

# Factor Incomes in Global Value Chains: The Role of Intangibles

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## Abstract

Recent studies document a decline in the share of labour and a simultaneous increase in the share of residual ('factorless') income in national GDP. We argue the need for study of factor incomes in cross-border production to complement country studies. We define a GVC production function that tracks the value added in each stage of production in any country-industry. We define a new residual as the difference between the value of the final good and the payments to all tangibles (capital and labour) in any stage. We focus on GVCs of manufactured goods and find the residual to be large. We interpret it as income for intangibles that are (mostly) not covered in current national accounts statistics. We document decreasing labour and increasing capital income shares over the period 2000-14. This is mainly due to increasing income for intangible assets, in particular in GVCs of durable goods. We provide evidence that suggests that the 2000s should be seen as an exceptional period in the global economy during which multinational firms benefitted from reduced labour costs through offshoring, while capitalising on existing firm-specific intangibles, such as brand names, at little marginal cost.

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## 1. Introduction

The long-run decline in the income share of labour in GDP since the 1980s is one of the most debated macro-economic trends in recent years. Various studies have documented that the trend is widely shared across industries and countries. While it has been particularly strong in the US, it has also been observed for other advanced countries, and perhaps surprisingly, also for various emerging and poor countries.<sup>1</sup> Recent research zooms in on potential drivers. Barkai (2017) and Karabarbounis and Neiman (2018) document a large increase in so-called ‘factorless income’ in the US: a residual that remains after subtracting payments to labour and cost of capital from GDP. Karabarbounis and Neiman (2018) argue that it can be alternatively interpreted as economic profits, arising from firms’ pricing power; as income that accrues to forms of capital that are unmeasured in current national accounts statistics or as a wedge between imputed rental rates for assets and the rate that firms perceive when making the investment. They argue that it is likely a combination of the three, concluding that the latter is most promising in explaining long-term trends in U.S. GDP income shares.

So far, the discussion on factor incomes is around shares in GDP of single countries. This paper argues the need for a multi-country approach in better understanding the drivers of increasing ‘factorless income’. In today’s world, goods are typically produced and distributed in intricate networks with multiple stages of production and extensive shipping of intermediate goods, services and information. We refer to this as *global value chain* (GVC) production.<sup>2</sup> So-called ‘factory-free goods producers’ like Apple provide an iconic example: they sell and organise the production of manufacturing goods without being engaged in the actual fabrication process (Bernard and Fort, 2015; Fontagné and Harrison, 2017). They capture a major part of the value as compensation for provision of software and designs, market knowledge, intellectual property, systems integration and cost management, as well as a strong brand name. These assets are key in the coordination of the GVC and in the creation of value. Yet, we have no way to directly infer the income that accrues to these ‘intangibles’ due to their non-physical nature such that their use cannot be attributed to a geographically location. In contrast, tangible assets (such as machinery) and labour have a physical presence and their use is recorded in the national account statistics of the countries where they are

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<sup>1</sup> See Elsby, Hobijn and Şahin, 2013; Karabarbounis and Neiman, 2014; Rognlie 2015; Barkai 2016 and Dao et al., 2017

<sup>2</sup> See UNECE (2015) for examples of various types of global production arrangements.

located. A further complication is the fact that GVC production opens up the possibility for profit-shifting of multinational enterprises across countries.<sup>3</sup> More generally, increased cross-border sharing of intangibles is undermining the very notion of country-level factor incomes and GDP. This problem of income attribution is not new and has been discussed in the context of the system of national accounts for quite some time. The twenty-six percent jump in Irish GDP in 2015 brought this ‘statistical problem’ also to public light and scrutiny.<sup>4</sup> Guvenen et al. (2017) find that US multinationals have increasingly shifted income from intellectual property rights to foreign jurisdictions with lower taxes, suggesting an understatement of the labour share decline in U.S. GDP.

The presence of GVC production suggests that there is a need to complement conventional factor income studies (at the country-industry level) by study of global value chains (that cross borders). Factor income analysis in GVCs will not be affected by the attribution problem, and offers a unique opportunity to track the payments to intangible assets. This paper is the first to provide such a study at the macro-economic level.<sup>5</sup> To fix ideas, consider a firm selling shoes using local labour  $L$  and tangible capital  $K$ . This requires two activities: fabrication and marketing. Both activities require firm-specific knowledge  $B$  (e.g. market intelligence on consumers’ preferences for particular types of shoes). Next suppose the fabrication stage is offshored to country 2. In this case the (vertically integrated) production function is:  $Y=F(K_1, L_1, K_2, L_2, B)$ . To infer payments to  $B$ , we calculate residual profits in the chain as the sales of a good minus the payments to tangible factor inputs needed in any stage of production:

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<sup>3</sup> Through profit shifting, including transfer pricing and other tax strategies, transnational companies can allocate the largest share of their profits to subsidiaries (Dischinger et al., 2014). A firm might not be fully free to do so, as it is bound by cost-pricing rules. Yet, in practice profit shifting is abundant, involving complex IP arrangements, and this practice is not restricted to affiliated firms only, see Neubig and Wunsch-Vincent (2017). Tørsløv, Wier, and Zucman (2018) estimate that close to forty percent of multinational profits are shifted to tax havens globally each year.

<sup>4</sup> See <https://www.reuters.com/article/uk-ireland-economy/irish-2015-gdp-growth-raised-to-26-percent-on-asset-reclassification-idUKKCN0ZS0ZC>. UNECE (2015) and Landefeld (2015) report on the discussions in (inter)national statistical organizations.

<sup>5</sup> Studying factor incomes in GVCs has a much longer history in case study research going back at least to Gereffi (1994), see Kaplinsky (2000) for an overview. Studies in that tradition are typically more qualitative and analyse how interactions between buyers and sellers in the chain are governed and coordinated. In a seminal case study, Dedrick et al. (2010) apply the residual income approach to the value of an Apple iPod, using technical ‘teardown’ reports to trace inputs. They find that Apple retains up to half of the iPod value.

$$rB = pY - \sum_n w_n L_n - \sum_n r_n K_n,$$

with  $w_n$  the wage rate and  $r_n$  the rental rate of tangible capital used in country  $n$ .  $pY$  is the output value of the final good.  $rB$  is measured as the residual after subtracting the sum of payments to labour  $L$  and to tangibles  $K$  across all countries involved in production. We will refer to this residual as payment for intangible assets in the GVC.

It should be noted that, given the residual approach, we measure the combined income to all intangible assets used in a chain and do not attempt to measure the stock of intangibles and their rates of return separately. In seminal work, Corrado et al. (2005, 2009) showed how stock estimates for certain types of intangibles that are currently not treated as investment in the national accounts (such as market research, advertising, training and organisational capital) could be derived. This requires data on intangibles' investments as well as additional information on their depreciation rates and asset prices. Corrado et al. (2013) provide updated analysis, expanding measurement to a large set of countries. Yet, the industry detail currently provided is too aggregate for our purposes. At this stage we therefore remain agnostic about the type of intangibles, their separate stocks and returns. This is left for future research. Our main aim is to establish the overall importance of payments to intangibles compared to tangible assets and labour.

The rest of the paper is organised as follows. In section 2 we outline our GVC accounting methodology. The main measurement challenge is the fact that GVCs are not directly observable in the data and need to be inferred from information on the linkages between the various stages of production. We will build upon the approach to measuring value added in global production networks as introduced by Los et al. (2015). They showed how one can derive the value added contributions of country-industries in a given GVC. This allows for a decomposition of the ex-factory value of a final product into the value added in each stage of production. We use information from so-called global input-output tables that contain (value) data on intermediate products that flow across industries as well as across countries. These are published in the World Input-Output Database (WIOD, see Timmer et al., 2015). This is combined with information on factor incomes in each stage as discussed in section 3. We collected additional information from national accounts statistics on industry-level wages and investment in tangible assets in a wide set

of countries. We built capital stocks using the perpetual inventory method and imputed the income payments to tangible capital by multiplying with a standard Hall-Jorgenson type of rental rate. Crucially, we use an ex-ante rate of return such that a residual remains.

Throughout the paper we will study factor income distribution in the global production of manufacturing goods. Worldwide consumption of manufactured goods (at purchasers' prices) makes up about a quarter of world GDP (in 2000). This includes value that is added in manufacturing industries as well as non-manufacturing, such as in transport, communication, finance and other business services, and also raw materials production. These indirect contributions will be explicitly accounted for by using information on input-output linkages across sectors. Section 4 provides main results on trends in factor incomes in GVCs over the period 2000 to 2014 (the begin and end points of the analysis are dictated by data availability in the WIOD 2016 release). Our main finding is that the share of intangibles in the value of final goods has increased, in particular in the period 2000-07. Its share is generally (much) higher than the tangible capital income share. This is found at the aggregate as well as for more detailed manufacturing product groups. Nevertheless, there is clear heterogeneity in the pace of the increase. For some non-durable products such as textiles or food the intangible share in GVCs increased only marginally. In contrast the share increased rapidly in durable goods' GVCs such as of machinery and electronic equipment products. We provide suggestive evidence that this variation is linked to variation in the speed of international production fragmentation. Taking the results together, one could consider the 2000s as an exceptional period in which global manufacturing firms benefitted from reduced labour costs through offshoring, while capitalising on existing firm-specific intangibles, such as brand names, at little marginal cost. Section 5 provides a discussion of the robustness of the main results, concluding that the current system of national accounts is likely to still miss out on a large range of intangible assets, confirming Corrado et al. (2005). Section 6 offers concluding remarks. The measurement framework puts high demand on the data and our results should thus be seen as indicative only. This study is explorative and mainly aimed at stimulating further thinking about the interrelatedness of factor incomes across industries and countries.

## 2. Accounting for factor incomes in global value chains: method

In this section we outline our empirical method to slice up incomes in global value chains (GVCs). The basic aim is to decompose the value of a final good into worldwide factor incomes. By representing the global economy in an input-output account in the tradition of Leontief, we can use his famous insight to map consumption value of products to value added in industries.<sup>6</sup> We first outline our basic accounting framework and intuition (section 2.1). Next, we outline how we trace value added in production stages of the GVC building upon the method of Los et al. (2015) (section 2.2). We extend this approach by including the distribution stage (section 2.3). This stage is ignored in all previous input-output based studies. Yet, by overlooking distribution one might miss out on up to half of incomes generated in GVCs. This is particularly the case for non-durable goods where retailers capture a major part of the value in delivery from producer to consumer, as shown in section 4. This way we are also much more likely to fully capture intangible income in the production of goods, particularly in the case of factory-less goods producers (FGPs). In the current U.S. statistical system FGPs might be classified in wholesaling, and their output is recorded as a wholesale margin, rather than as manufacturing sales. See also contributions in Fontagné and Harrison (2017) on this topic.

### 2.1 Preliminary notation and intuition

We illustrate our empirical approach in Figure 1. We distinguish three sets of activities in a global value chain. These are activities in:

- the distribution of the final product from factory to consumer ( $D$ ). This includes transportation, warehousing and retailing activities.
- the final stage of factory production ( $F$ ). This can be thought of as a low-value added activity such as assembly, packaging or testing, but might also involve high value-added activities such as placing an engine in a car body.

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<sup>6</sup> This approach of mapping final demand to value added is also used in related settings by Johnson and Noguera (2012), Valentinyi and Herrendorf (2008), and Herrendorf, Rogerson and Valentinyi (2013). It should be noted that this type of analysis does not depend, nor presumes, that the production process is linear (“chain”). It is equally valid in any network configuration that can be described by individual stages of production that are linked through trade. To stick with commonly used terms, we refer to all fragmented production processes as “chains”, despite the linear connotation of this term.

- all other stages of production (*O*). This might include the manufacturing of parts and components as well as business services (e.g. legal advice, finance or consulting) and raw material production (e.g. mining and agriculture).

The sum of value added across the production stages makes up the value of the product at basic (ex factory) prices. When one adds the value added in the distribution stage plus (net) taxes paid by the final consumer, one arrives at the value of a final product at purchasers' prices (see first pillar in Figure 1). Subsequently we decompose the value added in each stage into income payments to labour, tangible and intangible assets (second pillar in Figure 1). Income to labour and tangible assets can be tracked in the data, and we define income to intangible assets residually.

**Figure 1 Decomposition of factor incomes in global value chains**

<i>Value at purchaser's price</i>	DISTRIBUTION stage (D)	Taxes	Taxes
		Value added	Intan Cap
			Tan Cap
Labour			
<i>Value at basic price</i>	FINAL STAGE of production (F)	Value added	Intan Cap
			Tan Cap
			Labour
	OTHER STAGES of production (O)	Value added	Intan Cap
			Tan Cap
			Labour
0			

The three activity sets (*D*, *F* and *O*) are mutually exclusive and together cover all activities that contribute to the value of the final product. More formally, let *p* be the consumer (purchaser's) price of a good (adjusted for net product taxes), *Y* the quantity consumed and *V<sub>x</sub>* value added in stage *x* then we can state the following accounting identity:

$$(1) \quad pY \equiv V_D + V_F + V_O.$$

In each activity factor inputs are being used and we will distinguish between labour ( $L$ ), tangible capital ( $K$ ) and intangible capital ( $B$ ) inputs. Using this notation, we can write the production function of the final good as:

$$(2) \quad Y = f(B_D, K_D, L_D; \quad B_F, K_F, L_F; \quad B_O, K_O, L_O)$$

DISTRIBUTION    FINAL STAGE    OTHER STAGES

The corresponding cost equation is given by multiplying the factor quantities with their respective prices:

$$(3) \quad pY = \sum_{x \in F, O, D} (r_x^B B_x) + \sum_{x \in F, O, D} (r_x^K K_x) + \sum_{x \in F, O, D} (w_x L_x)$$

INTAN CAPITAL                      TAN CAPITAL                      LABOUR

with  $w$  the wage rate and  $r$  the rental price for capital. This is our basic decomposition of the output value of a final product into three elements: the income to intangible capital, to tangible capital and to labour. Some of these variables are observable in the data, while others need to be imputed. In brief,  $V_x$ ,  $w_x L_x$  and  $K_x$  can be observed for each stage,  $r_x^K$  will be imputed based on an ex-ante rate of return, and  $r_x^B B_x$  will be derived residually in each stage as  $V_x - r_x^K K_x - w_x L_x$  (see section 3 for more explanation). Our main variable of interest will be the income share of intangibles in the GVC:

$$(4) \quad \frac{\sum_{x \in F, O, D} (r_x^B B_x)}{pY}$$

to be compared with similarly derived shares for tangible capital and labour. The three shares add to one by construction.

## 2.2 Factor incomes in production stages

Stages in GVCs can be inferred from information on the linkages between the various stages of production. A GVC is defined for a country-industry where the final stage of production is taking place, e.g. the GVC of cars finalised in the German transport equipment manufacturing industry. We use information from so-called global input-output tables that contain (value) data on



intermediate products that flow across industries as well as across countries. An example is the delivery of inputs from the steel industry in China to the automobile industry in Japan. More formally, our decomposition method builds upon the approach outlined in Los, Timmer and de Vries (2015). It is a multi-country extension of the method suggested by Leontief (1936).

Leontief started from the fundamental input-output identity which states that all products produced must be either consumed or used as intermediate input in production. This is written as  $\mathbf{q}=\mathbf{A}\mathbf{q}+\mathbf{c}$ , in which  $\mathbf{q}$  denotes a vector of industry-level gross outputs and  $\mathbf{c}$  is a vector with final consumption levels for the outputs of each of the industries. Both vectors contain  $SN$  elements, in which  $N$  stands for the number of countries and  $S$  for the number of industries in each country.  $\mathbf{A}$  denotes the  $SN \times SN$  matrix with input coefficients which describe how much intermediates are needed from any country-industry to produce a unit of output. The identity can be rewritten as  $\mathbf{q}=(\mathbf{I}-\mathbf{A})^{-1}\mathbf{c}$ , in which  $\mathbf{I}$  represents an identity matrix. The matrix  $(\mathbf{I}-\mathbf{A})^{-1}$  is famously known as the Leontief inverse. It can be used to derive output that is generated in all stages of the production process of one unit of a specific final product. To see this, let  $\mathbf{z}$  be an  $SN$  column vector with a one for the element representing say iPhones assembled in China, and all other elements are zero. Then  $\mathbf{A}\mathbf{z}$  is the vector of intermediate inputs, both Chinese and foreign, that are assembled, such as the hard-disk drive, battery and processors. But these intermediates need to be produced as well and  $\mathbf{A}^2\mathbf{z}$  indicates the intermediate inputs needed to produce  $\mathbf{A}\mathbf{z}$ . This continues until the mining and drilling of basic materials such as metal ore, sand and oil required to start the production process. Summing up across all stages, one derives the gross output levels for all  $SN$  country-industries generated in the production of iPods by  $(\mathbf{I}-\mathbf{A})^{-1}\mathbf{z}$ , since the summation over all rounds converges to this expression.<sup>7</sup>

To find the value added by a particular factor, for example labour, we additionally need wages paid per unit of output represented in an  $SN \times SN$  diagonal matrix  $\mathbf{H}$ . The elements in this matrix are country- and industry-specific: one element contains the wages paid per dollar of output in the Chinese electronics industry, for example. To find the income of all labour that is directly and

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<sup>7</sup> This is under empirically mild conditions. See Miller and Blair (2009) for a good starting point on input-output analysis.

indirectly involved in the production of a  $\mathbf{z}$ , we multiply  $\mathbf{H}$  by the total gross output value in all stages of production given above such that

$$(5) \quad \mathbf{L} = \mathbf{H}(\mathbf{I} - \mathbf{A})^{-1} \mathbf{z}.$$

A typical element in the  $SN$  vector  $\mathbf{L}$  indicates the wages of labour employed in country  $i$  and industry  $j$  in the production of  $\mathbf{z}$ . A similar procedure can be followed to find the incomes of tangible and intangible capital with a suitable chosen requirement matrix (see next section on data). Following the logic of Leontief's insight, the sum over incomes by all factors in all countries that are involved in the production of this good will equal the output value of that product at basic prices. Thus we have measures for production stages F and O in decomposition equation (3).

### ***2.3 Factor incomes in the distribution stage***

The Leontief method can be applied to decompose value added in various stages of *production*. It remains silent on the value added in *distribution* of the final product to the consumer however. This is due to the nature of the data used: the distribution sector is represented in input-output tables as a so-called margin industry. This means that the goods bought by the distribution sectors (to be resold) are not treated as intermediate inputs. The gross output of the distribution sector is measured in terms of the 'margin', that is the value of goods sold minus the acquisition value of those goods. Accordingly, we define the value added in the distribution stage by a margin to sales ratio ( $m$ ), such that:

$$(6) \quad V_D \equiv m(pY).$$

We use the factor shares in the wholesale and retailing industries to derive the factor requirements in the distribution stage.

### 3. Data sources

For our empirical analysis we use three types of data: world input-output tables, information on distribution margins and data on factor incomes of industries. The input-output tables and data on labour compensation and value added are derived from the World Input-Output Database (WIOD), 2016 release and have been extensively described in Timmer et al. (2015). Important to note here is that the WIOD contains data on 56 industries (of which 19 are manufacturing) in 43 countries and a rest of the world region such that all value added in GVCs is accounted for. In this section we provide more information on two new pieces of empirical information that are needed additionally: the income shares of tangible (and intangible) capital and data on distribution margins.

#### *Capital income shares at the country-industry level*

Gross value added ( $V$ ) and labour compensation ( $wL$ ) can be derived from national accounts statistics (with appropriate adjustment for the income of self-employed) and this information is taken from the WIOD. As in Karabarbounis and Neiman (2018) we impute the income to tangible assets and derive intangible income as the residual for each industry  $i$  as :

$$(7) \quad r_i^B B_i \equiv VA_i - w_i L_i - r_i^K K_i .$$

Tangible asset income for industry  $i$  is derived through multiplying tangible capital stock  $K_i$  with an (ex-ante) rental price  $r_i^K$ . According to neo-classical theory, the rental price (user cost) of capital consist of four elements: depreciation, capital taxes (net of subsidies), (expected) capital gains and a (net) nominal rate of return (Hall and Jorgenson, 1967). For want for data we abstain from capital taxes in our empirical analysis. The rental price is then given by

$$(8) \quad r_i^K = (\delta_i^K + \rho_i^K) p_i^I$$

with depreciation rate  $\delta_i^K$ , the real (net) rate of return  $\rho_i^K$  and tangible investment price  $p_i^I$ . The rate of return is ex-ante such that a residual remains in (7) which is the income for intangible capital. The rate of return reflects the opportunity cost of capital in the market. We set it to 4 per cent for all tangible assets, following long standing practice (at least before the financial crisis in 2007). We show in additional robustness analysis that using time-varying rates based on

government bond yields, or other alternative, instead will have no significant impact on our main results (reported upon in section 5).

Our definition of tangible capital assets follows the tangible asset boundary in the System of National Accounts (SNA) 2008, including buildings, machinery, transport equipment, information technology assets, communication technology assets, and other tangible assets. Country-industry tangible asset stocks are derived from the EU KLEMS database December 2016 release (Jäger, 2016) for Australia, Japan and the United States and twelve major European countries (Austria, Czech Republic, Denmark, Finland, France, Germany, Italy, the Netherlands, Slovenia, Spain, Sweden and the United Kingdom). For the other countries we only have stocks by industry, but not by asset type. These countries are mostly reporting under the rules of SNA93 which means that the industry-level asset stocks may include some intangible assets, most notably software. They typically constitute a small share though, as most countries still reporting in SNA93 are poor. Geometric depreciation rates for detailed asset types are taken from EU KLEMS. These rates take into account the differences in the composition of capital assets both across countries, industries as well as over time. We carefully distinguish between various data environments across countries. The appendix in Chen et al. (2017) provides elaborate discussion on a country-by-country basis.

#### *Value added in distribution stage*

To measure the value that is added in the distribution stage, we need to have information on the margin to sales ratios for final manufacturing goods ( $m$ ). We derive this from the ratio of output valued at basic and at purchaser's prices. The purchaser's price consists of the basic price plus trade and transport margins in the handling of the product and any (net) product taxes. Put otherwise, the margin is the difference between the price paid by the consumer and the price received by the producer. Margins are calculated from information on final expenditures at purchaser's and basic prices as given in national supply and use tables. This data can be found for most countries in the WIOD (under the heading of national SUTs). For China, Japan and the U.S. only data at producer prices is given in WIOD however. We complemented this with data from detailed retail and wholesale sector censuses. We adjust purchaser's prices for (net) taxes on the products as these are paid for by the consumer to the government and do not constitute payment for factor inputs in any stage of production.

#### 4. Main results

In this section we will present our main findings on the factor income shares in global value chains of manufactured goods. As background it is useful to note that consumption of manufactured goods (at purchasers' prices) makes up about 27.9 per cent of world GDP (in 2000, derived from the WIOD). This high number might be surprising given that gross value added in the manufacturing sectors, aggregated across all countries in the world, is only 18.4 per cent of world GDP. This is because consumption value of manufactured goods also includes value added from primary goods and services sectors (including distribution).<sup>8</sup> We will map the consumption value of final manufactured goods into income generated for labour and capital in all countries that contributed to production and distribution of these goods. We will do this for nineteen detailed manufacturing product groups and also present aggregate results.

The production processes of goods have been fragmenting across borders with major impetuses from the NAFTA agreement in the early 1990s, and China's accession to the WTO in 2001. Previous work on manufactured goods, reported on in Timmer et al. (2014), found that the share of labour income in final output was declining over the period from 1995 to 2007. Surprisingly, this was the case not only in those stages carried out in advanced countries, but also in stages carried out in less advanced regions. The former was expected, given that offshored stages are typically labour-intensive, but the latter finding was not. This highlighted the increased importance of capital in production, as its income share increased in virtually all GVCs. Timmer et al. (2014) hypothesised that this was related to the increased importance of intangibles. With our new data we are in the position to test this hypothesis, distinguishing between tangible and intangible incomes. We can also investigate trends in the period after 2007.

##### *Finding 1: Declining share of labour income in GVCs*

The GVC decomposition results, aggregated across all manufacturing goods, are given in Table 1. It shows the income shares for labour, tangible and intangible capital as defined in equation (4).

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<sup>8</sup> And not all manufacturing value added ends up in final manufacturing goods (e.g. when used in production of final services). See Herrendorf et al. (2013) for results from a similar exercise mapping consumption to sectoral value added for the U.S. economy.

Figure 2 charts the cumulative changes in factor income shares with the year 2000 as base. We find a strongly increasing capital share, and a concomitantly declining trend in the share of labour. The labour share dropped from 56.4 per cent in 2000 to 51.8 per cent in 2007. This resonates well with previous findings (Timmer et al., 2014).<sup>9</sup> It stabilized afterwards: in 2014 the share was 51.2 per cent. We conclude that the declining trend in labour share did not continue after 2007, but also did not reverse. This is suggesting that the decline was not a temporary phase in some kind of business cycle pattern.

**Table 1 Factor income shares in GVCs of manufacturing goods (%-share).**

	<i>Labour</i>		<i>Tangible capital</i>		<i>Intangible capital</i>	
	Share (%)	Change	Share (%)	Change	Share (%)	Change
2000	56.4		15.8		27.8	
2001	56.2	-0.2	16.1	0.3	27.7	-0.1
2002	55.1	-1.1	16.2	0.1	28.7	1.0
2003	54.6	-0.5	16.3	0.1	29.1	0.4
2004	53.5	-1.1	16.3	0.0	30.2	1.1
2005	52.7	-0.8	16.2	-0.1	31.2	1.0
2006	52.1	-0.6	16.1	-0.1	31.8	0.6
2007	51.8	-0.3	16.3	0.2	31.9	0.1
2008	51.8	0.0	16.8	0.5	31.4	-0.5
2009	52.2	0.4	17.6	0.8	30.2	-1.2
2010	50.5	-1.7	17.8	0.2	31.7	1.5
2011	50.6	0.1	17.6	-0.2	31.8	0.1
2012	51.0	0.4	17.7	0.1	31.3	-0.5
2013	51.1	0.1	17.8	0.1	31.1	-0.2
2014	51.2	0.1	18.1	0.3	30.7	-0.4

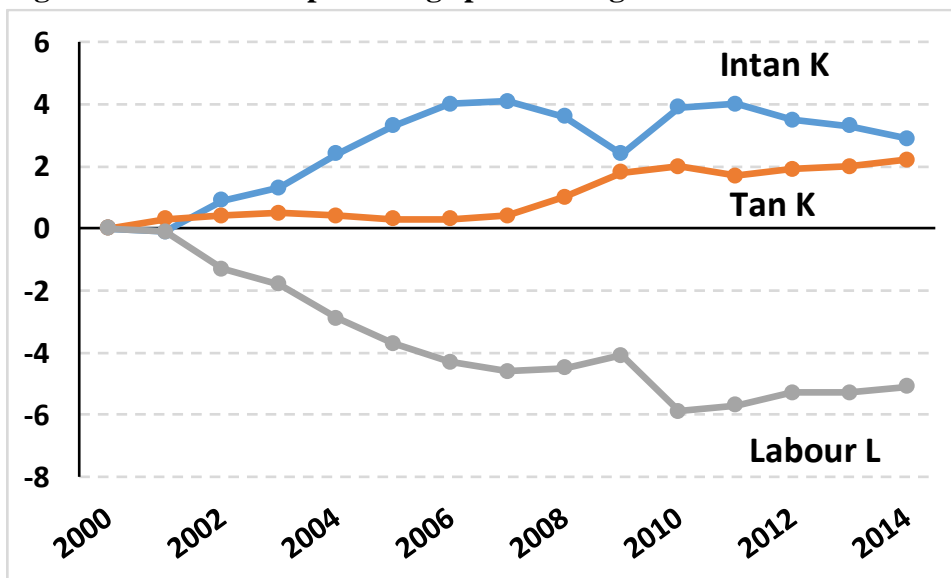
*Notes:* Share of factor income in worldwide output of final manufacturing products valued at purchaser's prices, before product tax (in percentages). Labour income includes all costs of employing labour, including self-employed income. Tangible capital income includes gross returns to tangible assets based on a 4 per cent real (net) rate of return. Intangible capital income is calculated as a residual (gross value added minus labour and tangible capital income). Own calculations based on the WIOD 2016, extended with data on tangible capital stocks and distribution margins as described section 3.

<sup>9</sup> The 2014 study used a previous version of the WIOD (the 2013 release) and did not include distribution activities but only production stages (F and O), that is, it decomposed output at basic prices. Our extension to output at purchaser's prices did not appear to have a major impact on factor income distribution.

*Finding 2: Increasing share of intangible income share up to 2007, but not after.*

A novel finding of this study is that the increasing share of capital after 2000 is mainly due to increasing incomes to intangibles. The income share of tangible capital grew only slowly, from 15.8 per cent in 2000 to 16.3 per cent in 2007. The low volatility of the tangible share is partly by virtue of its measurement: it is based on a stock estimate multiplied by an ex-ante rental rate and both variables move only slowly over time. The decline in the labour share was thus mainly mirrored by an increase in the intangible share, which is measured as a residual after subtracting labour and tangible capital incomes. Its share jumped from 27.8 per cent in 2000 to 31.9 per cent in 2007. This increase was not sustained however, and even reversed in 2011, declining to 30.7 per cent in 2014.

**Figure 2: Cumulative percentage point change in factor income shares (2000 base)**



Note: see Table 1.

*Finding 3: Income share of intangible assets in GVCs is (much) higher than of tangible assets*

Another interesting, and perhaps most surprising finding is the high income share of intangibles relative to tangible assets. For all manufacturing goods combined, intangible income was 27.8 per cent of final output value in 2000 relative to only 15.8 per cent for tangible assets, so about 1.8

times as high (Table 1).<sup>10</sup> The ratio reached a peak in 2007 at 2.0 and gradually declined again to 1.7 in 2014. Similarly high ratios are found for more detailed product groups. In Table 2 we provide an overview of the factor income shares in 2014 for twelve major manufacturing product groups.

**Table 2 Factor income shares in GVCs (%-share), major product groups, 2014**

Final product group name	ISIC rev. 4 code	Labour share	Tangible capital share	Intangible capital share	Ratio of intangible to tangible
Petroleum products	19	37.9	20.0	42.1	2.1
Chemical products	20	44.9	17.5	37.5	2.1
Pharmaceuticals	21	48.8	16.5	34.7	2.1
Food products	10t12	52.6	16.4	31.0	1.9
Furniture and other	31t32	53.7	16.3	30.1	1.8
Textiles and apparel	13t15	52.4	17.7	29.9	1.7
Electronic products	26	50.0	18.6	31.3	1.7
Motor vehicles	29	51.3	19.0	29.7	1.6
Electrical equipment	27	50.6	20.0	29.5	1.5
Non-elec. machinery	28	53.9	18.8	27.2	1.4
Other transport equipment	30	55.2	18.5	26.3	1.4
Fabricated metal products	25	55.2	20.8	24.0	1.2
All manufacturing products		51.2	18.1	30.7	1.7

*Notes:* See Table 1. Twelve major manufacturing product groups, ranked by ratio of intangible to tangible income share (last column).

Factor income shares are informative on the factor intensity of production. Traditionally, products are classified as labour or capital intensive depending on the factor intensity of production in the parent industry. With production fragmentation this classification is less straightforward as factor intensities of all contributing industries need to be considered. The intangible income share is shown to be more than double the tangible share for pharmaceuticals, chemical products and oil

<sup>10</sup> In related research Karabarounis and Neiman (2018) find what they call the “factorless” income share to be 15 per cent of value added in the 2000s in the US private business sector. This is the share that is not attributable to labour or measured capital stocks, using the asset boundary of the SNA 2008 (thus including IPP). Factorless income is found to be larger than measured capital income. In a different exercise, Bhandari and McGrattan (2018) also find a high ratio of intangible to total assets: their estimate of what they call “sweat equity” (firm-specific intangibles) is close to the estimate of marketable fixed assets used in production by private businesses.



refining products (see last column in Table 2). The high ratio for petroleum products is likely related to the importance of brand names, tightly controlled distribution systems and restricted resource access generating supra-normal profits that end up in our residual intangible measure. Pharmaceuticals are known to be highly R&D and patent intensive which is reflected in the high intangible to tangible income ratio. Perhaps more surprising is the finding that the ratio is also high for textiles and wearing apparel and ‘other’ manufacturing products, which includes amongst others furniture and toys. These products are mainly produced in extensive international supply networks and value added generation relies on chain orchestration, as well as strong marketing and branding of the products. The ratio between intangible and tangible incomes is lower, but still well above one, for electrical equipment (not including electronics), non-electrical machinery and other transport equipment. Their production is characterised by large tangible investments with high minimum efficient scales. The ratio is lowest for metal industries that are characterised by heavy reliance on tangible assets in the form of large-scale smelters and metal processing plants. The ranking of product groups is rather stable of time (not shown).

What type of intangible assets might be responsible for the large income share found in GVCs? One might suspect that intellectual property plays a major role. In the 2008 System of National Accounts (SNA08), investment in *intellectual property products* (IPP) is tracked. This includes computer software and databases, research and development, mineral exploration and artistic originals. Thus we can carry-out a simple back-of-the-envelope exercise to impute the income accruing to IPP, using information on IPP capital stocks (from national accounts statistics, as reported in EU KLEMS) and proxy the rental price by the IPP depreciation rate (taken as 30 per cent) plus a real (net) rate of return of 4 percent, as we did for tangible assets.<sup>11</sup> Doing so, we find that the income share to IPP in manufacturing GVCs would amount to 2.4 per cent in 2000, hovering between 2.2 and 2.7 per cent during the period 2000-14. It thus can explain only a minor part of the intangible income share that stood at 27.8 per cent in 2000. We conclude that there must be a major set of intangible assets that is still outside the asset boundary currently covered in the SNA08. This reinforces the findings of Corrado et al. (2005, 2009, 2013). They provide estimates for market research, advertising, training and organisational capital that are currently not treated

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<sup>11</sup> Not all countries have implemented the SNA08 however (most notably China, India and Japan), so we are not able to carry out a full exercise, but it seems plausible that the majority of IPP is in Europe and the US.

as investment in the national accounts. Yet, the industry detail currently provided is too aggregate to be used for analysis of GVCs of manufacturing products. “Aggregate manufacturing” is the lowest level of industry detail for which data is given.<sup>12</sup> This is a fruitful avenue for future research.

*Finding 4: Increase in intangible income is driven by international production fragmentation*

In Table 3 we provide an overview of the changes in intangible income shares for twelve manufacturing product groups. They are ranked according to the change over the 2000-14 period. There is clear heterogeneity. For some products such as pharmaceuticals, textiles and food the intangible share barely increased over the whole period 2000-14. An initial increase up to 2008 was almost nullified in the period after. In contrast the share increased over 2000-14 by 4.0 per cent or more in electrical machinery, chemicals, vehicles, metal products and non-electrical machinery. For some of these product groups, the intangible income shares increased strongly until 2008, followed by a moderate decline afterwards. Yet, the share continued to increase in the production of chemicals, and barely declined in production of vehicles.

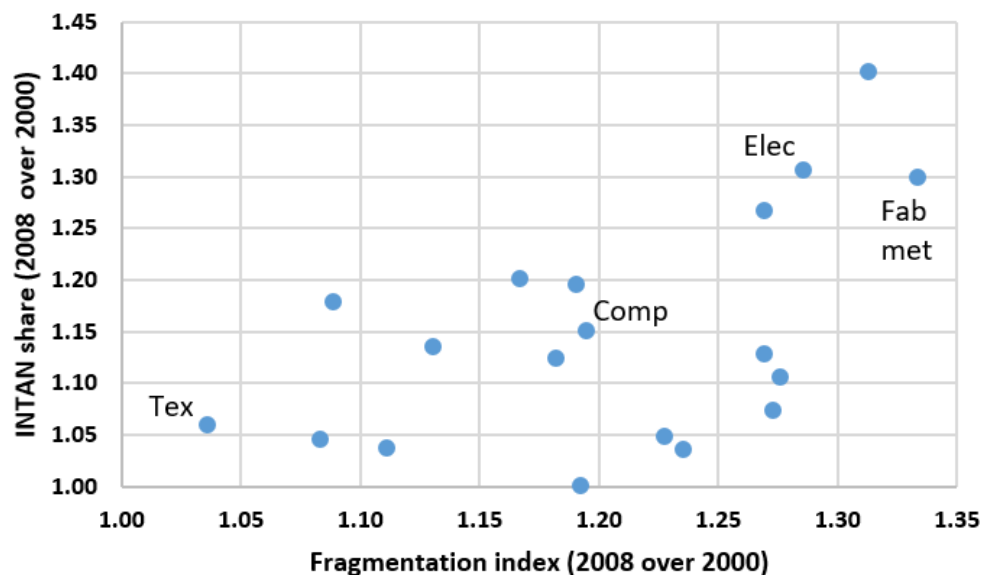
**Table 3 Income shares for intangible capital in global value chains ( per cent of final output).**

Final product group name	ISIC rev. 4 code	2000	2007	2014	Change 2000-07	Change 2007-14	Change 2000-14
Elec. machinery	27	24.3	31.6	29.5	7.3	-2.1	5.1
Chemicals	20	32.4	36.5	37.5	4.1	1.0	5.1
Vehicles	29	24.8	29.9	29.7	5.1	-0.2	5.0
Metal products	25	19.3	25.6	24.0	6.3	-1.6	4.7
Non-elec. mach.	28	23.3	30.1	27.2	6.8	-2.8	4.0
Electronics	26	28.2	33.8	31.3	5.6	-2.4	3.2
Other transport eq.	30	23.4	29.4	26.3	6.0	-3.1	2.9
Furn. and other	31t32	28.0	30.5	30.1	2.5	-0.4	2.1
Oil products	19	40.5	47.0	42.1	6.5	-4.9	1.6
Food	10t12	29.8	31.1	31.0	1.3	-0.1	1.2
Textiles	13t15	28.7	31.1	29.9	2.4	-1.2	1.2
Pharmaceuticals	21	34.8	37.7	34.7	3.0	-3.1	-0.1
All products		27.8	31.9	30.7	4.1	-1.2	2.9

*Notes:* Share of intangibles in the final output value of manufacturing products (%). Product groups ranked by change during 2000-14 (last column).

<sup>12</sup> See <http://www.intaninvest.net/> for a database covering a large set of countries.

**Figure 3 Intangible income shares and international production fragmentation**



*Notes:* Fragmentation index from Timmer et al. (2016) based on all imports made along the production chain (2008 as ratio of 2000 level). Intangible income share in 2008 as ratio of level in 2000. Observations for nineteen manufacturing product groups. Observations for textiles (tex), electrical machinery (elec) electronics and computers (comp) and fabricated metal products (fab met) are indicated.

The variation in intangible income shares across products invites further investigation into possible drivers. One possible hypothesis centres around the speed of international production fragmentation. The period from the mid-1990s until 2008 is characterised by a strong process of fragmentation across borders, speeded up by the opening up of China and its joining the WTO in 2001. Yet, the impact varied across product groups (Timmer et al., 2016). International fragmentation was for example high in the production of electronics (including computers), electrical machinery and metal products in the 2000s. But production of textiles and furniture was already quite fragmented before 2000. Other products are arguably less susceptible to international fragmentation trends, such as food manufacturing (which has strong domestic supply links for intermediate inputs) and pharmaceuticals manufacturing. To test this hypothesis more formally, we combine our estimates of intangible income shares with information on international fragmentation of production processes. Timmer et al. (2016) provide a new measure that tracks all imports that are made along the production chain and argue that this is a good indicator for international production fragmentation. In Figure 3 we plot the change in this indicator for our 19 manufacturing product groups against the change in the share of intangible income in those GVCs from Table 3 for the period 2000-08. We find that there is a clear positive correlation (0.52), which

fits our conjecture. Yet, unexplained variation is still high, and further investigation into the drivers of intangible income shares is warranted.

*Finding 5 Increasing importance of intangibles in upstream production stages.*

So far, we reported on income for factors aggregated over all stages, and remained agnostic about the division across stages. Yet, our methodology allows one to also to track in which stage of the GVC the returns to intangibles are recorded, using a straightforward disaggregation of equation (4) by stage: distribution stage, final stage of production and other upstream stages of production. Results are reported in Table 4. We find that in 2014 about one quarter of the intangibles income is accounted for in the distribution stage. One quarter is accounted for in the final production stage and about half in other upstream production stages. There is a clear shift away of intangible income recorded in the final production stage (minus 4.2 %-points over the period 2000-2014), to the other production stages (plus 5.5 %-points). This shift mainly occurred before the crisis of 2008. This finding is consistent with a story of offshoring of final production stages (such as assembly, testing and packaging) from advanced to low-wage economies such that the incomes in this stage decline rapidly compared to the other stages that remained.

Interestingly, the aggregate trend is not shared across all product groups which might be related to the type of governance in the chain. Gereffi (1999) proposes a distinction between what he refers to as buyer-driven and producer-driven GVCs. GVCs are governed by so-called ‘lead firms’ that have a large share of control over the activities that take place in the chain. The lead firm in a buyer-driven chain is typically a large retail chain or a branded merchandiser and often has little or no goods production capacity. The lead firm in a producer-driven chain is a manufacturer that derives bargaining power from superior technological and production know-how.<sup>13</sup> We find that for buyer-driven GVCs like textiles, furniture, toys and other manufacturing the returns to intangibles are mostly realised in the distribution stage, up to 50 per cent (see Table 4). In contrast, in producer-driven GVCs like vehicles, fabricated metal and other transport equipment, intangible

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<sup>13</sup> Most GVCs are governed in complex ways and combine elements of both governance modes. Governance modes are not necessarily product-group specific. An electronic gadget can be produced in a chain driven by an international retailer, e.g. in the case of a generic not-branded product, or in a producer driven chain, e.g. in the case of a high-end branded product.

returns are mostly realised in the upstream production stages (up to 60 per cent). All products share the trend of a declining share of the final production stage in intangible income, with the notable exception of vehicles production.

**Table 4 Share of stages in intangible capital income (in %).**

Final product group name	Code	Distribution stage			Final production stage			Other (upstream) production stages		
		2000	2014	change	2000	2014	change	2000	2014	change
Furn. and oth.	31t32	48.3	50.0	1.7	23.1	18.8	-4.3	28.7	31.3	2.6
Textiles	13t15	44.1	50.6	6.5	21.6	14.9	-6.7	34.3	34.5	0.2
Food	10t12	30.6	29.8	-0.8	36.9	30.1	-6.7	32.5	40.1	7.6
Chemicals	20	25.8	23.5	-2.2	35.7	35.9	0.3	38.6	40.5	2.0
Non-el mach.	28	25.2	23.6	-1.6	26.3	24.4	-1.9	48.5	52.0	3.5
Metal	25	23.2	17.4	-5.7	20.7	20.4	-0.3	56.1	62.1	6.0
Vehicles	29	22.7	16.3	-6.5	26.4	29.3	2.9	50.9	54.4	3.5
Pharma	21	22.1	19.9	-2.1	48.6	46.1	-2.5	29.3	34.0	4.7
Elec. mach.	27	19.7	23.3	3.6	28.1	21.8	-6.3	52.2	54.9	2.7
Oth. trans.	30	17.7	15.2	-2.6	30.5	24.8	-5.7	51.7	60.0	8.3
Electronics	26	17.6	20.7	3.0	38.6	34.9	-3.6	43.8	44.4	0.6
Oil	19	16.8	12.7	-4.1	26.0	20.9	-5.2	57.2	66.5	9.3
All products		28.3	27.0	-1.3	30.8	26.6	-4.2	40.9	46.4	5.5

*Notes:* Intangible capital income in each stage of GVC, as share in total income for intangibles across all stages, see Table 1 for sources.

#### 4.2 Interpretation

So far, we have interpreted the residual income share in GVCs of goods as payments to intangible assets. Other interpretations are possible. For example, Barkai (2017) suggests that the increase in the residual in US GDP is related to a decline in competition.<sup>14</sup> On our view, competition and the build-up of intangible assets are interrelated. More specifically, we prefer to think of the global market for manufacturing goods in the following way. Final goods are supplied by large firms that

<sup>14</sup> Karabarbounis and Neiman (2018) contend that the residual, which they dub ‘factorless income’, also contains a possible wedge between imputed rental rates for assets and the rate that firms perceive when making the investment. In the robustness section that follows, we show that this wedge needs to be extremely large in order to explain away the residual.

organise production in vertically integrated processes spanning across borders. The market structure for final goods is monopolistic competition: each firm supplies a differentiated good and is able to charge a price higher than average costs.<sup>15</sup> A firm derives monopoly power from investment in intangible assets that are specific to the firm. Conceptually, they differ from other factor inputs because, by and large, companies cannot freely order or hire them in markets. Instead, these assets are produced, and used, in-house: they are not reported in balance sheets and not tracked as investment in national accounts statistics. Viewed this way, intangible capital is the firm-specific “yeast” that creates value from hired labour and purchased assets. The residual that remains can thus be interpreted as income to own-account intangibles.

The ‘yeast’ perspective on residual income has old antecedents harking back at least to Prescott and Visscher (1980). See Cummins (2005) for further analysis on firm-level data. It is also related to the concept of sweat equity, defined as the time that business owners spend in building up firm-specific intangibles, see Bhandari and McGrattan (2018) for recent work. They emphasize the importance of organizational capital that is typically build at own-account and not (adequately) picked up as investment in national account statistics. In the Appendix we show through a capitalization-of-intangibles exercise as in Corrado et al. (2005) that residual income in a GVC is equal to the income for own-account intangibles when (part of the) workers are assumed to build-up firm-specific capital. Under a ‘steady-state’ assumption such that the creation of intangibles in each period is equal to depreciation, the intangible income is shown to be a *net* measure. So in terms of disposable incomes (Bridgman 2017, Rognlie 2015), intangible earnings might be even larger relative to tangible earnings as the latter is inclusive of depreciation. Yet, this is only under the steady-state assumption which cannot be verified through direct observation.

Taking our findings together, we argue that the 2000s was a unique period in the global economy where supra-normal returns to tangibles were (temporarily) captured, based on firm-specific intangible assets that went largely unrecorded in national account statistics. Our results support a

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<sup>15</sup> Romalis (2004) provides a many-country version of a Heckscher-Ohlin model with a continuum of (final) goods, produced under monopolistic competition and with transport costs. Mark ups might of course also be the result of a natural monopoly or government regulation. This situation is less likely to be relevant for manufacturing goods that are heavily traded worldwide (with the exception of petroleum products).

story in which global manufacturing firms benefitted from increased opportunities for offshoring. Changes in the global economic environment in the early 2000s, in particular China's ascension to the WTO, and developments in ICT made it profitable to develop extensive global production and distribution networks. Multinational firms built-up firm-specific coordination systems, benefitting from increased opportunities for offshoring of labour-intensive activities to low-wage locations. The income accruing to labour in the GVC declined due to wage cost savings. This matches our finding that incomes in final production stages (such as assembly, testing and packaging) declined rapidly compared to upstream production stages. If the production requirements (and prices) for tangible capital remain unaltered, the share of intangibles must go up by virtue of its definition as a residual.<sup>16</sup> In addition, the growth in purchasing power in the global economy (such as growing consumer demand in China) might have benefitted incumbent multinational firms that were able to capitalise on existing intangibles such as brand names and distribution systems at little marginal costs. Apparently, this process was interrupted by the financial crisis in 2007, likely related to subsequent heightened uncertainty on future global demand.

## **5. Discussion of robustness of main findings**

How robust are our main findings presented in section 4? Gross value added and the income payments to labour are recorded in the national accounts. The payments to tangible assets are imputed based on asset stocks and a rental price that includes a chosen rate of return. The higher this rate is set, the higher the tangible income will be and the lower the intangible income which is measured residually. Setting the real (net) rate of return to tangible assets is not straightforward: from theory it depends on the opportunity cost of capital in the market as well as the expected inflation. It was set at 4 per cent in our analysis so far, but alternative choices can be defended as well.

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<sup>16</sup> This is true only under the assumption that factor substitution possibilities between labour and capital are limited. See Reijnders et al. (2016) for an econometric analysis of factor substitution and technical change in global value chains. They find wage elasticities to be well below one.

To have an idea about the sensitivity of results, one might ask what rate of return to *tangibles* would exhaust all non-labour income such that no residual remains. The physical capital to output ratio is about 1.3 (that is value of the tangible asset stock relative to final output) in 2000. It follows that the real (net) rate of return to physical capital needs to be as high as 25 per cent to exhaust final output, clearly well outside the boundary of plausible rates. For example, Barkai (2017, Fig 1) shows that debt costs in the U.S., set to the yield on Moody's Aaa bond portfolio, declined from about 7 per cent in 2000 to 5 per cent in 2014. He calculated expected capital inflation as a three-year moving average of realized capital inflation, and found it to oscillate around 2 per cent. This suggests a small, but steady, decline in the real rate of return from 5 per cent to 3 per cent over our period of analysis (2000-14). Rognlie (2015) took the 10-year Treasury bond yield, subtracting the lagged 5-year rate of change of the GDP deflator as a proxy for inflation expectations. This real rate was about 4 per cent in 2000, gradually declining to just above 0 per cent in 2014. These alternative estimates are relatively close to our chosen 4 per cent, so our findings on relative levels of tangibles and intangibles incomes appear robust. Moreover, the findings of a *declining* rate of return over the period considered suggests that, if anything, we are *underestimating* the importance of intangibles in later years. For example, using a 0 per cent real rate of return instead of 4 per cent would indicate that in 2014 the tangible income share is only about 12 percent, and the intangible share more than 36 per cent: a ratio of 3 rather than barely 2 as we reported. These results suggest that using plausible time-varying instead of a constant real (net) rate of return to tangible assets is strengthening our conclusions on the increased importance of intangibles in manufacturing GVCs.

Yet, one might argue that we nevertheless overestimate intangible incomes as we are using gross value added statistics that are measured according to the 2008 system of national accounts (SNA08). Gross value added is defined in the SNA as the value of output less the value of intermediate consumption. In the SNA08 expenditures on intellectual property products (IPP) is treated as capital formation, not intermediate consumption.<sup>17</sup> This increases the value added but not the *tangible* capital stock. Thus if we take value added statistics recorded in SNA08, gross value added might be overestimated for our purposes, and so will be our intangible income measure

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<sup>17</sup> IPP covers R&D, computer software and databases, mineral exploration and entertainment and artistic originals. See Koh et al. (2016) for more information on treatment of IPP by the U.S. BEA.



through its residual nature.<sup>18</sup> To have an upper limit estimation of the bias, we assume that all IPP is bought in the market and recorded at cost.<sup>19</sup> Costs of IPP can be proxied by multiplying IPP stocks with the sum of the IPP depreciation rate (taken as 30 per cent) plus a real (net) rate of return of 4 percent (as we did before). Doing so, we find that value added (and hence intangible income) in the GVC is overestimated within a range of 2.2 to 2.7 per cent during the period 2000-14. This shows that our main results on the relative levels and growth rates of intangible income are robust to this data issue.

A potentially more serious issue is the asset boundary of tangible capital. We follow the convention of the SNA08 and include fixed assets (such as machinery, equipment and buildings), but not land and inventories. Yet, both land and inventories tie up capital and their use entails an opportunity cost. Estimating stocks of inventory and of land is fraught with difficulties however. The SNA tracks changes in inventories, but not necessarily their value. Land is even more problematic as land improvement expenditures do fall within the SNA asset boundary, in particular when they are tied with (improved) buildings or infrastructure. The US Bureau of Labor Statistics tries to take into account these assets when constructing their multi-factor productivity statistics along the lines of Jorgenson (1995). They find for the manufacturing sector that capital compensation for inventories and land adds about a quarter to the income of the tangible assets covered in the SNA. This can go up to 65 per cent in retail and even 100 per cent in the wholesaling sector, due to the important role of inventories in these sectors.<sup>20</sup> Yet, these numbers are based on calculations that use an *ex-post* rate of return which exhaust value added, rather than an *ex-ante* rate as required. As such, the reported incomes contain also all income by assets that are not covered in the analysis. Corrado et al. (2005) argued forcefully that many intangibles are still outside the SNA asset boundary, echoed in our finding of a large residual income. In that case, the *ex-post* rate of return will be overestimated and likewise the rental price of land and inventories, the more so because

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<sup>18</sup> For countries that still publish national accounts according to SNA93 these imputations will be only small, including an imputation for own-account software at best. More discussion of this overestimation can be found in Chen et al. (2017).

<sup>19</sup> This is clearly an extreme assumption as a major part of IPP is own-account and not purchased. In the US, the share of purchased is about two-third and own-account is about one-third, while half-half in the U.K. (from additional info in national account statistics).

<sup>20</sup> The data is taken from *Bureau of Labor Statistics*, Office of Productivity and Technology, Division of Major Sector Productivity, published on line March 21, 2018 at <http://www.bls.gov/mfp/>.

their depreciation rates are zero by nature. We conclude that the capital compensation numbers for income to land and inventories as in the BLS statistics are not suitable for our purposes. It does highlight however, that more information on these asset types, in particular on their stocks, is desirable.

A particular caveat is needed for our findings on intangible incomes in each stage (finding 5). For a proper interpretation of the results, one should realise that what is measured here is the stage where the intangible income is recorded. This does not necessarily imply that the income is also captured by the firms that operate in that stage. For example, compare a situation in which Apple charges the iPhone assembler for its intellectual property with a situation in which it does not. The ex-factory price of the iPhone would be higher in the former case and the measured return to the intangibles consequently lower in the distribution stage. But the measured return to intangibles would be higher in one of the earlier stages of production as it would include a payment for use of Apple's intangibles. The division of intangible incomes across stages is thus sensitive to accounting practices by lead firms, as discussed in the introduction. Results that are based on aggregating across all stages (which underlie findings 1 to 4) are not sensitive to these shifts.

As a final remark, it should be clear that the validity of all the findings relies heavily on the quality of the database used. Data can, and needs, to be improved in many dimensions. For example, the WIOD is a prototype database developed mainly to provide a proof-of-concept, and it is up to the statistical community to bring international input-output tables into the realm of official statistics. For example, one currently has to rely on the assumption that all firms in a country-industry have a similar production structure, because firm-level data matching national input-output tables are largely lacking. If different types of firms, in particular exporters and non-exporters have different production technologies and input sourcing structures (i.e. exporters import larger shares of inputs), more detailed data might reveal an (unknown) bias in the results presented here.<sup>21</sup> From the perspective of measuring intangibles' returns, one of the biggest challenge is in the concept and measurement of trade in services (Houseman and Mandel, 2015). Fortunately, there are important developments in the international statistical community. Recently, the UNUCE

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<sup>21</sup> The development work done by the OECD is certainly a step in the right direction, see <http://oe.cd/tiva> for more information.

published its *Guide to Measuring Global Production* (UNUCE 2014). Building on this are new initiatives, most notably the initiative towards a *System of Extended International and Global Accounts* (SEIGA). In the short run this would involve mixing existing establishment and enterprise data (in extended supply and use tables) as well as expanding survey information on value-added chains and firm characteristics. In the longer term this would entail common business registers across countries, increased data reconciliation and linking as well as new data collections on value-chains beyond counterparty transactions (Landefeld, 2015).

## **6. Concluding remarks**

Recent studies document a decline in the share of labour and a simultaneous increase in the share of residual ('factorless') income in national GDP. We argue that study of factor incomes in global value chains (GVCs) is needed to better understand this residual. This is the first paper to do so. We show how to measure income of all tangible factor inputs (capital and labour) in a GVC. We define intangible capital income residually by subtracting the payments for tangible factors (capital and labour) from the value of the final product. Importantly, these factors are identified in all stages of production (final and upstream stages) as well as in the distribution stage. This is important as a large share of value might be added in the delivery of the good to the final consumer, rather than in the production stages.

We focus on GVCs of manufactured goods and find a declining labour income share over the period 2000-14, and a concomitantly increase in the capital income share. Our main finding is that this increase in capital income in GVCs is mostly due to the increase in income for intangible rather than tangible assets. This is found at the aggregate as well as for more detailed manufacturing product groups. Yet we also find clear heterogeneity: for some non-durable products the intangible share increased only slightly, contracting later on. In contrast the share increased rapidly in durable goods (such as machinery and equipment products). We provide suggestive evidence that this variation is positively linked to variation in the speed of international production fragmentation. Taken together, our results suggests that the 2000s should be seen as an

exceptional period in the global economy during which multinational firms benefitted from reduced labour costs through offshoring, while capitalising on existing firm-specific intangibles, such as brand names, at little marginal cost.

We discussed robustness of these results to issues like missing information on land and inventories, value added imputations for some intangibles in the SNA08, and choice for (ex-ante) rate of return to tangible assets. We argued that the level of intangible income might be *overestimated*, but the trend over time is likely to be *underestimated*, if anything. In any case, there is a robust large residual income in GVCs that cannot be attributed to tangible assets, nor to the wider asset class considered in the SNA08 (which includes intellectual property products). We reinforce the claim made by Corrado et al. (2005) that national account statistics are missing out on a sizeable set of intangible assets. Our conjecture is that most of these are own-account. To bring this hypothesis to the data, one would need information on investment in assets that are (or can be) purchased in the market, to be distinguished from ‘own account’ investment that is firm specific. Unfortunately, investment statistics from the national accounts typically do not separate own-account and market-mediated investment flows, although company balance sheet might provide information. (Peters and Taylor, 2017). Hopefully this type of information will be systematically collected and separately reported in future national account statistics. We also emphasized that the measurement framework puts high demand on the data and our results should thus be seen as indicative, rather than definitive.

The main aim of this study was to stimulate further thinking about the interrelatedness of factor incomes across industries and countries. We showed that it mattered in an accounting sense, as the use of intangibles is blurring attribution of incomes to particular geographical locations and industries in national accounts statistics. In addition, it invites further investigation of the role of governance in global value chains. Gereffi (1994, 1999) highlighted the crucial role of multinational lead firms in the generation and division of value in the chain. In particular the importance of internationally operating retailers highlights the need to consider the distribution stage alongside production stages that are the traditional confines of empirical GVC studies based on input-output tables. Further research is also needed to identify various types of intangibles, their investment flows, prices and depreciation rates in macro-work following Corrado et al. (2005,

2009, 2013) as well as firm-level research, such as in Peters and Taylor (2017). At the minimum, we hope to have convinced the reader that a deeper understanding of global value chains is needed before our measurement systems will adequately capture the importance of intangibles, and their incomes, in today's global economy.

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## APPENDIX Linking ‘factorless’ income to intangible assets: an accounting model

In this appendix we will outline a simple accounting model that points to a straightforward interpretation of the factorless (residual) income measure in GVCs as reported upon in the main text. We will show how, under steady-state condition, this residual can be interpreted as net income payment to intangible assets. We analyse the case in which the intangible is produced by the firm for own account (that is, in house). To do so, we follow the capital accounting approach to intangibles as pioneered in Corrado et al. (2005).

To fix ideas, we use the example of a multinational firm that sells goods, but does not produce them. This firm imports a good, say shoes from an affiliate, and sells them (at a premium) under its brand name. The firm only employs marketing staff that work on branding. We model the production function of this firm as  $Y(L^B, S)$ , with  $Y$  sales of shoes,  $L^B$  number of workers and  $S$  imports of shoes. Let  $p$  denote prices, with superscripts indicating the output or input to which it refers.<sup>22</sup> Gross profit of the firm in the distribution stage,  $\pi^B$ , is then given by:

$$(A1) \quad \pi^B = p^Y Y - w^B L^B - p^S S$$

$\pi^B$  can be observed in the data, yet how should it be interpreted? The brand name is created with a view of generating profits over a longer time period and hence should be considered as a capital input as argued by Corrado et al. (2005). In their capitalization approach, the firm is using an intangible asset input, namely the intangible capital stock  $B$  (for “brand”). This stock is generated by the usual accumulation of investments:

$$(A2) \quad B_{t+1} = (1 - \delta^B)B_t + I_t^B,$$

where  $\delta^B$  its depreciation rate and  $I_t^B$  the investment flow. The firm is producing the brand using its own workers (producing for own account in the jargon of the *System of National Accounts*). Viewed this way, nominal output of the firm should now also include the value of the assets

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<sup>22</sup> We only use the time subscript in cases where its omission might generate confusion. Otherwise it will be suppressed for expositional simplicity.

created, namely  $p^B I^B$  with  $p^B$  the investment price. Factor input costs go up as well: by  $r^B B$  with  $r^B$  its user cost, as the brand stock is used. As in the main text, we simplify and write the user cost as

$$(A3) \quad r^B = (\rho^B + \delta^B) p^B,$$

where  $\rho^B$  is the (net) real rate of return to intangible capital. This rate is pinned down by the requirement that the sum of all factor incomes exhausts output, as we now have included all factors of production. Put otherwise,  $\rho^B$  is determined using an *ex-post* endogenous rate of return such that

$$(A4) \quad p^Y Y + p^B I^B = w^B L^B + r^B B + p^S S.$$

It is obvious, but important, to see that the measured returns to intangibles depend crucially on the price the firm is paying for the imported shoes. Suppose the shoes are produced by an affiliated firm, opening up the possibility for profit shifting. In that case, returns to intangibles cannot be identified by studying the last stage only. The solution is to consider the profits in the two stages together.

To see this, we also model the fabrication stage (F) of shoes. Assume shoes are fabricated with labor ( $L^F$ ) and tangible capital ( $K^F$ ), say machines. We can then write:

$$(A5) \quad \pi^F = p^S S - w^F L^F - r^F K^F,$$

where  $\pi^F$  is the residual profit measure after subtracting cost of tangible inputs from gross output in the fabrication stage. The particular division of the profits in the selling and fabrication stages will depend on the price of the shoes which is an endogenous variable to be set by the lead firm for accounting purposes. However, the overall profit in the chain,  $(\pi^R + \pi^F)$  is independent of this choice. It equals sales minus cost of tangible inputs in the integrated production process. Combining (A5) and (A1) we derive

$$(A6) \quad (\pi^B + \pi^F) = p^Y Y - (w^B L^B + w^F L^F) - r^F K^F.$$

(A6) shows how  $(\pi^B + \pi^F)$  can be measured in the data. The method to do so is outlined in the main text. How can we interpret it? Using (A4) and (A5), we have:

$$(A7) \quad (\pi^B + \pi^F) = r^B B - p^B I^B.$$

The left-hand side is observable in the data, but none of the right-hand side variables are. In practice many alternative combinations of  $r^B$ ,  $B$ ,  $p^B$  and  $I^B$  are possible that satisfy the accounting restrictions set by the observable data. To simplify, let us consider two extreme cases. First, suppose a start-up firm produced the intangible, but is not producing and selling shoes yet. In that case  $w^B L^B = p^B I^B$  and  $r^B B = 0$ . Alternatively, when the firm stops to produce its intangible, but continues selling, it can be said to “exhaust” its brand name. In that case  $(\pi^B + \pi^F) = r^B B$  as  $p^B I^B = 0$ . An intermediate situation is when the firm is in a steady-state such that in each period depreciation of the intangible is equal to new investment:

$$(A8) \quad \delta^B p^B B = p^B I^B.$$

Substituting (A8) in (A7), and using (A3) we find that in this case

$$(A9) \quad (\pi^B + \pi^F) = \rho^B p^B B.$$

Under a steady-state assumption, the observable profit in the GVC is measuring the returns to intangible assets, net of depreciation. It is thus a net income measure.

A number of characteristics of this measure need to be noted. First,  $\rho^B$  is an *ex post* rate of return. It is calculated to exhaust output minus tangible costs, such that all value added is allocated to factors of production. This *ex post* rate contains a ‘normal’ rate of return to capital,  $\bar{\rho}$ , which is the opportunity cost of the invested capital. This rate is by definition similar to the rate for tangible capital assets. Any returns above this can be referred to as ‘supra-normal’ such that the rate of return for intangibles can be split into normal returns and supra-normal returns:  $\rho^B = (\rho^B - \bar{\rho}) +$

$\bar{\rho}$  . There are many reasons why the rate of return to intangibles might be different from the rate of return to tangible capital. Beyond the standard business risk, it may include additional compensation for its unusual risk-profile (Hansen et al., 2005). Second, for simplicity we abstained from tax and capital gain considerations in the discussion above, as in our empirical work reported on in the main text. This is not to say that they are unimportant, but simply unknown and further work is needed in this direction. Third, equation (A9) shows that intangible income measured by  $(\pi^B + \pi^F)$  can increase because of an increase in its rate of return  $\rho^B$ , or because an increase in the nominal stock,  $p^B B$ . Without quantifying the stock, we are not able to distinguish between the two. More generally, the firm might not be in a “steady state”, driving a wedge between depreciation and new investment. This wedge will also be absorbed in  $(\pi^B + \pi^F)$ . Without further information on intangible depreciation, prices and quantities ( $\delta^B, I^B$  and  $p^B$ ) we will not be able to separate changes in stocks and in rates of return. Corrado et al. (2005, 2009, 2013) provide stock estimates for intangible assets that are currently not treated as investment in the national accounts. This is a fruitful avenue for future research .