

Income Inequality and Job Creation*

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Abstract

We propose a novel channel through which rising income inequality affects job creation and macroeconomic outcomes. High-income households save relatively more in stocks and bonds but less in bank deposits. A rising top income share thereby increases the relative financing cost for bank-dependent firms, which in turn create fewer jobs compared to other firms. Exploiting variation in top income shares across US states and an instrumental variable strategy, we provide evidence for this channel. We then build a general equilibrium macroeconomic model with heterogeneous households and heterogeneous firms and calibrate it to our empirical estimates. The model shows that the secular rise in top incomes accounts for 13% of the decline in the employment share of small firms since 1980. Through the new channel, rising inequality also reduces the labor share and aggregate output. Model experiments show that ignoring the link between inequality and job creation understates welfare effects of income redistribution.

JEL classification: D22, D31, E44, E60, L25.

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1 Introduction

The rise in income inequality over the past decades has given new impetus to the long-standing debate on its effects on the real economy (Jones, 2015). Recent work shows that rising top income shares can depress aggregate demand and output, as high-income households save a larger fraction of their income (Auclert and Rognlie, 2017, 2020) and finance the indebtedness of lower-income households (Mian, Straub, and Sufi, 2020, 2021a). This paper proposes a novel channel linking income inequality to job creation and economic activity through firms' financing conditions.

The channel rests on two observations. First, low-income households hold a larger share of their financial wealth in the form of bank deposits, while top earners invest in financial assets such as stocks or bonds. Second, banks' access to deposits affects their cost of funds and ability to grant loans, and changes in loan supply affect bank-dependent firms. These observations suggest that rising top income shares, through non-homotheticity in the allocation of savings, improve the relative funding conditions for firms with access to bond and equity financing. But they lead to a relative increase in financing costs for bank-dependent firms, which in turn create fewer jobs than firms with access to other forms of funding.

The first part of the paper tests this mechanism empirically with US data. The second part builds a quantitative macroeconomic model to study the consequences of rising top income shares for macroeconomic outcomes and welfare. Our analysis uncovers an intricate link between two salient trends in the US economy: the increase in top income shares on the one hand and the changing firm size distribution and decline in dynamism on the other.

Our empirical analysis establishes that an increase in the top 10% income share reduces job creation among bank-dependent firms and provides evidence for the mechanism. Motivated by the literature on the importance of bank lending for small firms, our baseline analysis focuses on job creation of small relative to large firms. For identification, we exploit variation in top income shares across US states from 1980 to 2015, using an instrumental variable (IV) strategy and granular fixed effects.

We find that a 10 percentage point (p.p.) increase in the top income share significantly reduces the relative net job creation rate of smaller, bank-dependent firms by 1.2 p.p. The US-wide increase in the income share of the top 10% from 1980 to 2015 was around 16 p.p. Small firms' net job creation rate would be 1.9 p.p., or over 50%, higher today had top income shares remained at their 1980 levels. Rising top incomes reduce job creation both along the intensive and extensive margin, with 20% of the overall decline in the net job creation rate due to changes in firm entry and exit.

To address omitted variable bias and reverse causality we develop an instrumental variable. It builds on each state's 1970 top 10% income share, adjusted for its

‘leave-one-out’ national trend. Specifically, we exclude each respective state from the nationwide evolution in top incomes used to adjust initial income shares in that state. The predicted income shares are then used as an IV for the actual shares.

To tighten identification, granular time-varying fixed effects control for observable and unobservable characteristics that could affect job creation within each state or within the same state and industry. State \times year fixed effects absorb, for example, the effects of technological change or globalization in each state over time, two common explanations behind the rise in income inequality. When possible, we include state \times industry \times year fixed effects that absorb common trends affecting firms within each state-industry cell. These include changes in industry concentration or import competition, as well as changes in demand across industries within a state.

We provide evidence for the link between income inequality and firms’ funding conditions. First, we show that the magnitude of the effect of rising top income shares on job creation is declining in firm size, consistent with the empirical evidence that smaller firms are more bank-dependent (Petersen and Rajan, 1994; Chodorow-Reich, 2014). Second, a given increase in top incomes reduces net job creation of small relative to large firms by more in industries that rely more on bank financing.

To investigate the effect of rising top incomes on deposits directly, we estimate bank-level regressions. We find that a rise in top income shares in banks’ headquarters states has a significant positive effect on banks’ deposit rates and a significant negative effect on deposit amounts. The increase in prices and fall in quantities are consistent with higher inequality leading to a relative reduction in households’ preference to save in deposits, which requires banks to raise deposit rates to attract funds and meet loan demand. We obtain similar results for commercial and industrial loans: higher top income shares increase loan rates but reduce loan amounts.

We address alternative explanations that could link top incomes, funding conditions, and job creation. Rising top income shares could affect local consumption if richer households demand more services (Boppart, 2014) that are predominantly provided by smaller, bank-dependent firms. To preclude this channel, we exclude non-tradable industries or add state \times industry fixed effects to our regressions and find similar effects. Our estimates are similar for industries that produce homogeneous goods and those that produce heterogeneous goods, addressing the concern that richer households might have a stronger demand for high-quality goods that could be produced by firms that are less bank-dependent. Further, controlling for the impact of house prices on small and large firms does not affect the results, suggesting that they are not explained by a collateral channel (Chaney, Sraer, and Thesmar, 2012; Adelino, Schoar, and Severino, 2015). The results are also robust to controlling for state-level education expenditure, implying that they do not arise from changes in

the provision of public goods (Braggion, Dwarkasing, and Ongena, 2021).

The second part of the paper studies how rising top incomes affect macroeconomic outcomes and welfare in quantitative experiments. We build a macroeconomic model with heterogeneous households and firms and calibrate it to our estimates. It features a general equilibrium interaction between household portfolios and employment decisions of firms with different funding sources and is a distinct contribution.

On the household side, the model builds on the tradition of studying savings with incomplete markets and uninsurable income risk. Households allocate their portfolio between bank deposits and direct firm investments. Deposits yield a lower return but provide utility. Borrowing ideas from De Nardi (2004) and Straub (2019), the deposit share declines with income through non-homothetic savings behavior.

On the production side, the model features a continuum of firms that are heterogeneous in their productivity, as in Hopenhayn (1992). Moreover, firms can either be ‘public’ or ‘private’, similar to Peter (2021). Households can make frictionless investments in public firms. Private firms cannot access the public capital market and require bank funding to cover their wage bill. They also need to pay an entry cost and a fixed cost to operate, which introduces an intensive and extensive margin of firm employment and production. To circumvent the dependence on banks, private firms can become public subject to a cost. A competitive banking sector offers deposits to households and provides loans to private firms.

We calibrate the model to target the stylized facts and estimates from our empirical analysis. In the initial stationary equilibrium, we match households’ income and portfolio shares, as well as the employment shares and relative sizes of the different firm types, to their counterparts in US data in the early 1980s. In our calibration an increase in the top 10% income share reduces the relative net job creation rate of small firms by the same magnitude as implied by our estimated coefficients, both along the extensive and intensive margin. The calibrated model also replicates empirical facts that are not directly targeted. For instance, poorer households have a higher marginal propensity to consume and rely more on labor income than richer households.

Our quantitative experiment raises the top 10% income share from 34.5% to 50.5%, matching its evolution in the data over our 1980 to 2015 sample period. The initial share of 34.5% results from permanent labor income risk heterogeneity between households. The subsequent increase is generated by redistributing income from poorer to richer households through permanent lump-sum taxes and transfers that net out to zero. In this way, the underlying source of rising top income shares in the model does not otherwise have direct macroeconomic implications.

We first examine macroeconomic outcomes and the impact across firms. With more income accruing to top earners, aggregate investments in public firms grow,

while aggregate deposits fall, a consequence of non-homothetic preferences over different forms of savings. These changes in the supply of funds are reflected in returns: the return on public firm investments falls, while the deposit rate increases, as banks need to offer higher rates to attract deposits. Due to banks' zero profit condition, the increase in bank funding costs raises the loan rate, in line with our empirical findings. Faced with higher loan rates, private firms find it more costly to hire and their job creation declines, compared to public firms. The decline is mainly driven by active private firms demanding less labor, but also by more private firms exiting the market or becoming public firms.

The model experiment shows that rising inequality has contributed to several important macroeconomic trends and lowered aggregate employment and output. A rise in the top 10% income share moves resources away from smaller bank-dependent firms towards larger firms. This inequality-induced reallocation of resources increases the employment share of large firms by 0.64 p.p. In the US, the employment share of firms with more than 500 employees has increased by around 5 p.p. since 1980. Rising inequality thus explains around 13% of the overall increase in the large firm employment share. As larger firms are more capital-intensive, the rise in the top income share also leads to a fall in the labor share of 0.3 p.p., corresponding to around 7.5%–15% of its decline in the data over the same period. Moreover, since smaller firms have higher marginal products than larger firms due to tighter financial constraints, the rise in the top 10% income share reduces output by 0.3%.

The experiment also shows that our mechanism amplifies the welfare effects of income redistribution. By design, redistribution towards the top increases welfare for the top 10% and decreases it for the bottom 90%, implying a decline in welfare for the average household. Our channel magnifies both the negative welfare effects at the bottom and the positive ones at the top. To establish this result, we benchmark the welfare consequences arising from our experiment to those in an alternative fixed portfolio share model that restricts households to save in deposits and public firm capital in constant proportions, irrespective of their income.

The amplification of the welfare effects arises from changes in different sources of income in equilibrium. First, as the top income share increases, private firms become more constrained and their employment and wages fall. Public firms increase employment and wages to a lesser extent, so average wages in the economy decline. As labor income matters disproportionately for lower-income households, their welfare declines. Second, capital income matters more at the top end of the income distribution. In response to receiving more income, richer households invest a higher share of their assets in public firms. As investments into public firms yield higher returns than deposits, richer households experience an additional increase

in income and welfare beyond the initial transfer. In contrast, in the fixed portfolio share model savings keep flowing to public and private firms in the same proportion. Low-income households benefit from higher wages, while high-income households cannot shift their portfolio into high-return investments.

Finally, we demonstrate that our model can answer further questions related to income inequality and job creation. In an additional experiment, we generate rising income inequality through changes in households' income processes, model complementarities between different worker and firm types, and allow for aggregate income growth. While our main experiment abstracts from these features to isolate the quantitative implications of our channel, higher top income shares lead to a relative decline in job creation at bank-dependent firms also in alternative environments.

Literature. We contribute to three strands of literature. The first is the large empirical literature on the effects of inequality on the real economy.¹ Early work uses cross-country panel data (Barro, 2000; Forbes, 2000; Banerjee and Duflo, 2003), which makes identification challenging. More recent papers use variation in inequality across US geographic areas. Bertrand and Morse (2016) and Coibion, Gorodnichenko, Kudlyak, and Mondragon (2020) show that the consumption and debt levels of poorer households vary with local income inequality. Braggion, Dwarkasing, and Ongena (2021) use an IV strategy to establish a negative effect of wealth inequality on entrepreneurship and the supply of public goods. Our paper provides well-identified evidence for a novel channel through which rising income inequality affects the economy. To quantify aggregate implications, we calibrate our macro model to the cross-regional estimates.

Second, our paper relates to work on the macroeconomic effects of income inequality arising from the inter-temporal decisions of households. Mian, Straub, and Sufi (2021a) show that a higher top income share depresses aggregate demand in a general equilibrium model with non-homothetic consumption-savings behavior. Building on the insight that richer households finance the borrowing of poorer households (Mian, Straub, and Sufi, 2020), they argue high debt levels reduce aggregate demand, as borrowers cut their spending to repay high-income savers with a lower propensity to consume. Auclert and Rognlie (2017, 2020) develop a model in which households' marginal propensity to consume declines in income. They show how rising inequality depresses aggregate demand and output in the short and long run. Beyond calibrating our model to cross-sectional estimates, an important difference in

¹While our paper analyzes the consequences of income inequality, a series of papers studies its causes. Demirgüç-Kunt and Levine (2009) and Beck and Doerr (2023) review how financial sector policy affects inequality. Gabaix, Lasry, Lions, and Moll (2016), Jones and Kim (2018), and Aghion, Akcigit, Bergeaud, Blundell, and Hemous (2019) argue that entrepreneurship and innovation affect income inequality. Acemoglu and Restrepo (2022) highlight the importance of automation technologies.

our setting is that inequality affects the economy through changes in firms' financing conditions, as households adjust the allocation of their savings.

Third, by linking rising inequality to the decline in job creation along the intensive and extensive margin, we speak to the literature on declining dynamism and the rising footprint of large firms. [Decker, Haltiwanger, Jarmin, and Miranda \(2014, 2016\)](#) document that the US economy has become less dynamic, in large part due to declining firm entry and exit. At the same time, the employment share of large firms has increased substantially over the last decades ([Dorn, Katz, Patterson, and Van Reenen, 2017](#); [Autor, Dorn, Katz, Patterson, and Van Reenen, 2020](#)). The literature has provided a number of explanations for these trends, including demographics ([Karahan, Pugsley, and Şahin, 2022](#)), adjustment frictions ([Decker, Haltiwanger, Jarmin, and Miranda, 2020](#)), import competition ([Pugsley and Sahin, 2019](#)), and technological change ([Autor, Dorn, Katz, Patterson, and Van Reenen, 2020](#)). Our findings suggest rising top income shares as another driver.

On the methodological side, we develop the first macroeconomic model with an interaction between households' portfolio choices and employment decisions of firms with heterogeneous funding sources. In [Den Haan, Rendahl, and Riegler \(2017\)](#), households' portfolio choice between a liquid and a productive asset connects precautionary savings behavior with employment by homogeneous firms. Existing papers in which firms differ in their funding sources do not incorporate household portfolio decisions, see e.g. [Zetlin-Jones and Shourideh \(2017\)](#) and [Crouzet \(2018\)](#). As in [Peter \(2021\)](#), our model incorporates the possibility that private firms become public firms, a margin often left unmodeled in the firm dynamics literature.

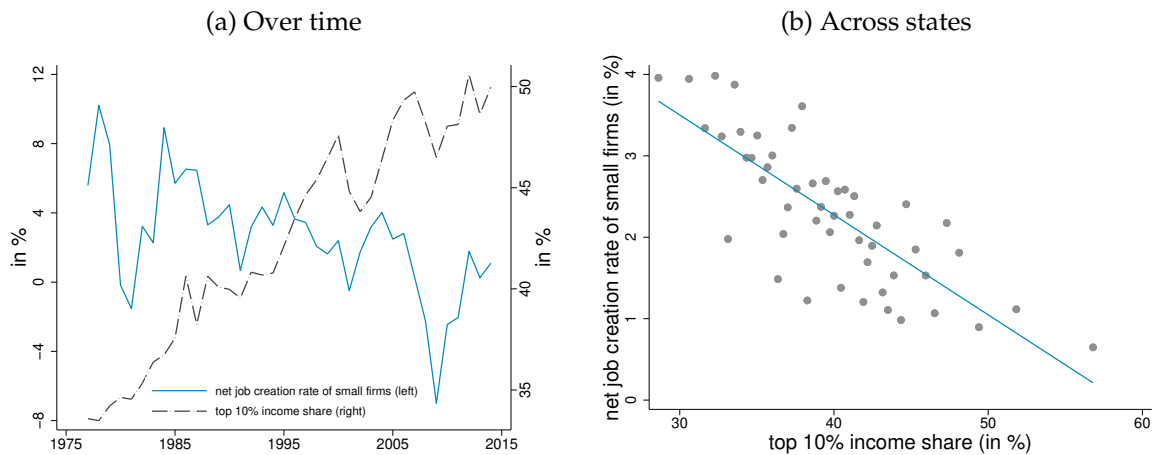
2 Motivating evidence and hypothesis

[Figure 1](#), panel (a) shows two salient trends in the US economy: since the 1970s, the top 10% income share (black dashed line, right axis) has steadily increased.² Meanwhile, net job creation at small firms (blue solid line, left axis) is in secular decline. Panel (b), discussed in more detail below, shows a similar negative relationship at the level of individual state-year pairs. In fact, every single US state has seen an increase in its top 10% income share and a decline in the net job creation rate at small firms between 1975 and today.

In this section, we argue that both developments are closely linked. To do so, we

²Our empirical analysis focuses on income inequality, as data coverage is substantially better than for wealth inequality. Importantly, there is no reliable data on wealth shares at the state-year level, which would be needed for our empirical strategy. However, aggregate data show that wealth inequality has increased to a similar degree as income inequality; and in the SCF, a household's position in the income distribution is strongly correlated with their position in the wealth distribution.

Figure 1: Top incomes and job creation



Note: Panel (a) shows the evolution of the top 10% income share over time (black dashed line, right axis) and the evolution of the net job creation rate of small firms with 1–499 employees (blue solid line, left axis) over time. Both series are averaged across states. Panel (b) provides a binned scatter plot with linear fit of the net job creation rate of small firms on the vertical axis and the top 10% income share on the horizontal axis across state-year cells in the sample. Sources: Frank (2009) and BDS.

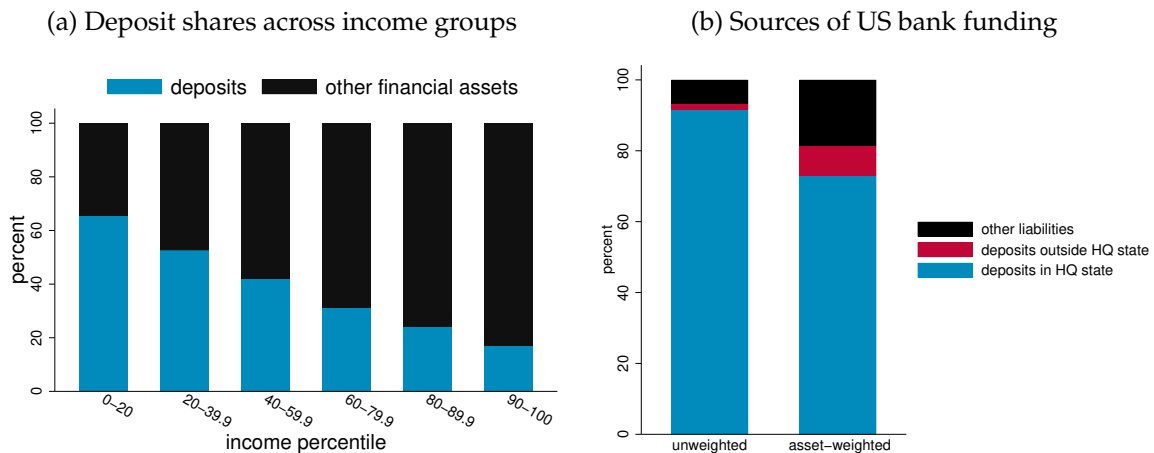
first present facts on the relation between household income and savings in different financial assets. Second, we examine the relevance of deposits for bank funding, and review the literature on the importance of bank lending for firms. Based on these motivating facts, we then develop our main hypothesis.

Household income and asset allocation. We examine the allocation of financial assets across the US household income distribution with data from the Survey of Consumer Finances (SCF) of the Federal Reserve.³ Figure 2, panel (a) reveals that the share of financial assets held as deposits declines in household income (see also Wachter and Yogo (2010); Guiso and Sodini (2013)). Deposits represent around two-thirds of financial wealth for the bottom 20% of the income distribution, but less than one-fifth for the top 10%. Instead, the share of stocks, bonds, and other financial assets increases with household income (see also Melcangi and Sterk (2025)). These patterns suggest that the distribution of income across households matters for the allocation of household savings between bank deposits on the one hand and direct investments such as stocks and bonds on the other hand.

While panel (a) presents relative *shares* of deposits, we show in the Online Appendix that the *level* of deposit holdings and income exhibit a log-linear relationship.

³We combine the survey waves from 1992 to 2007, and compute the deposit share as the ratio of deposits to total financial wealth. We exclude non-financial assets. The SCF defines financial wealth as ‘liquid assets, certificates of deposit, directly held pooled investment funds, stocks, bonds, quasi-liquid assets, savings bonds, whole life insurance, other managed assets, and other financial assets’. The SCF also accounts for assets in retirement accounts, for example stock ownership through a 401(k) account. The SCF does not account for future claims on social security benefits in households’ financial assets, but it does include current social security payments in the calculation of income. The Online Appendix provides summary statistics.

Figure 2: Household asset allocation and bank funding sources



Note: Panel (a) presents the allocation of households' financial wealth in deposits (defined as the sum of checking accounts, savings accounts, call accounts and certificates of deposit) and other financial assets (life insurance, savings bonds, money market (MM) deposits, money market mutual funds (MMMF), pooled investment funds, stocks, bonds, and other financial assets) by income group. Panel (b) provides a breakdown of banks' total liabilities into deposits held in branches located in the banks' headquarters state, deposits held in branches outside the banks' headquarters state, and liabilities other than deposits. Numbers reflect unweighted and capital-weighted averages across all banks and years in the sample. Sources: SCF and FDIC

This pattern reflects that high-income individuals have more resources to save, and is consistent with the economic mechanism we study throughout the paper.⁴

Deposits, lending, and bank dependence. The US banking system is, to this day, not fully deregulated. States use a variety of policy tools to protect local banks from outside competition (Rice and Strahan, 2010; Kroszner and Strahan, 2014), which explains why banks' headquarters state still plays an outsized role in their ability to raise deposits and engage in small business lending, as discussed in what follows.⁵

The Federal Deposit Insurance Corporation (FDIC) provides information on the sources of funding of all US banks. Figure 2, panel (b) shows that deposits account for 93% of total liabilities for the average bank between 1993 and 2015. Deposits' role as the major source of cheap and stable funding in the US banking system suggests that households' willingness to save in deposits has an impact on banks' overall liabilities and ability to serve firms' loan demand.

The same panel reveals that the average bank raises around 98% of its total deposits in its headquarters state. Weighted by total bank assets, the respective number is 89%. The strong reliance on local deposits is also reflected in the fact that only 2% of banks hold more than 10% of their deposits in branches outside their headquarters state. Moreover, the share of deposits held in branches of out-of-state banks equaled

⁴The Online Appendix also provides a finer breakdown of asset classes, shows that the deposit share also declines in income within the top 10%, and that the deposit share declines in income if housing wealth is added to households' assets. Furthermore, the negative relationship between income and the deposit share is not explained by a large set of household characteristics.

⁵See the Online Appendix for more details on US banking deregulation and the geography of bank deposits and lending.

only 1% in the early 1990s and still less than 30% in the average county even as late as 2015 (Doerr, 2024). We exploit the fact that the *local* supply of deposits by households in a state affects the funding conditions of banks headquartered in the same state in our identification strategy.

Banks' access to deposits as a cheap and stable source of funding affects their ability to extend credit (Ivashina and Scharfstein, 2010; Gilje, Loutskina, and Strahan, 2016; Drechsler, Savov, and Schnabl, 2017). Deposits are uniquely stable and dependable (Hanson, Shleifer, Stein, and Vishny, 2015) and banks cannot replace them with other sources of funding without incurring costs (Stein, 1998). Hence, an increase in deposit rates implies an increase in banks' overall funding costs, which – as banks need to maintain their profitability – translates into a higher cost of credit for firms, reducing loan demand (McLeay, Radia, and Thomas, 2014; Jakab and Kumhof, 2015).⁶

The literature also highlights the importance of banks in screening and monitoring borrowers, which is especially relevant for firms that are informationally opaque (Gertler and Gilchrist, 1994; Liberti and Petersen, 2019). Consequently, a large literature shows that smaller firms, which are more difficult to screen and monitor, depend relatively more on bank lending (Petersen and Rajan, 1994), and that their investment and employment are more sensitive to changes in credit supply (Becker and Ivashina, 2014; Chodorow-Reich, 2014). Likewise, banks play an outsized role in financing new firms (Robb and Robinson, 2014; Kerr and Nanda, 2015), suggesting that the availability of bank credit also affects firm entry.

Main hypothesis. Motivated by these stylized facts, we propose a novel channel that links household savings behavior to firm financing and job creation: As the income share of top earners rises, a relatively larger amount of total financial assets is held in the form of stocks and bonds. Through this non-homotheticity in households' portfolio allocation, relative funding costs in turn decline for firms that make greater use of equity and bond financing, which are generally large firms. Meanwhile, households' propensity to save in deposits relative to other assets declines. This increases the rate banks need to offer on deposits compared to the return on other assets to attract a given amount of deposits, leading to a relative increase in loan rates. The cost of financing for bank-dependent firms (which are predominantly small firms and entrants) increases relative to other firms. In turn, they create rela-

⁶By providing loans, banks create new ledger-entry deposits on their balance sheet (Jakab and Kumhof, 2015). Their business model requires receiving higher interest on the loans than the interest paid on deposits (or other liabilities). McLeay, Radia, and Thomas (2014) provide a detailed explanation of this process, emphasizing that banks need to "attract or retain additional liabilities to accompany their new loans". This creates a positive relationship between deposit and loan rates.

tively fewer jobs.⁷

3 Data and empirical strategy

This section first describes the data and main variables. It then explains our empirical strategy and the construction of the instrumental variable.

3.1 Data

Job creation. Data from the Business Dynamics Statistics (BDS), provided by the US Census Bureau, contain detailed yearly information on job creation at the state–firm size level for firms in 12 distinct size categories. The BDS provide a similar breakdown at the state–2-digit NAICS industry–firm size level. We define our baseline measure of *small firm* as firms with 1–499 employees, as is standard in the literature. Our main outcome variable is the net job creation rate (net JCR), defined as job creation rate minus job destruction rate (JDR). The net JCR hence captures overall job creation through entry, exit, and continuing establishments. An important advantage of the net JCR is that it can be decomposed into an extensive (entry and exit) and intensive (continuing establishments) margin.⁸

Top income shares. Frank (2009) provides annual data on income inequality and the share of income that accrues to the top 10% and top 1% across 48 states from 1917 to 2015. Income shares are derived from pretax adjusted gross income data reported in the Statistics of Income published by the Internal Revenue Service (IRS).⁹ Income data include wages and salaries, capital income (dividends, interest, rents, and royalties), and entrepreneurial income. These data provide the most comprehensive state-level information on income shares for a longer time period.

⁷For this mechanism to operate, it is necessary that, as a result of higher top income shares, the *level* of funding available to bank-dependent firms decreases (or the cost of funding increases) *relative* to the *level* of funding (or cost of funding) available to other firms. Our evidence on the *shares* of different savings types is directly connected to how their respective *levels* respond to changes in income inequality. We formalize this connection between shares and levels in the Online Appendix. The Online Appendix also shows that the channel operates even when lower-income households have lower overall savings rates than higher-income households.

⁸The job creation (destruction) rate is the ‘count of all jobs created (destroyed) within the cell over the last 12 months’ in year t , divided by ‘the average of employment for times t and $t - 1$ ’. We decompose the net job creation rate as follows: $net\ JCR = JCR - JDR = JCR\ births + JCR\ continuers - (JDR\ deaths + JDR\ continuers) = (JCR\ births - JDR\ deaths) + (JCR\ continuers - JDR\ continuers) = net\ JCR\ extensive + net\ JCR\ intensive$.

⁹Auten and Splinter (2024) show that while US *pre-tax* income inequality has been rising, *post-tax* inequality has increased less than previously shown. Our mechanism can operate through changes in top income shares before taxation, as pre-tax income can be invested through e.g. 401(k) accounts.

Other state-level information. We obtain information on employment by 4-digit NAICS industry in each state from the County Business Patterns (Eckert, Fort, Schott, and Yang, 2020). We also collect yearly state-level information on the total population, the share of the black population, the share of the population of age 60 and above (all provided in the Census Bureau’s Population Estimates), the log difference in income per capita (BEA), the Gini index (Frank, 2009), and the unemployment rate (BLS Local Area Unemployment Statistics). Finally, we collect state-level data on the number of venture capital deals from PWC’s Money Tree Explorer; as well as on expenditures on education as a share of state-level GDP from the Census Bureau.

Bank dependence. We compute each industry’s bank dependence (BD) from the 2007 Survey of Business Owners (SBO). The survey contains firms’ sources of business start-up and expansion capital, as well as two-digit NAICS industry codes. Among firms with fewer than 100 employees that were founded before 1990, for each industry we compute the fraction of firms that report using bank loans to start or expand their business (Doerr, 2021). We split industries into high and low bank dependence along the median.

Bank-level data. Our bank-level data are from the US Call Reports provided by the Federal Reserve Bank of Chicago, collapsed to the bank-year level (Drechsler, Savov, and Schnabl, 2017). We obtain consistent data from 1985 to 2015 that contain information on the income statements and balance sheets of all commercial banks in the US. For each bank, we use the headquarters location to assign the respective evolution of state-level top incomes. We collect information on total deposits, deposit rates (defined as deposit expenses over total deposits), total assets, the share of non-interest income, return on assets, and leverage (defined as total assets over equity). We further collect data on total C&I lending, as well as interest income on C&I loans over total C&I loans, both of which are available only for a subset of banks.

Summary statistics. Our final panel has 16,435 state–firm size–year observations for 47 states from 1981 to 2015. Once we break down the data by industry, the panel expands to up to 192,968 state–firm size–industry–year observations. The sample for the bank-level regressions contains a total of 18,092 unique banks. The Online Appendix provides summary statistics.

3.2 Empirical strategy

This section analyzes how rising top incomes affect job creation of bank-dependent firms relative to firms with access to other sources of financing. Motivated by a large literature on the importance of bank lending for small firms, our baseline analysis investigates the effect of top incomes on job creation of small relative to large firms.

Figure 1, panel (b) previews our main finding. It presents a binned scatter plot of the net job creation rate of small firms on the vertical axis against the top 10% income share on the horizontal axis at the state-year level. The blue line denotes the linear fit. The strong negative relationship suggests that a higher top 10% income share is associated with a substantially lower net job creation rate of small firms.

3.2.1 State-level empirical specification

We estimate variations of the following regression:

$$\begin{aligned}
 net\ jcr_{s,f,t} = & \beta_1\ top\ 10\%\ income\ share_{s,t-1} + \beta_2\ small\ firm_f \\
 & + \beta_3\ top\ 10\%\ income\ share \times small\ firm_{s,f,t-1} \\
 & + controls_{s,t-1} + \theta_{s,f} + \tau_{s,t} + \epsilon_{s,f,t}.
 \end{aligned} \tag{1}$$

The dependent variable *net jcr* measures the net job creation rate by firms in size category f that are located in state s in year t . In some specifications, we decompose the net job creation rate into an extensive (entry and exit) and intensive margin. The *top 10% income share* $_{s,t-1}$ is the share of income that accrues to the top 10% in state s , lagged by one period. The dummy *small firm* $_f$ takes on a value of one for firms with 1–499 employees, and zero for firms with 500 or more employees. We include the following set of lagged state-level controls: average income per capita growth, log population, the unemployment rate, the share of the population aged 60 and above, and the share of the black population. Standard errors are clustered at the state level to account for serial correlation among observations in the same state.

The regressions include state or state \times firm size fixed effects ($\theta_{s,f}$), which gives equation (1) an interpretation in terms of changes: a given increase in the state-level share of income that accrues to the top 10% decreases the net job creation of small firms, relative to large firms, by β_3 . By controlling for growth in *average* incomes, coefficient β_3 reflects the effect of a change in state-level top income shares on net job creation, holding average state-level income growth constant.

Our hypothesis implies $\beta_3 < 0$, as bank-dependent firms (i.e. small firms) should see a tightening in funding conditions, relative to firms that do not rely on banks (i.e. larger firms), as top income shares rise. Note that our argument is about a relative tightening in funding conditions of bank-dependent firms. As long as the propensity to hire out of an additional dollar of funding of bank-dependent firms does not substantially exceed that of firms not dependent on banks, the relative job creation rate of bank-dependent firms decreases in response to rising top income shares even if the absolute level of available funding would increase for firms that

depend on banks and those that do not.¹⁰

Identification and instrumental variable. The relationship between top income shares and job creation could be driven by reverse causality or omitted variable bias. Reverse causality could arise, for example, if shocks to large firms increase their job creation, and larger firms pay higher wages than small firms. Such shocks would lead to a relative decline in small firm job creation while raising income inequality through higher wages at large firms. Omitted variable bias could arise if unobservable state-level factors are simultaneously correlated with top income shares and job creation.¹¹

To address these endogeneity issues and assess the causal effect of rising top income shares on job creation, we include granular time-varying fixed effects and develop an instrumental variable for the top income share.

We can include state \times year fixed effects ($\tau_{s,t}$) in equation (1). These fixed effects control for observable and unobservable time-varying characteristics at the state level that could affect job creation, for example technological change or globalization – two common explanations behind growing inequality (Cowell and Van Kerm, 2015). Any unobservable factor that could simultaneously drive job creation and top income shares hence needs to affect firms of different sizes within the same state. Moreover, in regressions at the state-industry level, we include time-varying fixed effects at the state \times industry level to account for trends at the state-industry level common to all firms. Any unobservable shock correlated with top income shares would then need to differently affect job creation of small and large firms e.g. only within the retail trade sector in California.

Our instrument (henceforth ‘pre-determined share IV’) uses each state’s top 10% income share in 1970, ten years prior to our sample period, interacted with the national evolution in the top 10% income share indexed to 1970. Specifically, we compute the ‘leave-one-out’ national trend by excluding each respective state from the nationwide evolution to adjust the pre-determined income share in that state: $\widehat{top\ 10\% \text{ share}}_{s,t} = top\ 10\% \text{ share}_{s,1970} \times \frac{1}{S} \sum_{j \neq s}^S top\ 10\% \text{ share}_{j,t}$. We then use the predicted top income shares as an instrument for the actual shares between 1980 and 2015 in each state in equation (1). The IV has a highly significant positive relationship with the actual state-level top 10% (1%) income share.

¹⁰If the propensity to hire out of an additional dollar of funding of bank-dependent firms would strongly exceed that of non-bank dependent firms, this would result in $\beta_3 > 0$.

¹¹Companies could hold the extra financing they receive from high-income households primarily in the form of bank deposits. However, Darmouni and Mota (2024) show that large corporations put a significant share of their savings into marketable securities, rather than cash or bank deposits. They also show that even those corporate savings that are accounted for by ‘cash and cash equivalents’ are typically allocated to financial instruments such as money market fund shares or commercial paper instead of bank deposits.

The instrument has several desirable properties.¹² First, top income shares remained flat between 1970 and 1980. Initial income shares are hence unlikely to be determined by trends that were already in operation before the 1970s and that could also have affected employment and wages at small and large firms. Moreover, the instrument's construction requires any such (unobservable) trend in a state to exhibit a similar break around 1980 in all *other* states. Second, it excludes a mechanical relationship between large firms' job creation and income inequality, which would arise if *i*) states with initially more large firms also had higher income inequality in 1970 because of large firms' wage premium, and *ii*) the initial footprint of large firms was positively correlated with an increase in the employment share of large firms going forward. We find no such systematic correlations.

We report several tests in the Online Appendix to support the validity of our instrument. We first show the strong positive correlation between the IV and top income shares. Second, we estimate regressions at the state–industry level and exclude industries that account for a particularly large share of employment in a state, addressing the concern that an unobservable shock has a direct effect on employment in these industries and thereby affects top income shares. Further, we include state×industry×year fixed effects to absorb any common trends that affect firms within an industry in each state. These include industry concentration, import competition, or technological change. Finally, we exclude firms with 10,000 or more or 5,000 or more employees from the analysis, as these 'mega firms' experienced a substantial increase in employment and earnings. Our results remain robust.

3.2.2 Bank-level empirical specification

Our hypothesis asserts that an increase in top income shares has a negative effect on households' desire to save in bank deposits. Banks hence need to increase deposit rates to continue to attract funds and meet their loan demand. However, an increase in banks' cost of funds increases the cost of credit for firms (McLeay, Radia, and Thomas, 2014). An increase in the top income share in a state should thus have a positive effect on deposit rates and a negative effect on the amount of bank deposits, relative to states with less of an increase in the top income share. To provide direct

¹²We discuss these properties in more detail in the Online Appendix. In addition, we construct a second instrument, which follows a shift-share research design. It is based on the insight that income inequality is driven by a small subset of industries (Haltiwanger, Hyatt, and Spletzer, 2024). The instrument combines the beginning-of-sample employment shares of those industries in each state with heterogeneity in the nation-wide employment trends for these industries over time.

evidence for these effects, we estimate the following bank-level regression:

$$y_{b,t} = \delta \text{ top 10\% income share}_{s,t-1} + \text{controls}_{b,t-1} + \text{controls}_{s,t-1} + \theta_b + \tau_t + \epsilon_{b,t}. \quad (2)$$

The dependent variable $y_{b,t}$ is either the deposit rate or the log amount of total deposits of bank b headquartered in state s in year t . The share of income that accrues to the top 10% is measured at the bank headquarters state s and instrumented with our pre-determined share IV. We include the same state-level controls as above, as well as the bank-level log of total assets, the share of non-interest income, return on assets, deposits over liabilities, and the leverage ratio, all lagged by one period. To reflect the skewed distribution in bank size, we weight regressions by total assets.

Each regression includes bank (θ_b) and year (τ_t) fixed effects that control for time-invariant bank characteristics and aggregate trends. Standard errors are clustered at the headquarters state level. The inclusion of bank fixed effects implies an interpretation in changes. If, for example, rising top incomes increase deposit rates, we expect $\delta > 0$. An important assumption underlying equation (2) is that banks raise a significant share of their deposits in their headquarters state. Figure 2, panel (b), shows that this is the case. The Online Appendix further shows that, while this ratio declines in bank size and over time, even in 2015 the vast majority of banks raise the lion's share of their deposits in their headquarters state. However, to the extent that banks raise deposits outside their headquarters state, this leads to an attenuation bias and the coefficient δ would reflect a lower bound of the magnitude of the true estimate.

4 Results of the empirical analysis

Table 1 shows evidence consistent with our main hypothesis that rising top income shares reduce job creation of bank-dependent firms. It reports 2SLS results for equation (1).¹³ Column (1) employs state and year fixed effects, as well as state-level controls. Rising top income shares are associated with lower net job creation rates on average ($\beta_1 < 0$), and small firms have higher average net job creation rates ($\beta_2 > 0$). Importantly, higher top income shares significantly reduce net job creation rates of small firms, relative to larger firms ($\beta_3 < 0$), in line with our hypothesis.

Column (2) uses state \times firm size and state \times year fixed effects. The former account for time-invariant factors that affect firm size groups in a given state. The latter

¹³We provide results from OLS regressions in the Online Appendix. Coefficients are similar in terms of sign and significance to those obtained in IV regressions, but OLS estimates are about a quarter smaller in magnitude. This could reflect measurement error in the top income share.

Table 1: Rising top incomes and job creation

VARIABLES	(1) net JCR	(2) net JCR	(3) ext net JCR	(4) int net JCR	(5) net JCR	(6) low BD net JCR	(7) high BD net JCR
top 10% income share	-0.017 (0.129)						
small firm (1-499)	0.056*** (0.009)						
top 10% × small firm (1-499)	-0.124*** (0.021)	-0.161*** (0.022)	-0.027** (0.011)	-0.133*** (0.016)		-0.255*** (0.034)	-0.348*** (0.033)
top 10% × firms with 1-9 emp					-0.315*** (0.037)		
top 10% × firms with 10-99 emp					-0.098*** (0.023)		
top 10% × firms with 100-499 emp					-0.049*** (0.017)		
Observations	16,435	16,435	16,435	16,435	16,435	60,372	63,823
Controls	✓	-	-	-	-	-	-
State FE	✓	-	-	-	-	-	-
Year FE	✓	-	-	-	-	-	-
State*Size FE	-	✓	✓	✓	✓	✓	✓
State*Year FE	-	✓	✓	✓	✓	-	-
State*Industry*Year FE	-	-	-	-	-	✓	✓

Note: This table reports results from regression (1) at the state-firm size-year level in columns (1)–(5) and at the state-industry-firm size-year level in columns (6)–(7). The dependent variable is the net job creation rate. Columns (3) and (4) use the net job creation rate along the extensive and intensive margin as dependent variables. The variable *top 10% income share* denotes the income share that accrues to the top 10% in state s , lagged by one period, and instrumented with the IV based on pre-determined income shares. The variable *small firm* is a dummy with a value of one for the group of firms with 1 to 499 employees. In column (5), small firms are separated into firms with 1 to 9, 10 to 99, and 100 to 499 employees and the regression is weighted by employment within each firm size bin. *Low/high BD* refers to industries with low/high dependence on bank lending. Standard errors are clustered at the state level. The first-stage F-statistics are 4.27 and 95.44 in column (1); 300.77 in columns (2)–(4); 119.50, 132.30, and 133.31 in column (5); and 282.14 and 275.90 in columns (6) and (7). *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

account for unobservable time-varying state-level characteristics that could affect net job creation. The coefficients on *small firm* and *top 10% income share* are absorbed by the fixed effects. The coefficient on the interaction term between the top 10% income share and the small firm dummy remains highly significant and increases in magnitude relative to column (1).

To put our estimates into perspective, the US-wide increase in the income share of the top 10% from 1980 to 2015 was around 16 p.p. Hence, relative net job creation of small firms would have been 1.9–2.6 p.p. higher today had top incomes remained at their 1980 levels. Relative to the average job creation of small firms during the 1980s, which equaled 3.3%, the effect is economically large.

4.1 Intensive vs. extensive margin

Decker, Haltiwanger, Jarmin, and Miranda (2014) and Sterk, Sedlacek, and Pugsley (2021) highlight the important role of firm entry and exit for aggregate dynamism

and productivity growth. Columns (3) and (4) split the net job creation rate into job creation along the extensive (job creation and destruction through entry and exit) and the intensive margin (job creation and destruction by continuing firms).

Rising top income shares lead to significantly lower net job creation rates along both margins. In terms of magnitude, the effect on the extensive margin (coefficient estimate of -0.027) is around one-fifth as large as on the intensive margin (-0.133). In other words, out of the overall decline in small firms' net job creation rate due to an increase in the top 10% income share, around 20% stems from a reduction of net job creation along the entry-exit margin. The fact that the extensive margin effect is weaker may be because more income in the hands of high-income individuals could also positively affect new business creation through a separate net worth channel (Hurst and Lusardi, 2004; Cagetti and De Nardi, 2006).

While new businesses have an outsized influence on job creation and growth, the rate of business startups has declined in recent decades (Decker, Haltiwanger, Jarmin, and Miranda, 2016). To investigate the effects of rising inequality on firm entry, we focus on gross job creation of entrants (rather than net job creation through entry and exit) in the Online Appendix. We first show that a rise in the top income share has a significant negative effect on the gross job creation rate of small firms. The inequality-induced decline in job creation of entrants accounts for almost 50% of this overall effect. Consistent with this finding, a higher top 10% income share also leads to a relative decline in the number of young firms.

4.2 Further evidence on the mechanism

Banks have a comparative advantage in screening and monitoring opaque firms (see the discussion in Section 2). Small firms are informationally more opaque, so they depend more on banks as a source of credit than larger firms. The relative effect of a given increase in top income shares on job creation should therefore decline in firm size. Column (5) in Table 1 supports this argument by separating the small firm dummy into finer categories: while a 10 p.p. increase in the top 10% income share reduces the net job creation rate by 3.2 p.p. for very small firms with 1-9 employees, net job creation declines by 0.98 p.p. and 0.49 p.p. for small (10-99 employees) and medium (100-499 employees) firms, relative to firms with 500 or more employees.

Next we exploit variation in the importance of banks across industries. If small firms in an industry depend more on bank funding, a relative increase in the cost of credit should hurt firms in this industry by more than those in other industries. We estimate regressions analogous to equation (1), but at the state-industry-firm size-year level. Specifically, we estimate regressions separately for industries in the bottom (low BD) and top (high BD) tercile of bank dependence. Columns (6)–(7)

show that the negative effect of rising top income shares on job creation of small relative to large firms is significantly larger in bank-dependent industries. A 10 p.p. increase in top 10% income shares leads to a relative decline in job creation among small firms of 2.6 p.p. in low bank-dependent industries in column (6). The corresponding number is 3.5 p.p. in high bank-dependent industries in column (7). As we show in the Online Appendix, rising top income shares have a relatively stronger effect on job creation both along the intensive and extensive margin in bank-dependent industries.

Taken together, [Table 1](#) provides evidence consistent with our proposed mechanism. A rise in top income shares reduces job creation of smaller firms, both along the extensive and intensive margin. It does so especially among the smallest firms, as well as those that operate in bank-dependent industries.

4.3 Top incomes and bank deposits

Our hypothesis suggests that as income inequality increases, households will save less in deposits. In response, banks need to offer higher deposit rates to attract a given amount of deposits. [Table 2](#), columns (1)–(2) use the deposit rate as dependent variable and show that the price of deposits increases significantly as top income shares rise. In column (1), a 10 p.p. increase in the instrumented top income share increases the deposit rate by 1.06 p.p. (28% of the mean) for the average bank, relative to banks in states with no change in the top income share. As discussed in [Section 2](#), a given increase in the top 10% income share should affect banks' ability to raise deposits by relatively less than a similar increase for the top 1%. The reason is that the latter hold an even lower share of their financial wealth as deposits. To test this hypothesis, we estimate equation (2), but use the *top 1% income share*_{s,t-1} as independent variable. Column (2) shows that the coefficient increases in magnitude, consistent with the fact that the share of deposits out of financial assets declines in household income.

Columns (3) and (4) use the log of total deposits as dependent variable. Column (3) shows that a 10 p.p. increase in the top income share leads to a 23% decline in bank deposits, relative to banks in states with no change in the top income share. The coefficient is significant at the 1% level. Column (4) again shows that estimated coefficients are larger for the 1% income threshold.

The results in columns (1) to (4) suggest that a rise in top income shares leads to a relative increase in the *price* of deposits and a relative decline in their *quantity*. This pattern is consistent with a relative decline in the supply of local deposits by households as state-level top income shares rise. In response, banks need to raise deposit rates to attract funding and continue lending. These results also make clear

Table 2: Rising top incomes and bank deposits

VARIABLES	(1) dep rate	(2) dep rate	(3) log(dep)	(4) log(dep)	(5) CI rate	(6) log(CI)
top 10% income share	10.606*** (2.580)		-2.328*** (0.576)		46.619** (19.373)	-2.405*** (0.657)
top 1% income share		11.768*** (4.306)		-4.928*** (1.134)		
Observations	242,651	242,651	242,651	242,651	112,393	112,393
Bank FE	✓	✓	✓	✓	✓	✓
Year FE	✓	✓	✓	✓	✓	✓

Note: This table reports results from regression (2) at the bank-year level. The dependent variable is the deposit rate in columns (1)–(2) and the log amount of total bank deposits in columns (3)–(4). In columns (5)–(6), the dependent variable is the ratio of C&I interest income to total C&I lending and the log amount of total bank C&I lending. *top 10/1% income share* is the share of income that accrues to the top 10/1% in state s , lagged by one period. All regressions include state and bank controls and are weighted by total bank assets. Standard errors are clustered at the state level. Moving from column (1) to (6), the first-stage F-statistics are 117.12, 89.52, 117.12, 89.52, 77.45, and 77.45. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

that the partial effect of higher top income shares on deposit quantities can to some degree be counteracted by the equilibrium response of deposit rates. Our structural model will account for the general equilibrium changes in both the price and the quantity of deposits, as well as implications for bank lending.

Loan rates and lending. Columns (5)–(6) of Table 2 show that higher top incomes also increase banks’ interest income on C&I loans and decrease their C&I lending. As for deposits, there is an increase in prices (loan rates) and a decrease in quantities as inequality rises. This pattern suggests that rising top incomes, through their effect on the cost of bank deposits, affect banks’ credit supply to firms, thereby hurting bank-dependent businesses more than those that can access other forms of financing.

4.4 Alternative explanations and additional results

Alternative channels. We examine alternative explanations for the link between top income shares and job creation of firms of different sizes in the Online Appendix. First, our results remain similar when we control for state-level house price growth or exclude states with a housing boom, suggesting that the relationship is not explained by a collateral channel (Chaney, Sraer, and Thesmar, 2012; Adelino, Schoar, and Severino, 2015). Second, venture capital is an important source of financing for startups and could possibly substitute for the decline in bank lending to firms. Our results are robust when we exclude states that account for the majority of venture capital funding or directly control for the amount of venture capital deals. Third, controlling for education spending does not render our results insignificant, which ensures that our channel is distinct from Braggion, Dwarkasing, and Ongena (2021). Fourth, we move

to state-industry-firm size-year level regressions and control for time-varying confounding factors at the state-industry level through granular state \times industry \times year fixed effects. Our coefficient of interest remains near-identical in terms of sign, size, and significance. Fifth, we investigate whether non-homotheticities in household demand, rather than household savings, might confound our results. See [Bergman, Jaimovich, and Saporta-Eksten \(2025\)](#) for a general framework with non-homothetic demand. In one test, we run state-industry-firm size-year level regressions in which we exclude non-tradable industries. Results remain similar, addressing the concern that high-income households demand more services ([Boppart, 2014](#)) that might be predominantly provided by more bank-dependent smaller firms. In a separate test, we show that our coefficient estimates are similar for industries that produce homogeneous goods and those that produce heterogeneous goods. This addresses the concern that richer households might have a relatively stronger demand for high-quality goods that could, in principle, be produced by larger firms. Finally, in additional robustness exercises, we exclude the years of the Great Recession, years of economic downturns, or the post-crisis period; and report regressions including our second IV.

5 Macroeconomic model

This section develops a macroeconomic model that incorporates the link between income inequality, household portfolios, and job creation of firms with access to different sources of funding. We calibrate the model’s parameters to match our empirical estimates. Section 6 presents quantitative model experiments.

5.1 Model setup

Time is denoted by $t = 1, 2, \dots$ and continues indefinitely. The economy is populated by a continuum of infinitely-lived households and a continuum of firms that are either private or public. We use ‘private’ and ‘public’ as shorthand for bank-dependent, smaller firms and large firms with access to capital markets, analogous to our classification of firms in the empirical analysis. We denote variables and parameters pertaining to private firms with a tilde (“ \sim ”). The model also features a representative bank. We describe these agents in turn.

Households. There is a unit mass of households indexed by i , which differ in their idiosyncratic income risk $s_{i,t}$. Each household supplies labor to both private and public firms, taking wages \tilde{w}_t and w_t as given. Households consume, save, and allocate their savings between bank deposits $d_{i,t}$ and direct investments in public

firms $k_{i,t}$. The returns on these two assets are $R_{d,t}$ and $R_{k,t}$. Deposits and investments differ in the services they provide. We assume that bank deposits give utility. This implies that $R_{d,t} < R_{k,t}$ in equilibrium. A household's within-period utility flow is

$$u(c_{i,t}, n_{i,t}, \tilde{n}_{i,t}) + v(d_{i,t}) = \frac{\bar{u}(c_{i,t}, n_{i,t}, \tilde{n}_{i,t})^{1-\sigma}}{1-\sigma} + \psi_d \frac{d_{i,t}^{1-\eta}}{1-\eta}, \quad (3)$$

where $c_{i,t}$ is consumption and $\tilde{n}_{i,t}$ and $n_{i,t}$ are labor supplied to private and public firms. We assume $\eta > \sigma$, which generates non-homotheticity in preferences, making deposits a *necessity good*. This assumption allows us to generate in a tractable way the empirical fact that the share of deposits in savings decreases in income. De Nardi (2004) and Straub (2019) make a similar assumption to generate an increasing share of overall savings, by making wealth (bequests) a *luxury good*.¹⁴ Our assumption stands in for unmodeled determinants of the deposit share along the income distribution. One example is liquidity services that benefit households at different income levels, e.g. because of health risk.¹⁵ The Online Appendix provides evidence from the SCF that households' self-reported liquidity needs relative to income fall with income.

The household's objective is to maximize expected lifetime utility

$$\mathbb{E}_0 \left[\sum_{t=0}^{\infty} \beta^t \left\{ u(c_{i,t}, n_{i,t}, \tilde{n}_{i,t}) + v(d_{i,t}) \right\} \right], \quad (4)$$

subject to

$$c_{i,t} + d_{i,t+1} + k_{i,t+1} = s_{i,t}(w_t n_{i,t} + \tilde{w}_t \tilde{n}_{i,t}) + R_{k,t} k_{i,t} + R_{d,t} d_{i,t} + \Pi_{i,t} + T_{i,t}, \quad (5)$$

$$d_{i,t+1}, k_{i,t+1} \geq 0, \quad (6)$$

where $\Pi_{i,t}$ are profit rebates from firms and $T_{i,t}$ is a lump-sum transfer (or tax when $T_{i,t} < 0$). In our main experiment, we introduce changes in $\{T_{i,t}\}_i$ to generate a change in the top income share that matches its evolution since the early 1980s.

Firms. There is a continuum of firms, indexed by j . Firms consist of two types, private and public. The share of each type is endogenously determined. For a firm of either type, idiosyncratic productivity is denoted by $z_{j,t}$. As is common in firm dynamics models (Hopenhayn, 1992), $z_{j,t}$ is independent across firms and follows a first-order Markov process. Its autocorrelation is ρ_z and its standard deviation is σ_z .

¹⁴In our model, while deposit shares fall in income, overall savings shares (the sum of capital and deposits relative to income) can rise in income, as in Straub (2019).

¹⁵Equity holdings are generally less liquid because in the US a large share is held through retirement accounts (Melcangi and Sterk, 2025). Private equity holdings, widespread among high-income earners, are typically also less liquid than bank deposits. Another example of a structural factor could be differences in financial literacy or sophistication across the income distribution.

Entry of firms is determined endogenously. We describe the entry margin further below and begin with the characterization of the firm problem after entering.

In a given period, a private firm can either produce, transition to become a public firm, or exit. When producing, it produces $\tilde{y}_{j,t}$ according to

$$\tilde{y}_{j,t} = z_{j,t} \tilde{n}_{j,t}^{\tilde{\alpha}} - \tilde{f}_{j,t}, \quad \tilde{\alpha} < 1, \quad (7)$$

where \tilde{n}_j is firm j 's employment. The fixed cost $\tilde{f}_{j,t}$ is stochastic and independently and identically distributed (iid) uniformly over the interval $[0, \tilde{f}_{max}]$. Decreasing returns ($\tilde{\alpha} < 1$) pin down a firm's size (Lucas, 1978).

Private firms do not have access to public capital markets, but instead require bank loans. Specifically, they finance a share $\tilde{\phi}^e$ of their fixed cost and a share $\tilde{\phi}$ of their wage bill before production using a bank loan at gross interest rate $R_{\ell,t}$. The value of an operating private firm with productivity level $z_{j,t}$ and fixed cost $\tilde{f}_{j,t}$ is

$$\begin{aligned} \tilde{V}(z_{j,t}, \tilde{f}_{j,t}) = \max_{\tilde{n}_{j,t}} \left\{ z_{j,t} \tilde{n}_{j,t}^{\tilde{\alpha}} - \{1 + \tilde{\phi}^e (R_{\ell,t} - 1)\} \tilde{f}_{j,t} - \{1 + \tilde{\phi} (R_{\ell,t} - 1)\} \tilde{w}_t \tilde{n}_{j,t} \right\} \\ + \beta_f \mathbb{E}_t \left[\tilde{W}(z_{j,t+1}) | z_{j,t} \right], \end{aligned} \quad (8)$$

where β_f is the discount factor common to both firm types and $\tilde{W}(z_{j,t+1} | z_{j,t})$ is the value of the private firm at the beginning of the period $t + 1$. The optimal choice of employment is given by

$$\tilde{n}^*(z_{j,t}) = \left[\frac{\tilde{\alpha} z_{j,t}}{\{1 + (R_{\ell,t} - 1) \tilde{\phi}\} \tilde{w}_t} \right]^{\frac{1}{1-\tilde{\alpha}}}. \quad (9)$$

If a private firm's value is less than zero, it is optimal to exit the market. Thus, for a given level of productivity, there is a cutoff fixed cost $\tilde{f}^*(z_{j,t})$ above which a firm with productivity level $z_{j,t}$ exits. It is pinned down by

$$\tilde{V}(z_{j,t}, \tilde{f}^*(z_{j,t})) = 0. \quad (10)$$

A private firm can transition to become a public firm, which allows it to obtain an additional funding source by accessing capital markets (Peter, 2021). In our framework, this transition away from bank-dependence is an endogenous choice for private firms. At the beginning of period t , the cost of becoming a public firm $\tilde{\kappa}_{j,t}$, independently and identically distributed uniformly over the interval $[0, \tilde{\kappa}_{max}]$, is realized. Then, each private firm decides whether to become a public firm or not. If a firm chooses not to, then it operates as a private firm and the fixed cost of production is realized. If a firm decides to pay the cost $\tilde{\kappa}_{j,t}$, it becomes a public firm and produces

as a public firm in the same period. The transition decision is based on whether the value of becoming public exceeds that of remaining private, resulting in a cutoff cost $\tilde{\kappa}^*(z_{j,t})$ pinned down by

$$V(z_{j,t}) - \tilde{\kappa}^*(z_{j,t}) = \int_0^{\tilde{f}^*(z_{j,t})} \tilde{V}(z_{j,t}, x) d\Phi_{\tilde{f}}(x), \quad (11)$$

where $V(z_{j,t})$ is the value of being a public firm, defined below. $\Phi_{\tilde{f}}$ is the cumulative distribution function of fixed costs.

The value of a private firm at the beginning of the period can now be defined as

$$\tilde{W}(z_{j,t}) = \tilde{p}(z_{j,t})V(z_{j,t}) - \bar{\kappa}(z_{j,t}) + \{1 - \tilde{p}(z_{j,t})\} \int_0^{\tilde{f}^*(z_{j,t})} \tilde{V}(z_{j,t}, x) d\Phi_{\tilde{f}}(x), \quad (12)$$

where $\tilde{p}(z_{j,t}) = \text{Prob}(\tilde{\kappa}_{j,t} \leq \tilde{\kappa}^*(z_{j,t}))$ is the probability of becoming a public firm. $\bar{\kappa}(z_{j,t}) = \int_0^{\tilde{\kappa}^*(z_{j,t})} x d\Phi_{\tilde{\kappa}}(x)$ is the expected cost incurred when optimally transitioning to become a public firm for firms with productivity level $z_{j,t}$, where $\Phi_{\tilde{\kappa}}$ is the cumulative distribution function of $\tilde{\kappa}_{j,t}$.

Firm entry is determined as follows. At the beginning of each period, a unit mass of potential entrants draws its productivity level z_j . Afterwards, an entry cost \tilde{f}^e , iid across entrants over the interval $[0, \tilde{f}_{max}^e]$, is realized. This entry cost \tilde{f}^e is separate from the fixed cost \tilde{f} introduced above. Entrants are required to finance a fraction $\tilde{\phi}^e$ of the entry cost using a bank loan at the gross interest rate $R_{\ell,t}$.¹⁶ If an entrant chooses to pay the entry cost, it begins operating as a private firm and faces the decision problem described above: whether to produce as a private firm, become public, or exit the market. Entry occurs only if the net present value of operating as a private firm exceeds zero, implying a cutoff entry cost $\tilde{f}^{e,*}(z_{j,t})$ pinned down by

$$\tilde{W}(z_{j,t}) - \{1 + \tilde{\phi}^e(R_{\ell,t} - 1)\} \tilde{f}^{e,*}(z_{j,t}) = 0. \quad (13)$$

The mass of entrants that enter the market each period is given by

$$\tilde{\mu}_e = \int \int_0^{\tilde{f}^{e,*}(z_{j,t})} d\Phi_{\tilde{f}^e} d\Phi_z, \quad (14)$$

where $\Phi_{\tilde{f}^e}$ and Φ_z are the cumulative densities.

Taking stock of the above choices, the optimal behavior of a private firm and a potential entrant is characterized by $\{\tilde{n}^*(z_{j,t}), \tilde{f}^*(z_{j,t}), \tilde{\kappa}^*(z_{j,t}), \tilde{f}^{e,*}(z_{j,t})\}$. Using the

¹⁶This is the same parameter $\tilde{\phi}^e$ as the fraction of fixed costs \tilde{f} that the firm needs to finance with bank loans. In principle, these shares could be separate parameters, but we are able to match our desired targets with one single parameter related to bank financing requirement of both \tilde{f}^e and \tilde{f} .

optimality conditions, it can be shown that, for a given wage, $\frac{\partial \tilde{n}_{j,t}^*}{\partial R_{\ell,t}} < 0$, $\frac{\partial \tilde{f}_{j,t}^*}{\partial R_{\ell,t}} < 0$, $\frac{\partial \tilde{\kappa}_{j,t}^*}{\partial R_{\ell,t}} > 0$, $\frac{\partial \tilde{f}_{j,t}^{*,e}}{\partial R_{\ell,t}} < 0$, $\frac{\partial^2 \tilde{n}_{j,t}^*}{\partial R_{\ell,t} \partial \phi} < 0$, $\frac{\partial^2 \tilde{f}_{j,t}^*}{\partial R_{\ell,t} \partial \phi} < 0$, $\frac{\partial^2 \tilde{\kappa}_{j,t}^*}{\partial R_{\ell,t} \partial \phi} > 0$, $\frac{\partial^2 \tilde{f}_{j,t}^{*,e}}{\partial R_{\ell,t} \partial \phi} < 0$, $\frac{\partial^2 \tilde{f}_{j,t}^*}{\partial R_{\ell,t} \partial \phi^e} < 0$, $\frac{\partial^2 \tilde{\kappa}_{j,t}^*}{\partial R_{\ell,t} \partial \phi^e} > 0$, and $\frac{\partial^2 \tilde{f}_{j,t}^{*,e}}{\partial R_{\ell,t} \partial \phi^e} < 0$. These comparative statics reveal how the model captures the findings of our empirical analysis. In general equilibrium a higher top income share reduces aggregate deposit supply, pushing up the loan rate. In the private firms' problem, a higher loan rate suppresses employment demand due to the working capital constraint. It also makes it less attractive to stay in the market and more attractive to become a public firm, as the value of being a private firm decreases when loan rates are higher. As the value of being a private firm falls, potential entrants also become less willing to enter the market. The relative strength of these intensive and extensive margin effects is driven by the degree of bank dependence of the private firm sector. This allows us to match the empirical magnitude of the effect of higher top income shares on small firm employment by calibrating the working capital parameters $\tilde{\phi}$ and $\tilde{\phi}^e$ accordingly.

We now turn to the description of public firms. They produce $Y_{j,t}$, using both capital $K_{j,t}$ and labor $N_{j,t}$, according to the production function

$$Y_{j,t} = z_{j,t} K_{j,t}^\theta N_{j,t}^{\gamma-\theta}, \quad (15)$$

where $0 < \theta < 1$ is the share of capital, and $\theta < \gamma \leq 1$ governs the returns to scale in production. Note that public firms' productivity is governed by the same stochastic process as private firms'. The value of a public firm with productivity level $z_{j,t}$ is

$$V(z_{j,t}) = \max_{K_{j,t}, N_{j,t}} z_{j,t} K_{j,t}^\theta N_{j,t}^{\gamma-\theta} - (R_{k,t} + \delta - 1)K_{j,t} - w_t N_{j,t} + \beta_f (1 - \lambda) \mathbb{E}_t [V(z_{j,t+1}) | z_{j,t}], \quad (16)$$

where λ is the exogenous exit probability of public firms and δ is the depreciation rate. Profit maximization implies

$$R_{k,t} = \theta z_{j,t} (K_{j,t})^{\theta-1} (N_{j,t})^{\gamma-\theta} + 1 - \delta, \quad (17)$$

$$w_t = (\gamma - \theta) z_{j,t} (K_{j,t})^\theta (N_{j,t})^{\gamma-\theta-1}. \quad (18)$$

This firm's funding is 'public' in the sense that there are no agency conflicts or other frictions that prevent households from undertaking direct investments into the capital of this firm. In other words, public firms do not need bank funding.

Banking sector. A representative bank operates in a perfectly competitive environment. It offers deposits to households and grants loans to private firms. We assume

that banking operations require a fixed cost Ξ . The bank pays the gross interest rate $R_{d,t}$ on deposits and lends at the gross rate $R_{\ell,t}$. Since there is no uncertainty associated with private firms, the bank does not face default risk. The bank's zero profit condition and the loan market clearing condition imply

$$R_{\ell,t} = R_{d,t} + \frac{\Xi}{D_{t+1}}, \quad (19)$$

where D_t is the total amount of deposits in the economy.

Since our model features rich heterogeneity on the household and firm side, we keep the bank's problem stylized for tractability. The main role of the banking sector is that in equilibrium it connects deposit supply and loan demand, and thereby the income distribution and job creation. Households' deposit supply is upward-sloping, as higher deposit rates make deposits more attractive. Importantly, banks need to offer a higher deposit rate to raise a given amount of deposits in a more unequal society. The reason is that deposits have a non-pecuniary benefit that is stronger for low-income households. Loan demand by private firms is downward-sloping, as higher loan rates make borrowing more costly.

These features imply that when a higher share of income accrues to the top earners, banks need to offer a higher deposit rate. As this higher deposit rate translates into a higher loan rate, banks move along the downward-sloping loan demand function, so that the equilibrium amount of lending falls. A higher loan rate suppresses private firms' ability to hire labor – their job creation declines. This interplay between households, firms and the banking system in the model generates the relationships that our empirical analysis uncovered in Tables 1 and 2.

Market clearing and model solution. The Online Appendix provides a definition of the stationary equilibrium and a detailed description of the algorithm. Although the model features both heterogeneous households and heterogeneous firms, it can be solved with a relatively straightforward algorithm. It is akin to solving an [Aiya-gari \(1994\)](#) model, but with a nested loop structure in which quantities and prices in different markets are guessed. We iterate over these guesses until all markets clear.

5.2 Specification and calibration

Our strategy is to characterize a stationary equilibrium that captures the aggregate US economy in the early 1980s, i.e. the beginning of the sample period of our empirical analysis. In this equilibrium, we match household portfolio shares across the income distribution to the SCF, as well as features of the firm size distribution to the BDS. We then carry out a model experiment that increases the top income share in line with its actual evolution from 1980 to today. In this experiment, we directly

match our estimated responses of net job creation among firms of different sizes to changes in the top income share, both at the extensive and intensive margin.

Income risk and preferences. Heterogeneity across households comes from ex-ante and ex-post differences in idiosyncratic labor income risk $s_{i,t}$. There are permanent ex-ante differences between two types of households $\chi = L, H$, with mean s_χ and mass μ_χ . Type $\chi = L$ gets lower income draws in expectation than type $\chi = H$. The ex-post differences arise from the realized income draws, which are idiosyncratic also within the two type groups. This generates the idiosyncratic risk standard in incomplete markets models. Formally, household i of type χ faces the process $s_{i,\chi,t} = s_\chi \tilde{\zeta}_{i,t}$ with $\log \tilde{\zeta}_{i,t} = \rho \log \tilde{\zeta}_{i,t-1} + \varepsilon_{i,t}$, $\varepsilon_{i,t} \sim N(0, \sigma_\varepsilon^2)$, where ρ and σ_ε are the persistence and standard deviation, common across all households. $s_H \neq s_L$ allows for permanent income differences, and we calibrate these parameters to match the initial top 10% income share in US data. We specify $\bar{u}(c_i, n_i, \tilde{n}_i, s_i) = c_i - \psi_n s_i \frac{n_i^{1+\frac{1}{\nu}}}{1+\frac{1}{\nu}} - \tilde{\psi}_n s_i \frac{\tilde{n}_i^{1+\frac{1}{\nu}}}{1+\frac{1}{\nu}}$. In our main experiment, both household types work at both firm types. In an additional model experiment, we assume that household type L works at private and type H at public firms.¹⁷

Categorization of public and private firms. We calibrate the public and private firm sectors such that private firms represent companies with fewer than 500 employees. This definition is in line with the standard definition of “small and medium enterprises”, see e.g. [Caglio, Darst, and Kalemli-Özcan \(2022\)](#), and reflects our econometric choice of firm size as a proxy for bank-dependence.

Net job creation vs. employment. While our empirical analysis uses the net job creation rate (i.e. a growth rate), the model does not feature employment growth in the stationary equilibrium. We target the percentage point change in the net job creation rate in response to rising top income shares in our empirical estimates ([Table 1](#)) with the percentage change in employment. This assumption likely understates the effects of rising inequality on employment levels, as a change in the growth rate implies a similar level difference only as long as the change is temporary. If the change in the net job creation rate is persistent or permanent, the resulting level change in employment would be larger and our channel would have stronger effects.¹⁸

¹⁷In additional experiments, we specify $\bar{u}(c_i, n_i, \tilde{n}_i, s_i)$ such that the two types of labor supply are non-separable, with a constant elasticity of substitution. Results remain qualitatively and quantitatively similar for plausible values of substitutability found in the literature.

¹⁸Suppose employment of small and large firms equals 1 each (in 1980 both make up roughly half of employment, so this normalization is applicable). Suppose their net job creation rates are 6% and 3%. Then the percent level difference in employment after one year is $\frac{1.06}{1.03} - 1 \approx 3\%$. Suppose now, because of higher top income shares, the small firm net job creation rate falls to 4%. The level difference is instead $\frac{1.04}{1.03} - 1 \approx 1\%$. That is, the fall of 2 p.p. in the rate is equal to a 2% relative level change. If the growth rate stays lower in subsequent years, the level difference grows, but we calibrate

Structural parameters. The model’s frequency is annual. We first set a few standard parameters to external values common in the literature. We then internally calibrate the remaining parameters to target empirical moments related to households’ income and portfolio shares, firms’ employment shares, and our identified response of net job creation rates to changes in top income shares.

Panel (a) of [Table 3](#) presents the externally calibrated parameters. We set the coefficient of relative risk aversion to 1.5 and the Frisch elasticity to 3. The persistence of the idiosyncratic income process is 0.92, implying a quarterly autocorrelation of 0.98. The standard deviation is set to 0.12, based on [Storesletten, Telmer, and Yaron \(2004\)](#). The mass of each household type captures the size of the top 10% and bottom 90% income groups. The degree of decreasing returns to scale in private firms’ production function $\tilde{\alpha}$ is set to 0.99. We set $\lambda = 0.1$.

Panel (b) presents the internally calibrated parameters. Total hours worked and initial wages are normalized to 1. We set the coefficients of labor disutility ψ_n and $\tilde{\psi}_n$ such that the shares of public and private firm labor that households supply match the corresponding employment shares in the BDS in 1981 (46.9% and 53.1%). ψ_d determines the desirability of deposits relative to capital, while η determines how rapidly marginal utility of deposits falls with income. We calibrate these parameters to match the deposit share of the middle quintile and the top 10% income group in the SCF in the early 1980s (0.45 and 0.22). β governs households’ overall desire to save, and is calibrated to match the net return on public firms’ capital to the historical average of US stock returns of around 8%. We set β_f to the same value. s_L is normalized to 1, while s_H is calibrated to ensure that the initial top 10% income share equals 34.5%, the starting point of our experiments. In line with the [Frank \(2009\)](#) data used in our empirical analysis, total income consists of labor income, asset income, and profits.

Given households’ labor supply and the normalization of initial wages, we need to ensure that labor demand from public and private firms also corresponds to the targeted employment shares for each firm type. We first calibrate public firms’ capital share θ to match the capital depreciation rate to the value computed from NIPA. Given this choice, we set public firms’ return to scale γ such that they demand 46.9% of total labor, while calibrating the standard deviation of firm productivity σ_z to ensure that private firms demand the remainder. We set the upper bound of the stochastic fixed cost \tilde{f}_{max} and the entry cost \tilde{f}_{max}^e to deliver an average firm exit rate of 10% and a steady-state firm mass of one in the baseline. The working capital constraint parameters, $\tilde{\phi}$ and $\tilde{\phi}^e$, are calibrated to precisely reproduce our empirical estimates in [Table 1](#), for the intensive and extensive margin. We define the extensive

the model only to 2% level difference in this example, consistent with a one-off change.

Table 3: **Model parameterization to target the US economy in the early 1980s**

Panel (a): externally calibrated parameters

Parameter and description	Value	Parameter and description	Value
σ Relative risk aversion	1.50	μ_L Mass of L type households	0.9
ν Frisch elasticity of labor supply	3	μ_H Mass of H type households	0.1
ρ Persistence of productivity process	0.92	ρ_z Firm productivity autocorrelation	0.9
σ_ϵ Standard dev. of productivity process	0.12	$\tilde{\alpha}$ Private firm returns to scale	0.99
λ Public firm exit probability	0.10	\tilde{f}_{max}^e Upper bound of entry cost	0.04

Panel (b): internally calibrated parameters

Parameter and description	Target (source)	Value	Model	Data
ψ_n Labor disutility (public)	Labor supply share 500+ (BDS)	1.2871	0.469	0.469
ψ_n Labor disutility (private)	Labor supply share 1–499 (BDS)	1.2349	0.531	0.531
ψ_d Deposit utility scale	Deposit share in 3rd quintile (SCF)	0.0632	0.45	0.45
η Elasticity of deposit utility	Top 10% deposit share (SCF)	2.6096	0.22	0.22
β Household discount factor	Mean return US stock market	0.9182	1.08	1.08
s_H Productivity scale H vs. L	Top 10% income share (Frank (2009))	4.6324	0.346	0.346
θ Public firm capital share	Capital depreciation rate (NIPA)	0.2193	0.06	0.06
γ Public firm return to scale	Labor demand share 500+ (BDS)	0.9883	0.469	0.469
σ_z Firm productivity standard dev.	Labor demand share 1–499 (BDS)	0.0297	0.531	0.531
$\tilde{\phi}$ Private firm bank dependence	Int. margin estimate (Table 1, Col 4)	0.952	-0.133	-0.133
$\tilde{\phi}^e$ Private firm bank dependence	Ext. margin estimate (Table 1, Col 3)	0.801	-0.027	-0.027
\tilde{f}_{max} Upper bound of fixed cost	Firm death rate (BDS)	0.0043	0.10	0.10
$\tilde{\kappa}_{max}$ Upper bound cost of going public	Share of firms 500+ (BDS)	14964	0.003	0.003
Ξ Banking sector fixed cost	Average deposit rate (Call Reports)	0.1018	1.04	1.04

Note: Summary of calibration for the initial stationary equilibrium. Panel (a) shows the parameters we fix to standard values. Panel (b) presents the internally calibrated parameters, which match data from the SCF and the BDS in the early 1980s. This makes the model consistent with the motivating evidence in Section 2 and the empirical estimates in Section 3.

margin as the combination of entry and exit, as well as the transition from private to public firms. This is consistent with the BDS data, where the employment of a firm transitioning from one bucket to another is then counted in the new bucket. We set the upper bound of the cost of going public $\tilde{\kappa}_{max}$ to match the share of firms with more than 500 employees in the BDS data. The bank's fixed cost implies a deposit rate of 4%, consistent with its national average over the period we consider.

Specification of the main model experiment. We increase the top 10% share from 34.5% to 50.5%, matching its US-wide evolution from the early 1980s to 2015 in the Frank (2009) data (see Figure 1, panel (a)). We generate this increase through permanent lump-sum transfers between households. By changing lump-sum redistribution, we remain agnostic about the multi-faceted sources of the rise in top income shares and abstract from any *direct* relation between macroeconomic trends and top incomes. Instead, our exercise studies the effects that arise exclusively through portfolio reallocation, our channel of interest. In an alternative experiment below, we study different drivers of rising income inequality.

The transfers net out to zero to keep ex-ante aggregate income constant, in the spirit of controlling for mean income growth in our empirical specifications. In

addition to increasing lump-sum taxes on income group L and using the revenue to provide a lump-sum transfer to income group H , we also vary the amount of taxes (transfers) that low-income (high-income) agents pay (receive) within each group. This provides flexibility in calibrating the experiments to reproduce our empirical estimates in the model. Formally, $T_{i,\chi} = c_\chi \tau \frac{s_{i,\chi}^\varphi}{\bar{s}_\chi}$, $\bar{s}_\chi = \sum_{i=1}^{n_\chi} s_{i,\chi}^\varphi m_{i,\chi} / \sum_{i=1}^{n_\chi} m_{i,\chi}$, where $c_\chi = -1$ if $\chi = L$ and $c_\chi = 1$ otherwise, and $s_{i,\chi}$ is i -th level of productivity in group χ . m_χ is the mass of households with productivity $s_{i,\chi}$ and \bar{s}_χ is the mean of $s_{i,\chi}^\varphi$. The total amount of taxes and transfers is denoted by τ . The parameter φ captures the degree to which households with higher productivity in the low (high) group pay (receive) a larger amount of tax (transfer). Precisely replicating our empirical estimates is achieved with $\varphi = 3.5$. τ is equal to 0.0282.

Untargeted moments. We evaluate various untargeted moments. First, the Online Appendix illustrates key economic forces of the model in partial equilibrium. This includes an analysis of marginal propensities to consume and save (MPC and MPS) out of transitory income (Kaplan, Moll, and Violante, 2018). The model implies an average MPC and differences in the MPC along the income and wealth distribution that are in line with empirical estimates in the literature. Second, the Online Appendix presents the wealth distribution implied by the model, for steady states with high and low top income shares. The wealth dispersion is broadly in line with the data. Third, our model implies that lower-income households rely more on labor income, in line with the data. Fourth, regarding firms, our calibration results in an average public-to-private firm employment ratio of 204, compared to 254 in the BDS data. All of these patterns provide additional validation of the model.

6 Quantitative experiments in general equilibrium

Our empirical results suggest that rising top incomes impact job creation among different types of firms. To examine the macroeconomic and welfare consequences, our main general equilibrium model experiment raises the top 10% income share permanently by as much as it increased in the data since 1980, from 34.5% to 50.5%.

6.1 Aggregate and firm-level outcomes

Figure 3 presents the realizations of model variables as the top 10% income share rises. Each variable is normalized to its initial level, when the top 10% income share stands at 34.5%. Panel (a) shows that, as deposits are more important for low-income than high-income households, a smaller proportion of aggregate income is saved in the form of deposits when top income shares are higher. While aggregate

deposits fall by more than 2%, savings flow to a larger extent into public firms' capital, leading to a 2% increase. Relatively more income accruing to high-income households slightly raises aggregate savings. This shows that total savings rates in the model can increase in permanent income, as in [Dynan, Skinner, and Zeldes \(2004\)](#) and [Straub \(2019\)](#).¹⁹

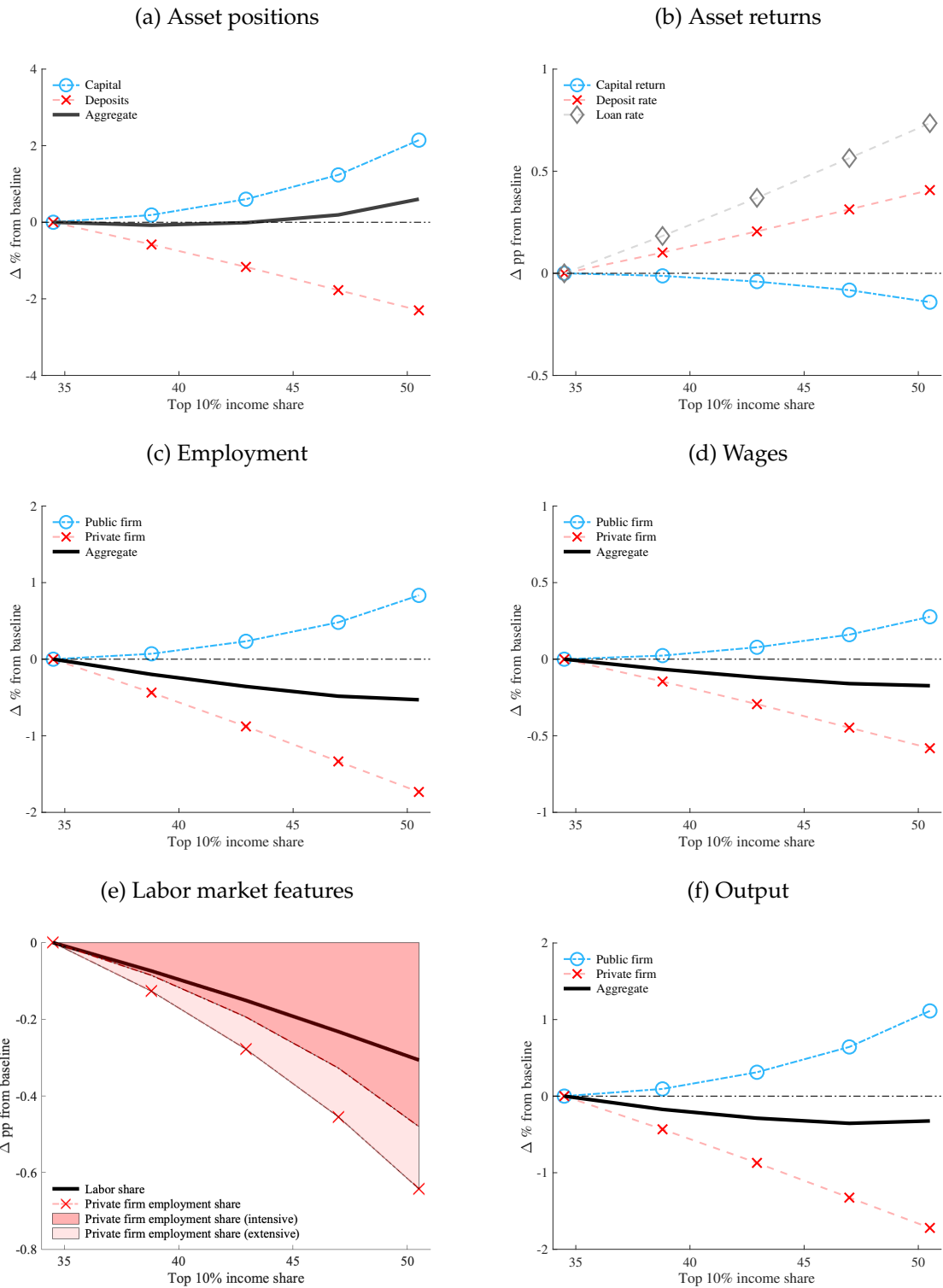
Panel (b) shows how a higher top income share affects the returns on different assets. The return on direct firm investments, determined by public firms' marginal product of capital, falls by about 0.14 p.p. The deposit rate increases by 0.4 p.p., raising loan rates by about 0.7 p.p. due to the fixed cost in the bank's zero profit condition. Qualitatively, the latter two effects line up with the estimates in [Table 2](#). According to [Mian, Straub, and Sufi \(2021b\)](#), income inequality has put downward pressure on equilibrium real interest rates. Our experiment is consistent with this finding in the sense that the marginal product of public firms' capital falls. We show in addition that returns on different assets move in different directions as a consequence of higher inequality. Furthermore, note that our calibration implies that high-income households experience higher average portfolio returns for any realization of the economy's top income share, consistent with the SCF.

Our private firm comparative statics in the previous section make clear that a higher loan rate puts downward pressure on private firms' loan and labor demand. It also makes it more costly for private firms to remain in production, compared to exiting the market or becoming a public firm. Panel (c) confirms that the rise in the top income share implies almost 2% lower equilibrium employment in the private firm sector. Conversely, public firms, which now receive more capital, increase their employment by a bit less than 1%. We discuss the decline in aggregate employment below, when we interpret the behavior of aggregate output.

While not plotted in [Figure 3](#) and not targeted by our calibration, the rise in top income shares also increases the relative number of public to private firms, in addition to the rise in their employment share. This is because a higher loan rate lowers the value of being a private firm and makes it more attractive to incur the cost of becoming a public firm. This increase is only about 6% of its counterpart in the data, though both in the model and in the data the increase is very small, 0.0046 p.p. and 0.08 p.p. Recall that in the model we calibrate the cost of transitioning from private to public to match the initial share of public firms of 0.35% in the data. Also, the mass of entrants falls in the model, by about 0.7%, as a result of the rise in the entry cost and a fall in the value of being a private firm.

¹⁹Aggregate savings increase only slightly as a consequence of matching our empirical estimates. If overall savings significantly increased due to rising income inequality, then the level of deposits would exhibit a decrease only relative to other savings, but would increase in levels. This would lead to both the deposit and loan rates to fall, which is not what we find in the data. The Online Appendix provides a discussion of absolute and relative changes in our mechanism.

Figure 3: General equilibrium consequences of rising top income shares



Note: Selected equilibrium quantities and prices for different top 10% income shares, generated by the main experiment. We focus on aggregate outcomes as well as outcomes across different asset types, firm types and firm sizes. The calibration shown in Table 3 is used for the initial stationary equilibrium with a top 10% income share of 34.5%.

Panel (d) shows that wages increase in the public firm sector and fall in the private firm sector. Employment and wages move in the same direction for each labor type, reflecting that the relative labor demand effects across firm types are key for outcomes in the model's labor markets. On average, wages in the economy fall.

Panel (e) shows that the share of total employment in private firms decreases by 0.64 p.p. According to the BDS, between 1980 and 2015 the US economy experienced a decline in the share of employment in firms with fewer than 500 employees of 4.97 p.p. Rising top incomes, through their effect on funding conditions, can thus explain a sizeable 13% of the overall decline of that share. In line with our empirical estimates, the shaded areas highlight that around one fifth of this effect comes from the extensive margin, that is, from the combination of reduced entry, increased exit, and more frequent transitions of private to public firms.²⁰ These findings connect our mechanism to salient trends in the US economy over the last decades, such as the decrease in business dynamism and the growing importance of large firms (Decker, Haltiwanger, Jarmin, and Miranda, 2016; Autor, Dorn, Katz, Patterson, and Van Reenen, 2020).

The labor share falls by 0.3 p.p. as the top income share rises, as shown in panel (e). This is a consequence of public firms growing relatively larger and being more capital-intensive. While we make the simplification that private firms produce with labor only, larger firms indeed have higher capital-to-labor ratios in the data (Oi and Idson, 1999). The effect of rising top income shares on the labor share aligns with another macro trend in the US and globally (Karabarbounis and Neiman, 2014). Depending on how the US labor share is computed, the literature suggests that it has fallen by 2 p.p. to 4 p.p., so our channel explains about 7.5% to 15% of this decline.

Finally, panel (f) presents the effects of higher inequality on output. As higher top income shares affect the relative funding situation across firms, public firms increase and private firms reduce production. In the aggregate, there is a modest decline in output of 0.3%, similar in magnitude to the reduction in aggregate employment. This effect is the result of two offsetting forces. On the one hand, higher top income shares lead to a larger steady state capital stock and therefore higher output, all else equal. A larger capital stock results from a given public firm getting more investment and from relatively more firms being public firms. On the other hand, a higher top income share reallocates resources across firms. If smaller, financially more constrained firms have higher marginal products, this suppresses aggregate output. The second of these effects dominates in general equilibrium for two reasons.

First, the marginal product of labor of private firms is about one sixth higher than

²⁰Specifically, the share of entrants relative to the total mass of potential entrants declines, and the shares of both exiting firms and firms transitioning to public firms relative to the total mass of private firms increase.

that of public firms. Second, aggregate savings increase only modestly. Importantly, the difference in marginal products is not an a priori assumption, but a consequence of matching our empirical estimates in [Table 1](#), where small firm net job creation responds relatively more strongly. *Marginal* products can be different even when the *level* of productivity of larger firms is higher than that of smaller firms, as some research suggests ([Autor, Dorn, Katz, Patterson, and Van Reenen, 2020](#)). Indeed, in our model public firms have higher average productivity than private firms, as firms with higher productivity have a higher likelihood of becoming public.

In summary, [Figure 3](#) shows that a higher share of income going to top earners has a substantial impact on the returns on different assets, on wages, and on firms. A sizeable fraction of the increase in the employment share of large firms as well as of the fall in the labor share over the past decades can be explained by rising top income shares. Moreover, aggregate employment and output are lower in an economy where incomes are distributed less equally. The next section will show large distributional consequences across households, with significant implications for welfare.

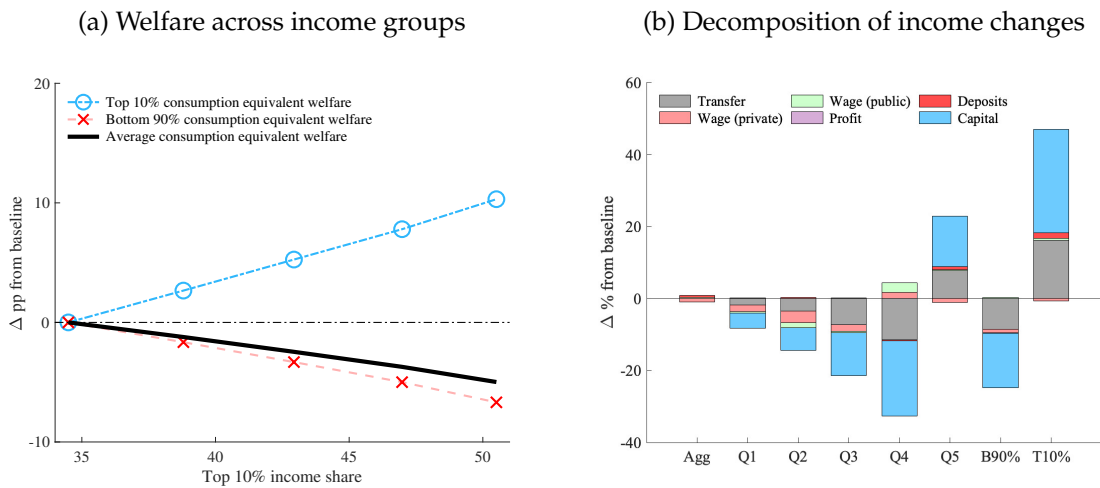
6.2 The welfare effects of rising top income shares

We compute the consumption equivalent (CE) welfare for households along the income distribution. Panel (a) of [Figure 4](#) shows that our experiment increases welfare for the top 10% and decreases it for the bottom 90%. As the bottom 90% of households form a bigger group, with a higher marginal utility than the top 10%, the average household experiences a decline in welfare. A significant part of these patterns result from changes beyond the direct, mechanical effects of lump-sum taxes and transfers. The reason is that agents' choices, as well as wages and returns, adjust, giving rise to general equilibrium effects. Panel (b) of [Figure 4](#) decomposes the changes in income across income groups into different sources. We consider the aggregate, the top 10% and bottom 90% of the income distribution, as well as the bottom, middle, and top quintiles, where 'Q1' ('Q5') represents the bottom (top) 20% earners. Capital income increases at the top and decreases at the bottom. Wage income declines most among households in the bottom 40% of the income distribution.

Welfare in a model with fixed portfolio shares. By construction, our redistribution of income benefits the top 10% and hurts the bottom 90%. To gauge the contribution of our mechanism to the welfare consequences of rising top incomes, we therefore benchmark the welfare effects in [Figure 4](#) against their counterparts in an alternative model with fixed portfolio shares. This allows us to “net out” the direct, mechanical effects of lump-sum taxes and transfers on welfare.

In the alternative model, we restrict households to save in a composite of deposits

Figure 4: Welfare effects and income decomposition



Note: Welfare effects (in consumption equivalents) for different top 10% income shares and decomposition of income changes between the highest and the lowest top 10% income share for different income groups. The calibration shown in Table 3 is used for the initial stationary equilibrium with a top 10% income share of 34.5%.

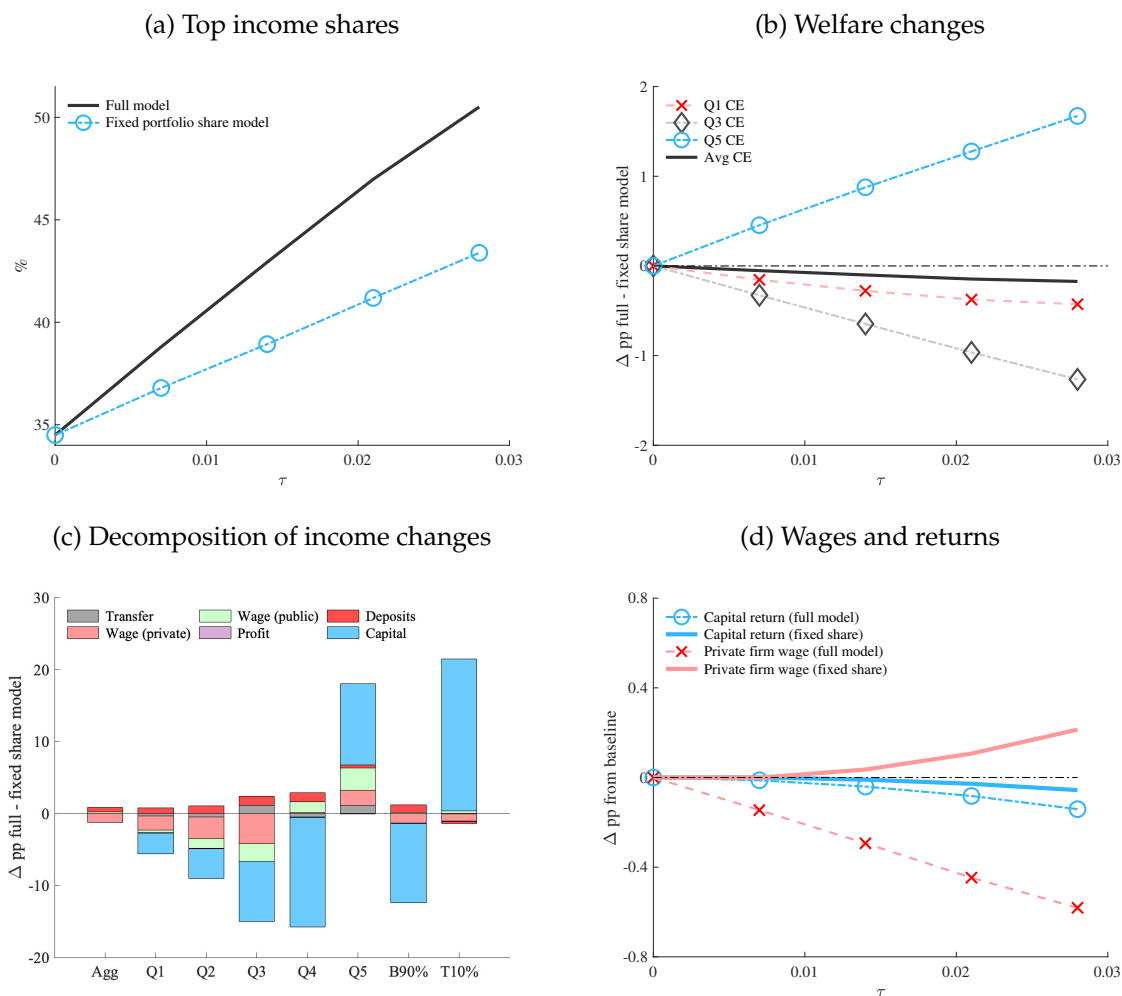
and capital, with shares fixed to match the average deposit share in the 1980s SCF data. The composite asset pays the weighted average of the deposit interest rate and the marginal product of capital of public firms. This ‘fixed portfolio share model’ is otherwise identical to our full model, and calibrated to match identical targets. The Online Appendix provides the equivalents of Figure 3 and Figure 4 for the fixed portfolio share model. Forcing capital and deposit savings to respond in a proportional way to rising top income shares implies substantially different effects, which we now discuss in comparison to the full model.

Contribution of portfolio allocation to welfare. Figure 5 shows the effects of rising inequality when households can and cannot adjust their portfolios. Panel (a) plots the change in the top 10% income share for our lump-sum transfer scheme (changes in τ as defined in Section 5). Recall that our experiment is designed to generate a change in the top 10% income share from 34.5% to 50.5% in the full model (black solid line). Imposing the same set of transfers across households in the fixed portfolio share model leads to a weaker increase in income inequality (blue circled line). When households cannot adjust their portfolios in response to income changes, the top 10% income share rises only up to around 43% in equilibrium. Our mechanism thus amplifies the effects of the initial redistribution on the top income share.

Panel (b) plots the differences in welfare between the full and the fixed portfolio share model. Positive numbers imply a relatively better welfare outcome in the full model. We find that top earners experience a stronger increase in welfare in the presence of portfolio reallocation, while households in the bottom and middle parts of the distribution face a stronger decline in welfare. Portfolio heterogeneity

amplifies the positive impact of rising top income shares at the top as well as the negative impact at the bottom. The effects are economically large, amounting to differences on the order of 1% in consumption equivalents. Ignoring the effects of income inequality on the allocation of savings thus understates the welfare effects of changes in the income distribution significantly.

Figure 5: Welfare differences between model and alternative



Note: Welfare analysis across two different model versions. The full model is the one analyzed in Figure 3 and Figure 4. In the fixed portfolio share model (labeled 'fixed share') our main channel is shut off. The calibration shown in Table 3 is used for the initial stationary equilibrium with a top 10% income share of 34.5%.

Panels (c) and (d) examine the driving forces behind these patterns. Panel (c) plots the difference in income between the full and the fixed portfolio share model across income groups, decomposed into different sources.²¹ By benchmarking the experiment against an alternative model, the direct effect of exogenous transfers nets out. The figure shows that the stronger welfare impact at the top and bottom is driven by differences in both asset and labor income. We focus on the two components

²¹CE welfare differences arise from different sources, including differences in income. Welfare changes in our experiments are mirrored relatively closely by income differences, and we thus focus our interpretation of the welfare results on income changes.

with the largest contribution across income groups, income from holding capital in public firms and wage income from private firms. To inform our discussion, panel (d) examines public firm returns and private firm wages in the two models.

In the full model, labor income from private firms decreases sharply, as they reduce labor demand in response to the higher loan rate. In equilibrium, private firm wages fall (see panel d). This stands in contrast to the fixed portfolio share model, in which top earners increase deposits after receiving more income, benefiting private firms through lower rates and allowing them to increase wages. Wages make up a high share of the incomes of lower-income groups. In the full model, this reduction in labor income has a strong negative impact on the welfare of low-income households, and while wages at public firms rise, average wages across all firms fall.

The full model also implies that capital income rises more strongly for top earners, as they shift into the higher-return investment. In turn, their capital income increases, despite a fall in the return on public firm capital (panel d). Indeed, the reduction in returns is driven by the influx of capital from high-income households. This also puts downward pressure on the capital income of lower-income groups, for whom asset income is lower than with fixed portfolio shares, a pattern that is particularly pronounced in the middle of the distribution. Note that in the full model, low-income households do receive higher interest rates from holding deposits. However, as panel (c) shows, differences in deposit income contribute little to overall income changes.

In summary, the link between households' portfolio adjustments and job creation of different firms amplifies the welfare impact of changes in the income distribution. Low-income individuals suffer from falling wages paid by private firms, which see a tightening in their bank funding when income inequality rises. High-income individuals benefit from higher income from capital investments in public firms that attract more funding when top income shares are higher.

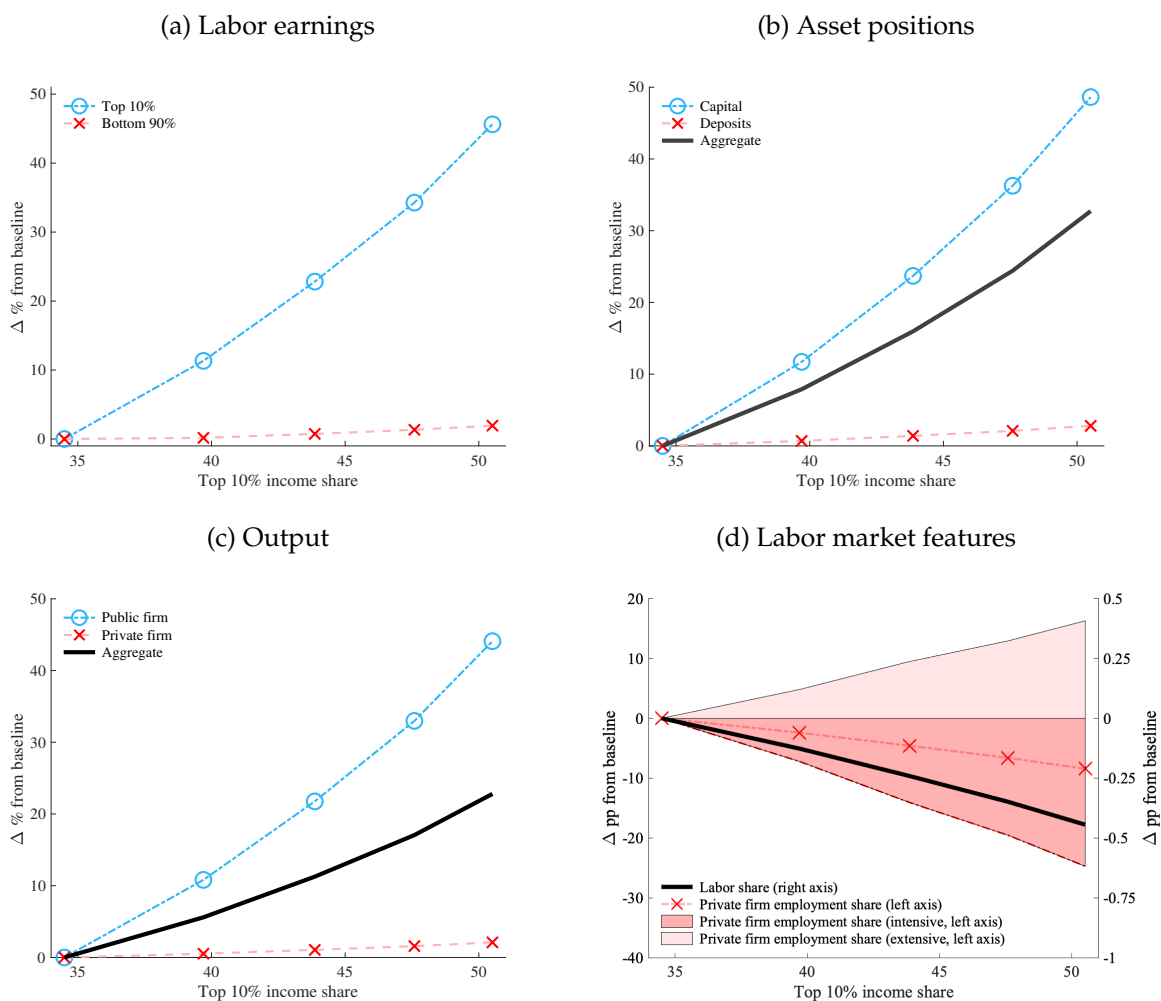
6.3 Alternative inequality source, complementarities and growth

In our main experiment, we study lump-sum redistribution as a 'neutral' change in top income shares, assume that all households work at both firm types, and abstract from growth in aggregate income. While these features allow us to isolate the quantitative importance of our mechanism, our model is general enough to modify all of these aspects. We do so in an additional experiment, which demonstrates how our model can answer further questions related to income inequality and job creation.

The additional experiment starts from the same initial equilibrium and calibration. We then vary top income shares by increasing the permanent component of high-income households' income processes s_H , to again raise the top 10% income share from 34.5% to 50.5%. We keep s_L the same, so this change not only generates

income inequality, but also leads to higher aggregate income. Furthermore, we assume that type L households only work at private firms and type H households only at public firms, a stand-in for complementarities between high-income workers and public firm capital. This experiment is motivated by the literature on skill-biased technological change (SBTC), according to which technological change and capital-skill complementarities lead to economic growth that benefits high-skilled workers. [Acemoglu \(2002\)](#) provides a general discussion.²² The Online Appendix contains further information about the setup of the experiment and additional results.

Figure 6: **General equilibrium effects in additional experiment**



Note: Selected equilibrium quantities and prices for different top 10% income shares, generated by the additional experiment. The additional experiment is motivated by the literature on skill-biased technological change. The calibration shown in [Table 3](#) is used for the initial stationary equilibrium with a top 10% income share of 34.5%.

Figure 6 plots the general equilibrium realizations of key model variables. To validate that our SBTC-inspired experiment delivers results in line with the data,

²²The literature also suggests other drivers of inequality. [Cowell and Van Kerm \(2015\)](#) provide a survey. Our model could also be used to study specific aspects of tax systems, such as progressivity. See e.g. [Heathcote, Storesletten, and Violante \(2017\)](#).

we compare the responses of labor earnings inequality in the model with evidence presented by [Heathcote, Perri, Violante, and Zhang \(2023\)](#). Our experiment exactly matches the change in the top 10% share of *total* income in the US, so the implied evolution of *labor* income inequality, of particular interest in the SBTC literature, serves as an untargeted moment. Since our model has two ex-ante income types that capture the top 10% and bottom 90%, we consider the empirical facts about labor earnings at the top and the middle of the distribution in [Heathcote, Perri, Violante, and Zhang \(2023\)](#). Panel (a) shows that the top 10% relative to the middle 50% labor earnings share rose by a factor of 1.5 in our model experiment. In the data, it increased by a factor of 2 since 1980.

Panel (b) plots the allocation of savings. The economy experiences an increase in aggregate income, so savings in all asset types increase. As the rise in income is especially elevated at the top of the income distribution, where deposits matter less for households, savings in public firms expand strongly and increase relative to the level of deposit savings. Panel (c) shows aggregate output. The size of the economy increases by about 20%. This expansion is mostly due to public firms, which receive an increasing amount of capital investment.

Panel (d) shows that higher top income shares lead to a relative decline in job creation at bank-dependent firms. The private firm employment share falls by 8 p.p., a much larger reduction than in our main experiment. Interestingly, the contributions of the intensive and extensive margin have different signs in this experiment. Bank-dependent firms hire fewer workers at the intensive margin, but higher aggregate income leads to more entry and less exit, as the value of private firms increases.

It is also noteworthy that the alternative setup leads to a stronger reduction in the economy's labor share than in the main experiment (around 0.4 p.p. instead of 0.3 p.p.), closer to what is observed in the data. This is because the degree to which public firms, which are more capital-intensive, expand relative to private firms is larger than in the main experiment, due to s_H increasing and s_L staying constant.

In sum, [Figure 6](#) shows that the new economic mechanism we put forward in this paper has a meaningful economic impact also in a substantially different experiment. Quantitatively, the differential effect on bank-dependent relative to publicly funded firms is even stronger in the alternative experiment inspired by SBTC. Our model can generate rising income inequality in various ways, but the heterogeneity in how savings by low- and high-income households are channeled to different firms remains a central element that connects income inequality with firm job creation.

7 Conclusion

This paper proposes a novel channel that links income inequality and job creation through firms' financing conditions. Exploiting variation across US states and an IV strategy, we provide empirical evidence for the channel. Higher top income shares reduce job creation at bank-dependent firms, relative to other firms. Quantitative model experiments suggest that the rise in the top 10% income share over the past decades increased the employment share of large firms, decreased the labor share, and lowered aggregate output. The non-homotheticity in the allocation of savings amplifies the welfare effects of redistributive policies. Our insights shed new light on the long-standing debate on the connection between inequality and economic outcomes. They can help to design policies addressing growing income disparities.

Data availability statement

The data and code underlying this article are available on Zenodo at <https://doi.org/10.5281/zenodo.18611450>.

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