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Taxing Wealth: Past, Present, Future

Workshop Proceedings

Edited by Caterina Astarita

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Directorate-General for Economic and Financial Affairs

Taxing Wealth: Past, Present, Future

Proceedings of the workshop organised by the Directorate General for Economic and Financial Affairs held in Brussels on 13 November 2014

Edited by Caterina Astarita

Abstract

In times of fiscal consolidation and strong macroeconomic adjustment needs in some EU Member States, the debate on wealth taxation gained momentum, both in the academic and in the policy debate. In this context, the aim of the workshop, held by DG ECFIN on 13 November 2014, was to discuss theoretical and policy issues associated with wealth taxation, including the broad principles and the concrete design challenges of an optimal wealth tax. Different types of wealth taxation have been scrutinised including transmission taxes, housing taxes and the taxation of financial assets. The challenges they may raise have been discussed also with respect to recent experience in particular Member States. The workshop was organised in two sessions: "Taxation of wealth: state of play and rationale" and "Taxing wealth: specific instruments and challenges". The proceedings offer a detailed summary of the most recent research related to various aspects of wealth taxation and carried out by academics and international organisations' representatives.

JEL Classification: F38, H2, H26, H300, H310, H320, H71, H87.

Keywords: wealth taxation, property taxation, inheritance taxation, wealth transfers, tax migration, international exchange of information, tax evasion, tax avoidance.

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Acknowledgements

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1. SUMMARY OF THE WORKSHOP

by Caterina Astarita*

The debate on wealth taxation gained momentum, both in the academic and in the policy debate, in times of fiscal consolidation and strong macroeconomic adjustment needs in some EU members. In this context, the aim of the workshop was to discuss theoretical and policy issues associated with wealth taxation, not least the broad principles and concrete design challenges of an optimal wealth tax. Different types of wealth taxation have been scrutinised including transmission taxes, housing taxes and the taxation of financial assets. The challenges they may raise have been discussed also with respect to recent experiences in selected Member States. Organised in two sessions, the workshop involved speakers from academia and international organisations.

Lucio Pench (*Director of Fiscal Policy in DG ECFIN*) in his introductory statement highlighted how, in the aftermath of the crisis, the debate on wealth taxation gained momentum at different levels: policy, academic and public. He recalled some Member States having reintroduced, in the process of reducing large budget deficits, some form of wealth taxation or engaged in the political discussion about the possibility of taxing wealth. Also the academic discourse, reinforced, among others, by the work of Thomas Piketty on the accumulation of wealth, have re-launched a sometimes heated public debate about the economic relevance of taxing wealth with a focus on distributional issues. Pench recalled some of the pros and the cons of taxing wealth, anticipating some possible points of discussion. Furthermore, he widened the perspective of the debate contextualizing it into that of growth-friendly tax policy, with the tax structure in the EU often being mentioned to be skewed towards taxation of labour, while the taxation of less distortive sources of revenue is underused in many countries. He underlined that the political economy dimension is particularly relevant in the context of wealth taxes, regardless of their form, as these are relatively visible and run into strong societal opposition.

Florian Wöhlbier (*Deputy Head of the Revenue Management and Tax Policy Unit in DG ECFIN*) presented the key messages from the 2014 edition of the joint DG ECFIN and DG TAXUD report "Tax reforms in EU Member States". The report presents recent trends in tax reforms in EU Member States and identifies tax policy challenges for Member States relevant for macroeconomic performance. Wöhlbier put a focus on the section of the report dealing with wealth-related taxes. He illustrated the mitigating effect of the tax and benefit system on income inequality in the post crisis years and provided a short overview of the renewed debate on wealth taxes, also presenting a brief review of wealth-related taxes levied in EU Member States.

First session on taxation of wealth, state of play and rationale

The first session, chaired by Lucio Pench, focused on the state of play and the rationale behind the taxation of wealth. It took a horizontal and comprehensive view at the relevant economic dimensions related to wealth taxation. Pench recalled that the purpose of this session was to look into the policy challenges and the recent debate on wealth taxation (presented by Michael Keen) and the presentation of some arguments in favour of taxing capital income, wealth, and inheritances (by Gabriel Zucman as presenting author of the joint work with Thomas Piketty). Both the interventions were discussed (by David Bradbury). A specific focus on wealth taxes in France and Germany (by Alain Trannoy and Stefan Bach, respectively) were announced. A general discussion with the speakers and the audience concluded the session.

Michael Keen (*Deputy Director of the Fiscal Affairs Department of the International Monetary Fund - IMF*) highlighted the revived interest toward wealth taxation recalling some related issues such as the marked increase in income inequality and in wealth-to-income ratios along with the strengthening of the perception of unfairness in the post-crisis period. He, then, described the different wealth tax instruments (recurrent, non-recurrent, market and non-market transfers) and their rationale also providing some data about the current state of wealth taxes in OECD countries. Then he focussed on the debate on whether to tax capital income or capital, explaining the conceptual and the practical differences between the two and clarifying the conditions under which the equivalence relation holds. The possibility of differentiating tax rates across assets were discussed with an eye

on the relative reasons and challenges. He concluded by referring to challenges related to international tax competition and the necessary exchange of information.

Gabriel Zucman (*Assistant Professor in Economics at the London School of Economics*) described the evolution of the wealth-to-income ratios in the richest countries. He explained its increase by referring to the Harrod-Domar-Solow formula on wealth-income ratio and stressed that wealth is becoming increasingly important relative to income. He listed the key rationales for wealth taxation. Furthermore, he explained that given the fuzzy frontier between capital and labour income, a possible solution could be that of imposing a similar tax rate on both especially in the case of a high shifting elasticity between capital and labour income. Furthermore, he stressed that the difficulty to observe both income and consumption in the upper part of the distribution, makes wealth a valid proxy for income. He then specified that a bequest tax can be desirable on top of capital income wealth taxes and should be designed according to the meritocratic Rawlsian optimum bequest tax rate formula.

David Bradbury (*Head of the Tax Policy and Statistics Division within the Centre for Tax Policy and Administration – CTPA – at the Organisation for Cooperation and Development - OECD*) provided some background about the renewed interest in wealth taxation, which is probably due both to an increase in inequality and to the effects of the crisis. He described the challenges related to wealth taxation and issues concerning the optimal design of any wealth tax, including taxing stocks or flows, taxing gross or net wealth, taxing comprehensive or selected classes of assets and the valuation of wealth. He addressed the topic of tax avoidance and globalization, recalling that concerns about mobility and avoidance had led to discussions about a possible global wealth tax. However, many questions remain open in this respect. He stressed the importance of transparency and information-sharing on tax matters, and highlighted the OECD's mandate from the G20 to work to increase transparency in coordination with organisations including the EU. Following on from the continued success of the Multilateral Convention on Mutual Assistance in Tax Matters, he noted the OECD has presented a single, common global standard on automatic exchange of information (AEOI), which is being adopted by an increasing number of countries and the Global Forum on Transparency and Exchange of Information for Tax Purposes will be monitoring its implementation, and helping developing countries to benefit from it. The implementation of AEOI will improve transparency and potentially present tax policy makers with a raft of new policy tools to more effectively tax wealth in the future.

Alain Trannoy (*Directeur d'Études at EHESS - École des hautes Études en Sciences Sociales - in Marseille, Director of IDEP - Institut d'Économie Publique – in Marseille and Director of AMSE - Aix-Marseille School of Economics*) gave an overview of wealth taxation in France (i.e. *impôt sur les successions* and *taxe foncière*) examining, in particular, the solidarity tax on wealth (ISF, *Impôt de solidarité sur la fortune*). After providing some details on the ISF tax base and on the evolution of tax schedule, some figures picturing the dynamics of the tax revenues deriving from ISF were analysed. In line with the public debate in France, the issue of tax migration from France to Belgium and Switzerland was considered in depth. Trannoy underlined that it can be difficult to measure a causal impact of the ISF on outmigration and highlighted the sources of potential unclear upward and downward bias also considering that what matters was the difference of the tax regime between France and neighbouring countries. He provided some empirical evidence on how the proximity to the borders can trigger more out-migration in the presence of a more lenient tax regime abroad.

Stefan Bach (*Deputy Head of the Public Economics Department at the German Institute of Economic Research - DIW Berlin - and lecturer at University of Potsdam*) started by providing some background information on the rising inequality in income and wealth in OECD countries and then described the debate on wealth taxation in Germany. He stressed the limited importance of property and wealth related taxes in Germany over the last decades, despite the long tradition of personal wealth taxation in the country. After giving an overview about top wealth assessing issues, he presented two proposals that, in the recent years, have played a relevant role in the German policy debate: the options of a one-time capital levy and the re-introduction of the recurrent wealth tax. He discussed some proposals in detail and offered some lessons that can be drawn from the political debate.

Second Session on specific instruments and challenges in taxing wealth

The second session of the workshop, chaired by Gaëtan Nicodeme (Head of Unit of the "Economic Analysis, Evaluation & Impact Assessment Support" Unit in DG TAXUD), focused on specific forms of wealth taxation and the challenges associated with them. The purpose of the session was to disentangle some aspects of taxing wealth transfers, including gift and inheritance taxes, and of housing taxation along with discussing some issues linked to the practical implementation of wealth taxes. He recalled that the main topic of the session were the social and political constraints facing wealth transfer taxation and some possible reform proposals (by André Masson), an in depth analysis of the wealth and wealth transfers taxation system (by Robin Boadway), the taxation of immovable property and the assessment of the tax burden of owner-occupied housing in the EU (by Serena Fatica) and the challenges linked to taxing financial wealth (including capital flight, tax heavens and valuation of wealth (by Gabriel Zucman).

André Masson (Directeur de Recherches at CNRS - Centre National de la Recherche Scientifique - and Directeur d'Etudes at EHESS - École des Hautes Études en Sciences Sociales - in Paris) gave a glimpse on the current debate in France on wealth taxation. The focus in the debate lies on lifetime wealth taxation whereas wealth transfer taxation seems not to be the central issues. In this respect, Masson discussed the main elements of the trade-off between the two forms of wealth taxation. He described the growing unpopularity of wealth transfer taxation and examined the possible underlying reasons also providing some examples of attempts to new wealth transfer taxes. After suggesting a diagnosis of wealth in France, he advocated as a possible proposal for the French case that of Taxfinh (tax family inheritance) – not gifts or bequests to charities. The main philosophy of the proposed tax is to tax (much) more (large) family inheritances. Its design, the expected effects and performance along with the possible pitfalls were described in detail.

Robin Boadway (Professor Emeritus at the Department of Economics, Queen's University, Kingston Ontario, Canada, after describing the different features of taxes on wealth transfers as well as of taxes on wealth, reviewed some specific issues related to taxing bequest. First, the standard welfarist approach was portrayed in its main traits which gives due weight to the welfare effects on donors and non-donors when transfers are voluntary. Some conceptual difficulties, inherent to the welfarist approach and, in particular, related to the double counting of bequests were also considered, suggesting two possible alternatives. The first one being the "restricted welfarist approach" that treats voluntary donation as transfer of income from donor to donee giving deduction for donation and taxing donee receipts (analogously with the donation to charity case). The second one is the "equality of opportunity approach" that, to the extent that bequest behaviour is a matter of choice but inheritances are not, considers that bequests should have no tax consequences for donors, but should be taxed in the hands of recipients. With respect to the two approaches, Boadway discussed detailed design issues, including those related to taxpayers, the tax base, the tax structure and special treatments, stressing that most of the work remaining to be done regarded international coordination.

Serena Fatica (Economic Analyst of the Unit C3 "Revenue Management and Tax Policy Issues" in the Directorate General for Economic and Financial Affairs - DG ECFIN - of the European Commission) discussed the tax pressure on owner-occupied housing in the EU and its drivers. The presentation illustrated how the tax code rules for owner-occupied housing across the EU affect the annual user cost of housing capital. While a significant level of heterogeneity is uncovered, some common features seem to point to a general favorable tax treatment of owner-occupation, while transfer taxes upon purchase are sometimes levied at high statutory rates. The second part of the presentation focused on the distributional issues arising from current housing tax rules in selected Member States. In this respect, the potential adverse impact from measures taken to improve the efficiency of housing taxation could be compensated by appropriate adjustments in the tax design, also in the context of broader reforms aimed at lifting the burden from labour.

Gabriel Zucman (Assistant Professor in Economics at London School of Economics) described the data available on the wealth managed by offshore financial institutions, the way some tax heavens and institutions can facilitate tax evasion also analysing the information available on the magnitude of offshore tax evasion. He referred to the progress made in the exchange of information, confirming that lot remains to be done and

suggested, in this respect, the establishment of a world financial registry. He stressed that tax avoidance by multinational companies is severely eroding the corporate tax base providing some figures about the phenomenon. After describing the core principles for international taxation (source based taxation, arm's length pricing, bilateral agreements) he suggested some solutions that may address artificial profit shifting and tax competition for real investment.

Concluding policy panel

During the concluding panel discussion, the complexity of the design of wealth taxation was recalled and some of the numerous dimensions covered during the two sessions were recalled: the different instruments used for taxing wealth, issues related to taxing flows and stocks, the issue of who ultimately bears the burden of wealth taxation (i.e. tax incidence), the existence of a blurry frontier between capital and labour income for high-income earners, the role of transparency and automatic exchange of information in facilitating tax compliance and serious political economy constraints. The panel also reflected on whether wealth-related taxes may be used to rebalance taxation in Europe, supporting the tax shift away from labour. In this respect, it was considered relevant to identify the least distortive forms of wealth taxation. The paradox that sees, on the one hand, an increasing demand for equity in the wake of the recent crisis and, on the other hand, strong reluctance towards most forms of wealth taxation, was highlighted.

Lucio Pench (*Director for Fiscal Policy in DG ECFIN*) closed the workshop by envisaging need for further work in the area.

2. KEYNOTE ADDRESS

2.1. LESSONS FROM THE 2014 REPORT "TAX REFORMS IN EU MEMBER STATES"

by Florian Wöhlbier*

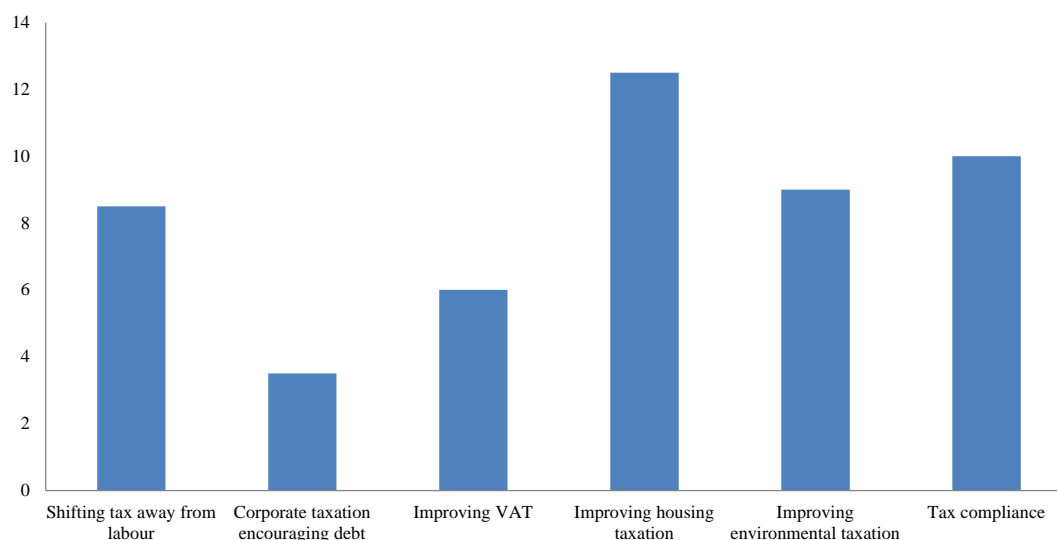
2.1.1. Introduction and general issues

The 2014 edition of the ECFIN/TAXUD report "Tax reforms in EU Member States – tax policy challenges for economic growth and fiscal sustainability"¹ presents the recent trends in tax reforms in EU Member States. Furthermore it includes an indicator based screening, which serves as a first attempt to identify tax policy challenges in Member States for areas of tax policy impacting macroeconomic performance. In addition, the report looks in the link between tax and benefit systems and income inequality.

In the current political debate a lot of attention is put on tax issues. This is reflected in the European Semester, the EU's annual cycle of economic policy surveillance. The Semester is launched every year by the Annual Growth Survey. The 2014 Annual Growth Survey (COM(2013) 800 final) prompts Member States to "...design taxes to be more growth-friendly, for instance by shifting the tax burden away from labour on to tax bases linked to consumption, property, and combatting pollution." The Report provides an analytical input for the policy advice given in the context of the Semester, which is followed up by further country-specific analysis.

The report makes use of a wide variety of indicators to assess Member States' performance and to identify potential challenges in relevant areas of tax policy. A relatively poor performance on the indicators indicates a potential policy challenge. No automatic conclusions should be drawn however. The indicator-based assessment must be complemented by in-depth country analysis before any firm conclusions on policies can be made. The European Commission carries out such in-depth work in the context of the European Semester.

Figure 1: prevalence of tax policy challenges in EU Member States



Source: European Commission (2014)

* Florian Wöhlbier is Deputy Head of Unit C3 "Revenue management and tax policy issues" in the Directorate General for Economic and Financial Affairs (DG ECFIN) of the European Commission. The views expressed in this contribution are those of the author and do not necessarily represent those of the European Commission.

¹ See European Commission (2014).

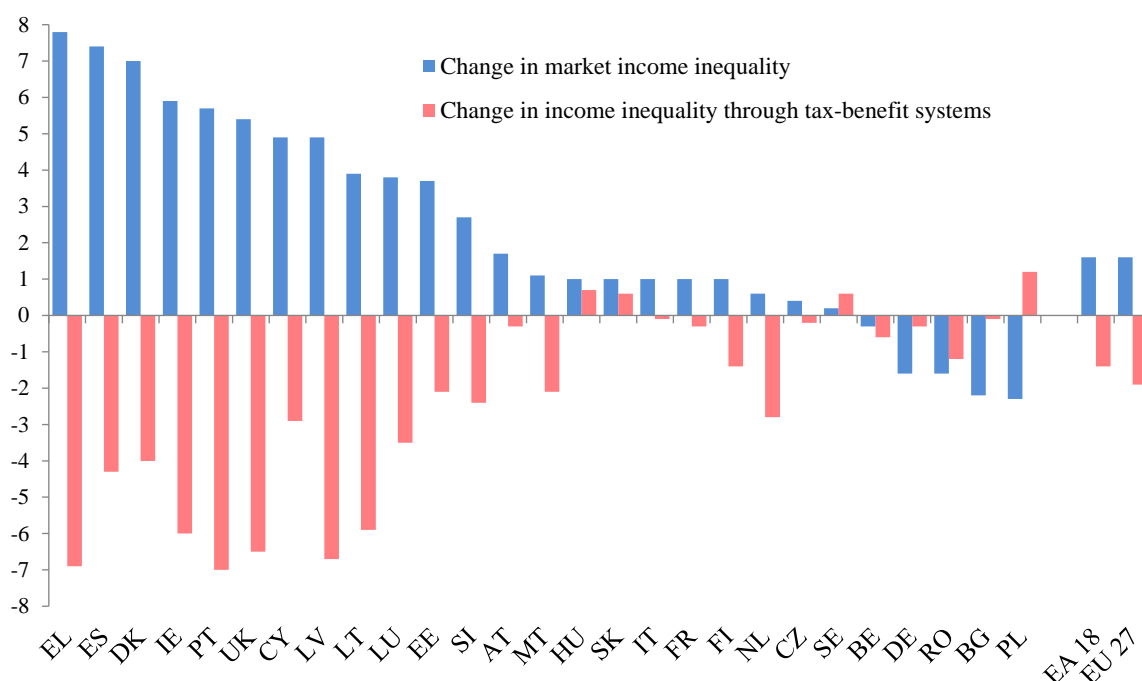
Figure 1 highlights the prevalence of tax policy challenges in main areas of taxation analysed in the report. It shows that several Member States could particularly benefit from a tax shift away from labour, could consider to broaden tax bases and improve the design of individual taxes as concerns housing taxation, VAT, the debt bias in corporate taxation, environmental taxation, and take measures to improve tax compliance. All these potential challenges are discussed in detail in the Report.

This chapter will, however, zoom into the issue of wealth taxes, which are already addressed in the report, providing also additional information based on a study by EY for the European Commission, DG TAXUD (2014).

2.1.2. Income inequality and tax and benefit systems

It is much discussed, in how far the financial and economic crisis has led to an increase in income inequality over the past years in the EU Member States and which role the tax and benefit systems have played.

Figure 2: mitigating effect of tax and benefit system on income inequality – contribution to the change in the Gini index, 2008-2012



Source: Eurostat (European Commission)

Figure 2 presents the changes in income inequality, as measured by the Gini index, between 2008, the last year with positive growth and 2012, the last year for which data is available. While market income inequality increased in the time period covered on the European average, the tax and benefit system helped cushion this increase. In general, the mitigating effect of the tax and benefit system was the strongest in those Member States with the highest increase in market income inequality (left line for each Member State). On average, no major change in income inequality can be observed, while differences across Member States are rather big. Furthermore, low-income households in some Member States have seen their circumstances deteriorate disproportionately.

2.1.3. Wealth-related taxes – renewed debate

Wealth-related taxes raise relatively little revenue (around 2 % of GDP on the EU average) and have not received particular attention in the pre-crisis years. Most net-wealth taxes were removed or scaled down by

Member States between 1995 and 2007. Such reforms took, e.g., place in German, Luxembourg, Sweden, Finland and Spain.

The debate on wealth taxes has, however, gained momentum in times of fiscal consolidation and strong macroeconomic adjustment needs particularly in vulnerable countries. At the same time, the academic discussion around the possibility of levying taxes on assets has increased and gained particular attention with the publication of Piketty's (2014) analysis of long-run returns on capital and wealth-concentration.

The topic of taxation of wealth is very complex and several different wealth-related need to be distinguished, including taxes on wealth-transfers, taxation of immovable property and recurrent taxes on net wealth. IMF (2013) reviews a range of discussions on the different forms of wealth taxation.

For some, wealth taxes are an effective way of supplementing capital income taxes. They can help rebalancing the tax burden away from the neediest and the middle class. Furthermore, very low taxes on net wealth could help limit their distortionary effects. Moreover, such low rates would tax only, or mainly, accumulated economic rents.

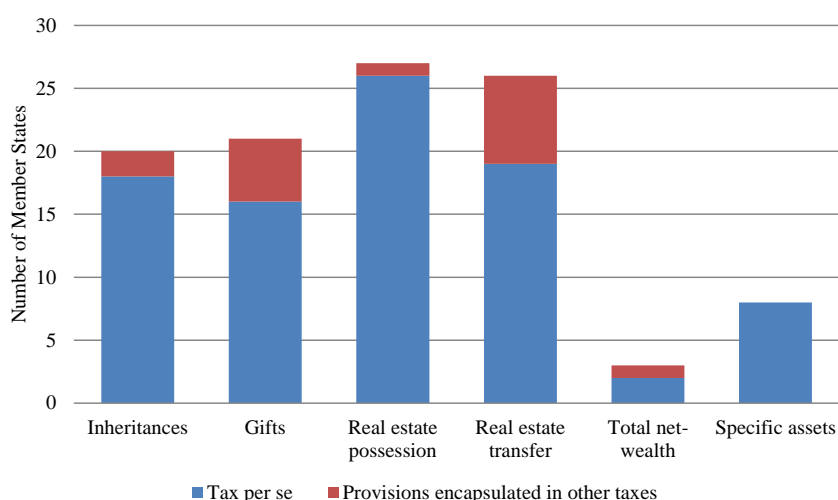
For others, wealth taxes are characterised by significant downside risks. They can have potential negative behavioural effects on capital accumulation, especially when raised at high rates. Their revenue potential is subject to large uncertainty. Moreover, they are associated with important compliance issues, including tax avoidance using existing loopholes, the risk of capital flight and the problem of tax havens.

An important question in the current debate is whether wealth-related taxes should be raised at different rates depending on the form of wealth. Taxation depending on the degree of mobility would, for example, imply higher rates for immovable property than for financial assets. In this context it is important to point out that recurrent property taxes are considered less distortive. Inheritance taxes could be used to limit the intergenerational transmission of inequality. The evidence of the distortionary effects of such taxes is, however, mixed.

2.1.4. Wealth-related taxes – situation in EU Member States and importance for tax revenues

Wealth taxes with the exception of net-wealth taxes are widely used in the EU Member States. Presenting the results of a study carried out by Ernst & Young, commissioned by the European Commission, DG TAXUD, Figure 3 provides an overview of the prevalence of wealth-related taxes in EU Member States.

Figure 3: wealth-related taxes in EU Member States

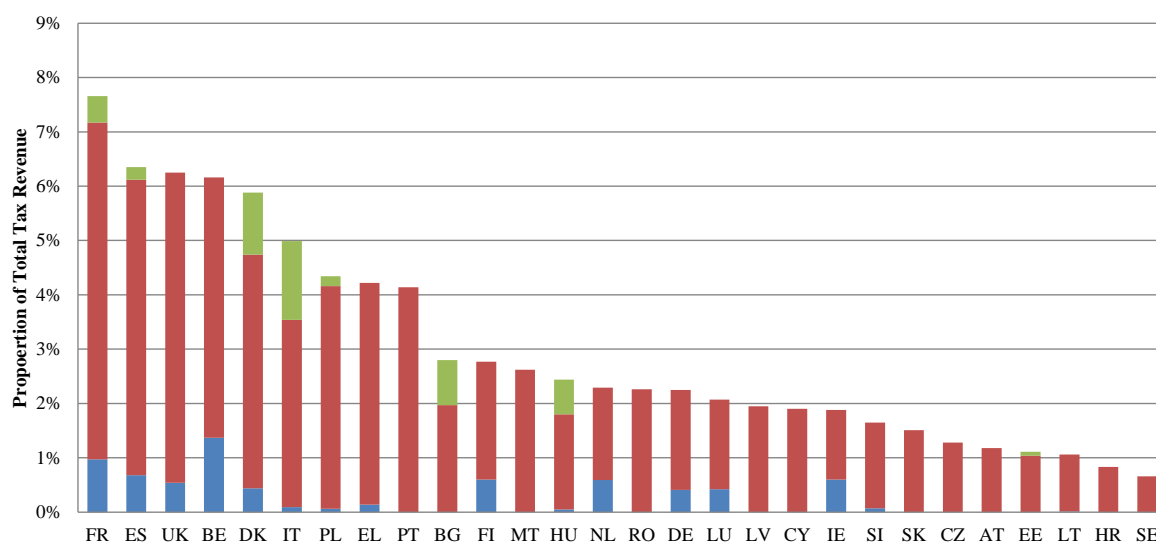


Source: Ernst & Young (2014)

In addition to the number of EU Member States which raise different types of wealth-related taxes, it is important to look at the revenue raised from these taxes. As can be seen from Figure 4, these taxes raise rather limited revenues, with rather large differences across Member States ranging from revenues of more than 3 % of GDP to below 0.25 % of GDP. For the three different categories differentiated in the figure, the situation looks as follows:

- (i) net-wealth taxes raise rather little revenue in only few Member States. On average 0.15 % of GDP (0.36 % of total tax revenues) in those Member States in which they are applied;
- (ii) real estate and land taxes raise by far the highest revenue in Member States; on average these revenues amount to 0.89 % of GDP (2.59 % of total tax revenues) in those Member States in which they are applied;
- (iii) inheritance and gift taxes generated limited revenue: 0.16 % of GDP (0.39 % of total tax revenues) in those Member States in which they are applied.

Figure 4: revenue from wealth taxes in Europa, 2012 in % of GDP



Source: EY (2014).

2.1.5. References

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3. SESSION I - TAXATION OF WEALTH: STATE OF PLAY AND RATIONALE

3.1 SOME NOTES ON TAXING WEALTH

by Michael Keen*

3.1.1. Introduction

This short note, after some remarks on the broader context, highlights three particular issues in the taxation of wealth: the relationship between taxes on capital and on capital income; the possibility of taxing different types of wealth at different rates; and challenges related to tax competition and the cross-border information exchange.

The immediate background, of course, is a greatly increased interest in wealth-related taxes. Powerful academic contributions have shown that income inequality has increased significantly over the last couple of decades, at least in many Anglo-Saxon countries, that wealth-income ratios too have been rising, and has reminded us that wealth is much more unequally distributed than income. Adding to this a post-crisis malaise — the perception of bailouts and aggressive tax avoidance opportunities for some, austerity for others — that has translated into a deeper sense of unfairness, and the heightened revenue needs that many governments now face, the renewed focus on wealth-related taxes is no surprise.

Importantly, there are of course many different types of tax on wealth taxes,² one key distinction being that between recurrent wealth taxes — levied periodically, typically annually — and non-recurrent ones.

There are two main rationales for recurrent wealth taxes: to address non-income benefits associated with high personal wealth, and to exploit information on individuals' circumstances and behavior that is not fully or best exploited by prevailing or potential taxes on income, consumption and bequests.

Recurrent taxes on some notion of aggregate wealth have been in decline over recent years, having been removed, for instance, in Australia, Canada, Pakistan and Sweden. This is generally attributed to both tax competition, as countries seek to offer a more attractive deal than others in order to attract a mobile base, and a perception that the tax was often simply not accomplishing its distributional objectives, being all too easy for the healthy, wealthy and well advised to avoid. At the same time, however, such taxes have survived in France, Norway and Switzerland, and have had some revival in crisis-affected Spain and Iceland. Reports of the death of the annual wealth tax may have been premature. Recurrent taxes on immovable property. Annual taxes on immovable property, however, remain widespread.

Non-recurrent wealth taxes take a variety of forms, serving a variety of possible purposes. A capital levy—that is, a one-off charge on capital assets—has sometimes been proposed as a revenue-raising device that is an alternative to outright default on government debt. It does, indeed, have the theoretical attractions of being a lump sum tax: past wealth having already been accumulated, taxing it can cause no distortions. But despite some influential supporters (including Pigou, Schumpeter, and until he changed his mind, Keynes) few successful examples can be cited.³ Taxes on non-market transfers are another form of non-recurrent wealth tax. Inheritance taxes can be imposed either on the donor, as an estate tax, or on the recipient, as an accessions tax; in either

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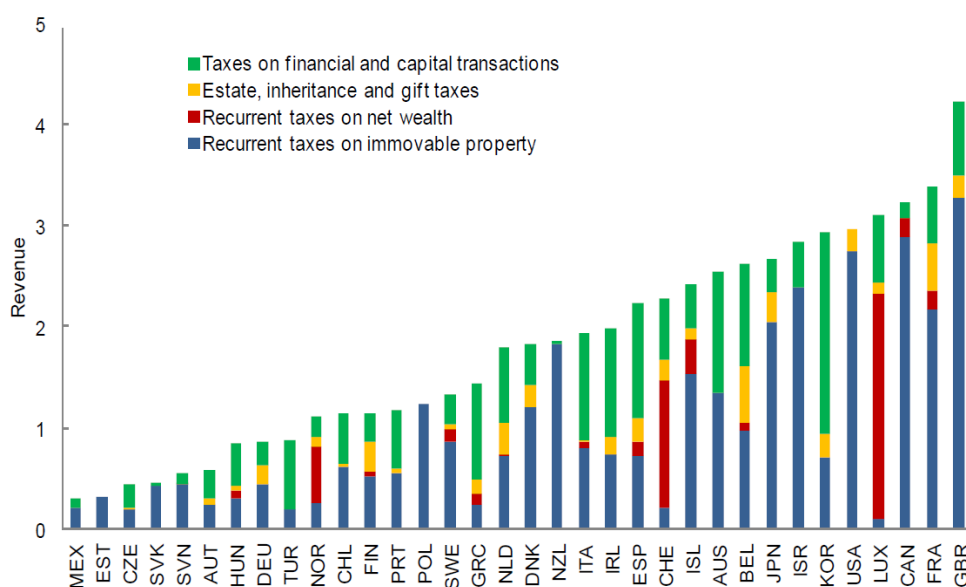
² Excellent reviews of the literature are provided by Boadway and others (2010) and, on intergenerational aspects, Kopczuk (2013).

³ Eichengreen (1990) explores experiences with capital levies.

case, to prevent avoidance, gifts needs to be taxed as well. In designing such taxes, one key lesson from the literature is that the reason why people make a bequest matters a great deal. When bequests are unintended, for example—people simply die before they can spend all their money—then even a very high tax rate will create few distortions. If, on the other hand, bequests are motivated by the sheer pleasure of giving, there is an argument for subsidizing them: looking only to their own interests, and so not valuing the benefit they confer on their heirs, those motivated in this way will tend to leave too little. Another category of non-recurrent wealth taxes are those on market transfers, including stamp duties and financial transaction taxes. These can be highly distortionary, because they can mean that transactions which would otherwise be mutually beneficial simply do not place; their primary merit is that they can be relatively easy to collect, especially when the transfer of legal title is conditional on the tax payment.

For the OECD, Figure 1 shows that the revenue collected from recurrent taxes on immovable property (including in particular, property taxes) is generally by far the largest contributor to revenue from wealth-related taxes, followed by non-recurrent taxes on financial and capital transactions. Estate, inheritance and gift taxes make only a minor contribution.

Figure 1: tax revenue by kind of tax (average 2000 – 2012)



Source: OECD revenue statistics

3.1.2. Taxing wealth vs. taxing capital income

There are some important similarities between taxing capital (wealth) and taxing capital income. To see this, note that a tax on capital at the rate T_K (leaving the holder with $1 - T_K$ to invest at the rate of return R) has the same effect as taxing capital income at rate T_R (reducing their after-tax return to $(1 - T_R)R$) if

$$(1 - T_K)(1 + R) = 1 + (1 - T_R)R,$$

which will be the case if $T_R = T_K(1 + R)/R$. At an interest rate of 5 percent, for instance, a one percent tax on capital is equivalent to a 21 percent tax on capital income.

This suggests that a recurrent tax on wealth is unnecessary if capital income is effectively taxed. But there are also important differences between the two. First, if the rate of return varies across individuals, then a uniform tax on capital income tax does not correspond to a uniform tax on capital. If the rich, for instance, can obtain a

higher return on their savings, then a uniform tax on capital income will translate into a lower rate of tax on their capital. In principle, this can be dealt with by levying tax not on the actual return to capital but by reference to some notional rate of return, common to all taxpayers—as is done under the Dutch 'box' system.

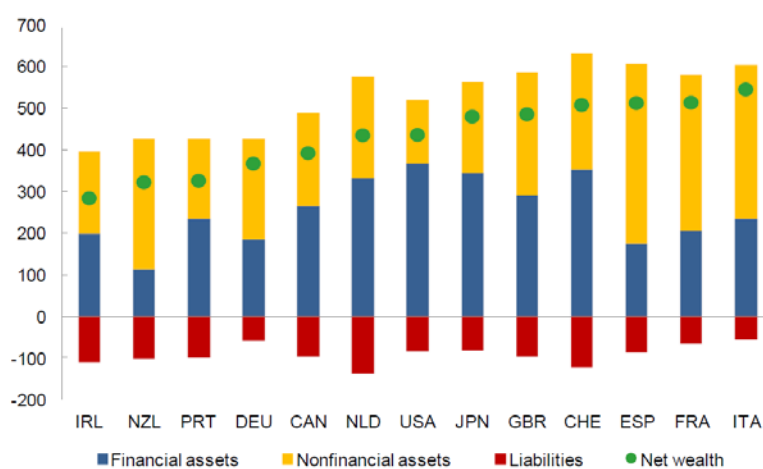
A second important difference relates to the treatment of losses: if capital income is zero or negative, liability is generally also zero or negative under a capital income tax, whereas it is still be positive under a wealth tax so long as the capital value of the assets remains positive. This is essentially a timing issue, but implies differing automatic stabilization properties of the two taxes. Another practical difference is that while withholding at source and third party reporting are well-developed for many forms of capital income, such as dividends and interest, wealth taxes have relied to a large degree on self-reporting. There seems little reason however, why those same administrative tools should not come to be applied to the corresponding stocks.

While taxes on capital and on capital income are thus not twins, they are at least cousins. An open question in political economy is whether taxes on capital income have proved more robust than taxes on wealth against the evident pressures to include exceptions and special treatments under the latter. Related, the greater familiarity with taxes on capital income may make it easier to turn them more effectively to the purposes of a recurrent wealth tax than to introduce wholly new taxes that are explicitly of that kind.

3.1.3. Differentiating across assets?

Wealth is held in different forms, a central distinction being that between financial and non-financial assets. Figure 2 shows their relative importance in a range of countries for which data are available; while this evidently varies, non-financial assets, predominantly real estate, often account for a sizable portion of personal wealth.

Figure 2: assets in percent of GDP

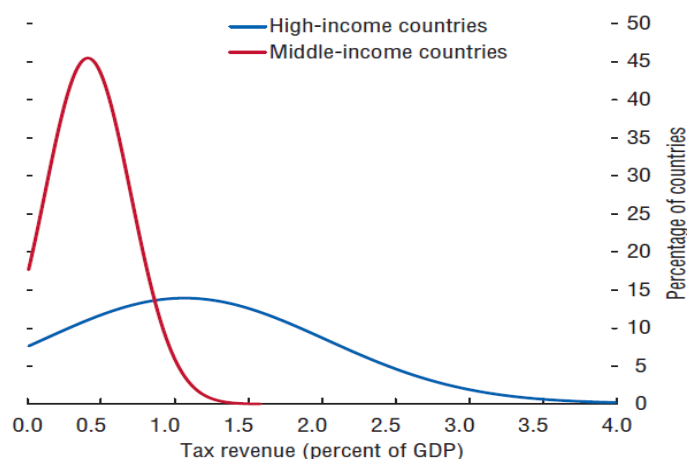


Source: Fiscal Monitor, October 2013

There may be good reason to tax these forms of wealth differently. Perhaps most importantly, non-financial assets are likely to be less mobile internationally than are financial assets: it is easier to move a bank account abroad than it is to move an attractive house (or, more to the point, the value that derives from its location). This, in the absence of some degree of international cooperation, points to heavier taxation of non-financial assets. The case for this is strengthened by some empirical evidence that property taxes are among the most growth friendly (or least growth unfriendly) of broad tax types (Arnold and others, 2011) — though it is important to be aware that taxing business properties can run counter to the general principle of avoiding distortions to production decisions. The appeal of these taxes is greater where property values reflect local public spending, in which case these taxes have particular appeal as a source of marginal revenue for local governments. And, with equity concerns in mind, property taxes can of course be made progressive in property values.

The pattern of revenues shown in Figure 3 suggests that many countries have scope to make further use of property taxes. But doing so can be a far from trivial exercise. In practical terms, a well-established cadastral register is necessary, and so is keeping assessed property values up to date. Even some advanced countries have struggled with the latter. Often, however, the main obstacle is political: property taxes are often highly visible to taxpayers, and resistance to increases correspondingly fierce.

Figure 3: distribution of yields from real property taxes in 2009



Source: Fiscal Monitor October 2013

3.1.4. Tax competition and information exchange

The mobility of financial assets is a likely source of the international tax competition that is reflected in declining rates of taxes on both wealth and capital income. And there is no doubt that among the significant motives for relocating financial assets has been the desire to evade taxes by locating funds in low tax jurisdictions and failing to report the proceeds to the taxpayers' home authorities. The best empirical assessment of the potential scale of such activities is provided by Zucman (2013), who puts the amount concealed in tax havens in 2008 at around 4.5 trillion dollar.

Perhaps the most important development in international taxation over recent years has been collective action to encourage the exchange of information between tax authorities, so as to help the enforcement of residence-based taxes. There have been several landmarks: the EU Savings Directive adopted in 2003, the US Foreign Account Tax Compliance Act (FATCA) of 2010, and now the pursuit by the G20 and OECD of automatic exchange of information (not just, for instance, exchange on request) as the new global standard.

These are potentially highly significant initiatives, holding out the prospect of greeter effectiveness in taxing wealth and capital income. Some issues do, however, remain. While there are surely gains from joining a group of countries exchanging information with each other, there may be even bigger gains from remaining outside: it may be better not to exchange information oneself, and instead take advantage of the reduced attractiveness of those other locations to those seeking to avoid tax. As Elsayyad and Konrad (2012) show, the value of being a tax haven is greater the fewer other havens there are. And indeed there is some evidence of money flowing to non-participating jurisdictions (Johannesen and Zucman, 2013).

Worth remembering too is that while exchange of information helps to enforce residence-based taxes, residence is generally something that can be changed—for tax reasons as well as others. There can, and seemingly is, tax competition to attract wealthy individuals to become residents. That raises issues surrounding the use of exit charges on changing tax residence, and links with maintaining freedoms of movement. One might wonder if taxation by citizenship (as in the United States) rather than by residence would resolve this difficulty. But

citizenship can be renounced: three times as many US citizens did so in 2014 as in 2012, which some have linked to the FATC legislation.

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3.2 RETHINKING WEALTH TAXATION

by Gabriel Zucman* and Thomas Piketty**

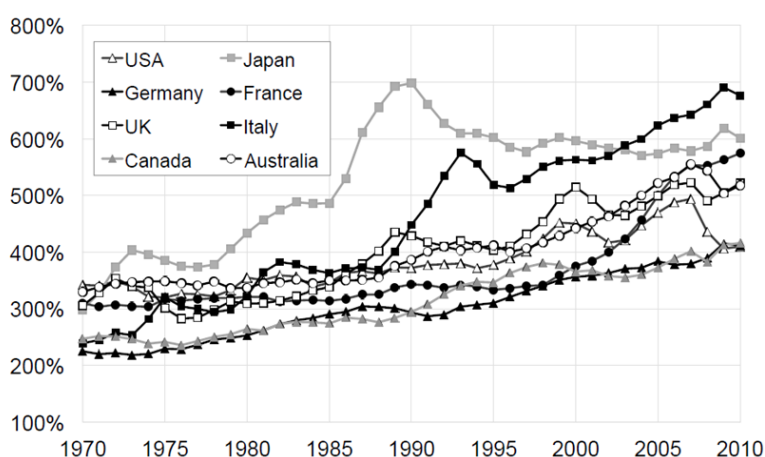
3.2.1. Introduction

This contribution will focus on two main issues. First, it will show that, in rich countries, wealth is becoming increasingly important compared to income. This is the key reason why particular attention should be devoted to wealth taxation (see Piketty and Zucman, 2014). Second, it will set out a number of arguments why taxing capital income, the stock of wealth and inheritances is desirable.

3.2.2. Capital is back

What do we know about the long-run evolution of aggregate wealth-income and wealth-output ratios? Until very recently it was not possible to address this question because national accounts focus on flows. In recent years, the statistical institutes of most rich countries have started to collect and annually publish national balance sheets that record the total amount of wealth of each sector of the economy. By drawing on these balance sheets, we assembled a new database on wealth. The database allows us to examine the long-run evolution of wealth-to-income and capital-to-output ratios. The database is in the process of being expanded into a World Wealth and Income Database (W2ID).

Figure 1: private wealth / national income ratios 1970 – 2010



Source: authors' computation using country national accounts.

Note: private wealth = non-financial assets + financial assets – financial liabilities (hh and non-profit sector).

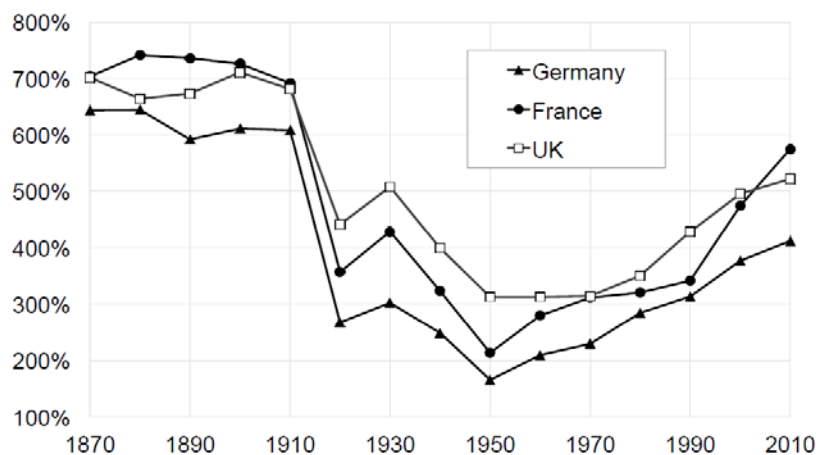
From the database we learnt that private wealth, that includes all household wealth both financial and non-financial, as a fraction of national income has been gradually rising in the top eight richest economies - US, Japan, Germany, France, UK, Italy, Canada and Australia - over the past four decades, from about 200–300 % in 1970 to 400–600 % in 2010 (Figure 1). As revealed in Figure 2, European private wealth to national income ratios today appear to be returning to the high values registered in the nineteenth and early twentieth century. The available historical data shows that wealth was very large compared to income, with a ratio in the order of magnitude of 6 or 7 before World War. It subsequently declined in the period of the two World Wars and the

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great depression while increasing again after 1950. As we know that the rise of private wealth has been larger than the decline of government wealth this implies that national wealth in total has increased, and substantially so.

Figure 2: private wealth / national income ratios in Europe 1870 – 2010



Source: authors' computations using country national accounts.

Note: private wealth = non-financial assets + financial assets - financial liabilities (hh and non-profit sector). Data are decennial averages (1910–1913 averages for 1910).

In order to explain the 1970-2010 rise (Figures 1 and 2) in the wealth-income ratio, two key developments should be distinguished. The first development is a long-run rise in asset prices which was, in turn, driven by changes in capital policies. A number of anti-capital policies (such as high tax rates on capital, a large fraction of domestic capital stock being owned by the public sector, rent controls, strong union power) depressed asset prices through the 1970s. These policies were gradually lifted from the 1980s on, contributing to an asset price recovery. In other words, asset prices, since the 1970, tended to rise faster than consumer prices and this generated a capital gain on wealth. The second development is a slowdown of productivity and population growth. According to the Harrod-Domar-Solow formula, in the long run the wealth-income ratio (β) is equal to the net of depreciation saving rate (s) divided by the income growth rate (g). On that basis, countries with a low income growth rate are bound to have a high wealth-income ratio.

3.2.3. Rethinking wealth taxation

The three key arguments in favor of wealth taxation are the following.

First, the frontier between capital and labour income flows can be fuzzy in many different situations. Take, for example, a business owner that can, to a large extent, decide whether to pay himself a salary or reward himself with dividends. Another example is that of a corporate executive receiving compensation packages that are a complex mixture of labour and capital income. Given the difficulty to distinguish between capital and labour income, it would be suggestible that the higher the shifting elasticity between the labour income tax base and the capital income tax base is, the more efficient it is to apply the same tax rate on capital and labour.

The second argument pertains to an important limitation of income taxes when it comes to top wealth holders. For this group, it may be difficult to identify what constitutes capital income and what constitutes capital consumption. For example, if the capital is retained in holding companies, this can create a large gap between economic and taxable income. In principle the value of the income can be recovered according to the following formula

$$y_{it} = \Delta k_{it} + c_{it}$$

Where y is the income, k is the capital and c is the consumption. Nevertheless, as far as top income is concerned, consumption can be as difficult to define as the income flow itself. For this reason, for those with high wealth, wealth is a better indicator of the capacity to pay taxes than income, arguing for a progressive wealth tax. The elasticity of the rate of return on wealth with respect to the wealth tax rate is key in determining the optimal tax rate: the lower the elasticity the higher the optimal tax rate from the point of view of a revenue-maximizing government.

The third argument relates to inheritance taxes for which more than one mechanism is at work at the same time. In this field an optimal tax formula can be found in the "meritocratic Rawlsian" equation. There are arguments in favor of and against taxing inheritances/bequests. On the one hand, the merit-based argument of normative theories of distributional justice lead to the conclusion that inherited wealth should be taxed and should be taxed heavier than self-made wealth. On the other hand, there is the situation in which someone who did not inherit themselves (a zero-bequest receiver) wants to leave a bequest to their offspring. In the presence of labour taxes, it may be difficult to gather some wealth to transfer. This situation could lead to the conclusion that bequests should not be taxed.

Taking all these arguments into account, Piketty and Saez (2013) try to figure out which is the optimal linear bequest tax rate from the point of view of the zero-bequest receivers, which comes down to about half of the population. The answer to this question is given by the following formula (meritocratic Rawlsian optimum bequest tax rate):

$$\tau_B = \frac{1 - v \cdot \frac{G}{R} \cdot \frac{\bar{b}^{left}}{\bar{y}_L}}{1 + e_B}$$

Where:

- e_B is the long-run elasticity of the aggregate bequest flow with respect to the net-of-tax rate. The idea is that the higher the elasticity, the more people responds to bequest taxes with leaving a lower bequest. Then the lesson is not to tax what is elastic which implies a low tax rate.
- v is the fraction of wealth accumulated because of a bequest motive. If this fraction is zero then we end up in the standard inverse-elasticity formula.
- \bar{b}^{left} is the relative position of zero-bequest receivers in the distributions of bequests left.
- \bar{y}_L is the relative position of zero-bequest receivers in the distribution of labour income
- G is the generational growth rate.
- $R = e^{rH}$ is the generational rate of return (where r is the annual return and H is the generational length).

Under some assumptions the optimal tax rate (τ_B) could be in the region of 50-60 %. If, for example the ratio \bar{b}^{left}/\bar{y}_L is in the region of 0.5, e.g. if zero-bequest receivers expect to leave bequests that are only half of average bequests (i.e. $\bar{b}^{left} = 0.5$) and to earn the same average labour income as the rest of the population (i.e. $\bar{y}_L = 1$), then it is in their interest to tax bequests at rate $\tau_b = 50$ %.

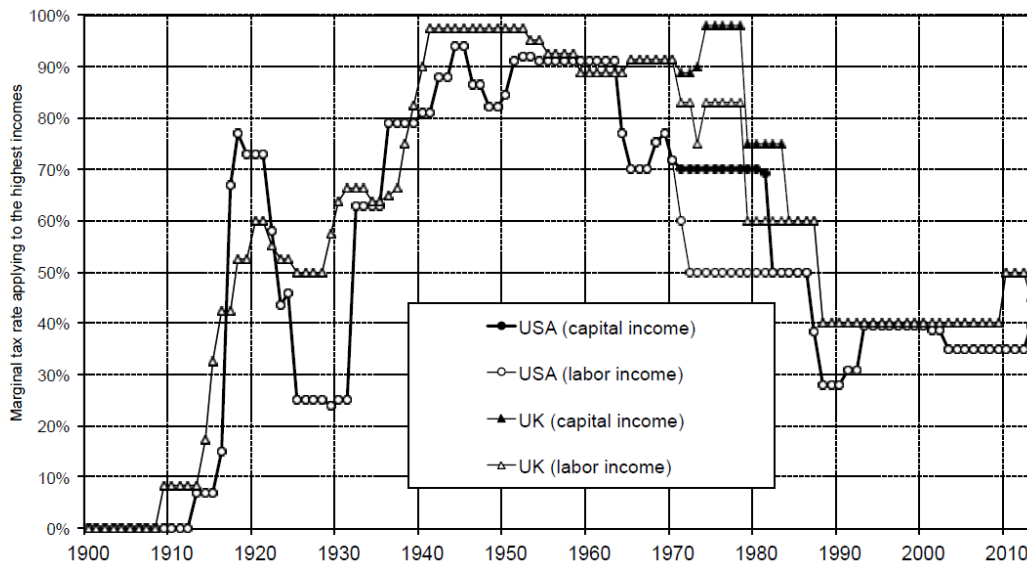
3.2.4. Taxation trends in taxation in modern democracies

In practice, the main developed economies follow the ideal triptych of taxing capital and labour income flows along with wealth and inheritances/bequests. Traditionally, in most modern democracies, capital and labour income have been taxed at a similar rate with some exceptions such as the US and the UK (Figure 3) where, for distributional reasons, capital income has been taxed heavier than labour income.

Modern democracies, in general, also have sizeable and sometimes steeply progressive inheritance taxes. As shown in Figure 4, the highest top tax rates on inheritances – in the range of 80 % in US and UK in the seventies

– started declining to around 40 %. Germany's and France's inheritance tax rates have never been above 40 % to start with (with the exception of Germany in 1940—1950 and France in 2010).

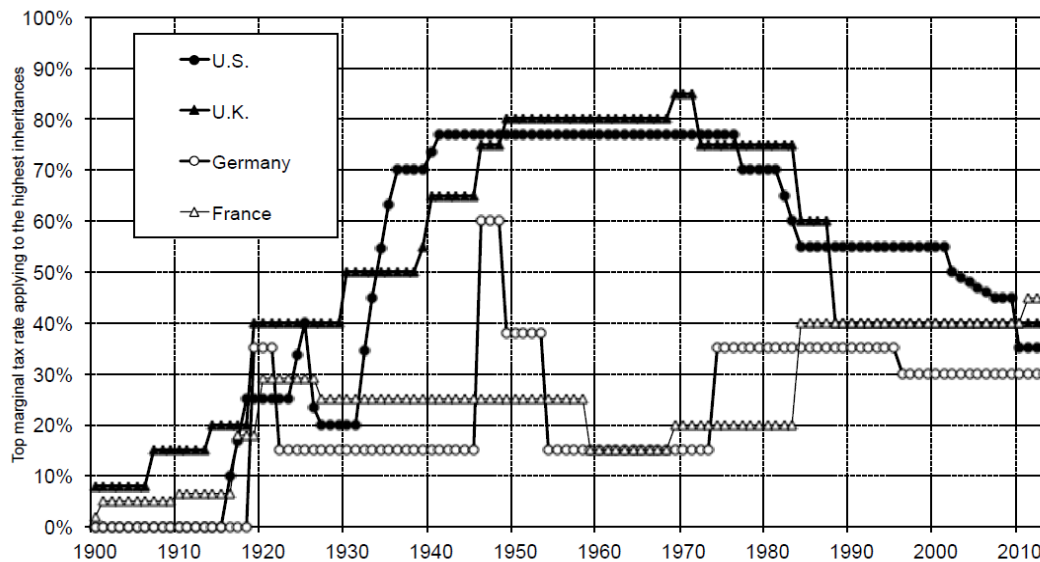
Figure 3: top tax rate: "unearned income" vs. "earned income"



Note: in the 1970s-1980s, the top marginal tax rate on capital income (applying to the highest incomes) in the US and the UK was higher than the top tax rate on labour income.
Sources: see piketty.pse.ens.fr/capital21c.

Wealth taxes had been much more prevalent in Europe than in the US. However these taxes were sometimes abolished in Europe as they had too small bases, were not related to market values or lacked international cooperation. These problems could be addressed in the near future with the use of prefilled tax declarations, the automatic exchange of information and a financial registry.

Figure 4: top inheritance tax rates, 1900-2013



Note: the top marginal tax rate of the inheritance tax (applying to the highest inheritances) in the US dropped from 70 % in 1980 to 35 % in 2013.
Sources and series: see piketty.pse.ens.fr/capital21c.

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3.3 DISCUSSION OF PRESENTATIONS BY MICHAEL KEEN, GABRIEL ZUCMAN AND THOMAS PIKETTY – WEALTH POLICY CHALLENGES AND RECENT DEBATE

by David Bradbury*

3.3.1. Background – the rise in global inequality

In recent years, there has been a growing acceptance across the political and policy spectrum that global inequality is on the rise across many countries. Its causes, consequences and remedies have been and remain the subject of wide debate, but it is nonetheless widely known that this is a problem that needs to be addressed (OECD 2008, 2010).

There are many facets to the changing distribution of global inequality and wealth. The share of labour in income in the developed world has fallen, while the share of capital in total income has risen (Karabarbounis and Neiman, 2013). The work of Piketty, Saez, Zucman and others has demonstrated a rise in income and wealth inequality in many countries in the developed world (Piketty and Saez, 2003; Piketty and Zucman, 2014; Saez and Zucman, 2014). Recent work has also argued that the rise in capital income and reduction in the taxation of this income can account for much of the change in the income distribution in Germany (Bartels and Jenderny, 2014).

This rise in inequality has had political consequences in many OECD economies. The financial crisis, the resulting policies of intense fiscal consolidation implemented across the developed world and public perceptions of increases in inequality have led to the issue of inequality and "fair shares" of global wealth becoming increasingly politically salient. Popular movements have called for increased taxation of wealth and for reform of the financial sector. Aggressive tax planning by many multinational enterprises engaged in artificially structuring their affairs to minimise the levels of tax they pay has also received significant attention in the policy debate. The OECD has been playing a central role in responding to these concerns through its involvement in the OECD/G20 base erosion and profit shifting (BEPS) project.

3.3.2. The changing tax mix

In this context, it is important that governments across the developed and developing world ensure that public policy, and tax policy in particular, is responsive to these challenges. The tax policy landscape has, however, become increasingly challenging in recent years, with many difficult trade-offs; ensuring labour taxes promote fairness while keeping employment high, attracting foreign investment without eroding the corporate and capital tax bases, and providing tax relief to struggling economies while maintaining a sound fiscal position.

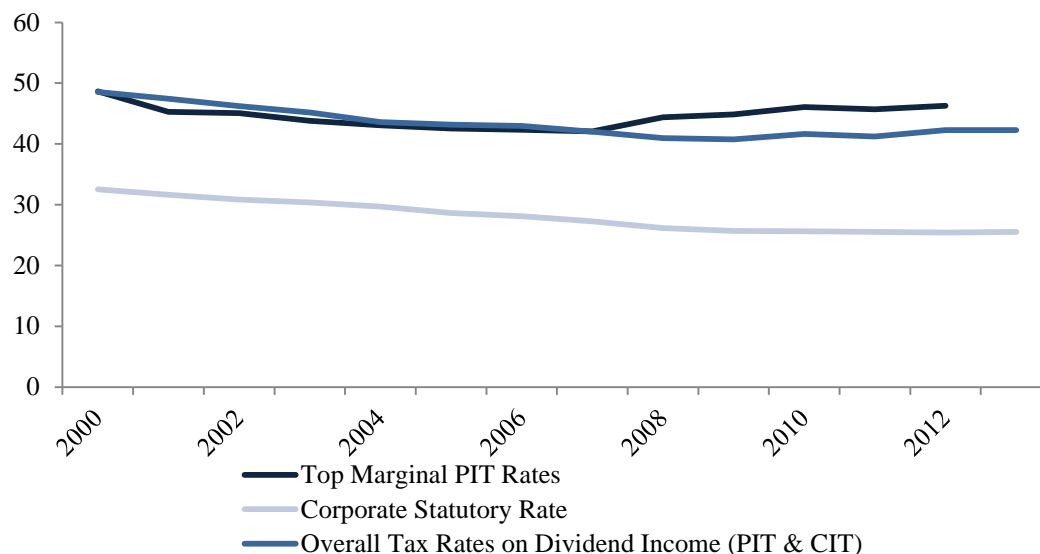
Conventional thinking on tax policy, at the OECD and elsewhere, has emphasised the need for shifts in the overall tax mix to maximise growth, as well as reform within various tax categories (OECD, 2010). The OECD has argued that pro-growth tax reforms can be characterised by marginal shifts from distortive corporate and personal income taxes, as well as other taxes on labour, and towards more growth-friendly taxes. Taxes such as recurrent taxes on immovable property, as opposed to transaction-based property taxes, can be an important growth-friendly source of government revenue. Shifts to consumption taxes from labour taxes can also boost growth at a lower distributional cost than previously thought.

But the recent focus on growing levels of inequality in many countries has highlighted the need to make growth as inclusive as possible. Moves towards greater fiscal consolidation have reduced the scope available to governments to use expenditure to tackle inequality. This raises the question as to whether the tax system needs

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to play a more significant role in ameliorating inequality. In this context, there are some potentially worrying signs that tax rates on capital and capital income are falling. Increases in the ratio of capital income to labour income have been accompanied by decreases in the tax rates on capital income (see Figure 1).

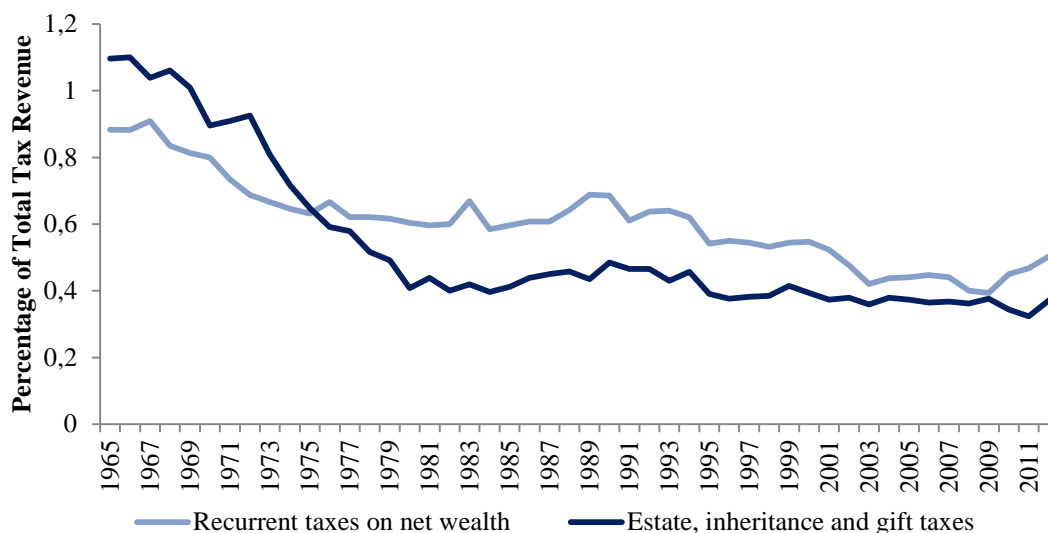
Figure 1: changing tax rates on capital, corporate and personal income



Source: OECD Tax Database.

Revenues from net wealth, as well as from wealth taxes have fallen as well (see Figure 2). Top personal income tax rates had fallen in the pre-crisis period across the OECD, though overall statutory labour tax progressivity has remained broadly constant, and has increased at lower income levels (OECD, 2014). In this context, tax systems may be able to play an even more important role in tackling inequality.

Figure 2: changing revenues from wealth and wealth transfer taxes



Source: OECD Revenue Statistics 2013.

Proposals for changes to the tax mix to tackle inequality abound; many are featured in this volume. Many commentators argue for the expansion of existing tax policy tools such as inheritance, estate and gift taxes; other

commentators (most notably Thomas Piketty) have called for a new global wealth tax. Should we use new or existing taxes to address inequality? Despite differences on these issues, there is an increasing body of opinion that argues that we need to more effectively tax capital, be it the flow of capital income or the stock of capital itself (wealth). How to do this, especially in a globalised world, is very challenging, and will require significant international cooperation.

The tax system can tackle inequality directly through taxes on wealth and the income from wealth. However, tax systems can also play a very important role in tackling inequality by ensuring that those on lower incomes have sufficient incentives to invest in human capital, through reducing the taxation of human capital. By helping to raise human capital levels, especially among those earning low incomes or the children of households with low incomes, the tax system can help to combat intergenerational inequality in a way that has the added benefit of boosting growth. The tax system can also provide incentives for those with low earnings potential to stay in the workforce (by making sure the tax burden on labour is moderate at low income levels) and for companies to hire and train more unskilled workers. These human capital tax approaches show that the tax system can help to reduce inequality not just by redistributing the existing wealth, but also by changing the future wealth distribution by increasing opportunity and reducing income inequality.

3.3.3. The wealth tax – challenges and issues

As mentioned, a key proposal of some commentators has been to institute a global tax on wealth. There are many design issues pertaining to the taxation of wealth and wealth transfers. Valuation can be challenging: of illiquid assets (art, jewellery, *etc.*), of pension savings, of imputed income from owner-occupied housing, of small businesses and of non-listed corporations. The base of a wealth tax can also be difficult to define; net income and net wealth taxes better approximate ability to pay, but accounting for debt can encourage excessive leverage. There are sound economic arguments for excluding many classes of assets such as small businesses, low-return asset classes, pension savings, and so on. But this too facilitates avoidance, and can erode the base such that the tax becomes ineffective, both from equity and revenue-raising perspectives. Other authors in this volume discuss these issues in more detail. This contribution is confined to considering two substantial and interrelated challenges: the political economy challenges of wealth and wealth transfer taxes, and the need to address tax avoidance in a global economy.

The political challenges surrounding wealth taxes are significant. These taxes are increasingly unpopular (Graetz and Shapiro, 1994, Boadway *et al.*, 2010). They are widely perceived to be unfair, as those on higher incomes are more likely to avail of tax avoidance mechanisms, leaving the middle classes to bear the burden of many taxes. Taxes on wealth, bequests, and gifts are all usually conspicuous (the taxpayer must actively make a payment to the state, and so is more aware of the tax) which often makes these taxes more unpopular. Taxes on net wealth, once common across the OECD, have been abolished in all but a handful of member countries. Introducing new taxes or re-introducing taxes is often much more politically challenging than increasing existing ones; thus the political challenges involved in a new wealth tax, in particular a global one, are considerable. In addition, ageing populations, and increasing insecurity of retirement provision mean that many households have savings in various forms. It may be particularly politically difficult to tax pension savings, or other forms of provision for retirement in the context of ageing populations (Profeta *et al.* 2014).

With a Global Wealth Tax in particular, as proposed by Piketty, the challenges become even more significant (Piketty, 2014). While international cooperation in the tax sphere is increasing - notably through the BEPS project, the automatic exchange of information (AEOI), and the EUs increasing cooperation on tax matters - national governments continue to enjoy and exercise the tax sovereignty that is the right of every sovereign nation.

The enormous variation in political opinion, in social models, and economic development across the world means that the optimal tax system varies enormously from country to country. In this context, the difficulty

associated with reaching global consensus on the features of the optimal tax system makes it hard to envision the implementation of such a global tax on wealth or other tax bases.

This does not, however, mean that global cooperation on taxation, and in particular on the taxation of wealth and income from wealth is beyond our reach. Indeed quite the opposite is the case; it is ever more crucial if we are to address the challenges of tax avoidance, of the taxation of mobile factors of production and of tax evasion.

3.3.4. International tax evasion and automatic exchange of information

In a global economy with increasingly mobile capital, the taxation of capital and wealth faces many challenges. Where governments have sought to tax wealth or capital income they have often faced difficulties associated with assets and income being shifted into other jurisdictions or being concealed from their view. In this environment, a co-ordinated response to these issues as well as increased tax transparency is naturally crucial.

In response to the increasing global disquiet surrounding international tax evasion, the OECD was mandated by the G20, in cooperation with other organisations such as the EU, to end bank secrecy, and to increase tax transparency to improve tax information exchange. This process followed the opening up of the OECD/Council of Europe Multilateral Convention on Mutual Assistance on Tax Matters for signatures by other countries. Currently over 60 countries have signed the Convention and it has been extended to over 10 jurisdictions. Since 2009, the OECD's Global Forum on Transparency and Exchange of Information, which comprises 126 members, including the EU, has put in place a robust peer review mechanism to ensure that the internationally agreed standard of exchange of information on request (EOIR) is effectively implemented by its member and relevant non-member jurisdictions.

In September 2014, the OECD, along with G20 countries presented a single, common, global standard on automatic exchange of information (AEOI) to G20 Finance Ministers. This standard provides for regular, automatic exchange of taxpayer information between participating countries of all relevant financial information, and is a key step in the fight against tax evasion and harmful tax avoidance. Importantly from the wealth taxation perspective, AEOI includes account balances and all types of investment income, including interest, dividends, income from insurance contracts, and other similar types of financial income. Financial institutions required to report under the new standard include banks, custodians, brokers, some collective investment vehicles and certain insurance companies. These financial institutions must report accounts held by both individuals and entities, with an obligation to look through passive entities.

At the meeting of the Global Forum on the Exchange of Information on 28-29th of October 2014, 89 member countries adopted the standard. Implementation plans will be provided in 2015, with exchange of information commencing in 2017 for almost fifty "early-adopter" countries, and in 2018 for other signatories. The Global Forum membership is much larger than the membership of the OECD itself, signalling the broad global interest in these issues, and the desire for international coordination. For developing countries with limited capacity to develop sophisticated tax architecture, support is being provided by the Global Forum to enable them to benefit from participating in the new transparent global tax environment.

Assessing the effects of these initiatives is difficult; the AEOI mechanisms are still being implemented, and analysing their effects is challenging; it is hard to assess the quantity of missing revenue, although some important efforts in this regard have been made by Zucman (2013) and others. It is difficult to assess with certainty the counterfactual of a non-AEOI world. It is also important to note that many of the positive revenue effects come about in anticipation of the introduction of EOIR or AEOI; taxpayers who anticipate that their offshore assets will be discovered by domestic tax authorities will voluntarily come forward to avail of lower penalties. This is often complemented by the announcement of voluntary disclosure initiatives by governments and tax administrations. Thus the threat of AEOI can be as effective as the mechanism itself.

Nonetheless, the signs that exchange of information upon request as well as AEOI may result in increased revenues and a more horizontally equitable tax system are promising. In the Netherlands, for example, more than 12,000 taxpayers have voluntarily disclosed an estimated 6 billion euro to avoid penalties. Approximately 900 million euro in taxes is expected to be recovered.¹ Sweden received a total of 139 million euro from 230 tax information exchanges between 2009 and 2013. In 2014 it has received 208 million euro from 7,142 disclosures. Voluntary disclosure in France in the early half of 2014 has resulted in more than 31,000 cases processed and 1.85 billion euro recovered. These figures suggest that as the implementation timetable for AEOI approaches, more and more taxpayers with offshore assets will decide to come forward.

As AEOI is embraced by more and more countries, tax policy makers may well find new opportunities to turn to old taxes – that are directed towards the more effective taxation of capital and wealth - that have been relied upon less in recent years because of the ease with which some taxpayers have been able to conceal their assets and income from tax administrations. In this area, more work needs to be done, however, there may be new and improved tax policy tools available to governments, which may assist them in tackling inequality.

3.3.5. Conclusions

The debate around the role of the tax system in combating inequality is an important one; building inclusive societies requires utilisation of all the tools at our disposal. As the share of capital in income has increased over time, it would seem logical that the share of taxes on capital in the tax mix would rise also. Whether this should come about through taxes on the stock of capital or through the flow of income from capital is and will continue to be the subject of much debate; in many ways the two types of taxes are substitutes. The taxation of both wealth and capital income should become the focus of increased attention by policy makers. Recognising the changes to the global tax landscape that will be driven by AEOI, there may well be a renewed effort to find more efficient and effective ways to levy taxes on wealth and capital income to help tackle the growing inequality that many countries are currently facing.

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3.4 MUCH TO DO ABOUT NOTHING: THE SOLIDARITY TAX ON WEALTH (ISF) IN FRANCE

by Alain Trannoy*

3.4.1. Introduction²

President François Mitterrand launched the *Impôt sur les grandes fortunes* (Tax on great fortunes) in 1982. It was abolished by Jacques Chirac for the period 1987-1989 and re-established by François Mitterrand in 1989 with a slight change of name, *Impôt de solidarité sur la fortune* (ISF, the solidarity tax on wealth). When it came to power, the right did not abolish the ISF but limited its impact through a tax cap and a streamlining of the tax schedule. It is not totally surprising that France is still one of the very rare European countries with a wealth tax, whereas many European countries have given it up in the recent years. If we put this tax into a historical perspective, one realizes that France has always been quite reluctant to introduce income taxation. It was not until the First World War that the income tax was introduced. One explanation is that, historically, wealth was viewed as the favoured tax base. It was obviously true in the "Ancient Régime" and from 1791 to 1914 proportional property tax (on land and housing and gradually on physical capital) was the main tool to finance the central government. Indeed, the agricultural sector remained dominant in France for all the nineteenth century, contrary to England. Along with the importance of land and property, there is a long tradition of provocative and stimulating proposals in the French public fiscal debate about the introduction of a wealth tax, starting with the proposal of a 0.1 % tax by Emile-Justin Menier, around the period 1870-1880, followed by Maurice Allais's proposal (1966, 1977) of a 2 % capital tax that would replace an income tax³ and now Thomas Piketty's proposal of a world wealth tax (Piketty, 2013).

In the following, I first describe the tax base, the tax schedule and the dynamics of the tax revenues, before looking up at the possible extent of tax migration. I end up with an overall assessment.

3.4.2. Tax base, schedule and revenues

Wealth must be declared by French residents by June 15. The tax base is made of global wealth, whatever the country (except for countries that have signed an agreement with France). Wealth should be assessed to market values minus deductible debts. There is a special deduction of 30 % for the main home. Whatever the marital status, the tax is the same and there are no more deductions for minors. The list of exemptions is quite impressive. It includes:

- Professional goods such as businesses (depending on the percentage owned),
- Vintage (more than one century old) and collection objects,
- Artistic, literature, or industrial rights,
- Woods and participation in forestry plantations (for 75 % of their value),
- Capital value of pensions and retirement plans,
- Capital obtained as compensation for physical injury in accidents or due to illness.

The tax base only represents about 10 % of the total net wealth of French households (10,300 billion euro in 2011 (Insee, 2013), since the total tax base for ISF amounts to 850 billion euro in 2013.

The tax schedule as in 2014 (integrating a tax discount - *la décôte*) is as shown in Table 1. It can be seen that the marginal tax rate is not monotonically increasing. The highest marginal tax rate is for the first bracket. Furthermore, there is a discontinuity at the wealth tax threshold.

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² The Author thanks Pierre Henri Bono and Clement Schaff for their help.

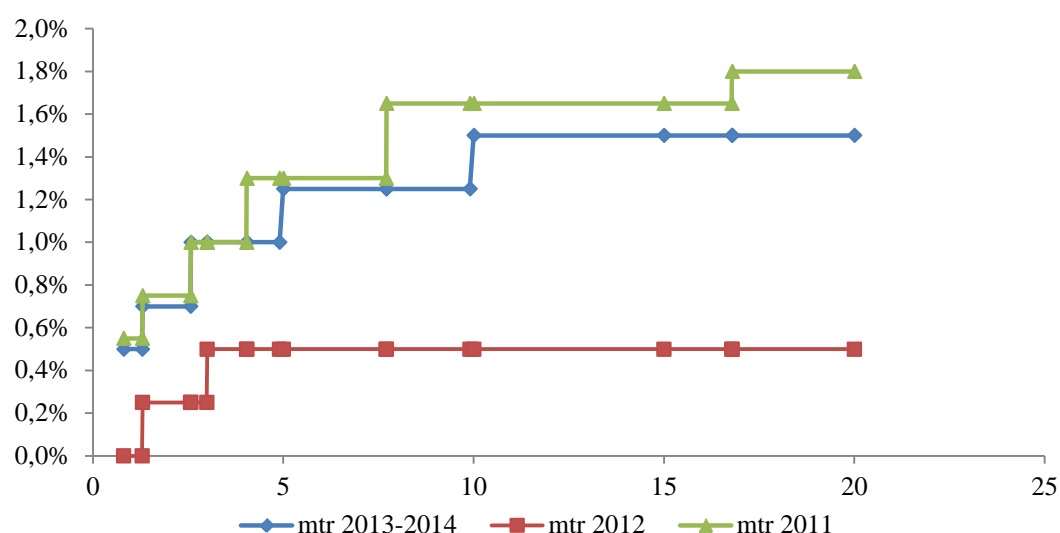
³ See Bozio, Dell and Piketty (2005) for a study on Allais's proposal.

Table 1: the wealth tax schedule as in 2014

For X equal to	€1 300,00	€1,25
For X between	€1.30 - 1.4 million	€1,250 + 1.95 % (X-1,3)
For X between	€1.40 - 2.57 million	€3,200 + 0.7 % (X-1,4)
For X between	€2.57 - 5 million	€4,019 + 1 % (X-2,57)
For X between	€5 - 10 million	€6,449 + 1.25 % (X-5)
For X over	€10 million	€12,699 + 1.50 % (X-10)

The recent evolution of marginal tax rates (neglecting la décôte) is depicted in Figure 1. It shows that President Sarkozy reduced quite significantly the marginal tax rates from 1.8 % (almost the tax rate recommended by Nobel Prize Maurice Allais but in a system without income tax) to 0.5 %. President Hollande came back to almost the marginal tax schedule that had prevailed before President Sarkozy.

Figure 1: the recent evolution of the marginal tax rates of the ISF.



Because of the quite high profile of tax rate, there has always been a concern that some taxpayers cannot pay the ISF because of the tax burden of the other taxes, specifically the income tax. A tax cap (*bouclier fiscal*) was introduced quite early. For instance, in 2014, the cumulate tax burden for the income tax, the high wage tax (an additional tax over the wages beyond 1 million euro), the tax on capital income for the social security system (15,5 %) plus the ISF cannot be larger than 75 % of the annual income. If not, the ISF tax is reduced. There have been many variations of the tax cap over the years of the tax cap. For instance when Nicolas Sarkozy came to power, he lowered the tax cap to 50 %. It remains a hot topic between the left and the right.

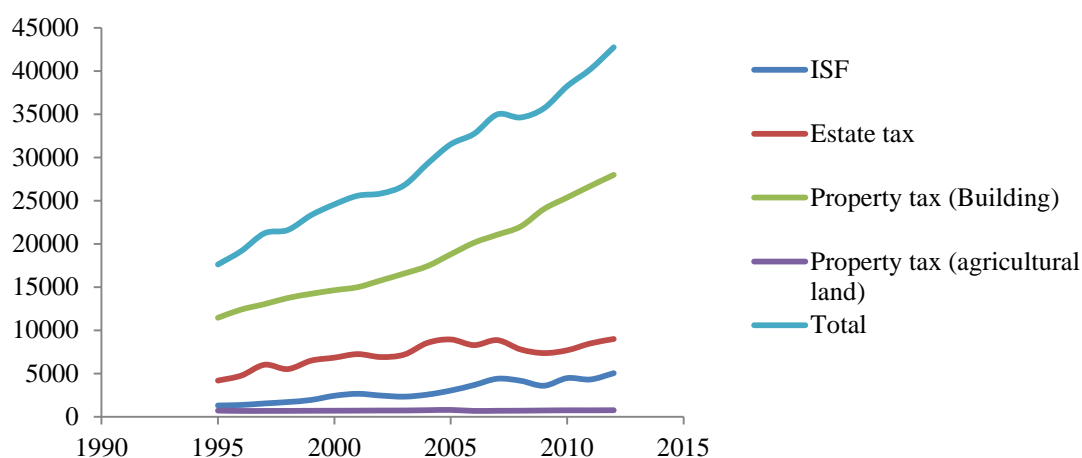
On the long run, taxpayers face a more or less constant average tax rate of 1.4 % for a large declared wealth (13 million euro). The tax threshold decreased from about 1 million euro to 800,000 euro from 1982 to 2011 and then jumped to 1.3 million euro in 2012. Consequently, the number of the tax returns has been multiplied by a factor six from about 100,000 to more than 600,000 in 2011. The surge in housing prices that have doubled in France over the first decade of the millennium can also be blamed for the huge increase in the number of taxpayers.

In 2013, the ISF tax receipts represent 0.5 % of the tax base (4.5 billion euro) and therefore 0.04 % of the total wealth. Ironically, in terms of order of magnitude, we are back to the modest proposition of Menier in the nineteenth century of for introducing a 0.1 % wealth tax.

Since its beginning, the total amount of ISF revenues has added up to 63.5 billion euro (in current euro), 0.6 % of the total net wealth. Even if it had been transferred to the poor households as initial asset, a policy which has not been implemented or even thought of, its direct impact on wealth inequality would have been negligible.

The ISF is only one among many taxes on wealth in France. The other main taxes on wealth are the estate tax (tax on inheritance, *impôt sur les successions*) and the property tax (*taxe foncière*). It turns out that the ISF represents about 10 % of the total of tax revenues collected on wealth (less in 1982, more in 2014) as shown in Figure 2. It is true that in the long run, the evolution of the tax revenues for ISF is quite dynamic, whereas the share of estate tax shrinks.

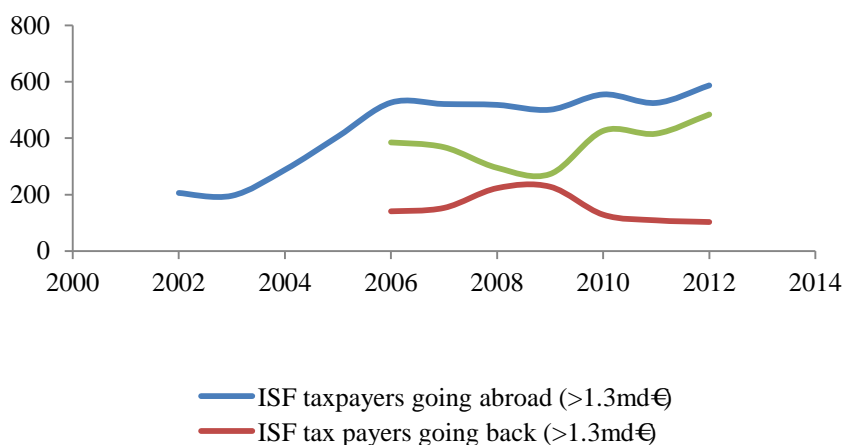
Figure 2: evolution of tax revenues for the different components of wealth taxation, million euro



3.4.3. Evidence on tax migration.

Much of the public debate about the ISF in France is about the fear that the ISF can fuel tax migration. The evidence is scarce because it is a difficult subject and, on top of that, the access to fiscal data to researchers in France is up to now all but easy.

Figure 3: the recent dynamics of net outflow of ISF taxpayers (on the vertical axis, the number of taxpayers is reported)



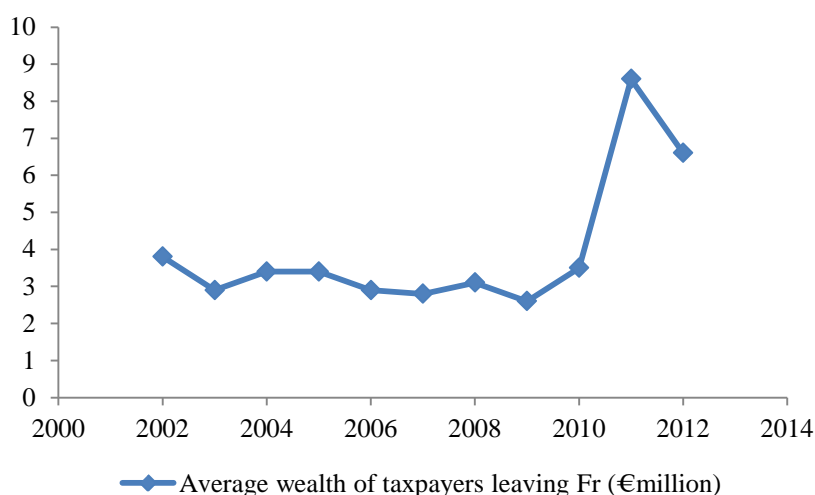
Source: parliamentary report by Yann Galut and DGFIP.

Gabriel Zucman (2008) did a good job in his master dissertation to look at this question for the period around the millennium (1995-2006). He concluded that the migration caused by the ISF was all but impressive. In Figure 3, we use more recent data coming out from the French Treasury, distinguishing between gross outflows, and net outflows. A warning is necessary here. We do not know for sure that taxpayers missing in the tax files for ISF went abroad because they were fed up with the high marginal tax rate of the ISF.

What we know about people going abroad is that they are wealthier than the average ISF tax payer as shown by in Figure 4. Indeed the average reported taxable wealth for ISF is a little bit above 2 million euro. The favourite countries for tax exit are Belgium and Switzerland. Apparently the spike in 2011 is not due to the ISF but to other changes in the tax code.

It is difficult to measure a specific causal impact of the ISF on outmigration because there are both sources of potential upward and downward bias.

Figure 4. The evolution of the average wealth of taxpayers leaving France



There is a risk of overestimation because, as has been shown previously, the ISF is only a (small piece) of the wealth taxes, not to mention the whole tax system. However, it is the whole tax system that may induce tax migration. Let us just mention that estate taxes are much lower in Switzerland, that taxes on capital income matter, that taxes on capital gains are notorious low in Belgium, that deduction of notional interests is possible in Belgium and that tax on stock options are even higher than on wages in France.

There is also a risk of underestimation and, for instance, one can mention the descendants in the case of estate taxes the exit of whom will not be counted in the case of estate taxes, and the fear of having to tax register for entrepreneurs when they are willing to sell their professional good (which is exempted from ISF as long as it remains a professional good). In that case, they will move abroad earlier.

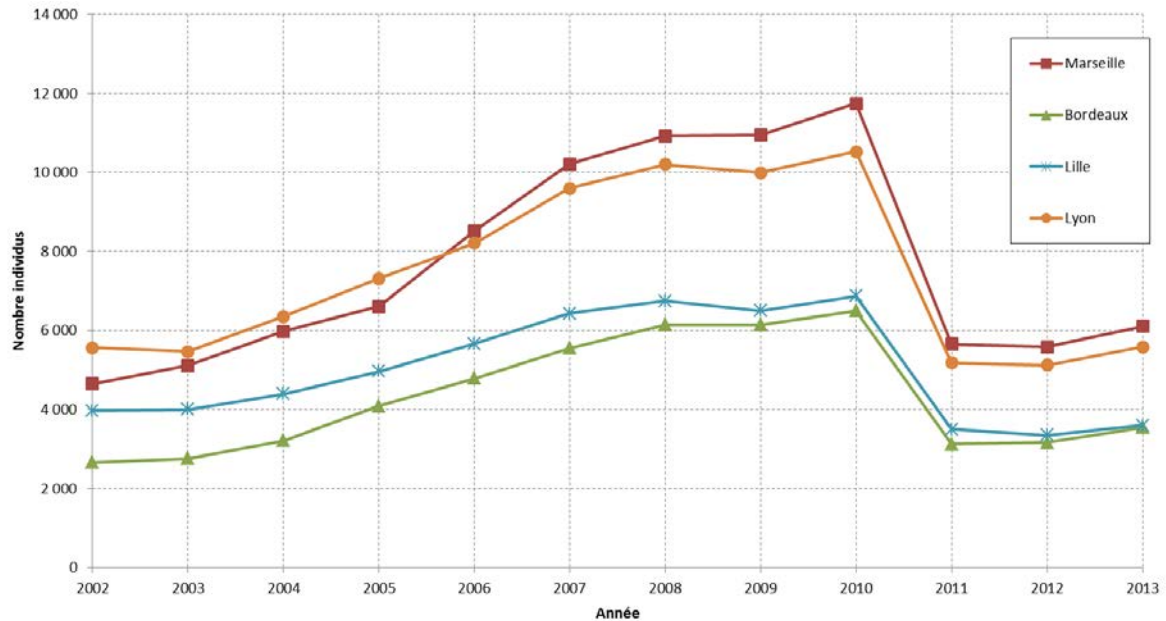
More importantly, what matters is the difference in the tax regime between France and foreign countries. A favourable change in the tax regime in a foreign country for tax filers can increase the threat of migration.

Still, according to the press, at the very top of the wealth scale, there are about 65 French billionaires of whom one third is apparently living abroad or has big financial or residential assets in Belgium and Switzerland. Before 1981, hardly any very wealthy Frenchmen used to live in Belgium. It was much less true for Switzerland (because of the absence of estate tax there). If the empirical evidence of a strong national impact of the ISF is still lacking, I am wondering if the local impact (at the region level) can be more easily detected. I am

investigating whether the differential wealth taxation between France and Belgium has a detrimental effect on the residential choice of wealthy people living in the North of France, near Lille which is the fourth largest city in France after Paris, Lyon and Marseilles and is located very close to the Belgian border (20 km).

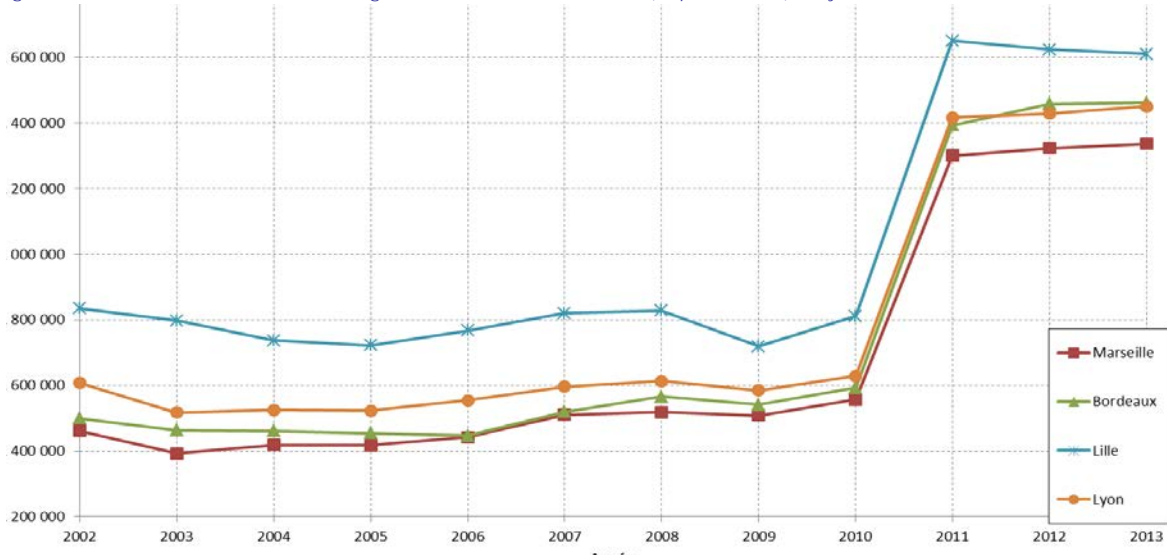
As can be checked in Figure 5, the evolution of the number of taxpayers for the ISF in the districts of four major cities in the Province (Lyon, Marseille, Lille and Bordeaux) has been slower in Lille than in other cities and the same pattern also occurs for the declared average wealth. Lille was clearly well ahead of the pack for this second indicator at the beginning of the study period and the other cities are catching up.

Figure 5: evolution of the number of ISF-taxpayers in the districts (départements) of Lyon, Marseilles, Lille and Bordeaux.



Source: Direction Générale de Finances Publiques

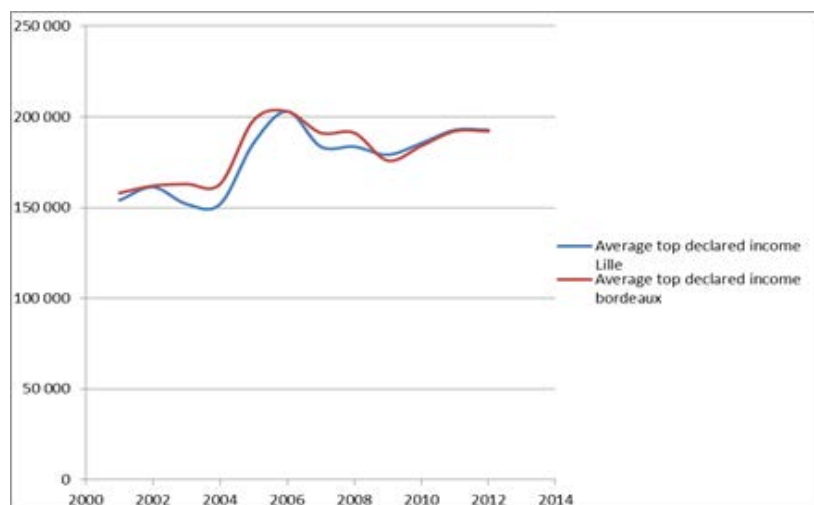
Figure 6: evolution of the declared average wealth for ISF in the districts (départements) of Lyon, Marseilles, Lille and Bordeaux.



Source: Direction Générale de Finances Publiques

An alternative explanation would be a lower growth in Lille. However, comparing the growth of average top declared income for the income tax in Lille and Bordeaux does not reveal a specific pattern in Lille. Clearly this point needs more investigation but at first glance, there is some empirical evidence that the proximity of the border can trigger more out-migration when the tax regime abroad is more lenient.

Figure 7: evolution of the average top declared income for the income tax for the districts (*départements*) Lille and Bordeaux.



Source: Direction Générale de Finances Publiques

3.4.4. Overall assessment: the "ISF" as a rich repellent

We have noticed the quite modest contribution of ISF but, arguably not completely negligible those times, to the French tax revenues. A narrow tax base and a quite high tax rate cannot be much welcomed by economists. The ISF contributes to fuel tax emigration to Switzerland and Belgium. It is however difficult to measure its impact on the French economy because the emigrants can still invest in France. A recent example is provided by Patrick Drahi, a billionaire who invested 13.5 billion euro from Geneva in the French telecom industry.

The efficacy to reduce wealth inequality among French residents is more easily established than among French citizens. Maybe wealth inequality in France has been reduced at the expense of an increase of inequality in neighbouring countries! If they are more tolerant to wealth inequality than France, it will represent a global welfare improvement if we adopt Tiebout's perspective on public finance. Different countries offer different packages in terms of redistribution and taxation. The wealthy vote with their feet up to the point their destination country is going to increase wealth taxation, under the pressure of voters who will start to become less tolerant to wealth inequality. In the context of lack of tax coordination, wealth tax in some countries seems more efficient to repel the very rich than to effectively redistribute wealth at the world level!

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3.5 THE DEBATE ON WEALTH TAXATION IN GERMANY

by Stefan Bach*

3.5.1. Introduction

Rising inequality in income and wealth is observable in several OECD countries, particularly Germany. Measured at the level of household net equivalent income, German's Gini coefficient jumped four percentage points between the end of the 1990's and 2005 (Grabka and Goebel, 2013; OECD, 2014). Concentration measures have remained at the higher level, although employment has increased remarkably since then, only temporarily interrupted by the financial crisis. The main reasons behind these trends are the low performance of wage and transfer incomes, the rising low-pay sector, increased part-time work, rising incomes of managers and highly-qualified employees, and rising business and capital incomes (Biewen and Juhasz, 2012; Rehm, Schmid and Wang, 2014). Moreover, the distribution of personal wealth in Germany is one of the most unequal in Europe, as discovered by the new Household Finance and Consumption Survey (HFCS, 2013; European Commission, 2013; Carroll, Slacalek and Tokunaka, 2014). At the same time, tax progressivity has been reduced due to international tax competition. The top rates of personal income tax, as well as business and capital income tax rates have been lowered, the personal wealth tax has been discarded, and inheritance taxation remains at a low level.

Against this background, capital income and wealth taxation have in recent years regained attention in Germany's tax policy debate. Left-wing parties have endorsed proposals for higher taxes on the "rich", such as hikes in the rates of personal income and capital income taxes, the re-introduction of a recurrent wealth tax, a one-time capital levy to reduce public debt, or strengthening inheritance tax by reducing tax privileges for company succession and other tax breaks. These topics played a role in the 2013 federal election campaigns. Moreover, real estate tax reforms are also being discussed i.e. the local property taxes and the property transfer taxation. However, such property-related taxes do not clearly focus on the "rich", i.e. the top percentiles of the income and wealth distribution.

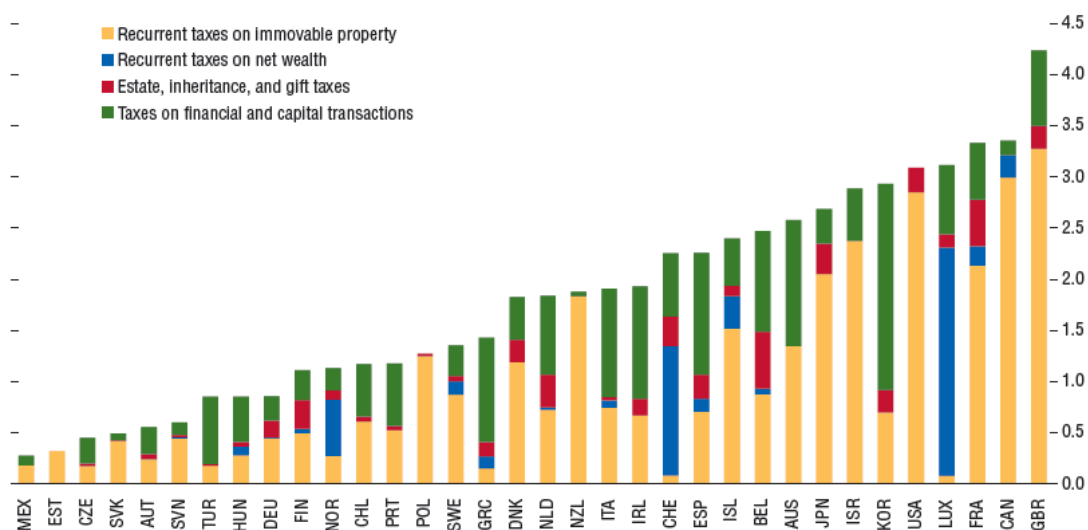
In the following we give a brief overview of the debate on wealth taxation in Germany. In Chapter 2, we show the minor importance of property and wealth-related taxes in Germany over the last decades, although there is a long tradition in personal wealth taxation. Two concrete proposals on personal wealth taxation are discussed in Chapter 3, which played a role in German the tax policy debates of recent years: a one-time capital levy and the re-introduction of the recurrent wealth tax. The pending reform of inheritance taxation in Germany is summarised in Chapter 4. Chapter 5 concludes.

3.5.2. Property and wealth-related taxes in Germany

Property and wealth-related taxes play a minor role in the German tax system, compared to other countries (Figure 1). They raise revenue of less than one per cent of GDP, most of which stems from taxes on real estate property, i.e. the local property tax and the property transfer taxation of the individual states (*Länder*). The inheritance and gift tax as the remaining tax on the wealthy strata of the population raises only 0.2% of GDP.

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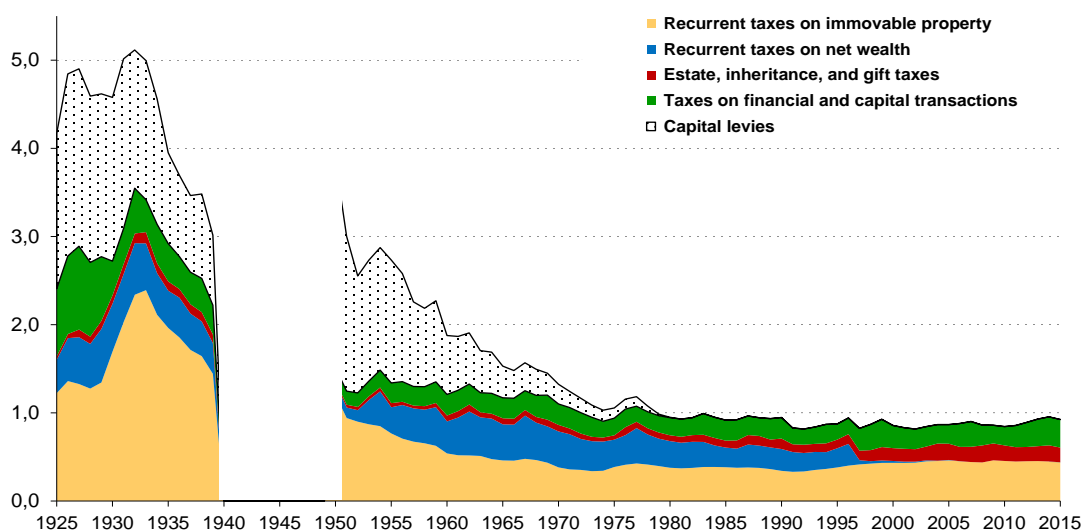
Figure 1: average property taxes in OECD economies, 2000–11, % of GDP



Source: OECD, Revenue Statistics, compiled by IMF (2013)

At the same time, Germany has a long tradition in personal wealth taxation and has raised much more revenue from these taxes in the past (Figure 2). Inheritance taxation and recurrent wealth taxation were introduced by the individual states at the end of the nineteenth century. After World War I, they were strongly increased and centralised at the federal level. Moreover, capital levies were introduced to fight the ballooning public debt, but the hyperinflation of 1923 solved this problem. After the monetary stabilisation as of 1924, the mortgage profit legislation (*Hauszinssteuer*) raised high revenues by absorbing the inflation gains of mortgage debtors. After World War II, a capital levy was introduced as the principal funding source of the "burden sharing" legislation (*Lastenausgleich*) of 1952.⁴

Figure 2: average property taxes in Germany, 1925–2015, % of GDP



Source: Federal Statistical Office, Germany

⁴ See Hughes (1999) and Bach (2012). A tax rate as high as 50 per cent was imposed on personal net wealth exceeding a personal allowance, with quarterly instalments spread over 30 years. The tax burden mainly fell on real-estate and business property since financial assets were largely devalued by the 1948 currency reform. The levy raised yearly revenues of about 1 per cent of GDP at the beginning of the 1950s and was successful in funding war indemnities, reconstruction programmes and the integration of displaced persons.

The main reason for the low revenue importance of wealth taxation in Germany over the last decades were the outdated "standard values" (*Einheitswerte*) of real estate properties which have not been updated since the 1960's. After the federal constitutional court cancelled their usage for personal wealth taxation, the recurrent wealth tax was suspended in 1997. The inheritance and gift tax was reformed and slightly increased afterwards, although it remains relatively low in comparison to real estate property taxation. A further judgment of the Federal Constitutional Court in 2006 repealed the remaining undervaluation of real estate and business property and stipulated valuation procedures systematically oriented to actual market values, which were introduced in 2009. At the same time, wide-ranging exemptions on corporate assets have been introduced to prevent job losses in the event of business succession. In December 2014, the Federal Constitutional Court ruled out these exemptions and demanded new legislation.

3.5.3. Proposals on personal wealth taxes in Germany

Two concrete proposals on personal wealth taxation

In the following, we discuss concrete proposals for the introduction of personal wealth taxes in Germany which have played a role in the tax policy debates of recent years.

The Parliamentary group of the Greens party (2012) in the German federal parliament endorsed the introduction of a one-time capital levy to raise 100 billion euro (equivalent to roughly 4% GDP in 2011). The revenue would be used to reduce public debt caused by the financial crisis. The capital levy would be imposed on individuals with a personal net wealth greater than 1 million euro in order to focus the tax burden on the wealthy. It should be confined to individuals. Corporations would be exempt since their shareholders are subject to individual taxation. Specific reliefs are proposed for business property, including corporate shares, in particular, a specific allowance of 5 million euro for the net equity of each firm and a restriction of the annual tax payment to 35% of the annual gross business income, in order to mitigate the impact on firms' liquidity. In keeping with historical examples, the payment of the levy would be stretched out over 10 years, with tax paid in instalments, using a standard interest rate for public debt. This effectively turns the levy into a recurrent tax on capital income, thus mitigating the income and wealth effects of the tax burden.

The German Social Democrats and various governments of the individual states (*Länder*) ruled by Social Democrats and Greens proposed a draft bill to re-introduce the recurrent wealth tax (see Bach and Beznoska, 2012) with the aim of raising 10 billion euro per year (0.4% of GDP 2011). Both individuals and corporations would be liable to the wealth tax. Double taxation would be avoided by exempting half of the taxable wealth of corporations and individuals' corporate shares respectively. There should be no specific allowances for business property. In return, the personal allowance would be set at 2 million euro. The annual tax rate is proposed at 1%.

Taxing personal net wealth requires the assessment of taxable assets, i.e. real estate properties, business properties, financial assets, some household assets, less liabilities. For the ascertainment and appraisal of the tax base, German tax legislation would rely on the improved valuation procedures introduced for inheritance and gift taxation in 2009. They aim to capture market values as closely as possible for tax purposes. As a matter of fact, standardised appraisal is an intricate issue (see Rudnick and Gordon, 1996), particularly for real estate properties and small firms. Special valuation procedures, based on standard business and real estate appraisal practices, must be implemented since there are often no reliable market values. The assessment of financial assets would require the same disclosure obligations for financial institutions as already exist for inheritance and gift taxation in Germany. With respect to the foreign investments of domestic taxpayers, some room for tax evasion will remain, since international cooperation between tax authorities is still insufficient, although gradually improving. Claims to social security or private pension and health care plans would be tax exempt, at least as long as they do not exceed a certain amount. The same procedure would apply to other durable goods such as furniture and ordinary motor vehicles. However, higher-value household assets, such as expensive cars, yachts, private aircraft and collections of art, jewellery *etc.*, would be subject to taxation in order to prevent tax

avoidance. Liabilities are to be deducted from the tax base as far as they refer to taxable assets. Thus this does not apply to consumer credit taken out for the purchase of non-taxable household assets.

Revenue and distributional effects

We analysed the revenue and distributional impact of both proposals (Bach, Beznoska and Steiner, 2014; Bach and Beznoska, 2012). For the household wealth data base, we combined survey data on households' net wealth stocks from the 2007 wave of the German Socio-Economic Panel (SOEP, 2015) with a ranking of the 300 richest German families, provided by the business periodical "Manager Magazine" (2007). The wealth distribution of individuals with net wealth of more than 2 million euro is estimated using the Pareto distribution. Corporate wealth is estimated using financial statement data for incorporated German firms (database DAFNE, provided by Bureau von Dijk) and financial accounts for German financial corporations provided by the Bundesbank. The resulting aggregates on assets and liabilities are consistent with the stocks reported in the national and financial accounts statistics (Deutsche Bundesbank and Federal Statistical Office, 2014).

Since net wealth is strongly concentrated at the top of the distribution, a personal wealth tax could raise substantial revenue even if high personal allowances are granted, thus restricting the number of affected people to a small number of taxpayers (Table 1). In the case of a high personal allowance of 1 million euro, a child allowance of 250,000 euro, and a specific allowance for business property of 5 million euro, the tax base is still estimated at 1400 billion euro, or 56 % of GDP (2011). The number of affected taxpayers is around 330,000, or 0.5 % of the adult population. Thus, a personal wealth tax of 1 % could raise 14 billion euro or 0.6 % of GDP (2011), disregarding tax avoidance or tax evasion. A one-off capital levy mobilising 100 billion euro from this tax base would require a tax rate of 7.1 %. Reduced allowances could significantly broaden the tax base. However, this would strongly increase the number of taxpayers. For estimation risks which result from the survey sampling error and the standard error for the additional estimates on top wealth, we report 95 % confidence intervals in Table 1.

Table 1: potential tax base of a personal wealth tax in Germany for alternative scenarios

	Personal allowance: 250 000 Euro		Personal allowance: 500 000 Euro		Personal allowance: 1 mill. Euro		Total net wealth
	Child allowance: 100 000 Euro		Child allowance: 250 000 Euro		Child allowance: 250 000 Euro		
	Specific allowance for business property						
	none	5 mill. Euro	none	5 mill. Euro	none	5 mill. Euro	
Tax base, bill. Euro	2 941	2 303	2 234	1 694	1 864	1 398	7 215
<i>CI¹⁾ lower bound</i>	2 551	2 024	1 855	1 426	1 500	1 144	6 739
<i>CI¹⁾ upper bound</i>	3 332	2 582	2 613	1 962	2 229	1 653	7 691
Tax base, % GDP	118%	92%	89%	68%	75%	56%	289%
<i>CI¹⁾ lower bound</i>	102%	81%	74%	57%	60%	46%	270%
<i>CI¹⁾ upper bound</i>	133%	103%	105%	78%	89%	66%	308%
Taxpayers, 1 000	4 787	4 384	1 394	1 162	414	332	
<i>CI¹⁾ lower bound</i>	4 451	4 065	1 194	990	320	241	
<i>CI¹⁾ upper bound</i>	5 124	4 703	1 593	1 334	508	423	
Taxpayers, % pop. ²⁾	6.9%	6.3%	2.0%	1.7%	0.6%	0.5%	
<i>CI¹⁾ lower bound</i>	6.4%	5.8%	1.7%	1.4%	0.5%	0.3%	
<i>CI¹⁾ upper bound</i>	7.3%	6.7%	2.3%	1.9%	0.7%	0.6%	

1) 95% confidence interval, robust standard errors.- 2) Persons aged over 16.
 Sources: Simulations based on German Socio-Economic Panel Study (SOEP), 2007, adjusted for top wealth concentration.

Source: Simulation based on German Socio-Economic Panel Study (SOEP), 2007, adjusted for top wealth concentration.

The wealth tax proposal of the German Social democrats and state governments would raise an estimated 16.5 billion euro, or 0.64 % of GDP (Table 2). Tax base and tax revenue are roughly equally divided by corporations and individuals, taking into account the half exemption of corporate wealth. About 143,000 individuals and 164,000 corporations would be liable to the wealth tax.

The compliance and administrative costs of wealth taxation have been rather contentious in policy debates in Germany and in other countries (see Rudnick and Gordon, 1996; Boadway, Chamberlain and Emmerson, 2010). Using the detailed information from the micro database, we simulate the potential compliance and administrative costs, also taking into account taxpayers' incentives to appeal against assessments. For the valuation of assets and assessment procedures, we rely on standard cost rates from the fiscal authorities and estimations of the time involved for compliance. With respect to the potential estimation errors of the real-estate appraisal, we use empirical information on the performance of the new valuation schemes used for inheritance taxation. According to our simulations on wealth taxation, the total cost of assessment makes up less than 2 % of tax revenue, which seems rather low. However, assessment costs strongly depend on the number of taxpayers. Lower personal allowances would subject many more households and small firms to the tax. Moreover, specific allowances for business property are expensive for tax administration and compliance and reduce tax revenue. Thus, they would strongly increase assessment costs relative to tax revenue.

Table 2: tax base, tax revenue, and costs of tax assessment of a wealth tax

	Wealth tax		
	Individuals	Corporations	Total
Tax base (including half exemption of corporate wealth)			
billion Euro	890	760	1 650
% GDP	35%	30%	64%
Tax revenue			
billion Euro	8.9	7.6	16.5
% GDP	0.35%	0.30%	0.64%
Taxpayers	143 000	164 000	307 000
Costs of tax assessment as % of tax revenue			
Compliance costs ¹⁾	0.8%	0.9%	0.9%
Administrative costs ²⁾	0.5%	0.5%	0.5%
Revenue loss from valuation corrections	0.7%		0.4%
Total	2.1%	1.4%	1.8%

1) Compliance costs of the taxpayers.- 2) Administrative costs of the fiscal authorities.

Source: Simulation based on German Socio-Economic Panel Study (SOEP), 2007, adjusted for top wealth concentration, financial accounting data of incorporating firms (database DAFNE of Bureau von Dijk, Deutsche Bundesbank)

Economic effects

The crucial drawbacks of a recurrent wealth tax are that it would potentially discourage capital accumulation and could cause many behavioural responses, such as choices on location and investment, financing, royalty administration, legal form, as well as other tax avoidance strategies and tax evasion. Insofar a recurrent wealth taxes are rather similar to the taxation of businesses and capital income. With respect to risk allocation, a recurrent wealth tax is likely to be even worse, as it does not include an 'insurance' against fluctuations in income, in particular against losses. The induced liquidity effect especially harms SMEs with limited access to the capital market. This calls for tax breaks at least for SMEs, however this would reduce revenues, create new distortions and significantly increase assessment costs of administration and compliance.

Effectively, an annual 1 % wealth tax would place a significant extra tax burden on business and capital income, which is the higher the lower the rate of return is, as shown in the following. The current tax burden of a recurrent wealth tax could be easily converted into an implicit tax rate on long-term income capitalised for market valuation.⁵ In this case, the implicit income tax burden of the wealth tax would be equal to the wealth tax rate over the rate of return, or capital costs respectively, used for capitalisation. Thus, a 1 % annual wealth tax equals to a:

- 50 % implicit income tax rate for 2% returns or capital costs,
- 25% implicit income tax rate for 4% returns or capital costs,
- 12.5% implicit income tax rate for 8% returns or capital costs.

In the current low interest rate environment, in which it is hard to get even a nominal interest rate of 2 % for safe investments, e.g., bank deposits or bonds, such an extra tax burden would seem to be unfeasible. It might even raise constitutional concerns with respect to overtaxation.⁶ Investments with higher returns or capital costs benefit from the risk premium which is effectively not liable to wealth taxation. However, even successful real investments in firms or real estate, which could earn returns of 5-10% in the long run, would still face an extra income tax rate of 10-20 %

We analysed the potential impact of this tax hike on business and capital income using estimations of the relevant elasticities of taxable income (Bach and Beznoska, 2012). Based on studies for Germany and taking into account the reduced opportunities for international tax avoidance and tax evasion, we assume an elasticity of the tax base of -0.25 , both for business and capital income. That means, when the income tax burden increases by 1 % (not percentage points) the tax base will decrease by 0.25 %. We estimate a marked decline in tax revenue of 5 billion euro, most of which is caused by a reduction in business and capital income tax revenue. Presumably, the main adjustments involved refer to tax avoidance. However, as far as real economic activities such as investment and employment are discouraged, there will be a negative impact on economic growth. Revenue from wage taxes and indirect taxes would be expected to decrease too.

In contrast to a recurrent wealth tax, a one-time capital levy would be imposed on the existing wealth stock. To the extent that taxpayers did not anticipate the levy, there are no incentives for immediate tax avoidance once the levy is assessed and fixed. Thus, there are no likely substitution effects and the levy implies no excess burden in terms of standard optimal taxation theory. This is a main advantage compared with hikes in recurrent taxes on business and capital income or wealth. However, if potential taxpayers expect that the capital levy will be repeated, this could discourage long-term saving and investment, while encouraging capital flight. Eichengreen (1990) argues that even if its recurrence cannot be ruled out, a capital levy can be welfare improving if adopted to redress debt problems created by extraordinary circumstances. Generally, such levies would provoke political backlashes and resistance since the affected wealthy elite might feel targeted by the government. Finally, a one-off capital levy could only serve as an extraordinary instrument in times of fiscal emergency (see IMF, 2013). Some over-indebted countries in southern Europe are in or close to such a situation. But this is not the case for Germany or most other EU or OECD countries.

3.5.4. Reform of inheritance taxation in Germany

Inheritance tax is the last remaining tax on ‘the rich’ in Germany. The German system is donee-based, thus taxing gratuitous transfers (inheritances, legacies, gifts *inter vivos*) at the single beneficiary. For close relatives there are personal allowances: 500,000 euro for spouses and 400,000 euro for children. Thus, the inheritance tax solely burdens the transfer of higher wealth in these cases. Since it is levied only when the assets are passed on,

⁵ See also the contribution of M. Keen in this volume.

⁶ In Germany, there is a constitutional debate on recurrent income and wealth tax burdens systematically exceeding the returns of an investment. This is deemed as conflict with the fundamental right to property as set out in the constitution.

which generally happens in old age, it may be less relevant for economic decisions during the more economically active years. Inheritance taxes only affect behaviour when the assets are intended to be inherited or gifted. This is not the case when assets are accumulated or held for the proprietor's own use, such as retirement or risk prevention, children's education, or prestige, and there are no specific bequest motives. Thus, compared to recurrent taxes on business and capital income or wealth, inheritance taxation is considered by many economists and tax experts to be the economically more favourable version of wealth taxation.⁷

The burden on beneficiaries of high inflows lacking effort increases the acceptance of this form of asset taxation, since it takes into account 'meritocratic' ideas and equal opportunities between members of individual generations.⁸ The increase in income and wealth concentration in the upper levels of the distribution also argues in favour of preserving or even expanding inheritance tax because, due to the increasing "dualisation" of income tax since the late 1990s, high and very high corporate and capital income is hardly being taxed progressively at all, as it is no longer subject to the personal income tax rate.

For these reasons, international organisations such as the OECD (2011) and the IMF (2013) recommend shoring up property-related taxes such as inheritance tax and reducing current taxes on earned income. But it must be remembered that, when corporate and capital assets are high, inheritance incentives and family succession both frequently play a role. Inheritance tax is accounted for in tax planning and can trigger avoidance reactions including relocation of residency, especially since inheritance tax is no longer levied in a number of OECD countries and current net wealth taxes have been abolished in most countries (Förster, Llena-Nozal and Nafilyan, 2011). Moreover, inheritance taxation is rather unpopular in the German middle classes as it is the case in other countries. This argues in favour of limiting the tax burden.

Inheritance taxation is currently under debate in Germany. In December 2014, the German Federal Constitutional Court ruled that wide-ranging exemptions on inheritance taxes for corporate assets were partially unconstitutional. If certain conditions are met, 85 or even 100 per cent of corporate assets are tax exempt to ensure the continuation of a company and retaining jobs. In particular, large transfers consisting mainly of corporate assets benefit from the favourable conditions. In 2012 and 2013, over half of all transfers of 5 million euro or more were tax exempt, and over 90 per cent of transfers of 20 million euro or more. In recent years, these tax breaks have exempted half of all assets subject to inheritance tax (Bach, 2015). Revoking these company privileges would more than double annual inheritance tax revenue in the medium term at present tax rates. Legislators have to submit new regulations by mid-2016.

The extensive exemptions are not really required in larger companies to prevent job losses in the event of business succession and are sometimes even counterproductive. Legislators ought to place ceilings on tax benefits and restrict them to operating assets. They should be limited to required operating assets and be offset against other transferred assets or against the assets of the beneficiary. After allowances and deductions, tax burdens on corporate assets should be deferred or annuitised with no specific conditions over long periods, in order to allow the corporate successor to pay them off using current revenues. Furthermore, other liabilities could be given priority over the tax claim or could be pegged to the commercial success of the company. As a result, liquidity problems resulting from high inheritance tax payments would be avoided and the tax authorities would become a kind of silent partner of the company until the tax liability is paid off. This would also avoid complicated means testing which would otherwise be required for a continuation of previous tax breaks for large companies, in accordance with the judgment by the Federal Constitutional Court.

In addition to restricting corporate privileges, further tax benefits should be reduced or revoked, such as tax exemption for the family home or tax exemption for donations. Furthermore, the multiple use of personal allowances could be limited by extending the ten-year period for aggregating transfers or permitting personal

⁷ See the relevant survey literature, e.g., Kopczyk (2013), Boadway, Chamberlain and Emmerson (2010), and the contributions of G. Zucman and R. Boadway in this volume.

⁸ See Piketty and Saez (2013) and the contribution of G. Zucman in this volume.

allowances to be applied only once in a lifetime. In return, personal tax allowances could be raised, particularly for spouses, partners, and children. This would avoid the need to assess cases where there is no significant tax revenue and also counteract latent reservations against inheritance tax by the middle classes.

3.5.5. Conclusions

Higher taxes on high income and wealth are under discussion in Germany, such as increased top income and capital income tax rates, the re-introduction of a recurrent wealth tax, a one-time capital levy, or strengthening inheritance tax by reducing tax privileges. These topics played a role in the 2013 federal election campaigns.

Since net wealth is strongly concentrated at the top of the distribution, a personal wealth tax could raise substantial revenue even if high personal allowances are granted. For a personal allowance of 1 million euro and a specific allowance for business property of 5 million euro, we estimate the annual tax revenue of a 1 % wealth tax to be 14 billion euro or 0.6 % of GDP (2011). The number of affected taxpayers is around 330,000, or 0.5 % of the adult population. Reduced allowances would significantly broaden the tax base, but strongly increase the number of taxpayers.

The main drawbacks of recurrent wealth taxes are the incentives they create for taxpayers to avoid or evade the tax burden. An annual 1 % wealth tax would place a significant extra burden on business and capital income which is the higher the lower the rate of return is. By contrast, a one-time capital levy would give no incentives for immediate tax avoidance once the levy is assessed and fixed. In this respect there are no substitution effects and thus no excess burden. In the long run, however, saving and investment might be discouraged if potential taxpayers expect that the capital levy will be repeated. Moreover, the unexpected tax burden would prompt political protest, particularly from the wealthy elite. Finally, a one-off capital levy could only serve as an extraordinary instrument in times of fiscal emergency, in particular, for over-indebted countries in crisis.

Inheritance taxation is often considered to be the economically more favourable alternative for taxing the "rich". Efficiency losses seem to be lower and the tax burden on intergenerational transfers promotes 'meritocracy' and equal opportunities between members of individual generations. However, wide-ranging exemptions on corporate assets particularly unburden the very high wealth transfers in Germany. The Federal Constitutional Court ruled out these exemptions and demanded a new legislation. Legislators ought to place ceilings on tax benefits and restrict them to operating assets. The preferred solution might be to defer or annuitise tax burdens on corporate assets with no specific conditions over long periods to mitigate the liquidity problems of high tax liabilities. In addition to restricting corporate privileges, further tax benefits could be reduced or revoked, such as tax exemptions for the family home or tax exemptions for donations.

Lessons from the recent policy debates in Germany show that there are no clear prospects for higher taxes on high personal wealth. Such proposals provoke strong resistance from the business sector, in particular from the German *Mittelstand*, which is widely accepted as a cornerstone of the German economy. Dangers to domestic investment and employment are emphasised and extra appraisal and assessment procedures attract complaints. Moreover, middle class voters are against tax hikes on personal wealth or inheritances. Presumably, they also fear economic drawbacks or even feel potentially affected. Against the high tax burden on earned income and expenditures and the government's balanced budget they see no need for tax hikes. The disappointing election results for the Social Democrats and Green Party are said to be also caused by the tax plans on the wealthy.

Increases in top income taxation, however, look more likely. Income distribution has increased and tax avoidance and tax evasion decreases. This clearly creates room for higher top income tax rates. Including a further trimming of tax privileges, it would be not so difficult to raise an extra 10-15 billion euro per year with conventional income taxation, which equals the wealth tax revenue targeted by the left-wing parties. This extra revenue could be used for a reduction of bracket creeping in income taxation or for lowering indirect taxes. This could counteract latent reservations by the middle classes against a somewhat more progressive taxation at the

top. In the longer run, improved international tax coordination will markedly enhance the opportunities to tax high incomes and wealth more progressively.

Finally it is conceivable to integrate some elements of wealth taxation into current income taxation to close some gaps in income assessment. For instance, it is often hard to determine taxable income not only for the imputed rent of owner-occupied dwellings but also for rented real estate properties. Income taxation could be replaced by a recurrent net wealth tax on market value less liabilities, as it is realised in the Netherlands (Cnossen and Bovenberg, 2001). A similar regime could be implemented for business and capital income, in particular for very rich households whose periodic income is often difficult to observe (Piketty and Saez, 2013).⁹ Likewise, recurrent wealth taxation could serve as a minimum tax by crediting it to the income tax liability if the latter exceeds the first (Jarass and Obermaier, 2003). This could also be implemented for corporate taxation to fight tax base erosion due to tax breaks and international tax avoidance.

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⁹ See also the contribution of G. Zucman in this volume.

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4. SESSION II - TAXING WEALTH: SPECIFIC INSTRUMENTS AND CHALLENGES

4.1. TAXING MORE POST MORTEM FAMILY BEQUEST

by André Masson *

4.1.1. Introduction

In Europe at least, the present economic situation has renewed the interest for wealth or capital taxation issues: massive unemployment makes labour income taxation more problematic; the reimbursement of heavy public debts calls for additional tax revenue; growing wealth inequality and concentration put back to the front redistribution issues; strong international fiscal competition makes taxes on immovable property, such as residential housing, relatively more attractive; a too slow economic growth may legitimate tax advantages given to risky, long-term productive investments, *etc.*

In that respect, the recent French debate on wealth taxation is quite revealing, in so far, as the main protagonists do not share at all the same views. This appears clearly when we apply to the two revealing examples of Piketty (2013) and Aghion *et al.* (2014) the same framework of threefold analysis – in terms of diagnosis (the wealth situation that needs to be rectified), objectives pursued, and proposals made. In his diagnosis Piketty emphasizes: the rise in Europe of wealth or capital-income ratios to levels unknown since hundred years; the increasing concentration of wealth and the danger of plutocracy resulting from the growing wealth and lobbying of an ultra-minority of very rich people; the present high rates of return to wealth, which are moreover increasing with the size of wealth; the fact that the annual flow of bequests has increased much more rapidly than economic growth (GDP). On the other hand, Aghion is much more concerned by the rise in income inequality since 1980, which he attributes to technical change, and claims that capital is overtaxed in France compared to Scandinavian countries. In terms of prime objectives, Piketty aims at re-controlling capital and regulating capitalism – bringing more democracy and transparency –, limiting the power of the ultra-rich, and preserving the "European social model". By contrast, Aghion wants first to promote a new model of "inclusive" economic growth based upon entrepreneurship and advocates a fiscal and social convergence of France towards the Rhineland and Nordic models. Main proposals are, again, very different. Piketty wants to introduce more transparency on capital as well as more international fiscal cooperation. Rejecting a rise in consumption taxes, he advocates three annual highly progressive taxes, on income, bequests and (individual, total, net) wealth, the revenue of the latter reaching 2 % of GDP. In addition, a one-time capital levy, bringing tax revenue of 20 % of GDP, should help reduce public debt. In short, an avalanche of taxes hits specifically the 2-3 % top wealth holders. In contrast, Aghion recommends for France a higher consumption tax, a moderately progressive tax on labour income, a limited flat tax on capital income, and a reduction of corporate taxes, notably in order to preserve new (Schumpeterian) accumulation; he also views inequalities at the bottom of the social ladder as a key obstacle to economic growth, underlying the beneficial role of prime education, training, and additional "flexicurity" on labour markets. Inheritance or estate taxation plays a minor role in the controversy, owing it first to its growing unpopularity. However, we believe that there is now justification for introducing heavier, progressive taxation on "family inheritances" (excluding charitable bequests and *inter vivos* transfers), as the appropriate response to the unprecedented wealth situation of countries like France. We will show how suboptimal this situation is – i.e., inefficient, unfair and a source of the perpetuation of inequalities –, in particular because people now inherit later in life than they did in the past. Such a move would require the

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development of an original legislative and fiscal mechanism, to avoid the criticisms levelled at traditional inheritance taxes: we call this mechanism Taxfinh (Tax family inheritances).

4.1.2. Our approach in the (French) debate on wealth taxation.

In Masson (2015), we highlight four features of the debate: the emphasis given to the tax mix (and rightly so); the key role played by heightened international fiscal competition and capital mobility; the secondary importance given to wealth transfer taxes (even in Piketty's book); finally, at the heart of the controversy, the assessment made of "new primitive accumulation", concerning both their origin (from robbery or quasi-monopoly to genuine entrepreneurship) and their impact on growth (where wealth trickles down or not).

Our intention is not to indicate our own position, but to go back to the origins of the debate, by proposing first of all a return to the tax on wealth transfers, an issue which we believe to be largely "orthogonal" to the above controversy. We begin then by proposing a legal and fiscal reform of wealth transfers, applying to well-off and upper middle-class families, i.e. 10 to 20 % of the population. This Taxfinh reform does not exclude other elements of (lifetime) taxation on capital or income, but we do not consider the optimal tax mix nor prejudge the social utility of new wealth created; and it may further require reforms of the Welfare State, education, training and the labour market.

Our contention is that the Taxfinh program could be first implemented without too much damage in France alone, thus serving as an example to other countries. The argument that capital mobility and tax or jurisdictional competition for mobile tax bases between countries and governments leads to reduced tax rates is more relevant in the case of wealth ownership than it is in the case of wealth transmission.¹⁰ Distortions and disincentive effects on labour supply and saving are also expected to be somewhat lower for wealth transfer taxation than for lifetime wealth taxation: above a given wealth threshold, childless households thus save as much as other households.¹¹ Finally, viewed from the beneficiary angle, wealth transfers received can be seen as unearned income, if not a windfall gain, a rent that has nothing to do with talent, hard work or merit, and creates unfair differences. Indeed, inheritance is a key factor in the inequality of life chances. On the other hand, an annual wealth tax, for instance, has a number of defects: it does not distinguish between rents and productive investments, ignores the origin of wealth (whether inheritance, luck or effort), and may entail a double pain in case of capital losses. These observations argue in favour of a form of wealth transfer taxation. But we face a major challenge: the strong and growing unpopularity of these taxes in most countries.

4.1.3. Unpopular wealth transfers taxes

Small and decreasing revenues from wealth transfer taxes

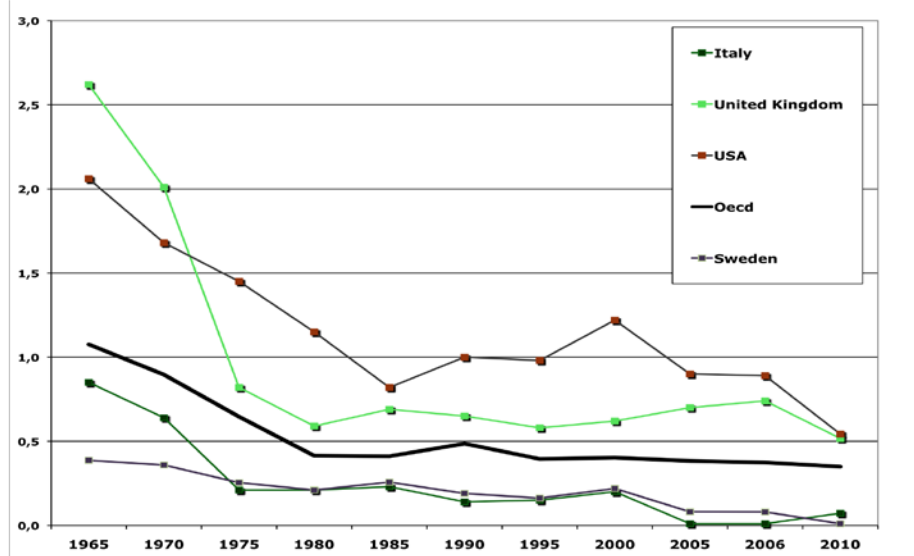
Wealth transfer taxation yields little in the way of revenues: less than 1 % of all tax revenues in the vast majority of developed countries and less than 0.5 % of GDP virtually everywhere, with the exception of France (over 0.5 % prior to 2007) and Belgium (0.6 %).

Worse still, OECD statistics show that the yield of this increasingly disparaged wealth transfer taxation has been on the downturn in most countries since the 1960s. Figure 1 shows the growth in the share of inheritance and gift taxes in total tax revenues for a range of countries for the 1965-2010 period. Figure 1 displays the sharp drop observed for the United Kingdom and the United States, where wealth transfer taxation was initially highest.

¹⁰ Brülhart and Parchet (2011) actually cast doubt on the empirical relevance of tax competition arguments in the case of bequests, whether in the US, between states or, in Switzerland, between neighboring "cantons".

¹¹ See for instance Arrondel and Lafferrère (1998) for France.

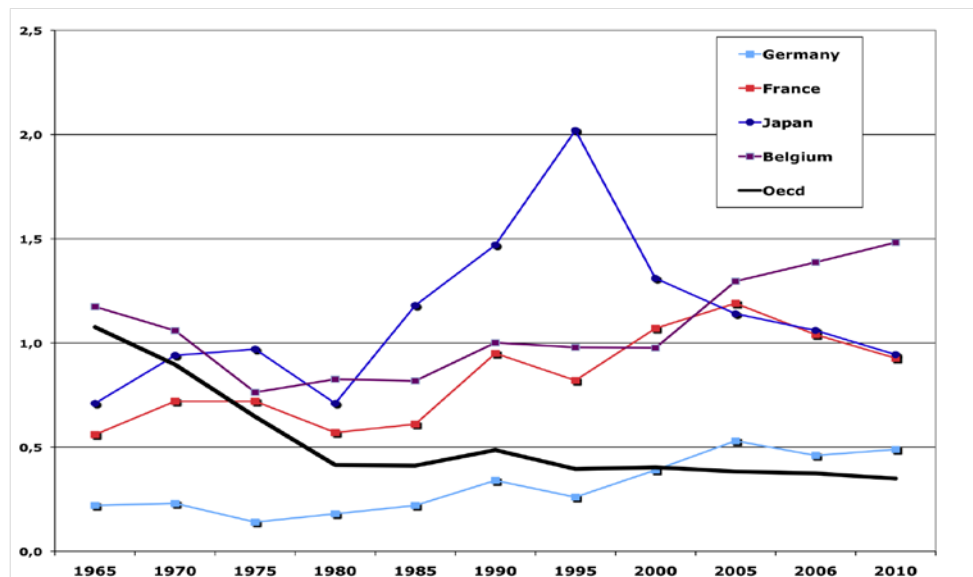
Figure 1: estate, inheritance and gifts taxes (% of total tax revenue), decreasing trend for a majority of countries



Source: OECD

This drop is typical of the trend observed in the Anglo-Saxon countries. Italy and Sweden present another fairly representative case: the scrapping of wealth transfer taxation in recent years (Italy in 2001 and Sweden in 2005). Just to give an idea of this widespread phenomenon, the following is a non-exhaustive list of countries that no longer have wealth transfer taxation: in Europe and Northern America; Canada (in 1972), and since 2000, Italy, Portugal, Sweden, Austria – and severe limitations in Switzerland and the US (at federal or state level); elsewhere, Australia (in 1977), New-Zeland, Hong Kong, Singapore, Malaysia, India. It is therefore no wonder that total OECD figures show a sharp downward trend: revenues from wealth transfer taxation have fallen from more than 1 % of total tax revenues in the 1960s to less than 0.4 % in the last ten years.

Figure 2: estate, inheritance and gifts taxes (% of total tax revenue), four exceptions with a non-decreasing trend



Source: OECD

Figure 2 shows the four main nations that do not display such a downward trend: Japan, Germany, Belgium and France. However, there should be no getting the wrong impression from these exceptions. In the case of France, at least, the relative increase in wealth transfer taxation has been somewhat "inadvertent": it is due primarily to

rare and overly lax inflation-adjusted changes to the tax exemption and tax break thresholds, combined with sharp growth in assets, especially real estate assets.

In France, today, taxes on wealth transfers generate about 6 or 7 times less revenue than total lifetime wealth taxation. And the ratio is almost 1 to 20 if we compare inheritance tax to all the taxes on capital, including, in addition to private wealth, the capital owned not only by businesses and firms but also by self-employed (in all, some 9 or 10 % of GDP).

This strong preference for lifetime wealth or capital taxation rather than wealth transfers taxes is not specific to France: if anything, it is even more pronounced in the other OECD countries. Moreover, it has tended to increase almost everywhere over the last few decades: as a proportion of GDP or total tax receipts, lifetime tax revenues on wealth or capital have tended to remain constant or even grow in most countries.¹²

Possible explanations

The theory of optimal capital taxation remains fairly mystified by the growing and specific unpopularity of taxes on wealth transfers. Cremer and Pestieau (2012), for instance, claim that if "our basic goal is to finance government services with a tax that is as efficient, fair and painless as possible, [then] on all counts, it is difficult to imagine a better tax than the estate tax"; this quotation appears quite representative of the views of the profession, at least in Europe. Moreover, a number of straightforward explanations of the growing unpopularity of wealth transfer taxation, such as the greater efficacy of lobbying by the rich getting richer (Stiglitz, 2012), apply *a priori* as well to other taxes on capital. Many economists are then reduced to accepting this state of affairs as an inescapable fact, proposing as a substitute for this unpopular tax some form of lifetime wealth taxation, or a tax on capital gains, especially on those recorded at the moment of the owner's death (as in Canada).

If we want to propose a new form of wealth transfer taxation that would be not so unpopular, it is important, however, to identify the main objections addressed to traditional inheritance taxation. In a recent poll, French people were asked to rank a dozen of different taxes: the annual wealth tax, or ISF, paid by the 2 % top wealth holders, came first, before corporate taxes; inheritance taxation came last, even after TV license fee. In short, why is ISF so popular and inheritance taxation so unpopular?¹³

A first reason is tax illusion: "People prefer to pay an annual property tax equal to 1 % of their property value (or 25 % of their 4 % annual return) for 30 years rather than pay 30 % of their property value all at once when they inherit the asset" (Piketty and Saez, 2012). In this realm, a more convincing explanation adds false beliefs of people overestimating their propensity to bequeath: if I own 1 million euro at 40 years old, I may be (still) now – and for the next years to come – in favour of the ISF (the exemption level is 1.3 million euro); but an increase of estate taxation breaks my (irrational?) dream to become rich one day.

Strong capital market imperfections, namely a rate of return to wealth which is highly uncertain and unpredictable over the long run and increases with the size of wealth, advocate for current and regular capital taxation, instead of inheritance taxation coming far too late: being rich at 40, I can behave like a rentier for the next 40 years.

Another well-known objection, albeit not entirely convincing, is double taxation: my parents already paid taxes on income, savings... and the ISF. Also, there is the argument that estate taxation violates more than other taxes

¹² See Arrondel and Masson (2013): this is more an effect of a rising wealth tax base than a tightened tax schedule (as it is exemplarily shown by the rising percentage in the US during the Bush years).

¹³ See Arrondel and Masson (2012). The fact that people hate to pay their taxes using their checking accounts may explain the relative tolerance to consumption taxes or social contributions, but not the popularity of ISF.

the principles of horizontal equity: for a given estate or inheritance, the amount paid in taxes will depend on the asset structure, tax engineering, but also on the suddenness of death and on how close-knit the family is.

The last objections rest already on the family dimension of inheritance: as the French adage says: *toucher à l'héritage c'est comme toucher à la famille* – "interfering with inheritances is tantamount to interfering with the family". Wealth transfer taxation is seen first as a "virtue tax" on the wealth that altruistic parents accumulate for their children – as former French president, Nicolas Sarkozy, put it in 2007, "when you have worked your entire life to build up a capital, you should be able to leave it to your children tax free".¹⁴

Inheritance taxation is also labeled a "death tax", which compounds the loss of a parent, and prevents the deceased from "living on" through the bequest to the children. It is again a tax on the family business, which could jeopardize the survival of the firm and its management by family members; and it is a tax on the family (real) estate, to whom the family members are attached, and which ensures family cohesion and solidarity.

Hence, if we are to explain the specific and growing unpopularity of wealth transfer taxation, the best candidate is perhaps the increasing strength of family values: the family would appear increasingly as a safe haven against growing insecurity and declining economic growth, reflecting waning trust in capital markets, the Welfare State, returns to education, and possibilities for upward social mobility (see Beckert, 2012). Yet, this conjecture needs much further qualification, coming also from other social sciences than economics.

4.1.4. Taxfinh as a remedy to the objections raised by standard inheritance taxation

The Taxfinh programme would combine (for France) two inseparable components:

- (i) heavier, highly progressive taxes on family inheritances (i.e., non-charitable); the taxing of family gifts would not be lightened – the tax schedule could even be slightly raised –, but the period of time separating gifts from inheritance should be limited, e.g. 10 years;
- (ii) providing more numerous and easier means to sidestep this new tax, thus encouraging people to make *inter vivos* gifts or donations (to their children or to charities) or to consume their wealth during their old age.

We shall get into more details later. While pointing out that the Taxfinh programme does not exclude other wealth taxes, we already emphasize the fact that it differs markedly from standard inheritance taxes, and does not suffer (so much) from the disadvantages raised above. Unlike a simple inheritance tax, the programme cannot be criticised for intervening "too late" to correct wealth inequalities, because it encourages people to take decisions well before the end of their lives to organise the transmission of their wealth; such incentives will also reduce horizontal inequalities. Lifetime gifts are comparatively less taxed than *post mortem* bequests, in line with the "virtue tax" argument. The disincentive to bequest to one's death is a way to answer to the "death tax" objection. Note also that the transmission of the family business will not be (much) more taxed if the latter occurs soon enough during the lifetime of its owner. Finally, the Taxfinh programme is not an anti-familial machine, since it gives an active role to (wealthy) families, letting them to decide what is best for them.

The debate between the supporters and the opponents of wealth transfer taxation has been running fiercely for more than 40 years with the mere outcome of growing unpopularity and declining revenue of these taxes. The elements given above in favour of the Taxfinh programme are certainly relevant but not compelling: above all, this programme is justified by the dangers of an unprecedented and lasting wealth situation. In short, the current wealth situation of countries like France, clearly harmful, offers new and powerful arguments in favour of such

¹⁴ The virtue tax argument has a number of implications: *inter vivos* gifts, being presumably more often altruistic, should be less taxed than *post mortem* bequests; also, transfers going to beneficiaries other than children should be more taxed; in the estates, the self-accumulated component should be less taxed than inherited wealth, etc.

an original inheritance tax system that would provide the appropriate incentives while taking care not to undermine morale or family values.

4.1.5. Justification of the Taxfinh approach: wealth diagnosis and objectives

This is the occasion to subject our approach to the same framework of analysis as Piketty and Aghion: wealth diagnosis, primary objectives and proposals.

Diagnosis: an unprecedented and clearly suboptimal wealth situation in France

The current wealth situation in France is characterised by five elements which can doubtless also be observed, at least partly, in other euro zone countries:

- (i) Children inherit their parents' wealth, in full ownership, at increasingly older ages

The unprecedented rise in life expectancy, combined with stronger rights for the surviving spouse, means that children are most likely to inherit the family wealth, in full ownership, upon the death of the second parent, when they are 60 years old on average and their lives are already established.¹⁵ As recently as during the thirty-year post-war boom, the average age at which children inherited did not exceed 40.

- (ii) The annual flow of transfers has increased at a much faster rate than economic growth

According to Piketty (2013), the annual flow of wealth transfers as a percentage of GDP has doubled in France over the last thirty years, to reach more than 10 %. Moreover, these transfers are characterised by strong and deepening inequality, in particular between inheritors and non-inheritors, or between the three-quarters of old people who are home owners and the other quarter: they therefore constitute an ideal tax base.¹⁶

- (iii) There has been a historic rise in lifetime gifts, which appear to be concentrated among the wealthy, tax-sensitive, and useful to the beneficiaries in their wealth projects

Gifts (declared) have grown as a proportion of total transfers, especially since the 1990s, partly because of the tax relief they have been afforded. French parents have shown themselves to be sensitive, to a certain degree, to the tax advantages given to gifts compared with inheritances (Arrondel and Masson, 2013). Apart from farming families, gifts are still the reserve of the rich, a practice of wealthy households; nevertheless, they are "socially useful" insofar as, when they are received early enough, they free the beneficiaries from liquidity constraints and boost their wealth projects, whether that involves buying a house, creating a business or taking over a business outside the family.¹⁷

- (iv) An excessive and rising concentration of wealth in the hands of the oldest

Despite this increase in gifts, Insee wealth data reveal an ever-stronger concentration of wealth in the hands of the oldest over the last twenty years or more: whether in terms of the average or the mean of gross, net or financial wealth, or the proportion of homeowners, the relative position of the over-60s improves perceptibly

¹⁵ The contrary effect of the widening intergenerational age gap (people are having children at a later age) only very partially offsets this phenomenon.

¹⁶ During the same period (1980-2010), the flow of social transfers towards the over-60s (pensions, health, long-term care) also doubled as a percentage of GDP, to reach 20 % today: the "Ricardian" circuit of public (upwards) and private (downwards) intergenerational transfers has therefore been considerably strengthened.

¹⁷ See Arrondel *et al.* (2014) on the retrospective data of the Insee's Patrimoine 2010 survey: the probability of becoming an entrepreneur is multiplied by 1.5 for donees (and even more if they are less than 35 years old), but does not depend at all on whether one has received financial assistance or an inheritance from one's parents.

from one cross-sectional survey to the next, compared to that of the under-40s. This wealth inequality between generations is self-perpetuating, to the extent that on average, children are already nearly 60 years old when they inherit. To reduce the imbalance, it is therefore necessary to introduce suitable measures or incentives to increase the downward mobility of wealth, towards the younger generations.

(v) A "tightening" in the wealth behaviour of older people in France

Despite relatively generous social protection, there has been a certain tightening in the wealth behaviour of older French people, who "oversave" for their old age: driven first by long-term precautionary motives, retirement needs or the risk of longevity, their savings usually represent a low-risk reserve of value, a sort of "sleeping" wealth; the bequest motive is often present but it only comes in second place.

Increasing weight and inequality of an inheritance received ever later in life; over saving and "tightening" of wealth behaviour among the oldest generation; young active people ever more hindered in their capital projects: the wealth situation in France appears to be totally unsuitable, both for the parents and for their adult children. This situation is bad for the economy in a context where it is necessary to boost consumer spending, to have sufficient demand to finance the silver economy, to direct savings towards the risky, productive long-term investments needed to stimulate sluggish economic growth, and to help the younger generations whose professional, family and housing needs are subject to powerful liquidity constraints and high house prices.

Objective: to change our attitude towards property

Our prime objectives differ considerably to those of Piketty or Aghion. The basic intuition is that we must start by rectifying the wealth situation described above, before seeking to improve social protection and the functioning of the labour market. But this means going back to the root of the problem, and questioning our very attitude towards property.

(i) A new attitude towards property: not to be the "richest person in the cemetery"

Here we must tackle something of a taboo: people's aim regarding their wealth should not be to become the "richest man in the cemetery". To quote the well-known phrase by Durkheim (1900): "Individual property, one may say, is that which begins and ends with the individual". Care must be taken to ensure that family wealth does not, through inheritance, become too much of a safe investment, a haven against the vagaries of the market, the feared withdrawal of the welfare state and the uncertain future of their children.

This involves changing attitudes towards property through legislation, taxation and a supply of savings products that offer the "right incentives" for individuals to avoid transferring their wealth too late, after their death, or "tightening" their hold on their property. At the same time, the reforms proposed in these domains must not jeopardise the new creation of wealth – without prejudging its legitimacy or utility.

(ii) Rectifying the unfavourable wealth situation.

Any remedy to the current wealth situation faces a contradiction. Our diagnosis calls for wealth transfers to be considered as an ideal tax base and therefore taxed on a large scale; but it also highlights the need to accelerate the circulation of wealth towards the younger generations, and therefore to lower taxation on lifetime gifts, albeit a luxury good. The recent fiscal reforms in France have been unable to handle this contradiction: heavier wealth transfer taxes together with a relative advantage given to (early) *inter vivos* transfers.

4.1.6. The Taxfinh programme: architecture, philosophy and impact

A suitable solution to the deleterious wealth situation in France must at the same time: offer the right incentives, leading in particular to an increase in lifetime gifts; reduce both inter- and intra-generational wealth inequalities, and generate increased tax revenues – all that without assailing morale or family values.

The two components of Taxfinh in more details

The first component advocates heavier and progressive taxation of family inheritances. The raising of the tax schedule would only concern *post-mortem* family bequests to children (or close relatives), and would not affect bequests to charities or *inter vivos* transfers. It would result in high marginal rates in the upper brackets (up to 70 or 80 %), which would be justified by the increased possibilities to avoid leaving bequests of too high a value (second component). The tax-free allowances could be reduced a little to tax latent (unrealised) capital gains, especially on real estate. However, the progressive nature of the taxation means that it would only affect the 10 to 20 % of wealthiest families, since the others do not have the means to make large *inter vivos* transfers.

The taxing of family gifts would not be lightened: the tax scale could even be slightly raised, but the period of time separating donations from inheritance should be reduced in France, from 15 years now to 10 years or even less. The incentive to make a gift during one's lifetime would no longer come from an incentive to donate but from a disincentive to bequeath; it should be all the more effective as a result. This measure is novel, but it is the response to an unprecedented postponement in the age at which people inherit.

Gifts or bequests to charity, together with professional property, should be the object of special treatment, requiring the introduction of a certain freedom to bequeath. If we are to avoid provoking a revolution in France or offending family values, this freedom will need to be carefully defined and controlled. Firstly, the freedom to bequeath will only be exercised outside the family: the "domestic" wealth, destined for the children (or grandchildren), should exceed a given proportion of the estate (depending on the size of the latter), and will be governed by the rules currently in force ('reserve' of each child). Secondly, gifts or bequests to charity will receive tax advantages and benefit from a certain freedom to bequeath, but the destination will be controlled: they must concern charities or foundations of which the public interest can be verified; also, charitable lifetime gifts will be the least taxed, if at all. Lastly, the family business could benefit from a special regime, provided that it is transferred as a donation and sufficiently early: the freedom to test could allow the donor to choose, if the children are unsuitable, a more highly motivated and competent successor.

The second component of Taxfinh aims at providing more numerous and easier (legal) means to avoid the inheritance surtax. Like the inter-family donation, these increased means to avoid inheritance surtax will have the advantage of orienting savings behaviour in the desired direction compared with the current wealth situation: they therefore represent "right incentives". They may include tax advantages given to risky and long-term investment and will help to reduce the amount of wealth bequeathed *post-mortem* in two different ways: by encouraging the right to give, whether in the form of a family donation or gifts (and bequests) to charities; by facilitating the possibility to consume one's wealth over a longer period of retirement, which entails making this wealth more liquid or more easily available in case of need.

The strengthening of the possibility to consume one's wealth during one's old age – which should prevent people from finding themselves destitute if unforeseen events arise after they have made a donation to their children –, would be achieved by a marked improvement in the supply of suitable financial products: immediate life annuity (converting a financial lump sum into regular income), long-term care insurance, new "viager" and reverse mortgage. These products are not very popular today, and the inheritance surtax would make them more attractive, allowing a broader diffusion. The two most promising products, viager and reverse mortgage, are designed to generate liquidity from real estate wealth.¹⁸

The viager provides the seller with a sum of capital (the "*bouquet*") and/or life annuity while remaining in his house until his death or departure to an institution: the seller loses the *nue propriété* (bare ownership) but keeps

¹⁸ Nearly three-quarters of the over-60s in France own their own homes. See Masson (2014) and the references in this paper for more details on these new products.

the usufructs. It is a form of life insurance, subject to the pooling of survival risks: the longer the seller lives, the more he gains. The standard viager, where the buyer is a private individual, is fairly uncommon (5,000 to 8,000 sales per year) and suffers (justifiably) from a poor reputation. Recently, a better-adapted "mutualised" viager has been proposed, where the buyer is an institution subject to certain rules and even social imperatives, which can pool the risks on both sides – on the survival of the seller and on the value of the housing at his death.

The reverse mortgage allows a retired person to borrow on their home equity, receiving a sum of capital (and sometimes annuities) based on the value of the house. At death, the accumulated debt is deducted from the estate. It is a loan: the longer a person lives, the greater the debt and the smaller the inheritance remaining to the children. In France, the *Crédit Foncier* is the only organisation to propose this product (since 2006) and the stock is of only 6,000 reverse mortgages with a high interest rate of 8%, due to the bank's need to cover the risk that the accumulated debt exceeds the value of the house at the time of death. So the standard reverse mortgage is not to be encouraged. The reverse mortgage for dependence, on the other hand, would be a welcome substitute for LTC insurance. It would be only paid in the event of duly certified dependence: in this case, the life expectancy is much shorter and easier to predict, and the lender can offer a much lower interest rate, of the order of 4%.¹⁹

The development of these complex products is a major element in the Taxfinh programme. At present, these are niche products that are little-known and poorly regulated. The increased taxation of inheritances could give them a boost. But intervention by the state and the legislators is essential, to structure and organise the market and regulate professional bodies that are rather apt to overestimate the probability of survival or the risk of dependency.

Subtleties, philosophy and performance of the Taxfinh programme

However, the transitional period during the introduction of the Taxfinh programme faces a major difficulty, owing notably to the ten-year limit, or so, for lifetime gifts. It is essential for families to be able to prepare sufficiently early to avoid the increased inheritance tax. This is not possible for parents who are in their 1990s.

The implementation of the programme must therefore be gradual (over 10 years?) to avoid penalising very old households unfairly. On the other hand, the "threat" must be credible, to discourage younger seniors from counting on the repeal of the measure by a subsequent government: if this is the case, these younger seniors, including the first baby-boomers, will be impacted by the programme from the moment of its launch and will be able to act accordingly – if they leave a large inheritance that will be taxed heavily, they will only have themselves to blame.

The philosophy underlying this Taxfinh system prompted first and foremost by the current wealth situation in France should then emerge more clearly: the right to inherit will be somewhat reduced in favour of the right to donate one's wealth or to consume it during old age. As a compromise between liberal views and respect of family choices and values, the measures would only affect (relatively) wealthy households who do not display family altruism (no gifts) or social altruism (no donations or bequests to charity), and who do not prepare their inheritance early enough – possibly by increasing their own or their children's consumption. It is not a question of "taking from the rich" but of evaluating the use they make of their wealth in terms of social utility, allowing the families to decide this for themselves.

Indeed, the Taxfinh programme appears to be far better than traditional inheritance tax for additional reasons than those given earlier. It should be less unpopular because it is fair insofar as the inheritance surtax will essentially affect well-off households who "deserve it", through their short-sightedness and/or selfishness. Moreover, the increase in the number of means provided to avoid inheritance tax should reduce the disincentive

¹⁹ The decision to borrow would be taken by the family and the granting of the loan should follow swiftly; the loan would be reversible, the children having the possibility to pay it back upon the death of their parent.

effects of the Taxfinh programme on wealth accumulation or investment and reduce the desire to expatriate. Finally, the programme will necessarily be productive, either because families will respond to the incentives aimed at rectifying the shortcomings of the French wealth situation (over-accumulation in old age and wealth transfers being made too late), or by generating new tax revenues, particularly welcome in these times of austerity.

More precisely, the Taxfinh programme will have four types of effects, in proportions that are largely unknown to begin with and likely to vary considerably over the spectrum of incomes and levels of wealth: from its launch, it will (1) orient transfer behaviour in the desired direction – a faster circulation of wealth towards the younger generations; (2) increase consumption in old age; (3) encourage donations and bequests to charities; (4) generate extra tax revenues, which will increase over the course of the transition period.

To give some idea of the scale for this last point, an annual flow of wealth transfers of about 200 billion euro generates slightly less than 10 billion euro of revenue in France today, corresponding to an effective average tax rate of 5 %; doubling this to 10 %, which remains limited, would already bring in an extra 10 billion euro each year.

Overall, therefore, the proposed system would offer a response particularly well-adapted to the adverse effects of the current wealth situation in France, because it would limit the weight of inherited wealth, accelerate the circulation of wealth towards the younger generations who face liquidity constraints, reduce social and intergenerational inequalities, and introduce a number of dynamic elements into the economy. This is the main justification of the Taxfinh programme. If, as in the past, one died at about 70 and inherited before the age of 40, if the weight of inherited wealth in total accumulation and in the economy was limited and stable (or decreasing) – comparable to what it was in the 1950s –, and if wealth inequalities between ages and individuals were not higher than during the thirty post-war boom years, there would be much less of an urgent need to apply such a programme.²⁰

4.1.7. Conclusions

Should we tax wealth transfers or wealth ownership (and returns)? This issue has played a central role in the debate on capital taxation over the last forty years. During this period, the national preference for taxing the ownership of wealth has become ever more pronounced in France, as it has in other countries. Although not all economists announce the impending death of the "death tax", many recommend taxes on the return to or possession of capital which could, at the same time, serve as a substitute for inheritance taxes. But in this era of the globalised economy and heightened international tax competition, such taxes would gain in efficacy only if they were introduced at the European level at least, which call for close international cooperation, difficult to establish. Moreover, the current debate on (lifetime) wealth taxation has failed to produce any reasonable consensus.

This debate largely ignores the question of inheritance taxation. Our aim is, on the contrary, to attach decisive importance to the latter. At the same time, it is clear that an across-the-board increase in the tax on transfers is unrealistic today, because it would be too unpopular and too contrary to family values. A new form of taxation is therefore indispensable. The Taxfinh programme would considerably increase taxes on family inheritances alone, but at the same time it would provide more opportunities to avoid this surtax by encouraging gifts and the consumption of wealth during old age. This measure appears to be far superior to standard inheritance tax, being more equitable and producing less disincentive effects. Rather than just taking from the rich, it allows wealthy

²⁰ Masson (2015) analyses the technical difficulties that the Taxfinh programme raises and the possible answers which can be given to the numerous objections that this programme is sure to face: premature death, partial lifetime gifts (e.g. of bare ownership alone without the usufructs), horizontal inequality, family homes, etc.

families to decide for themselves, while encouraging the socially useful responses. In economists' jargon, this is a case of efficient redistribution. To risk an oxymoron: the aim of Taxfinh is to promote a form of "liberating taxation".

However, the primary justification for this programme lies elsewhere: in countries such as France, Taxfinh constitutes the most appropriate solution to the defects of the current wealth situation, notably resulting from the unprecedented rise in life expectancy. It could well be implemented without too much damage in France alone, thus serving as an example.

More fundamentally, the Taxfinh programme aims to promote and propagate new attitudes towards property, concerning life-cycle saving, transfers and entrepreneurship. On this point, the steel baron Andrew Carnegie was much more radical, declaring that: "the man who dies rich, dies disgraced"; Taxfinh simply entails that this man would have his estate heavily taxed.

4.1.8. References

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4.2. TAXATION OF WEALTH TRANSFERS

by Robin Boadway*

4.2.1. Introduction

The taxation of wealth transfers is enigmatic from a tax policy point of view. Wealth inequality, and the income inequality that accompanies it, has grown significantly in OECD countries in the past four decades. An increasing share of wealth ends up being passed to the next generation through bequests, thereby perpetuating wealth inequalities. At the same time, wealth transfer taxes either on bequests or inheritances yield relatively little revenue, and their use has been gradually diminishing as wealth inequality grows.

This is puzzling on normative grounds, given the concerns that wealth concentration has for the integrity of political governance. It is even more puzzling on positive grounds. Despite the fact that wealth transfer taxes typically apply to the minority of the population who possess the most wealth, these taxes seem to command limited public support. There may be many reasons for their unpopularity. Public opinion may be strongly influenced by the wealthy classes and by the media. There may be a perception in some countries that wealth has been earned by hard work, risk-taking and innovative activity, as opposed to luck. Taxpayers may perceive that wealth transfer taxation is unfair because the wealthy are able to avoid — or evade — tax through tax planning methods, such as making *inter vivos* transfers, directing wealth to trusts or private businesses, and moving wealth offshore. The middle classes, on the other hand, are swept into the tax base unavoidably as the value of their housing rises. Despite often high tax rates, wealth transfer taxes are seen by many to be a "voluntary tax on the wealthy".

There has been a renewed interest in wealth transfer taxation among academic and tax policy specialists (Kaplow, 2001; Cremer and Pestieau, 2006 and 2011; Farhi and Werning, 2010; Brunner and Pech, 2012; Kopczuk, 2013; Piketty and Saez, 2013 to name a few). But, there are significant challenges. Unlike with income, corporate and commodity taxation, there is no widely accepted template for wealth transfer tax design. The tax treatment of wealth transfers varies widely across countries. Some countries tax bequests, others tax inheritances and still others tax neither or only tax capital gains on death. Where wealth transfer taxation exists, the rate structure and design of the base differ.

At least some of this can be attributed to the fact that there is no commonly held view about the optimal design of wealth transfer taxation. As we shall argue, that is because there is ambiguity about how voluntary transfers from one person to another should be taxed, particularly from the point of view of the donor. This is true not just of bequests, but also of transfers to charities and non-profit organisations (Diamond, 2006). Part of the purpose of this paper will be to explore the normative underpinnings of wealth transfer taxation in light of the evolution of normative tax theory more generally. After outlining the principles of tax policy that might apply to wealth transfer taxation, some implications for tax design will be discussed. Throughout we draw on work that has been done for the Mirrlees Review (Boadway *et al.*, 2010) as well as on the Mirrlees Review (2011) itself.

4.2.2. Features of Wealth Transfers

Transfers of wealth take many forms. They can be transfers to persons either as bequests or gifts, or they can be transfers to organisations, such as charities, non-profits or political parties. They can be cash transfers or in-kind transfers, or they can be the donation of volunteer time. They can occur on death or during the donor's lifetime (*inter vivos* transfers).

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Importantly, the motive for transfers can vary. They can be intentional or unintentional. Unintentional, or accidental, bequests arise because of wealth held at death that was not accumulated with the intent of making a bequest. It may be wealth held for precautionary purposes to self-insure against the uncertainty of length of life or of extraordinary medical or care expenses. This may reflect imperfect annuity or health insurance markets, or simply neglect in lifetime planning. It might also reflect some benefit that persons obtain from holding wealth, such as prestige or implicit authority. In any case, the bequests resulting from such wealth are incidental and yield no benefit to the donor.

Intentional bequests can be of various sorts. Bequests to heirs may be for altruistic reasons, or simply because they yield some warm feeling to donors (so-called joy-of-giving). In these cases, bequests apparently yield benefits both to donors and to recipients, the consequences of which we return to below. Bequests may instead be given to satisfy social or ethical norms, in which case the benefit to donors is less obvious. Finally, bequests may be a form of exchange for services, such as a payment in return for care given or other forms of behavior by the recipient. These so-called strategic bequests are like purchases of services although not at arms-length on the market. In practice, bequests may be a mixture of these motives, and it will not be possible for third parties, including the government, to observe the reason, although unintentional bequests can be ruled out if they are made before death.

Taxes on wealth and wealth transfers can take different forms. Wealth transfer taxes can apply to the estate or on inheritances in the hands of the recipients. Indirect taxes can also apply on the change of ownership of wealth, whether voluntary transfers (probate taxes) or sales of wealth (financial transactions taxes). Transfers of wealth can also trigger changes in personal or corporate taxes, such as deductions for charitable and other donations. Wealth itself can be taxed periodically, either on individuals at personalized rates or more anonymously as in the case of property taxes on real estate. There can also be taxes levied on changes in the value of assets (capital gains taxes), though typically when the change in value is realized via asset sale rather than when it accrues.

In what follows, we focus mainly on the direct taxation of voluntary transfers of wealth to persons (e.g., heirs). Some similar issues arise with transfers to charities and non-profit organizations (Diamond, 2006). To put the principles of wealth transfer taxation into some perspective, it is useful to recount the evolution of tax ideas over the past several decades.

4.2.3. The Evolution of Tax Policy Principles

The fundamental normative ideas on which tax policy thinking has drawn have changed remarkably over the past six decades. This is reflected in the academic literature, in various tax reform commissions, and on tax practices. Some of the evolution has responded to the economic forces of the real world, such as globalization, the information and technological revolutions, growing inequality, and changes in labour market behavior. New directions in public economics scholarship have also been influential. Examples include the optimal tax revolution, behavioral economics and new directions in welfare economics. This evolution is very relevant for the way wealth transfer taxation is approached.

Prior to the 1970s, the accepted wisdom was that taxation should be based on the taxpayer's ability to pay, which represented the command over resources. Ideally, this translated into using comprehensive income as the tax base, a prescription associated with the names Shantz (1896), Haig (1921), Simons (1838) and Musgrave (1959) and enunciated in policy terms by the Royal Commission on the Taxation of Profits and Income (1955) in the U.K. and the Royal Commission on Taxation (1966) — the Carter Report — in Canada. Comprehensive income was a broad concept that included income from all sources, presumably including inheritances. Of importance is that no regard was given to how the income is used or of the efficiency consequences of treating all sources the same. What counted were the resources the taxpayer had at his disposal.

The rate structure was to be based on the concept of equal sacrifice, whose origins seem to be the classical utilitarians such as Edgeworth (1897). It is important to note that equal sacrifice depended on where taxpayers started out, as opposed to modern utilitarianism, which judges tax policy outcomes solely on where individuals end up. The notion of horizontal equity is a natural consequence of the equal sacrifice doctrine.

Kaldor (1955) refined the comprehensive income tax approach to include only the income that was used for consumption. In effect, the command-over-resources was reduced to the exercise of that command through consumption ("what one took from the social pot rather than what one contributed"). The implications of this for tax design were set out in the Meade Report (1978) in the UK and the U.S. Treasury Blueprints (1977) in the USA. Proponents of progressive consumption or expenditure taxation augmented Kaldor's equity argument with efficiency arguments for avoiding the double taxation of saving and, importantly, by arguments of administrative ease based on the recognition that comprehensive income was impossible to measure and that there were good reasons for encouraging saving. The Meade Report also argued for taxing wealth transfers using a progressive lifetime accessions tax, though oddly it did not base its arguments on consumption tax principles.

Current thinking about tax policy is dominated by the welfarist approach inspired by the optimal tax literature emanating from Mirrlees (1971), Atkinson and Stiglitz (1976) and Diamond (1980). The welfarist approach conceives of tax design being based on the maximization of a social welfare function that aggregates welfare or utility achieved by all taxpayers. In this approach, the preferences of taxpayers and the choices they make take centre stage, and one's tax liability is based on the utility one achieves. This leads to prescriptions about how to tax labour and capital income, and how to tax different consumption choices. It also leads to views about how progressive the tax should be, and pays particular emphasis on the effects of taxation on various margins of choice, such as intensive and extensive labour supply margins.

The Mirrlees Review (2011) represents the nadir of the optimal tax approach. It draws on an impressive body of empirical and theoretical research to make recommendations for tax reform that, although written in a UK context, are broadly applicable. Interestingly, the broad policy prescription is similar to the Meade Report, albeit explicitly based on welfarist reasoning. At the personal level, it calls for a form of progressive consumption taxation. This is to be supplemented by cash-flow-equivalent business taxation (the ACE) and uniform VAT. As well, the transfer system is to be coordinated with the direct tax system so as to take due account of participation choices. Finally, as in the Meade Report, a progressive recipient-based lifetime inheritance tax is recommended for reasons that we return to below.

The upshot of this review is that well-developed theories have emerged for the taxation of earnings, capital income and, consumption based on individual preferences. As well, views on the design of business taxation have evolved with those of personal taxation. The corporate tax was regarded as a withholding device for the personal income tax, taxing shareholder income at source to preclude shareholders from postponing tax by retaining profits tax-free within the corporation and only paying tax when dividends were received or capital gains realized. Under a personal consumption tax, withholding is not necessary. Instead, business tax design has emphasized its role in taxing rents, which can be roughly achieved by a cash-flow tax as recommended by the Meade Report or an equivalent tax like the ACE favored by the Mirrlees Review or the RRT as proposed by the Henry Review (2010) in Australia for mining firms.

However, an agreed on theory of wealth transfer taxation remains elusive. Before turning to that it is worth recounting some general problems with the welfarist approach to tax design that have motivated tax specialists to search for other principles.

The welfarist approach is attractive because it relies on individual preferences, and as a consequence it satisfies the widely accepted Pareto principle. But the aggregation of those preferences is a challenge. Indices of utility must be made measurable and comparable across persons. This is particularly challenging when persons differ in preferences: how do you compare two persons who earn the same income, but one is more productive but lazier than the other? Approaches that emphasize the command over resources sidestep this problem.

Relying on individual preferences can also cause difficulties. Individuals may take choices that are not in their long-term interest because of self-control problems or simply because decision-making may be complicated and time-consuming (Congdon *et al.*, 2011). They may also do things out of social or moral obligation rather than self-interest. Moreover some manifestations of individual preferences may be discounted for social purposes,

and this goes against the welfarist spirit. For example, decisions motivated by altruism or avarice may not count as contributing to social welfare. This turns out to be relevant in thinking about the tax treatment of wealth transfers.

Finally, welfarism judges social outcomes solely on the basis of where individuals end up. Where they start is inconsequential. Some object that this consequentialism denies the property rights of individuals, including rights to their own productive skills (Nozick, 1974; Feldstein, 2012).

Partly in response to these criticisms, other approaches to tax design have been developed, particularly those that recall the command over resources perspective. Prominent among them have been approaches that attach weight to equality of opportunity, often as a complement to utilitarianism (Roemer, 1998; Fleurbaey and Maniquet, 2011). Equality of opportunity emphasizes providing persons with comparable amounts of resources to use as they see fit, and does not reward or punish according to decisions taken. It responds to the observation that persons have heterogeneous preferences, and typically takes the view that persons are largely responsible for their choices. They should only be compensated for things over which they have no control, like their innate abilities or socioeconomic backgrounds. Other scholars take aim at the consequentialism of welfarist tax theory and argue for giving some weight to pre-tax allocations, harkening back to equal sacrifice and horizontal equity doctrines (Weinzierl, 2014).

With this background in mind, we now turn to the implications for bequest taxation. We begin with the welfarist approach to bequest taxation since it has been prominent in the recent literature.

4.2.4. The Welfarist Approach to Bequest Taxation

Recent literature on bequest taxation has adopted the welfarist approach, following the optimal taxation perspective (Kaplow, 2001; Cremer-Pestieau, 2006; Farhi-Werning, 2013; Kopczuk, 2013; Piketty and Saez, 2013). According to this approach, voluntary bequests are equivalent to consumption choices by donors, and by revealed preference, give welfare to the donors. This has a number of consequences.

From the point of view of the donor, bequests should not be treated preferentially relative to other items of consumption. Thus, if preferences are weakly separable between goods and labour, the Atkinson-Stiglitz (1976) theorem applies so uniform taxation should be applied to all consumption goods, including bequests. Indeed, the VAT should apply to bequests as well.

Next, bequests give benefits to the recipients as well as donors. This has two implications. First, since donors take account only of their own utility from the bequest, the benefit to recipients constitutes an externality that calls for a subsidy on donors. Second, inheritances that recipients receive should be treated like any other source of income for tax purposes.

This simple message of subsidizing the donors' bequests and taxing recipients' inheritances is more nuanced when other considerations are taken into account. A case can be made for taxing inheritances separately from other income if different efficiency conditions apply or if it is more difficult to administer an inheritance tax, because of tax planning, *inter vivos* and in-kind transfers, and so on. In the case of linear inheritance taxes, it makes little difference if the tax applies on recipients or donors. If imperfect information makes it difficult to deploy the optimal nonlinear inheritance tax based on recipients' incomes, an option might be for the tax rate to increase in the size of bequest.

More fundamentally, the welfarist approach to bequest taxation faces a persuasive objection in principle: should the benefits of bequests be double-counted? A number of objections to double-counting have been expressed (Hammond, 1987). If benefits of both donors and recipients counted, other forms of interdependent utility should also count, and that would be virtually impossible. For example, transfers within families can generate multiple benefits: the benefits to the donor are likely shared by other family members so should count as well. As well, if government transfers to low-income persons are viewed as being done on behalf of high-income taxpayers, these should be double-counted as well. Perhaps more fancifully, saving for one's future self provides altruistic benefits to the saver as well as benefits later in life when the fruits of the saving are consumed. On the other hand, not all wealth transfers give benefit to the donor. The case of unintentional bequests is a case in

point. But, even intentional bequests may be given out of a sense of duty or social obligation, so they do not contribute to the donor's utility. They are given despite that fact that the donor is made worse off.

For these kinds of reason, many observers reject the welfarist approach, including Mirrlees himself (Mirrlees, 2007 and 2011). We turn now to two alternatives.

4.2.5. Alternatives to the Welfarist Approach

No wealth transfer tax in practice conforms to the design recommended by the welfarist approach. We present two alternatives that have their approximate counterparts in actual bequest tax systems. One abides by the welfarist methodology but eschews double-counting, while the other takes an equality of opportunity perspective.

Restricted Welfarism

This approach restricts welfarism by not counting the utility of the bequest to the donor. Instead, it treats a voluntary bequest as a transfer of income from the donor to the recipient that reduces the welfare of the donor while enhancing that of the recipient. This calls for a deduction of bequests from the donor's taxable income and the inclusion of the inheritance in the recipient's income. Approximately the same result can be achieved by simply ignoring bequests in the tax system, as some countries do. The two treatments would be equivalent under a linear inheritance tax system.

Giving a tax deduction for bequests leads to differential taxation of donors and non-donors, and in that regard it is similar to the usual tax treatment for charitable donations. The externality still applies since the donor does not take account of the recipient's welfare gain except as it affects the donor. This means that in principle bequests should not only be deductible but also subsidized. Accidental bequests should be credited as well, although there is a conceptual issue of how to credit donors for bequests made on death.

Equality of Opportunity

This approach emphasizes a taxpayer's command over resources and does not penalize or reward differences in bequest behaviour. It corresponds with what has been recommended by both the Meade Report (1978) and the Mirrlees Review (2011), and is similar to the case where countries tax inheritances in the hands of recipients. Inheritances are regarded as windfall gains to recipients, while at the same time leading to no consequences for donors. There is no case for subsidizing bequests by donors, although the tax rate on inheritances could be tempered by incentive effects. In addition, account might in principle be taken of the fact that bequests should be subject to the VAT, although it is not clear how that could practically be achieved. The tax rate on inheritances could be progressive and applied to cumulative inheritances over the lifetime.

An additional consideration favouring progressive taxation of inheritances is that the size of bequests could be correlated with rents received as capital income by donors. This assumes importance to the extent that rents are under-taxed in the personal and corporate income tax systems, which under current regimes is likely to be the case.

The upshot of this discussion is that a major problem with designing a tax on bequests is coming to agreement on normative basis for such a tax. Existing bequest/inheritance tax systems most closely approximate equality-of-opportunity approach. In addition to the standard argument for taxing inheritances as windfall gains to recipients is the fact that an inheritance tax might capture rents or super-normal returns that would otherwise go untaxed in the income tax system. To the extent that this is true it lends support to relatively high rates of inheritance tax for large estates. Of course, this must be tempered to the extent that super-normal returns are actually returns to risk-taking, although it would be practically impossible to distinguish the two. Countries that have no inheritance tax implicitly opt for the restricted welfarism approach. Note that the equality-of-opportunity approach to bequest taxation, like the welfarist approach, leads to multiple taxation of bequest when they are passed from generation to generation.

4.2.6. Design Issues

Regardless of the normative approach adopted — welfarist, restricted welfarist, equality of opportunity — there are a number of design issues that arise in going from principles to practice. These issues are taken up in this section.

The Taxpayer and the Base

All the normative approaches support a tax on recipients based on cumulative lifetime receipts, that is, a residence-based inheritance tax. This is especially true when a bequest is divided among multiple recipients. A donor-based tax would be equivalent only if the tax were proportional and without an exemption. Tax implications for donors become relevant under welfarism approaches, restricted or otherwise. In these cases, a subsidy on bequests is called for on efficiency grounds, and in principle the VAT should apply. In the restricted welfarism case, donors should receive a deduction for bequests, although a similar effect can be achieved simply by having no tax on wealth transfers in the first place.

A residence-based lifetime inheritance tax encourages the splitting of estates among heirs, although a donor-based tax could achieve similar outcome. As well, a recipient tax would capture inheritances received from abroad, and would exempt bequests sent abroad, as is consistent with a residence base. In practice, residence systems are not universally applied. They are used in Ireland and in several civil-law countries with forced heirship rules. Donor-based systems apply in many other countries, including the UK and the USA. Other countries, like Canada and New Zealand, choose not to tax bequests, although in the Canadian case that is more a consequence of having decentralized inheritance taxation to the provinces rather than a matter of principle.

An important issue is the treatment of *inter vivos* transfers relative to transfers at death. From an equity point of view, there should be no real distinction: both represent wealth transfers from donors to recipients. However, the efficiency effects can differ since taxing unintentional bequests should not affect the behavior of donors. To the extent that transfers at death are more likely to be unintentional, a higher tax rate will do less to discourage saving for bequest. This might be reinforced by the fact that wealth held until death for purposes other than bequests can yield utility to the wealth holder, such as prestige or influence. At the same time, if *inter vivos* transfers are taxed at a lower rate, there is an incentive to make transfers before death to avoid taxes. For that reason, preferential treatment of *inter vivos* transfers is sometimes restricted to transfers that are made some minimum number of years before death. There can also be administrative problems with monitoring *inter vivos* transfers, especially when they tax the form of in-kind transfers.

The Rate Structure

A different rate structure is virtually always applied to bequests or inheritances than to personal income. The lumpiness of inheritances would be a problem for including them as income in the absence of income averaging. Moreover, there are arguments on both efficiency and equity grounds for taxing inheritances separately from income. Income taxes impinge directly on both labour supply and saving for life-cycle smoothing, whereas inheritance taxes affect bequest decisions — both the choice of size of bequest and the decision to make cash versus in-kind transfers at death or *inter vivos* — where efficiency effects might be much less.

On equity grounds, part of the purpose of inheritance taxation may be to break up large estates as well as to get at estates that include a substantial component of rents that might have gone untaxed in the corporate or personal tax systems. As well, in principle, the taxation of inheritances under welfarism should implicitly include a VAT component attributable to the donor.

These considerations usually lead to inheritance tax systems that are largely design to get at large estates. There will be a significant exemption level accompanied by piecewise linear tax rates with top rates that can be quite high. Piecewise linear tax rates mitigate the possibility of high marginal tax rates under linear progressive taxation.

The system is complicated if the base includes cumulative lifetime transfers since these can occur over long periods of time. Not only must the path of inheritances be recorded, but things become conceptually problematic if inheritance tax rates change over time.

Special Treatment

Some types of bequests call for special treatment. Bequests left to spouses or civil partners are typically exempt and become taxable only when eventually left to other heirs or persons. This is reasonable since no new opportunities are created for spouses, who were presumably already sharing the benefits of the wealth accumulated. There is no point in double taxing transfers that go first to spouses and then subsequently to other heirs. This is consistent with many income tax systems that provide special treatment for family income. However, those that are strictly based on individual income will not allow transfers of capital assets within the family in order to reduce income tax liability. At the same time, there is no case for treating bequests left to heirs any different than those left to non-heirs. Both create opportunities for welfare improvement of the recipients.

Exemption may also be granted to bequests left to charities and non-profit organizations. Indeed, charitable donations of assets may be further encouraged by exempting capital gains that have accumulated from personal taxation. We return to the interaction between capital gains and inheritance taxation below.

Trusts pose difficult problems for inheritance taxation. Wealth held in trust for heirs differ from bequests in the sense that they blur the definition of asset ownership: heirs have limited control over trust assets, although they can benefit from payments made from them. Inheritance taxes usually "see through" trusts to their effective owners, that is, those who receive interest payments from them. Further problems arise if trusts are held for more than one generation of heirs. Sometimes trusts are taxed every so many years at low rate on their capital value, as if they changed hands. This is obviously imperfect.

A substantial share of wealth held by lower and middle income households is housing. This tends to be passed on despite the possibility of running down housing equity in retirement while continuing to own and occupy the house. Thus, at least some proportion of housing bequests are likely unintentional. While housing is often afforded special treatment in the income tax system (e.g., exemption of capital gains and imputed rent), it is usually taxable as a bequest or inheritance. It is hard to avoid by moving offshore and transferring ownership while retaining residency can be precluded by tax rules. In some countries, the escalation of house prices has made an increasing number of taxpayers liable for bequest or inheritance taxation. Indeed, on this account the fairness of the tax has been compromised since wealthier taxpayers who hold their assets in financial form are better able to avoid taxation by *inter vivos* transfers, trusts or holding assets offshore.

Taxing housing bequests raises some problems. Despite the special treatment of housing under the income tax, it is often liable to annual property taxation, which can be substantial over a taxpayer's lifetime (though part of this might be viewed as a payment for local public services). Establishing the value of housing that is transferred to heirs may not be easy. As well, requiring heirs to pay taxes on the housing can give rise to liquidity problems if the heirs choose not to sell the house. For that reason, special provisions are often added such as the smoothing of tax payments over time with interest as in the UK or the deferral of tax liabilities if heirs continue to occupy the house.

Family farms and businesses are often exempt from inheritance taxation, usually to foster family businesses for social or political reasons. On economic grounds, this could be a costly policy apart from the tax revenue foregone. Family businesses may be encouraged to stay intact even though it would be more efficient to sell them or allow them to wind up. In fact, this way of protecting family businesses may be prone to abuse as inheritors may sell the firm or farm after receiving it as an inheritance. The government can respond by requiring that the property be held by the inheritor or some minimum period. In any case, it is questionable whether exempting family farms and businesses from inheritance taxation is a reasonable policy.

Some forms of transfers to heirs escape taxation because they are difficult to measure or enforce. In-kind transfers are an example of this. Perhaps more important are education, health, and other services provided by parents to children, which are important in enhancing children's lifetime opportunity. Advantages obtained by children who come from families of higher socioeconomic status are better addressed by the progressive income tax system, and need not detract from the role of inheritance tax in addressing opportunities that arise from inherited wealth.

Some Technicalities

There are many other detailed problems of designing and administering a tax as complicated as an inheritance tax. We touch on a few of them here. One is the incentive to skip generations to reduce the repetitive tax liability. At first sight, skipping generations poses no problems on normative grounds whether one takes a welfarist or an equality of opportunity view. What counts is the benefit created for the recipient whoever that may be. However, one could argue that the multiple taxation of bequests, passed on through the generations, is a problem in its own right. If recipients choose not to use the inheritance but instead pass it onto their heirs, no benefit is created and in principle the inheritance should only be taxed when it is used for a recipient's advantage. This could be accommodated in an inheritance tax system by allowing recipients to sequester their inheritances in an account that goes untaxed as long as it is not drawn on. This would add to the complexity of the system while making it fairer.

Next, the relation between inheritance and capital gains taxation has been a concern. In principle, the two taxes are independent: the taxation of capital gains is an element of the personal tax system that is distinct from inheritance taxation. But, tax policy discussion sometimes treats the deemed realization of transfers of wealth as a substitute for inheritance tax. There is no good reason for this. While it may be the case that inheritance tax applies on the deemed value of assets that are transferred at death, this should not affect the way the personal income tax system taxes capital gains. If capital gains are deemed to be realized at death, that should trigger capital gain tax on the estate. If deemed realization does not apply, the base value should be carried forward until the capital gain is eventually realized by whichever generation. It seems improper to rebase asset values when wealth transfers are made without any capital gains tax having been paid.

A final technical issue involves the relevance of residency and emigration. As mentioned, the inheritance tax — like the personal income tax — should be based on residency. Bequests from residents to non-residents should be tax-exempt, while inheritances received from abroad should be taxable. Applying these principles can be difficult. Since residency is a taxpayer's choice, it could be possible to escape inheritance tax by renouncing residency and moving abroad. To deter things, countries can require some minimum period abroad before liability is eliminated. Problems can also arise when non-citizens live in a country but retain residency abroad for tax purposes so escape taxation on inheritances. Resident taxpayers may also choose to hold some of their wealth abroad, including in offshore companies or trusts, to avoid or evade taxes when the assets are left to resident heirs. The fact that wealthier individuals are better able to do this than those whose wealth consists largely of housing and pensions contributes to the perception that the tax is unfair. In the absence of international tax treaties governing international wealth transfers, it is practically difficult to enforce inheritance tax perfectly.

4.2.7. Conclusions

In this brief paper, we have reviewed the issues that arise in taxing bequests, as well as some of the design and enforcement issues. We have not been able to do justice to a tax that is inherently controversial and complex, and difficult to enforce in an international setting. Even the rationale for taxing wealth transfers raises challenging normative issues. We have outlined the standard welfarist approach that gives due weight to the welfare effects on both donors and non-donors when transfers are voluntary. In this case, a tax on cumulative inheritances received by heirs is called for with no credit to donors. On the contrary, bequests should be subsidized to account for the double benefit of voluntary bequests.

We recounted some conceptual difficulties with the welfarist approach, in particular with double counting bequests and suggested two alternatives. The restricted welfarist approach does not count the welfare of the bequest to the donor, so differs from a welfarist based tax system by offering the donors a tax deduction for bequests. This is roughly equivalent to choosing not to deploy a tax on bequests or inheritances. In principle, the argument for subsidizing bequests still applies.

The equality of opportunity approach takes account of the fact that bequest behaviour is heterogeneous. Following the equality of opportunity literature, it argues that persons should be compensated for disadvantages over which they have control, but should be neither rewarded nor penalized for outcomes that they freely

choose. To the extent that bequest behavior is a matter of choice but inheritances are not, bequests should have no tax consequences for donors, but should be taxed in the hands of recipients.

These principles lead directly to policy recommendations. Common to all approaches is the desire to tax cumulative inheritances in the hands of heirs (unless bequest taxes are simply ignored) on a residence basis. Detailed design issues include what types of transfers should be taxed and what, if any, should be exempt. In addition, the rate structure must be chosen, presuming it is separate from the income tax. We have briefly outlined some of these issues that arise in applying these principles. Much work remains to be done, especially with regard to international coordination.

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4.3. HOUSING: TAX PRESSURE IN EU AND ITS DRIVERS

by *Serena Fatica**

4.3.1. Introduction

The main residence is usually the most significant asset held by households, both at the extensive and at the intensive margin. This makes a discussion on housing taxation compelling in a forum dealing with wealth taxes.

A house is both consumption good and an asset, and should be taxed accordingly, in a consistent way with the design of the whole tax system. In this respect, a guiding principle is to be found in tax neutrality (Mirrlees *et al.*, 2011). In simple words, the neutrality principle builds upon the notion that tax-induced misallocation of resources – both in an inter-temporal and in a cross-sectional perspective, by discriminating among assets, income sources, types of return – should be avoided. A corollary of this is that exemptions and relief creating deviations from neutrality should be limited, unless they are justified on other economic and/or social grounds.

The specific design of housing taxes is made complex by the fact that a house is at the same time the source of a flow of services and a capital asset for homeowners. Both aspects are relevant to taxation and would call for a rather different tax treatment. This distinction has important consequences for tax design. Taxing the consumption value of housing entails imposing a tax on the flow of housing services consumed. This could be efficiently done via a recurrent property tax, which has the additional merit to circumvent some shortcomings stemming from application of VAT to housing.

Taxing housing as an asset implies that taxation can take place at several instances. First, the net income flows from the housing investment might be taxed. This can be realised through a tax on the net return, i.e. the rental income net of the costs incurred to acquire it, and/or through a capital gain tax, which taxes the increase in asset value, usually upon realisation. Alternatively, taxes can be imposed on the stock value of the asset. Further, the sale and the purchase of the asset could be subject to a transaction tax. Finally, *inter vivos* donations and bequests can also be taxed.

In practice, taxation of owner-occupied housing varies significantly across the EU, in terms of both institutional arrangements and budgetary outcomes (European Commission, 2014). Some common features can nonetheless be easily identified: i) the level of recurrent taxes is fairly low, also due to the fact that the tax base is often calculated on outdated cadastral values; ii) imputed rent – i.e. the rental income homeowners implicitly benefit from by owning their residence – is tax exempt; iii) tax relief – in the form of credit or deduction – is granted to mortgage interest payments; iv) there are transfer taxes, sometimes levied at high statutory rates.

4.3.2. Tax pressure on owner-occupied housing

The tax pressure on owner-occupied housing can be gauged using an indicator of the user cost of investing one additional euro in housing capital, based on the established literature which models homeownership as an investment decision in the neoclassical framework (Poterba, 1984).²¹ The user cost conflates a number of elements that add up to the unit cost of owning and operating the main residence. These are economic and financial costs (e.g., economic depreciation, maintenance, the foregone interest earnings of the equity in the house, the expected nominal revaluation of the asset), but also, importantly, costs (and cost reductions) stemming from the different taxes applicable to the property. As discussed above, the recurrent property tax, the

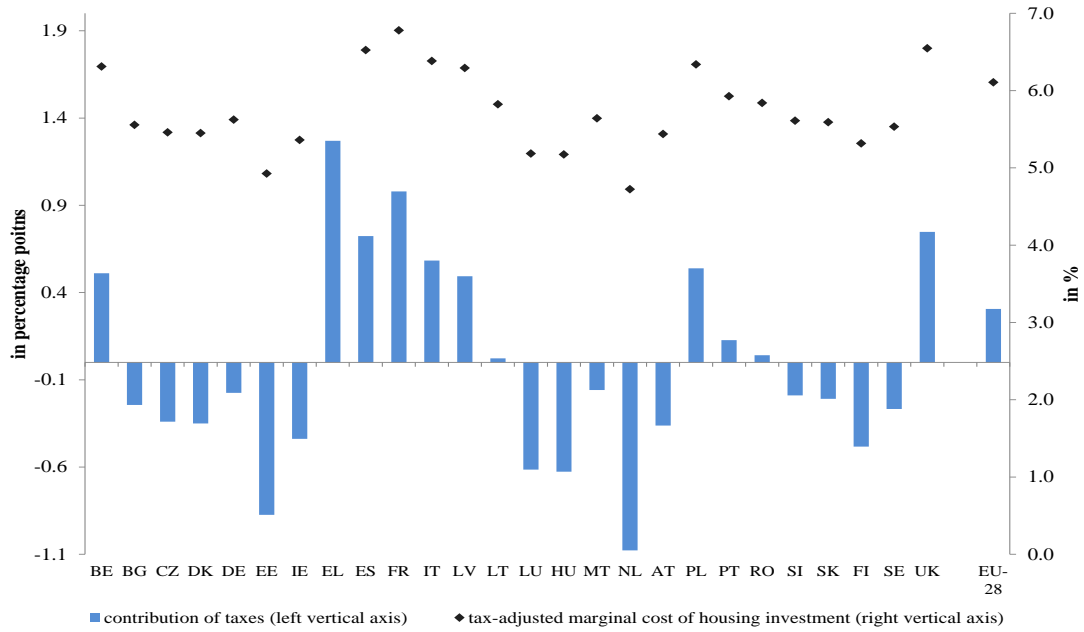
* Serena Fatica is Economic Analyst of the Unit C3 "Revenue Management and Tax Policy Issues" in the Directorate General for Economic and Financial Affairs - DG ECFIN - of the European Commission.

²¹ The indicator has been used in several studies to assess the size of housing tax expenditure in the US. See, for instance, Poterba (1992) and Poterba and Sinai (2008).

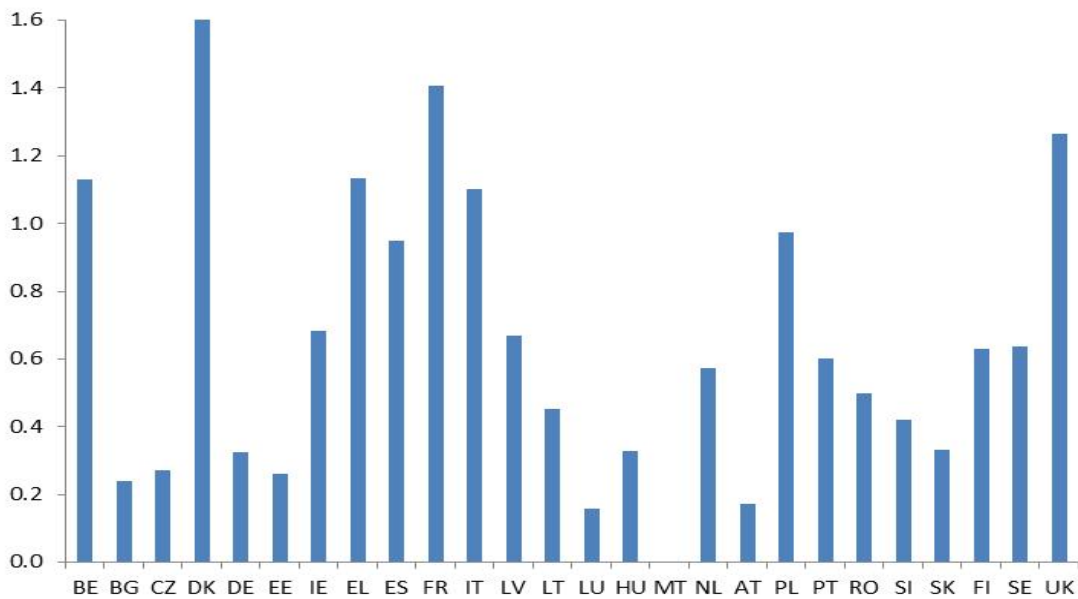
transaction tax and the capital gain tax – whenever applicable – contribute positively to the user cost, which is derived under the assumption that imputed rent be tax exempt. By contrast, the tax relief for mortgage interest payments reduces the user cost.²²

Figure 1: user cost of owner-occupied housing and contribution of taxes

a) User cost and contribution of taxes

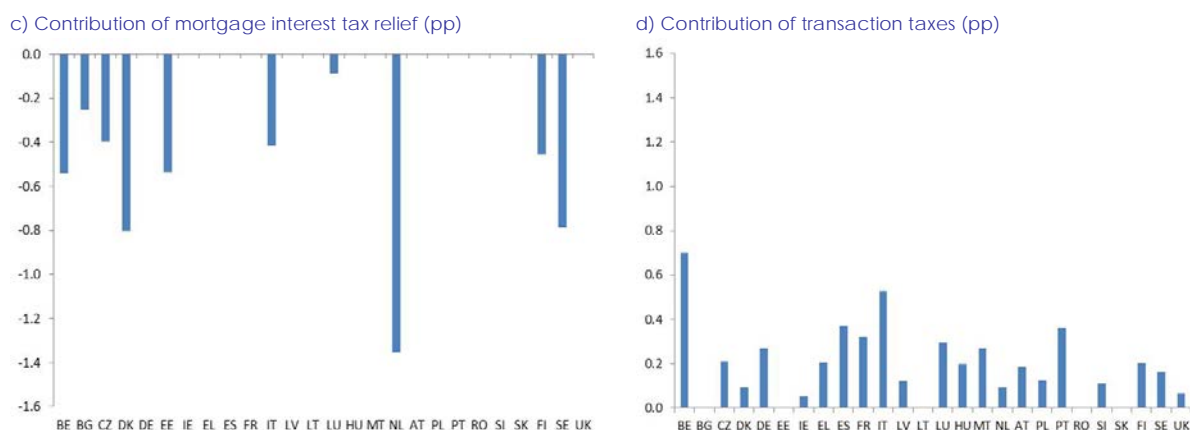


b) Contribution of recurrent property taxes (pp)



Source: Commission services

²² So does the tax rate applicable to interest income, because it proportionally reduces the after-tax opportunity cost of housing equity.



Source: Commission services

Panel *a*) in Figure 1 depicts the level of the tax-adjusted cost associated with an additional euro invested in housing capital, alongside the contribution of taxes, obtained as the difference between the tax-adjusted cost and the same marginal cost calculated setting all the tax parameters to zero.²³ The Netherlands, Estonia, Hungary, Luxembourg and, to a lesser extent, Finland, Ireland and Austria are the countries where the marginal cost of housing investment is relatively low (in the bottom quartile of the distribution). By contrast, the upper quartile comprises Belgium, Poland, Italy, Spain, the United Kingdom, France and Greece. The size of the deviations from this no-tax benchmark varies significantly across countries, hovering at around one-fifth of the benchmark at the extreme points of the distribution.

The contribution of selected housing-related taxes is singled out in panels *b*), *c*), and *d*) of figure 2. Recurrent housing taxes raise the marginal cost on average by 0.7 pp. In line with relative revenue from recurrent property taxes, the increases are particularly marked in Denmark, France, the UK, Greece, Italy and Belgium (*panel b*). By contrast, the contribution of taxes on the stock of housing is the lowest in Malta, Luxembourg, Austria, Bulgaria, Estonia and the Czech Republic. The impact of the tax relief for mortgage interest payments is shown in panel *c*). The marginal cost of housing decreases by 0.6 pp on average for the countries currently offering relief to new mortgage contracts. With its very generous subsidy, twice as large as the conditional average, the Netherlands is clearly an outlier. By contrast, on the low side, in Luxembourg the tax subsidy accounts for only 0.1 pp of the tax-adjusted marginal cost of the investment. The effects of transfer taxes are shown in panel *d*). The average contribution of those levies, calculated over the countries where housing transactions are taxed, is slightly above 0.2 pp. Comparing this level with the contributions from other tax rules might be partly misleading when it comes to drawing conclusions on the potential (dis)incentive effect of the different tax instruments, as the taxed occurrence is not the same. Clearly, transfer taxes are applied one-off upon acquisition of the property, and thus naturally differ from taxes and reliefs pertaining to the ownership of the property. When it comes to the country-specific results, the upper range comprises France, Portugal, Spain, Italy and Belgium, reflecting the high level of the statutory rates. A limited contribution to the user cost of investment is instead recorded in Ireland, the UK, the Netherlands and Denmark.

4.3.3. Distributional impacts

Housing-related taxation might have important distributional impacts. In order to gauge these, it is essential to move away from the representative agent framework utilised for the user cost analysis and get into actual data.

²³ The indicator is built for a stylised taxpayer, i.e., single, without children, earning 167 % of the AW in the manufacturing sector, who buys an existing dwelling worth four times his annual earnings. More details and the methodological background on the indicator are provided in Annex 1, and also in European Commission (2014), Tax reforms in EU Member States: Tax policy challenges for economic growth and fiscal sustainability (No. 6). European Economy, Directorate General for Economic and Financial Affairs.

Based on the EU-wide microsimulation model EUROMOD, results on the effect of recurrent property taxes and mortgage interest tax relief across households in selected Member States are presented.²⁴

These results presented in Table 1 suggest that recurrent property taxes have a relatively neutral impact across income categories in Germany and Finland, in addition to their relatively low size. In France, the effect of such taxes tends to be progressive until middle-range income and regressive afterwards for richer households compared to the middle quintiles. In the other countries considered, particularly Spain and the UK, property taxes appear to be generally regressive. These tax liabilities represent 3.3 % and 6.6 % of the gross disposable income of the poorest quintile in Spain and the UK respectively. By contrast, households in the top income quintile disburse roughly 1 % of their gross disposable income for property taxes in these two countries.

Table 1: recurrent property taxes in % of household gross disposable by income quintile in selected countries

	quintile 1	quintile 2	quintile 3	quintile 4	quintile 5	Total
France	1.8	2.3	2.8	2.5	2.2	2.3
Spain	3.3	2.4	1.7	1.2	0.9	1.6
UK	6.6	3.1	2.6	1.8	1.0	2.9
Germany	0.3	0.3	0.3	0.3	0.3	0.3
Finland	0.3	0.2	0.2	0.2	0.2	0.2
Italy	1.0	0.6	0.4	0.4	0.3	0.8
Belgium	1.2	0.9	0.6	0.5	0.4	0.8

Source: European Commission, Joint Research Centre, based on the EUROMOD model

Table 2 provides similar evidence for the mortgage interest tax relief.²⁵ This tax benefit appears regressive in the Belgian and Spanish cases. In Belgium, the deduction amounts to more than 2 % of the net disposable income for the top two quintiles. In Spain, the impacts of the tax credit on disposable income also differ significantly between the richest quintile (0.9 %) and the poorest ones (0.1 %). In France, Finland and Italy, these policies also seem to have regressive effects although their overall size appears relatively low compared to household disposable income.

Table 2: mortgage interest tax relief in % of household net disposable by income quintile in selected countries

	quintile 1	quintile 2	quintile 3	quintile 4	quintile 5	Total
Belgium	0.2	0.8	1.7	2.3	2.0	1.3
Finland	0.1	0.2	0.4	0.4	0.4	0.3
France	0.0	0.1	0.1	0.3	0.3	0.2
Italy	0.1	0.2	0.2	0.3	0.2	0.2
Spain	0.0	0.2	0.6	0.9	0.9	0.5

Source: European Commission, Joint Research Centre, based on the EUROMOD model

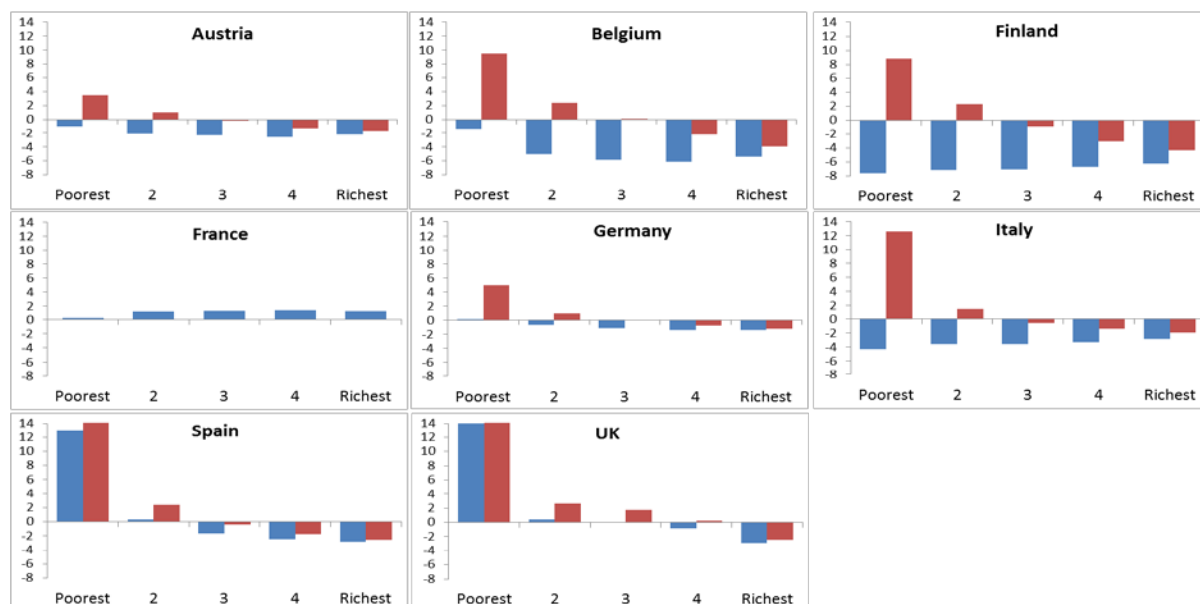
Finally, it is worth mentioning avenues through which reforms to housing taxation could be used to improve the efficiency of the whole tax system, while minimising the potential adverse distributional impacts. Figure 6 illustrates the hypothetical case of taxing net imputed rent under the (progressive) personal income tax scale (while repealing mortgage interest tax relief and recurrent property tax) alongside the introduction of a refundable tax credit for low income earners (i.e. individuals with employment or self-employment income up to the 25th percentile of the earnings distribution). The changes in disposable income due to taxation of imputed rent are depicted by the blue bars, while the effect of the tax credit is given by the blue bars. Leaving aside a detailed illustration of country-specific results (driven also by the incidence of the recurrent property tax and

²⁴ The countries have been selected on the basis of a recent study by the European Commission (Joint Research Centre- JRC). See Verbist *et al.* (2014).

²⁵ In the case of France, the results refer to the stock of mortgages benefitting from the tax credit in place until 2010. The relief was abolished then with a grandfathering clause.

mortgage interest relief), this theoretical exercise illustrates that it is possible to implement a revenue-neutral tax policy mix which realises efficiency gains for the system while preserving equity.

Figure 3: a hypothetical tax shift from labour to housing



Note: blue bars depict the % change in household disposable income following taxation of net imputed rent (and repeal of mortgage interest tax relief and recurrent property tax). Red bars depict the % change in household disposable income from the introduction of a refundable income tax credit targeted to low income earners.

Source: European Commission, Joint Research Centre, based on the EUROMOD model

4.3.4. Conclusions

There is a large degree of heterogeneity in housing taxation arrangements across the EU, both in terms of tax code provisions and in terms of ultimate budgetary impacts. A common denominator can however be found in the relatively low contribution of taxes to the cost of homeownership. This is the combined result of a number of tax provisions, namely the tax exemption for imputed rent, the relief for mortgage interest payments, the low level of recurrent taxation and the fact that capital gains taxation is *de facto* strictly conditioned. All these aspects raise issues in terms of efficiency – as suggested from the application of the tax neutrality principle – and equity.

As a final caveat, it should be kept in mind that taxation as a demand-side policy can create significant spillovers, both in the housing market and beyond. In this respect, the broader economic and institutional context – particularly when it comes to macro-prudential policy and regulation –, is not to be overlooked when housing tax reforms are discussed.

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4.4 CHALLENGES OF TAXING FINANCIAL WEALTH

by Gabriel Zucman*

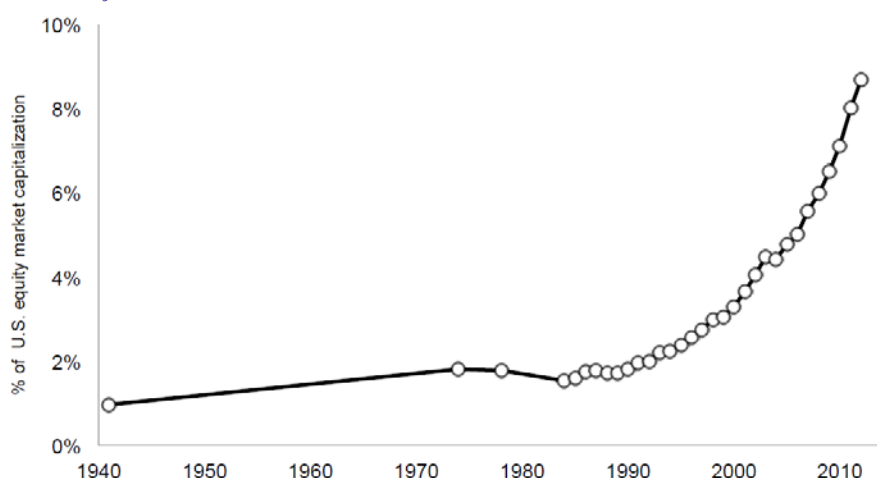
4.4.1. Introduction

This contribution discusses the challenges related to taxing financial wealth, focusing on tax evasion and avoidance and possible ways to address these challenges. First, it considers the issue of financial wealth held in offshore tax havens (Zucman, 2013), looking into its nature (either declared or undeclared) and its evolution over time. Subsequently, it turns to tax avoidance by multinational companies. Tax avoidance is severely eroding the corporate tax base (Zucman, 2014). Analysis shows that, largely because of profit shifting to offshore tax havens, the effective corporate tax rate of US firms declined from 30 % in the late 1990s to currently 20 %. This implies an overall loss of revenues for the government in the order of 200 billion dollar per year. Fortunately, there are concrete solutions, which are the subject of the final element of this contribution. Solutions include well-defined sanctions and penalties, on the one hand, and a financial registry on the other hand. Such measures serve not only to improve the enforcement of taxes on wealth but also to make progress on a number of financial regulation issues.

4.4.2. Offshore private wealth

As shown in Figure 1, a rapidly growing fraction of wealth is managed by offshore financial institutions. Most activity in offshore centres is legal and legitimate: investment funds, shadow banking, treasury management and personal wealth management.

Figure 1: US equities held by tax haven firms and individuals



Note: in 2012, 9 % of the US listed equity market capitalization was held by tax haven investors

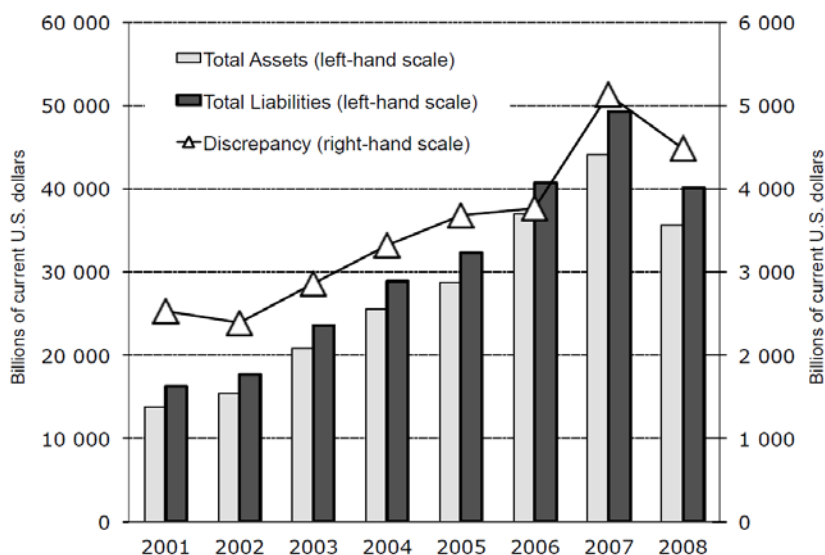
Source: author's computations using US TIC data.

Some offshore centres, institutions and instruments however also facilitate tax evasion and avoidance by wealthy individuals and firms. Tax evasion through offshore centres generally works according to a pattern that involves creating shell companies and producing fake invoices. The aim is to disconnect legal and beneficial ownership of wealth. The magnitude of offshore tax evasion can be derived making use of different sources of data. One source is the data provided by some central banks. For instance, monthly statistics by the Swiss National Bank show that the foreign wealth held by Switzerland banks nowadays amounts to 2.5 trillion dollar. A second type of evidence can be found in systematic anomalies in the international investment positions of

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countries caused by offshore portfolio wealth. Figure 2 shows that at the global level there is a discrepancy between the level of cross-border assets and liabilities, reflecting the fact that, on the world's balance sheet, fewer liabilities are recorded than assets.

Figure 2: each year, less securities assets are recorded than liabilities



Source: <http://gabriel-zucman.eu/files/Zucman2013DataAppendix.pdf>

This discrepancy occurs in a situation where, for example, someone residing in France opens a bank account in a tax haven, and uses this account to invest in, for example, a mutual fund in Luxembourg. From a statistical point of view, the portfolio (the asset) held by the French residents is neither registered in France nor in the tax haven, whereas the mutual fund (the liability) is registered in Luxembourg.

The total financial wealth held offshore amounts to 8 %. This value represents a lower bound as it disregards real assets. Not all this wealth evades taxes but the rate of evasion is still very high. There, for instance, evidence provided by the Swiss tax authority that about 80 % (Davies *et al.*, 2011) of the wealth held by European depositors in Switzerland is not declared to the depositor's tax authorities. Under the assumption that 80 % of offshore wealth is undeclared, the cost in terms of lost revenue is about 200 billion dollar (including only tax evasion on financial wealth such as taxes on dividends, capital gains and interest, but not considering for example evasion of taxes on corporate income).

Significant progress in tackling tax evasion has been made recently, but a lot remains to be done. Automatic exchange of bank information should become the global standard by the end of the 2010s, but there three important obstacles remain at this stage:

- (i) securing compliance from offshore bankers;
- (ii) making sure that offshore banking does not move to other uncovered jurisdictions. In this respect, there is the need of well-defined, proportional sanctions to secure global compliance;
- (iii) addressing the opacity of international financial record-keeping. With regard to the latter, a concrete step would be a world financial registry to fill in the giant gap in international data.

4.4.3. Multinational corporation tax avoidance

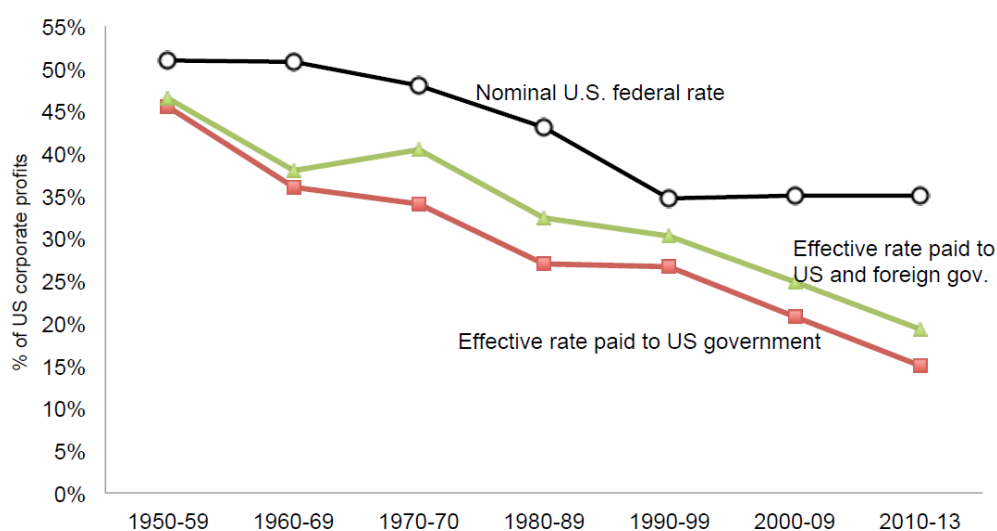
Corporate income tax is a key component of the tax systems of developed countries. Indeed, it is one of the primary ways of taxing capital: for example, in the US about a third of total tax revenues came from capital taxes in 2013. Corporate taxation is relatively straightforward in a closed economy but becomes more complicated when companies operate in different countries. The way multinational companies are taxed is based

on three principles that were adopted in 1920. The first principle is "source-based taxation", i.e. tax has to be paid to the governments of the countries where profits have been made (and not to the governments of the countries where shareholders live). It is not always easy however to determine where profits have been made. Replying to this question leads to the second principle of "arm's length pricing" according to which the various subsidiaries of a given multinational should be treated as independent from the parent and from each other, implying that when they trade goods and services among themselves they do so at market prices. The third principle is that the issues mentioned above have to be dealt with in bilateral agreements.

Each of the three principles raises its own issues. Source-based taxation is problematic because it provides, on the one hand, an incentive to firms to shift profits as well as real investments, including headquarters, workers or factories, to countries where taxes are lower and, on the other hand, an incentive to governments to compete on the basis of lower taxes. Arm's length pricing is a problematic concept as transfer prices are easy to manipulate, but more importantly, in many cases relevant market prices simply do not exist as no equivalent goods exist in the market (e.g. algorithms, intangible capital, logos). Finally, bilateral agreements leave scope for extensive "treaty shopping" with multinational companies strategically choosing the location for their subsidiary to exploit inconsistencies in the tax treaties.

The main cost of multinational corporate tax avoidance derives from artificial profit-shifting to lower-tax jurisdictions, but there are many difficulties in quantifying these costs in terms of government revenue losses. The approach we choose to use an estimate of revenue losses is based on national accounts and balance of payments data. Focussing on US firms, in 2013, one third of US corporate profits were made abroad.²⁶ A country-by-country decomposition indicates that 55 % of these profits were made in tax havens, a figure that has significantly risen over the years and continues to increase. On this basis, we conclude that the share of tax havens in total US corporate profits was 18 % in 2013.

Figure 3: nominal and effective corporate tax rates on US corporate profits



Note: the figure reports decennial averages (e.g. 1970-79 is the average of 1970, 1971 and 1979). In 2013, over \$100 of corporate profits earned by US residents, on average \$16 is paid in corporate taxes to the US government (federal and States) and \$4 to foreign governments.

Source: author's computations using NIPA data.

²⁶ The profits of US owned firms, accounts for 2.1 trillion dollar and includes 1.7 trillion dollar of domestic profits, plus 650 billion dollar of profits made by foreign firms owned by US residents, minus 250 billion dollar made by domestic firms owned by foreigners. So 31 percent (650/2,100) of US corporate profits were made abroad in 2013.

Moreover, out of the 10 percentage points decline in the effective corporate income tax rate between 1998 and 2013, pictured in Figure 3, two-thirds or more of the decline can be attributed to increased tax avoidance via low-tax countries. The cost of tax avoidance by US firms is borne by both the US government and the governments of other countries.

4.4.4. The way to go: formula apportionment

One viable solution to address the significant revenue losses due to artificial profit shifting would be to abandon the arm's length pricing principle and instead to tax corporations' consolidated profits. The profits would be apportioned to each country according to a specific formula. One possibility is for the formula to take into consideration a combination of sales, capital and employment. If, e.g., a company registers half of its sales and has half of its capital/workers in the US, then half of the profits will be taxable in the US). Nevertheless, if the formula is based on real capital, the incentive for the company to shift the real capital to a low-tax country remains. In this light, a more radical solution would be to fully allocate the profits on the basis of where the sales are made. This way, both profit shifting and harmful tax competition would be addressed. Formula apportionment is feasible and would render corporate tax planning obsolete. More specifically, the European Union and the US – which together account for close to 50 percent of world GDP – could jointly decide to move to formula apportionment and an integrated individual–corporate tax with reciprocal crediting.

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5. CONCLUDING PANEL DISCUSSION

The panellist considered that the 2014 ECFIN taxation workshop on the past present and future of wealth taxation covered a wide variety of relevant and interesting topics, several of which were the subject of discussion. The best design of a wealth tax was discussed, not least with an eye to meeting its potential in terms of revenue. The extent to which revenues gained from wealth taxes may be able to finance a growth-friendly tax shift away from labour was another topic that received much attention. Wealth taxation is a sensitive topic and there was a particular focus on political economy considerations as well as on the need to ensure the necessary conditions for a wealth tax to function effectively in terms of transparency and the availability of data. Some panellists argued also about the issue of international tax rate harmonization.

The panellist recalled that before the outbreak of the financial and economic crisis, wealth taxation received fairly little research interest and its application was limited in practice. Most existing taxes on net wealth were scaled down or even abandoned by EU Member States between 1995 and 2007. Partial taxation on wealth exists in Europe, however. For instance, inheritance is taxed in 18 Member States and gifts are in 16. Taxes on immovable property, including land, are in place in nearly all EU Member States, either in the form of transaction tax or recurrent tax. Lastly, recurrent taxes on the ownership of assets, such as vehicles, bank accounts, financial assets and net wealth, are used in about a third of Member States. The contribution of wealth taxes to government revenue has been fairly limited, reaching around 3 % of public revenue as a maximum.

Panel discussion highlighted that the design of wealth taxation is complex and raises a variety of questions such as whether to tax net or gross wealth and whether to tax different assets at different rates. It is important to understand who ultimately bears the burden of wealth taxation once that the second round effect and the macroeconomic feedback loop are taken into account. There is also a necessity to address the uncertainties determined by the unclear frontier between capital and labour income at the top of the distribution. A possible solution to the latter is to apply a similar tax rate, especially when the substitution elasticity between capital and labour income is high.

Many countries do not rely on any form of wealth tax. In this respect, a possible question is how much revenue could be collected after the introduction of a wealth tax. In a more dynamic perspective, the stabilizing effect and the certainty of the revenues deriving from a wealth tax are considered two relevant dimensions to take into consideration. The revenue from wealth tax, on the one hand, may not have a stabilizing effect partly due to the fact that stocks do not move along the economy activity path as flows do. On the other hand, the existence of tax havens and of tax rate competition among countries causes capital flight that may impact revenue certainty.

Panellist argued that in principle, introducing a tax on wealth can offer a viable source of revenue, along with other relatively growth-friendly sources of revenue, such as consumption and environmental taxes. These revenues could be used to finance a shift in the tax burden away from labour, a measure particularly relevant in times of high levels of unemployment.

Nevertheless, the suggestion to introduce or raise wealth taxation and in particular inheritance/bequest taxes, may find strong political and societal resistance. It was considered that policy makers may be afraid of losing their support in case citizens fear of losing part of their savings. A possible solution to the legitimacy and the confidence problems may be to raise awareness among the population about the possible alternative solutions. Governments face difficult decisions in times of budget constraints, while needing to reconcile the challenging situation that sees, on the one hand, an increasing demand for social fairness and, on the other hand, a strong scepticism toward wealth taxation. The panellist argued that negative perception of wealth taxation may improve when compared with other viable solutions. Increased transparency may create the right context to include wealth taxation more broadly among the possible tax policy choices.

Tax erosion and profit shifting are serious challenges for effective wealth/corporate income taxation. The direction taken, *inter alia*, is that of establishing guidelines for monitoring the scale of tax erosion and profit shifting and recommendations to counter these phenomena. Nevertheless, it was considered that in terms of effectiveness, the automatic exchange of bank information was a very important step ahead and that it may not be sufficient to tackle all the problems linked to unfair tax competition and artificial profit shifting. In particular for multinational companies, in order to avoid them to shift profits across districts, the taxes could be levied not in a specific district but over all the jurisdictions in which the multinational is active. More specifically, the amount of taxes each district could levy can be based either on an apportionment formula that takes into consideration a mixture of sales, capital, and employment or exclusively on where the sales are made. In this case as well, however, the exact design of the corporate taxation deserves particular attention in order to avoid those distortive effect linked to formula apportionment.



DG Economic and Financial Affairs (ECFIN)
Brussels, Rue de la Loi 170, B-1049, Charlemagne building, Room: Jean Durieux

ECFIN Taxation Workshop "Taxing Wealth: Past, Present, Future"

- 08:30-09:00** Registration and welcome coffee
- 09:00-09:10** **Introduction** - *Servaas Deroose** (DG ECFIN)
- 09:10-09:30** **Keynote address** - *Florian Wöhlbier* (DG ECFIN). Main messages from the 2014 report "Tax Reforms in EU Member States"
- 09:30-12:40** **Session I - Taxation of wealth: state of play and rationale**
Chair: *Lucio Pench* (DG ECFIN)
- 09:30-10:00** **Taxing wealth: policy challenges and recent debates** – *Michael Keen* (IMF)
- 10:00-10:30** **Rethinking wealth taxation** – *Gabriel Zucman*** (LSE) and *Thomas Piketty* (Paris School of Economics)
- 10:30-10:50** Discussant: *David Bradbury* (OECD)
- 10:50-11:20** Coffee break
- 11:20-12:00** **Forty years after: the solidarity tax on wealth (ISF) in France 1982** - *Alain Trannoy* (University of Aix-Marseille) and **the debate on wealth taxation in Germany** - *Stefan Bach* (DIW)
- 12:00-12:40** **General Discussion** and floor open to the audience
- 12:40-14:00** Lunch break
- 14:00-16:30** **Session II - Taxing wealth: specific instruments and challenges**
Chair: *Philip Kermode**** (DG TAXUD)
- 14:00-14:30** **Taxing more post-mortem family bequests** – *André Masson* (Paris School of Economics)
- 14:30-15:00** **Taxation of wealth transfers** – *Robin Boadway* (Queen's University)
- 15:00-15:30** Coffee break
- 15:30-16:00** **Housing: tax pressure in the EU and its drivers** – *Serena Fatica* (DG ECFIN)
- 16:00-16:30** **Challenges of taxing financial wealth** – *Gabriel Zucman* (LSE)
- 16:30-17:10** **Closing panel discussion**
Chair: *Gilles Mourre* (DG ECFIN)
Panellists: *Georg Fischer* (DG EMPL), *David Bradbury*, *Michael Keen*, *Gabriel Zucman*
- 17:10-17:15** **Closing address** - *Lucio Pench* (DG ECFIN)

* Replaced by Lucio Pench, ** Presenting speaker, *** Replaced by Gaetan Nicodeme (DG TAXUD)

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