

Capitalists in the 21st Century

Smith, Yagan, Zidar and Zwick

presented by Anna Stansbury

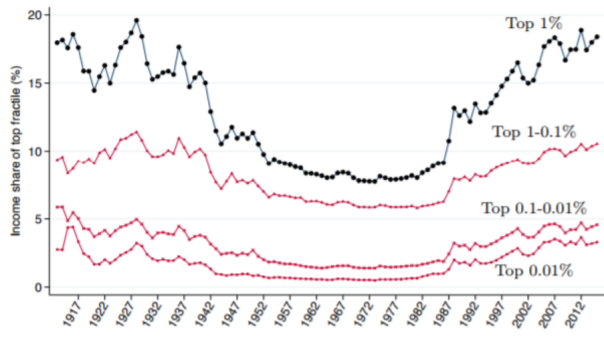
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Outline

- Nearly all of the post-2000 rise in top incomes has come from business income.
- Evidence suggests that these are largely active owner-managers not “passive rentiers”:
 - ▶ Premature owner deaths cause substantial decline in firm performance.
 - ▶ Top owned firms are more profitable
 - ▶ Profitability of top owned firms has risen disproportionately; scale has not
- Thus, post-2000 rise in top incomes is consistent with rising returns to skill

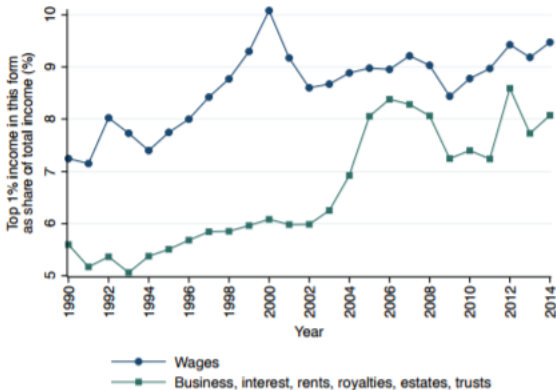
Rise in top incomes since 1980s...

A. The Rise in Income Inequality



...mostly driven by rising capital income since 2000

B. Wage Income vs. Capital Income



US business types

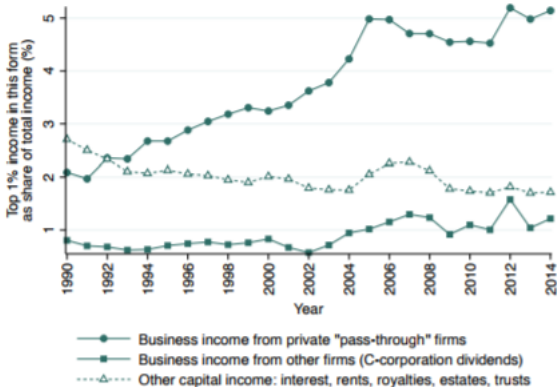
- C-corp: Incorporated and officially registered business entities
 - ▶ Distinct legal entities, limited liability
 - ▶ Corporation pays corporate income tax, shareholders pay dividend and capital gains taxes
 - ▶ 75% of 1985 TI, 46% of 2011 TI
- Pass-through entities:
 - ▶ Various different forms: most common are S-corp and partnership
 - ▶ Typically have limited liability
 - ▶ No entity-level tax; income “passes through” and is taxed as personal income
 - ▶ 25% of 1985 TI, 54% of 2011 TI

Since 1986 tax reform, tax incentive to be an S-corp.

Restrictions: 100 or fewer owners, only US owners, only one class of stock.

Rising top capital income driven by privately held pass-through businesses

C. Types of Capital Income



Data

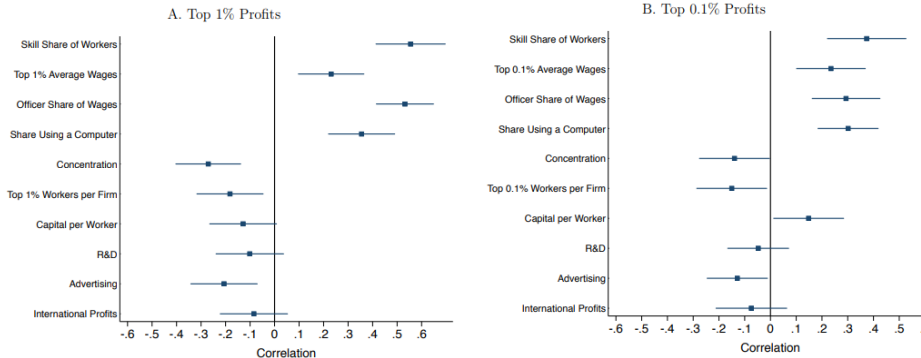
- US administrative owner-firm-worker data 2001-2014
- S-corps:
 - ▶ Business income tax returns & information returns
 - ▶ Owner income tax returns (1040) and wage information returns (W2)
 - ▶ 7.3M firms with 9.8M owners
- Partnerships:
 - ▶ Business income tax returns & information returns
 - ▶ US owners only: income tax returns and wage information returns
 - ▶ 3.9M firms with 12.8M owners

What are the top S-corps like?

- S-corporation profits are earned broadly across sectors and are similarly distributed as overall corporate profits
- Top 0.1% typical firm: a regional business with \$20M in sales and 100 employees. Top 5 industries:
 - ▶ Management of companies and enterprises
 - ▶ Other financial investment activity
 - ▶ Automobile dealers
 - ▶ Other professional and technical services
 - ▶ Oil and gas extraction
- Top 1-0.1% typical firm: single establishment professional or medical services. Top 5 industries:
 - ▶ Offices of physicians
 - ▶ Other professional and technical services
 - ▶ Offices of dentists
 - ▶ Other specialty trade contractors
 - ▶ Legal services

What are the top S-corps like? #2

Figure 4: Correlates of S-Corporation Profits across Industries



notes

Are S-corp owners “passive rentiers”?: Descriptive evidence

- Most S-corporations owned by top earners have few owners and most top S-corporation owners own just one firm
- Over 90% of top 1% and top 0.1% S-corp owners report their income as actively earned

Are S-corp owners “passive rentiers”?: Model

Supply

$$y = f(L, K, E) = AL^{\alpha_L} K^{\alpha_K} E^{\alpha_E} \quad (1)$$

Demand

$$y = Dp^\eta, \quad \eta < -1 \quad (2)$$

Profitability

$$\frac{\pi}{L} = \left[\frac{1}{1 + \frac{1}{\eta}} - \left(\alpha_L + \alpha_K + \frac{\alpha_E}{1 + \frac{1}{\varepsilon}} \right) \right] \frac{w}{\alpha_L} \quad (3)$$

Owner talent can increase profitability directly through α_E , or by increasing η (making demand less elastic).

Are S-corp owners “passive rentiers”?: Owner deaths

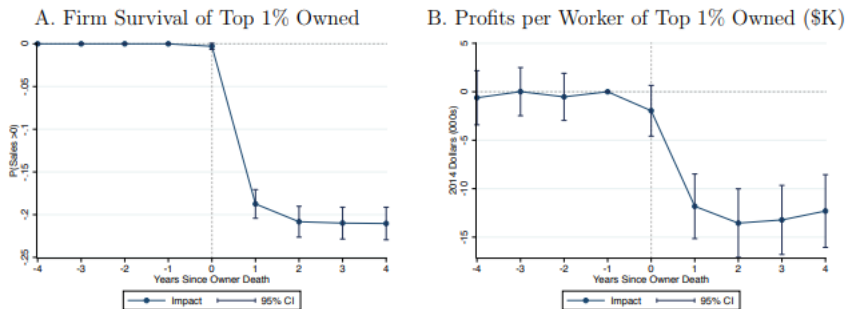
- Firms with death of top 1% owner aged over 65 matched with all “counterfactual” firm-owner-year observations along (a) owner age, (b) owner in same top income fractile, (c) same 3-digit NAICS industry code, (d) same sales decile
- Sample: 9 years of observations on 2,509 owner-death firms and 301,972 counterfactual firms
- Outcomes of interest: firm survival, profits per pre-period worker

Difference-in-difference event study:

$$\Delta Y_{jj's} = \sum_{k \in \{-4, -3, -2, 0, 1, 2, 3, 4\}} \beta_k D_{js}^k + \varepsilon_{js} \quad (4)$$

Are S-corp owners “passive rentiers”?: Owner deaths

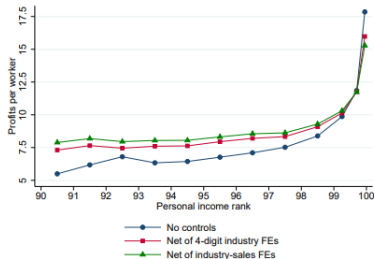
Figure 5: Impact of Top 1% and Top 0.1% Owner Death on Firm Performance



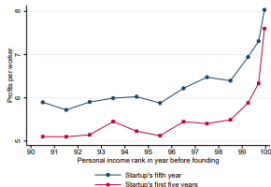
Are S-corp owners “passive rentiers”?: Profitability

Figure 6: Profitability Rises with Owner Income Rank

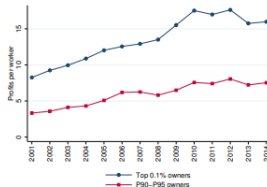
A. Profitability Increases with Owner Income Rank (All Firms)



B. Profits per worker in startups first five years



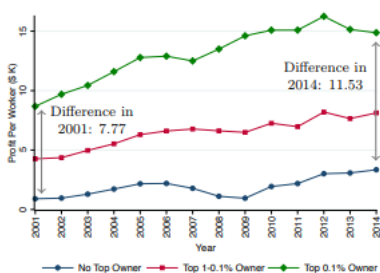
C. Rising Top 0.1% Profitability over Time



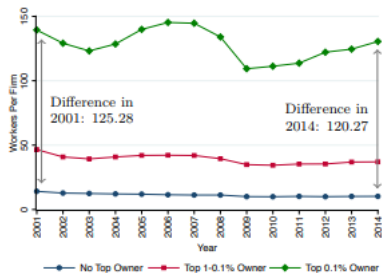
Are S-corp owners “passive rentiers”? : Scale vs profitability

Figure 8: Rising Profitability Explains Most Top S-Corporation Income Growth

A. Profitability Differences are Diverging

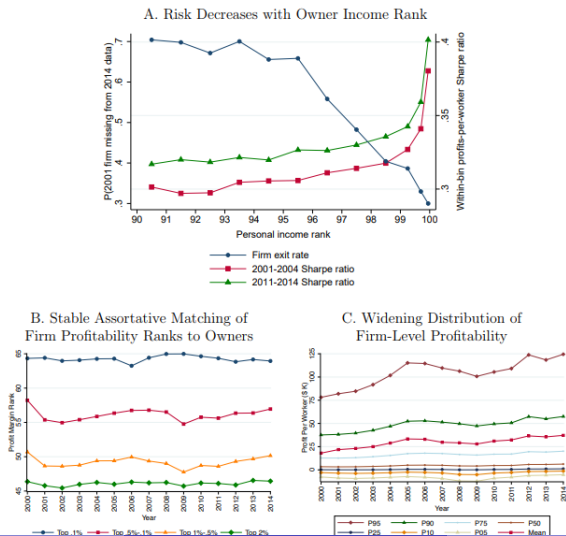


B. Firm Size Differences are Not



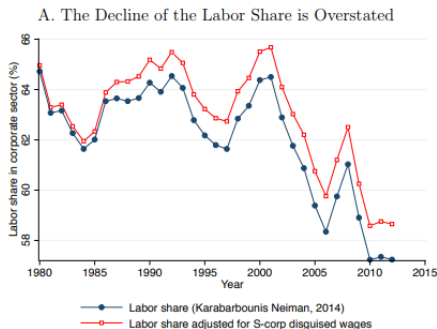
Are S-corp owners “passive rentiers”?: Risk and assortativeness

Figure 9: Diverging Firm Profitability, Not Risk or Assortativeness



Implications for the labor share

- Transformation of C-corp activity into S-corp activity mechanically reduces the measured labor share as owner-managers have incentive to report income as profits not wages.
- c. 26K switchers from C-corp to S-corp form over 2001-2014: labor payments fall in event year by 1.95% relative to sales, and profits rise by 1.76%.
- Counterfactual: if all corporations were C-corporations...



Implications for optimal tax policy

- Top wage income taxed at $39.6\%+2.9\%+0.9\%$
- S-corp income is taxed only at 39.6%
- Applying the estimate from owner deaths that 61% of S-corp top income is wage income in disguise:
the effective federal marginal tax rate on labor income in personal income distribution starts to *fall* at the very top (as personal income rises above \$50m, falls by c. 1%).

Questions

Descriptive:

- Most of the rise in pass-through income seemed to happen between 2002 and 2004. What happened during these years?
- What are the expected impacts of the 2017 tax reform on this pattern?

Inference:

- SYZZ claim that “much of rising top income inequality remains consistent with rising returns to top skill”:
- To what extent has their evidence ruled out a concentration/monopoly power explanation?
- If rising business income reflects disguised returns to labor, why have top labor incomes stopped rising?

Implications:

- What does this finding imply for optimal labor and corporate income tax policy, and the design of corporate forms?

Notes to S-corp correlations

Notes to Figure 4: This figure presents correlations and robust 95% confidence intervals among firms owned by the top 1% in Panel A and top 0.1% in Panel B for total profits and several industry-level characteristics, defined below. **Top profits** are the 2014 level of profits in 2014 dollars among firms with top 1% or top 0.1% owners. **Skill share of workers** is the 2000-2014 average share of workers in a 4-digit industry who have at least some college in the CPS. **Top average wages** is total 2014 wages among top-owned firms divided by top-owned firms' 2014 number of W-2 payees. **Officer share of wages** is the share of labor compensation (the sum of salaries and wages paid to employees, employee benefit programs such as health insurance, and contributions to pension and profit-sharing plans) that accrues to officers. Specifically, on Form 1120S it is line 7 divided by the sum of lines 7, 8, 17, and 18. **Share using a computer** is the share of 2000-2014 average share of workers who use a computer as part of their role, following Autor, Levy and Murnane (2003). **Concentration** is the sales Herfindahl in each 4-digit industry, including both C- and S-corporations, averaged over the years 2000-2014. **Top workers per firm** is the number of W-2 payees in top-owned firms in 2014 divided by the number of top-owned firms in 2014. **Capital per worker** is total book value of depreciable assets less accumulated depreciation divided by aggregate W-2 payees. Capital is measured as the average for all S-corporations in the IRS SOI corporate sample between 2000 and 2014, weighted to represent the population. Aggregate W-2 payees is measured directly for the population of S-corporations. **R&D** and **advertising** are the industry's average share of total R&D expenditures and total advertising expenditure in Compustat between 2000 and 2014. **International profits** is the 2000-2014 average of total foreign net income reported by S-corporations on Schedule M3 of their tax return divided by the 2000-2014 average of total S-corporation profits. All variables are standardized.

[return](#)

What are the top partnerships like?

- Similar overall industrial mix to S-corps
- Partnership profits skew more toward high skilled services
 - ▶ Other financial investment activity, which includes private equity, venture capital, and hedge funds
 - ▶ Legal services.
- These two industries account for 65.7% of the total partnership profits among firms with a top 0.1% owner in 2014