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Some commentators call for the introduction of a wealth tax in the UK. Proposals range from a regular wealth tax to a more specific and time limited one to help finance the fiscal burden of the COVID-19 pandemic. Discuss the economic rationale for and against such wealth taxes.

1. Introduction

After their continuous phasing out in the OECD, net wealth taxes have sparked renewed interest. Defined as "broad-based taxes on the ownership of net wealth" (Advani et al. 2020), they apply to all types of assets and allow debt-deductibility, that is, only the value of an individuals' assets exceeding its debts is taxed. Historically, they have had high administrative and efficiency costs and have not raised significant revenue nor achieved substantial redistribution (OECD, 2018), however, the current urgency of reducing the UK's government deficit and soaring wealth inequality underlie their current reconsideration.

In the aftermath of the COVID-19 pandemic, there is indeed a clear need for increasing tax receipts following record-government spending which pushed public debt over 100% of GDP in the UK (ONS, 2021). While other tax rates can and are being increased, assessing whether the alternative introduction of a net wealth tax is more desirable for achieving this goal is a useful exercise. Furthermore, several authors highlight widening wealth inequality which exceeds income inequality as another justification for a wealth tax (Glennerster, 2012; OECD, 2018). In the UK, the highest decile of the income distribution earned 29% of total income in 2021, while the highest decile of the wealth distribution held 52% of total wealth in the same year (OECD, 2022). Given the self-reinforcing nature of wealth, taxation is required to achieve a more equal distribution, but again, a wealth tax is only one of the available policies for this purpose.

This essay will present the merits and shortcomings of the introduction of an annual or one-off wealth tax in the UK compared to available reforms for other taxes on wealth proposed by the literature (Mirrlees et al. 2011; Summers, 2021). To do this, we will look at the policies' redistributive and revenue-raising potential, administrative costs and welfare losses resulting from behavioural adjustment.

2. Annual net wealth taxation

The OECD (2018) explains that previously implemented annual wealth taxes possess similar features. First, being levied annually, annual wealth taxes rely on periodic asset valuations. Second, taxpayers under a pre-set wealth threshold are often exempted from the tax and flat rates are employed. Third, while many asset classes are taxed, asset exemptions and preferential valuations have often been granted, in this way introducing complexity and avoidance opportunities. This section draws from empirical insight and theoretical arguments to discuss the costs and benefits of policies with these characteristics.

2.1 Arguments against an annual wealth tax

The costs of an annual wealth tax encompass direct costs to the public sector and inefficiency costs resulting from the adjustment of taxpayers' behaviour, given the distortions it introduces. The latter include real, avoidance and evasion responses.

First, the administrative and compliance costs are recurrent and significant. These arise from the need to regularly valuate taxable assets as taxpayers' wealth changes (OECD, 2018; Advani et al. 2020). Employing a model simulating wealth taxes with specific characteristics in the UK[1], Advani et al. (2021) show that where a low tax rate of 0.17% on wealth above £500,000 is used to collect £10 billion of revenue, annual administration costs to the government and compliance costs to the taxpayers are £1.2 billion and £7.8 billion, respectively. This significantly high revenue to cost ratio can however be reduced by increasing the tax exemption threshold, given that a lower number of taxpayers would be liable to pay the tax, and thus, required to conduct costly asset valuations. Given that wealth is concentrated at the top of the distribution, significant revenue could still be raised.

Second, to understand real behavioural responses and their associated costs, it is useful to first consider that any given net wealth tax has a capital income tax equivalent (OECD, 2018). For instance, for an individual with assets worth £100,000 earning a rate of return of 10%, taxing net wealth at a rate of 1% is equivalent to taxing capital income at a rate of 10%. An important distinction, however, is that a net wealth tax applies regardless of whether assets earn a rate of return at all. In fact, the lower is an asset's rate of return, the higher is the capital income tax equivalent to a net wealth tax (Scheuer and Slemrod, 2021). Where the previous individual earns a rate of return of 5%, taxing net wealth at a rate of 1% is now equivalent to taxing capital income at a rate of 20%. If earned income is consumed instead of reinvested, a wealth tax is revealed to treat owners of high-returns assets more favourably and is inequitable (Scheuer and Slemrod, 2021). Underlying this argument is the fact that net wealth taxes apply to normal returns, that is, the rate of return required for delaying consumption; but not to excess returns, contrary to economic theory (OECD, 2018; Adam and Miller, 2021). This further introduces distortion in lifecycle consumption by incentivising current consumption and disincentivising saving. The penalisation of low-returns assets mainly held by low- and middle-income individuals (OECD, 2018) and the distortion in lifecycle consumption provides another justification for high tax exemption thresholds.

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[1] The tax considered is broad based, centralised and applies third-party reporting. The model also accounts for a reduction in taxable wealth ranging from 7% to 17% due to average behavioural responses to the policy (Advani et al. 2021).

An additional real behavioural response concerns the policy's negative effect on entrepreneurship given the tendency to initially generate low or negative profits and the positive tax liability which still prevails (OECD, 2018). Furthermore, Scheur and Slemrod (2021) explain that the consistent erosion of an entrepreneur's ownership in view of the need to pay the wealth tax may provide further discouragement.

It should be clarified that while these arguments on real behavioural responses are often used against annual wealth taxes, they are theoretical and there is little evidence of effects on savings and entrepreneurship as in practice, the main behavioural responses associated with net wealth taxes are avoidance and evasion (OECD, 2018; Advani and Tarrant, 2021). This fact may in turn explain the resulting low revenue often collected and the faltering redistributive power of these taxes (OECD, 2018).

Tax avoidance refers to actions taken to reduce tax liability and encompasses a range of measures depending on the policy context. Where a wealth tax is narrow and grants exemptions or preferential treatment to different assets, portfolio allocations in the economy are distorted in favour of lower-taxed assets (OECD, 2018; Advani et al. 2020; Advani and Tarrant, 2021). Another form of tax avoidance where wealth taxes are decentralised is the change in residence within a country from regions with higher tax rates to those with lower ones to reduce liability (Advani and Tarrant, 2021). Chamberlain (2020) denotes that individuals may also transfer asset ownership within their households to limit taxable wealth exceeding the exemption threshold.

In contrast, tax evasion regards the underreporting of wealth, a behaviour which is exacerbated when reports are not verified (Advani and Tarrant, 2021). The OECD (2018) explains that very low barriers to cross-border capital mobility also facilitate evasion through capital flight among wealthiest individuals.

2.2 Arguments for an annual wealth tax

First, the OECD (2018) explains that an initial benefit of introducing an annual wealth tax instead of increasing capital income taxation is that it is levied on an accrual basis. That is, updated asset values are taxed annually, regardless of whether assets are sold. Compared to the realisation basis liability of a capital income tax, it does not add barriers to the allocation of capital and taxes more efficiently individuals' ability to pay. It is also associated with a more immediate redistribution of wealth (Summers, 2021).

Second, Scheuer and Slemrod (2021) argue that while constant valuations required for a wealth tax entail high direct costs, successful evasion is more difficult after the first years of implementation. Moreover, an annual wealth tax may also be used to check other income declarations across the tax system.

Two further arguments supporting the net taxation of wealth stem from introduced distortions and their effects on growth. The OECD (2018) states the favourable treatment of high-return assets described above encourages taxpayers' investment and leads to efficiency gains where high-yield assets are the most productive form of saving. This last assumption, however, is debated in the literature. Alternatively, the OECD (2018) argues that as human capital is untaxed under a wealth tax, the relative return of investing in human capital increases. The encouragement of such investments can in turn have positive economic growth implications. Nevertheless, as a high exemption threshold is advocated on equity and administrative grounds, these two effects could be negligible.

Finally, while historically low revenue has been raised by net-wealth, a broad based, centralised wealth tax which applies third-party reporting may have higher revenue-raising potential as it minimises avoidance and evasion. However, administration and compliance costs are still a significant component (Advani et al, 2021).

2.3 Section summary

A narrow, decentralised annual wealth tax relying on self-valuation induces strong distortions in the form of avoidance and evasion, reducing the tax base. In the absence of such behavioural responses, the policy distorts saving decisions, has equity implications and imposes substantial recurrent administrative and compliance costs. While annual wealth taxes possess certain advantages with respect to other forms of taxation and the application of a high exemption threshold limits some inefficiencies, the case cannot be made for their introduction.

3. One-off net wealth tax

One-off tax proposals have been previously employed both in the UK and internationally to respond to extraordinary economic situations and several authors recommend the use of a one-off wealth tax to fund the cost of COVID-19 (Advani et al. 2020; Adam and Miller, 2021).

Unlike an annual wealth tax, it is levied once, even though liable tax may be collected over several years; and can be designed to introduce no distortion (Advani et al. 2020; Adam and Miller, 2021). To achieve this the literature advocates the valuation of liable wealth prior to the policy's announcement, pre-determining payable tax and making it unresponsive to subsequent changes in wealth. In this way taxpayers cannot adjust their behaviour to reduce their tax liability as only previously accumulated wealth is taxed. Such a tax introduces no distortion nor inefficiency and is equivalent to a lump sum tax (OECD, 2018; Adam and Miller, 2021). Furthermore, this entails that a one-off wealth tax is an efficient way to raise revenue regardless of any potential exemption threshold and asset exemptions granted. Even if only easily valuated assets are taxed with the scope of minimising valuation costs, the policy would still be efficient and induce no distortion.

Nevertheless, an important requirement for a one-off wealth tax to act as lump sum taxation is the credibility of the one-off levy (Adam and Miller, 2021). If individuals expect future taxes on wealth, similar negative behavioural responses to those associated with an annual wealth tax would ensue. The commitment may be more credible where it is linked to a one-off policy requirement, such as reducing extreme levels of wealth inequality or funding the public cost of COVID-19.

In view of the lack of distortions, the policy's revenue-raising potential exceeds that of an annual wealth tax. Moreover, the one-off valuation requirement leads to a lower revenue-cost ratio. Advani et al. (2021) models the revenue raised by a broad based, centralised one-off wealth tax which applies third-party reporting in the UK. They estimate that it could raise £250 billion with a tax rate of 4.8% on wealth above £500,000 at a cost of £1.7 billion and £7.8 billion to the government and taxpayers, respectively[2]. Like annual wealth taxes, higher exemption thresholds can decrease the administration and compliance costs, but higher rates would be required to raise the same revenue. The case for a one-off wealth tax with the scope of reducing government debt or wealth inequality is strong.

4. Reforming other wealth taxes

Reforms to other existing taxes on wealth put forward by the literature could be preferred for achieving wealth redistribution and raising revenue compared to the introduction of net wealth taxes. Reforms to capital and inheritance taxation are discussed in this section, as a considerable proportion of wealth at the top of the distribution is derived from capital in the UK, which is taxed at a lower rate than labour income; and often escapes inheritance taxes (Adam and Miller, 2021).

The main reforms proposed advocate the alignment of rates for all taxes on income while allowing for a tax-exempt threshold, and the comprehensive and consistent taxation on gifts and inheritances (Summers, 2021).

Current distortions resulting from capital taxes' lower relative rates and from the fact that these taxes currently apply to normal returns underlie the first reform (Advani et al. 2021; Mirrlees, 2011). Using static estimation methods[3], Advani et al. (2021) find that well over £10 billion a year could be raised if dividends and capital gains taxes applied the same rates as labour income taxation. This higher revenue would partly be the result of the more neutral tax treatment across income sources and the lower distortions that would be achieved (Summers, 2021). In contrast, an annual net-wealth tax cannot correct these pre-existing inefficiencies in

[2] While a one-off tax has no associated behavioural responses, the revenue estimates presented have been reduced by 10% to account for intentional and accidental non compliance (Advani et al. 2021).

[3] Additional dynamic modelling which accounts for behavioural responses is required to obtain more reliable estimates (Advani et al. 2021).

the tax system and while it also collects additional revenue, it further distorts lifecycle consumption, as net wealth taxes are equivalent to taxing normal returns, but not excess returns.

The second reform advocated would correct the UK's incoherent inheritance tax which only captures some assets transferred at or near death. In its current form it presents multiple avoidance opportunities for wealthier individuals who can adjust their asset composition, and as a result, it is inefficient and inequitable (Mirrlees et al. 2011; Adam and Miller, 2021). A key shortcoming highlighted by Summers (2021) is the preferential treatment of agricultural and business property, and unclaimed pension-pots. A second one regards the fact that only those transfers undertaken seven years prior to death are subjected to inheritance taxation. Addressing these features would remove strong avoidance incentives and increase the policy's efficiency. Using static estimation techniques, Advani et al. (2021) determine the potential increase in annual inheritance tax receipts to equal £2.7 billion if all assets were taxed at the same rate in the UK.

While falling short of the proposal made by Mirrlees (2011), the reforms discussed can correct incoherencies in the UK's tax system and thus may be simpler to implement than an annual wealth tax. They could raise comparable revenue at a lower direct and efficiency cost and would achieve a gradual reallocation of wealth in the economy.

5. Conclusion

This essay has discussed a range of policy options available for increasing government revenue and reducing wealth inequality in the UK. An annual wealth tax would be an inefficient policy to achieve these goals, given strong avoidance and evasion incentives and the policy's distortion of saving decisions, equity implications and recurrent administration and compliance costs. In contrast, reforming capital income and inheritance taxes would correct pre-existing inefficiencies and collect comparable revenue at a lower cost, while achieving a gradual reallocation of wealth in the economy. These reforms could be paired with a one-off wealth tax, which is equivalent to a lump sum tax and can raise substantial revenue while accelerating wealth reallocation.

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