Labor and Capital in American Businesses

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How large is capital income in the US and how fast has it grown over the last decades?

Important question for analyzing:

- Consequences of globalization & technological change
- Sources of rising top-end inequality (rising wage inequality vs. capital concentration)
- Tax policy (taxing wealth vs. labor)
Macro data suggest a large increase in the corporate capital share

Labor share = Income going to workers (compensation of employees) / Value-added

Capital share = Income going to capital owners (interest, dividends, reinvested profit) / Value-added

Labor share + capital share = 100%
Macro data suggest a large increase in the corporate capital share.
Controversy over the extent of the rise of the capital share

Measurement challenges:

- A growing number of businesses are organized as partnerships & S-corporations...
- ... where labor/capital frontier is fuzzy and can be manipulated for tax reasons
- Smith, Yagan, Zidar, Zwick (2019): 3/4 of partnerships & S-corp profits are in fact labor income → very low capital share in these businesses (≈ 10%)

→ Is the rise of the capital share an illusion?
This paper: New series of US capital and labor shares

Comprehensive approach:

▷ Cover all types of businesses → controls for changes in business organization

▷ Cover all forms of income → allows to estimate contribution of $K$ to US income growth, by percentile

Address all potential sources of bias:

▷ New data & method to neutralize tax-induced shifting

▷ Address other identified challenges: housing (Rognlie, 2015; Cette et al., 2019), depreciation (Bridgman, 2014), self-employment (Piton and Gutiérrez, 2020), international profit shifting (Tørsløv et al., 2020)
Main contributions

New data:

- Systematic exploitation of IRS business income statements & balance sheets, 1993–2017
- Tabulations by business type, sector, and size; future extensions with micro data

New methodology:

- Estimate factor shares in big private firms by using return to capital observed in similar listed firms
- Estimate factor shares in firms with suspected shifting using similar firms where there is no shifting incentive
Example of data used: income of S-corporations in a few manuf. sectors

<table>
<thead>
<tr>
<th>Item</th>
<th>(26)</th>
<th>(27)</th>
<th>(28)</th>
<th>(29)</th>
<th>(30)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from trade or business:</td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total receipts</strong></td>
<td>127,660,372</td>
<td>55,415,227</td>
<td>33,274,247</td>
<td>32,169,146</td>
<td>46,104,576</td>
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<tr>
<td>Business receipts</td>
<td>126,442,911</td>
<td>54,949,893</td>
<td>32,942,279</td>
<td>31,897,817</td>
<td>45,541,489</td>
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<tr>
<td>Net gain, noncapital assets</td>
<td>212,101</td>
<td>122,724</td>
<td>73,377</td>
<td>25,944</td>
<td>19,579</td>
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<tr>
<td>Tax-exempt interest</td>
<td>8,636</td>
<td>10,177</td>
<td>3,061</td>
<td>2,812</td>
<td>8,507</td>
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<tr>
<td>Other receipts</td>
<td>986,724</td>
<td>332,433</td>
<td>255,531</td>
<td>242,572</td>
<td>535,001</td>
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<tr>
<td><strong>Total deductions</strong></td>
<td>117,247,441</td>
<td>51,295,587</td>
<td>30,408,462</td>
<td>29,343,302</td>
<td>42,242,581</td>
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<tr>
<td>Cost of goods sold</td>
<td>83,804,525</td>
<td>34,169,961</td>
<td>19,267,614</td>
<td>20,175,036</td>
<td>32,088,031</td>
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<tr>
<td>Compensation of officers</td>
<td>3,798,835</td>
<td>1,624,172</td>
<td>1,047,302</td>
<td>906,528</td>
<td>982,880</td>
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<tr>
<td>Salaries and wages</td>
<td>9,174,536</td>
<td>5,933,807</td>
<td>4,282,624</td>
<td>3,398,297</td>
<td>3,097,666</td>
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<tr>
<td>Repairs and maintenance</td>
<td>649,231</td>
<td>239,359</td>
<td>144,049</td>
<td>89,218</td>
<td>192,302</td>
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<tr>
<td>Bad debts</td>
<td>d</td>
<td>78,153</td>
<td>54,819</td>
<td>d</td>
<td>25,388</td>
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<tr>
<td>Rents paid</td>
<td>2,493,851</td>
<td>906,538</td>
<td>758,535</td>
<td>376,102</td>
<td>591,499</td>
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<td>Taxes and licenses</td>
<td>2,681,844</td>
<td>1,164,041</td>
<td>743,300</td>
<td>571,810</td>
<td>794,524</td>
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<td>Interest paid</td>
<td>622,175</td>
<td>278,929</td>
<td>167,584</td>
<td>176,742</td>
<td>255,862</td>
</tr>
<tr>
<td>Amortization</td>
<td>149,725</td>
<td>74,991</td>
<td>d</td>
<td>d</td>
<td>58,061</td>
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<tr>
<td>Depreciation</td>
<td>2,551,125</td>
<td>1,140,565</td>
<td>394,966</td>
<td>512,017</td>
<td>751,693</td>
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<tr>
<td>Depletion</td>
<td>d</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>d</td>
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<tr>
<td>Advertising</td>
<td>503,668</td>
<td>472,102</td>
<td>234,391</td>
<td>262,503</td>
<td>205,853</td>
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<td>Pension, profit-sharing, etc., plans</td>
<td>815,786</td>
<td>394,405</td>
<td>251,908</td>
<td>226,018</td>
<td>285,796</td>
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<td>Employee benefit programs</td>
<td>2,462,133</td>
<td>1,053,491</td>
<td>592,843</td>
<td>605,842</td>
<td>687,828</td>
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<tr>
<td>Net loss, noncapital assets</td>
<td>26,772</td>
<td>6,135</td>
<td>d</td>
<td>3,916</td>
<td>d</td>
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<tr>
<td>Other deductions</td>
<td>7,350,990</td>
<td>3,758,937</td>
<td>2,393,376</td>
<td>1,959,030</td>
<td>2,220,329</td>
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<tr>
<td><strong>Total receipts less total deductions</strong></td>
<td>10,402,931</td>
<td>4,119,639</td>
<td>2,865,785</td>
<td>2,925,844</td>
<td>3,661,985</td>
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<tr>
<td><strong>Net income (less deficit) from a trade or business</strong></td>
<td>10,394,295</td>
<td>4,109,463</td>
<td>2,862,724</td>
<td>2,823,032</td>
<td>3,853,488</td>
</tr>
</tbody>
</table>
Contrary to persons, US businesses must report wealth in addition to income.

<table>
<thead>
<tr>
<th>Item</th>
<th>Fabricated metal product manufacturing</th>
<th>Machinery manufacturing</th>
<th>Computer and electronic product manufacturing</th>
<th>Electrical equipment, appliance, and component manufacturing</th>
<th>Transportation equipment manufacturing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of returns</td>
<td>(26)</td>
<td>(27)</td>
<td>(28)</td>
<td>(29)</td>
<td>(30)</td>
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<tr>
<td>Total assets</td>
<td>30,371</td>
<td>12,327</td>
<td>4,428</td>
<td>3,648</td>
<td>5,792</td>
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<tr>
<td>Cash</td>
<td>12,294,358</td>
<td>6,838,560</td>
<td>4,327,695</td>
<td>3,110,837</td>
<td>3,037,303</td>
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<tr>
<td>Trade notes and accounts receivable</td>
<td>16,270,751</td>
<td>7,288,440</td>
<td>4,954,339</td>
<td>4,313,864</td>
<td>4,842,209</td>
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<tr>
<td>Less: Allowance for bad debts</td>
<td>197,344</td>
<td>142,976</td>
<td>98,862</td>
<td>57,163</td>
<td>49,569</td>
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<tr>
<td>Inventories</td>
<td>14,944,607</td>
<td>9,437,737</td>
<td>4,778,700</td>
<td>4,413,682</td>
<td>6,641,134</td>
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<tr>
<td>U.S. government obligations</td>
<td>d</td>
<td>0</td>
<td>0</td>
<td>d</td>
<td>0</td>
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<tr>
<td>Tax-exempt securities</td>
<td>* 174,628</td>
<td>0</td>
<td>0</td>
<td>d</td>
<td>0</td>
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<tr>
<td>Other current assets</td>
<td>2,748,603</td>
<td>2,059,228</td>
<td>945,454</td>
<td>604,505</td>
<td>951,546</td>
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<tr>
<td>Loans to shareholders</td>
<td>d</td>
<td>255,085</td>
<td>108,892</td>
<td>238,349</td>
<td>d</td>
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<tr>
<td>Mortgage and real estate loans</td>
<td>* 56,733</td>
<td>0</td>
<td>* 6,386</td>
<td>d</td>
<td>d</td>
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<td>Other investments</td>
<td>5,988,387</td>
<td>3,340,920</td>
<td>2,424,662</td>
<td>3,844,377</td>
<td>2,341,217</td>
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<td>Depreciable assets</td>
<td>66,880,826</td>
<td>23,218,082</td>
<td>9,342,054</td>
<td>9,378,568</td>
<td>15,410,745</td>
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<tr>
<td>Less: Accumulated depreciation</td>
<td>49,655,875</td>
<td>16,281,256</td>
<td>6,879,818</td>
<td>5,973,386</td>
<td>9,643,985</td>
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<tr>
<td>Depletable assets</td>
<td>0</td>
<td>d</td>
<td>0</td>
<td>d</td>
<td>0</td>
</tr>
<tr>
<td>Less: Accumulated depletion</td>
<td>0</td>
<td>d</td>
<td>0</td>
<td>d</td>
<td>0</td>
</tr>
<tr>
<td>Land</td>
<td>970,719</td>
<td>360,091</td>
<td>d</td>
<td>d</td>
<td>307,064</td>
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<tr>
<td>Intangible assets (amortizable)</td>
<td>1,956,668</td>
<td>1,456,525</td>
<td>1,477,297</td>
<td>952,320</td>
<td>720,452</td>
</tr>
<tr>
<td>Less: Accumulated amortization</td>
<td>865,452</td>
<td>639,279</td>
<td>713,235</td>
<td>d</td>
<td>316,808</td>
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<tr>
<td>Other assets</td>
<td>1,041,648</td>
<td>1,185,101</td>
<td>655,725</td>
<td>1,813,635</td>
<td>674,433</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>73,656,672</td>
<td>38,421,126</td>
<td>21,604,190</td>
<td>22,694,884</td>
<td>25,189,156</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>6,623,062</td>
<td>3,331,393</td>
<td>2,331,221</td>
<td>2,450,409</td>
<td>2,790,782</td>
</tr>
<tr>
<td>Mortgages, notes, bonds payable in less than 1 year</td>
<td>4,063,219</td>
<td>2,102,877</td>
<td>972,003</td>
<td>703,784</td>
<td>1,687,487</td>
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<tr>
<td>Other current liabilities</td>
<td>6,762,399</td>
<td>4,608,147</td>
<td>2,507,864</td>
<td>1,867,726</td>
<td>2,670,361</td>
</tr>
<tr>
<td>Loans from shareholders</td>
<td>3,773,369</td>
<td>1,424,264</td>
<td>1,640,190</td>
<td>936,882</td>
<td>1,955,955</td>
</tr>
<tr>
<td>Mortgages, notes, bonds payable in 1 year or more</td>
<td>10,267,473</td>
<td>4,291,324</td>
<td>1,633,236</td>
<td>3,346,718</td>
<td>4,179,264</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>2,044,418</td>
<td>2,066,553</td>
<td>589,325</td>
<td>1,827,114</td>
<td>790,550</td>
</tr>
<tr>
<td>Net worth, total</td>
<td>40,122,734</td>
<td>20,596,560</td>
<td>11,910,350</td>
<td>11,762,251</td>
<td>11,114,757</td>
</tr>
<tr>
<td>Capital stock</td>
<td>1,120,699</td>
<td>586,156</td>
<td>296,889</td>
<td>451,152</td>
<td>368,368</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>3,706,495</td>
<td>2,636,404</td>
<td>2,020,539</td>
<td>605,871</td>
<td>1,986,766</td>
</tr>
<tr>
<td>Retained earnings, unappropriated</td>
<td>39,509,477</td>
<td>18,175,436</td>
<td>10,620,291</td>
<td>11,438,837</td>
<td>9,477,418</td>
</tr>
<tr>
<td>Less: Cost of treasury stock</td>
<td>4,215,935</td>
<td>801,428</td>
<td>1,027,368</td>
<td>733,609</td>
<td>657,795</td>
</tr>
</tbody>
</table>
Results: we confirm rising capital share, although rise more muted.
The capital share of US national income has increased by 4 points since 2000.
A growing fraction of income derives from capital at the top since 2000
Over 2000–2018, more than half of US macro income growth came from capital.

<table>
<thead>
<tr>
<th></th>
<th>National income per adult</th>
<th>Labor income per adult</th>
<th>Capital income per adult</th>
<th>[4] Share of aggregate per-adult income growth attributed to income from…</th>
<th>[5]</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>[1]</td>
<td>[2]</td>
<td>[3]</td>
<td></td>
<td>[4]</td>
</tr>
<tr>
<td>1980-2018</td>
<td>1.4%</td>
<td>1.3%</td>
<td>1.8%</td>
<td>69%</td>
<td>31%</td>
</tr>
<tr>
<td>1980-1990</td>
<td>1.6%</td>
<td>1.6%</td>
<td>1.6%</td>
<td>79%</td>
<td>21%</td>
</tr>
<tr>
<td>1990-2000</td>
<td>2.3%</td>
<td>2.3%</td>
<td>2.2%</td>
<td>80%</td>
<td>20%</td>
</tr>
<tr>
<td>2000-2018</td>
<td>0.8%</td>
<td>0.5%</td>
<td>1.8%</td>
<td>48%</td>
<td>52%</td>
</tr>
</tbody>
</table>
We find capital share of S-corp. & partnership profit around 50% vs. 25% in Smith et al. (2019)

▷ Our results are consistent with low capital share in small pass-through businesses (doctors, dentists, etc.)

▷ But we find high capital share in big partnerships and S-corporations, which are few in number but large in $

▷ Ex: Bloomberg L.P.: capital share of profit likely close to 100% (vs. 25% in Smith et al., 2019)

▷ Smith et al. main results are people-weighted (dentist weighs as much as Bloomberg), while we care about $
Conceptual Framework and Macro Trends
What is capital income?

Capital income is income earned from owning assets, independently of any current labor input

- Dividends and reinvested profit of listed companies, housing rents, interest, royalties, etc.
- Can be higher or lower than marginal product of capital (due to monopoly positions, risk, unions, etc.)
- In this paper we care about who receives income, not who creates income

Capital income is different from inherited wealth:

- Jeff Bezos, Warren Buffett earn capital income, but their wealth is mostly self-made, not inherited
National income $Y$ (net of depreciation) is generated by corporations, non-corporate businesses (partnerships, sole proprietorships), housing sector, government, non-profits, foreign sector (cross-border assets and workers)

$$Y = Y_c + Y_{ncb} + Y_h + Y_g + Y_n + Y_f$$

In each of these sectors, fraction $\alpha$ of income goes to capital (owners) and $1 - \alpha$ goes to labor (workers)

$\rightarrow$ National income $Y = Y_K + Y_L$ with $Y_K = \sum_s \alpha_s Y_s$
Standard computation of capital income

▷ Corporations: $Y_c = \text{wages} + \text{profit} = Y_{cL} + Y_{cK}$ with 100% of $Y_{cK}$ being capital income

▷ Non-corporate businesses:
  ▷ Do not separate working owners’ income into wages vs. profit: $Y_{ncb} = Y_{ncb,L} + Y_{ncb,mix}$
    ▷ Need assumptions on capital/labor split of $Y_{ncb,mix}$

▷ Housing: $\alpha = 100\%$

▷ Government and non profits: $\alpha = 0\%$

▷ Foreign sector: $\alpha$ close to 100\% (foreign dividends, reinvested earnings, etc.)
Key measurement issues in US context:
1. Income shifting in corporations

**Some corporate profit is labor income & vice-versa**

- Doctors, dentists & other self-employed frequently operate as corporations (S-corporations)
- Must pay themselves “reasonable compensation” but incentives to classify income as profit → $Y_{cK}$ includes a labor component
- Same problem in some other countries where self-employed incorporate (Piton and Gutiérrez, 2020)
- Opposite incentives in private C-corporations (until 2018) → $Y_{cL}$ includes a capital component
Many large businesses operate as partnerships:

- Real estate (Trump), pipeline (Energy Transfer), pharma (Purdue), private equity and hedge funds...
- Partnership status popular following 1986 tax reform, corporate status popular again since 2018 (21% rate)

Consequences:

- Possible bias in corporate capital share due to sorting
- Huge heterogeneity among non-corporate businesses

→ Capital share of mixed income $Y_{mix}$ ranges from 0% (paid speech) to 100% (listed partnerships)
Despite the ↑ of S-corporations, a ↓ share of US output comes from corporations.
A growing fraction of US output is generated by non-corporate businesses.
The rise of non-corporate businesses is a US phenomenon.
Housing sector output has been multiplied by 2 since 1980.
The rise of non-profits

Non-profit value-added
(% of total US value-added)
The decline of government output

Government value-added
(% of total US value-added)
Methodology
Listed firms: clean $Y_K$ vs. $Y_L$ frontier

When frontier between labor and capital is fuzzy ($Y = Y_L + Y_{mix}$), three methods to estimate factor shares:

1. **Assign a return to capital** of the business, using return observed for similar listed firms
2. **Match business to similar businesses** that have no tax incentive to shift income
3. Impute a wage to working owners using observed compensation of salaried executives in similar firms

→ Today show results on 1. and 2. Future work on 3.
Method 1: How we impute a return to the capital of private businesses

Estimate return to capital of listed corporations by 3-digits NAICS (Compustat)

Apply this return to S-corp. & partnerships capital (IRS)

▷ Harmonize measure of capital stock

▷ Remove influence of largest listed firms with few counterparts among private firms

▷ Deal with private firms with no counterpart among listed firms (e.g., doctors’ practices, law firms)
Harmonized measures of capital stock

**Benchmark measure: market value of equity**

- Listed firms: observed
- Private firms: apply market/book ratio of listed firms in same 3-digits sector & 25% valuation discount
- Methodology followed by Federal Reserve to estimate market value of S-corporation equity

For robustness consider other measures of capital stock: total assets, book equity, plant property and equipment
Dealing with selection into being listed

Largest firms more likely to be listed:

▷ Benchmark: winsorize Compustat at 5% (remove influence of ≈ Fortune 500 companies)

▷ Robustness: trim 5% listed firms with highest income & 5% with highest loss; trim top 10% by sales

Generally meaningful sectoral overlap between listed firms and private businesses

▷ Home Depot v. Menards (Yagan 2015)

▷ When no/little overlap (law firms, doctors, dentists): assume 25% of $Y_{mix}$ is capital (Smith et al., 2019)
Dealing with double-counting in partnership tax returns

Computing the capital stock and profit of partnerships raises specific challenges:

- Income and assets are double-counted in partnership tax returns due to partnership chains
- Partnerships can also be owned by corporations
- We address this by allocating partnership wealth & income to individual partners, using tabulated IRS data on distributions by type of partner × sector
- Results consistent with Cooper et al. (2016) which used micro-data for 2011
A declining fraction of partnership income is earned by individuals.
Method 2: Assigning to private businesses the capital share of similar businesses

Match private firms to firms where one can observe true capital share $\hat{\alpha}$ then compute $\alpha_{mix}$ such that $\frac{\alpha_{mix} Y_{mix}}{Y} = \hat{\alpha}$

- Match S-corporations and partnerships to C-corporations of same asset size
- Assumption: within asset bin, same factor shares for C-corp. vs. S-/partnerships (eg, same $Y = F(K, L)$)

Potential improvements:
- Exclude private C-corporations (where $\alpha$ may be downward biased)
- Use micro-data to control for sector differences
Results
Capital share of private business income

Overall level and trend:

▸ Around 50% of S-corporation profit and partnership income is capital income in mid-2010s

▸ Evidence that a rising share of partnership income is capital since 2010

Heterogeneity among private firms:

▸ Dentists vs. multinationals have widely different $K$ shares → uniform heuristics (say $\alpha = 30\%$) misleading

▸ High capital share in private businesses (owned by the rich) → high wealth and capital income at the top
Method 1: Return on equity in the top sectors by S-corporation profit

Rate of return on equity

- Winsorized listed firms
- S-corporations (reducing reported profit by 3/4)

3-digit NAICS sector

- Construction buildings
- Motor vehicle dealers
- Durable goods wholesale
- Securities
- Metal product manuf.
- Food/drink services
- Non-durables wholesale
- Admin & support services
Applying the return to equity of listed firms to S-corporation equity

Rate of return on equity

Capital share of S-corporation profit = 42%

Winsorized listed firms
S-corporations (flexible capital share of profit)

3-digit NAICS sector

Construction buildings
Motor vehicle dealers
Durable goods wholesale
Securities
Metal product manuf.
Food/drink services
Non-durables wholesale
Admin & support services
Assigning to S-corp. the return of listed firms suggests half of profit is $K$ income.
A rising fraction of partnership mixed income seems to be capital income.
A rising fraction of partnership mixed income seems to be capital income.
A rising fraction of partnership income is exempt from the income tax

Excess of tax depreciation over economic depreciation for non-farm non-corporate businesses (% of proprietor’s income)
Method 2: Comparing factor shares of S-corporations and C-corporations

Capital share of value added in C- vs. S-corporations (2014)

- C-corporations
- S-corporations (reducing reported profit by 3/4)
3/4 of S-corporation profit looks like labor in small firms, but not in big ones.
Large S-corporations have a high capital share of profit

Capital share of value added in C- vs. S-corporations (2014)
- C-corporations profit
- S-corporation profit (flexible capital share of profit)
- C-corporations interest
- S-corporations interest

Capital share of S-corporation profit = 40%
From business capital income to total capital income

To capture total capital income need to add:

**Housing income**
- Large rise since 1980
- Pure capital income (net of depreciation)

**Net foreign income**
- Significant rise since 2000
- Profit shifting
- Rising cross-border return differential (US investments in direct equity vs. foreign in US government bonds)
A declining fraction of US capital income originates from domestic corporations.
More than half of income is capital income in the top 1%
Conclusion
Main findings

2000–2018: labor stagnates, capital grows

▷ Rising capital share of US national income
▷ High & ↑ fraction of top incomes derives from $K$

Research and policy implications:

▷ Results based on public data → could be incorporated into official national accounts
▷ Improved measure of capital/labor split of pass-through business income → improved estimates of wealth inequality (Saez and Zucman, 2020)
▷ Valuation of private equity: key for wealth taxation
Concluding remarks

Conceptually, capital income is income earned independently of any labor input.

In practice, it can require effort to earn capital income (time spent managing wealth, etc.):

- Cost was non-negligible in the past
- But close to zero today (rise of Vanguard)

→ Rise of the capital share under-estimated? With more perfect capital markets, higher $\alpha$
Supplementary Slides
Key measurement issues in US context: Rising tax-exempt capital income

A growing fraction of capital income is legally exempt from the individual income tax:

- Rising corporate retained earnings since 2000
- Rise of tax-exempt retirement accounts
- Rise of bonus depreciation (full expensing since 2018)
  → taxable business income < true income

→ capital/labor split cannot meaningfully be studied using individual income tax data only (which capture only 1/3 of economic capital income)
The rise of partnerships

Mixed income of non-corporate businesses (% of national income)

- Non-farm sole proprietorships
- Partnerships
- Farms
The rise of S-corporation equity wealth
Over 2000–2018, almost all income growth came from capital in the top 1%
Capital share in the corporate sector: before vs. after S-corporation correction

Capital share in US corporate sector

Official

Corrected for income shifting in S-corporation
Return on assets in the top sectors by S-corporation profit

Rate of return on assets

- Winsorized listed firms
- S-corporation profit (reduced by 3/4)
- S corporation interest

Assets:
- Food/drink services
- Motor vehicle dealers
- Admin & support services
- Metal product manuf.
- Durable goods wholesale
- Construction buildings
- Non-durables wholesale
- Securities