Key Takeaways

- Income inequality has been hotly debated in recent years.
- Some research has suggested that income of the top 1 percent is mostly earned by the idle rich drawing on non-human capital income.
- However, this new paper counters this narrative and shows that most of those in the top 1 percent earn their income through human capital.
- A better understanding of income at top levels is helpful as policymakers discuss the ramifications of, and responses to, income inequality.

Debate about income inequality in the United States in recent years has placed increased scrutiny on the top of the earnings spectrum, especially the top 1 percent, whose share of the income pie has grown since the late 1980s, reaching levels not seen since the early 20th century (see Figure 1).

However, it’s not just whether income has become less equal over the last three decades that has fired debate, but attention has also focused on the nature of that inequality. Were the top 1 percent reaping the benefits of their own sweat equity and collecting the fair value of their ingenuity and labor? Or were they sitting on inherited and accrued capital wealth like proverbial fat cats? Through the early 2000s, research suggested that the answer was the former: the wealthy were earning their keep. That story has since changed, according to some recent analysis (notably that of Thomas Piketty et al.): over roughly the last 15 years capital income has overtaken labor income for those in the top 1 percent. The very wealthy, in other words, have achieved a sort of aristocratic status that was fast becoming permanent.
But is this narrative correct? New research by Matthew Smith of the US Treasury Department, Danny Yagan of UC Berkeley, Owen M. Zidar of Princeton, and Eric Zwick of UChicago’s Booth School of Business, tells a different story. In their recent working paper, “Capitalists in the Twenty-First Century,” the authors reveal that most in the top 1 percent do not depend on capital income for their earnings (see Figure 2); rather, they rely on their labor, networks, reputation, and other forms of what economists define as human capital. Even among the top one-tenth of 1 percent where non-human capital income plays a significant role, human capital income remains more important.

Understanding how the very wealthy earn their income is important, especially as many consider tax policies to address disparity, and others worry that the US economy is inexorably tilting toward the idle rich. However, the authors caution about making too many qualitative conclusions from their analysis of the facts: just because the very wealthy mostly earn their income rather than inherit and/or accrue it does not mean that income dispersion is purely meritocratic. Inequalities and privileges still exist, for example, among people lucky enough to grow up in certain neighborhoods and benefit from better schools.

**Many 1-percenters are working stiffs**

To investigate the question of how those in the top 1 percent earn their income, the authors employ a new anonymized dataset of 11 million business owners between 2001 and 2014. Much media attention is focused on the executive salaries of publicly owned companies, which are organized as C corporations and taxed at both the entity level and the owner level. Rankings of top earners at public companies, as well as ratios of CEO to median worker pay, are regularly posted by media outlets. However, most top-earned business income is derived from private businesses that are not taxed at the entity level. Instead, income is said to “pass through” the entity level and is taxed only at the income level of owners. There are basically two types of “pass-through” businesses, those with limited owners (S corporations) and those with unlimited owners and/or different types of ownership (partnerships and most LLCs).

While the income of public C corporation owners is well known, most of the very rich earn pass-through income that is never made public: 69 percent of the top 1 percent and over 84 percent of the top 0.1 percent earn pass-through income. This raises the question: how much of this pass-through income represents labor income or just capital income accruing to idle owners?

The answer to this question is hinted at by the professional status of those earning pass-through income in the top 1 percent to 0.1 percent. These are mostly consultants, lawyers, and specialty tradespeople in single-establishment service firms, or physicians and dentists in health service firms. In the top 0.1 percent, typical firms are regional businesses with $20 million in sales and 100 employees, such as an auto dealer, beverage distributor, or large law firm.
To cut to the chase: most pass-through income at the upper end accrues to working-age owners of midmarket firms in skill-intensive industries.

The finding that most 1-percenters earn labor income is reinforced by the fact that the ages of these working owners mirrors those of other working professionals, while those who passively draw capital income are mostly older. Also, as described above, most of the profits for these firms are derived from relatively labor-intensive industries, like law, health, and finance. Profits at these relatively small firms are highly dependent on individual human capital, which includes personal goodwill and client relationships. Traditional C corporations, on the other hand, are more capital intensive and dependent on manufacturing processes to derive profits.

To examine their finding that most of the 1-percenters represent the working rich rather than the idle wealthy, the authors conduct a series of novel tests. Two such tests measure the impact on a firm’s income when one of its owner/partners either retires or dies. If such owners were indeed earning their income, then a firm that lost, say, a top lawyer or doctor would necessarily suffer a loss in income. And that is indeed what the authors found. Using Social Security Administration data, the authors identified non-elderly owners who died between 2005-2010 and who earned over $1 million in the year before their death. Firms that experience such a death suffer an 82 percent decline in firm profits relative to similar firms that do not experience an owner death. A similar drop, 83 percent, occurs when firms lose an owner to retirement. Averaging their estimates across the top 1 percent, million-dollar earners, and the top 0.1 percent, the authors estimate that approximately 75 percent of top pass-through income are returns to human capital, despite being reported as non-labor income for tax reasons.

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Conclusion

This research runs counter to recent research (and conventional wisdom), which says that the majority of those in the United States earning income in the top 1 percent are living off of capital income, or essentially returns on investments. Rather, the authors find that 75 percent of pass-through income—the largest component of top capital income—is earned and is driven instead by the returns from human capital, which can include returns to rent-seeking, elite connections, and unequal opportunity to enter certain professions, industries, or markets.

What does this mean for policymakers and others who are concerned about income inequality, and those who worry that many people are falling so far behind that their chances of moving up the income ladder are increasingly slim? The authors acknowledge that more research is needed on the nature of top-level income to answer those and other questions, and they outline three areas for more analysis, but their work does offer broad suggestions. First, income taxes for C corporations and pass-through corporations could be aligned to prevent owners from shopping around for the best tax rates. For example, because of various payroll taxes, executives at C corporations pay higher taxes than pass-through firms. Second, policymakers hoping to increase tax revenue by raising tax rates on the rich need to carefully consider the mix of earned income at 1 percent and above. Focusing narrowly on the sources of true capital income, for example, will likely disappoint such efforts.

Finally, and importantly, as this research and other recent work reveals, high-skilled occupations that require more education are, for the most part, paying the best salaries. Also, those jobs are aggregating in cities where housing prices are increasing, including in neighborhoods with better schools and other positive social effects. For those with the economic wherewithal to live in the best neighborhoods, attend the best schools, attain the best jobs, and earn the highest income, the cycle is certainly virtuous. For others, though, such a cycle may be out of reach. In reinforcing the meritocratic notion that most 1-percenters work to earn their income, this paper does not discount concerns about income inequality; rather, it shines a light on the need to address issues that reinforce inequality, like access to good schools and neighborhoods.

CLOSING TAKEAWAY

In reinforcing the meritocratic notion that most 1-percenters work to earn their income, this paper does not discount those who worry about income inequality; rather, it shines a light on the need to address issues that reinforce inequality, like access to good schools and neighborhoods.

READ THE WORKING PAPER

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Capitalists in the Twenty-First Century
bfi.uchicago.edu/working-paper/201926

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