Getting Rich in America: A Few Easy Rules to Follow

Richard B. McKenzie and
Dwight R. Lee

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Richard B. McKenzie
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Policy critics often speak of "the rich" with none-too-subtle disdain, as if those at the very top of the income ladder are all crooks or as if becoming "rich" is difficult and means others must become poorer. While we would be the first to admit that some crooks are rich, we hasten to add that achieving the status of "the rich" (defined, say, by having a net worth of $1 million) is not particularly difficult, contrary to popular wisdom. Remarkably, the rules for acquiring substantial wealth are few, simple, and well worn. That fact suggests that becoming rich for most Americans is largely a matter of choice.

Surely, some people are rich because their parents were rich. Senator Ted Kennedy would never have lived his lifestyle or achieved his high office if he had parents of modest means. Of course, Ted Kennedy is not alone in the good fortune of his birth. By world standards, most Americans are "rich" precisely because they were born in this country. Americans typically have far more wealth than people in other countries and, as a consequence, can generate more income each year with greater ease. Americans produce nearly 60 percent more per person than Europeans. They produce each year close to 300 times the output of the typical person in Ethiopia, a notably poor country. The relatively high production levels in this country mean that most people can earn a lot and save some of what they earn.

The first rule for becoming rich is have a reasonable income base, which is what most Americans have virtually by the fact of their birth. Few people who have subsistence income levels can expect to ever be rich. They must devote themselves entirely to survival, which means they can't save and their wealth can't grow. This doesn't mean that *all* Americans live in luxury or have high incomes. Some do live in squalor and are incapable of saving. But the fact remains that even poor Americans have more than the subsistence-income levels of people in Ethiopia and many other countries. By world standards, most Americans start with a reasonable income base from which they can save, invest, and build their net worth. What is interesting is that less than 4 percent of Americans are "millionaires," that is, live in households with a net worth of more than $1 million.[1]

How can an ordinary American become rich? One surefire method is to live modestly.

Without question, some Americans have become inordinately rich because they have been lucky. They won a lottery or had the right talents at the right time. If Michael Jordan (who, by all accounts, is "super rich") had been born 30 years earlier, he might have done well in basketball, but he certainly would not have earned the substantial fortune that he has. Contrary to conventional wisdom, the overwhelming majority of millionaires in the country do not have anywhere close to Jordan's tens of millions of annual earnings. Indeed, half of all millionaires have an annual income of less than $131,000.[2]

How can an ordinary American (with a modest annual income) become rich? One surefire method is to live modestly (if not close to poverty), that is, to save a substantial portion of earned income, until the savings pile up, which is precisely the route most rich people have taken to their good fortunes.[3] For most Americans of modest or above modest means the savings will, through the power of compounding, eventually make for a substantial net worth — and an income level that will be the envy of those who has chosen to fritter away their incomes on compact discs, chips, cigarettes, and new cars. Indeed, a modest and continuous saving plan started early in life can ensure wealth later in life, say, at retirement.

As a simple illustration, suppose that a newly minted 22-year-old college graduate, who has a typical starting salary of, say, $30,000 a year, salts away a mere $2,000 the first year (and *only* the first year) on his or her first job (or a saving rate of 6.6 percent). Assume also that the new graduate is able to secure an annual rate of return (above the inflation rate) on the accumulated investment of 15 percent until retirement.[4] The one-time investment will be worth more than $800,000 at age 65 and more than $1.6 million at age 70. This American would clearly be considered "rich" even in this country, given that in 1993 (the latest year of available data), the median household net worth for all Americans was a mere $37,587 (including the value of the equity in their houses). However, median net worth varied from under $6,000 for young adults to a high of $91,481 for people in their prime earning years, 54 to 64 years of age. Households headed by Americans 75 and older had a median net worth of $77,654.[5]

Granted, 15 percent might be an unreasonably high expected rate of return for such a long period of time, but notice that the calculations are based on a one-time saving of only $2,000. If the person could only achieve a 10 percent compounded rate of return (which is approximately equal to the appreciation of the stock market over the last half century), then his or her one-time, $2,000 investment would reach $120,000 at age 65 and $194,000 at 70, a not inconsequential wealth level compared to what most retirees have.[6] If the person could achieve a compounded return of only 6 percent (which assumes the average rate of increase in the stock market for the past 70 years, minus an inflation rate of 3 to 4 percent), the investment would reach only $24,500 at age 65 and just under $33,000 at age 70. The person would not then be rich at age 65 or 70, but neither would he or she have sacrificed much in consumer goods along the way. Indeed, the person's sacrifice would have been zero during every year of his or her career other than that very first year.

The second rule for becoming rich is to take the power of compound interest seriously and do so very early in life. The sooner the saving, the greater the opportunity for the power of compound interest to work. The higher the return on the investment, the greater the growth. An obvious reason many Americans are not rich is that they save little or wait until late in life to take saving seriously, and then they are not able to achieve a reasonable rate of return on their investments. Most Americans have no one other than themselves to blame for their modest means late in life. They end up their careers with modest means often because they resisted the opportunities to live modestly along the way.

Take the power of compound interest seriously and do so very early in life.

If a person were to resist the temptation to consume away all earnings and were to save more aggressively (but still modestly) — say, $2,000 a year from age 22 until retirement — the investment would, of course, mount more rapidly. If the investor were then able to get the 15 percent annual return, the nest egg would swell to over $6 million at age 65 and to between $12 and $13 million at 70. If he or she were only able to get 10 percent, the nest egg would still exceed $1.3 million at 65 and $2.1 million at 70. If the return were only 6 percent, the retirement fund would still be almost $400,000 at age 65 and well over a half million dollars upon retirement at 70 — many times the net worth of the typical retired American today.

An even more reasonable career saving plan would run the wealth to extraordinary levels at retirement. Suppose that the college graduate's first job paid $30,000 a year and that over the course of the student's career, he or she gets raises that, for purposes of simplifying the calculations, are 2 percent a year (after adjusting for inflation). The person's annual income would be just under $70,300 at age 65 and $77,600 at age 70. The person would not be "rich" based on salary alone, but he or she could be very rich, assuming the person saved 10 percent of each year's salary. Even at a rate of return of 6 percent on investments, the person's wealth would be nearly $800,000 at age 65 and $1.1 million at age 70. At a 10 percent compounded rate of return, the person's wealth would be $2.4 million at age 65 and $3.9 million at 70. With a 15 percent rate of return, the wealth would be a stupendous $10.8 million at 65 and $21.7 million at 70. The person would be "rich" by any standard.

The third rule for being rich is to save a lot and do it consistently and, again, from an early age.

We submit that most elderly Americans are now not rich largely by choice. By world standards (and by past standards in this country), most elderly Americans had reasonable income levels during the course of their careers. They could have saved far more than they did. In effect, they chose their standard of living today. Our point is that if they had chosen during their careers to live on the living standard of, say, the British, and had saved the rest of their income, they would have been quite well off now.

Many Americans have simply been unwilling to forego the good life along the way. They were unwilling to resist the expensive cars and "had" to trade them in for a new one every year or so. Some were sucked in by cigarette ads, and they are now "paying" for their habits both in terms of health problems and in terms of the unrealized income they don't have because of the expense of their habit. And bad habits do add up in terms of lost wealth. A retired person who smoked two packs of cigarettes a day since college graduation may have averaged spending, say, $547 a year on cigarettes (assuming an average cost of $1.50 a pack). If the money that literally went up in smoke had been invested, the person's retirement fund would obviously have been much greater, and surprisingly so. At age 70, the smoker's retirement fund would have been almost $150,000 greater with a rate of return of 6 percent and an eye-popping $3.4 million greater at 15 percent. Understandably, one investment adviser concludes after calculating his own wealth loss from his own past smoking, "It comes down to this: If you want to be in the upper reaches of wealth in America, you don't have to do anything complicated or heroic. All you need to do is dump the dumb habit. Is this a great country or what."[7]

The fourth rule for being rich is to avoid "irresistible" (meaning frivolous) temptations. That's easier said than done, and we do not necessarily recommend that all people should lead a pure and joyless life. We mean only to point out that the great majority of those 4 percent of Americans who have a million in net worth get to where they are because they control their pleasures. For example, rich Americans buy cars that are on average only slightly more expensive than the cars that less wealthy Americans buy.[8] Another way of stressing the same point is to note that habits and fun living have costs in terms of the build-up in wealth. They also have benefits, which, presumably, are greater than the value of the foregone wealth. This, of course, explains in part why many rich people are not much happier than their counterparts of more modest means. This also means that richness is not always to be envied or pursued, but neither should it be denigrated by those who chose not to be rich, as apparent by their consumption decisions throughout their working lives.

Being able to save and accumulate considerable wealth, of course, is not automatic. People must have a reasonable income in order to save amounts that will make for wealth, which requires several auxiliary rules for achieving an income level that will allow for a minimum saving level. For most Americans — those without the requisite luck, inheritance, special talents, or good ideas — becoming rich means getting an education. Few people who drop out of high school will be rich. The income of high school dropouts is about two-thirds that of those Americans with only a high school diploma. To have a good chance at being rich, most ordinary Americans (aside for the lucky ones) will need at least a college education, which will just about double their incomes over what they would have been with only a high school diploma. A professional degree will result in an average annual income of about twice the income of college graduates (or six times the incomes of high school dropouts). This means that those who invest in education do not have to save as high a percentage of their incomes (or achieve as high a rate of return on savings) to be rich at retirement. However, in all probability, educated Americans will be richer at retirement simply because they *can* save more along the way and because they are likely to be smarter and *can* achieve a higher rate of return on their savings.

For most Americans becoming rich means getting an education.

The first auxiliary rule for becoming rich is to stay in school and, if out of school, go back to school. Of course, this presumes that students will do more than "tread water" while in school; it presumes they will learn something worth the time and effort. Contrary to all the talk about the rising costs of education, it has never been easier for Americans to get an education. Public schools are free for the taking. College costs have been rising steadily in real terms and relative to family income levels for more than a decade. But the rate of return on a college education has also been rising, making the investment a good deal (which explains why more and more Americans are availing themselves of higher education opportunities and remain willing to pay higher prices). And the cost of self-education has surely fallen with the decreases in the prices of books and a multitude of sources of knowledge and information available on CD-ROMs and the Internet.

The second auxiliary rule for becoming rich is to pick your education carefully. Teachers will find getting rich tougher than engineers, given that teachers can expect to earn half as much over their careers as engineers. History and music professors can expect to earn less than accounting professors. For that matter, history and music professors can expect to earn a lot less than their students who major in business. That means that to become rich, some people with lots of degrees will have to be more frugal than other people with few degrees.

Marry someone with an equal or higher education, and then stay married.

The third auxiliary rule is to marry someone with an equal or higher education, and then stay married. By itself, marriage seems to provide a stable institutional setting that promotes greater earnings, which affords greater savings. Married couples not only earn more than non-married people, they also economize on the costs of running their households, which allows them to save and invest at higher rates. Moreover, the binding legal contracts at the foundation of marriages, which reflects their personal commitments to each other, give the couple an added economic incentive to invest in the joint assets of the union.

Two people simply living together without a binding contract between them must worry that if they agree to invest in assets for their mutual benefit (a house, farm, business, car, or other durable goods). If one person walks away, the other person has limited claims on that partner's income stream to cover the debt on the assets. Breaking up is simply harder to do for married couples, a fact that gives each additional claims on the other. Hence, married couples should be expected, as a rule, to build up more assets than two single people or couples simply living together, and this is precisely what researchers have found and survey data show.[9]

Not surprisingly, about 95 percent of millionaires are married. Even when marriage doesn't, in and of itself, make people millionaires, it appears to make it harder for the couple to fall into poverty. Nearly 14 percent of all Americans lived in poverty in 1996; less than 6 percent of married couples did. One-third of families headed by a single woman live in poverty in 1996, while one in seven families headed by a single man lived in poverty. However, less than one in 50 intact families with at least one full-time worker (no matter how menial the job) lived in poverty. The reason for the higher poverty rate in 1996, in contrast to what it was in the last half of the 1970s, seems to be the growth in family breakups. The poverty rate for married couples has held steady for the past two decades. Married African-American couples have made significant progress in catching the incomes of their white counterparts over the past 30 years. In 1967, they earned 68 percent of married white couples' incomes; now they earn 84 percent of white couples'. All the while, the incomes of all blacks has remained unchanged at 59 percent of the incomes of whites.[10]

In 1993 (the latest year of available data), the median value of married couples' assets was $61,905, two-thirds higher than the median assets for all households. The median value of assets of male- and female-headed households was one-fifth as much.[11]

Given that more highly educated people earn more, it stands to reason that most educated Americans can assure they achieve the ranks of the rich by marrying someone who is similarly educated, thus guaranteeing a family income level that will allow for substantial annual savings. Of course, staying married ensures that past savings will not be used to finance the legal costs of divorce or to support two households. Divorce is a gateway to poverty for many Americans, especially women with children. Making divorce easier is a surefire way of reducing the accumulation of wealth in the country. The logic is straightforward; when divorces are less costly, we should expect more of them. Because of the greater ease and speed of getting a divorce, more incompatible couples will get married, knowing that they can make a break later at lower cost. The increase in divorce will make many of the divorcing parties poorer. Many couples will waste some of their assets squabbling over the split of the assets. Some married couples will be more resistant to investing in family assets, given that the marriage can be broken with greater ease.[12]

Be willing and able to work for a living. Diligence still pays in this country.

The fourth auxiliary rule for becoming rich is simple; be willing and able to work for a living. Diligence still pays in this country, obviously, given that welfare pays little and that household incomes rise markedly with the number of workers in them. Households with one breadwinner take home on average nearly 70 percent more than households with none, and households with two earners have incomes that are 80 percent higher than households with one earner (and three times the incomes of households with no earners). And more of the added income from hard work can be saved with greater ease and with the power of compound interest in mind. Of course, one of the most fundamental justifications for hard work is that it makes frugality and denial less consequential in the wealth-accumulation process.

Most people at the top of the country's income ladder are there not for mysterious reasons, but because they live in families with more than one full-time income earner. It's a little known fact that there are seven times as many full-time workers in the fifth of households with the highest incomes than the fifth of households with the lowest incomes, and most of the those high-income households are unified families. Of course, having high incomes doesn't assure richness, but it certainly makes saving easier and more likely.

The fifth auxiliary rule for becoming rich is to be able to work with some diligence and to work and save for a long time. Alcoholics and drug addicts who are not yet rich are unlikely candidates for becoming so. They will be unable to work long and hard enough to earn the requisite incomes; their careers will be fraught with instability, if they can even have careers. Most will drink, inject, or smoke up whatever incomes they earn; their suppliers will undoubtedly get rich at the expense of their customers, the addicts. And don't expect to become rich early in life. It's understandable why most people are in their 50s before they become rich: it takes time to save the requisite amount and for the power of compound interest to work.

The sixth auxiliary rule for becoming rich is to do something of value for a large number of people. The late Wal-Mart founder Sam Walton and the very much alive and working Microsoft founder and chairman Bill Gates are often cited for having amassed vast fortunes, sometimes with a derisive tone, as if they took their wealth from others. What should be noted is that Walton and Gates achieved their fortunes in a well-worn way, by providing their customers with value for the dollars collected. They accumulated a lot of wealth by adding to the well-being of large numbers of other Americans. Very likely, the collective increase in the wealth of Wal-Mart and Microsoft customers has, over the years, been far greater than the increase in Walton's and Gates' personal wealth.

The final auxiliary rule for becoming rich is to take some risks. No doubt, some readers will object to our use of 15, 10, and 6 percent rates of return on the grounds that hidden in the rates are "risk premiums," or returns for accepting the prospect that the investments will go sour and, in the end, the frugality will be for naught. And the critics are right. Moreover, the higher the expected rate of return, generally speaking, the greater the assumed risks. But let's be frank about matters — not many people will get rich by playing it safe. Indeed, richness comes to those who do the country the social service of accepting the pain from risk.

The final auxiliary rule for becoming rich is to take some risks.

However, we hasten to add that for young people, the risk of their investments is moderated by the long period over which their investments will be in place. Young people can ride out the temporary and expected ups and downs in the market. The fact that people are now living longer has reduced the risk of investment. Moreover, there has never been a time in which the problems of risk could be more minimized. This is because there has never been a time when people could more easily build a portfolio of varied assets that neutralize the problems of not knowing exactly which investments will pay off. Not too many decades ago, Americans could invest in a few important assets, their own human capital, their houses, and a few stocks and bonds. Now, however, they still have the old investment outlets but they can invest in a wide range of stocks and bonds through mutual funds. Indeed, they can buy the entire stock market by way of index mutual funds (which buy shares of all companies in, say, the Standard & Poor's stock index). They can also diversify their portfolios by buying shares in a host of different mutual funds (close to 8,000 at last count), many of which are focused on foreign investments.

We acknowledge the limitations of our rules for being rich, not the least of which is that the process of becoming rich is necessarily far more complex than our rules suggest. Becoming rich normally takes decades and a lot of hard work. Above all, for most Americans it takes denial, dedication, and perseverance.[13] We understand that many readers will object to our theme on any number of grounds, more likely some combination of the following:

- Most people don't have the incomes to save what is required to become rich;
- Our estimates of wealth growth are much too unrealistic;
- The world is filled with too many temptations carefully cultivated by a plethora of mean-spirited multinational corporations; and
- A lot of people are unlucky with lives full of problems that range from business failures to expensive spells of poor health to unemployment.

The list of retorts could easily be extended, and we except them at face value. Taken together, they help explain why more Americans aren't rich. But far too many Americans want to believe some combination of the above reasons. These reasons (or excuses) for not becoming rich are beside our central point, which is that devising a strategy for becoming rich is not as complicated or unattainable as many Americans seem to believe.

From our perspective, becoming rich (or richer) for most Americans is really a matter of choice. Opportunities to do so abound. The hundreds of thousands, if not millions of rich Americans — those who have "made it" with only modest means to start with — validate our point. At the same time, they have eased the lives of others because they have invested and contributed to the wealth of the country while they have done well for themselves.

Too many people believe that the rich in America got their wealth in ways not open to most of us. The rich inherited most of their wealth, or they were born with special talents for singing, acting or sports, or they just happened to be lucky. Inheriting money, being a star in the National Basketball Association, or winning the lottery are great ways of getting rich. But these are not the ways most people get rich in America, and it is a costly mistake to believe they are. Most rich people in America did not come from rich families, are not great athletes, and have never won the lottery. They got rich because they chose to do so, and pursued a path to wealth open to most of rest of us.

Of course, recognizing that you can choose to become rich does not mean that you should. As we have noted, choosing to become rich requires sacrifices that many people have quite rationally chosen not to make. One can lead a life rich in satisfaction and accomplishment without becoming rich financially, and nothing we write here is meant to suggest otherwise. The distinction we wish to stress is more fundamental: it is one thing to make a conscious choice not to pursue great wealth and another not to know the choice exists. Even if you decide that becoming rich is not the right choice for you, understanding how to become rich can help you determine, and realize, the best financial goal for you. You will also have a more informed perspective on important public issues such as the growing controversy over the politics of imposing special taxes on the rich.

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Notes

1. Stanley and Danko (1996) estimate that 3.5 percent of Americans have a net worth of $1 million. However, the percentage must be growing, given the substantial increase in stock prices since Stanley and Danko did their research.

2. See Stanley and Danko, p. 9

3. See Stanley and Danko (1996).

4. We would be the first to admit that a 15 percent rate of return on an investment portfolio for a long stretch of time would be admirable, but it is not a rate of return that is out of the question for those who know what they are doing. There are many books for those who want to learn more about investing and financial planning. Three useful ones, in order of difficulty, are Chilton (1996), Spitz (1992) and Malkiel (1995a). Plenty of books and magazine articles claim to give you can't-miss investment tips. These books and articles are not recommended. Of course, some of these tips will occasionally work out. Monkeys occasionally fall out of trees. But over the long run these tips make money only for those selling the books and magazines and the stockbrokers who charge commissions for all the buying and selling acting on the tips requires.

5. See Eller and Fraser (1996).

6. Although the Dow Jones average is the most widely reported market index, most professional investors use the Standard & Poor's 500 index as the best measure of how the general market is performing. This index is composed of the stocks of five hundred of the largest companies in America, and represents about 75 percent of the total value of all the stocks traded in the United States. Investors who have, in effect, have bought indexed mutual funds that simply buy stock in proportion to their representation in the S & P 500 have generally done better than those who have gone with fund managers who thought they could beat the market. According to Casteneda (1997; p. B1), "Since 1993, index funds that mirror the Standard & Poor's 500 have posted higher returns than 80 percent of all actively managed mutual funds." Numerous scholarly studies support this statement. For example, Malkiel (1995b) shows that the Standard & Poor's index has significantly outperformed the average managed fund over the period 1971-91. And Carhart (1997) has shown that

managed funds that do beat the market in one year are no more likely than other managed funds to beat it the next year, meaning they are unlikely to do so.

7. See Burns (1997). Burns admits to smoking a pack of cigarettes a day from age 18 to 31. He estimates that his bad habit for some other young adult starting smoking today would result in a reduction in the persons wealth portfolio of $1.1 million by the age 66. Burns makes his calculations assuming that the price of a pack of cigarettes costs $2 at age 18 and rises10 percent a year until age 31. He also assumes that that the money that would have been spent on cigarettes will be invested in the stock market, which he assumes will rise in the future close to its historical average, or 10.7 percent a year. Even after deducting out the impact of a 3 percent inflation rate, Burns still calculates that the loss in the smoker's wealth at age 66 would, in today's dollars, be $228,000.

8. See Stanley and Danko (1996, pp. 112-113).

9. For more on the economics of the marriage contract and family, see Becker (1974 and 1981)

10. As reported by Brownstein (1997) with reference to *Poverty in the United States: 1996,* a publication from the U.S. Census (1997).

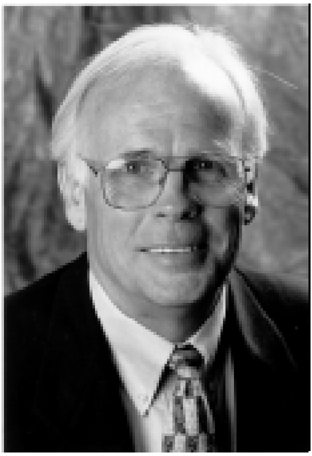
11. See Eller and Fraser (1996).

12. See Frieden (1974).

13. Many Americans are actually richer than they think they are because of Social Security.

    However, there are retirement benefits of $1,326 a month—or $15,912 a year — for a single Social Security recipient and $1,989 a month—or $23,868 a year — for a 65-year-old couple (only one of whom contributed to the system). That means that the maximum annual Social Security benefits for a single person are the same as having a portfolio of the inflation-proof bonds of almost $398,000 (because the annual interest yield on such bonds — $398,000 times 4 percent — would be $15,912). The person who retires with a reported net worth of $100,000, which seems very meager, really has the equivalent of nearly half a million. The two-retiree family receiving the maximum benefits has the equivalent of a bond portfolio of $597,000 or nearly $700,000 in total wealth. With employer-based retirement benefits, the couple could easily have the equivalent of $1 million in total wealth. Indeed, at an inflation-protected interest rate of 4 percent, all it takes is a combined annual retirement income of $40,000 for a couple to have the equivalent wealth of $1 million (.04 x $1 million = $40,000). Hence, it is altogether reasonable to suggest that many retirees are richer than they estimate; there are, effectively, also more "millionaires" among retirees than official statistics indicate.

However, could not the retirees have been even wealthier had they not been forced to contribute to the Social Security system? For the person paying the maximum Social Security taxes of $8,110 (employer and employee shares combined), the answer is a resounding "yes." Even with a rate of return on the investment portfolio of only 6 percent, the retiree's wealth would be $1.6 million at age 65. This means that if the retiree receives only a 4 percent interest rate on the portfolio after retirement, he or she could have an annual income of $64,000, three to four times the benefits from Social Security. With a rate of return of 10 percent, the portfolio would be worth $5.3 million, which would produce an annual income of $212,000 at age 65. Obviously, the Social Security system is a rather large tax on wealth and retirement income.



Richard McKenzie is the Walter B. Gerken Professor of Enterprise and Society at the Graduate School of Management at the University of California, Irvine. He has written more than 20 books and monographs, including *The Paradox of Progress: Can Americans Regain Their Confidence in a Prosperous Future?*

Dwight Lee is Ramsey Professor of Private Enterprise in the College of Business at the University of Georgia, Athens. He is the co-author of seven books and many articles and is currently president of the Southern Economic Association.

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