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The great wealth tax debate

Inequality is back at the forefront of economic policy debates, for good reason. A wealth tax is no panacea, and not even an ideal response to growing inequality at the top. But absent a better alternative, it can serve as a reasonable second-best policy, **writes Jean Pisani-Ferry**

Differing stance on wealth tax

In 1990, 12 advanced economies had a tax on household wealth. Now only four do, after French President Emmanuel Macron scrapped his country's version in 2017. Yet, a fierce debate has erupted in the United States over the proposal by Senator Elizabeth Warren, a leading Democratic presidential candidate, to introduce a tax of 2% on the wealth of "ultra-millionaires" (and 3% on that of billionaires).

> *The top 1% of US households now own 40% of the country's wealth*

In a new book, economists Emmanuel Saez and Gabriel Zucman of the University of California, Berkeley, who have advised Warren, claim that her tax would tackle growing wealth concentration in the US and yield some $250 billion per year, or 1.2% of GDP. But critics such as Larry Summers, a former US Secretary of the Treasury under President Bill Clinton, and Greg Mankiw, who served as President George W. Bush's chief economic adviser, argue that a wealth tax would yield little revenue, distort investor behavior, and fail to curb the billionaires' power. The ongoing controversy over the wealth tax is bound to be a defining one for the Democrats.

The starting point of this debate is fairly clear. As Lucas Chancel of the Paris School of Economics noted at a recent conference on combating inequality organized by the Peterson Institute for International Economics, the increase in wealth concentration is unmistakable, at least in the US. According to Saez and Zucman, the top 1% of US households now own 40% of the country's wealth, while the bottom 90% hold only one-quarter. Since 1980, the 1% and the 90% have traded places.

Wealth taxation gives rise to disputes

Economists are generally reluctant to make normative judgments about wealth inequality, because theory does not provide them with a proper yardstick for doing so. If innovators become immensely rich, it is presumably because their innovation was immensely valuable – in which case their wealth is deserved – or because they have managed to turn their idea into a monopoly rent, which should be addressed via competition policy, not taxation. Although many economists advocate curbing Amazon's growing monopoly power, for example, most do not propose taxing away the value of Jeff Bezos's innovation.

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Furthermore, wealth taxation itself gives rise to disputes. As Mankiw suggests, consider two high-flying professionals with comparable incomes but different lifestyles. Why should the one who saves and invests be taxed more than the one who uses a private jet to go skiing? Surely, the saver contributes more to collective wellbeing; if anything, the tax burden should fall on the skier.

For that reason, many economists advocate a combination of a progressive income tax and an inheritance tax, rather than a tax on wealth. But there are two problems with this idea. The first is that many of the super-rich have little income. As Saez and Zucman point out, Warren Buffett and Mark Zuckerberg earn little more than they spend. Their wealth increases as a result of capital gains, not saved income. And because such gains are taxable only when the corresponding assets are sold, their annual increase in wealth essentially escapes taxation.

Politically unsustainable

The second obstacle is that inheritance tax is politically toxic. Opinion polls consistently show that while economists love the idea, most voters hate it. Politicians understandably tend to steer clear of what most voters reject.

But if the income tax does not apply to capital gains and the estate tax does not redistribute wealth when someone dies, wealth inequality is bound to increase further. Some will say there is nothing wrong with that, provided capital is put to productive or collectively beneficial use. In Germany, for example, private companies are exempt from inheritance tax so that family-owned Mittelstand firms – which are essential to the country's prosperity – can be transferred to the next generation.

However, a society of heirs in which a person's lifetime labor income matters less than the capital they inherit from their parents is morally indefensible, unlikely to be politically sustainable, and may not be economically efficient. Heirs are often poor managers and poor investors.

Absent a better alternative

True, a wealth tax does not come without difficulties. How, for example, should a start-up founder be taxed when their firm has a market value but is yet to generate any income? Should he or she pay the government in shares? And in Europe, which lacks a harmonized tax regime, how can national authorities cope when rich people can simply move to another country? Designing a fair and efficient wealth tax is bound to be more complicated than its proponents typically claim.

> *A wealth tax is no panacea, and not even an ideal response to growing inequality at the top*

At least one thing is clear: the European wealth taxes of the past are not examples to follow. They kicked in at far too low a threshold – €1.3 million ($1.5 million) in the case of France's impôt de solidarité sur la fortune – and were riddled with loopholes as a consequence. In the French case, a business owner was exempt as long as he or she did not sell the company. That led to successful serial start-up founders being taxed while sleepy entrepreneurs were not. And whereas a moderately wealthy French household's financial portfolio could easily generate a negative after-tax return, the effective tax rate on the wealth of the country's 100 richest individuals was a ridiculously low 0.02%.

As Saez and Zucman argue, a wealth tax should treat all assets equally and have a high enough threshold. Warren is proposing a 2% tax on wealth above $50 million. The equivalent threshold in Europe would probably be lower, but certainly not low enough to satisfy Thomas Piketty, who proposes in his latest book a 5% annual tax on wealth of €2 million. Whereas Warren wants to reform capitalism, Piketty would like to end it and eradicate private property as we know it.

Inequality is back at the forefront of economic policy debates, for good reason. A wealth tax is no panacea, and not even an ideal response to growing inequality at the top. But absent a better alternative, it can serve as a reasonable second-best policy. At the very least, the idea does not deserve to be banished as a heresy.

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Author

Amrita Naik Nimbalkar
Junior Economist, Global Macro

amrita.naik.nimbalkar@ing.com

Mateusz Sutowicz
Senior Economist, Poland
mateusz.sutowicz@ing.pl

Alissa Lefebre
Economist
alissa.lefebre@ing.com

Deepali Bhargava
Regional Head of Research, Asia-Pacific
Deepali.Bhargava@ing.com

Ruben Dewitte
Economist
+32495364780
ruben.dewitte@ing.com

Kinga Havasi
Economic research trainee
kinga.havasi@ing.com

Marten van Garderen
Consumer Economist, Netherlands
marten.van.garderen@ing.com

David Havrlant
Chief Economist, Czech Republic
420 770 321 486
david.havrlant@ing.com

Sander Burgers
Senior Economist, Dutch Housing
sander.burgers@ing.com

Lynn Song
Chief Economist, Greater China
lynn.song@asia.ing.com

Michiel Tukker
Senior European Rates Strategist
michiel.tukker@ing.com

Michal Rubaszek
Senior Economist, Poland
michal.rubaszek@ing.pl

This is a test author

Stefan Posea
Economist, Romania
tiberiu-stefan.posea@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Jesse Norcross
Senior Sector Strategist, Real Estate
jesse.norcross@ing.com

Teise Stellema
Research Assistant, Energy Transition
teise.stellema@ing.com

Diederik Stadig
Sector Economist, TMT & Healthcare
diederik.stadig@ing.com

Diogo Gouveia
Sector Economist
diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Ewa Manthey
Commodities Strategist
ewa.manthey@ing.com

ING Analysts

James Wilson
EM Sovereign Strategist
James.wilson@ing.com

Sophie Smith
Digital Editor
sophie.smith@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist

frantisek.taborsky@ing.com

Adam Antoniak
Senior Economist, Poland
adam.antoniak@ing.pl

Min Joo Kang
Senior Economist, South Korea and Japan
min.joo.kang@asia.ing.com

Coco Zhang
ESG Research
coco.zhang@ing.com

Jan Frederik Slijkerman
Senior Sector Strategist, TMT
jan.frederik.slijkerman@ing.com

Katinka Jongkind
Senior Economist, Services and Leisure
Katinka.Jongkind@ing.com

Marina Le Blanc
Sector Strategist, Financials
Marina.Le.Blanc@ing.com

Samuel Abettan
Junior Economist
samuel.abettan@ing.com

Franziska Biehl
Senior Economist, Germany
Franziska.Marie.Biehl@ing.de

Rebecca Byrne
Senior Editor and Supervisory Analyst
rebecca.byrne@ing.com

Mirjam Bani
Sector Economist, Commercial Real Estate & Public Sector (Netherlands)
mirjam.bani@ing.com

Timothy Rahill
Credit Strategist
timothy.rahill@ing.com

Leszek Kasek
Senior Economist, Poland

leszek.kasek@ing.pl

Oleksiy Soroka, CFA
Senior High Yield Credit Strategist
oleksiy.soroka@ing.com

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com

Jeroen van den Broek
Global Head of Sector Research
jeroen.van.den.broek@ing.com

Edse Dantuma
Senior Sector Economist, Industry and Healthcare
edse.dantuma@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Rico Luman
Senior Sector Economist, Transport and Logistics
Rico.Luman@ing.com

Jurjen Witteveen
Sector Economist
jurjen.witteveen@ing.com

Dmitry Dolgin
Chief Economist, CIS
dmitry.dolgin@ing.de

Nicholas Mapa
Senior Economist, Philippines
nicholas.antonio.mapa@asia.ing.com

Egor Fedorov
Senior Credit Analyst
egor.fedorov@ing.com

Sebastian Franke
Consumer Economist
sebastian.franke@ing.de

Gerben Hieminga
Senior Sector Economist, Energy

gerben.hieminga@ing.com

Nadège Tillier
Head of Corporates Sector Strategy
nadege.tillier@ing.com

Charlotte de Montpellier
Senior Economist, France and Switzerland
charlotte.de.montpellier@ing.com

Laura Straeter
Behavioural Scientist
+31(0)611172684
laura.Straeter@ing.com

Valentin Tataru
Chief Economist, Romania
valentin.tataru@ing.com

James Smith
Developed Markets Economist, UK
james.smith@ing.com

Suvi Platerink Kosonen
Senior Sector Strategist, Financials
suvi.platerink-kosonen@ing.com

Thijs Geijer
Senior Sector Economist, Food & Agri
thijs.geijer@ing.com

Maurice van Sante
Senior Economist Construction & Team Lead Sectors
maurice.van.sante@ing.com

Marcel Klok
Senior Economist, Netherlands
marcel.klok@ing.com

Piotr Poplawski
Senior Economist, Poland
piotr.poplawski@ing.pl

Paolo Pizzoli
Senior Economist, Italy, Greece
paolo.pizzoli@ing.com

Marieke Blom

Chief Economist and Global Head of Research
marieke.blom@ing.com

Raoul Leering
Senior Macro Economist
raoul.leering@ing.com

Maarten Leen
Head of Global IFRS9 ME Scenarios
maarten.leen@ing.com

Maureen Schuller
Head of Financials Sector Strategy
Maureen.Schuller@ing.com

Warren Patterson
Head of Commodities Strategy
Warren.Patterson@asia.ing.com

Rafal Benecki
Chief Economist, Poland
rafal.benecki@ing.pl

Philippe Ledent
Senior Economist, Belgium, Luxembourg
philippe.ledent@ing.com

Peter Virovacz
Senior Economist, Hungary
peter.virovacz@ing.com

Inga Fechner
Senior Economist, Germany, Global Trade
inga.fechner@ing.de

Dimitry Fleming
Senior Data Analyst, Netherlands
Dimitry.Fleming@ing.com

Ciprian Dascalu
Chief Economist, Romania
+40 31 406 8990
ciprian.dascalu@ing.com

Muhammet Mercan
Chief Economist, Turkey
muhammet.mercan@ingbank.com.tr

Iris Pang
Chief Economist, Greater China
iris.pang@asia.ing.com

Sophie Freeman
Writer, Group Research
+44 20 7767 6209
Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

James Knightley
Chief International Economist, US
james.knightley@ing.com

Tim Condon
Asia Chief Economist
+65 6232-6020

Martin van Vliet
Senior Interest Rate Strategist
+31 20 563 8801
martin.van.vliet@ing.com

Karol Pogorzelski
Senior Economist, Poland
Karol.Pogorzelski@ing.pl

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de

Viraj Patel
Foreign Exchange Strategist
+44 20 7767 6405
viraj.patel@ing.com

Owen Thomas
Global Head of Editorial Content
+44 (0) 207 767 5331
owen.thomas@ing.com

Bert Colijn
Chief Economist, Netherlands
bert.colijn@ing.com

Peter Vanden Houte
Chief Economist, Belgium, Luxembourg, Eurozone
peter.vandenhoute@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Gustavo Rangel
Chief Economist, LATAM
+1 646 424 6464
gustavo.rangel@ing.com

Carlo Cocuzzo
Economist, Digital Finance
+44 20 7767 5306
carlo.cocuzzo@ing.com