The High-Salary Employee Fallacy

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When it comes to money and wealth, most people have it all wrong in their heads. They usually come from a flawed money mindset and are victims of several misconceptions and fallacies.

One such common misconception is what I call the "High-Salary Employee Fallacy".

The majority of people believe that the only way to increase your income and achieve financial success is by becoming a high-salary employee. As a result, such positions are craved and pursued by many individuals.

A common path to this is to join a company at an early age, work like a madman for several years, play along the office politics and then, after perhaps 2-3 decades, reach a high position in the company which will yield a serious salary.

A similar path is to obtain a degree in a prestigious profession (e.g. medicine or law) and then spend decades building your name in the industry and networking with clients, so that you are able to charge high fees later on. In this case, you are self-employed of course, but the exact same principles apply as with an employee.

The problem with these approaches is that they have many drawbacks even if they are not apparent from a first look. That is the reason that I use the term "fallacy" here. Let's delve into them.

No residual value

This is actually the largest drawback in being an employee, even a high salary one. It is the fact that, since you are working for someone else, you have zero to little "residual value" to show for your work. With the term "residual value" we describe the value that is left after you are finished working on a task or project or even your whole career.

In order to better understand the concept of "residual value", let's consider a case where there actually exists some kind of it.

For example, let's suppose that you spend a few years building an online company. After the business is established, you as the owner have a great amount of residual value. This comes as the value of the business itself, the brand you have built for the business, the goodwill you have with your customers, the Intellectual Property created by the business, the connections with other entrepreneurs and business owners etc.

In contrast, as an employee, the residual value you have to show for after a few years of working is much more limited. It might come as the expertise you get on a specific field (which is very narrow-focused though), a good name in the industry if you have been exceptional in your job, perhaps some connections in the field and that is pretty much it.

Think about it. Everything that you build or create for the company you work for stays with the company when you leave. If you are a programmer working for a software company, the source code is under the property of the company. If you are a customer service representative, the goodwill you create with the customers is associated with the company. If you are a product designer, the designs you have created are owned by the firm.

Let's now focus on the financial aspect of this example, since that will highlight the difference even more.

Suppose you are a software developer. You are very good at your job so you get a salary of $100,000 per year, with a 10% increase per year. You stay with the company for 3 years. In financial terms, you will have received a total amount of $100K + $110K + $121K = $331K in salary. Not a small amount, but not life-changing. Other than that though, you have no residual value (monetary wise).

Consider now another version of yourself, in a parallel universe. There, you start your own company based on a software service you provide. Granted, you will need business skills and marketing/sales skills to make it happen (developers are notoriously bad at all of them). It takes some time to get traction, but let's suppose that the results for the first three years in net income are $50K, $90K and $162K respectively, for a total of $302K (a bit less than working as an employee).

The reason that the net income of the company increases by 80% each year (something unheard for employees), is because you were smart enough to start a business that can scale. This is a crucial point for success, I can't stress it enough.

Now the residual value in the second scenario is the value of the business itself. A business with positive cash-flow is a precious asset that has value in the marketplace. It can be sold and bought (albeit with limited liquidity) and has a value of its own, called Asset Value.

The valuation of this asset depends mainly on the earnings it can produce and it is usually a multiple of the yearly net income. To keep things simple, let's say that the business has a valuation of 3 times its annual earnings, which in this case would be 3x$162K=$486K.

So the monetary residual value you have by building your own company is almost half a million. In this case, you can cash out (sell the company) or automate it and be free to start your next venture.

It is obvious that the second approach is more preferable than the first one ($331K < $302K +$486K). For sure, it will be much harder to succeed at building your own thing, and will require a whole array of skills other than programming, but the reward is so much greater.

Overall, being an employee leaves you with little to none of residual value, so what actually happens is that you trade your time for money, an activity that has no leverage. Compare that to building a scalable, automated business. The residual value is insanely larger.

Your hourly-rate will always be capped

As an employee or a self-employed individual you are bound by a limited resource: yourself. Since we are finite, we are not capable of working in an unlimited way. We are not able to work an indefinite amount of hours per day, even if we wanted it.

With that variable constrained, if an employee wants to increase his income, the only route he can follow is to increase his hourly rate. This rate can range from a few dollars (think the minimum wage) to several thousand dollars, but again this figure also has constraints.

Of course you can argue that some people enjoy enormous payouts (like NBA players or movies super-stars), but, first, even those have a ceiling, and second, only a few of these professionals can command such high rates.

So how can somebody go around these limitations?

If you take a look at the list of the wealthiest people in the world compiled by Forbes, you are not going to find a single employee there. All these people (or their families in the past) built their fortunes by creating and scaling businesses that changed the world and continue to provide massive value to society. It is just not possible to achieve something like that when you are a single entity.

By creating scalable businesses, their owners are able to leverage the labour of their employees. This is known as making use of Other People's Time (OPT). In such a system, the constraints of the hours per day and of the hourly rate do not apply. What only matters is how much value you can provide to the marketplace.

The bottom line is that a single individual, due to our nature, will always have an upper limit on the amount of money he can generate on his own.

You can't outsource yourself

On the same note, it is obvious that as an employee, you can't "outsource yourself" since you are the one that has to do the job. This carries an inherent "opportunity cost" in the sense that you are restricted by your job and you can't pursue other opportunities that might yield an additional income for you in the future.

Contrast this to how businesses function. What all great businesses have in common is that they are built upon systems that allow their founder to "get out of the business" without any impact on its operations. This means that the business owner is free to engage into other activities (business and/or pleasure) without worrying that his income will evaporate.

A serial entrepreneur like Mark Cuban of Shark Tank can be an owner of multiple businesses which grow his Net Worth in an automated way. After building one company and growing it, he can leave it to his team of great professionals who will operate it, and he is free to move on to the next venture. This is one of the many reasons why wealth is created exponentially.

Concluding, if you are an employee or self-employed, you are not able to remove yourself from the equation, you can't "outsource yourself". You have to always be present, otherwise you will not receive any monetary compensation.

You lose your income if you stop working

As a corollary of the above, it is obvious that, as an employee, your income is totally dependent on yourself working. This is active income we are talking about (zero passivity), so unless you do it yourself, you are not receiving any financial return.

You work, you get paid. You don't work, you don't get paid. Simple as that.

So, what happens if you have an accident and are unable to work for a few months? Will you be able to sustain your lifestyle or will your Net Worth get devastated?

In business management, there is figure used as a measurement of the concentration of information in individual team members. It is known as the bus factor. It represents the number of team members that can be unexpectedly lost from a project before the project collapses. If you are an employee, your income's bus factor is the lowest that can be: one!

But let's consider some more common incidents.

What if the company you are working for goes bankrupt? Or what if you have an argument with your boss and you get fired? In those cases, you are left hanging as an employee, and in order to find a new job and reach again the same compensation levels might be difficult and take time.

Summing up, keeping your income (however high that might be) is contingent upon you being able to actively work. Failing that, your income is lost triggering various negative consequences.

You are not tax-optimized

Another rarely discussed issue when it comes to employees is that of taxation.

If you are an employee, your employer probably withholds income tax from your paycheck. That amount is directly paid to the tax collection service of your country in your name. This means that you never see that money, they go straight to the government.

What many people fail to realize is that this taxation burdens the worker, and not the employer. As Wikipedia states:

"The economic burden of the payroll tax falls almost entirely on the worker, regardless of whether the tax is remitted by the employer or the employee, as the employers' share of payroll taxes is passed on to employees in the form of lower wages than would otherwise be paid."

In most cases, the higher the salary you receive, the higher the progressive tax rate will be. So the high-salary employees will pay a disproportionately larger amount of money in taxes, essentially negating their higher income.

Another negative of this taxation structure is that you are taxed on your "full-income" and not your "after-expenses" income, essentially paying much more in taxes. Consider the following example.

Suppose you are an employee that receives $5,000 per month. With an effective tax rate of 20%, your tax contribution will be $1,000, so your disposable net income will be $4,000. If you wish to purchase a laptop that costs $500, your "after-expenses" income will be $3,500.

In contrast, if you are running a business, the laptop cost will be tax deductible (in some cases the same applies for self-employed professionals too). Suppose again that your company has revenue of $5,000 during that month. You purchase (as a business) the same laptop for $500. In that scenario, the taxation will be applied to your net income, i.e. $5,000-$500=$4,500. For an effective tax rate of 20%, the tax will be $900, and the final income $4,500-$900=$3,600.

This is just a simple example, but if you have several items like these, you can get a nice tax break for your company. Also keep in mind that in some instances you also avoid VAT charges as a corporation, an added bonus.

Overall, employees have the worst tax structure and their high taxes can eat up a significant portion of their salary.

Conclusion

In general, being an employee sucks, even if you are a high-salary one. There are concrete, although subtle, drawbacks that are not given the consideration that they should have, like those mentioned above.

Look, if you are skillful enough to be able to command a high-salary in the labour marketplace, it is quite possible that you could venture on your own, build something of value to the marketplace and enjoy fully the rewards of your labour.

Sure, if you are a high executive on Wall Street, a CEO of a Fortune 500 company or one of the first employees in a major company like Facebook or Google (thus you have valuable equity), the risk/reward analysis probably does not justify leaving your job in favour of entrepreneurship. But only a few people are in such privileged positions, while most are struggling with jobs they are not satisfied with.

If you want to move strategically with this, read some business books, hone your business skills and start cautiously with a business on the side. Who knows, it might take you to $1M in Net Worth faster than you imagined.