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Wealth Taxation

Robin Boadway and Pierre Pestieau The Dubious Case for Annual Wealth Taxation¹

INTRODUCTION

The purpose of this paper is to critically evaluate the case for an annual wealth tax as part of a nation's tax system. To do so, we review currently received wisdom on the elements of a good tax system drawing on the normative tax design literature and best practices. The preferred tax system varies across nations because of historical and institutional factors, social norms and exposure of the national economy to international influences. Nonetheless, a number of design features are common across countries, especially with regard to the choice of a tax base.

The current interest in wealth taxation is a response to the increase in wealth concentration and income inequality that have occurred in most OECD countries. The share of the wealthiest 1% in total pre-tax income has grown in recent decades, particularly in some English-speaking countries, but also in some Nordic and Southern European countries. To address that, Piketty (2013) proposed a world wealth tax, which is more utopian than feasible. We consider a national wealth tax as a more viable option.

WEALTH TAXATION IN PRACTICE

Wealth taxation and wealth transfer taxation can take different broad forms. A wealth tax typically applies to net wealth, that is, assets less liabilities. It can be levied periodically (e.g., annually) or as a one-off capital levy. Related to a wealth tax is the property tax, which is levied annually on real property and is typically used to finance local government. A wealth transfer tax can take two main forms: it can be an estate tax levied on the total value of the estate of a donor; or it can be an inheritance tax levied separately on the amount of inheritance received by each recipient. Wealth transfer taxes are levied on lifetime accumulations of wealth, and apply on death or within a prescribed number of

years prior to death. There may also be gift taxes levied either on donors or recipients when gifts are made during the lifetime of donors or recipients.

While wealth transfer taxes are relatively common, several countries have abolished or decreased net wealth taxes. Net wealth is now taxed in only a few OECD countries, and taxes on immovable property represent a small percentage of overall taxation. A couple of decades ago, one-half of OECD member countries had some type of annual wealth tax. These countries have progressively discontinued it. In those few countries that still have a wealth tax, its proceeds have decreased over time. Wealth tax revenues as a share of total tax revenues in 2015 were 3.6% in Switzerland, 0.3% in Spain, 1% in Norway, 1.5% in France, and 2% in Luxembourg.

Occasionally, a once-off tax on private wealth has been used as an exceptional measure to restore debt sustainability. To be effective, such a tax has to be implemented before avoidance is possible and with the expectation that it will not be repeated. Only in these circumstances does it not distort behaviour. A one-off wealth tax is seen by some as fair, despite the fact that it amounts to an unannounced confiscation of wealth. That is because it is only applied in unusual circumstances of financial stringency, or when wealth holders might be thought to have gained disproportionately while others suffered.

WEALTH TAXATION AS PART OF THE BROADER TAX SYSTEM

An annual wealth tax is one of a family of taxes that apply to asset wealth or its return. Other such taxes include capital income taxes, business income taxes, wealth transfer taxes and annual taxes on real property. These taxes generally exist alongside broad-based taxes on consumption and taxes on labour income. Different countries adopt very different mixes of tax bases, but virtually all are hybrid systems that combine elements of two benchmark tax bases. One is comprehensive income taxation under which the tax base is the sum of consumption and net changes in wealth or net savings. The second benchmark base is consumption itself, which can be taxed either by personal taxation or indirectly by taxes on consumption transactions. Neither comprehensive income nor personal consumption are readily observed by the tax authority, but both can be indirectly measured using tax bases that are equivalent to them in present value terms. Using the consumer's lifetime budget constraint,



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the comprehensive income tax base is equivalent in present value terms to the sum of labour income, capital income and inheritances. By the same token, the consumption base is equivalent in present value terms to labour income, inheritances and that part of capital income reflecting windfall, or unexpected, gains.² In what follows, it will be useful to fit annual wealth taxes into this framework of broad tax bases.

As mentioned, most tax systems are some hybrid of income and consumption taxes. To appreciate the potential for wealth taxes to be a component of these hybrid tax systems, it is useful to recount how various elements of standard tax bases contribute to the comprehensive income versus consumption balance. Consumption can be taxed explicitly and indirectly by a broad, destination-based value-added tax (VAT), although progressive rate structures are precluded. Alternatively, consumption can be also taxed under the personal tax system using one of two approaches. Consumption expenditures can be directly and progressively taxed by a personal base defined as labour and capital income (including inheritances) less savings. This is equivalent to what the Meade Report (1978) called the registered asset approach, and corresponds roughly to the way in which private pensions are typically treated. The alternative form of personal consumption tax, also identified by the Meade Report, is the tax-prepaid approach whereby the base is labour income and inheritances, that is, total income less capital income. The tax-prepaid approach captures consumption imperfectly to the extent that capital income includes windfall gains, such as unexpected returns or rents from monopoly circumstances.

Arguably, the returns on investment are increasing in the size of an individual's portfolio, so are higher for high-income persons.³ For that reason, the Mirrlees Review (2011) proposed a variant of the tax-prepaid approach whereby for savings in assets other than interest-bearing accounts and pensions, only returns up to a risk-free rate-of-return allowance (RRA) would be tax-exempt, while above-normal returns would be fully taxed. This would ensure that consumption financed by rents is taxed. To the extent that above-normal returns accrue to higher-income taxpayers, taxation equity might be improved by taxing them differentially.

Actual tax systems do not include all consumption in the tax base, regardless of whether they aim to tax income or consumption. VAT systems typically exempt or zero-rate some types of consumption, such as food

and other necessities. Tax bases that rely on the tax-prepaid approach do not include consumption financed from rents or windfall gains. And, personal tax bases do not include consumption financed from inheritances to the extent that the latter are not themselves taxed, although they do implicit tax bequests made, which might not be regarded as consumption. When inheritances are taxed, they are usually only partially taxed and are taxed more favourably than ordinary income. High exemption levels apply, and some forms of wealth transfers are exempt such as farms and family businesses. On the other hand, housing is often included in inheritance tax bases. Countries that do not have inheritance taxes nonetheless apply a capital gains tax to accrued capital gains on inheritances. In the few countries that have annual wealth taxes, these are typically in lieu of an inheritance tax, despite the fact that they fulfil very different functions.

There are many reasons for taxing capital income favourably compared with consumption or labour income, and why some forms of capital income are exempt. On theoretical grounds, some taxation of capital income can be justified as an efficient way of redistributing from better-off to worse-off individuals (Banks and Diamond 2010). In addition, taxing capital income has been justified as a way of addressing the inefficiencies associated with the absence of wage insurance and with credit constraints (Conesa et al. 2009). Typically, these arguments would support capital income taxation at lower rates than labour income taxation, and at rates that are higher for high-income persons. At the same time, capital income tax rates are constrained by the possibility of avoidance through tax planning or capital flight. Some types of asset income would be difficult to tax from an administrative point of view, such as human capital and housing for which imputed income is hard to measure. Some assets are also tax-sheltered on policy grounds, like saving for retirement for which encouragement might be warranted on behavioural grounds. Preferential treatment of investments by entrepreneurs and small businesses is a response to the high risk of failure and limited access to capital markets many face.

There are also strong arguments supporting the case for deploying an inheritance tax as a complement to consumption, labour income and capital income taxation, regardless of the extent to which capital income is taxed. From the point of view of recipients, inheritances represent a form of windfall gain that can be used to finance consumption over one's lifetime. Regardless of whether the personal tax system is based on consumption tax or comprehensive income tax principles, taxing consumption is an element. Insofar as consumption is taxed explicitly, taxing inheritances that finance that consumption would be redundant. For example, a VAT will tax consumption expenditures regardless of how they are financed. On the other hand, taxing consumption at the personal level by using either the tax-prepaid approach or the registered asset

² To see this, consider the two-period case where an individual earns E_1 and E_2 in the two periods and receives an inheritance I in the first period. The budget constraints in each period are $C_1 = E_1 + I - S$ and $C_2 = E_2 + (1+r)S + k\bar{S}$, where C_i is period- i consumption (including bequests given), S is saving, r is the interest rate, and $k\bar{S}$ is above-normal returns accruing on a portion of savings $\bar{S} < S$. Eliminating S from the two budget constraints yields the intertemporal budget constraint:

$$C_1 + \frac{C_2}{1+r} = E_1 + I + \frac{E_2}{1+r} + \frac{k\bar{S}}{1+r}.$$

³ For empirical evidence of this, see Fagereng et al. (2016) and Kacperczyk et al. (2016).

approach will require that inheritances be taxed. Let us recall that the tax-prepaid approach exempts capital income from the base, and will be equivalent to consumption taxation only if all forms of non-capital income are in the base, including labour income, transfers and inheritances. Similarly, under registered asset treatment, the tax base is income less savings, where income includes labour and capital income, transfers and inheritances. If the tax base is income rather than consumption, the same principles require including inheritances in the base, since they are equivalent to income. Naturally, in choosing tax rates one must take into account behavioural responses, such as changes in labour supply, savings, and in the case of inheritance taxation changes in bequests, but the choice of the tax base is separate from these considerations.

A wealth tax would add one more layer of taxation of assets to the existing patchwork of capital income and inheritance taxes. In principle, the annual taxation of wealth is analogous to the taxation of income from that wealth, depending on how it is designed. To the extent that income from wealth is proportional to the stock of wealth, taxing wealth directly is equivalent to taxing the capital income from that wealth, as discussed in more detail below. However, there are some differences. If wealth taxation is based on the market value of wealth, which is the expected present value of future returns possibly adjusted for risk, a capital income base will be more variable than a wealth base. Moreover, capital income taxation will tax unexpected, or windfall, gains whereas a wealth tax will not. Where returns to wealth take an imputed form, taxing wealth itself may be much simpler than taxing the returns. This may be the case for housing and for valuables that yield an intrinsic return. On the other hand, some forms of wealth are inherently more difficult to measure than the income streams to which they give rise, such as human wealth that either has been endowed in the individual or has been accumulated.

Two final points can be made about wealth taxation versus other forms of asset taxation before analysing the case for and against it. Firstly, some might argue that wealth per se should be taxed because of the benefit it generates for its owners. This may be an intrinsic benefit, such as the prestige and status associated with being seen to be wealthy. Alternatively, wealth may confer power and influence on wealth-owners, particularly those with substantially higher-than-average accumulations. Basing a tax on wealth on the possibility of its power and prestige would represent a motive for taxation that goes beyond standard utilitarian arguments. If the wealth had been accumulated from above-normal returns due to windfall gains or monopoly rents, taxing them ex post might be justified to the extent that the tax system did not tax them as they were earned regardless of the power and prestige to which they give rise. Insofar as these considerations are true, they would reinforce the case for highly progressive wealth taxation.

Secondly, while wealth taxation is analogous to the taxation of the returns on wealth, it is different from bequest or inheritance taxation. Bequests represent a cumulative accrual of wealth over a lifetime, while inheritances represent windfall increases in wealth early in one's lifetime. By contrast, wealth taxation is a recurring annual tax on wealth over the life cycle. Thus, a wealth tax applies to saving done partly for life-cycle smoothing purposes, while a bequest tax applies to wealth accumulated over and above that used for life-cycle smoothing and an inheritance tax applies to windfall increases in wealth. Even if one did not want to tax capital income or capital itself, for example, if the tax system aimed to tax consumption, one might still want to tax inheritances. This would be the case insofar as consumption is taxed on the income or source side of the budget rather than directly, since the budgetary source of consumption finance comes from both labour income and inheritances.

ECONOMIC ARGUMENTS FOR WEALTH TAXATION

In this section, we explore the case for including wealth tax as part of the tax system in greater detail. The arguments for taxing wealth are heavily influenced by the similarities between taxing wealth and capital income. Under certain conditions, these two forms of taxation are effectively identical. To illustrate this, let us suppose that an individual has wealth consisting of a fully owned house and a portfolio of stocks. Let us also suppose that the tax on capital income includes the imputed income of the home and the dividends plus the accrued capital gains of the stocks. We will assume that these capital incomes are such that their present value is equal to the value of the wealth to be taxed; and also that both taxes are flat rate. Under these assumptions, there would be equivalence between the two types of levy.

In practice, this is far from the case for many reasons. The two taxes do not have the same base. Some assets are exempt from the wealth tax and others from the capital income tax. Taxes on capital income apply at most at preferential rates to realised capital gains and not to accrued capital gains, although these are covered by the wealth tax assuming the value of assets is properly assessed. In that respect, there can be a huge discrepancy between the market value of a dwelling and its cadastral value. The tax rates are also different in level and progressivity, and in the exemption level. Another important difference is the tax base. The annual wealth tax base comprises housing net of debts, deposits, and some financial assets, but not business assets.

Besides the differences between wealth and capital income taxes mentioned, two other differences are often cited in the discussion on the relative merits of the two taxes. The first one concerns the liquidity aspect. Persons can be very wealthy in terms of their assets, but have a small income that makes them una-

ble to pay the annual tax. In Germany, a court held that the sum of wealth tax and income tax should not exceed one-half of a taxpayer's income. Eventually the wealth tax was declared to be unconstitutional because of its confiscatory nature. As for the second difference, there is the argument that the wealth tax would induce taxpayers to get the highest return possible to pay the tax, whereas the capital income tax would have the opposite effect.

A wealth tax might be viewed as a supplement to capital income taxation where the latter is imperfect. For some types of assets, the rate of return might be difficult to measure. Examples include owner-occupied housing, automobiles and other consumer durables, personal valuables, and cash. A wealth tax that targeted these assets could be beneficial, although valuation and compliance problems would be challenging. For some other assets, both the rate of return and the asset value might be difficult to measure. An important example of this is human capital. Its return can be implicitly taxed if the income tax system is progressive, but otherwise human capital tends to be a tax-sheltered asset. Personal businesses also yield capital income that can be challenging to measure, but measuring their asset value is no less difficult, especially for intangible assets, which are increasingly important. More generally, capital income earned on behalf of shareholders by corporations can be taxed using a corporate income tax and integrated with the personal tax of shareholders. Arguably, it would be easier to tax corporate-source income using a wealth tax. The latter would apply to the value of corporate stocks held by taxpayers directly with no need to use a corporate tax at all.

Overall, the case for implementing a wealth tax as a complementary way of taxing capital income is limited. The argument is strongest for assets like housing and other durables whose returns are difficult to measure, and for corporate stocks whose returns can be sheltered within the corporation unless they are pre-emptively taxed using a corporate tax. In the case of housing and some business assets, the property tax already applies to them.

At the same time, there are significant drawbacks to wealth taxation as a substitute for capital income taxation. An important difference is that a tax on capital income includes windfall gains in the tax base while a wealth tax does not. The value of wealth reflects expected returns, and these do not change if there is a windfall gain. Given that the taxation of windfall gains is highly desirable, this is a significant drawback to a wealth tax. By the same token, a tax on capital income will apply to returns to risk, while a wealth tax will not. As long as there is loss-offsetting in the income tax system, this should not be a significant drawback to capital income taxation. Indeed, in some circumstances taxing returns to risk can be a valuable form of insurance that increases risk-taking (Domar and Musgrave 1944, Stiglitz 1969, Buchholz and Konrad 2014).

Capital income taxes also have some advantages of flexibility from a tax design point of view. Capital income taxes can have exemption levels as in France and the UK. In addition, some forms of capital income are tax-sheltered, such as saving for retirement, and these tax-sheltered savings can have an upper limit that restricts their availability to high-income persons. Moreover, capital income tax can be designed so that it only applies to above-normal earnings, as in the case of RRA taxation proposed by the Mirrlees Review mentioned above. Capital income tax may not apply to certain asset returns, like housing, but it can be augmented by property taxation or taxation of housing capital gains. Finally, under a dual income tax, a proportional tax rate can be applied to capital income. This makes evasion more difficult than with ordinary income taxation, since financial intermediaries can be used to withhold tax. These aspects may be difficult to replicate using wealth taxation.

The upshot of this discussion is that a wealth tax is largely an imperfect substitute for a tax on capital income. It has the advantage that it can tax assets whose return is difficult to measure for income tax purposes, especially consumer durables. At the same time, it is inferior to capital income taxation when rates of return are easier to measure than asset values, such as intangible assets, intellectual and knowledge property and personal businesses. But it has the significant disadvantage that it does not tax windfall gains. Moreover, it is no better than capital income taxation for taxing human capital returns and for taxing inheritances at rates reflecting their advantage to inheritors.

There are also various administrative problems with wealth taxation that make compliance and collection costly. For one thing, there is risk of capital flight and pervasive inequity arising from wide variety of loopholes (like change of residency). Measurement difficulties also lead to exemptions like artwork and durables, and family enterprises are often exempt on social grounds. These problems also affect inheritance and capital income taxation. The need to value assets frequently implies that the wealth tax has a low yield relative to administrative costs compared with inheritance tax. Finally, wealth and wealth transfer taxes are surprisingly unpopular, even although a majority of citizens would be net gainers from such a tax.

CONCLUSIONS

Wealth and capital income taxes are analogous and fulfil similar functions. The ultimate rationale for taxing wealth is the same as for taxing capital income, and we have recounted the arguments underlying this rationale. In view of these facts, the case for an annual wealth tax rests primarily on shortcomings of capital income taxation. There may be some assets for which the returns are difficult to measure, such as housing and other consumer durables. An annual tax on the value of such assets could be a useful complement to capital

income taxation. That must be weighed against the administrative and compliance costs of such taxes, which could be substantial. In practice, annual taxes on housing values are frequently used as instruments for financing local government. Given that, the case for taxing the imputed income of housing is reduced.

Our judgment is that a well-functioning capital income tax dominates an annual wealth tax. The benefit of implementing the latter alongside a capital income tax does not compensate for the significant administrative costs that would be involved. However, this judgment comes with some caveats. The case for relying solely on capital income taxation (along with labour and consumption taxation) is strongest when the capital income tax includes all forms of capital income including capital gains. That is not to say that the rate of taxes applied to capital income should be the same as that applying to labour income. A dual income tax system with a uniform rate applied to capital income has significant administrative advantages. At the same time, taxing housing wealth using a property tax rather than taxing imputed rent makes good sense, especially since property taxation is a well-established tax for financing local government.

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