Should the rich pay for fiscal adjustment? Income and capital tax options

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1. The rise of European wealth-income ratios

In order to answer the question whether the wealthy should bear a larger portion of the EU fiscal adjustment burden, one should start by analysing the dynamics of income and wealth distribution. The World Top Incomes Database (WTID) is in this respect an excellent source of information, as it includes annual series covering most of the 20th century for over 25 countries from the five continents and is the largest historical data set on income inequality.

When looking at the income shares of the top decile from 1910 to 2010 (Figure 1), a different pattern can be observed for the United States and continental Europe. In the US, the top decile share rose dramatically from 35 to 50 % of national income (top percentile share from 10 to 20 %) over the period 1980-2010, absorbing 70 % of macroeconomic growth and reaching the levels registered at the beginning of the 20th century. In continental Europe, the rise in top income shares started only during the mid-1990s and was quantitatively much smaller. As a result, income concentration is much lower in continental Europe than in the United States.

Figure 1. Top Decile Income Shares 1910-2010

![Figure 1. Top Decile Income Shares 1910-2010](image)

Source: World Top Incomes Database, 2012. Missing values interpolated using top 5 % and top 1 % series

A recent study (Piketty and Zucman, 2013) analyses how and why aggregate private wealth-national income ratios evolve in the long-run. Until recently, it was impossible to answer properly this basic question because national accounts were mostly about flows – on income, output, savings – and very little about stocks and liabilities. In order to address the aforementioned question a new data set of national balance sheets for the top 8 rich countries was compiled to estimate wealth accumulation equations over the timeframe 1970-2010.¹ For the United States, Germany, France and the United Kingdom the analysis was expanded by looking at the official national accounts as well as at the historical estimates over the period 1870-2010.

¹ The top 8 countries are: the United States, Japan, Germany, France, United Kingdom, Italy, Canada and Australia
The study provided evidence of a gradual rise of wealth-income ratios over the 1970-2010 period in every developed country considered, from about 200-300 % in 1970 to 400-600 % in 2010 (Figure 2). Another interesting result of the study is the fact that today's ratios seem to be returning to the high values registered in the 19th century in Europe (600-700 %) (Figure 3). This can be accounted for by a combination of factors. Politics is responsible for the long-run asset price recovery effect (itself driven by changes in capital policies since the World Wars, from anti- to pro-private wealth holders). Also economic factors as high saving rates and low growth rates (driven down by near zero population growth and the slowdown of productivity) have contributed to the rise of wealth-income ratios in Europe (Piketty and Saez, 2012). These factors explain the different long-run evolution of private wealth in Europe and the United States.

2 The Harrod-Domar-Solow steady-state formula $\beta = s/g$ (where $\beta$ is the wealth-income ratio, $s$ is the net saving rate and $g$ is the total growth rate) allows to explain accurately the rise in wealth-income ratios.
2. A proposal for a European wealth tax

Given the above mentioned results, the introduction of a comprehensive wealth tax at European level could be justified. A comprehensive wealth tax would be based on the market value of the net personal worth and calculated as the sum of the non-financial and financial assets minus the liabilities. It would therefore be very different from the 19th century style wealth tax, based on cadastral values. It is actually closer to the current French wealth tax (Impôt sur la fortune, ISF), based on annual wealth returns (assets are valued at market prices). The European wealth tax would however need to have a broader tax base than the ISF (no exemptions) and the returns should be prefilled by the tax administration on the basis of information transmitted by the third parties (banks). Although this process requires a lot of data exchange, it is technically doable. Political aspects play a key role here – automated cross-border information exchange on financial assets and financial flows should be linked to every EU free trade agreement, and appropriate sanctions should be enforced. Being able to publish credible tabulations on the number of European wealthy individuals by net wealth brackets would also be an appropriate test for the working of automated information exchange systems.

Introducing a marginal tax rate of 1 % for net wealth above EUR 1 million (about 2.5 % of the EU’s population concerned) and a marginal tax rate of 2 % for net wealth above EUR 5 million (about 0.2 % of the EU’s population concerned), would raise revenue of approximately 2 % of EU GDP. There are two reasons why such high revenue could be raised: (i) aggregate private wealth is very large in the EU (500 % of EU GDP), (ii) wealth is highly concentrated, as the top decile owns 60 % of the aggregate wealth, and the top 1 % holds 25 % of it. Hence, the wealth tax base for the very rich – holding 1 % of the wealth – is estimated at 125 % of EU GDP.

Alternative options are possible, but would raise less revenue. A financial transaction tax (FTT) would only raise less than 0.5 % of EU GDP; introducing a supplementary tax rate of 20 % on top 1 % income earners (above EUR 100 000) would increase revenue by 0.5 % of EU GDP; increasing the tax rate on corporate profits by 10 % would represent extra revenue of about 1 % of GDP. All these options are useful, especially the increase in corporate tax, given the tax competition and the large decline in rates. Nevertheless, in the long-run the wealth tax is the most promising option. It is also worth noting that this is the most natural option in order to reduce public debt. Europe is the continent with the highest private wealth-income ratio, so it is quite paradoxical that it is also the continent facing the largest difficulties to solve its public debt problem.

3. Conclusion

This presentation showed that top income shares are significantly higher in the United States than in Europe, while wealth-income ratios are superior in Europe. The taxation of wealth is therefore most useful in Europe, while in the United States top income taxation could be exploited. The introduction of a European wealth tax can be beneficial if it helps the Member States to raise tax revenue, which is adapted to their economic fundamentals and which they cannot raise on their own. Although top income or corporate taxation meet the two criteria as much as the suggested wealth tax, the latter is even more appropriate in the long-run as it raises more revenue. The increase of VAT or general income or payroll taxation meet none of the criteria.

4. References