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Net Wealth Tax: The Wrong Answer to a Justified Question

A growing number of people in Germany are calling for a revival of the wealth tax. The Social Democratic Party (SPD) isn't the only one that favors a wealth tax – the Greens have voiced their support, too. The justification given for this demand is the increasingly unequal distribution of wealth, which owes primarily to the boom in real estate prices. Is this a good idea?

Net Wealth Taxes have been Eliminated Nearly Everywhere

It is frequently claimed that other countries impose higher taxes on wealth – and that Germany would merely be drawing level with them by introducing a net wealth tax. That's not true. This assertion equates a variety of "wealth-related" taxes with each other, but they are actually very different. Foremost among them is the municipal property tax, the revenue from which accounts for 0.4 percent of Germany's GDP, which is indeed below the OECD average of 1.1 percent. That's why, for instance, the IMF recommended that Germany raise property taxes and use the additional revenue to lower taxes on labour income. However, this comparison fails to account for the fact that property taxes abroad often finance municipal services such as garbage collection. In Germany, these services are paid for through separate fees. But the current debate isn't about property taxes – it's about taxes on the net wealth of private households and companies. Net wealth taxes have been eliminated in almost all industrialized countries in the last several years. A number of Swiss cantons still collect significant revenues with this tax, but income taxes there are lower than elsewhere. Spain and Norway also still tax net wealth, but with less revenue. All other OECD countries, including such high-tax countries as Denmark and Sweden, forgo this tax. Thus, if Germany were to introduce a net wealth tax, it would clearly be departing from international tax trends and following a special path. That needn't be wrong, of course, but there should be good reasons for doing so.

Combined Wealth Tax and Income Tax Creates a High Overall Burden

Let's consider an SME entrepreneur whose income, as an individual filing separately, is EUR 300,000, putting him in the top tax bracket with a rate of nearly 47.5 percent including the solidarity surcharge. He owns a single-family home in which he also lives and the value of which is equal to the tax-free allowance for the wealth tax. He is considering using equity capital to establish a new production site in Germany. If we assume a 4 percent return on the investment, this would mean an annual EUR 40,000 increase in gross income for the entrepreneur. The income tax due on that amount would be EUR 18,990. Then comes the wealth tax—at a tax rate of 1 percent, that would be EUR 10,000, leaving the entrepreneur with EUR 11,010 net. The overall tax burden would be 72.5 percent of the gross profit generated by the investment. In this example, introducing the net wealth tax is equivalent to raising the marginal income tax rate by 25 percentage points. The effect is smaller for projects with higher returns, but even for an 8 percent return, the wealth tax would still act like an income tax increase of more than 12 percentage points.

Will the Wealth Tax Result in a "Fair" Tax Burden?

Whether one considers this tax burden fair or not is a matter of taste. In this example, of course, the taxpayer is at the peak of the distribution of income. Proponents of such a tax will also point out that it is "only" a marginal burden – that is, the additional tax measured as a percentage of the increase in income. However, when it comes to whether investments are actually implemented, this marginal burden is decisive. How does the tax affect the average burden – the ratio of total taxes to total income of the entrepreneur? Let's assume, for instance, that the company already has EUR 1 million in equity. This would incur an additional EUR 10,000 in wealth tax. Thus the wealth tax would raise the average tax burden from 42 percent to 48 percent of total income– still a significant tax increase.

Distortions and Other Problems of Wealth Taxes

If the entrepreneur resides in Germany, he can't avoid the tax by shifting the investment to another country – his foreign assets would also be taxable. He also can't avoid the tax by leaving his capital in his bank account. He would have to spend the money on vacation travel or some other form of consumption, gift it to his children if he has any, or move abroad. One might doubt that the entrepreneur in our example would consider moving to a different country due to a EUR 20,000 per year wealth tax, but the validity of examples is ultimately limited. Many entrepreneurs have far more capital tied up in their companies, resulting in a much higher burden and thus a larger incentive not to invest or even to move.

Four additional aspects argue against net wealth taxes and explain why many countries have eliminated them.

- First, it requires the privacy of the individual being taxed to be fully illuminated. Jewelry, paintings, expensive rugs – all of these things must be documented in order to prevent tax avoidance.
- Second, all assets must be regularly appraised, which wastes time, is expensive, and is frequently disputed.
- Third, once the assets have been fully documented, the temptation is great for policymakers to continually raise the tax rate.
- Fourth, unlike with income tax, entrepreneurs must still pay the wealth tax even if they incur losses. It could be countered

that the wealth tax being independent of income creates better incentives than income tax. This, however, would merely argue in favor of lowering income taxes and replacing them with wealth taxes. Tacking the wealth tax on top reduces incentives to work and invest.

Studies show that, in certain cases, taxes strongly influence a person's choice of residence. However, the existing studies are based mostly on taxpayers who are professional athletes, artists, or top-ranking scientists. Or they investigate the impact of special tax rules that serve specifically to attract foreign professionals. In other words, they are concerned with groups that are highly mobile. It is not clear whether these findings are transferable to other groups. Nevertheless, it should be kept in mind that taxes can result in a long-term migratory movement even if individual willingness to move is limited. Many well-off families in Germany send their children to school abroad, for instance. When it comes to deciding whether to return to Germany or to work or start a business abroad, a German wealth tax would be an argument for remaining abroad – in Austria, for instance, where there is no tax either on inheritance or on net wealth.

Stronger Effects on Foreign Investors to be Expected

While domestic taxpayers would have to move abroad to avoid a wealth tax, foreign investors with activities in Germany can sidestep it more easily. They can avoid the tax by moving their investments to other countries. This would have considerable negative impacts on investments and jobs in Germany. The situation is similar for larger companies and listed corporations, which normally have foreign shareholders. They would respond to a German wealth tax by moving their investments abroad and financing their remaining activities in Germany largely with debt rather than equity. This can easily be structured in such a way that no domestic wealth tax is incurred for foreign activities.

Bottom Line: Less Growth and Less Not More Tax Revenue

In 2017, the ifo Institute presented a model-based analysis of the introduction of various variants of wealth taxes in Germany. It concluded that a wealth tax of 1 percent, with a EUR 1 million allowance and no other exceptions, would generate tax revenue of EUR 17 billion per year. At the same time, businesses would significantly reduce their investments and growth would decline. After a transition period of eight years, Germany's economic performance would be 6 percent lower than without the tax, and revenue from income and consumption taxes would likewise drop. On balance, the tax take would be lower. The findings of these kinds of simulation studies must be viewed critically and in the light of the assumptions on which they are based. One important premise of this study is that the revenues from the wealth tax are used not for public investments, but rather for consumption. If at least part of the tax revenues were to be invested, the bottom line would be more attractive. But it is unlikely that the negative growth effects would disappear entirely. As a variant, the study considers a wealth tax that places a greater burden on real estate than on business assets. This reduces the negative impact on growth, but also the redistributive effects.

Experiences in Other European Countries

In addition to simulation studies like these, which estimate the effects of hypothetical tax reforms, there are also empirical analyses of the effects of existing wealth taxes. One study on Switzerland concludes that a 1 percent wealth tax reduces declared wealth by 23–34 percent. In other words, this study finds a mass exodus of capital. In Denmark, the top wealth tax rate was lowered from 2.2 percent to 1 percent in 1989 and was then completely eliminated in 1997. The reduction from 2.2 percent to 1 percent increased declared wealth in the affected group by 30 percent within eight years. Sweden had a wealth tax up until 2007 and likewise saw a large taxpayer response to its elimination. But there are also studies that find only weak effects. We can assume that the observed changes in wealth comprise a combination of real changes in capital formation and tax avoidance reactions, such as transferring assets to the corporate sphere, which is taxed at a more favorable rate. The observed effects are strongly dependent on how the relevant wealth tax is structured and enforced and thus cannot always be expected to apply to the case of Germany.

Incidentally, even proponents of the tax do not dispute the fact that a comprehensive wealth tax could have a negative impact on investments and jobs in Germany. This is why the SPD recommends providing exceptions for companies, similar to the inheritance tax. The catch here is that most of the large fortunes in Germany as in other countries happen to be shares in companies. If they are spared, then the wealth tax mutates into a tax on SME entrepreneurs and people who have own real estate assets as retirement provisions. This would compound the injustice that currently mark Germany's inheritance tax. And it could no longer be claimed that the net wealth tax hits the multimillionaires in Germany.

Conclusion:
Use Other Means to Achieve a Fairer Distribution of Wealth

The question of whether more can be done to spread tax burden more fairly and achieve a more balanced distribution of wealth in Germany is a valid one, but the introduction of a net wealth tax is not a convincing answer. It would put Germany on a unique path in terms of its tax policy and send a signal to domestic and foreign investors to avoid Germany. It would buy limited redistribution at the risk of a significant decline in growth. The negative growth effects can be allayed by exempting company assets from the wealth tax, but the result is then a highly unfair tax that treats taxpayers with similar levels of wealth very differently. It also opens the floodgates to tax-avoidance strategies. For years now, tax revenues have been on the rise and interest spending has been decreasing, so the argument that the government needs more revenues is not particularly convincing. And in view of the negative growth effects, it is doubtful that the government would end up with higher revenues anyway.

Are there better instruments for achieving a more even distribution of wealth? In principle, individual countries that have strong international ties, like Germany, have limited options for increasing the burden on high-wealth taxpayers. Nevertheless, there are several starting points:

- The income tax could be reformed with a view to improving taxation of appreciation of non-owner-occupied real estate.
- In the inheritance tax, the privileged treatment of company assets and owner-occupied real estate should be eliminated and a uniform low tax rate of, for instance, 8 percent introduced. This would avoid endangering the livelihood of SMEs.
- Wealth creation could be encouraged more effectively than it has been to date based on such ideas as rent-to-own or, a current topic of discussion, the introduction of a citizens' fund that uses the German government's special financing terms to create wealth for all citizens.

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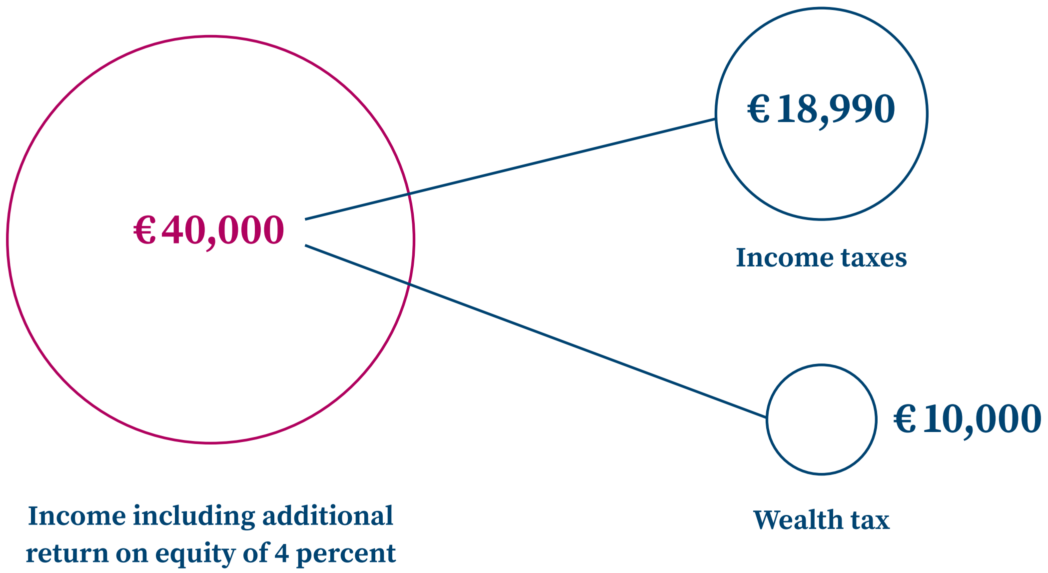
TOTAL BURDEN IS HIGH

Only EUR 11,010 remain of a total profit of EUR 40,000



Source: ifo Institute.