Insight

Down, But Not Out: 6 Reasons the Wealth Tax Should be Abandoned

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For progressive political candidates and policymakers, the shiniest object in tax policy has been a wealth tax. Senators Bernie Sanders and Elizabeth Warren have both advocated for wealth taxes with graduated rates. The policy case made by its advocates is typically couched in righting income and wealth inequality, while offering a means of financing (some) of the progressive spending agenda. Advocates typically elide the deleterious effects such a tax would have on workers and the American economy as a whole.

Bad for Workers

Wealth taxes reduce the accumulation of capital, which translates directly into lower productivity and real wages. According to an AAF analysis, Senator Sanders' wealth tax proposal would reduce real wages and diminish the number of people working and their average hours of work. Over the next decade, the Sanders wealth tax would reduce workers' incomes by $1.6 trillion. Over the long run (with "long run" meaning the effect of the tax after the economy has fully adjusted to it), workers would see their earnings reduced a further $301 billion to finance an additional $380 billion in tax revenue. Accordingly, under the Sanders wealth tax, workers would bear 63 percent of the long-run tax burden through lower wages.

Bad for the Economy

The Sanders wealth tax would reduce the level of gross domestic product (GDP) by an average of 0.8 percent annually over the first 5 years, 1.0 percent annually over the second 5 years, and 1.3 percent annually over the long run. These rate declines translate into corresponding losses of $941 billion in GDP over the first 5 years, $1.3 trillion over the second 5 years, and then $368 billion annually over the long run (in 2018 dollars).

Bad for Americans

The Sanders wealth tax is levied on the return to savings of wealthy Americans. The U.S. economy, however, is not closed to foreign investment. Indeed, the United States benefits from foreign-direct investment. Were the Sanders wealth tax imposed, investment would on net decline (hence GDP losses) but would be partially offset by foreign investment. As a result, foreign ownership of U.S. assets would increase, as would the income derived from those assets.

Bad Tax Design

While the candidates couch their new taxes as being mere cents on the dollar, the effective rates under these plans are quite high. In essence these annual wealth taxes amount to an annual tax on the return to capital. Senator Sanders has proposed *annual* wealth tax rates as high as 8 percent. If the rate of return to invested wealth is 5 percent (and good luck finding that right now!), an 8 percent tax on wealth would be an effective capital income tax of 160 percent – truly confiscatory tax policy. Among the more curious elements of this design is that as the return to wealth rises, the effective tax rate drops. A hedge fund manager with a banner year, for instance, would pay a lower wealth-tax rate than an equally wealthy retiree invested conservatively.

Bad Budget Policy

A key rationale for the wealth tax is that it will finance a costly domestic spending agenda. Yet any wealth tax would fall well short of offsetting many of Senator Sanders' proposals, and the revenue collected by the Sanders wealth tax would likely raise less than expected. Substantially high effective tax rates would incentivize aggressive tax avoidance and tax planning by affected taxpayers. The progressive economists that helped design and advocate for these wealth-tax proposals arguably assumed substantially more wealth would be subject to taxation than is likely. Central to this issue is the valuation of wealth. For holdings such as publicly traded securities and other liquid and marketable assets, this valuation is relatively straightforward. But a substantial amount of wealth subject to this proposed tax is not so easily evaluated, such as family businesses. These administrative challenges prompted the majority of European nations that once embraced wealth taxes to drop them. Moreover, they likely underestimated the degree to which some of this wealth would be shielded from the tax. According to Larry Summers, President Obama's first director of the National Economic Council, advocates may have overstated the revenue effect of a wealth tax by a factor of *eight*.

Bad Tax Law

Separate from the economic challenges, it is possible the Sanders wealth tax is unconstitutional. The Constitution precludes "direct Taxes," i.e. taxes that are not apportioned based on population. The constitutionality of the federal income tax was assured only by the 16th amendment. The Supreme Court would have to determine whether a wealth tax is an impermissible direct tax or an indirect tax that faces no such constitutional bar. Legal opinions appear to be divided on whether a wealth tax would be an impermissible direct tax, but there is some risk that it would be.