Taxes, Regulations of Businesses and Evolution of Income Inequality in the US*

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Abstract

The share of business receipts of pass-through entities (S corporations, partnerships and sole proprietorships) in the total business receipts in the US increased from 13.1 percent in 1980 to 36.9 percent in 2012. This significant change in the structure of the legal forms of organization of the US businesses has been accompanied by increase in the top shares of individual income and manifests itself as a change in their composition. The top 1 percent income share has increased from 8.2 percent to 18.9 percent in this period. At the same time the share of entrepreneurial income, composed mainly of income from pass-through entities, in the top 1 percent has risen from 7.9 percent to 31.3 percent, contributing largely to the income inequality increase. In this paper we document, using The Longitudinal Business Database, new facts about the shift in the distribution of organizational forms and provide its decomposition into the entry and switching margin. We argue the changes in the distribution have been driven by the tax reforms and regulations of businesses implemented in the US after 1980, which made running a business as pass-through entity more attractive. To validate this claim we write down heterogeneous agent model with endogenous choice of occupation between worker and entrepreneur, and legal form of organization for entrepreneurs. The model captures key trade-offs in choosing an occupation, as well as in choosing the legal form of organization. C corporations, unlike pass-through entities, are subject to double taxation of profits but have easier access to exogenous financing by raising equity. The resolution of these trade-offs leads to an endogenous distribution of legal forms of organization in the model. Given the model replicates the key facts, documented in the empirical part, about the shift in the distribution of organizational forms we use it as a measurement device to quantify the impact of changes in taxes and regulations on inequality evolution in the US after 1980. Our model delivers predictions on the evolution of income, wealth and consumption inequality among workers and entrepreneurs.

Keywords: Pass-through entities; Income Inequality; Taxes and Regulations

JEL Codes: E60; H32; K2; L2

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