BARRON'S

Wealth Taxes Don't Work. Here's Why.

Randall W. Forsyth

October 18, 2019

"Let me tell you about the very rich. They are different from you and me," F. Scott Fitzgerald wrote. To which his contemporary, Ernest Hemingway, would retort years later, "Yes, they have more money.

This difference these days is referred to as inequality, which of course figures prominently in today's politics. This week's Democratic debate displayed that in spades, with potential presidential candidates proffering measures to narrow the difference between Fitzgerald's very rich and presumably just about everybody else who watched the proceedings.

Prominent among these suggestions was a wealth tax, proposed by the two leading lights of the left, Sens. Elizabeth Warren and Bernie Sanders. Warren, the Massachusetts Democrat, would levy a 2% tax on a household's wealth that exceeds $50 million, and 3% on the amount above $1 billion. The Vermont independent's plan would start at 1% on a household's wealth over $32 million and increase to 8% on assets above $10 billion.

Warren estimates her levy would bring in $2.75 trillion over the next 10 years, while Sanders says his tax would yield $4.35 trillion over the next 10 years. The tax would fund the ambitious social programs each favors.

But if wealth taxes are such a bonanza for government coffers, countered Andrew Yang, the tech entrepreneur making a long-shot bid for the presidency, why have they been ended by all but three European countries that once levied them?

Looking at the record, it appears there were several reasons, most notably that these levies brought in relatively limited revenues, especially compared with their costs. Éric Pichet, a professor at the Kedge business school in France, estimates that the now-repealed French wealth tax raised 3.6 billion euros ($4.01 billion) a year, but cost the nation's economy some €7 billion annually in fraud and shrinkage of the tax base, Bloomberg reported this year. Germany, Sweden, the Netherlands, and Austria also found the revenues were small, relative to the cost of implementation.

Yet the appeal of a wealth tax is visceral, especially when Berkshire Hathaway CEO Warren Buffett, No. 4 on Bloomberg's Billionaires Index, has famously pointed out that he pays a lower tax rate than his secretary. That's because the vast majority of his $82.4 billion in wealth is in Berkshire shares, whose unrealized appreciation continues to build without being taxed. That helps explain why Buffett famously says his preferred holding period for a stock is "forever." Just as famously, Berkshire doesn't pay a dividend, so that all its earnings are retained instead of being distributed to shareholders, most of whom would owe taxes on the payouts.

Indeed, the main reason the rich are different is that their wealth begets wealth. For a household in the top 1% of wealth—$10,374,030, according to the Federal Reserve's 2016 Survey of Consumer Finances, released this year—a 4% return from a portfolio of 60% tax-efficient exchange-traded equity funds or individual stocks and 40% in municipal bonds would return $414,000 annually. That would be lightly taxed, if at all. Dividends and capital gains get favorable tax treatment, while most munis are tax-free.

The biggest problem in administering the wealth tax in Europe was valuing assets. Warren's and Sanders' levies would apply to a far smaller number of uber-rich. But in an article published this year on Politifact.com, Wojciech Kopczuk, a Columbia University economist, warned that the problems "are as daunting in the United States as in Europe."

The popular image of the superrich is that their wealth is in megayachts, private jets, jewelry, or artworks. But according to a recent study from the libertarian Cato Institute, those baubles comprise only 2% of billionaires' wealth. In contrast, 73% of the wealth of Americans in the top 0.1% of the wealth arena is in equity in public or private businesses, with another 5% in the value of their homes. The value of those assets could be readily determined. As every homeowner knows, houses are assessed for property taxes, a form of wealth tax, while publicly traded securities—even rarely traded debt issues—can be valued.

Many of these assets, however, especially private businesses, are difficult to value and illiquid. Their owner would have to sell some to render unto Uncle Sam.

As Cato points out, the lion's share of the wealth of the wealthiest is in business assets that produce economic growth, and forcing their owners to sell them to pay taxes could hurt growth. Such arguments have held sway for four decades now, but are being met with counterarguments that these policies have generated increased inequality and stagnant household income.

Emmanuel Saez and Gabriel Zucman, the economists at the University of California, Berkeley, who are advising Warren, estimate that if a "radical" wealth tax of 10% would have been imposed since 1982 on fortunes above $10 billion, the share of wealth owned by the richest 400 Americans would have stayed flat at around 1%. A "moderate" wealth tax of 3% on the portion above $1 billion (the Warren plan) would have resulted in the 400's share rising to 2% over that period. (In both cases, wealth above $50 million would have been taxed at 1%, which is also Warren's plan.)

If reducing inequality is the aim, there are other ways to do it. A 2018 study by the Organization for Economic Co-operation and Development found that a net wealth tax results in more distortions and is less equitable than levies on capital income (dividends and interest) or capital gains. An inheritance tax is an important complement to capital taxes in reducing inequality, the report added. The federal estate tax currently starts on wealth of $11.4 million, but the threshold is effectively doubled for married couples. As a result, the tax should affect only 2,000 U.S. estates—0.1% of them—in 2019, according to the Tax Policy Center.

The remaining wealth taxes in Switzerland, Norway, and Spain are far lower, but kick in at more modest levels. They also provide a relatively trivial percentage of those nations' tax revenue.

Besides having more money, the rich are different in another way. They use some of it to hire expert lawyers and accountants to minimize their taxes. You can be sure they will do that if a wealth tax comes to fruition.