firms and rich people over citizens in general; politicians helping business firms but not workers; weakness of the American labor movement; the American labor movement and American workers are willfully ignorant about economics and about how real capitalism works; workers have little idea how productive their job is generally and they are individually; and workers have outdated ideas of good relations between workers and owners. To sort this out would require an essay on its own and that essay would be an entirely different kind of essay with data and analysis. For here, we need to accept that: American salaries do not reflect productivity gains, incomes are stagnant, the two effects are related, and some of the stagnation comes because American workers are moving from a privileged advantage over other workers of the world to parity in productivity with many world workers.

AMERICAN INCOMES VERSUS WORLD INCOMES

Because income depends on productivity, pretty much everything that applies to productivity applies to incomes. Until about 1975, American incomes were too high compared to world incomes for similar work, just as men's incomes are too high compared to women's incomes for similar work, even if, in some cases, men used to be a bit more productive than women. Since 1975, we have adjusted to the gap between American and world incomes, primarily by not raising real American incomes while real incomes around the world have risen. Because real incomes in America could not rise as fast as incomes for similar work in other parts of the world, in effect, American incomes did not rise although America got richer. In fact, this is pretty much how women's incomes became more equal to men's incomes; because women's incomes rose a bit while men's incomes stagnated. Because new wealth could not go to non-rich people while American incomes could not rise, the new wealth went to already-rich people. The very many people now with bad jobs with low incomes do lower the average income but they do not account for the total amount of stagnation. The problem is much bigger than bad jobs. Again, this outcome might not be fair, but it is what it is. It is not clear when this particular adjustment will end. It is not clear if democracy can survive the wait. The adjustment would be a lot less harsh, and we would better preserve democracy, if we controlled rising costs, especially for health care, housing, education, and food.