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COMMENTARY 20180503

To address inequality you need to know where the money is

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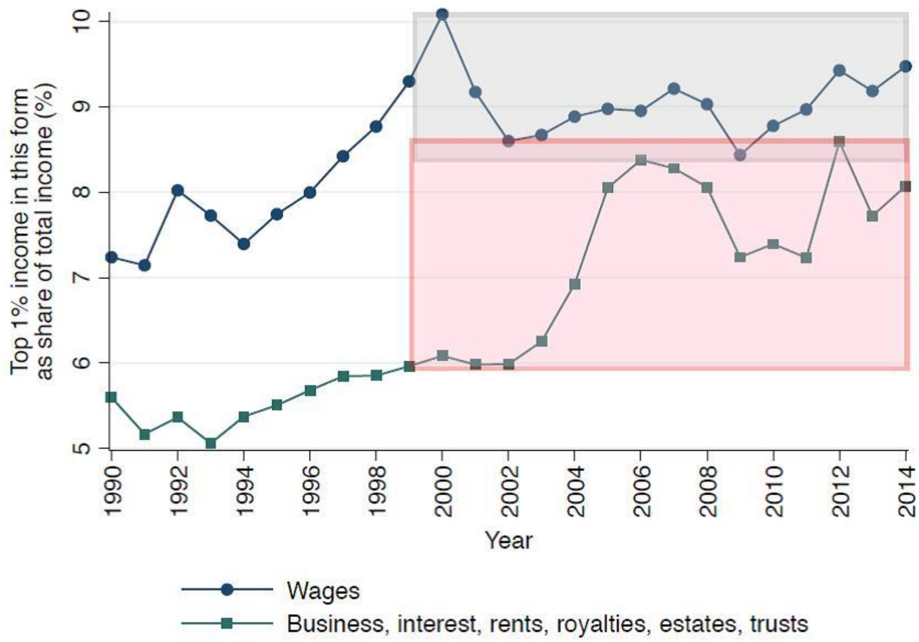
Income inequality in the United States is rising. Prior research contends this is due to returns on accumulated capital. For the 15 years ending in 2014, the top 1 per cent of income earners increased their share of total income from 15.0 per cent to 17.5 per cent, almost entirely due to an increase in capital income. But new research suggests that a large proportion of business income is really the payoff to individuals for specialized skill, just like the premium earned by top-tier athletes and movie stars. Researchers at UC Berkeley, Chicago, and the U.S. Treasury examined the premature deaths of 2,509 business owners from within the top 1 per cent of income earners. They found that an unexpected owner death is associated with a 61 per cent decline in profits and a 21 per cent reduction in firm survival. This runs counter to the notion that return to capital is the leading driver of growing income inequality.

It is well-documented that income inequality in the United States is high and rising. But any policy response depends critically on the reason for this trend. Is growing income inequality the result of the accumulation of capital or a rising premium for specialized skill? This matters because what has previously been documented by economists is a surge in the "return to capital" while the "return to labor" has barely moved since 2000.

The capital accumulation argument is supported by the chart below. For those in the top 1 per cent of income, it shows the prolonged march in the share of capital income in the 15 years ending in 2014. In 1999, people in the top 1 per cent of income earned 15.5 per cent of total income. By 2014 this percentage had increased to 17.5 per cent, and can be attributed almost entirely to an increase in capital income.

Figure 1. Wage income (grey) vs capital income (pink)



New research suggests that the increased return to capital is not as large as previously thought.[1] Rather, a large proportion of business income is really the payoff earned by business owners for specialized skill.

The researchers examined the tax returns of 20 million taxpayers over 14 years ending in 2014, who owned 11 million businesses. The researchers' broad objective is to document the sources of income for the top 1 per cent of income earners. Their more specific objective is to determine whether the top 1 per cent have high earnings because of accumulated capital, brands and patents, or whether high income results from the same premium for talent paid to athletes and entertainers.[2]

To understand the difference, consider action movie star Tom Cruise. Forbes estimates the 2016 earnings of Mr ("Show me the money!") Cruise at $43 million.[3] His 2016 film Jack Reacher: Never Go Back, has worldwide gross box office revenue of $162 million and his production company, TC Productions, is one of the films' production companies.[4] A typical research study would classify the income earned by the

[1] Smith, M., D. Yagan, O. Zidar, and E. Zwick, 2017. "Capitalists in the twenty-first century," November 15, Working paper, U.S. Treasury Department, UC Berkeley, University of Chicago and National Bureau of Economic Research, http://www.ericzwick.com/capitalists/capitalists.pdf.

[2] Descriptive statistics appear in Table 1, Summary Statistics on S-Corporations and Their Owners. The median owner in the top 0.1 to 1.0 per cent income bracket has personal income of $600,000 per year. The median firm owned by the top 0.1 to 1.0 per cent income bracket has sales of $1.2 million. For the 76 per cent of firms that have at least one employee, the median number of employees is 13. The median owner in the top 0.1 per cent income bracket has personal income of $2.4 million per year. This owner has a stake in a firm with median sales of $3.5 million. Just 68 per cent of firms in this group have employees and amongst the firms with employees the median number of employees is 35.

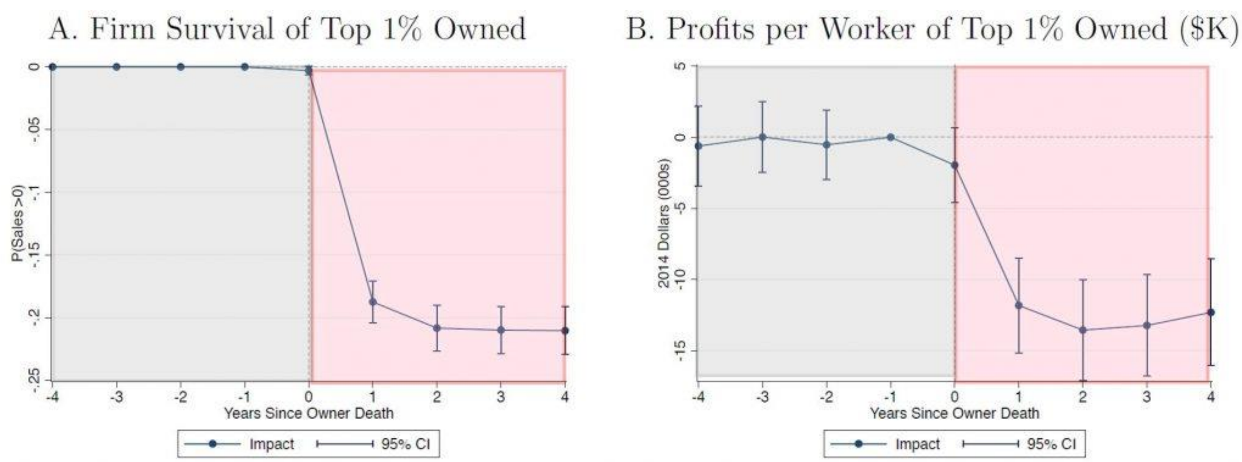
[3] https://www.forbes.com/profile/tom-cruise/ accessed on May 2, 2018.

[4] imdb.com accessed on May 2, 2018.

production company as return to capital, and the wages earned by Mr Cruise as return to labor. But in substance the only return to capital is the income that would be earned in the absence of Mr Cruise himself.

The interesting part of the study is the examination of 2,509 premature owner deaths. This sub-sample represents the unfortunate demise of people in the top 1 per cent of income who died before the age of 65. After death, their firms suffer a 61 per cent decline in profits compared to 300,000 firms matched by owner age, owner income, industry and sales. The firms owned by those dying prematurely were also 21 per cent less likely to have survived four years later. In short, over half of firm profitability ends with the sudden demise of the owner.[5] This runs counter to the notion that return to capital is the leading driver of growing income inequality.

Figure 2. Impact of top 1 per cent owner death on firm performance



The researchers point out that high returns to owner-manager skill need not be socially optimal and can include returns to rent-seeking or elite connections.[6] But the research does challenge the notion that top earners reach and maintain this status largely as the result of accumulated wealth.

[5] Figure 5: Impact of Top 1% and Top 0.1% Owner Death on Firm Performance and Table 4, Impact of Owner Death on Firm Outcomes.
[6] Smith, Yagan, Zidar, and Zwick (2017, p. 5).