Short Reply: Comment on Auten and Splinter (2023)

David Splinter
December 22, 2023

This is a short reply to a comment by Piketty, Saez, and Zucman (2023, PSZ) on Auten and Splinter (forthcoming). These PSZ comments are variations on their prior comments that we addressed in Auten and Splinter (2019, appendix p. 4) and Splinter (2020). For a related discussion, see Splinter (2023b).

First, PSZ say audit data suggest adding underreported income implies little change in top 1% shares. We agree. But their approach **increases** recent top 1% shares about 1.5 percentage points, with about 50% of underreported passthrough income going to the top 1% by reported income. However, Johns and Slemrod (2012) found only 5% of underreporting went to the top 1% by reported income. This discrepancy is because PSZ allocate underreported income proportional to reported positive income, which ignores that a substantial share of business underreporting (about 40%) goes to individuals with reported **negative** business income. Moreover, misreporting rates are the highest among tax returns with reported negative incomes (online appendix Table B3). The concentration of underreporting at the bottom of the reported distribution causes substantial upward re-ranking when adding underreported income, but that's mostly ignored in the PSZ approach. The PSZ approach also implies that someone who decreases their underreporting rate by increasing their reported income is allocated more underreporting. That's backwards.

In contrast, our approach fits prior estimates from audit data, makes use of many years of audit data, and improves upon prior approaches. We find that underreported income slightly lowers top 1% pre-tax income shares and slightly increases after-tax income shares (online appendix Figure B6), which is consistent with the audit data. In 2001, about 19% of underreporting is in our top 1% ranked by true income (online spreadsheet for Figure B5)—far less than PSZ's near 50%-allocation—and a bit under the 27% in Johns and Slemrod (2012) because we improve upon prior approaches that misallocate undetected underreporting (as discussed in Auten and Splinter 2021). Contrary to the assertions and approach of PSZ, our online appendix Figure B5 (bottom panel) shows that re-ranking between reported and true (reported plus underreported) income matters substantially. PSZ appear confused about the difference between ranking by reported versus true income. Our underreporting allocations (as are theirs) must be based on reported income because that is all one observes with the primary tax data we both use. But, unlike their method, our allocations are done such that we match the re-ranking implied by audit data. Therefore, we match both the distributions by reported and true income after re-ranking (top two panels of online appendix Figure B5).

Second, income missing from individual tax returns has shifted from the top to outside the top. The shift from the top was from movements out of closely-held C corporations, whose income is missing from individual tax returns, to passthrough businesses, whose income is on individual tax returns. This created growth in the top share of taxed business income. The growth in PSZ's top share of untaxed business income, however, is due to their skewed allocation of underreported income that re-allocates underreported income to the top of the distribution. Outside the top, the growth of missing income is from increasing tax-exempt employee compensation, especially from health insurance (see online appendix Figure B16).

Third, PSZ suggest that top wealth and capital income shares should run parallel over the long run. This is a problematic assumption. Economic changes can push down capital income shares relative to wealth shares. Most importantly, interest rates fell dramatically between 1989 and 2019—the federal funds effective rate fell from 9 to 2 percent. This decreased the ratio of interest-income to bond-wealth and therefore falling interest rates likely increased the gap between top income and wealth shares. Also, much of top wealth patterns are driven by passthrough business, but this is fully or two-thirds excluded from PSZ's definition of "capital" income here. When fully including passthrough business, the Auten–Splinter top 1% non-housing "capital" income share increased by 5 percentage points between 1989 to 2019, about two-thirds the Federal Reserve's estimated increase in top 1% wealth shares. Therefore, the Auten-Splinter estimates are consistent with increasing top wealth shares.

The Auten–Splinter approach is fundamentally a data-driven approach (list of data used in AS Table B2). Based on Saez and Zucman's (2020) suggestions and conversations, our more recent work adds new uses of data to account for high-income non-filers, flexible spending accounts, and depreciation issues from expensing. Where we rely on assumptions, alternative ones suggest top 1% shares change little, see AS Table 5. Our headline finding of relatively flat long-run top 1% after-tax income shares is robust.

References

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