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PERCSPECTIVES ON POLICY

TAXING WEALTH

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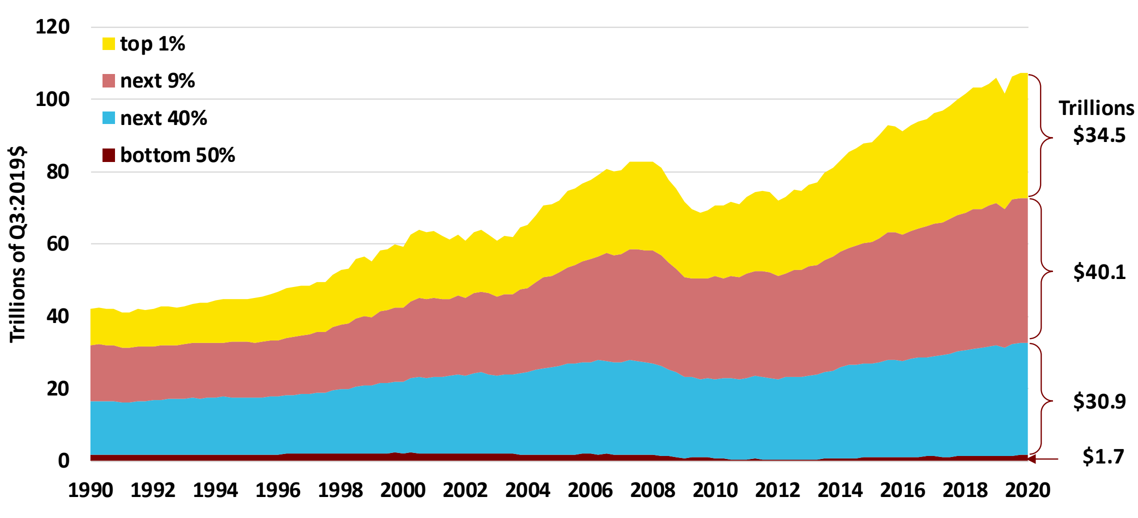
Persistent budget deficits and the desire to expand federal programs have led to proposals for a federal wealth tax. Senator Warren has proposed a 2% tax on the wealth of households with a net worth above $50 million, rising to a tax rate of 6% of the wealth of billionaires, in order to finance her Medicare for All program. Senator Sanders has proposed a wealth tax that begins at 1% for those with net worth between $32 and $50 million and eventually increases to 8% for household wealth above $10 billion.

Why the recent focus on wealth taxes? Government seems to have an insatiable appetite for spending, and the public is resisting further increases in traditional taxes. Our ongoing record federal budget deficits during a time of economic expansion is one indication that the public opposes new taxes but desires continued spending. A new tax on 'the wealthy' is envisioned as a tax on someone else. This is reminiscent of the first federal income taxes, which applied only to those with, what were at the time, very high incomes. It is not obvious that a wealth tax, once enacted, will be limited to 'the wealthy'.

Fueling the move to tax wealth are estimates of rising wealth inequality. This rising wealth inequality seems to provide an additional reason to tax the wealthy, as they are supposedly benefiting disproportionately from the economy compared to the rest of society. Direct measures of wealth are difficult to find, but that has not stopped economists from making estimates, and the most referenced may be the estimates by Emmanuel Saez and Gabriel Zucman published in the Quarterly Journal of Economics in 2016. They find that the top 1% of households held 42% of total wealth in 2012, up from about 28% in 1990. Unfortunately, these estimates of the wealth distribution are built on many assumptions that greatly influence the final results, and there are plenty of critics who question those assumptions and therefore, Saez and Zucman's findings.

The Federal Reserve System has produced new Distributional Financial Accounts of the United

FIGURE 1. REAL HOUSEHOLD NET WORTH BY PERCENTILE GROUPS



Source: Distributional Financial Accounts, Board of Governors of the Federal Reserve System.

States, shown in Figure 1. The figure depicts the total real wealth by percentile groups from the third quarter of 1989 to the third quarter of 2019. As of the third quarter of 2019, total household wealth came to $107 trillion with $34.5 trillion or 32.2% held by the top 1% of households. The bottom 50% of households held $1.7 trillion and the next 40% held $30.9 trillion, so the combined net worth of the bottom 90% of households was $32.6 trillion or 30.4% of the total. The 90th to 99th percentiles held $40.1 trillion, or 37.4% of the total wealth.

Figure 2 depicts the shares of total wealth by percentile groups over time. The percent held by the top 1% grew from 23.9% in the third quarter of 1989 to the current share of 32.2%. As seen in the figure, the wealth share of the top 1% is impacted more by recessions and has increased more in the current expansion. This is consistent with the idea that the top 1% of households are making riskier investments. The estimates in Figure 2 suggest a lower concentration at the top of the distribution, and less growth over time in the share held by the wealthy, than do Saez and Zucman. In fact, the percent held by the 90th to 99th percentiles was about the same at the beginning and the end of the 30 year-period, though the share held by the bottom 90% declined from 39.1% to 30.4%.

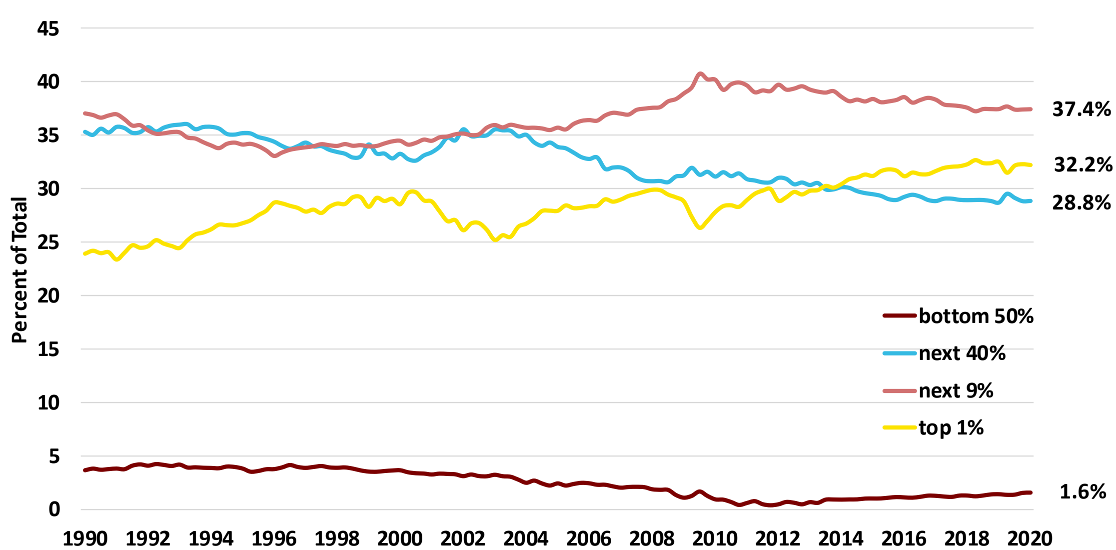
We are all familiar with taxes on income like the federal and state personal income taxes, corporate income taxes, and payroll taxes. We also pay taxes on our consumption through various forms of sales taxes. These taxes are all taxes on "flows." Personal income taxes and payroll taxes are largely a tax on our labor market wages which are flows from our human capital. The income taxes we pay on our interest, dividends, and capital gains are largely taxes on the flows from physical capital.

In comparison, a wealth tax is a tax on a "stock" of resources. The common property tax can be considered as a type of wealth tax, as it taxes the market value of housing. Many of the complaints about the property tax would find analogs in taxes on other wealth. Furthermore, some of the proposed tax rates for the wealth of the 'very wealthy' are confiscatory. An 8% tax rate on a stock of wealth would require huge rates of return pre-tax in order to just pay the taxes.

As with any tax, the devil is in the details, and details of current proposals are often vague. Still, taxes produce behavioral responses, and the resulting distributions of earned income and accumulated savings are by-products of the existing tax regime. Below we summarize some of the ways individuals will respond to a new tax on wealth.

A wealth tax would cause legal and illegal capital outflows – With increasing ease in the movement of capital and people across country borders, wealth tends to relocate to countries which have lower tax rates on wealth.[1] The capital outflows caused by a wealth tax could be either legal or illegal, but the consequences will be that productive capital will contribute to the economy of the destination economy rather than the origin economy. This is the main reason why wealth taxes were abandoned by many

FIGURE 2. SHARES OF HOUSEHOLD NET WORTH BY PERCENTILE GROUPS



Source: Distributional Financial Accounts, Board of Governors of the Federal Reserve System.

European countries that tried adopting them.[2]

A wealth tax would discourage wealth accumulation and capital formation – Rich households make rational decisions regarding how much to spend and how much to save according to their preferences and values. A wealth tax would certainly tilt their choices towards spending more and saving less. In this age where persistent budget deficits crowd out real capital investments, further impeding capital formation with a federal wealth tax seems to be an ill-advised policy. The federal government is unable to save – witness the large budget deficits – and now there are proposals to limit private saving as well!

The burden of a wealth tax is also borne by workers According to the economic theory of tax incidence, people who are legally responsible for remitting the tax payments under a tax do not necessarily bear the entire burden of the tax. In the case of a wealth tax, wealthy households would reduce their wealth holdings in response to the tax, thereby reducing the capital-labor ratio. This, in turn, would increase the return to capital and decrease wages. Therefore, the wealthy do not bear the entire burden of the wealth tax (through the increase in capital return), and some of the tax burden is shifted to the workers (through the decrease in wages).

A new wealth tax amounts to double taxation of wealth – There already exist many taxes that directly or indirectly fall on wealth. There are estate and gift taxes and the capital gains tax at the federal level, and the property tax at the local level. These taxes are directly based on wealth or wealth creation. There are also corporate and individual income taxes at various levels that are based on income derived from one's wealth. So wealth, and income from wealth, is already taxed.

The main rationale for a wealth tax is logically flawed – It is often argued by the advocates of wealth taxes that the full income flows for the very wealthy are difficult to determine because the top wealth holders typically choose to receive taxable income flows that are much smaller than the full income flows and save the differences in various wealth vehicles. Therefore, according to these advocates, we must tax their entire wealth in order to bring rich individuals' full income flows under a tax regime. However, note that one's full income is simply his reported income plus the increase in his wealth level during a year. So if one's wealth level is readily observable to be taxed, so is his full income.

A natural extention of the wealth tax is a tax on human capital – The same rationale for taxing the stock of capital could also be applied to taxing the stock of one's human capital. Suppose there is an artist whose works are highly prized, and this artist has a collection of her own works that are each as valuable as those that have been sold. Should these works be taxed under a new wealth tax? How would the value of this wealth be determined? Suppose they are taxed, and the artist decides to sell the paintings to pay the taxes. Now the paintings are also subject to the income tax. Given the new tax policy, the artist may decide to only produce paintings to sell and does not replenish her own stock of paintings beyond the threshold subject to the tax. However, the tax collector knows her potential to produce more paintings for her personal collection. The tax collector might reason that her human capital should be taxed to garner the same tax revenues as before.

Excluded wealth - Most measures of wealth and wealth inequality do not include the substantial Social Security and Medicare wealth. Accrued Social Security benefits are like an annuity and are much more evenly distributed than other components of wealth. Comprehensive measures of the wealth distribution would include transfer wealth, and comprehensive measures of the income distribution would include transfer income and would net out tax payments. In fact, consumption is the ultimate measure of economic welfare, not income and not wealth. A recent study by Bruce Meyer and James Sullivan indicates that consumption inequality has not grown to the same degree as income inequality.[3]

To summarize, economic theory and evidence strongly support the arguments against a federal wealth tax, and the logic and rationale behind arguments for a wealth tax are questionable. If growing income/wealth inequality is a concern, revising the existing taxes on estates, gifts, or capital gains could deal with the issue. Moreover, the desire for new revenue in this era of government deficits can also be 'solved' by cutting government spending.

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[1]Capital Flight and Capital Controls in Developing Countries, Edited by Gerald A. Epstein, 2005, Edward Elgar: Cheltenham UK and Northampton, MA, USA

[2]12 European countries had wealth taxes in 1990, but only 4 still had it in 2017. See The Role and Design of Net Wealth Taxes in the OECD, 2018, Paris: OECD.

[3]They find that income inequality grew by almost 30% between the early 1960 and 2014, but that consumption inequality only rose 7%. NBER Working Paper 23655, August 2017.

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