Looking for a deal on happiness? **Page 13** // How slow thinking could help at-risk youth **Page 15**
Yes, US productivity really has slowed **Page 17** // Behind skyrocketing CEO pay: option grants **Page 18**

DATAPOINTS

The $100 billion tax dodge

Pass-through businesses pay lower rates

We often hear about corporate America, but rarely about "pass-through America." Yet pass-through businesses—sole proprietorships, S corporations, and partnerships—account for 94 percent of US businesses, more than 60 percent of net business income, more than half the private-sector workforce, and 37 percent of the total private-sector payroll, according to the Tax Foundation, a tax policy research organization.

Since 1980, the number of traditional C corporations has fallen, while the number of pass-through businesses has risen sharply. The rise has allowed mostly very wealthy individuals to pocket about $100 billion that would have gone toward taxes under traditional corporate structures, according to research by economists at the US Department of the Treasury, the University of California, Berkeley, and Chicago Booth.

The study—by the Treasury's Michael Cooper, John McClelland, James Pearce, Richard Prisinzano, and Joseph Sullivan; University of California, Berkeley's Danny Yagan; and Chicago Booth's Owen Zidar and Eric Zwick—documents the soaring popularity of pass-through structures, which allow business earnings to be taxed as individual income and typically at significantly lower rates than earnings

ILLUSTRATION BY SEBASTIEN THIBAULT

in traditional corporations. Pass-through businesses are not directly taxed. Instead, their earnings are "passed through" to the individual shareholders, who are required to report their portions of earnings and losses on personal tax returns and pay taxes accordingly. By contrast, C corporations pay corporate taxes, and their shareholders also pay individual taxes on any distributions.

Between 1980 and 2011, the portion of US business earnings originating from pass-through companies rose from 21 percent to 54 percent, and the vast majority of pass-through earnings went to the top earners in the country, according to the study. Overall, 69 percent of pass-through income earned by individuals accrued to the top 1 percent of earners, mostly through partnerships in finance. By comparison, the top 1 percent collected 45 percent of corporate dividends accruing from traditional corporations. Relative to households in the bottom half of the country's earners, the top 1 percent were 50 times as likely to receive pass-through partnership income.

Tax breaks for pass-through businesses have come under fire recently from Americans concerned about the quickly widening gap between low and high earners. Between 1980 and 2013, the top 1 percent's portion of all earnings doubled to 20 percent, according to previous research by study team members. During that time, pass-through entities grew from

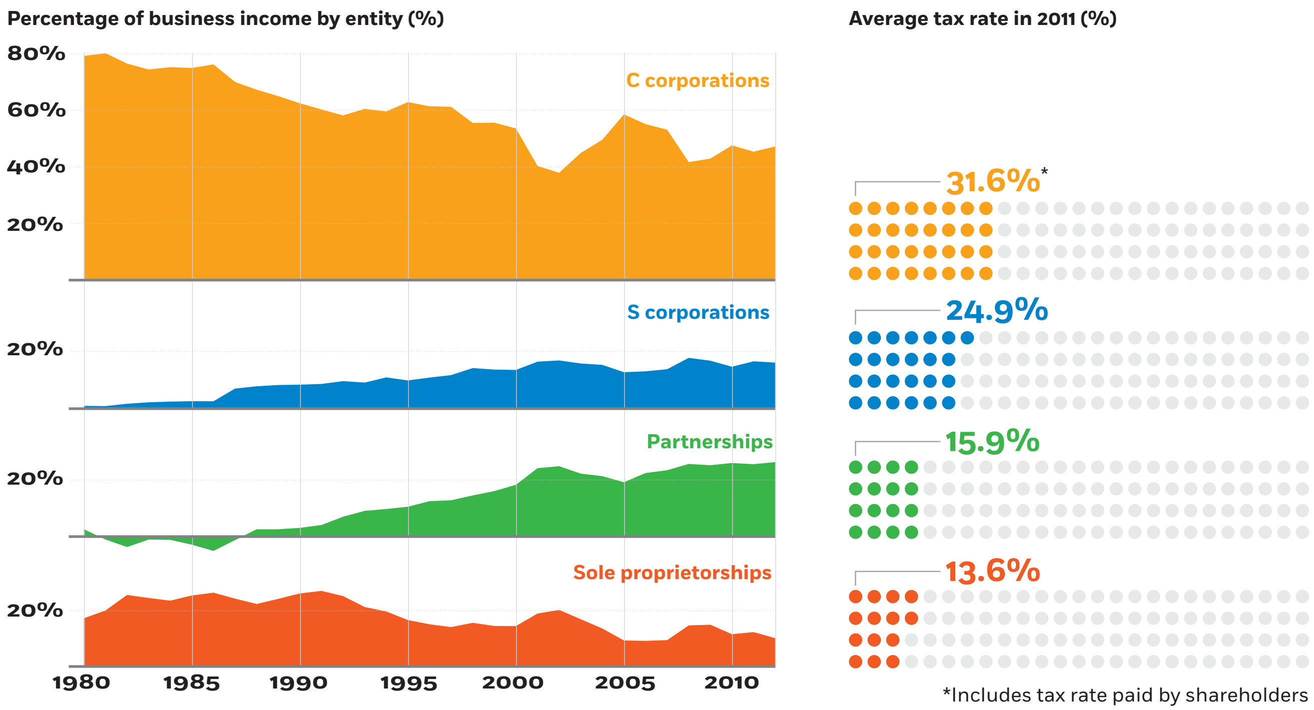
FOLLOW THE MONEY

Partnerships, the largest and fastest-growing type of pass-through businesses, can be surprisingly opaque. Researchers developed an algorithm to trace income through partnerships to the ultimate taxpayers, but they had trouble following the money.

In many cases, the shareholders in partnerships were other partnerships, which sometimes were owned by yet other partnerships. The researchers were unable to trace some 30 percent of pass-through earnings to an individual recipient.

Follow the tax rates

Between 1980 and 2011, business income shifted significantly from C corporations to pass-through businesses, which enjoy lower tax rates.



Sources: Cooper et al., 2015

*Includes tax rate paid by shareholders

HENRY PAULSON ON CLIMATE CHANGE

The world needs to concern itself with rising global temperatures, says the former 74th Secretary of the US Treasury.

Environmentalists often have a bad name because they don't compromise, they're zealots, they don't seem to understand that you need economic growth also.

[Climate change] is a particularly pernicious problem because governments deal best with a problem when there's an immediate crisis, and this strangles you slowly if you don't deal with it.

Climate change is the risk of our times. It is going to change life on earth as all of us know it.

As long as we keep the global ecosystem and nature as if it's a free good, we're quickly going to be at the tipping point of this planet.

convenient structures for independent workers and small businesses into popular tax-saving devices for high-income earners, corporations, and foreign investors.

The researchers were unable to trace some 30 percent of pass-through earnings to an individual recipient—a surprisingly high percentage, they write, in a system that links businesses with their responsible taxpayers and is designed to hold shareholders accountable.

Their use of comprehensive tax data, including all partnership filings as well as individual K-1 filings on all partnership income, allowed them to provide a novel picture of the tax savings that pass-through entities provide specific industries. Almost all hedge funds are partnerships, for example, and some 70 percent of all partnership income comes from these and other financial companies. The study estimates that financial partnerships are taxed 15 percent on average, as opposed to the 32 percent corporate rate. The traditional partnership industries pay the highest rates, with professional services and health care at an average 22 percent.

The findings call into question the business-tax collection estimates commonly used in economic models for forecasting and research. The decline in average business-income-tax rates documented by the study suggests that the commonly used statutory rates on C corporations for this work—35 percent for annual corporate taxes, or 45 percent, including dividend and capital gains taxes—considerably overestimate actual business-tax collection. The movement of business income into pass-through entities, the study shows, significantly lowers the average.—*Dee Gill*

Michael Cooper, John McClelland, James Pearce, Richard Prisinzano, Joseph Sullivan, Danny Yagan, Owen Zidar, and Eric Zwick, "Business in the United States: Who Owns It and How Much Tax Do They Pay?" Working paper, October 2015.

ILLUSTRATION BY OLIVER MUNDAY

HOW STRICT ACCOUNTING RULES COULD CAUSE BANK FAILURES

IN THE YEARS since the 2007–10 financial crisis, US lawmakers have tightened accounting rules governing what information banks must disclose and how they must present the data. The tighter rules make it harder for banks to paint a rosy but inaccurate picture of their financial health. Theoretically, that should lead to more-rational trading in the sector.

But research finds that strict disclosure requirements can lead to unnecessary bank failures. Without allowing banks discretion to modulate worrisome news, disclosure requirements can set off panic runs that cripple weak but solvent institutions, according to Chicago Booth's Pingyang Gao and Duke University's Xu Jiang. Banks that might have survived liquidity crises will instead fail.

Banks finance their long-term assets, such as loans, with short-term liabilities, such as deposits. This maturity mismatch between assets and liabilities makes them uniquely vulnerable to panic-driven runs even if there is no real crisis. Say depositors want to withdraw their assets, and a bank doesn't have the cash on hand to immediately cover all the withdrawal requests. Hearing that the bank is short cash, more depositors are likely to worry about the bank's health and demand their money too, and the resulting run will cause the bank to fail.

This scenario hurts all involved, but banks can prevent it if they have some leeway in terms of what they disclose, and how, the researchers argue. For example, a bank can still, legally, estimate the borrowers' default risk in a more aggressive fashion to reduce loan-loss-provision charges and present a rosier financial report. And while this leeway gives a bank the cover to misrepresent its financial health, it also gives a bank an important tool it can use to reassure investors.

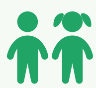
Gao and Jing find that such inflated reports reduce panic selling, and reduce the amount of investor selling even when fundamentals suggest the shares are overvalued. But regulation is a balancing act: "We show that reporting discretion reduces panic runs, but excessive reporting discretion weakens the market discipline," write the researchers, who note that when one bank opportunistically massages its reports, it motivates other banks to do the same.—*Dee Gill*

Pingyang Gao and Xu Jiang, "Reporting Discretion, Market Discipline, and Panic Runs," Working paper, December 2015.

The problems are much too big for philanthropy. It's going to take government policies.

This is so much more important than putting a man on the moon.

I see China very, very committed to making a difference. Dirty air is literally killing people, it's a political flashpoint.



I didn't want my grandchildren to look back and say, why didn't my grandfather deal with the issue of our times?

—Henry M. Paulson, Jr., chairman of The Paulson Institute, exerpted from remarks given at Chicago Booth's Social Impact Leadership Series.