Chapter 5. Conclusions and policy implications

This chapter highlights the main conclusions of the report regarding the role of the tax system in addressing wealth inequality and whether a net wealth tax is the most appropriate instrument to achieve that objective. It also provides a number of practical tax design recommendations for countries that already have or wish to implement net wealth taxes.

This report has attempted to answer four key questions:

- Is there a rationale for addressing wealth inequality through the tax system?
- If so, is a net wealth tax the most appropriate instrument to address wealth inequality?
- What have been the practical experiences of countries that currently have or have previously had net wealth taxes?
- And where a country has decided to implement a net wealth tax, how should it be designed to maximise efficiency and equity and minimise tax administration and compliance costs?

This report argues that there is a strong case for addressing wealth inequality through the tax system. Wealth inequality is far greater than income inequality, and there is some evidence suggesting that wealth inequality has increased in recent decades. In addition, wealth accumulation operates in a self-reinforcing way and is likely to increase in the absence of taxation. High earners are able to save more, meaning that they are able to invest more and ultimately accumulate more wealth. Moreover, investment returns tend to increase with wealth. Wealthy taxpayers, who tend to have more diversified asset holdings, are in a better position to invest in riskier assets which will tend to generate higher returns. The ability of the wealthiest taxpayers to generate higher average returns may also come from their higher level of financial education as well as their access to financial expertise and more lucrative investment opportunities. Rich taxpayers are also more likely to obtain loans, which will in turn allow them to invest more and accumulate more wealth. Finally, it may be argued that wealth may confer more power, which may ultimately beget more wealth.

There are many channels through which tax systems can affect wealth inequality. Sources of wealth inequality are diverse. The most significant ones include income inequality, inheritances and asset value appreciation. This means that a broad range of taxes will affect wealth inequality. In addition to net wealth taxes, taxes on wealth transfers, labour and capital income taxes, and capital gains taxes can have an impact on the distribution of wealth. Therefore, the question is whether a net wealth tax is the most appropriate tax policy option, among those that are available, to address wealth inequality. The most appropriate tax policies are those that minimise equity and efficiency trade-offs and involve comparatively lower tax administration and compliance costs.

While reducing wealth concentration at the top is essential, it will not be enough to reduce wealth inequality. Supporting wealth accumulation by households with medium or low levels of wealth is also critical to narrowing wealth gaps, which implies that the design of taxes on capital or on capital income should not discourage households in the middle or at the bottom of the wealth distribution from saving. This also highlights the need to use policy tools beyond taxation to address wealth inequality. In some countries, wealth inequality has been explained, among other factors, by differences in saving rates and investment returns, with lower saving rates and investment returns at the bottom of the wealth distribution, resulting in a decline in the share of wealth held by the poorer segments of the population. Therefore, measures supporting savings at the bottom of the income and wealth distribution as well as financial education to inform lower income and wealth individuals about investment opportunities yielding higher returns can play an important role in addressing wealth inequality.

Overall, the report suggests that from both an efficiency and equity perspective, there are limited arguments for having a net wealth tax on top of broad-based personal capital income taxes and well-designed inheritance and gift taxes. However, there are stronger

arguments for having a net wealth tax in the absence of broad-based capital income taxes and taxes on wealth transfers. Where the overall tax burden on capital is low or where levying broad-based capital income taxes or an inheritance tax is not feasible – net wealth taxes may play an important (albeit imperfect) substitution role.

While net wealth taxes can to some extent be compared to taxes on capital income, there are a number of features that clearly distinguish them. A first key difference is that a net wealth tax is equivalent to a proportional tax on a presumptive return, meaning that the tax is levied irrespective of the actual returns earned on savings. A second significant difference is that a wealth tax is in theory levied on an accrual basis while income taxes are typically levied upon realisation. Another major difference is that a net wealth tax can potentially be more comprehensive than a capital income tax, covering both income and non-income generating assets.

The equivalence of a net wealth tax with a proportional tax on a presumptive return has negative efficiency implications. As discussed in Chapter 3, a tax on the stock of wealth is equivalent to taxing a presumptive return but exempting returns above that presumptive return. Where the presumptive return is set at the level of or at a level close to the normal - or risk-free – return to savings, a wealth tax is economically equivalent to a tax on the normal return to savings, which is considered to be inefficient. Indeed, 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 (Mirrlees et al., 2011).

Taxing a presumptive return may encourage a more productive use of assets, but this argument has limitations. The argument is that wealth taxes do not discourage investment *per se* but discourage investments in low-yielding assets and reinforce the incentives to invest in higher-yielding assets because there is an additional cost to holding assets, which is not linked to the return they generate. However, higher returns do not always mean higher productivity and efficiency. There may be cases where asset returns do not reflect higher productivity and where recurrent net wealth taxes may therefore not support an efficient allocation of resources. For instance, above-market returns may be the result of luck or privileged market access. Favouring high returns may also discourage potentially highly profitable investments, such as investments in start-ups which are likely to generate low returns in their early stages.

Taxing a presumptive return also has negative equity implications. As net wealth taxes are equivalent to taxing a presumptive return, the effective tax rate decreases when actual returns increase. This may have negative equity effects. Indeed, as mentioned above, there is evidence of heterogeneous returns that are positively correlated with wealth. This means that if the wealth tax applies to (part of) the middle class, it might have regressive effects. For instance, taxpayers with a large portion of their assets in regular savings accounts, for which the rate of return is close to zero, are taxed for a return they generally did not realise, while wealthier taxpayers who have invested a lot of their savings in shares tend to realise higher gains than they are taxed for.

Nevertheless, a net wealth tax can be designed to be progressive. Despite inequities that arise from the taxation of a presumptive return, a wealth tax can be levied at progressive rates and/or different presumptive returns which increase with household wealth can be used. A high wealth tax exemption threshold can also create a significant amount of tax progressivity, even under a proportional tax rate.

As mentioned above, another major characteristic of net wealth taxes is that they are in theory levied on an accrual basis, which has positive efficiency effects. Under the assumption that the wealth tax base is kept up to date through regular asset valuations, the appreciation in asset values is taxed every year under a wealth tax. This differs from income taxes which are typically levied upon realisation. Accrual-based taxation does not create lock-in effects and the resulting inefficiencies in capital allocation. Indeed, under a wealth tax, there is no tax-induced incentive to defer the realisation of capital gains and to bring forward the realisation of capital losses to benefit from their tax deductibility (if any).

However, accrual-based taxation has mixed equity implications and involves significant practical challenges. As the net wealth tax has to be paid irrespective of actual returns, taxpayers may face liquidity issues when the tax has to be paid, especially if part of their wealth cannot be converted into liquid funds and if they cannot rely on alternative sources of income. On the other hand, tax liabilities will in theory be less affected by taxpayers' tax planning strategies and will therefore be more equitable across taxpayers. Accrual-based taxation also involves significant practical challenges, in particular related to the valuation of taxable assets.

An alternative could be to levy capital income taxes upon accrual. Under a mark-to-market tax, the increase in wealth would be taxed upon accrual. Such an approach would limit some of the tax arbitrage opportunities that exist in current capital income tax systems in OECD countries. An in-depth discussion of these issues could be the focus of future work.

Net wealth taxes can be levied on broad bases, although in practice numerous exemptions and reliefs have narrowed tax bases. As opposed to capital income taxes, under a net wealth tax, even the assets that do not generate monetary returns are generally taxed. For instance, artworks which increase their owner's wellbeing but do not generate any monetary returns until they are sold are often (at least partly) included in the tax base. In practice, however, these assets have often been excluded from net wealth tax bases because they are hard to value, easy to underreport or hide, and lead to liquidity difficulties.

Finally, when they are levied on top of capital income taxes, net wealth taxes can result in very high overall tax burdens on personal capital. When net wealth taxes have to be paid on top of capital income taxes, overall tax burdens on personal capital can reach very high levels, with METRs sometimes reaching values close to or above 100% in some countries. In addition to their discouraging effects on savings and investment, very high overall tax burdens on capital may encourage wealthy taxpayers to adjust their wealth portfolio, engage in tax planning or evasion, or change their tax residence to minimise their wealth tax liability.

Overall, broad-based capital income taxes tend to be a more efficient and less administratively costly way of taxing capital. To strengthen progressivity, the way countries tax personal capital income could be revisited. In particular, progressive rates could be applied to personal capital income. As argued in previous OECD work (Brys et al., 2016), countries could consider introducing "dual progressive income tax" systems which would tax capital income under a separate rate schedule at progressive rates. The rate schedule could exempt or tax at low rates total household capital income below a minimum threshold. This could also encourage taxpayers at the bottom of the income and wealth distribution to save more, which could ultimately contribute to reducing wealth

inequality. Finally, as mentioned above, consideration could be given to taxing capital gains upon accrual, noting the practical difficulties of doing so.

Inheritance taxes are also central to addressing the persistence of wealth gaps from one generation to the next and tend to be less distortive than net wealth taxes. The report argues that capital income taxes alone will most likely not be enough to address wealth inequality and suggests the need to complement capital income taxes with a form of wealth taxation. The report finds that there is a strong case for an accompanying inheritance tax. The double taxation argument, often raised against net wealth taxes, is weaker in the case of inheritance taxes, as there is no double taxation of the donor and the inherited wealth is also only taxed once in the hands of the recipient. Effects on savings are also likely to be smaller than in the case of recurrent taxes on personal net wealth, and empirically they have generally been found to be negative but small. Inheritance taxes are also easier to administer and comply with as they are only levied once. Finally, and perhaps more importantly, there are meritocratic arguments for taxing inherited wealth more than self-made wealth. However, further work is needed to determine how to design inheritance taxes in a way that makes them both more efficient and fairer.

However, this report also argues that, in countries where the taxation of capital income – including capital gains – is low or where inheritance taxes are not levied, there is a stronger case for a net wealth tax. Brys et al. (2016) have argued for the need to consider tax systems as a whole rather than assess its different elements in isolation. In practice, understanding the efficiency and equity effects of net wealth taxes requires taking interactions with the rest of the tax system into account. In countries with dual income tax systems that tax capital income at low and flat rates or in countries where capital gains are not taxed (e.g. Switzerland), there is a stronger justification for levying a net wealth tax. In those countries, the double taxation effect and the cumulative distortion (i.e. on top of capital income taxes) imposed by a net wealth tax are less evident. A similar argument can be made for countries that do not levy taxes on inheritances (e.g. Norway), although the effects of a low net wealth tax are likely to be much stronger than those of an inheritance tax, with even a low recurrent wealth tax liability resulting in high effective tax rates when the total amount of net wealth taxes paid is expressed as a share of taxpayers' estates.

In reviewing countries' practical experiences with net wealth taxes, the study reveals notable variations in tax design, but also identifies a number of common features and trends across countries. Variations in the levels of tax exemption thresholds have been significant, with some countries taxing exclusively the very wealthy and others taxing a broader range of taxpayers. Practices regarding tax rates have also varied. On the other hand, countries' experiences have revealed a number of common characteristics. Across countries, net wealth tax bases have generally been narrow because of numerous exemptions and reliefs, motivated by a variety of economic, social and practical concerns. Tax avoidance and evasion behaviours have also been widespread in all countries. Generally, countries' experiences confirm the difficulties involved in taxing net wealth on a recurrent basis. In the countries that still have net wealth taxes, there has also been a trend towards raising tax exemption thresholds and lowering tax rates. The former has been driven primarily by a desire to avoid burdening the middle/upper middle class, while the latter party reflects tax competition between countries or local governments in countries where net wealth taxes are local.

Net wealth taxes can be designed in ways that make them both less distortive and fairer. Regarding tax exemption thresholds and rates, recommendations depend on whether the

net wealth tax comes on top of other taxes on capital, in particular on top of taxes on capital income. In the case of a wealth tax that comes on top of broad-based capital income taxes, tax exemption thresholds should be high, to ensure that the tax is only levied on the very wealthy, and tax rates should be low and take into account tax rates on capital income to avoid imposing excessively high tax burdens on capital. In cases where net wealth taxes do not come on top of broad-based capital income taxes, lower exemption thresholds and higher tax rates may be justified. Tax rates could be progressive, especially in cases where net wealth taxes do not come on top of capital income taxes and/or wealth transfer taxes, to enhance the overall tax system's progressivity.

Other recommendations that apply to all net wealth taxes include:

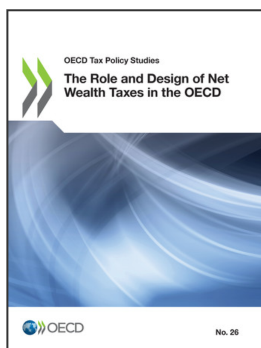
- Limited tax exemptions and reliefs;
- An exemption for business assets, with clear criteria restricting the availability of the exemption (ensuring that real business activity is taking place and that assets are directly being used in the taxpayer's professional activity)
- An exemption for personal and household effects up to a certain value;
- Determining the tax base based on asset market values; although the tax base could amount to a fixed percentage of that market value (e.g. 80-85%) to prevent valuation disputes and take into account costs that may be incurred to hold or maintain the assets
- Keeping the value of hard-to-value assets or the value of taxpayers' total net wealth constant for a few years to avoid yearly reassessments;
- Allowing debts to be deductible only if they have been incurred to acquire taxable assets – or, if the tax exemption threshold is high, consider further limiting debt deductibility;
- Measures allowing payments in instalments for taxpayers facing liquidity constraints;
- Ensuring transparency in the treatment of assets held in trusts;
- Continued efforts to enhance tax transparency and exchange information on the assets that residents hold in other jurisdictions;
- Developing third-party reporting;
- Establishing rules to prevent international double wealth taxation; and
- Regularly evaluating the effects of the wealth tax.

In addition, this report suggests that information about household wealth could be used in the design of other taxes. Income tax allowances or credits as well as benefit entitlements typically depend on income levels and the family status, but not on household wealth. This suggests scope for increased wealth-testing. For instance, mortgage interest relief and private pension tax incentives could be made income and wealth dependent. Information about total household wealth could also be used in the design of other property taxes and personal capital income taxes. Future work could explore ways in which wealth testing could be used to improve the design of taxes levied at the individual level.

This report also paves the way for future work on:

- The design of inheritance taxes
- The design of capital gains taxes
- The distributional effects of recurrent taxes on immovable property

- The use of wealth-testing for other tax and benefit purposes. In particular, the design and evaluation of recurrent immovable property tax rates and PIT rates which increase with both income and wealth levels
- The evaluation of accrual- versus realisation-based taxation within PIT systems – accrual-based PIT design to prevent lock-in effects
- Further work on the drivers of wealth inequality with a particular focus on the extent to which capital income taxes can contribute to a more equal wealth distribution



From:
The Role and Design of Net Wealth Taxes in the OECD

Access the complete publication at:
https://doi.org/10.1787/9789264290303-en

Please cite this chapter as:

OECD (2018), “Conclusions and policy implications”, in *The Role and Design of Net Wealth Taxes in the OECD*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/9789264290303-8-en

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