Taxing Wealth in an Uncertain World

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National Tax Association
49th Annual Spring Symposium
May 17, 2019
Wealth Taxation

Objectives

1. Reduce high-end wealth inequality
   - narrow/eliminate r-g gap

2. Raise revenue for provision of public goods/social insurance
Wealth Taxation
Near-Equivalent Alternatives

1. Annual wealth tax
2. Mark-to-market income tax
3. Retrospective capital gains tax
Wealth Taxation

Near-Equivalent Alternatives

1. Annual wealth tax
Wealth Taxation

Near-Equivalent Alternatives

1. Annual wealth tax
   - Assume $r = 5\%$
Wealth Taxation
Near-Equivalent Alternatives

1. Annual wealth tax
   - Assume $r = 5\%$
   - Levy tax of 1% of net worth on Jan. 1, 2019
Wealth Taxation
Near-Equivalent Alternatives

1. Annual wealth tax
   - Assume \( r = 5\% \)
   - Levy tax of 1% of net worth on Jan. 1, 2019
     - Starting wealth: $100
     - Wealth on Jan. 1, 2019: $99
     - Wealth on Dec. 31, 2019: $99 \times 1.05 = $103.95
     - Wealth on Jan. 1, 2020: $103.95 \times 0.99 \approx $102.91
     - Wealth on Dec. 31, 2020: $102.91 \times 1.05 \approx $108.06
Wealth Taxation
Near-Equivalent Alternatives

2. Mark-to-market income tax
   - Levy tax of 21% on ∆net worth
Wealth Taxation
Near-Equivalent Alternatives

2. Mark-to-market income tax
   - Levy tax of 21% on Δnet worth
     - **Starting wealth:** $100
     - **Wealth on Dec. 31, 2019:** $100 \times 1.05 \times (1 - 0.21) = $103.95
     - **Wealth on Dec. 31, 2020:** $103.95 \times 1.05 \times (1 - 0.21) \approx $108.06
Wealth Taxation
Near-Equivalent Alternatives

3. Retrospective capital gains tax
Wealth Taxation
Near-Equivalent Alternatives

3. **Retrospective capital gains tax**
   - **Step 1**: Determine amount realized at time of sale ($A_s$) and holding period ($s$)
   - **Step 2**: Assume growth at rate of $r$ over holding period
   - **Step 3**: Levy tax such that individual is as well off as she would have been if she had started with wealth of $A_s/(1+r)^s$ and paid mark-to-market tax of $t$ each year
Wealth Taxation

Near-Equivalent Alternatives

3. Retrospective capital gains tax
   - Formula: $T_s = (1 - ((1 + r(1-t))/(1+r))^s)A_s$
Wealth Taxation
Near-Equivalent Alternatives

3. Retrospective capital gains tax
   - Formula: $T_s = (1-((1+r(1-t))/(1+r))^s)A_s$
   - What happens to a taxpayer who purchases $100 asset on Jan. 1, 2019 and winds up with asset worth $100 \times 1.05^2 = $110.25 on Dec. 31, 2020?
Wealth Taxation

Near-Equivalent Alternatives

3. Retrospective capital gains tax
   - Formula: \( T_s = (1-((1+.05(1-.21))/(1+.05))^2)110.25 \)
   - What happens to a taxpayer who purchases $100 asset on Jan. 1, 2019 and winds up with asset worth $100 \times 1.05^2 = $110.25 on Dec. 31, 2020?
Wealth Taxation

Near-Equivalent Alternatives

3. Retrospective capital gains tax

- **Formula:** $T_s = \left(1-\frac{(1+0.05(1-0.21))}{(1+0.05)}\right)^2 \times 110.25$

- What happens to a taxpayer who purchases $100 asset on Jan. 1, 2019 and winds up with asset worth $100 \times 1.05^2 = $110.25 on Dec. 31, 2020?

  - $T_s \approx $2.19

  - Wealth on Dec. 31, 2020 = $110.25 - $2.19 = $108.06
Wealth Taxation

Nonequivalences
Wealth Taxation

Nonequivalences

1. Abnormal returns (e.g., entrepreneurial labor)
   - Taxed more heavily under a mark-to-market income tax than under an annual wealth tax or a retrospective capital gains tax
Wealth Taxation

Nonequivalences

1. Abnormal returns (e.g., entrepreneurial labor)
   - Taxed more heavily under a mark-to-market income tax than under an annual wealth tax or a retrospective capital gains tax
   - Normative implications?
Wealth Taxation

Nonequivalences

1. **Abnormal returns** (e.g., entrepreneurial labor)
   - **Normative implications?**
     - **View 1:** Argument in favor of a mark-to-market income tax because:
       a) high-end labor inequality is significant contributor to overall inequality
       b) undertaxation of entrepreneurial labor leads to allocative inefficiencies
1. **Abnormal returns** (e.g., entrepreneurial labor)
   - **Normative implications?**
   - **View 2:** Argument in favor of annual wealth tax or retrospective capital gains tax because:
     a) high-end labor inequality is less objectionable than wealth inequalities that accumulate over generations
     b) undertaxation of abnormal returns rewards positive externalities from entrepreneurial labor (Jones, 2019)
Wealth Taxation

Nonequivalences

1. Abnormal returns (e.g., entrepreneurial labor)
   - Normative implications?
   - View 3: Neither an argument in favor of mark-to-market income tax nor an argument in favor of annual wealth tax or retrospective capital gains tax because we have lots of other tools to tax abnormal returns (e.g., consumption tax)
Wealth Taxation
Nonequivalences

1. Abnormal returns (e.g., entrepreneurial labor)
   - Normative implications?
     - **View 3:** Neither an argument in favor of mark-to-market income tax nor an argument in favor of an annual wealth tax or retrospective capital gains tax because we have lots of other tools to tax abnormal returns (e.g., consumption tax)
   - **Note:** Also possible to integrate tax on abnormal returns into retrospective capital gains tax (Auerbach & Bradford, 2004)
Wealth Taxation

Nonequivalences

1. Abnormal returns (e.g., entrepreneurial labor)
2. Allocation of risk
Wealth Taxation

Nonequivalences

1. Abnormal returns (e.g., entrepreneurial labor)

2. Allocation of risk
   - Domar and Musgrave (1944): Income tax with full loss offsets imposes no burden on private risk-taking if taxpayers can borrow at risk-free rate and risky assets are unlimited in supply
Wealth Taxation

Nonequivalences

1. Abnormal returns (e.g., entrepreneurial labor)

2. Allocation of risk
   - Kaplow (1994): Absent adjustments, wealth and income taxes will differ in their implications for the government’s investment portfolio
Wealth Taxation

Nonequivalences

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2. Allocation of risk
   - Normative implications?
Wealth Taxation

Nonequivalences

1. Abnormal returns (e.g., entrepreneurial labor)

2. Allocation of risk
   - Normative implications?
     - View 1: Risk shift from private to public sectors is desirable for microeconomic (insurance) and macroeconomic (countercyclical) reasons
Wealth Taxation

Nonequivalences

1. Abnormal returns (e.g., entrepreneurial labor)

2. Allocation of risk
   - Normative implications?
     - View 2: Government can reproduce same risk allocation under an annual wealth tax or a mark-to-market income tax through:
       a) explicit insurance
       b) asset purchases/financial derivatives
Wealth Taxation

Nonequivalences

1. Abnormal returns (e.g., entrepreneurial labor)
2. Allocation of risk
3. Maximum rate
Wealth Taxation

Nonequivalences

1. Abnormal returns (e.g., entrepreneurial labor)
2. Allocation of risk
3. Maximum rate
   - Equivalence holds only if $t_{\text{wealth}} < r$
30-Year Treasury Yield (Nominal)
Wealth Taxation

Nonequivalences

1. Abnormal returns (e.g., entrepreneurial labor)
2. Allocation of risk
3. Maximum rate
   - Normative implications?
Wealth Taxation

Nonequivalences

1. Abnormal returns (e.g., entrepreneurial labor)
2. Allocation of risk
3. Maximum rate
   - Normative implications?
     - Annual wealth tax >>> 2% cannot be replicated via mark-to-market income tax or retrospective capital gains tax (without help from the Fed)
Three Types of Uncertainty
Three Types of Uncertainty

1. Valuation uncertainty
2. Political uncertainty
3. Constitutional uncertainty
Three Types of Uncertainty

1. **Valuation uncertainty**: Tax authority uncertain as to “true” value of asset
   - symmetric or asymmetric
Three Types of Uncertainty

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   - Annual wealth tax: *High exposure*
Three Types of Uncertainty

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   - **Mark-to-market income tax**: High exposure when:
Three Types of Uncertainty

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     - Durability of regime is in doubt; or
Three Types of Uncertainty

1. **Valuation uncertainty**: Tax authority uncertain as to “true” value of asset
   - **Annual wealth tax**: High exposure
   - **Mark-to-market income tax**: High exposure when:
     - Durability of regime is in doubt; or
     - Interest rates are high
Three Types of Uncertainty

1. **Valuation uncertainty:** Tax authority uncertain as to “true” value of asset
   - **Annual wealth tax:** High exposure
   - **Mark-to-market income tax:** High* exposure
   - **Retrospective capital gains tax:** Low exposure
Three Types of Uncertainty

2. **Political uncertainty**: Uncertainty as to whether regime will be repealed
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   - Annual wealth tax: *Low exposure*
Three Types of Uncertainty

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   - **Mark-to-market income tax:** Political uncertainty increases exposure to valuation uncertainty
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   - **Annual wealth tax**: Low exposure
   - **Mark-to-market income tax**: Political uncertainty increases exposure to valuation uncertainty
   - **Retrospective capital gains tax**: High exposure
Three Types of Uncertainty

3. **Constitutional uncertainty**: Uncertainty as to whether regime will be held to violate Constitution
Three Types of Uncertainty

3. **Constitutional uncertainty**: Uncertainty as to whether regime will be held to violate Constitution
   - Annual wealth tax: **High exposure**
Tax and the Constitution

- **Art. I, § 2, cl. 3:** “[D]irect Taxes shall be apportioned among the several States... according to their respective Numbers....”

- **Amend. XVI:** “Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment....”
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## What Is a “Direct” Tax?

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Three Types of Uncertainty

“That Congress has power to tax shareholders upon their property interests in the stock of corporations is beyond question; and that such interests might be valued in view of the condition of the company, including its accumulated and undivided profits, is equally clear. But that this would be taxation of property because of ownership, and hence would require apportionment under the provisions of the Constitution, is settled beyond peradventure by previous decisions of this court.”

— Eisner v. Macomber (1920)
Three Types of Uncertainty

3. **Constitutional uncertainty**: Uncertainty as to whether regime will be held to violate Constitution
   - **Annual wealth tax**: High exposure
   - **Mark-to-market income tax**: Low (>0) exposure
Three Types of Uncertainty

3. **Constitutional uncertainty**: Uncertainty as to whether regime will be held to violate Constitution
   - **Annual wealth tax**: High exposure
   - **Mark-to-market income tax**: Low (>0) exposure
   - **Retrospective capital gains tax**: Low (~0) exposure
Tax and the Constitution

- Art. I, § 8, cl. 1: “Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises”
- Amend. XVI: “Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment . . . .”
# Wealth Taxation and the Three Uncertainties

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Takeaways
Takeaways

- Annual wealth tax is doubtful to redistribute/raise revenue in current jurisprudential climate
Takeaways

- **Mark-to-market income tax lacks a decisive advantage** vis-à-vis retrospective capital gains tax, except as applied to assets for which valuation uncertainty is low (e.g., publicly traded securities)
- **Mark-to-market income tax** → >>>> administrative costs
- **Mark-to-market income tax** → (slightly) > exposure to constitutional uncertainty and possibly higher/possibly lower exposure to political uncertainty
Takeaways

- Success of retrospective capital gains tax depends in large part on whether taxpayers believe it is durable

  - If so, it’s a constitutionally secure, easily administrable, and broadly applicable alternative to an annual wealth tax