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WEBINAR

TAXING BUSINESS INCOME: EVIDENCE FROM THE SURVEY OF CONSUMER FINANCES

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PROCEEDINGS

MR. SABELHAUS: Good afternoon, everyone. And welcome to this tax policy center event, taxing business income evidence from the survey of consumer finances. I am doing the honors of the opening remarks. Bill is having a little bit of trouble with his internet.

Bill is the co-director of the Tax Policy Center and pulled all this together. TPC is of course a joint venture of the Urban Institute and Brookings Institution. And studies a variety of aspects in tax policy and research. Bill asked that I pointed out the tax box which is the blog for TPC. I myself, I subscribe to it. It’s a wonderful thing to get your tax information from. And Bill encourages you to sign up.

And today’s focus is going to be on the taxation of business income. So a quick overview of what we’re going to be talking about if you start with an economic measure of income generated by a closely held business, the fraction that shows up on tax forms is small and falling over time. So we’re interested in some big picture questions.

Like how big is the gap between economic income and the income that’s reported on tax forms? Where in the income distribution is that divergence occurring? And what are the revenue implications of those differences? And the findings fall at the intersection of several issues. The distribution of income and wealth, tax fairness, business tax reform and tax evasion. So that’s mostly what I’m going to talk about when I pick up with the presentation in a few minutes. But first a couple of housekeeping issues and I want to introduce the other speakers for today.

So first of all, we want to thank the Peter G. Peterson Foundation for generous financial support. We literally could not have done this project without that support. They put a lot of faith in us when we came to them with the ideas a year ago. And I think it’s borne out.

We also really want to thank Megan Waring and the AV team at Brookings for pulling all this together and making it so our jobs are easy. It’s going to run smoothly. And they’ve been doing this for almost two years now. So I also want to point out after the presentation and then discussing comments, we’ll have a Q&A session and you can submit questions via email to events@brookings.edu and via Twitter with #TaxingIncome.

So the next thing on the agenda is speaker introductions. My name is John Sabelhaus. I
am currently a nonresident senior fellow at Brookings Institution in Washington, D.C. I had a long stint at the Congressional Budget Office where I studied social security and Medicare, built an integrated micro/macro model. Another long stint at the Federal Reserve Board where I worked in the division of Research and Statistics on the Survey of Consumer Finances. And obviously, that's where my interest in today's topic comes from and using the SCF to study taxes.

The first discussant is Janet Holtzblatt, a colleague of Bill's at the Tax Policy Center. She serves as a senior fellow at the Urban Institute. For many years, she was the assistant director for Individual Taxation Division at the U.S. Treasury Office of Tax Analysis. And she was the unit chief for Tax Policy Studies in the Tax Analysis division at the Congressional Budget Office.

Janet was the recipient of the 2020 Davie Davis Public Service Award bestowed annually by the National Tax Association. Even among tax experts, she is the go-to person on a wide variety of issues involving the tax treatment of family and workers, the marriage penalty tax administration evasion and tax simplification. She wrote a paper 25 years ago on tax implication and I can add to those comments with a lot of my interaction with Janet over the past few years has been about SCF and thinking about how to use SCF in the tax model and work at TPC.

Our second discussant is a former colleague of mine and an ongoing coauthor of mine on a number of projects. Alice Henriques Volz, she is a principal economist with the Federal Reserve Board. At the Board, Alice works in the macro survey section, which oversees the survey of consumer finances.

Her research interests generally focus on inequality and retirement. Alice also has the great distinction of having served as a research assistant at the Brookings Institution. So as Bill points out, you'll know what she says is right.

So with that's the end of Bill's remarks. So what I'm going to do is go ahead and jump into the presentation and then we'll just segue directly into Janet and after that we'll follow with Alice.

So I am going to start with a screen share, and let's get the right screen. And share. And it looks like I am good to go so let me go ahead and start with the presentation. I'm going to time myself and make sure I stay on time.

So the title for the presentation is taxing business incomes. Again, we want to thank Peterson for generous financial support. In addition to Bill as a coauthored, we have two wonderful
younger coauthors, Chris Pullaim and he’s been at Brookings for a few years and is headed off to grad school next year. Swati Joshi who joined us last year on this project and immediately became a pivotal, crucial part of pulling the data together.

So we start this project with two motivating questions. First is what is the share of closely held business and financial incomes that is effectively subject to the income tax? And as I pointed out, SY business incomes, it’s well known are only about half of what we see in the NIPA aggregates. And I guess the other way to think about why we’re doing this? Why we’re approaching this the way we are is that most tax research is done with just tax data.

Tax data alone, however, is incomplete. We really want something that’s more of an economic measure. Something that gets closer to what we think true income is because tax data already has baked in some of the things that we’re concerned about that are driving the wedge between taxable and economic income.

The second question is where in the income and wealth distribution is this missing business and financial income? So evasion and conceptual differences are already baked in to the tax data and the question is can we measure something that’s closer to a true concept of business income at the household level? And this is where our data at the survey consumer finances in.

There’s also another reason for thinking about the distribution or another aspect to the distributional concerns that we’re going to raise. Many low AGI taxpayers are actually very high wealth. This is sort of I think commonly known to some people, rich people, very wealthy have very little income and pay very little tax. So having a dataset, being able to do distributional analysis where we’re looking at something that’s about income, but we’re tabulating or distributing in a dataset, but also have very comprehensive measures of wealth is a great advantage.

So that leads us into the survey of consumer finances. The survey has comprehensive incomes of wealth. We’ll show you that the SCF business incomes are much closer to the national income and product account, the NIPA values than they are to the tax reported values, the statistics of income values and these differences seem mostly to be about business losses. It’s not other types of income. It’s really about whether or not there are losses. The gross values as we’ll show you tend to line up better.
There are two things you could do at the SCF, but as I mentioned I've had interaction with Janet and others at TPC over the years where they're trying to bring SCF wealth data into their existing really large scale TPC tax model. That's one approach. One thing you could do. One of the problems is that the SCF frame, right, the sample itself, the survey itself, is household. It's not tax units.

So most of the work that went into this grant that Peterson funded was about building a new tool. And that new tool which we just gave the name SCF Plus TAXSIM is a tax calculator which we have benchmarked against published SOI data. So you may or may not know of TAXSIM. Anybody in the survey data world has certainly heard of TAXSIM. It is the NBR model that you can use to apply to a survey dataset and it will calculate tax liabilities for you.

So the basic gist of this is trying to get the SCF in a position where it can be run through the TAXSIM calculator and generate results. So our goals, we have three goals for today's presentation.

The first is we're going to compare the aggregate taxable and economic income measures and reinforce this point about low and declining taxation of business and financial incomes. Secondly, what we're going to do is describe in very, very high-level detail the methods for building this SCF Plus TAXSIM tax model and how we calibrate it through published tax data. And then the third thing, we're going to do a thought experiment. We're going to simulate an alternative tax regimen and we're going to ask the question assuming that there is useful information in the SCF business incomes which we think there is.

How would taxes relevant to wealth change if we could tax those business incomes differently? So that will launch into the first part. How much business income is effectively taxed? What we're going to do is compare the published SOI tax values to aggregate economic measures. So the SOI very nicely provides many, many -- I would probably say at this point it's hundreds of Excel files with tabulate tax data and we chose a few series of these over time that have the incomes in the categories that we need.

For this exercise, we're collapsing these SOI categories down to a very highly aggregated and hopefully comparable closely held business that includes things like rental income as well category. We're also going to add in for the first part all other financial related financial incomes because in some ways some recent work with tax data showed us that the connection, the distinction between
different types of financial incomes is sometimes nebulous.

And then we're going to put the rest of the incomes that are taxable for tax purposes in an all other category. And what we're going to do is again, I mentioned we're going to connect -- consider the business-related incomes together because they are connected flows and then we'll look at business separately.

We're also going to adjust the flows for tax-based exclusions and rate preferences. And our basis for doing this, I'll show you when we get there, is to make it so that we can think about different types of income being treated equivalently. In particular, if we have a preference for business income, whatever the economic justification for that is, we can debate that separately. But what we're going to show you today is how that dollar of income would be treated if it were, for example, a dollar of wages. That's in order to again compare the economic measure to the tax measure.

So this first line makes the point about how much of this business and financial income is taxed or included in the tax base relative to our NIPA benchmark. And basically, the sum of published SOI closely held business, dividend and interest incomes is less than 50 percent of the NIPA equivalent and it's declining over time. Depending on what your reference point is you can think about how much it's declining.

But as you stare at this graph, we'll bring in another line and reinforce the second point that I made that the solid line in the chart now answers the question how would dollar business and financial income be treated if it were wages or some other normal income at any point in the income distribution? We're not trying to figure out marginal tax rates that are applied, the different types of income or anything like that. This is just the aggregate amount of income.

So, for example, if we exclude 50 percent of dividends from the tax base, which we did beginning of 2003 then the amount of financial income subject to tax falls by 50 percent of dividends. And thus, the solid green line is below the dotted green line which doesn't make that adjustment. There's also a very sharp drop in the end of our time period in 2018, that's the last year for which we have tax data and SCF data. And that's associated with the QBI, the Qualified Business Income deduction.

As I said, other types of income, we can lump all this together. Now, you have to move your attention over to the right axis. And what we see is that all other taxable incomes, this is wages,
social security, pensions, other things, unemployment insurance. It’s basically close to 90 percent of NIPA and declining modestly. And even that’s mostly in the last few years.

So what this shows us is that other types of income are much more effectively taxed under the income tax than business and financial incomes. So that’s our first main takeaway from this. Doing this careful reconciliation against the NIPA, trying to get the concepts lined up, all of this is in the paper. We see that the share of income, business and financial income, subject to tax is low and declining.

The second thing we want to talk about is the role of business losses. The usual focus of SOI versus NIPA is -- generally we think of it as compliance. Somehow, businesses are noncompliant in their reporting of revenues or perhaps cost or things like that. And that might be part of what’s driving this very large gap. And certainly, that’s true. There is some evidence based on compliance studies. And there’s a great ongoing debate regarding the distributional implications from these studies. But in aggregate, noncompliance seems to only be a part of the story. And how much of a story is something we’re trying to get our own heads around. But at one point, I think we were thinking numbers like 20 or 25 percent of the gap.

There’s something much bigger. There’s something bigger in this gap between SOI and NIPA. And one of the things that we wanted to look at because the SOI data allows us to do this is the role of positive and negative incomes within each of these business income types. So again, these downloadable SOI Excel files allow you to separate out the positive and negatives.

And we ask what can we learn from comparing these positive and negative components? And again, looking and looking ahead to the SCF when we go to compare the SCF to published SOI when we’re doing this benchmarking exercise with our new tax model, losses are a big part of this gap.

So this is the business only part of the line that I showed you before. And here the numbers are a little bit higher. Business income by itself is about 50 percent of what’s in the NIPA, but it’s still -- it’s more cyclical. And there’s a little bit less of a decline, but again except for the QBI at the end.

The red line here is the amount of losses that we see in the SOI divided by the net NIPA aggregate. We don’t have any concepts of losses and gross positives in the NIPA so we have to compare to the net. So obviously, this is apples to oranges but what jumps out at us is the fact that
business losses are so large relative to the net, 30 percent. There is a cyclical, you know, aspect. They’re apparently cyclical aspect associated with the financial crisis, but this is mostly the drop in NIPA business incomes. It’s not that there was a big surge in SOI business incomes.

And what we see is sort of a strong upper trend especially since 2000 in the relative magnitude of business losses. It’s become more and more prevalent in the tax data that businesses are offsetting the positives with negatives. And this comes through if we look at the gross business income lines.

So again, this is relative to the NIPA metric so it’s still apples to oranges, but what we see is the same -- we see something where there’s not as much of a trend and we see the same cyclical phenomenon. But it really draws our attention to business losses as something when we look ahead on our to-do list and think about things, we want to focus on trying to reconcile what’s happening in the NIPA versus SOI, the losses really does capture our attention.

There’s a section in the paper. I’m going to go through this pretty quickly because it gets in the weeds very fast, but I will refer you to the paper. The one thing that tax economists may look at and say, well, if you’re trying to compare NIPA data to SOI data. NIPA does not include capital gains. NIPA is payments to factors of production. Nothing I’ve showed you so far from the SOI has capital gains in it and in principle this is an important omission because these business losses and the capital gains are, in principle, related.

In particular losses often reflect the declining basis on an appreciating asset. You buy a building. You depreciate it. The losses on that building offset some other types of income. That’s the usual model we have in mind. And the accounting loss, however, will show back up in the tax base when that appreciating asset is sold.

And what it suggests is that you can have an alternative measure of how much income is captured by the tax system. You would want to add realized capital gains to the numerator and then some measure of accrued capital gains to the denominator.

So the realized gains, we could take this again from the same SOI tables. And the NIPA gains, it gets a lot more complicated. There’s two ways to do it. One could use the value of corporate profits from another NIPA table, not the personal income table, but the national income table. Or you can
use a direct measure of accrued gains in the Financial accounts of the United States, which I've used in several other projects.

I will say that the corporate profits which is what people in the DINA literature, the Distributional and National Accounts literature use. Is about one-fourth of the gains of the corporate profits that we see -- I'm sorry. The corporate profits are about one-fourth of what we see in the financial accounts. So clearly, there's a lot more happening in the financial accounts in terms of financial capital gains.

There's also issues about what time period to average over the recent gains if we're trying to capture this? What should be realized? What is being realized? The FA is almost certainly a better measure of gains, but it's also more volatile. So this is just a number of permutations, different ways of thinking about it. But none of them were reverse this low and declining share of business income being taxed phenomenon. That is something that seems to be pervasive.

So these sort of observations from the macro data, everything so far has been macro data or published tabulations of micro data from the IRS. Lead us to approach Peterson and say, we need to bring a new tool to bear to look at these questions. And this led us to develop the Survey of Consumer Finances Plus Tax and Tax Model.

So the question why would you spend a year building a new tax model? And again, going back to where we started, the conceptual and compliance differences are baked in to the tax data. You can't make inferences about the economic values just by looking at the tax data.

The second reason is that taxable income itself is a very poor classifier variable if we're trying to think about where is the missing income? You say, this business really had a $100 million or had a $1 million of income but that is added to someone who has a tax reported value of minus 100. Then basically, it's showing up in the wrong part of the distribution. We know that these are wealthy families. And just like any tax data doesn't allow us to capture that.

So there are pluses and minuses of using the SCF. Everyone who has worked with the data I think knows this. The main advantage is the over sampling of high wealth families. And the work I've done with Alice and others, I think we've showed that the SCF does capture trends in well concentration. It's useful for studying inequality very generally.
It can be argued that the main disadvantage is a small sample size and using respondent reports instead of tax data is introducing a new source of error and that’s almost certainly true. Recall can be a problem. But several studies by people who I work with at the board and others have showed very close correspondence between SCF and macroaggregates, trends over time and also a business cycle frequencies.

And indeed, the biggest difference that one sees is in the business incomes. So you want to say, well, that’s a respondent reporting error, but is it? And that’s the question that propels us forward. Is there new information in what business owners are telling us in this dataset relative to what we see in the tax data? That’s the premise for everything that we do from this point going forward.

So there are two papers actually linkable through today’s website. The first is a paper that does nothing more than construct -- that explains how we built this tax model. Again, probably 80 percent of the work for this project. The code is based on a SAS version from Kevin Moore at the Federal Reserve Board.

We rewrote and extended data. Everything is going to be available for download that was part of the grant, the funding from Peterson. We made it clear we wanted to make this available to the research community. A lot of the program is focused on splitting households into tax units. Again, that’s the fundamental problem, the SCF is the household survey, but taxes are filed on a tax year basis. So there are 120 million households, 160 million tax units and basically this paper explains how we do that.

The paper also talks about how we reconcile income concepts, create and compute income adjustments, itemized deductions, things like that. And the question is how can we judge whether or not we did a good job with this tax model? So what we’re going to show you is some of the benchmarks. There are more benchmarks in the paper. We’re going to look at the number of returns and incomes relative to published SOI. And I will say in advance that there are some known differences but especially the fact that one of the problems with the SCF is that the SCF it focuses its questions on the respondent and the spouse within the household.

There is some information collected about other members of the household for people who know the SCF well, there’s actually more information about people who are in what’s called the
nonprimary economic unit outside the family. And the one group for whom we have the least amount of information would be children of the respondent’s spouse who are living in the household. Those who would likely show up in the dependent filers.

So then, I’ll point out, these are the first few benchmarks. Basically, just showing that over time the SCF in the blue line is tracking the number of returns published by the SOI in the orange line pretty well, the numbers are actually getting even a little bit closer over time as we move from these are SCF years, 1995 through 2019. The SCF is every three years. So we're showing you these nine values and they're getting closer over time.

When we drill into the type of tax unit, the married filing jointly, separately, head of household and single. We see this point that I made before that most of the gap is in the single returns. And when we look at the counts of returns that are dependent versus nondependent filers that gap is basically what we're seeing in the single returns. The other categories line up quite well.

So a lot of this work again was going into working with the SCF demographics and lining up these datasets. When we look at the amount of income, the ratio of the SCF to SOI total income subject to tax. So we have to take out the forms of income that are not taxable in the SCF. Think about, you know, why are other forms of income work with the various concepts of the SCF to try and make them conceptually comparable.

This ratio varies between 110 and 120 percent. It’s reliably over this time. We’re always getting a little bit more income in the SCF. So this data program that does this then allows us to create the inputs that are fed into the latest version of TAXSIM, version 32, TAXSIM has been developed to maintain by Dan Feinberg for many, many years. I don't know whether he named it version 32 because it has 32 inputs, but that is the case.

And so, it’s very carefully constructed. For example, to do things like the QBI adjustment in recent years. And Dan actually helped us with a lot of that. I really want to give a shout out to him for helping us get some of these SCF concepts properly mapped into the TAXSIM concept.

So TAXSIM when you call the file from within or you call the program from within our stated code. It returns estimated federal income tax. I will say upfront, we traded emails with Dan up until the last minute as we worked on this. The TAXSIM and the SCF tax stated program were both a
work in progress, refinements were needed. Part of making these things publicly available is to help us do a better job.

But the main outcome, the main takeaway, is that -- and you're not going to be surprised, we have more income in the SCF. Therefore, when we run it through TAXSIM, we're going to get more estimated taxes. So this is the black line is again published tax amounts from SOI. The red line is our estimated tax amounts by creating this tax file, running it through TAXSIM.

The gap, however, the proportional gap is actually a little bit bigger and the reason is that the SCF, the extra income in the SCF is not spread equally. It's concentrated at the top of the taxable income distribution. And that shows up here when we do our first distributional comparison. The SCF has too many high-income returns and too few negative EGI returns.

So go back to what we think is happening with the SCF where we think that the business incomes that are being reported. We know that they're higher than what's in the SOI, much closer to the NIPA values. So we're going to see those business incomes are concentrated in the AGI class and a little more. So the SCF, we have 906,000 returns where the SOI only has 549,000, 68 percent higher.

We know we also have many fewer business losses. We don't have anywhere near the negatives that you do see in the SOI. And therefore, we have fewer -- many fewer returns in this AGI class of none which is basically those with losses. So when we look at income subject to tax, same story. Most that income is going to be concentrated above the $100,000 mark and especially the $1 million mark.

So how does this tie into what's happening with these aggregates? So I'm going to show you the same graph I showed you before which is the amount of income in the SCF in the red versus SOI. So the total is those top two lines. That's just a repeat of the chart from before. The bottom line is the gap in the business incomes. And what I want to draw your attention to is the fact that gap, the gap between the dotted red and the dotted black lines, is roughly the same as the gap between the solid red and the solid black lines.

So in other words, very shorthand way and with a lot of caveats most of the difference between the two datasets comes down to differences in business income. The business incomes are roughly twice what's in the SOI and the gap is roughly equal to the total gap. The SCF had many fewer
business losses than the SOI. It would be pulling them down. Both pulling down the aggregate amount of business income and it would be pulling them down through the distribution. So both of these issues are in play.

And one of the things I know from working with the SCF for many years is that very few respondents look at their tax returns during the survey. And so, we're asking a business owner, what did your business earn last year? And we have a very -- I've always had a very strong suspicion that they're telling us that is what their business really earned. It's not what their business earned after manufactured losses.

So this leads us to the last part of the presentation, which is the thought experiment, right? So the ability to manipulate these losses is probably concentrated among the wealthy, but what if we conservatively say, all taxable business income is half of what was respondents report. And this gives us these two columns to the right.

So this is what we'll call the 50 percent business income alternative. Same distributional table. This is the number of returns, but here we're just going to divide all business incomes in half. Assume that every business owner in the SCF reports twice what their accountant reports to the IRS. And we bring these distributions much closer into alignment.

When we look at the amount of income its even more so. And in fact, you can look at the 103 percent in that bottom right corner that says that the total amount of income under this 50 percent business reporting scenario is almost equal in 2018 to what we see in the published SOI. And this line shows us that if we run it through TAXSIM with this 50 percent business reduction, the dotted line now lies very close to the solid black line. The simulated taxes, the estimated taxes after reducing business incomes by 50 percent are very close to the aggregated amount, and it's very consistent over time.

This is not a one-off thing. It's not just picking one year that happened to work. That dotted line was close to the black line in almost every year.

So here's the thought experiment. Assuming that 50 percent business income approximate the SOI. It lines up reasonably well. We could fine tune it, but it comes much closer. We can then think of the unadjusted SCF as an alternative in which we tax all of business income. And then we can look at the impact on estimated taxes by wealth.
So again, the problems of income by AGI is endogenous to the income concept. Many high wealth business owners on the SOI side are going to have lower AGI. That's a less true in the SCF because high world business owners also have high incomes because we think they're actually telling us what their true incomes are. So what we're going to do classify the distributional results by wealth instead.

So what you're looking at here. The first two columns of this last table are just the number of households and the share of total wealth. And the only real main takeaway from this is in 2018 the households with $10 million or more in wealth, that's about one percent of households, had about 40 percent of the wealth.

So this is a standard wealth and equality statistic, top share statistic. It doesn’t include a lot of the adjustments that Alice and I and other folks have made to try and broaden these concepts. But in general, it's about 40 percent of wealth owned by the top one percent.

So what are the tax liabilities? The average taxes and the share of taxes in this 50 percent business income? What we think of is the baseline. So I think that closely approximates what's in the SOI? And the answer is average taxes for families -- this is families. We aggregate the TAXSIM back up to the family level. $287 thousand for those with $10 million or more and they account for 27.6 percent of all tax liability.

If we move to what business owners actually report in the SCF, the number is much higher, right? $367,000 and in the next category down between $5 million and $10 million there's also a significant jump and a big jump in the share of taxes paid. So I'm already over time, but let me just try and do real quickly answers to the motivating questions.

The NIPA versus the SOI analysis shows a role in decline share of business income that's effectively subject to tax. And one might say, okay. Tell me something I didn’t know. We already know that the rich pay less in taxes. This tells us something about how they pay less in taxes. But really, it's not that we're taking them at low rates, but really we're just not capturing their income when we compare it to a NIPA, right?

And some of the gap here is compliance, but some is likely conceptual as well. And the policies enacted over the past 20 years have really reenforced this trend.
We also think that the SCF has the potential to contribute greatly to our understanding of missing business incomes. The business income measure is probably closer to an economic concept and we can tabulate results by wealth. But much remains to be done. So, you know, I would say that expanding the tax analysis to include NIPA and SCF data is already promising, but the first thing I think on our long to-do list, the SOI versus the NIPA reconciliation still needs more work.

We need to understand -- do a better job understanding compliance versus conceptual differences. Factoring the capital gains which I went through quickly, needs more thought. And we really do need to continue developing this SCF Plus TAXSIM capability. And we hope that some of you out there will join us in this. That's why we're making the code available and think about how SCF compares to SOI across more detailed incomes.

One thing, for example, for those of you who have access to tax data. We'd be very interested in learning more about joint distributions of different types of income in the tax data. So if we see a business owner with wages being paid to themselves what does that say about the distribution of their business income?

With that I just want to flash up real quick the supporting materials. I am going to have to shut this down quickly, but if you take a quick look. There are two papers, both accessible through the website that you log onto. And in addition, we will be making the data code and the relevant Excel. We did a lot of work with those SOI Excel files. All of that available for download use. With that I'm going to say thanks and with apologizes for running over. Stop sharing. And, Janet, take it away.

MS. HOLTZBLATT: Okay. Do we see and hear me? Okay. So bear with me because I always screw this up.

So the authors ask some very important questions with very important policy implications. How much revenue are we losing because we don't tax all business income? And who is benefiting? And as I would them, the authors, they take a very clever approach to this question. They look at the difference between the income reported and tax returns and economic income as explicitly reported in NIPA. And as perhaps implicitly reported in the SCF.

There's another question raised by the study that's important to tax and data nerds like me, which is tax data versus other data. I come from the tradition that administrative data like tax data is
superior to household data, household survey data. And often the comparison is how reliable is the household survey data at reporting income relative to tax data?

By them taking an alternative approach motivated in part by their interest in economic income. But a lot of my comments today will be going back and forth on this dichotomy between tax data and household survey data.

So again, to summarize, two big questions in their study. How much business income is not taxed in the United States? And the answer is the same roughly where the authors are comparing the SOI tax data to NIPA at the macro level or to the SCF at the micro level. About half of business income is not taxed and the untaxed business income is distributed disproportionately to the most wealthy households which is consistent with what we know about the ownership of privately held businesses in the United States.

The follow up question is always, okay, you've got two different types of data analysis coming up with very similar results. Is that validation or is that coincidence? And the second important question -- the answer to the question that they're getting to is what causes the gap between tax and untaxed business income?

Now the general answer which they mention in their papers is, you know, it's going to come down to tax laws, avoidance and noncompliance whether it's intentional or unintentional. They don't -- I mean empirically what they find as John has mentioned is that losses appear to be a big deal with respect to what's going on between the gap between economic income and what's reported on the tax return.

We still don't know though, and this is key in terms of policy, is whether the surge in losses that they find is caused by legitimate interpretations of the tax law, aggressive avoidance strategies or a noncompliance.

So first they work with the NIPA. And they talk, you know, they're using NIPA to obtain economic income, which according to the BEA is a comprehensive and consistent measure of income earned from current projection as then we see by the households. It's unaffected by changes in tax law. It's adjusted for nonreported and misreported income and it excludes items like dividends and net capital gains, et cetera.
When the authors go to the NIPA and the SOI. For NIPA, they're adding what is defined as proprietor’s income in NIPA plus rental income. And then they subtract imputed interest and imputed rent on owner occupied households. And for the SOI, they’re summing up the income report on tax returns. And so, sole practitioners, partnerships and escrow and also adding in rental income.

And then as they’ve said is that they’re showing that less and less of NIPA business income, the economic income from businesses is taxed over this period going down to actually about a third when you get to 2018 with the losses becoming a larger proportion of what’s going on in the NIPA income than before.

Why this is occurring, we don't know from a simple comparison between NIPA and SOI. But we do get some information from the BEA because in infamous note, table 7.14, they do a reconciliation of the SOI business income and what they’re reporting as proprietor income.

And in fact, they’re starting with tax return data. They’re taking the total amount reported in the SOI from net profits of nonfarm proprietorship and partnerships then adding information from another IRS source and that’s the compliance studies that are done every few years. And adding in the amount that’s either not reported because the person didn’t file a tax return or is underreported on their tax return.

And then they take another couple of steps to align with their accounting definitions which get them closer to this definition of economic income based on current production.

But I want to emphasize since this is the area that I know the most about. Is that the largest contributor to the distinction between SOI data and the NIPA is its misreporting on income tax returns. That that is always contributing -- doubling the amount of business income before you get to the NIPA conceptual changes, accounting changes.

And, you know, again in terms of the gap. Where they're showing that roughly about half of the proprietor’s income is not reported to the IRS during this period that’s sort of aligning with what we’re observing in the compliance studies with respect to underreporting rates for individual income taxes for items such as nonfarm proprietor income where we see only about half of that income reported.

Partnerships and escrowswe’ll turn to this exhibit more detail in a moment. You know, there’s a much smaller shortfall.
But in the IRS’ estimates of noncompliance is accurate on which the BEA is basing this adjustment to the tax return data. One is that we don’t have information from the IRS on compliance for all years. The decades of the 1990 decade is a loss decade because of conflicts between the IRS and Congress and where there should be a compliance study.

But even now when there’s support with the compliance studies, they lag so we don’t have information from 2014 going forward yet. And that raises this particular question because this is a period in time when the IRS enforcement budget has shrunk. Since 2010, it’s gone down by 26 percent, you know, after adjusting for inflation.

And even with a compliance study, you’re not picking up all income. And a particular note, this is a problem for hazard partnership income that we’re not detecting all partnership income. The audits are the individual tax returns. And so, to the extent that they are identifying shortfalls in reporting of partnership income is coming from -- it’s looking at the accuracy of what the partnership is reporting to the individual. How much that is an alignment.

But what’s missing here is whether the partnership is reporting accurately to the partner. And some estimates with low uptake would increase underreporting by $20 billion.

There is also an issue of law changes particularly since the last study was done. And one thing that doesn’t explain everything, but is an interesting component is the issue with respect to losses. From 2011 onwards, there has been a reporting requirement that for certain types of payments that are made with credit cards, those credit card payments have to now be reported in 1099s both to the IRS and to taxpayers.

And what a couple of studies have found is that since those requirements have gone into place, those reporting requirements have come into place, we’ve seen an increase in the reporting by -- either within the contracts they sold props. We’ve seen an increase in the reporting of income, but it’s almost been offset by also an increase in the reporting of losses. I don’t think it explains everything that the authors are observing with losses, but it’s an interesting thing to think about going forward.

So the authors turn to the SCF for more answers. And an important reason to turn to the SCF for more answers is because you gain this information on wealth and are able to do the kinds of distribution analysis. And that’s something that is unique to the SCF.
I’m going to focus though a lot on the income issues and measurement of the business income in the SCF. An advantage potentially of the SCF is if you’re picking up people who don’t file income tax returns either because they’re not required to or because they are noncompliant. But really, really all the self-employed at least are required to file an individual income tax return because of SECA.

But the authors make a working assumption. And I’m quoting them precisely from the paper which is “SCF business owners are more likely to report what their business earned as opposed to what their accountants reported to the IRS.” Let’s stipulate here that the business owners signed the tax returns that were prepared by their accountants. So it’s not just what the accountants are reporting to the IRS.

But there is this question of is that working assumption reasonable? Do the taxpayers report what their businesses earn as opposed to what they report on their tax return? And if that’s true that they are. You know, you ask how much do you make from your business? And they say -- basically say their net profit before all of the ways in which a tax code can manipulate that legitimately or in other forms. Then yeah, this is a good way of capturing economic income.

And certainly, with respect to compliance, you would think that there aren’t going to be the incentives to understate income. You’re not getting tax advantage as you would if you were understating tax income on your tax return. Of course, some conspiracy theories may think that all government agencies share information and that’s where I saw the big growth area.

But there are other factors that challenge the reliability of the SCF reporting of income relative to the tax data. It’s a small sample and the survey response is low especially among the wealthy. Now, the best and the brightest work on the SCF and two of those people are here on the panel. So I’m going to stipulate that they are taking care of those issues and have perfected those.

But there then remains the question of even if you could decide, you know, is the reporting accurate for those who are in the sample? Is there an incentive to overreport? You know, you want to impress the surveyor. Or to underreport which is it’s none of the surveyor’s business.

As John pointed out, we do know from the SCF that there are relatively few -- people are told they can go to documentation when answering these questions. And one of the examples of documentation is tax returns. But very few people actually walk away from the interview and go get that
But can we infer from that that they’re not answering what it was reported on their tax return?

The survey occurs as I understand it over a period that begins in May and it can extend through the end of the year. A few cases perhaps in the end of, you know, stumbling into the following year. But the reporting on the income that they earned in the calendar year before the survey year. If you’re answering in May maybe you are just going to answer what you remember that you put on your tax return rather than calculating in your head how much you earned. But by the time you get to December and you’re asking questions about what you had earned in the prior calendar year are you answering based on your tax return? Or are you, you know, responding based on some vague memory that you have of that year a long time ago?

As John also pointed out there’s this issue with respect to whose questions on the SCF? And there’s a study that I haven’t been able to locate but I do recall where it looked at a match between a CPI and tax return data. And the more distant the relationship between the respondent and the member of the household of whose income they were reporting there was far less of a match between what was the nonrespondent’s income in the survey relative to what their income was on the tax return.

And then finally and this happens to me every time I deign to answer a telephone survey. People can get tired the interview. The median length of time of this SCF survey is an hour, but in some cases can go up to as much as three hours.

But putting that aside there is that whole issue of that result in terms of losses. That they’ve found in the relationship between the SCF and the SOI. There were many more returns reporting losses in the tax returns in the SCF. And there were a lot more negative incomes in the tax return data than there were in the SCF.

The return data may, in fact -- the constant returns may in fact be indicative that people are responding perhaps more honestly on their, you know, when they are asked on the SCF. But there’s another issue that was raised 11 years ago by Barry Johnson of the IRS and by Kevin Moore of the Fed that indicated that many respondents when asked about their income would say they had zero income rather than they had negative income. And to the extent to which these are reflecting zero incomes, those two would be contributing to a lower amount of losses than what might be reported accurately on
the tax returns.

So I have some follow up questions. Two of which are related to policy issues because the data now -- the study has been largely empirical. But on the policy side, the two questions I would want to know is to what extent should we close or narrow that gap between business income measured in economic terms versus what it shows up on tax returns? And how do we achieve that goal?

And it's the achievement of that goal, the answer is going to have to depend on the extent to which this is really being driven by the tax law itself, by aggressive avoidance strategies or by noncompliance. There are a variety of different responses you can have depending on what the answer to that question is.

And then getting back to this question of with respect to these kinds of questions, beyond the wealth issue, which the SCF is superior in all ways. Isn't therefore SCF providing better insight into the measurement of income and then the measure of taxes than the IRS data, then the tax data?

And if I could have my wishes granted, I would start by testing with a match between tax returns and the SCF. There's a lot of matching. There is work being done for some time now where administrative data are being matched through survey data in order to look at various questions including accuracy of reporting. Disclosure laws and other kinds of issues may prevent this kind of match, but it would be great as a next step forward if they could arrange to have something like that done. And with that I turn to Alice.

MS. VOLZ: Great. Let me share my screen. I hope everyone can see my slides. So thanks to Bill for inviting me to discuss their paper. A standard disclaimer as an employee of the Fed that these are my views and they do not reflect anyone at the board or the research staff either.

And so, I will try to skip quickly over things that maybe were duplicative with Janet's feedback but I think that we had a link a little bit more. No, I think that there's a lot of great work and a lot of important issues that the authors are touching upon in a study and I really sort of (inaudible) how to think about what to focus on with my 10 to 15 minutes.

So the first, I'm going to focus on thinking more about business income and losses that we are observing in the tax data from businesses. And with the goal that in businesses more effect we're seeing what do we know about businesses and their (inaudible). We know that businesses are a little bit
(inaudible). These are typically referred to as, you know, low visibility items or personal visibility.

So when we’re talking about the businesses that are showing up, whose income is showing up on individual tax data, we’re talking about sole proprietorships, partnerships and escrow corporations because they show up in different places on (inaudible) blown up in terms of their private (inaudible).

Carefully about what that means when we’re interpreting (inaudible) things overall aggregate trends. One thing to keep in mind though all this is particularly for the partnerships that their profits can flow to a partner’s return on multiple lines so not just an ordinary business Schedule E filing.

And just because we observe a negative for a household or a business, it doesn’t mean that there would be many of some of the many SOI Excel files that John refers to earlier. There are still surprisingly to me in some even though there’s some substantially a large number of businesses with deficits in their total net income which is taking the portfolio income into account.

So one thing to think about when we’re trying to figure out how to interpret a rise in negative business income is, you know, where are we seeing mismatches between ordinary business income and overall loss? Or is this simply what we would expect if all businesses were behaving in a way that we thought was acceptable, right? So and unsurprisingly, we see a mismatch between losses and the finance. And this doesn’t surprise me when I think about the types of income that flow to these different types.

So we’re taking -- we think more about why are we seeing negative incomes? And why is this rising? Particularly in the expansion over the past 10 years pre-dating the pandemic? Right capital gains, but I’m going to put the capital gains piece aside for now.

And I think one thing that John is kind of talking about is the intersection of sort of different types of business income. And is it, you know, they’ve realized in capital gains when they have a bad (inaudible). But again, it gives a little bit more, you know, context and present a picture of where we are at with it coming out to about 20 percent of net income and for schedule -- it’s showing up on about -- it’s showing between a 25 percent in one third of individual returns on (inaudible).

I’m digging around more in the tax data these negative net incomes are coming from sole proprietorships. So we want to think about why they would be behaving differently than partners or S-
Corp owners.

But again, I think we want to think about what’s going on with the negative business incomes that we're observing. Are these big firms or small firms? Are these new firms or old firms? You know, is some of this simply reflecting business startups and the term over the firm life cycle? And I don't necessarily think that it is but we might want to think that that could be part of what we're observing.

So again, we know that the tax code allows the businesses to take a lot of deductions which is allowing them to maybe be creative in reducing their taxable income. But I think that, you know, from outside you might think that we know that the depreciation interest are very two deductions that come to mind when we think about small businesses. But that's -- these are not huge when we compare them to total business receipts.

However, many other provisions of the tax code that are on the partnership, you know, released by the SOI. The other deductions categories put large relative to receipts and the sort of outsized use of these other deductions concentrated in the information finance and the professional services sector.

And so, again we want to think about what’s going on in the background that’s leading to the data that we're observing. And I know I don't have a ton of time, but I just want to -- with creating the survey of customer finances, we do think about the relationship between income and wealth.

And modeling household wealth from business income is really challenging. So we try to think about when you observe losses on an individual return what does that mean for -- what kind of household is that? And it turns out that a lot of households that reports some losses on their returns, they’re actually quite wealthy households. But maybe that's not surprising. Whereas, these are the households that they can afford to take on risky endeavors and they -- maybe we're observing them when their businesses are getting started and are losing money.

That may not be the whole story, right? They might just be really good at getting their taxable income below zero and they're able to build their household wealth at the same time.

And again, Janet touched on this more so I won’t spend time. But, you know, thinking about the creation of the tax system and what we want to give preferences to in the tax code versus noncompliance. You know, these lead to some big picture of thinking about how do we want to be taxing
businesses? And what changes might we want to make?

And so, since I bring a little bit specific knowledge about the SCF to the event, I'll spend a little bit of time talking about how might the authors be able to improve their modeling of the exercise to think about different types of -- how much more revenue we could gain if we taxed businesses differently.

And there's a lot going on. And again, some of it we can't know. We're not inside the mind of every unit, but their observations where you're seeing business owners report as zero, but, you know, there's probably some true negative value underlying. So this might lead to some of the losses being underreported.

There also could be a little bit of misclassification across income types where partnerships, the business owner might not know exactly what the breakout is between his dividend or his interest in coming from a business different from his ordinary business income and may give us more in the business income line in the income section.

So just sort of the back story in this is kind of also loosely some of what Janet was saying about, you know, the compliance. So this year, the blue line is the SCF business income in the income section. And the orange line is the total from the SOI individual returns. And this is sort of like your starting point. And this is where you would say, well, maybe the SCF is not completely overstating what businesses, their income is, their taxable income is.

But if we can make one adjustment to the SOI reflecting findings from the audit studies on how much we might think the true taxable income should be and to adjust the SOI line. And we can also use what the survey respondents do tell us if they file a Schedule C or Schedule E or a Schedule F. So this isn't about whether they refer to their tax returns in the response but what schedules they filed with the IRS.

So we can adjust for households that tell us they didn't file Schedule E. So maybe they have one rental property and they, you know, don't report that income to the IRS. But they would still -- they could still tell us that they actually do have some income from a rental. So that would adjust down the SCF line to the dark blue.

And then the under sort of the avoidance part from the tax data would adjust up. So you get a lot closer when we're thinking about the role of kind of noncompliance on both the survey and the
So I think that there's a number of places where they could make adjustments to how --
what they are adjusting in the survey. So we might think rental incomes should be treated differently than
ordinary business income. And you could be more targeted in which households you adjust their
business income.

I'm going to go a little bit quickly through these because I don't have a lot of time, right?
But as we noted, we know that most losses that are reported are small. So maybe you could do
something more creative with how to deal with the losses that we do see. But I also think that there's
some room that you could use information from the business section where people give details about
their actively managed and nonactively managed businesses that could help maybe also adjust what is in
the income a little bit better.

And so, the business section is the light blue line here. And that's the total income. And
then the dark blue is from the income section which is what the authors are using. And there's a wedge
between the two and it is expected because, as I noted earlier, partnerships can have many kinds of
income. And they're reporting to the survey in the business section and should give some of all of their
business income sources. And we've done some work with colleagues at the board, Jessie Brooker
(phonetic) and Kevin Moore.

Kind of validate what's in the business section and does it match what, you know, the
sum of all of the income sources, and it does seem to be reflecting that. But so I think that there could be
some help where maybe the business section could be reflecting economic income more so than the
income section.

And then I will not run through any of this. But the idea is that households with sole
provider income are very different than households which passthrough or other Schedule E income. And
the authors talk about this a little bit, but I think that you could do some differential adjusting of what's in
the income section to better reflect what we know from compliance studies for the different types of
income.

And the other thing that has been running through the back of my mind is that a lot of
business owners may have multiple business and may be able to offset losses in one business with gains
in another. And so, if you look across the distribution on surprisingly wealthier and high-income households do you have more than one business? And that may allow some strategic income.

So I think that -- and there’s so many things to talk about. But I will just end with there’s a lot we don’t know and we want to know more about. I think that this paper has done a great job in sort of getting a lot of conversations started. And some of the high-level things to think about is entrepreneurship and is the current approach subject to much tax abuse both legal and illegal avoidance.

And as John said, we know that income is not necessarily great way to classify households and some of it is because people get to choose how they’re reporting, what they’re reporting to the IRS. So thank you so much. This was really interesting and I had a lot of fun sort of digging into a lot of issues of the paper.

MS. SABELHAUS: Thank you, Alice. And I assume we are moving forward to Q&A session. And I think Bill once again he was going to moderate the Q&A but has seeded responsibility to me because of his internet issues.

And I guess I should probably start by saying that mine and Bill’s collaboration goes back many, many years. And an aspect of our collaboration has always been that I came at it -- I come to the questions we like to ask as a measurement person. I’m more focused on inequality and income and wealth measurement. Bill is the tax guy. And so, a lot of what we were doing was bringing those two things together.

And that’s kind of the framework for how I want to answer, you know, some of what Alice and Janet have raised. These are excellent comments. We did a great job picking discussants. And so, let me just start with that and then I’ll move over to some of the other questions that I see have come in. And if others come in, I have someone who is going to be feeding those to me.

So let me start. So one of the issues. Janet spent a lot of time talking about NIPA concepts versus SOI concepts and Alice touched upon this as well. And putting up, for example, this table from the NIPA that shows how much they estimate is because of, quote, noncompliance.

And I probably shouldn’t tell stories, but I will tell a quick story from the Federal Reserve Board in 2019 when NIPA revisions came out. And the amount of proprietor income suddenly jumped several percentage points. And I was in a room filled with other people who didn’t think a lot about NIPA
measurement.

And they looked at me and I said, well, that's because they changed the misreporting estimate, and everybody looked at me. What are you talking about? And I said, well, they need the accounts to add up. They need to make these things to add up. And so, at that time that planted in my mind a seed that I really don't know how NIPA does these misreporting adjustments.

And we need to know more. And I think that echoes from what Janet was saying. I could not agree more that we need to a lot more about how NIPA is doing these things. And, you know, if what the compliance studies tell us is that 15 or 20 percent of the gap is because of true, true malfeasants, misreporting. You know, what's the rest of the gap?

And I'm just wondering, you know, how much of the gap on the NIPA side is made in order to make the accounts add up? And I really want to know more about it. So I think that puts me squarely in Janet's camp in terms of her first set of takeaways and her first set of recommendations. Learn more about what's happening and part of that involves drilling down into the types of income a lot more carefully.

I think I couldn't agree more with Janet and that actually hits upon Alice's first set of points as well. Thinking about how much of this is sort of prompts how much is partnerships and other types of forms. Just things that we, you know, we aggregated up so that we could take this first look from a measurement perspective and just answer the question. We have an aggregate economic income on one side, a taxable income on the other. How do the two compare? So that was the thing I think which both were discussing.

We're going to go onto some other things that Janet mentioned. So one of the things you focused on towards the end was thinking about the losses. And how, you know, we still aren't generating a lot of negative returns, right? All we're doing is cutting positive business incomes. We don't see losses, a lot of losses in the SCF. Some of them are not disclosed to the public, but Alice we do actually use the disclosure codes to figure out that somebody is negative and we put them in that bottom category even if we don't really know the amount. But we're still way short on the number of returns that have, you know, negative income.

So our 50 percent thought experiment doesn't help us with that. You could imagine a
different type of experiment that somebody else could run with the same model, same data. Where you say, okay, there's a certain probability that certain high-income firms generate enough of a loss to completely offset that income and that would push them down into the bottom income group.

And, in fact, that could be one of your calibrations. That could be a target that you're trying to generate those two million negative returns every year instead of the 500,000 or so that we actually see.

Janet's last point is one that is, you know, it's very well taken. It's one which I have to unfortunately give the traditional answer. We can't match the SCF for the taxpayer. To do so would be to violate the agreements under which the data is collected and it would violate the, you know, our commitment to the respondents who are really telling us, you know, what's happening with their finances. And it's just something that we can't imagine doing.

You asked a question. You know, what is the right income measure? And this is where Bill Gale my tax colleague would step in and say, well, a tax economist would think of it this way. And try and get at what is a more appropriate definition of income to a business owner.

And he might, for example, say, you know, if the depreciation schedules are right and so it's not as though they are generating manufacturing losses, these are true losses. But then I would come back in as the measurement economist and say, wait a minute. You just told me you lost money on an asset that went up in value. Did you lose money? You know, I thought (inaudible) income told me you made money.

And that's what I'm trying to get at. And what motivated us was to think about, you know, how is it that we have a lot of people who have a lot of money. They're making a lot of money. They're very wealthy and they're not paying any tax? And so, it's about finding an income concept that's not necessarily, you know, buried in the tax and literature that says, this is a great way to measure somebody's taxable income. It's really trying to think about something which is broader and get at this general public policy issue.

I can't answer your last points about how would we tax that income. That's something which I think at this point it's more just about identifying it.

So, Alice, again thank you. You know, as I said I think you did a great job picking
discussants. Knowing that you would dive into the SCF. The analysis that you did in looking at the business module is something that’s on our future to-do list in thinking about what we’re really seeing there.

That last chart where you shifted the SOI line up based on noncompliance studies that’s one where I guess I’m a little bit worried about exactly how one might do that? One of the problems with the SOI, the published SOI data is that you’re seeing net amounts, you know, in every category for a tax return. And so, you know, it’s a net positive or net negative in this category.

But, you know, what we might have is somebody with multiple businesses as you say who has a positive in one business, a negative in another. And it’s not going to show up. And so, I guess this would be my appeal. For I know there are based on some emails I’ve gotten, there are a few members of the community, the D.C. community, who have access to tax data.

That, you know, maybe one of the things that comes out of today is that there is a call. There’s a basis here for tabulating that tax data in other ways that may help us get at some of this mystery. May help us understand this thing. So this is as simple as univariate distributions of these different types of business income, the available tables show us the counts of returns and the net amounts or the total amounts by AGI class.

But, for example, if we knew something about univariate distribution of business incomes that would help us evaluate whether, you know, what is the SCF telling us about, for example, proprietor’s income? Are we getting that univariate distribution, right?

And then if we made it to that point, I would then my next appeal would be for joint distributions as I mentioned towards the end of the presentation where we said, okay, what is the joint distribution of proprietor’s income and say, for example, wage income? And my appeal is not based just on what we’re doing here today, but I think about, you know, the work on labor income and the capital share. Is it ours?

Where I can (inaudible) on others who, you know, who are talking about how income, labor income versus other types of income might be shifting within the pass-through world and how that maybe impacting. I think that’s completely related to the sorts of things that we’re talking about here. And so, again I would put down my appeal to those who do have access to the tax data. I think there’s
perfectly disclosable things that could be done that would help those of us from the outside looking in and trying to evaluate what’s happening in other datasets especially the SCF to answer those questions.

I think that’s all I had for the two of you. I think I’m still responsible for answering questions. Let me check my email real quick and see what’s coming in. I’ve got a few here. Let me go back to some that had come in early on and see what I can do with these.

So one question I had, we had, was to what extent does transfer pricing or international tax plan effect the results? This is where it would be great to have the tax economist half of the team up and running. And I guess my quick answer would be, I would think of that as that mostly being corporate sector issues less on the pass through front.

But I guess one could imagine that it would affect things. Again, I would just pull back to, you know, the measurement perspective we’re taking here. The national income accounts of this, the tax data say that. You know, that’s our opening statement. We want to know what is the difference? What’s causing that difference? And this could certainly be part of it.

Another question effects of TCJAA, not just the 199A deduction but the lower corporate tax rate? Again, this is, you know, getting to the question of, you know, what income should we be taxing? And that’s a question tax economists debate all the time, right? You think all the time about what is the appropriate amount to tax? And how should we tax it?

And I guess, you know, I’m trying to, you know, when we set out thinking about NIPA benchmark. And then the work that we did with the capital gains as well. It’s asking the question, well, what if we had a broader concept of what income means? Something, you know, a NIPA type concept as our starting point?

Any implications or references about state business taxes form this work? I guess my answer would be it passes through. Make a pun here. So anything at the federal level that’s passing through to the state level it would seem that, you know, it would be -- I think we’d have about the same things to say.

And how does the size of business factor into the estimates? I don't have a direct answer to that. I think it’s a great question. Alice touched on it a little bit when she talked about the SCF and how we have very, very different types of businesses in the SCF. And we have enough of the large
businesses and these -- these owners, these business owners who are so generous with their time to go through this long laborious survey. But we also have a lot of folks who are, you know, self-employed and running a business out of their truck and their basement.

And, you know, my own belief has always been that when we think about noncompliance. Some folks like to point to small businesses, mom and pops. And, you know, people doing service type work, construction type work as being some of the ones responsible for a lot of noncompliance. And you could see that during a mostly cash economy, things like that.

And I've always believed that that's true. It's certainly something that's happening, but a lot of the dollars are occurring in the bigger businesses, the dollar flows, particularly when we see it from the SCF perspective. And that's part of what motivates me. It goes back to the point that I raised a few minutes ago, which is that I don't think it's all just noncompliance.

I do think there's something going on with the way that NIPA thinks about business income. And how tax economists think about business income versus how a measurement economist such as myself might think about it. So nobody is going to interrupt me, it appears. So I am going to look and see what else Megan gave me.

MS. HOLTZBLATT: I'll interrupt you.

MR. SABELHAUS: Go ahead, please.

MS. HOLTZBLATT: I'm a little bit annoyed at myself because I did want to raise the issue of form of business and how the results could be very different with respect to people getting their income from so props and people getting their income from partnerships.

And that's kind of highlighted in the data we see on noncompliance. Where the noncompliance rate is so much higher at least by the way we measure it now for businesses for so props than it is for partnerships. So being able to do that kind of delineation in the data. What you can do is with the breakdown of the SCF and the breakdown in the SOI data would be very interesting to observe.

And with respect to my comment about my wish list of matching the SCF and tax return data. Yeah, I don't see that as part of your current study, but for anyone including you guys in the future who can get access to tax return data with, you know, the master file. And, you know, I don't know the disclosure laws, but if SCF could be made available to do that kind of matching, boy, the amount of
information that you gain from that would be helpful.

So IRS’ treasury folks out that listening maybe you're doing it. Think about it.

MR. SABELHAUS: And the IRS treasury folks who signed the memorandum about understanding what the Federal Reserve Board, I hope you weren’t listening. No, I don’t think there’s --

MS. HOLTZBLATT: No, no, no. It would have to -- I have my own vision of how this could be done, but --

MR. SABELHAUS: Janet, I couldn’t agree more that the ability to look at what people are telling us. But I guess I would argue in my response to that would be I would think there's a lot we can do if folks just tabulated the available tax data differently, right?

And in some ways, you know, you can really get into wormholes with individual -- you know, I’ve seen some of the linkages people have done with census data and tax data. And you can get into linkages or get into wormholes where some people seem to be overreporting, some underreporting. You know, there are linkage issues with using picks and things like that. So, you know, I would really just love to know if the story is right then it will show up in the univariate business income distributions.

You know, that we’ll see a pattern in the tax data that we don’t see in the SCF. But there’s some things that will line up, some things won’t. And it’s the gap between those that may help us get a better handle on what’s really happening with these tends over time.

One of the things I think we do see in the data. I didn’t probably say clearly enough. I didn’t hear too much from either of you. I think Alice might have touched on it. This tend towards business losses and our inability to tax business income because they're being offset by losses. I think it is getting a lot worse. You know, I think it’s something that we need to really focus on. It's not something that seems to be stopping.

I have one -- unless Alice or Janet wants to jump in. I will take this other question Megan sent me. Does the analysis account for significant differences in the accounting for employee benefits plans for financial statements versus tax reporting which is not income to the company? That's a great question from Debra Beerbaum (phonetic).

Again, what we're relying on here, everything is based on published NIPA data and published SOI data. The one thing I will say is that on the NIPA side -- there’s one adjustment we have to
make. I skirted over it because of the interest of time. In order to make the income concepts comparable, on the NIPA side personal income, for example, includes the employer contributions to pension plans. And it includes the interest in dividends earned on those pensions plans all imputed back to the household sector.

It does not include -- personal income does not include benefits that are actually paid from retirement plans. The income in quality literature, the DINA literature has this exact same problem. And so, you can do one of two things.

You could either try and make your microdata look like the microdata or you can do what we did which is to bring the macrodata to the tax data effectively. Because what you do is you don’t count the contributions to pensions in the interest and dividends, but you do count the benefits that are being paid out, both DC and DB benefits as forms of income because that’s what will actually show up on the tax return.

I think Deborah’s question is actually a little bit more subtle because I think she’s getting at whether or not when a small business pays these benefits or makes these contributions, they may affect tax reporting in a way that I’m not seeing immediately so maybe I can just ask her to follow up with me with an email and explain that a little more carefully.

I don’t see anything else in the cue. We are quickly running out of time. So unless I hear from someone else, I may actually say we can wrap it up. And I guess I want to say again, you know, thank you to Janet and Alice’s great comments.

Thank you again to the Peterson Foundation for supporting this work. We had a couple ideas a year ago and it’s been great being able to explore them and build this new tool. And I think hopefully push this conversation in a new direction. And think about what it really means to tax business incomes. So with that I will say good bye and I’m seeing that we’re going to get muted and at that point we will be off the air. Thanks again for everybody tuning in.

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I, Carleton J. Anderson, III do hereby certify that the forgoing electronic file when originally transmitted was reduced to text at my direction; that said transcript is a true record of the proceedings therein referenced; that I am neither counsel for, related to, nor employed by any of the parties to the action in which these proceedings were taken; and, furthermore, that I am neither a relative or employee of any attorney or counsel employed by the parties hereto, nor financially or otherwise interested in the outcome of this action.

Carleton J. Anderson, III
(Signature and Seal on File)

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