Issues in Distributing National Income in the US

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Several studies have analyzed the distribution of national income in the US using individual income tax data, reaching different conclusions about both the extent of income inequality and how much it has changed over time. Even with the best of efforts, there are many challenges in measuring income at a point in time, and even more when trying to compare distributions over time. There are also issues about whether national income provides a good measure of economic welfare and what is needed to ensure that the different forms of business organizations and ways to pay for health care and other social services can be made comparable with other countries.

This paper and presentation will include:

• A discussion of the pros and cons of using of national income as an appropriate measure for measuring economic welfare and for making comparisons across countries. Some studies use personal income as the benchmark measure and a few attempt to measure a version of Haig-Simons income.

• Relative to many European countries, a much smaller share of business income is earned by C corporations in the US (and other Anglo countries). More businesses in the US are organized as S corporations and partnerships to avoid the potential double tax on distributions. In the US, they can get limited liability treatment generally limited to C corporations in other countries. This creates significant issues for international comparisons of income inequality estimates based on individual tax return data (as are the DINA estimates) because of uncertainties in allocating C corporation income to individuals. In addition, this helps explain why multi-nationals comprise a much larger share of the corporate sector in the US than in other countries.

• A discussion and data about how much tax is collected on pass-through businesses whose income is reported on individual tax returns and taxed at individual tax rates. Other countries are sometimes confused about why the US has such low corporate income taxes relative to GDP. The large share of US business activity in pass-through entities (partnerships, S corporations and sole proprietorship) with taxes imposed at the individual level are part of the reason for the seemingly low-income taxes.

• In addition to not including many components of national income, another limitation of using tax data is the incentive to misreport (generally underreport) income. The US has long conducted special detailed audit studies that theoretically examine all income and deductions on returns as well as look for other evidence of misreported income on information returns. The proposal includes providing some insights into what has been learned from these studies and some of their limitations, such as less success in discovering offshore income and some sophisticated tax evasion schemes. Realizing that these audits don't discover all missing income, the IRS adds an allowance for undiscovered income (about $2 additional for each $1 discovered on average).

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