Who Rules the Top 1%?

By Editorial Staff *Thu, Sep 17, 2020*

Private businesses and partnerships lead most often to the top wealth brackets in the U.S., new research shows. In this edition of Research Roundup, we bring you summaries of research on variable annuity sales, the Fed's response to the March 2020 crash, and more.

The COVID-19 pandemic, the stock market crash, and Fed interest rate policy have all given economists and other academics plenty of topics to study during 2020. There's been an outpouring of research papers this year—with a mixture of praise and criticism for government policy.

In this latest edition of Research Roundup, we offer summaries of six recent noteworthy economic studies, which were published by the National Bureau of Economic Research, the Federal Reserve Bank of New York, Morningstar, and SSRN.

One paper analyzes the composition of America's richest demographic, while three others focus on the stock market and/or interest rates. A fifth article looks at the impact of the short-lived Obama "fiduciary rule" on high-cost variable annuity sales. A sixth asks: Why did so little fiscal stimulus trickle down to the most economically vulnerable this year?

Research Roundup, Sept. 18, 2020

- "Business Incomes at the Top," by Wojciech Kopczuk and Eric Zwick (NBER Working Paper 27752).
- "Effective Demand Failures and the Limits of Monetary Stabilization Policy," by Michael Woodford (NBER Working Paper 27768).
- "Conflicting Interests and the Effect of Fiduciary Duty—Evidence from Variable Annuities," by Mark Egan, Shan Ge and Johnny Tang (NBER Working Paper (27577)
- "Stock Market Participation, Inequality, and Monetary Policy," by Davide Melcangi and Vincent Sterk (Federal Reserve Bank of New York Staff Report No. 932)
- "Inside the Mind of a Stock Market Crash," by Stefano Giglio, Matteo Maggiori, Johannes Stroebel, and Stephen Utkus (NBER Working Paper No. 27272)
- "The Social Safety Net in the Wake of COVID-19," by Marianne Bitler, Hilary W. Hoynes and Diane Whitmore Schanzenbach (NBER Working Paper No. 27796)

The top one percent is rich in business owners

Who is rich in America and where does their money come from? In the course of researching the drivers of financial inequality in the U.S., Wojciech Kopczuk of Columbia University and Eric Zwick of the University of Chicago unveiled illuminating data about the sources of income of the wealthiest Americans.

It turns out that private business owners and professionals, more so than Fortune 1000 executives, are most representative of the top one percent. "A majority of the top income earners in the United States are owners of 'pass-through' businesses," they write in "Business Incomes at the Top" (**NBER Working Paper 27752**). [Note: Pass-through income is business income taxed at the individual level, not at the company level.]

In 2014, 69% of the top one percent of income earners and 84% percent of the top 0.1% percent of income earners accrued some pass-through business income, the paper said. Overall, there were more than 1.1 million pass-through owners with annual incomes above $390,000 and 140,000 pass-through owners with annual incomes of more than $1.6 million. There were 14,900 business owners in the top 0.01% percent of the income distribution. They received more than $100 billion in income from S-corporations and partnerships.

In 2014, about 270,000 wage earners in the top 1% and 27,000 wage earners in the top 0.1% worked for public companies, earning a total of $260 billion and $110 billion in wages and salaries, respectively. The 10,700 top public company executives earned $33 billion in salary and options that year.

"The typical top one percent earner is not a public company executive or tech billionaire," write Kupczuk and Zwick. "A top earner is typically a doctor, lawyer, or the owner of a middle-sized business… For every public company employee in the top one percent and top 0.1%, there are four and five pass-through owners, respectively."

"These top pass-through owners are predominantly working age, in contrast to the older top earners whose income comes from other categories of capital… 60% to 70% of the millionaires who get a majority of their income from either wages or pass-through ownership are in their 40s and 50s." By contrast, about two-thirds of millionaires are in their 50s to 70s.

As for the sources of economic inequality in the U.S., which has risen in tandem with stock and bond prices since the early 1980s, Kupczuk and Zwick concluded that the wealthiest one percent get 41% of their income from capital [investments] (as opposed to labor income), not 56%, as reported by others such as Thomas Piketty. Measuring income is apparently not easy; income is reported in several ways for tax purposes, and only an estimated 60% of national income shows up on any tax return.

Was it really necessary for the Fed to drop interest rates?

The zeroing-out of the benchmark interest rate by the Federal Reserve wasn't the optimal or even a necessary response to the economic impact caused by the COVID-19 pandemic in March 2020. A targeted fiscal response would have been better, and might have eliminated the need to reduce rates at all.

So writes Columbia University economist Michael Woodford in a recent **paper**, "Effective Demand Failures and the Limits of Monetary Stabilization Policy (NBER Working Paper

27768). Instead, he recommends the application of “pandemic insurance” that would keep the most vulnerable economic dominoes from falling, and prevent a cascade of failures to pay and be paid.

The most vulnerable economic dominoes, in Woodford’s model, would have been the business sectors that were shut down solely because of fear of contagion. If the government intervened to pay the immediate bills of those sectors, a chain reaction of missed payments and a collapse of the “circular flow of payments” might have been avoided.

“Fiscal transfers directly respond to the fundamental problem preventing the effective functioning of the market mechanism, and can bring about a much more efficient equilibrium allocation of resources, even when they are not carefully targeted. And when fiscal transfers of a sufficient size are made in response to the pandemic shock, there is no longer any need for interest-rate cuts, which instead will lead to excessive current demand.”

Monetary policy works better when there’s a general slowdown in business activity than when a pandemic shuts down only certain sectors of the economy, according to Woodford: “The COVID-19 pandemic presents a challenge for stabilization policy that is different from those resulting from either “supply” or “demand” shocks that similarly affect all sectors of the economy.”

Honey, Obama shrank the variable annuity market

The “fiduciary rule” as proposed by the Obama administration (later defeated in court by life insurers and others) was effective in driving down sales of high-cost, high-commission variable annuity contracts, according to economists at Harvard and New York University.

In their **study**, the economists found that “sales of high-expense variable annuities fell by 52% as [consumers] became more sensitive to expenses and insurers increased the relative availability of low-expense products,” after the Obama Department of Labor (DOL) introduced its “best interest” fiduciary rule in 2016.

The rule required brokers to act as fiduciaries when selling fixed indexed annuities and variable annuities for clients to purchase with tax-deferred retirement savings (in rollover IRAs, for instance). The rule required brokers to pledge that they would act only in the client’s best interest, and gave investors the right to sue brokers who broke the pledge.

In 2017, the Trump administration froze the rule, and it was rescinded in 2018 after the American Council of Life Insurers and others successfully challenged the rule in the federal

District Court of Appeals in Texas. The Trump DOL did not challenge the Texas ruling.

"Total variable annuity sales fell by roughly 19% year-over-year after the regulation was issued by the DOL in 2016. The drop in variable annuity sales was primarily driven by a decline in high-expense variable annuity sales; sales of low-expense variable annuities remained constant over this period. The results suggest that, in response to the proposal of the rule, brokers began complying with the rule by placing greater weight on investor interests. We also find that insurers responded to the rule by increasing the relative availability of low-expense products available for sale."

The intersection of stocks, interest rates and inequality

Over the past 30 years, cuts in interest rates by the Federal Reserve have led to greater investment in stocks, mainly by upper middle class Americans, and those investments have stimulated economic growth, write economists Davide Melcangi and Vincent Sterk in a recent staff **report** from the Federal Reserve Bank of New York.

The two researchers set out to discover how Fed policy is transmitted to the real economy. Their answer: "A group of high-income households who save a large fraction of their incomes, and do so primarily by adding to their stock portfolios [are] critical to the transmission of monetary policy via aggregate investments."

Investors react to decreases in interest rates by allocating new investments to stocks and to increases in rates by allocating to bonds, the authors wrote, relying on Investment Company Institute mutual fund flow data and other sources. These shifts, they added, have led either to increases or decreases, respectively, in capital investment by U.S. companies.

Stock ownership has broadened over the last few decades, but mainly among those with higher incomes who can afford to save. The increase in stock market participation "is driven by the upper middle-class, around the 60th to 80th percentile of income," the report said.

In 1988, 25% of U.S. households invested in stocks, with 60% of those with the highest incomes investing. By 2000, 44% of households invested in stocks, with almost 85% for those with the most income investing. The researchers conclude that these trends have strengthened monetary policy effects on investment.

"Much of the decline in aggregate output following a monetary tightening is driven by investment rather than consumption. Related to this finding, we also show that households reduce their net investments into equity-focused mutual funds following a monetary tightening. Finally, we show that the net investment inflows into equity-based funds predict changes in aggregate investment into physical capital. All three patterns are consistent with an important role for stock investments," the report said.

Turning their attention to the savings and consumption behavior of high-income Americans, they hypothesize that wealth investors save steadily out of income, invest more in stocks when interest rates go down, stop adding to their equity holdings when interest rates go up, and "liquidate stocks only when an infrequent expenditure opportunity arises." Examples of those opportunities include "exclusive medical or old-age care, tuition for elite education, starting capital for a private business, or large donations."

Retirement stops at age X

In hindsight, people can over- or under-save for retirement because, prior to retirement, they over- or under-estimate how long they would live. Those who plan on needing income until age 90, for instance, will try to save much more (or perhaps invest more aggressively) than those who plan on living to age 85.

For retirees, one alternative to saving too much or too little, or to over-spending or hoarding, or to gambling on longevity, is to buy a deferred income annuity (DIA) that starts paying income when mortality risk starts to accelerate (at age 85 or so).

A new **whitepaper** from Morningstar Investment Management, "The End of Retirement," explores the implications for advisers and clients of unknown longevity. The authors suggest that, rather than trust clients' subjective estimates of longevity, advisers should "base the estimate off objective information about the client." It doesn't recommend an annuity.

Morningstar reviewed data on 31,211 financial plans and found that 70% of plans assumed a client's or couple's lifespan of 90 years and 20% assumed a lifespan of 95 years. Generally, these assumptions weren't based on individual health assessments, and they didn't incorporate the survivorship bonus for couples.

As a rule of thumb, Morningstar recommended adding a buffer of five years to a single person's life expectancy and eight years to the member of a couple with the longer life expectancy.

This approach suggests a retirement period of 30 years (to age 95) as a reasonable assumption for the average 65-year-old male/female couple retiring today.

"Individuals who said they had a 0% probability of surviving to a given age (75) actually had about a 50% chance, and those who said they had a 100% probability actually had about an 80% chance. Therefore, retirement periods should be determined using objective criteria—that is, don't ask the client how long he/she thinks he/she will live, rather, base the estimate off objective information about the client."

What investors were thinking last spring

In their **paper**, "Inside the Mind of a Stock Market Crash," four researchers analyzed Vanguard shareholder data to see how investor expectations about economic growth and stock returns changed during the February-March 2020 stock market crash induced by the COVID-19 pandemic, as well as during the subsequent partial stock market recovery.

The researchers surveyed retail Vanguard clients at three points in time:

- February 11-12, around the all-time stock market high
- March 11-12, after the stock market had collapsed by over 20%
- April 16-17, after the market had rallied 25% from its lowest point

Following the crash, the average investor turned more pessimistic about the short-run performance of both the stock market and the real economy. Investors also perceived higher probabilities of both further extreme stock market declines and large declines in short-run real economic activity. In contrast, investor expectations about long-run (10-year) economic and stock market outcomes remained largely unchanged, and, if anything, improved.

Disagreements among investors about economic and stock market outcomes also increased substantially following the stock market crash, with differences of opinion persisting through the partial market recovery.

Survey respondents who were the most optimistic in February saw the largest decline in expectations, and sold the most equity. Those respondents who were the most pessimistic in February largely left their portfolios unchanged during and after the crash.

Pandemic reveals holes in public 'safety net'

The COVID-19 crisis has led to spiking unemployment rates with disproportionate impacts on Low-income families were disproportionately affected this year by lay-offs related to the COVID-19 pandemic, write Marianne Bitler, Hilary W. Hoynes and Diane Whitmore Schanzenbach in their **paper**, "The Social Safety Net in the Wake of COVID-19" (NBER Working Paper No. 27796).

School and child-care center closures have often meant lost free- and reduced-price school meals. Food prices have also increased sharply in some areas, lowering the purchasing power for families with limited incomes.

The Families First Coronavirus Act and the CARES Act expanded unemployment insurance (with broader eligibility and a supplement of $600 per week), provided a one-time payment of $1,200 per adult and $500 per dependent, increased SNAP payments, and launched the Pandemic EBT (Electronic Benefits Transfer) program to replace lost school meals.

But, as the pandemic continued, food insecurity rates increased to almost three times the pre-COVID rates and food pantry use spiked. The authors offer three reasons why: (1) Timing – relief was delayed because unemployment insurance (UI) systems were overwhelmed and new programs had to be started; (2) Magnitude – payments outside UI were modest; and (3) Coverage gaps –some groups didn't have access to relief programs and other groups were ineligible for them.