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'Working rich' prevail among today's top earners

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Many blame idle millionaires for the rise in income inequality, but today's top earners are actually the "working rich," according to a new working paper co-authored by Princeton University.

Illustrious entrepreneurs and skilled professionals running their own businesses prevail among today's top 0.1 percent, or those earning more than $1,600,000 per year. These "working rich," which include lawyers, physicians, financial professionals, car dealers and beverage distributors, derive most of their income from human capital, the study shows.

The researchers looked at 11 million firms between 2001 and 2014—before the 2017 Tax Reform was enacted—and found most top income comes from "pass-through" businesses wherein profits and losses are passed through the owners themselves. This means instead of paying corporate and dividend taxes totaling 55 percent, these firms often paid 11.6 percent less.

The findings draw attention to a world of entrepreneurs hidden from public view whose human capital income is key for understanding top incomes. They also illustrate the need for a more harmonized business tax system, more skilled workers, and improvement in the educational pipeline for innovators and entrepreneurs.

"We set out to understand what has been driving top incomes in recent years, and that upended some previous findings about the rich," said co-author Owen Zidar, assistant professor of economics at Princeton University's Woodrow Wilson School of Public and International Affairs. "People are earning a lot of dollars through private businesses, and that's important evidence that should influence the debate around taxing millionaires.'"

Zidar co-authored the study with Matthew Smith of the U.S. Department of the Treasury; Danny Yagan of the University of California, Berkeley;

and Eric Zwick of the University of Chicago Booth School of Business.

In the paper, the researchers explain how tax reforms under President Ronald Reagan, which raised corporate tax liabilities and lowered them on individuals, made pass-through business much more attractive. This was a boon for small businesses, but larger businesses have also taken advantage.

The most recent 2017 tax reform lowered taxes on qualifying pass-throughs. "It's unclear which businesses qualify as a pass-through for the new deduction, as it's been done in an ad hoc way. So, architecture and engineering firms receive the new 20 percent rate, while other service firms and consultancies do not," Zidar said. "It's complicated in terms of who is eligible, but it's now among the biggest tax breaks in the tax code."

Reagan's tax reforms created a unique paper trail through the U.S. Department of the Treasury, which the researchers used to link 11 million firms to their owners. They set out to determine who was making the most money—and how.

They found the median number of owners of a pass-through company was two, and they hit their peak income in their 50s. Around 93 percent of these owners were actively engaged in the business. Most top earners are not getting their income from labor; 75 percent comes from human capital income. For example, most top income is derived from active service provision as well as the personal network, reputation, and recruiting prowess of entrepreneurs, not from idle ownership of financial assets.

"It's common to wonder whether business owners grew the pie, or simply extracted more money from workers," Zidar said. "It looks like both are important, but growing the pie may be more significant."

Those in the top 1 to 0.1 percent making between $390,000 and $1.6 million annually occupy industries including medicine, professional and technical services, dentistry, specialty trade, and legal services—and all owned their own businesses. Owners in the top 0.1 making over $1.6 million included physicians, dentists and other skilled professionals as well as financial investors, automobile dealers and oil and gas extractors.

To determine whether top owners were actually working or just collecting checks, the research team also looked at what happened to businesses after an owner died or retired. In both scenarios, profits dropped by more than 80 percent and did not recover.

When considering business owners who inherited their companies from family members, they found these aren't as prevalent among top entrepreneurs. Most of those owners between ages 32 and 34 pulling in a million dollars a year did not have parents in the 1 percent. It's unclear where these owners come from, but Zidar is working on a study to investigate this further. Moreover, because of data limitations, those are the only ages that can be linked to parents.

"We show that if you look and decompose this income, a lot of it comes from these pass-through businesses, and that activity more closely resembles labor than the idle rich," Zidar said. "Our results suggest that educating the country's next generation of innovators may be more important than tax incentives."

The paper, "Capitalists in the Twenty-First Century," was published Jan. 14 in NBER as a working paper and was not peer-reviewed or subject to the review by the NBER Board of Directors that accompanies official NBER publications. The paper is currently under peer review by the *Quarterly Journal of Economics.*

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