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Income and the Art of Tax Distribution Analysis

By Dr. J.D. Foster
Executive Director and Chief Economist
Tax Foundation

Defining income properly is enormously important for an income tax, so economists, lawyers, and accountants have debated the matter for years. A new dimension of this debate has opened recently in the area of tax fairness, thanks to the growing use of tax distribution tables. These tables seek to portray the distribution of the tax burden or the tax cut across various income percentiles or income levels.

The Joint Tax Committee, which estimates tax changes for Congress, uses Adjusted Gross Income (AGI) as its definition for tax distribution analysis. AGI is relatively well understood, relatively simple, and derives from the income tax itself. But AGI is itself a consequence of tax policy and therefore could be an unsteady basis for measuring changes in tax policy.

The Treasury Department, on the other hand, uses Family Economic Income (FEI). In using FEI, Treasury seeks to develop a more comprehensive measure of income than AGI. FEI, for example, includes items of income excluded from AGI because otherwise the tax code would become too complex (e.g., imputed rent from owner-occupied housing), or for other policy reasons (e.g., the child care credit).

The disadvantage of using FEI is that it is a highly complex measure of income dependent on many critical assumptions, each of which open the calculation to criticism and possible manipulation. Take, for example,the inclusion of the imputed rent from owner-occupied housing. The idea is that a home owner is both asset owner and renter. The owner therefore enjoys both the housing services from his property and the imputed economic income he would receive if he rented the house to someone else. To make such a calculation, Treasury must estimate what the imputed income would be, which means estimating what the rent would be. It must then consider all the expenses that would be deductible if the owner were landlord, particularly depreciation and maintenance costs. It must then discount the imputed net rental stream going out to the indefinite future to see if that sum, plus the rental value itself, exceeds the purchase price of the house.

Given its difficulties and possible disadvantages, why choose FEI over AGI in running distribution tables? Primarily because FEI is useful when "ability-to-pay" guides tax policy. If you believe ability-to-pay is a reasonable guide, then at the very least you should attempt as comprehensive a measure of income as possible — as Treasury has done in developing FEI.

Ability-to-pay is at the heart of the belief that taxes should be used to redistribute income from the rich to the poor (or from producers to non-producers). But if you do not believe in redistributionism, you must conclude that ability-to-pay is not a proper guide to tax policy. There would be no justification for using the more complicated FEI in lieu of the more intuitive AGI as the basis for assessing the tax distribution. Its use in assessing tax cuts is also dubious. Ability to pay taxes has little to do with ability to receive tax cuts. At the very least, the more appropriate information would be the distribution of the tax burden after the tax cut has been put into effect — which, whether the table is done with FEI or AGI, would continue to show that middle and upper-income taxpayers are shouldering a disproportionate share of the tax burden.

Tax distribution tables burst on the scene only a few years ago, thanks to technological breakthroughs in tax analysis and the rise to prominence of the fairness debate. Most observers once took these tables at face value, assuming they reflected a dispassionate calculation about which we could all pretty much agree. What this year's debate has revealed, however, is that there are a great many assumptions built into these tables about which there may be little or no agreement at all.•