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The following is an excerpt from the Summer 2019 edition of The Linneman Letter.

What (Else) Drives Economic Inequality?

Complaints about the U.S. economic system regularly cite inequality as a failing. This narrative invariably views “the rich” and “the poor” as pre-determined lots in life. But as we see, much of the gap reflects savings decisions and aging. Further, decisions made about investing (seriously) in education explain much of the gap. For example, many of us were quite poor in our younger days in graduate school and early in our careers, but quite well off now. We probably think of ourselves as somewhat exceptional in our journey, but it is more so the norm than most people believe. A 2015 study by sociologists at Cornell and Washington University examined 44 years of income data and determined that about 12% of the population was part of the top 1% in at least one year, while only 0.6% remain in the top 1% for ten consecutive years. They further found that 39% of the population were in the top 5% at least one year, 56% were in the top 10% at least one year, and an amazing 73% were part of the top 20% for at least a year. That is, only 44% of the population was never in the top 10%, and only 27% never became part of the top 20%. Similarly, a Tax Foundation study found that from 1999 and 2007, only half of those who earned \$1 million did so for more than one of the nine years, and only 6% achieved millionaire status all nine years. Other multi-year studies have documented similar results and, nonetheless, the incorrect image of “rich” and “poor” endures. Further, the often noted high inequality in the U.S. relative to other countries, to a large extent, disappears when one focuses on income after taxes and transfers.

It is noteworthy that U.S. redistribution efforts, to date, have created three political fault lines. The first fault line is the resentment of well-off seniors based on a belief that these seniors are well off primarily because of redistributions from young to old. That is a, “we pay Social Security, and they sit around and collect Medicare and Social Security” syndrome. This feeds a “society would be better off if they were dead mindset.” A second fault line is that many well-off seniors view their less well-off senior counterparts as “squirrels who

failed to work hard or save their nuts for the winter of their lives.” The third fault line is the resentment of those who view their own lower income as not resulting from unwise work or savings decisions but rather, due to bad luck which kept them from working and saving. While each of these perceptions has an element of truth, none of them are fully accurate. But these simplistic narratives are exploited by politicians to promote their political careers. Right or wrong, expect these political tensions to grow larger and nastier as growing longevity increases inequality.

One reason for rising earnings inequality is that modern technology and global demand have expanded the value of those with high skills much more so than those with middle skills. Note that the top 10% earnings mark of \$115,000 hardly reflects the earnings of hedge fund managers and rock stars. This is lost on most peo-

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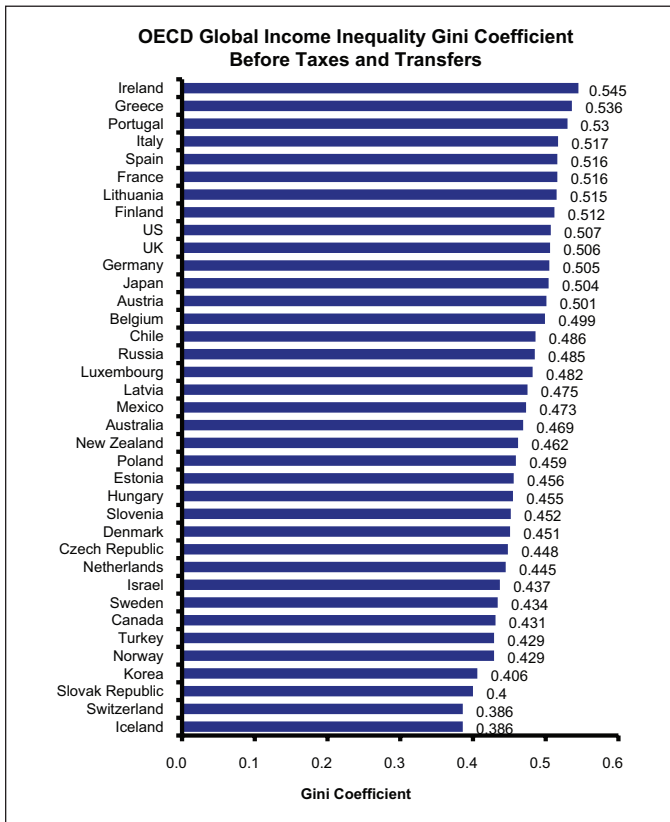


figure 1

ple. The middle in the U.S. lives better economically than in any other non-small (not Bermuda, Monaco, Lichtenstein, etc.) country. We have visited them all, and it is obvious in the lifestyles. And the U.S. middle class lives better and longer today than at any other time in U.S. history.

An important factor in explaining rising earnings gaps between the median and the top tenth percentile earner is rarely mentioned. It is the fact that workers in the U.S. (generally) get subsidized health insurance as part of their employment package. Since health care costs are relatively uniform across all workers and have risen rapidly, wages have grown less for middle-skilled than high-skilled workers.

This is a matter of very simple math. Assume that the median-skilled worker was worth \$50,000 “all in” ten years ago, while a high-skilled worker was worth \$100,000 “all in.” If health care costs were \$5,000 per worker, the middle was paid \$45,000 (\$50,000 minus \$5,000 for health care costs) and the high-skilled was paid \$95,000 (\$100,000 minus \$5,000). Thus, the “all in” compensation ratio of the tenth percentile to the median income was 2.0, and their earnings ratio was

2.11 ten years ago. If today, they are both worth 20% more in real terms, their “all in” values are \$60,000 and \$120,000, which maintains the “all in” ratio of 2.0. However, since health care costs have risen 120% over these ten years, health care costs per worker are now \$11,000. The result is that the median is paid \$49,000 (\$60,000 less \$11,000), while the tenth percentile is paid \$109,000 (\$120,000 less \$11,000). Thus, the earnings ratio rises from 2.11 to 2.22. By the way, these numbers reflect the rough magnitudes of reality and the associated widening gap found in the data. That is, health care payments skew the inequality picture.

Meanwhile in Europe, since health care costs are not paid by employers, this statistical distortion does not occur. But Europe has its own skew, as high-skilled workers are routinely given cars by employers, while middle-skilled workers are not. Using the same base numbers as above for “all in” value, it means median workers were paid \$50,000 ten years ago, while high earners were paid \$100,000 minus the \$15,000 annual cost of an auto, or \$85,000. Thus, while their “all in” ratio would be the same as the U.S. ten years ago at 2.0, their earnings ratio is only 1.7 versus 2.0 in the U.S. That

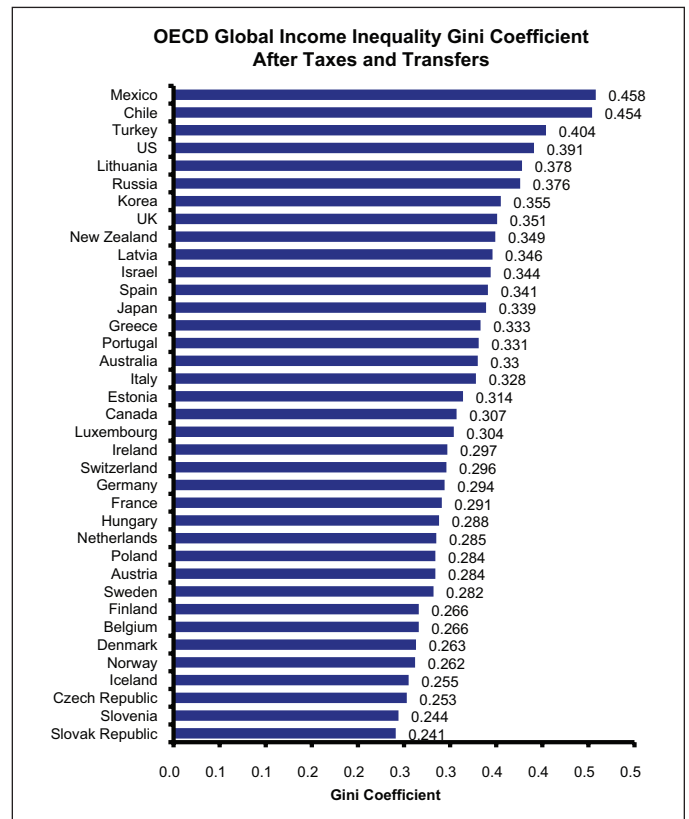


figure 2

Summary of U.S. Federal Income Tax Data, 2016							
	Top 1%	Top 5%	Top 10%	Top 25%	Top 50%	Bottom 50%	All Taxpayers
Number of Returns	1,408,888	7,044,439	14,088,879	35,222,196	70,444,393	70,444,393	140,888,785
Adjusted Gross Income (\$ millions)	2,003,066	3,574,828	4,729,405	6,950,051	8,979,705	1,176,907	10,156,612
Share of Total AGI (%)	19.7	35.2	46.6	68.4	88.4	11.6	100.0
Income Taxes Paid (\$ millions)	538,257	839,898	1,002,072	1,240,010	1,398,523	43,863	1,442,385
Share of Total Income Taxes Paid (%)	37.3	58.2	69.5	86.0	97.0	3.0	100.0
Income Split Point (\$)	480,804	197,651	139,713	80,921	40,078		
Average Tax Rate (%)	26.9	23.5	21.2	17.8	15.6	3.7	14.2

Source: IRS Statistics of Income, Individual Income Rates and Tax Shares, Tax Foundation (2018).
Note: Table does not include dependent filers. "Income split point" is the minimum Adjusted Gross Income (AGI) for tax returns to fall into each percentile.

figure 3

is, Europe looks more equal than it actually is relative to the U.S. However, real auto prices have fallen by 15% (roughly) over the past decade. Thus, the median now earns \$60,000 (and still gets no auto) today, while the high earner gets \$107,250 (\$120,000 minus \$12,750 for the auto). This means the “all in” high-to-middle earnings ratio is still 2.0, but the net earnings ratio has risen from 1.7 to 1.78. Once again, Europe appears to have greater income equality than the U.S., even though in this example, “all in” compensation is the same, both U.S. and European earnings ratios have risen notably, and all workers are better off. The point is that honestly evaluating inequality is far more nuanced than it appears. The fact is that the commonly presented numbers say nothing about whether inequality is growing.

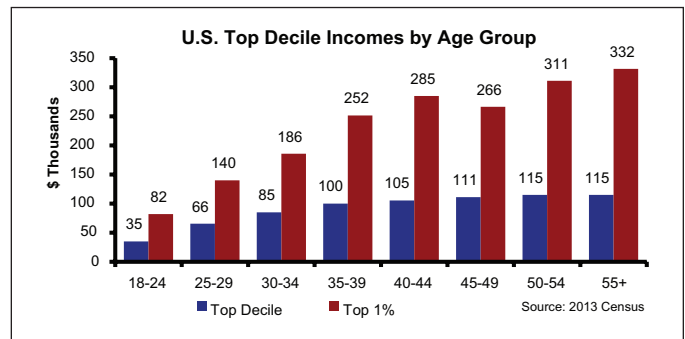


figure 4

About Dr. Peter Linneman

Dr. Linneman, who holds both Masters and Doctorate degrees in economics from the University of Chicago, is the Principal of Linneman Associates. For nearly four decades, he has provided strategic and financial advice to leading corporations. Through Linneman Associates, he provides strategic and M&A analysis, market studies, and feasibility analysis to a number of leading U.S. and international companies. In addition, he serves as an advisor to and a board member of several public and private firms.

Dr. Linneman is the author of the leading real estate finance textbook, *Real Estate Finance and Investments: Risks and Opportunities*, now in its fifth edition. His teaching and research focuses on real estate and investment strategies, mergers and acquisitions, and international markets. He has published over 100 articles during his career. He is widely recognized as one of the leading strategic thinkers in the real estate industry.

He also served as the Albert Sussman Professor of Real Estate, Finance, and Business and Public Policy at the Wharton School of Business at the University of Pennsylvania until his retirement in 2011. A member of Wharton’s faculty since 1979, he served as the founding chairman of Wharton’s Real Estate Department and the Director of Wharton’s Zell-Lurie Real Estate Center for 13 years. He is the founding co-editor of *The Wharton Real Estate Review*.

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