Taxing Wealth and Capital Income

By Chris Edwards

Taxing the wealthy is a hot issue among Democratic candidates for president. Sen. Elizabeth Warren (D-MA) is proposing an annual wealth tax on the richest households, while other candidates are proposing higher taxes on incomes, estates, capital gains, and corporations.

Calls for tax increases are animated by claims about the fairness of income and wealth distributions in the economy. Warren wants to address “runaway wealth concentration,” while Sen. Bernie Sanders (I-VT) says that the wealthy are not “paying their fair share of taxes.”

The proposed tax increases run counter to the international trend of declining tax rates on capital income and wealth. The number of European countries with a Warren-style wealth tax has fallen from 12 in 1990 to just 3 today.

The Europeans found that imposing punitive taxes on the wealthy was counterproductive. Wealth taxes encouraged avoidance, evasion, and capital flight. In most countries, wealth taxes raised little revenue and became riddled with exemptions.

This study discusses why targeting wealth for higher taxation is misguided. Wealth is simply accumulated savings that economies need for investment. The fortunes of the richest Americans mainly consist of active business assets that generate jobs and income. Increasing taxes on wealth would not help workers, but instead would undermine productivity and wage growth.

Basic economic theory suggests that taxes on capital should be low, and that conclusion is strengthened by the realities of today’s global economy. Furthermore, wealth taxes are even more distortionary than current federal taxes on capital income.

Nonetheless, taxing capital in a fair and efficient manner is a challenge. This study argues that the best approach would be a consumption-based tax system. Such a system would tax capital income but in a simpler way that does not stifle investment and economic growth.

INTRODUCTION

The federal tax system will collect $3.5 trillion in 2019. Some federal taxes are imposed on labor, such as payroll taxes. Some taxes are imposed on capital, such as the corporate income tax and the capital gains tax. Some taxes are a hybrid imposed on both capital and labor, such as the individual income tax.

Taxes on capital may be imposed on the stock of capital, such as estate taxes and wealth taxes, or on the income flow from capital, such as taxes on interest and corporate profits. The words capital, wealth, and savings are similar in meaning. This report uses “taxes on capital” to refer to taxes on both the stock of capital or wealth and the income flow from capital.

Federal taxation is uneven. With respect to capital income, it exempts some items from tax, such as interest on municipal bonds, but taxes other items heavily, such as corporate equity. Most experts would agree that uneven taxation across sources of income is inefficient because it distorts investment flows in the economy.

There is less agreement about the uneven taxation of
individuals at different income levels. Some experts and policymakers favor a flatter or more proportional tax system, which would apply equal tax rates to individuals across the board. Others favor a more progressive system that levies higher tax rates on people at the top.

Elizabeth Warren wants to address “runaway wealth concentration” with her wealth tax proposal. She says that people with great fortunes should “put a little bit back in the kiddy [sic]” and “pay a fair share.” Sanders, who is proposing higher taxes on estates, incomes, corporations, and capital gains, demands that “the wealthy and large corporations start paying their fair share of taxes.” Numerous other Democratic candidates for president support higher taxes, particularly on capital, including taxes on estates, corporations, capital gains, and financial transactions.

The federal tax system is already highly progressive. When considering all federal taxes—income, payroll, estate, and excise—Congressional Budget Office data show that the average effective tax rate for the top 1 percent of households is 33 percent, while the rate for the middle 60 percent of households is 15 percent, and the rate for the bottom 20 percent of households is less than 2 percent. The top 1 percent pays 25 percent of all federal taxes.

The Organisation for Economic Co-operation and Development (OECD) examined the distributions of household taxes within member countries. Household taxes include individual income taxes and employee payroll taxes. It found that “taxation is most progressively distributed in the United States” of the 24 nations it studied. The OECD study was published in 2008, but the findings likely still hold because our tax system has become even more progressive since then.

There is no agreement that progressive taxation is fairer than proportional taxation, but even if there were, it is clear that our tax system is already highly skewed before any further tax increases. And even if progressive taxation made sense, rather than adding a wealth tax or raising tax rates, a better approach would be to end current breaks for the wealthy that distort the economy, such as the income tax exemption for municipal bond interest.

This report addresses wealth taxes and broader issues of taxing capital. Taxes on capital are usually aimed at the rich, but they often harm lower- and middle-income workers who may own no capital at all. Taxes on capital also induce extensive avoidance, especially in today’s global economy.

A better way to tax capital is with a consumption-based tax system. Such a system would not distort saving and investment, thus generating higher productivity and wage growth over the long run.

**WEALTH TAX BASICS**

The major federal taxes—income and payroll taxes—are taxes on flows of income. By contrast, wealth taxes are imposed on stocks of assets owned by individuals and businesses. The United States currently imposes a number of different wealth taxes. One is the federal estate tax, which is imposed at death on net wealth above an exemption amount.

Local property taxes are also wealth taxes. They are paid by owners of residential, commercial, and industrial real property. U.S. property taxes are relatively high. As a share of gross domestic product (GDP), we have the fourth-highest property tax revenues among 36 major industrial countries.

Elizabeth Warren has proposed an annual federal tax on a broad measure of individual wealth including real property, personal property, and financial assets. Wealth taxes are imposed on net wealth—assets less debt. Warren’s proposal would impose a tax of 2 percent on net wealth above $50 million and 3 percent on net wealth above $1 billion.

Much of the advocacy for a wealth tax includes complaints about inherited wealth. In championing Warren’s tax, for example, New York Times columnist Paul Krugman claimed, “we seem to be heading toward a society dominated by vast, often inherited fortunes.” Yet a wealth tax would hit both self-made wealth and inherited wealth, and the latter is a small and declining share of the largest fortunes. Just 15 percent or so of the net wealth of the richest 1 percent of Americans is inherited.

A wealth tax would be imposed on stocks of assets, but it would be similar to an added layer of income tax. Suppose a person received a pretax return of 6 percent on corporate equities. An annual wealth tax of 2 percent would effectively reduce that return to 4 percent, which would be like a 33 percent income tax—and that would be on top of the current federal individual income tax, which has a top rate of 37 percent.

However, wealth taxes differ from taxes on capital income because the tax amount is not related to the actual return. The effect is to impose lower effective tax rates on higher-yielding assets, and vice versa. If equities produced returns of 8 percent, a 2 percent wealth tax would be like a 25 percent income tax. But if equities produced returns of 4 percent, the wealth tax would be like a 50 percent income tax. People with the lowest returns would get hit with the highest tax rates, and even people losing money would have to pay the wealth tax.

Another dissimilarity between wealth taxes and taxes on capital income is that the former often impose tax on items excluded under income taxes. Some household assets, such as owner-occupied housing, artwork, and jewelry, do not produce cash income flows and thus are not taxed under the
income tax, but these items may be taxed under wealth taxes.

Would a federal wealth tax be constitutional? The U.S. Constitution allows Congress to impose direct taxes if they are apportioned among the states. The Sixteenth Amendment allowed the government to impose an income tax without apportionment. A wealth tax would seem to be a direct tax that would need apportionment, which would perhaps block its imposition.

However, there may be wiggle room for a wealth tax to pass legal muster. Rather than taxing wealth directly, supporters could add a provision to the current income tax code to tax an assumed fixed annual return from a measure of household wealth. The economic effect would be similar, but such a new wealth tax would look like an income tax.

Whether or not the Supreme Court would find a wealth tax to be constitutional, such a tax would be a bad idea for economic and practical reasons, as the following sections discuss.

**WEALTH TAXES IN EUROPE**

Numerous European countries used to impose annual wealth taxes, but they have been mainly scrapped in recent decades. The number of European countries with annual wealth taxes has fallen from 12 in 1990 to just 3 today. Ireland imposed and then repealed its wealth tax in the 1970s. Table 1 shows countries that have had wealth taxes.16

Countries repealed their wealth taxes for a combination of reasons: they raised little revenue, created high administrative costs, and induced an outflow of wealthy individuals and their money. Also, many policymakers have recognized that high taxes on capital damage economic growth. Here are some country notes:

- Austria abolished its wealth tax in 1994 “mainly due to the high administrative costs that accrued in the data collection process and because of the economic burden the wealth tax meant to Austrian enterprises.”17
- Denmark cut its wealth tax rate in 1989 and repealed the tax altogether in 1997.18
- Finland abolished its wealth tax in 2006, a reform “motivated by the fact that the tax had an unfair impact on enterprises and provided many possibilities to evade,” noted a European Commission report.19
- France abolished its wealth tax in 2017 after many news articles noted that wealthy entrepreneurs and celebrities were fleeing the country. The government estimated that “some 10,000 people with 35 billion euros worth of assets left in the past 15 years.”20 A related reform was the 2015 repeal of France’s “supertax” on high incomes of 75 percent, which also raised little money and encouraged high-earners to leave.21
- Germany repealed its wealth tax in 1997 after a constitutional court struck it down due to inequities in the treatment of different asset types.22 The tax repeal appears to have had a positive effect on savings.23
- Ireland imposed a wealth tax in 1975 due to concerns

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<th>Country</th>
<th>Introduced</th>
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<tr>
<td>Austria</td>
<td>1954</td>
<td>Repealed 1994</td>
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<td>Denmark</td>
<td>1903</td>
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<td>Finland</td>
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<td>France</td>
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<td>Ireland</td>
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<td>Luxembourg</td>
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<td>Netherlands</td>
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<td>Sweden</td>
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<td>Repealed 2007</td>
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<td>Norway</td>
<td>1892</td>
<td>Reduced in recent years</td>
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<td>Spain</td>
<td>1977</td>
<td>Repealed 2008 but reinstated 2011</td>
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<td>Switzerland</td>
<td>1840</td>
<td>Imposed by cantons only</td>
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about wealth inequality. The tax was shot full of exemptions, raised little money, and the administrative costs were high. It was repealed in 1978.

- Netherlands abolished its wealth tax in 2001 and replaced it with an income tax on an assumed fixed return of 4 percent on financial assets. The new tax replaced prior personal taxes on capital income.

- Norway retains a wealth tax, but it abolished its inheritance tax in 2014 because it was considered unfair, raised little revenue, and impeded the transfer of family businesses.

- Sweden repealed its wealth tax in 2007 as it became clear that it was driving business people—such as the founder of Ikea, Ingvar Kamprad—out of the country. An analysis by Swedish economists found that wealth tax revenues were declining as “people could with impunity evade the tax by taking appropriate measures.” Sweden has low property taxes and it abolished its inheritance tax in 2004.

- Spain repealed its wealth tax in 2008 but brought it back during the financial crisis in 2011. The rates are established by regional governments. There has been a downward trend, with the current wealth tax in Madrid set at zero.

- Switzerland imposes wealth taxes at the canton level only. The country is unique because it raises substantial revenues from wealth taxes, partly due to low exemption levels. However, this tax burden on capital is offset by Switzerland’s moderate property and corporate income taxes, and its lack of taxation of individual capital gains. Wealth tax rates have been falling across the cantons in recent years.

In a 2018 study on wealth taxes, the OECD examined the reasons for their repeal. Concerns about capital flight were important, as well as “concerns about their efficiency and administrative costs, in particular in comparison to the limited revenues they tend to generate,” which “have led to their repeal in many countries.”

When European countries had annual wealth taxes in place, the statutory rates averaged about 1 percent on net wealth above various exemption amounts. The bases of the taxes also varied, as countries exempted different types of assets.

European wealth taxes typically raised only about 0.2 percent of GDP in revenues. Given the little revenue raised, it is not surprising that they had “little effect on wealth distribution,” as one study noted. Today, Norway raises about 0.4 percent of GDP, Spain about 0.2 percent, and Switzerland about 1 percent.

In the United States, the federal individual income tax raises 8 percent of GDP, so a wealth tax raising, say, 0.2 percent would raise just 1/40th as much. Even if one favors higher taxes on the wealthy, it would be simpler to eliminate a high-end loophole in the income tax—such as the tax exemption for municipal bond interest—than to impose a new wealth tax system.

Moreover, a U.S. wealth tax may not raise government revenues overall because it would suppress revenues from other tax sources. As discussed below, that appears to have been the experience in Sweden and France, and that is what computer modeling indicates would happen with proposed wealth taxes in Germany and United States.

Nonetheless, there has been renewed interest in wealth taxes since the 2014 book by economist Thomas Piketty, *Capital in the Twenty-First Century*. Piketty claimed that rising wealth inequality posed a major crisis for advanced economies. He proposed that countries impose annual wealth taxes with rates of 1 percent and higher above an exemption amount.

Many economists have found inaccuracies in Piketty’s data and pointed out that his theoretical claims are off-base. Nonetheless, his ideas have spurred pundits and politicians to champion wealth taxation. But the European lessons are clear, and the good news is that countries have not acted on Piketty’s bad advice to impose or reimpose these complex and harmful taxes.

**COMPLEX ADMINISTRATION**

Proponents of an annual wealth tax may imagine a system that is simple, broad-based, easy to administer, and lucrative for the government. But wealth taxes did not work that way in practice in Europe. Wealth taxes were complex and costly to collect, and they induced substantial avoidance while raising little revenue.

One problem is valuing assets. A wealth tax may require taxpayers to report valuations, not just of financial securities and homes, but also of such items as household furnishings, artwork, jewelry, vehicles, boats, life insurance policies, pensions, family businesses, and farm assets. Many of these assets have no ready market valuation. Accounting for wealth held in trusts would also be difficult, and for people with nontraded ownership in family businesses, book and market valuations can differ substantially. Furthermore, valuations of assets change over time, so a large industry of accountants would be needed to prepare regular valuations for tax returns.

Tax law professor Miranda Perry Fleischer finds that an annual wealth tax would be “hobbled by valuation issues.” She
discusses, for example, the unknown values of closely held businesses, especially those held jointly with multiple sorts of ownership rights. She notes that valuation disputes already bedevil estate tax returns, but wealth tax disputes would be even more contentious because they would come back year after year. And consider that while the IRS handled 12,700 estate tax returns in 2017, Elizabeth Warren’s proposed wealth tax would require annual filing by at least 75,000 taxpayers.40 In a recent survey of economists, 73 percent agreed and only 7 percent disagreed that Senator Warren’s wealth tax would be “much more difficult to enforce than existing federal taxes because of difficulties of valuation.”41

The difficulty of wealth valuation can be seen in an Internal Revenue Service study that compared valuations on estate tax returns to valuations of the same estates on the Forbes 400 list of wealthiest Americans.42 The study found that estate tax valuations were, on average, only 50 percent of the valuations on the Forbes list:

This research highlights the inherent difficulties of valuing assets which are not highly liquid. The portfolios of very wealthy individuals are made up of highly unique assets and often the value of assets, such as businesses, are very closely tied to the personality and skills of the owner. Determining a precise value for these assets can involve more art than science.43

The United Kingdom undertook a major examination of its tax system in 2001 called the Mirrlees Review. It studied a possible UK wealth tax and concluded:

Levying a tax on the stock of wealth is not appealing. To limit avoidance and distortions to the way that wealth is held, as well as for reasons of fairness, the base for such a tax would have to be as comprehensive a measure of wealth as possible. But many forms of wealth are difficult or impractical to value, from personal effects and durable goods to future pension rights—not to mention “human capital.” These are very serious practical difficulties. And where attempts have been made to levy a tax on a measure of current wealth—in France, Greece, Norway, and Switzerland, for example—practical experience has not been encouraging.44

Another problem with wealth taxes would be tracking wealth held abroad. A wealth tax could be imposed on just domestic assets, but that would create a large incentive for the wealthy to hold their assets abroad. So, Congress would likely impose the tax on worldwide assets, yet that would create a large incentive for evasion. The Internal Revenue Service would be charged with the impossible task of auditing everything affected U.S. residents owned on a global basis and judging whether the valuations on all those foreign assets were fair.

Taxpayer liquidity would be another issue. Wealth tax payment would be difficult for people who mainly held assets that are illiquid and do not generate regular cashflows, such as homes, artwork, and ownership shares of some family businesses. The need to pay wealth taxes each year would force inefficient sales of assets to raise cash or require taxpayers to borrow money. The OECD found that liquidity issues have been a major problem with wealth taxes in Europe.45

In the 1970s, the British Labour Party campaigned on imposing an annual wealth tax, and it tried to follow through after being elected. However, party leaders eventually dropped the idea when they realized how complex the administration would be. The Chancellor of the Exchequer at the time, Denis Healey, said in his memoirs, “We had committed ourselves to a wealth tax; but in five years I found it impossible to draft one which would yield enough revenue to be worth the administrative cost and political hassle.”46

India enacted an annual wealth tax in 1957 and repealed it in 2015. Indian finance minister Arun Jaitley described reasons for his government’s scrapping of the tax at an event in New York: “The practical experience has been it’s a high cost and a low yield tax.”47 The Indian wealth tax became riddled with exemptions, it was evaded, and it raised little revenue.48

An expert study for the Mirrlees Review concluded that the wealth tax in Europe “has been a particularly inefficient tax to collect,” and that for the UK it would be “costly to administer, might raise little revenue, and could operate unfairly and inefficiently.”49 An International Monetary Fund (IMF) study concluded that “taxing income from wealth, rather than taxing wealth itself, is more equitable and efficient.”50

For the United States, a wealth tax would not achieve the fairness that supporters are seeking. It would generate tax avoidance and lobbying by the wealthy for exemptions. In turn, that would increase public cynicism about the tax system. In countries that have had wealth taxes, the public has not perceived the actual operation to be fair. In its study, the OECD concluded, “A major concern with net wealth taxes is the ability of wealthier taxpayers to avoid or evade the tax. This has limited the potential of net wealth taxes to achieve their redistributive objectives and has contributed to perceptions of unfairness.”51

Economist Asa Hansson studied European wealth taxes and found that they often resulted in “poisoning general tax
morale” because of the exemptions provided and the widespread avoidance. The OECD reports that “wealth taxes were unpopular in a number of countries, which contributed to their repeal.”

**TAX AVOIDANCE AND CAPITAL MOBILITY**

The flow of capital across international borders has soared since the 1980s. Corporations and individuals are increasingly moving their investments to countries with better growth opportunities and lower taxes. Most nations have responded by cutting their tax rates on capital to defend their tax bases and spur economic growth. The OECD notes that the “repeal of net wealth taxes can also be viewed as part of a more general trend towards lowering tax rates on top income earners and capital.”

Since 1981, the average corporate tax rate across OECD countries fell from 47 percent to 24 percent, the average top personal income tax rate fell from 66 percent to 43 percent, and the average combined corporate-individual rate on dividends fell from 75 percent to 42 percent.

Many countries have cut their capital gains taxes, as well as their withholding taxes on cross-border investment flows. Numerous countries have abolished their estate and inheritance taxes, including Austria, Canada, the Czech Republic, New Zealand, Norway, Portugal, and Sweden. The share of GDP raised by estate and inheritance taxes in the OECD fell from 1.1 percent in 1965 to 0.4 percent today.

The OECD nations have recognized that wealth and capital income are responsive tax bases. High rates make the tax base shrink—both from domestic avoidance and from international mobility. Furthermore, individuals at the top end have more flexibility in their business and financial affairs than others, so they are particularly responsive to taxes.

Avoidance was common under European wealth taxes and was aided by governments that carved out exemptions. Farm and small business assets were often exempted over concerns about entrepreneurship. Pension assets were exempted over concerns about fairness. Artwork and antiques were exempted because of difficulties in valuation and worries about the break-up of collections. Forest lands were exempted for environmental reasons. Nonprofit organizations and intellectual property rights were often exempted. The French wealth tax exempted stocks of wine and brandy.

Over time, taxpayers shifted their wealth into exempted assets and tax bases shrank. The base of wealth taxes is net wealth, meaning assets less debt. The deductibility of debt encouraged people to borrow and then invest in the exempted assets and in assets that were hard for governments to find. People had the incentive to underreport assets and overreport debt. The OECD found there was “clear evidence of wealth tax avoidance and evasion” in Europe. An IMF article concluded, “The design of wealth taxes is notoriously prone to lobbying and the granting of exemptions that the wealthiest can exploit. Furthermore, the rich have proved adept avoiding or evading taxes by placing their wealth abroad in low tax jurisdictions.”

Wealth tax supporters imagine a simple, broad tax base. Thomas Piketty proposed that wealth taxes cover “all types of assets . . . no exceptions.” Senator Warren and the economists who designed her wealth tax plan say it would cover all assets above the exemption amounts. But actual wealth taxes have not worked that way:

Ireland’s experience in the 1970s is classic. The nation imposed a wealth tax in 1975 in response to concerns about wealth inequality, as described in a government White Paper at the time. But the government’s broad-based ideal for the tax was undone even as it was being implemented:

Pressure from influential lobby groups had debased and undermined the basic structure proposed in the White Paper. Pressure had come from agricultural interest groups; chambers of commerce; the accountancy profession, and the tourism lobby. The undermined wealth tax eventually enacted was therefore incapable of achieving the stated objectives of horizontal and vertical equity. The inevitably low yield then provided an apparent justification for its eventual abolition.

The Irish wealth tax exempted homes, farm assets, pensions, art, jewelry, and other items. The tax raised little money and the “administration and compliance costs were very high relative to the yield.” It was abolished in 1978. The Irish were quick learners about the folly of wealth taxes.

The Swedish wealth tax experience was similar, as described in a study by economists Magnus Henrekson and Gunnar Du Rietz:

The numerous forms of relief and exemptions introduced over the years not only lowered wealth tax revenue, they also increased the distortive effects of the wealth tax. Most important among these effects were capital outflow and an unsustainable valuation and growth of asset classes exempted from wealth taxation. These asset holdings were often financed by borrowing,
which in turn resulted in increased financial fragility.\textsuperscript{58}

Henrekson and Du Rietz describe how avoidance undermined the tax: “First, one should note that despite high statutory tax rates and rapidly increasing wealth levels, especially following financial market deregulation in the 1980s, wealth tax revenue remained low. This is in itself a strong indication that people could with impunity evade the tax by taking appropriate measures.”\textsuperscript{69} Sweden repealed its wealth tax in 1997.

The current Spanish wealth tax has similar problems.\textsuperscript{70} Avoidance is fairly easy because many assets have been exempted, including small business assets, some shareholdings, life insurance policies, pension plans, and certain art and antiques. The Spanish wealth tax rate is high (up to 3.45 percent), but the tax only raises 0.2 percent of GDP in revenue.

A few statistical studies have measured the responsiveness of taxpayers to wealth taxes. A study by Katrine Jakobsen and coauthors examined responses to Denmark's wealth tax, which was repealed in 1997. They found “sizable” responses to the tax with the effects being much larger at the top end of the wealth distribution.\textsuperscript{71} David Seim studied the Swedish wealth tax and found small responses from avoidance and evasion, but he did not study the shifting of assets abroad.\textsuperscript{72}

A 2016 study by Marius Brülhart and coauthors examined behavioral responses to wealth taxes in Switzerland, where different tax rates are imposed by cantons. They found that “reported wealth holdings in Switzerland are very responsive to wealth taxation. We estimate that a 0.1 percentage-point rise in wealth taxation lowers reported wealth by 3.5 percent.”\textsuperscript{73} The estimates are large compared to the usual estimates of income tax responsiveness.

While this Swiss study ties the response to domestic avoidance, in other countries international capital mobility was a major issue. Henrekson and Du Rietz’s study on Sweden finds:

> In 1989 all foreign exchange controls were lifted, making it difficult to prevent people from transferring wealth to tax havens, either illicitly or when taking residence in another country. Several studies found that a sizable share of large fortunes was being placed outside of Sweden in countries like Luxembourg and Switzerland. In those cases the government not only lost income from wealth taxation, but also tax revenue on capital gains, dividends and interest income. The Swedish Tax Authority (Skatteverket) reported that in the early 2000s the value of assets illicitly transferred offshore may have amounted to more than SEK \[\text{Swedish krona}\] 500 billion, and the accumulated assets of Swedish billionaires living abroad were at least as large. The magnitude of these outflows was a major motivation for the repeal of the wealth tax in 2007.\textsuperscript{74}

As Henrekson and Du Rietz observe, the problem with capital outflows is that governments not only lose wealth tax revenues, but also lose other tax revenues that would have been generated by outgoing individuals and assets.

The French experience was similar to Sweden’s. The tax raised far less revenue than expected when it was introduced in the 1980s, noted law professor Gilbert Paul Verbit, and the “compliance costs of the wealth tax may be such that its principal beneficiaries are the tax advisors to those who must file.”\textsuperscript{75}

Economist Éric Pichet calculated that domestic evasion reduced French wealth tax revenues by at least 28 percent, and that the tax induced a capital flight of about 200 billion euros between 1988 and 2007.\textsuperscript{76} He estimated that, while the French wealth tax raised 3.5 billion euros a year, the government lost money overall because other tax revenues shrank by about 7 billion euros a year. He concluded, “The fact that it costs more than it yields engenders a paradoxical situation in which all of France’s other taxpayers, including its least wealthy citizens, must bear the brunt of its overall tax burden.”\textsuperscript{77}

### HOW TO TAX CAPITAL

There are two basic things people do with their earnings: consume and save. Saving is abstaining from current consumption. Savings are channeled back into the economy and used to support investments by business enterprises. To grow, economies need pools of savings—that is, pools of capital or wealth.

Senator Warren and other policymakers are concerned that wealth is “concentrated.” But the wealth of the wealthy is mainly dispersed across the economy in productive business assets. Looking at the top 0.1 percent of the wealthiest Americans, 73 percent of their wealth is equity in private or public companies, while just 5 percent is the value of their homes.\textsuperscript{78}

Looking just at billionaires, only 2 percent of their wealth is accounted for by their homes and personal assets, such as yachts, airplanes, cars, jewelry, and artwork.\textsuperscript{79} The great majority of their wealth is in productive business assets, which generate output for the broader economy.

Nonetheless, many policymakers and pundits believe that people with substantial wealth should be targets of heavy taxation. They think that raising taxes on people owning capital would lighten the burden on labor and that taxing wealth would benefit the nonwealthy.
However, imposing heavy taxes on wealth would reduce living standards for everyone because it would reduce the overall size of the economy. Under certain assumptions, a basic finding from economic theory is that everybody should want taxes on capital to be low or even zero—including wage earners, who have no capital income.80

Economist Greg Mankiw describes a simple economy with two groups: workers and capitalists.81 The capitalists save and earn capital income, while the workers earn wages and do not save. The workers are in the democratic majority and can set tax policy anyway they want. Should they tax wages, capital income, or both? It turns out that—acting in their own interest—the workers should tax wages only, not capital income.

The reason is that the supply of capital is elastic or responsive to taxation, and so setting the tax rate to zero would generate increased saving and investment. In turn, that would create rising worker productivity and wages—worker efforts are more valuable when they have more and better machines to work with. In the long run, the after-tax wages of workers would be higher under this policy than under a policy of imposing taxes on capital.

This result assumes that the supply of capital is perfectly elastic or responsive. While that is not fully realistic, capital has become more responsive in today's global economy. In another paper, Mankiw and coauthors noted that the zero capital tax prescription “is strengthened in the modern economy by the increasing globalization of capital markets, which can lead to highly elastic responses of capital flows to tax changes even in the short run.”82 They conclude that the “logic for low capital taxes is powerful: the supply of capital is highly elastic, capital taxes yield large distortions to intertemporal consumption plans and discourage saving, and capital accumulation is central to the aggregate output of the economy.”83

From an average worker’s point of view, it is beneficial for the wealthy to maximize their savings and reduce consumption. Capital and labor are complements in the economy—workers are more productive and better paid when they are supported by more capital generated by savers. The Council of Economic Advisers has summarized the empirical evidence in support of low taxes on capital.84

The basic idea goes back at least to Adam Smith, writing in The Wealth of Nations. He described how heavy taxes on mobile “stock” or capital would cause losses to workers:

Stock cultivates land; stock employs labour. A tax which tended to drive away stock from any particular country, would so far tend to dry up every source of revenue, both to the sovereign and to the society. Not only the profits of stock, but the rent of land and the wages of labour, would necessarily be more or less diminished by its removal.85

This insight on the importance of savings also underlays opposition to the federal estate tax, which is a wealth tax imposed at death. From a liberal perspective, law professor Edward McCaffery has long made the case for abolishing the estate tax, arguing, “The rich person who passes on wealth is doing good things for society—continuing to work and save, keeping money in the capital stock.” McCaffery notes that a weird thing about the estate tax is that it is a “virtue tax,” or the opposite of a sin tax.86 Sin taxes discourage vices, but estate taxes and other wealth taxes discourage the virtuous behavior of saving.

Greg Mankiw has made similar points:

When a family saves for future generations, it provides resources to finance capital investments, like the start-up of new businesses and the expansion of old ones. Greater capital, in turn, affects the earnings of both existing capital and workers.

Because capital is subject to diminishing returns, an increase in its supply causes each unit of capital to earn less. And because increased capital raises labor productivity, workers enjoy higher wages. In other words, by saving rather than spending, those who leave an estate to their heirs induce an unintended redistribution of income from other owners of capital toward workers.

The bottom line is that inherited wealth is not an economic threat. Those who have earned extraordinary incomes naturally want to share their good fortune with their descendants. Those of us not lucky enough to be born into one of these families benefit as well, as their accumulation of capital raises our productivity, wages and living standards.88

All of this raises what appears to be a policy dilemma. How can we have a tax system that does not penalize beneficial wealth accumulation but also distributes the tax burden equitably? How do we ensure that the rich pay a fair share of taxes while not discouraging saving?

The answer is consumption-based taxation. Consumption-based taxes can be taxes on transactions, such as retail sales taxes and value-added taxes. Or they can be taxes assessed on individuals and businesses, such as the “flat tax” designed by economists Robert Hall and Alvin Rabushka and the “X-Tax”
designed by economist David Bradford.89

Both income and consumption-based taxes tax income from labor and capital. But unlike income taxes, consumption-based taxes exempt the “normal” return to capital, which removes the bias against saving and investment. The normal return is usually thought of as the yield on a riskless investment, which represents the time value of money.

Both income and consumption-based taxes tax the “above-normal” returns to capital. Those include the returns, or profits, attributable to market power, innovations, windfalls, and various rents available to certain businesses and investors.90 Economist Glenn Hubbard notes that wealthier households receive a larger portion of their capital income from these items, so consumption-based systems can be quite progressive.91

Bradford agrees that “sources of great wealth,” such as monopolies and highly profitable technology firms, are taxed under both income and consumption-based systems.92 However, by exempting the normal returns, the latter system is more conducive to growth. Bradford also long argued that consumption-based tax systems allow for much simpler administration and compliance.93

Consumption-based systems are also better at equalizing taxes on capital across activities and industries, and they capture some activities that escape taxation under the income tax. As one example, the “buy-borrow-die” strategy in real estate investment can allow individuals to go years without paying income tax if they borrow against appreciating properties to fund their consumption.94 That is the sort of loophole that angers the public about wealthy people, and it would be closed under a consumption-based system.

Theoretical models suggest that consumption-based taxes are superior to income taxes on both efficiency and distributional grounds.95 The key is that income taxes distort both work effort and savings, but consumption-based taxes just distort work effort. Consumption-based taxes are superior on efficiency because you can raise a given amount of revenue with fewer distortions than under income taxation. Regarding distribution, you can design a consumption-based tax to match the progressivity of an income tax, but which collects revenue with fewer distortions.

Tax law professors Joseph Bankman and David Weisbach conclude that “everyone is equally well off or better off under a properly designed consumption tax,” as compared to an income tax.96 They note that consumption-based taxes would tax the “idle rich,” which is often the motivation for taxes on the wealthy.97

Economists Kevin Hassett and Alan Auerbach agree that consumption taxes would target wealth, noting that “consumption taxes reduce the value of wealth, just as wealth taxes do” and “if the disproportionate political power of the wealthy is the concern, a consumption tax is potentially a more powerful tool.”98

Wealth taxes are an inefficient method for taxing the rich because they treat profits in the opposite way as consumption-based taxes. Wealth taxes exempt some above-normal returns to savings and tax the normal returns, which would distort savings and investment.99 In its report on wealth taxes, the OECD pointed to this problem: “The taxation of normal returns is likely to distort the timing of consumption and ultimately the decision to save, as the normal return is what compensates for delays in consumption.”100

Auerbach and Hassett come to similar conclusions: a consumption tax differs from a capital income tax in its treatment of capital income only by its exemption of the safe rate of return on investment. Thus, consumption taxes hit wealth without interfering with the incentive to save associated with the intertemporal terms of trade. Wealth taxes, on the other hand, effectively tax the safe rate of return on investment because they do not depend on actual rates of return, thereby incurring the intertemporal distortion but forgoing tax on other components of the rate of return.101

Bill Gates sort of captured the idea of consumption-based taxation when he said: “Think about the three wealthy people I described earlier: One investing in companies, one in philanthropy, and one in a lavish lifestyle. There’s nothing wrong with the last guy, but I think he should pay more taxes than the others.”102 A better framing would be to say that the last guy, who spends lavishly, is favored under income and wealth taxes, while the first guy, who saves, is penalized. Consumption-based taxation would fix that problem by taxing income and wealth only if consumed.

Because wealth taxes suppress savings and investment, they undermine economic growth. A 2010 study by Asa Hansson examined the relationship between wealth taxes and economic growth across 20 OECD countries from 1980 to 1999. She found “fairly robust support for the popular contention that wealth taxes dampen economic growth,” although the magnitude of the measured effect was modest.103

The Tax Foundation simulated an annual net wealth tax of 1 percent above $1.3 million and 2 percent above $6.5 million.104 They estimated that such a tax would reduce the U.S. capital stock in the long run by 13 percent, which in
turn would reduce GDP by 4.9 percent and reduce wages by 4.2 percent. The government would raise about $20 billion a year from such a wealth tax, but in the long run GDP would be reduced by hundreds of billions of dollars a year.

Germany’s Ifo Institute recently simulated a wealth tax for that nation. The study assumed a tax rate of 0.8 percent on individual net wealth above 1 million euros. Such a wealth tax would reduce employment by 2 percent and GDP by 5 percent in the long run. The government would raise about 15 billion euros a year from the tax, but because growth was undermined the government would lose 46 billion euros in other revenues, resulting in a net revenue loss of 31 billion euros. The study concluded, “the burden of the wealth tax is practically borne by every citizen, even if the wealth tax is designed to target only the wealthiest individuals in society.”

CONCLUSIONS

Nations around the world have cut taxes on capital in recent decades, and most nations that had annual wealth taxes have repealed them. Recent U.S. proposals to increase taxes on wealth and capital income run counter to the lessons learned about efficient taxation in the global economy.

The Europeans discovered that imposing punitive taxes on the wealthy undermined economic growth. They found that wealth taxes encouraged tax avoidance and generated capital flight. European wealth taxes raised little money and became riddled with exemptions.

Wealth is accumulated savings, which is needed for investment. The fortunes of the richest Americans are mainly socially beneficial business assets that create jobs and income, not private consumption assets. Raising taxes on wealth would boomerang against average workers by undermining their productivity and wage growth.

Senator Warren says that she wants rich people to “pay a fair share, so the next kid has a chance to build something great and the kid after that and the kid after that.” But encouraging the wealthy to invest in new and expanding businesses is what creates opportunities for those young people, not redistributing more income through the tax code.

Creating a fair and efficient method of taxing capital is a challenge, but experts are widely agreed that wealth taxes are an inefficient way to do so. Rather than sin taxes, wealth taxes are virtue taxes that penalize the wealthy for being frugal and for reinvesting their earnings.

Rather than imposing a wealth tax or raising tax rates on capital income, policymakers should rethink the overall federal approach to taxing capital. A better way is through consumption-based taxation, which would tax wealth but in a simpler way that does not stifle savings, investment, and growth.

NOTES

The author thanks David Kemp and David Titus for research help and David Burton for outside review.


10. Congressional Budget Office data show that the top 1 percent has increased its share of overall federal taxes since 2008. See Congressional Budget Office, “The Distribution of Household Income, 2016.”


16. Organisation for Economic Co-operation and Development, “The Role and Design of Net Wealth Taxes in the OECD,” 2018, p. 76. The OECD study does not have the year introduced for Iceland, so I took the first year that wealth tax revenue shows up in OECD’s tax revenue database. See also Alexander Krenek and Margit Schratzenstaller, “A European Net Wealth Tax,” Austrian Institute of Economic Research, April 15, 2018, Table 1. This study shows earlier enactment years than the OECD for a number of the countries. Also note that some countries have taxes that cover a portion of wealth. For example, Belgium imposes an annual charge on financial securities and Italy imposes a tax on real estate and financial assets held abroad.


31. OECD, “The Role and Design of Net Wealth Taxes in the
OECD,” p. 20.


37. Warren and her wealth tax advisers claim that all assets above the exemption amount would be included. Emmanuel Saez and Gabriel Zucman, University of California, Berkeley, letter to Sen. Elizabeth Warren, January 18, 2019.


40. Saez and Zucman, letter to Senator Warren.


45. OECD, “The Role and Design of Net Wealth Taxes in the OECD,” p. 64.


57. Drometer et al., “Wealth and Inheritance Taxation.”


59. OECD, “The Role and Design of Net Wealth Taxes in the OECD,” p. 82. And see Rudnick and Gordon, “Taxation of Wealth.”


65. As discussed in McDonnell, “Wealth Tax.”


70. Gabarro, “Spain’s Wealth Tax and 10 Legitimate Ways to Reduce It.”

71. Jakobsen et al., “Wealth Taxation and Accumulation.”


models assume that redistribution is a good thing and it is to be traded off with the damage caused by higher tax rates within a “social welfare function.” The utilitarian premise is dubious, but that is the starting point of these models.


84. In particular, the Council of Economic Advisers examined taxes on corporate income. It noted that “reductions in the corporate tax rate incentivize corporations to pursue additional capital investments as their cost declines. Complementarities between labor and capital then imply that the demand for labor rises under capital deepening and labor becomes more productive. Standard economic theory implies that the result of more productive and more sought-after labor is an increase in the price of labor, or worker wages.” Council of Economic Advisers, “Corporate Tax Reform and Wages: Theory and Evidence,” October 2017. And see Council of Economic Advisers, “The Growth Effects of Corporate Tax Reform and Implications for Wages,” October 2017.


91. Hubbard says the claim that “consumption tax reform is a sop to the rich is almost certainly unfair, especially if a progressive consumption tax like that proposed by Bradford” were being considered. R. Glenn Hubbard, “Would a Consumption Tax Favor the Rich?,” p. 91. David Bradford similarly discusses why it is a misconception that consumption-based taxation is regressive. See David Bradford, Blueprints for Basic Tax Reform (Arlington: Tax Analysts, 1984), p. 122.


93. Policymakers may add narrow breaks and unneeded complexity to both income and consumption-based taxes. However, the basic accounting under consumption-based taxes is simpler and they would do away with complex aspects of income taxation including depreciation, inventory accounting, and capital gains. See Chris Edwards, “Simplifying Federal Taxes: The Advantages of Consumption-Based Taxation,” Cato Institute Policy Analysis no. 416, October 17, 2001. David Bradford discussed how consumption-based taxation would be simpler than income taxation in many essays. For example, see Bradford, Taxation, Wealth, and Saving.

94. This is Edward McCaffery’s phrase. It is true that one needs to build wealth first before the strategy works. You buy and hold an asset, such as land, that appreciates while providing little current income flow, then you borrow against the appreciating asset for your personal consumption, and when you die your asset gets a step-up in basis. Edward J. McCaffery,


96. Bankman and Weisbach, “The Superiority of an Ideal Consumption Tax,” 1413–56. The authors note a “properly designed consumption tax is Pareto superior to an income tax.” Bankman and Weisbach are expanding on an idea explored in a 1976 study by Anthony Atkinson and Joseph Stiglitz.


99. A wealth tax would tax normal returns and “any foreseeable above-normal returns associated with tradable assets,” but would exempt other types of above-normal returns that may not be capitalized in asset prices. See S. Cnossen and A. L. Bovenberg, “Fundamental Tax Reform in the Netherlands,” METEOR research memorandum no. 024, Maastricht University, January 1, 2000, p. 4.


