Intelligence MEMOS

From: The Hon. Bill Morneau, Minister of Finance

To: Robin Boadway and Pierre Pestieau

Date: July 9, 2019

Re: Why an Annual Wealth Tax is Unnecessary

The idea of an annual wealth tax has taken on new prominence since French economist Thomas Piketty famously proposed one in 2013. US Senator Elizabeth Warren has made a national wealth tax a plank in her campaign to become the Democratic presidential candidate in 2020. And the NDP recently included a 1 percent tax on the net worth of Canadians in excess of $20 million in its election platform.

The current interest in wealth taxation is a response to the increase in wealth concentration and income inequality that has occurred in most developed countries. It has been well documented that both income and wealth inequality have risen significantly in recent decades. An annual wealth tax might seem like a reasonable response since it would directly and immediately address wealth concentration.

But is it the right policy? In our recent C.D. Howe Institute Commentary we found that an annual wealth tax adds relatively little to the taxes on capital and capital income that are already in place. The potential gains are insufficient to justify the substantial administrative challenges in measurement, collection and coverage for annual wealth taxes. These alone are enough to raise red flags about wealth taxation. Concerns about the social consequences of wealth concentration are better addressed by reform of existing capital-income taxes and by considering wealth-transfer (inheritance) taxation.

The use of financial wealth and wealth-transfer taxes in Canada is limited relative to other OECD countries, and they play almost no role in redistribution. The federal government and several provinces apply taxes on the capital of large financial institutions and life-insurance companies. But there is no tax on inheritances, estates or gifts. Accrued capital gains are taxed on death, but this is simply a prepayment of capital-gains tax that would otherwise have been taxed on realization.

An annual wealth tax would add one more layer of taxation of assets to the existing patchwork of capital-income, labour-income, consumption and property taxes. In principle, though, annual taxation of wealth is analogous to the taxation of income from that wealth, depending on how it is designed. To the extent that income from wealth is proportional to the stock of wealth, taxing wealth directly is equivalent to taxing the capital income from that wealth: So, why tax wealth?

Some arguments exist for a wealth tax viewed as a supplement to capital-income taxation since the latter is imperfect: but the case is limited. The argument is strongest for assets such as housing and other durables whose returns are difficult to measure, and for corporate stocks whose returns can be sheltered within the corporation unless they are pre-emptively taxed using a corporate tax. In the case of housing and some business assets, the property tax already applies to them. Another concern is liquidity. People can have huge wealth but a small income that makes them unable to pay the annual tax.

At the same time, there are significant drawbacks to wealth taxation relative to capital-income taxation. An important one is that a tax on capital income includes windfall gains in the tax base while a wealth tax does not. The value of wealth reflects expected returns, and these do not change if there is a windfall gain. Given that the taxation of windfall gains is highly desirable, this is a significant drawback to a wealth tax.

Wealth taxation differs from bequest or inheritance taxation. Bequests represent a cumulative accrual of wealth over the lifetime, and inheritances represent windfall receipts of wealth at some point in one's lifetime. A wealth tax applies to saving done partly for life-cycle smoothing purposes, while a bequest tax applies to wealth accumulated over and above that used for life-cycle smoothing and an inheritance tax applies to windfall increases in wealth. Even if one did not want to tax capital income or capital itself – for example, if the tax system aimed to tax consumption – one might still want to tax inheritances. The upshot of this discussion is that a wealth tax is an imperfect substitute for a tax on capital income.

Our judgment is that a well-functioning capital-income tax renders an annual wealth tax unnecessary. The benefits do not compensate for the significant administrative costs that would be involved.

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