



★ *Part I* ★

THE RELUCTANT CAPITALISTS



★ *chapter one* ★

THE ENDURING CONFLICT: ECONOMIC EFFICIENCY VERSUS ECONOMIC JUSTICE

I know of no country, indeed, where the love of money has taken stronger hold on the affections of men and where a profounder contempt is expressed for the theory of the permanent equality of property.

—Alexis de Tocqueville, *Democracy in America*, 1835

Examining the Roots of the Conflict

Perhaps the failure of many investors to achieve financial security stems from the fact that Americans are reluctant capitalists; that is, we desire all the benefits that a capitalistic free-enterprise system provides, without the costs. As we will see, the benefits and the costs are inextricably bound together. To set a course for successful investing, it is imperative that we distinguish between the economic and the social consequences of economic policy.

This distinction is made difficult because as Americans we have had a long-standing love affair with a four-letter word that begins with “F.” We use it every day to describe everything from our social values to our



legal statutes. The word is *fair*. Typically, we use the word as if it had but one meaning. Practically speaking, however, the meaning will depend on whether we are referring to our notion of economic justice or that of economic efficiency. Making the distinction is essential if we are to put into perspective the seeming conflict between the outcome of free-market economics and our desire for economic equality.

When referring to economic justice, fair implies freedom from self-interest, prejudice, or favoritism—evenhandedness. When referring to economic efficiency, however, fair has another meaning that is more appropriate: conforming with established rules. Thus, when defining our notion of economic justice, the word addresses the quality of a predetermined outcome; when referring to an efficiently functioning economy, fair means that, as long as we follow the established rules, whatever outcome is obtained from the dynamics of the system is considered just.

The fact is, a free-market economic system is blind. It does not care whether you are male or female, short or tall, old or young. All the system was designed to do was to provide the most output at the least cost. It will distribute goods and services in an economically efficient manner. It is important to emphasize that this does not necessarily mean it will distribute these goods and services in a socially desirable way.

Capitalism makes neither interpersonal comparisons nor moral judgments. It is amoral. Our worth, or value to the system, is determined solely by the extent of our contribution to the output of the system. You can be the kindest, gentlest, most considerate individual on earth, but if you do not produce something or contribute something to the overall production of goods and services, you have no economic value. Economically speaking, you are worthless. Conversely, you may be a serial killer, but if you produce marketable goods or services, you have value.

These are harsh statements, but they are true. They may fly in the face of everything you learned at home, in school, or in your place of worship. But, like it or not, understanding the nature of our economic

system is the first step in developing the mind-set to deal effectively with your financial affairs.

Let me illustrate. When used to describe the efficient functioning of our economic system, fair means that if you produce five dollars' worth of goods and services in an hour, you should receive five dollars of income for that hour of work. If you produce one hundred dollars' worth of goods and services in an hour, you should receive an hourly income of one hundred dollars. For our economic system to operate efficiently, then, each of us must earn enough income to buy back what we have produced. No more, no less. In fact, to the extent that all individuals are not equally productive, the efficient functioning of an economy *requires* income inequality.

In a freely functioning capitalistic society, we must produce in order to consume. The only way we will be able to consume is if we produce something of value. Under our free-market system, if allowed to operate unfettered, 20 percent of the population could wind up with 80 percent of the output if the same 20 percent had been responsible for 80 percent of the production. In an efficiently functioning economy, over time, the fruits of economic growth will accrue only to those who produced that growth and in proportion to their contribution to it. The outcome of a free-market system will not be evenhanded.

Fair as a synonym for economic justice is used to describe the allocation of goods and services based on need, irrespective of whether the level of goods and services is representative of an individual's productive contribution. In effect, a portion of income is redistributed from those who produce it to those who consume it. Typically, this result is achieved through tax policy. The object of policy becomes the reduction of the disparities between income levels created by market forces. Examples of such redistributive programs are welfare; unemployment and workers' compensation; and rent, crop, and food subsidies. While the objective of these programs is highly laudable and reflective of the American spirit, their implementation may very well impede the ability of the economy to operate at its most efficient level.

Capitalism and Democracy: Oil and Water

At this juncture, it is important that I make my point of view crystal clear. I believe government does have an important role to play in economic matters. Government should provide an environment in which corporations and individuals can pursue their legitimate economic objectives efficiently. Some governmental control is necessary to protect us from the evils of monopoly. Providing for the national defense, fair-labor practices, and taxation are all legitimate governmental functions.

The challenge is to work out a system whereby we can improve the workings of a less-than-perfect competitive system. As Paul Samuelson, the Nobel-prize-winning economist, has said, “The relevant choice for policy today is not a decision between the extremes of laissez-faire and totalitarian dictatorship of production, but rather the degree to which public policy should do less or more in modifying the operation of particular private economic activities.” The more efficiently an economy is allowed to operate, the more growth will be achieved, and an economic environment will be created in which each individual will be able to achieve his or her potential.

As we will see later, when the economic philosophy of our government tends to emphasize the redistribution of income away from the direction in which it would naturally flow, the economic environment becomes increasingly inefficient, growth slows, productivity stagnates, interest rates and inflation rise sharply, resources are misallocated, and financial markets do poorly. Conversely, during periods when the government advocates policies that allow markets to move freely and that enhance the desirability of saving, investing, and producing, the economy responds with vigor, inflation and interest rates decline, and the financial markets, reflecting economic health, respond favorably.

Predictably, each of these situations will set forces in motion that ultimately trigger a reaction. For example, the threat of a collapsing economy will lead to the adoption of policies designed to save it. After



THE ENDURING CONFLICT

• 7 •

its rescue, as the more productive segments of society get ahead faster than the less productive (a predictable outcome) and as income disparities between these groups widen, the unevenness of the results of economic freedom comes back into focus, and in a political system where the majority rules, the people will vote to change direction.

The conclusion to which one is led is disturbing—that capitalism and democracy are, by their very nature, incompatible. Satisfying the objectives of one system may—and often does—preclude achieving the objectives of the other. Perhaps the systems could work better together if we could accept the notion that a mechanic may have a lower standard of living than a neurosurgeon and that a neurosurgeon may have a lower standard of living than a rock star.

You might ask why a rock star is worth more on the economic ladder than a neurosurgeon. The answer is simple: because the market says so. The interaction of the supply of and the demand for goods and services represents the decisions of literally millions of individuals. The market value of work is determined by its productivity, irrespective of who produces it. In this sense, the economic value of a product or a service may differ from its social value.

While it is true that many factors enter into this determination, the marketplace is highly impersonal, and the result of market forces may not square with our own individual preferences or personal value systems. For example, when those collective decisions create a huge demand for a certain rock star's music and relatively less for neurosurgery, the rock star will command more money than a neurosurgeon will. We should remember, however, that the average neurosurgeon still earns more than the average rock musician.

As individuals, we must take market-determined results as a given. While this may seem defeatist, it is realistic. We live in a world governed by the laws of supply and demand. To try to change this reality would be like tilting at windmills. We must understand this reality and then deal with it. Remember, there is no moral standard in the market-

place. When it comes to successful investing, and as much as it might go against the grain, we must see the world the way it is, not the way we would like it to be. Unfortunately, dissatisfaction with the social implications of economic policy may be among the major distractions that prevent investors from making appropriate investment decisions.

Economic Gyroscope: The Inexorable Quest for Equilibrium

No matter how hard we try to force our economic system to be even-handed in a social sense through the redistribution of resources and output, the economic system will work against us in an attempt to restore market efficiency and equilibrium. A perfect example is the cruel hoax of the minimum wage. In an admirable attempt to help individuals at the lower end of the income ladder, we have instituted the concept of a minimum wage rate that will give people a minimum standard of living—a “living wage,” as it is often put.

In 1960, the minimum wage was \$1.00 an hour. In 2000, it was \$5.15. One is tempted to conclude that individuals earning the minimum wage in 2000 were more than five times better off than those earning this wage in 1960. However, when we give individuals more purchasing power than is represented by their production, we do not increase the amount of goods and services available. We have only increased the number of dollars chasing the same quantity of goods and services. Over time, that leads to higher prices and ultimately removes any advantage the increase bestowed. The economic system will try to take back from them what they did not produce.

Unless minimum-wage workers have become more productive over time, economic theory suggests that they will be able to buy as much as—and no more than—they could buy before. In fact, after adjusting for price increases since 1960, today’s \$5.15 per hour will buy what \$1.00 per hour bought 40 years ago. Despite all of society’s well-intentioned efforts, it has not been able to increase this group’s command over goods and services.

We do not have to constrain ourselves by looking only at the minimum wage to see how these forces work over time. Figure 1.1 illustrates the validity of the notion that the only way workers in general can improve their standard of living is by increasing their productivity. When they do not become more productive, any increase in their hourly wage will ultimately be taken away by inflation.

The most comprehensive and internally consistent set of statistics we have on the subject is the series produced by the Bureau of Labor Statistics. The figures cover the hours of work of all people engaged in the business sector, including the hours of proprietors and unpaid family workers. Their compensation includes fringe benefits and an estimate of wages, salaries, and supplemental payments for the self-employed.

By adjusting the hourly compensation reported in this series for the price of the totality of the output that the business sector produces, we can see how much of their own product workers can buy with the

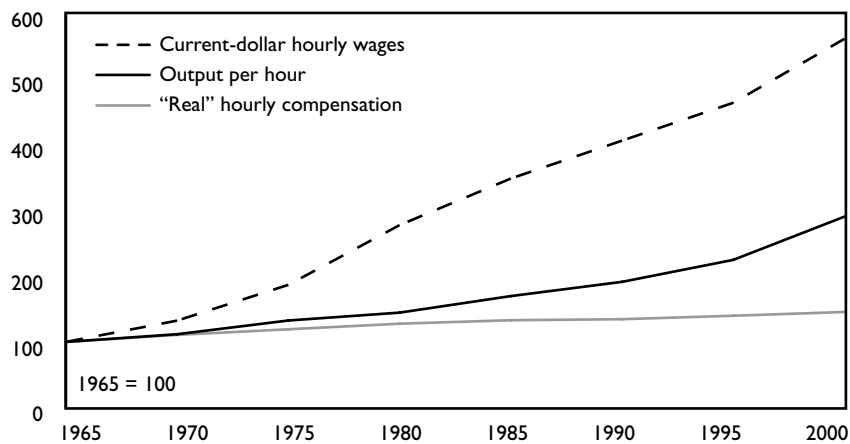


FIGURE 1.1 Regardless of how far or how fast workers' paychecks may increase, their real purchasing power will be determined by how much their productivity improves. Only when productivity rises can workers enjoy real gains in purchasing power. (Source: U.S. Department of Labor, Bureau of Labor Statistics.)

compensation for an hour's work. If we take 1965 as a base, we see that by the end of 2000, real compensation had tracked productivity quite closely throughout the entire period. Figure 1.1 shows how, over time, the relationship between the index of real compensation and the index of productivity remains relatively close.

The conclusion is inescapable: Over long periods, real purchasing power will conform to productivity growth. The growth in real wages and worker command over goods and services is inextricably tied to the ability of workers to increase their productive capabilities. Of course, individual workers can forge ahead of the pack by raising the amount of their individual output. Again, the rewards of production will be commensurate with the value of the product.

This relationship suggests that attempts by government to alter the income distribution between groups of workers manifesting different rates of productivity growth, over the long run, will be destined to meet with failure. Real compensation for each group ultimately will depend on that group's contribution to the overall growth of output.

The Economic Pendulum Swings Slowly

Our political system reflects our social values. We all count the same—one person, one vote—regardless of our contribution to overall production. Consequently, since the definition of economic justice, or what is fair, conflicts with the definition of economic efficiency, a tug-of-war becomes inevitable. This struggle between a political system seeking to allocate output in a socially desirable way and an economic system constantly attempting to utilize resources in the most efficient and productive manner gives rise to relatively long cycles that manifest profoundly different economic and investment conditions. Like a large pendulum, the slow oscillations between these policy cycles will persist as long as we have a free-market economic system working within a democracy.

As we will examine in greater detail later, successfully meeting your



THE ENDURING CONFLICT

• 11 •

long-term investment objectives requires that you be able to discern these subtle shifts in economic philosophy. If you do, you will be able to position your assets appropriately. Short-term movements of the business cycle can, and often do, obscure these more important longer-term trends. Your ability to distinguish between the economy's short-term cyclical movements and the longer-term trends is a crucial element in establishing your long-term investment plan and sticking to it.

