Taxing Wealth in an Uncertain World

Daniel Hemel
University of Chicago Law School
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Wealth Taxation

Objectives

1. Reduce high-end wealth inequality
   - <u>narrow/eliminate **r – g** gap</u>
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

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   - **Assume r = 5%**

Wealth Taxation

Near-Equivalent Alternatives

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   - **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 x 1.05 = $103.95
     - **Wealth on Jan. 1, 2020:** $103.95 x 0.99 ≈ $102.91
     - **Wealth on Dec. 31, 2020:** $102.91 x 1.05 ≈ **$108.06**

Wealth Taxation

Near-Equivalent Alternatives

2. **Mark-to-market income tax**
   - **Levy tax of 21% on Δnet worth**

Wealth Taxation

Near-Equivalent Alternatives

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   - **Levy tax of 21% on Δnet worth**
     - **Starting wealth:** $100
     - **Wealth on Dec. 31, 2019:** $100 x 1.05 x (1 – 0.21) = $103.95
     - **Wealth on Dec. 31, 2020:** $103.95 x 1.05 x (1 – 0.21) ≈ **$108.06**

Wealth Taxation

Near-Equivalent Alternatives

3. **Retrospective capital gains tax**

Near-Equivalent Alternatives

3. **Retrospective capital gains tax**
   - **Step 1**: Determine **amount realized at time of sale** ($\mathbf{A_s}$) 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 $\mathbf{A_s/(1+r)^s}$ 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

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

Near-Equivalent Alternatives

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Wealth Taxation

Near-Equivalent Alternatives

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   - **Formula:** $T_s = (1-((1+.05(1-.21))/(1+.05))^2)110.25$

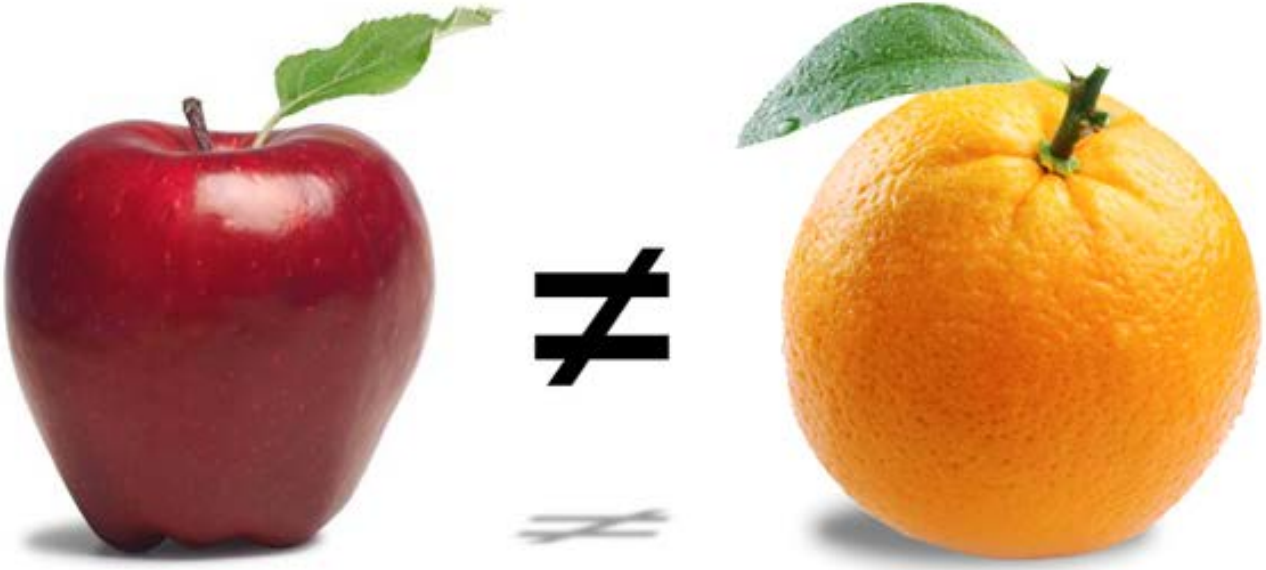
- **What happens to a taxpayer who purchases $100 asset on Jan. 1, 2019 and winds up with asset worth $100 x 1.05^2 = $110.25 on Dec. 31, 2020?**

→ $T_s \approx$ **$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

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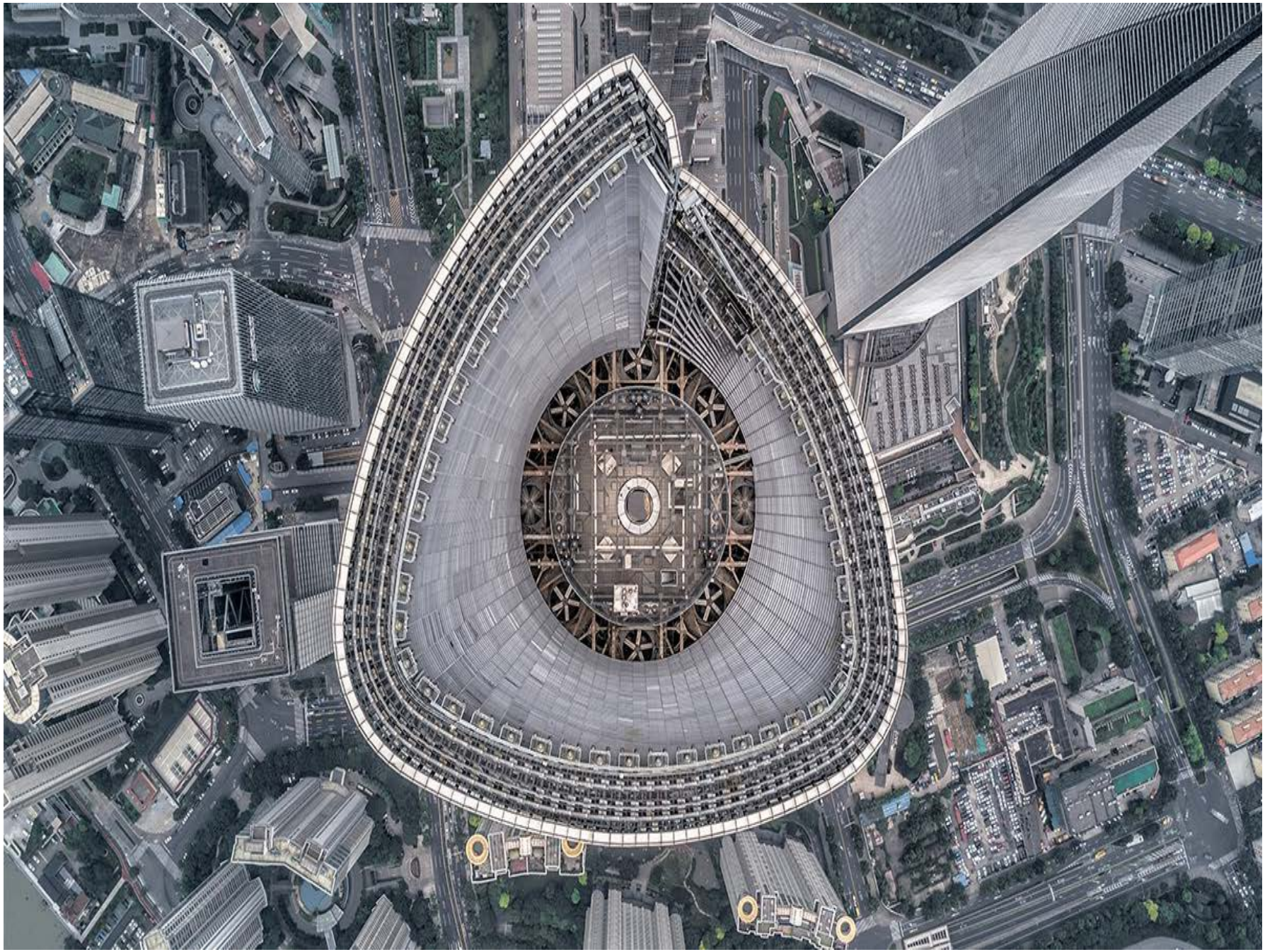
     - **Normative implications?**

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



Wealth Taxation

Nonequivalences

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)

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)

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     - **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)
       - **Note:** Also possible to integrate tax on abnormal returns into retrospective capital gains tax (Auerbach & Bradford, 2004)

Wealth Taxation

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2. **Allocation of risk**

Wealth Taxation

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

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

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     - **View 1:** Risk shift from private to public sectors is desirable for microeconomic (insurance) and macroeconomic (countercyclical) reasons

Wealth Taxation

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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

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3. **Maximum rate**

Wealth Taxation

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   - Equivalence holds only if $\mathbf{t_{wealth} < r}$

30-Year Treasury Yield
(Nominal)

Wealth Taxation

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   - **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

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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**

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     - 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**

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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?

	Tax on Land/Real Property	Tax on All Personal Property
Hylton v. US (1795) (Chase)		
Veazie Bank v. Fenno (1869)		
Scholey v. Rew (1874)		
Springer v. US (1880)		
Pollock v. Farmer's Loan (1895)		
Fernandez v. Wiener (1945)		
NFIB v. Sebelius (2012) (Roberts)		

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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

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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

	Annual wealth tax	Mark-to-market income tax	Retrospective capital gains tax
Valuation uncertainty	**HIGH**	**LINKED**	**LOW**
Political uncertainty	**LOW**		**HIGH**
Constitutional uncertainty	**HIGH**	**LOW** (>0)	**LOW** (~0)

Takeaways

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- 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**