

# AN ANNUAL WEALTH TAX: PROS AND CONS

Robin Boadway, Pierre Pestieau

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# An Annual Wealth Tax: Pros and Cons

Robin Boadway and Pierre Pestieau\*

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## Abstract

We explore the case for a wealth tax as part of the tax mix. Annual wealth taxes are roughly equivalent to capital income taxes on the assets to which they apply. Wealth taxes differ in purpose from inheritance taxes which are useful adjuncts to income taxes. We recount the arguments for taxing capital income, and for taxing inheritances regardless of whether capital income is taxed. We argue that if the desire to tax asset income and wealth transfers is appropriately addressed by capital income and inheritance taxation, the additional need for an annual wealth tax is minimal.

**Key Words:** wealth tax, capital income tax, inheritance tax

**JEL Classification:** H21, H23

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✉\* Boadway: Queen's University, Canada ([boadwayr@econ.queensu.ca](mailto:boadwayr@econ.queensu.ca)); Pestieau: University of Liège, Belgium ([p.pestieau@ulg.ac.be](mailto:p.pestieau@ulg.ac.be)). This paper draws on Boadway and Pestieau (2017). Two anonymous referees have provided many valuable comments on an earlier version.

# 1. Introduction

The purpose of this paper is to critically evaluate the case for an annual wealth tax as part of a nation's personal tax system. To do so we review current received wisdom on the elements of a good tax system drawing on the normative tax design literature, recent tax commission findings and best practices. Naturally, the preferred tax system varies across nations because of historical and institutional factors, social norms, and the exposure of the national economy to international influences, including membership in organisations. Nonetheless, there are several design features that are common across countries, especially regarding the choice of a personal tax base. We focus especially on the appropriate tax treatment of capital income since an annual wealth tax is closely equivalent to the taxation of income from wealth. We also relate annual wealth taxation to the taxation of wealth transfers, especially bequests, since both address concerns about wealth inequality. Our emphasis will be on the direct taxation of individuals, so we pay limited attention to the taxation of both corporate wealth and corporate income including their incidence. We abstract from indirect taxes on wealth and incidental taxes on asset transactions like real estate fees and stamp duties. We also abstract from property taxes which are typically levied by sub-national governments and serve more as payments for local government services than as instruments for equitable taxation. The case for or against annual wealth taxation does not hinge on these other forms of taxation of assets, asset transactions and asset income.

To anticipate our conclusions, in our judgment the case for an annual wealth tax is not strong, provided other elements of the taxation of assets are in place. In particular, if capital income is

appropriately taxed and if there is an inheritance tax in place, a wealth tax adds relatively little of substance and entails additional administrative and political costs.

The current interest in wealth taxation is a response to the increase in wealth concentration and income inequality that have occurred in most OECD countries. Piketty (2013) went so far as to propose a world wealth tax, which is more utopian than feasible. The share of the wealthiest one percent in total pre-tax income has grown in the past decades, particularly in some English-speaking countries but also in some Nordic and Southern European countries. Some, like Piketty, attribute this to the natural forces of a growing economies whereby the rate of return on assets tends to exceed the rate of growth of the economy, and therefore of labour income. Others see it as a consequence of globalisation, which hampers wage growth of lower- and middle-income workers and reduces their bargaining power. Finally, some argue that high incomes are due in part to rents that accrue to those with specialised knowledge and skills as well as to those with large portfolios of assets (e.g., Stiglitz, 2012).

After-tax income inequality has grown even more rapidly than pre-tax income inequality as national tax systems have become less progressive (OECD, 2008).<sup>1</sup> As Saez and Zucman (2019a) show, income tax rate structures have become flatter, and capital income tax rates have been competed down. Some countries, such as Nordic countries, France and Belgium have introduced a system of dual taxation whereby personal taxes on capital incomes were lowered relative to personal taxes on labour income. Realised capital gains are concentrated at the top of the income distribution and are only lightly taxed. In about one-half of OECD countries, capital gains made

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<sup>1</sup> Of course, there are many well-known drawbacks with existing measures of inequality, such as the reliance on annual income measures and the exclusion of several items. Despite these caveats, the trends are apparent.

on shares are only subject to corporate income tax but not to personal income tax. When capital gains are subject to personal tax, statutory tax rates on capital gains on shares range from 12 percent in Belgium to slightly above 55 percent in Denmark and Greece.

## 2. Wealth Taxation in Practice

Wealth can be taxed periodically in the hands of its owner, or it can be taxed only when wealth is transferred, typically at the end of life. Wealth taxation and wealth transfer taxation can take different broad forms.<sup>2</sup> A wealth tax is a personal tax typically levied on net wealth, that is, assets less liabilities. It can be levied periodically (e.g., annually) or as a once-off capital levy. Related to a wealth tax is the property tax, which is levied annually on real property and is typically used to finance local government. The property tax is applied separately to each property rather than to the aggregate property of the owner. While a wealth tax can vary according to the taxpayer's total net wealth, the property tax cannot.

A wealth transfer tax can take two forms. It can be an estate tax levied on the total value of the estate of a bequeather or donor, or it can be an inheritance tax levied separately on the amount of inheritance received by each recipient. These taxes are levied on lifetime accumulations of wealth, and they apply on death or within a prescribed number of years up to death. There may also be gift taxes levied either on donors or recipients when gifts are made during the lifetime of donors or recipients. These are not necessarily related to assets accumulated over the lifetime. In

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<sup>2</sup> Our focus is on direct taxes on wealth applied to individuals. We do not consider corporate wealth taxes or indirect taxes on wealth sales, such as real estate transfer taxes or stamp duties. Nor do we consider the tax treatment of charitable or political donations, or transfers of wealth into foundations.

some countries, capital gains are deemed to be realized on death and subject to capital gains tax, usually in lieu of an inheritance tax. This does not constitute an additional tax since it simply taxes capital gains that have accrued at the time of death and whose taxation would otherwise be postponed.

In 1990, a dozen OECD members countries levied an annual tax on net wealth (OECD, 2018). Many have progressively discontinued it, for example, Austria and Denmark in 1995, Germany in 1997, Finland and Luxembourg in 2006, and Sweden in 2007. France is the last country to have abandoned its wealth tax. In early 2018, it created a specific real estate wealth tax called *Impôt sur la Fortune Immobilière* (IFI) which is assessed only on real estate owned, directly or indirectly, by the taxpayer if the value of the taxpayer's real estate net assets exceeds €1,300,000.

The reform was sold on the promise that it would steer savings into financing companies and make France more attractive for investors, in turn benefiting growth and jobs. Another motivation was to stop the alleged wealth flight to neighbouring countries such as the UK, Belgium and Switzerland. The French reasons for discontinuing their wealth tax summarize the experience of other countries. These reasons were efficiency costs, risk of capital flight, failure to meet redistributive goals, and high administrative costs. It is not clear that the new tax will not present the same pitfalls that are mainly due to the design of the tax. Belgium has also a truncated wealth tax that applies a 0.15 percent rate on average value of securities holdings greater than €500,000 per account holder. By 2018, only two countries Norway and Switzerland — levied a full-fledged wealth tax, with Switzerland raising considerably more revenue than Norway.

Table 1 provides some summary statistics about the relative importance of the wealth tax in the OECD member countries in 1990 versus 2019. The numbers refer to what the OECD call “Recurrent taxes on net wealth”. The low level of tax revenue is striking. The highest is Switzerland in 2019 with just 1.3% of GDP.

**Table 1**

Wealth Tax Revenue as a % of GDP

| Countries   | 1990 | 2019 |
|-------------|------|------|
| Austria     | 0.5  | 0    |
| Belgium     | 0    | 0.2  |
| Denmark     | 0.1  | 0    |
| France      | 0.2  | 0.1  |
| Germany     | 0.5  | 0    |
| Iceland     | 0.6  | 0    |
| Netherlands | 0.2  | 0    |
| Norway      | 0.7  | 0.6  |
| Spain       | 0.2  | 0.2  |
| Sweden      | 0.2  | 0    |
| Switzerland | 0.9  | 1.3  |

Source: OECD (2020) *Revenue Statistics*, OECD Publishing, Paris

Occasionally, a once-off tax on private wealth has been used as an exceptional measure to restore debt sustainability or to react to an unexpected crisis. To be effective, such a tax must be implemented before avoidance is possible and with the expectation that it will not be repeated. Only in these circumstances does it not distort behaviour. A once-off wealth tax can be viewed as fair in some circumstances, despite the fact that it amounts to an unannounced confiscation of wealth. That is because it is only applied in unusual instances of financial stringency, or when wealth holders might be thought to have gained disproportionately while others suffered. There

is a surprisingly large amount of experience to draw on. Pigou (1920) famously advocated a one-time capital levy of 25 percent on wealth to address the UK's war debt. Such levies were widely adopted in Europe after World War I, and in Germany and Japan after World War II. Because they were anticipated by wealth-owners, these taxes led to capital flight, which limited their revenue take and spurred inflation.<sup>3</sup> A once-over wealth tax has been touted as a response to the 2020-21 Covid-19 pandemic (Advani et al., 2020; Landais et al., 2020). That is because low-income and precarious workers as well as the young have borne the brunt of the economic costs due to loss of jobs and of educational opportunity. At the same time, high tech workers have been protected and share values have been buoyant.

According to Piketty (2013), the two world wars and the 1930's economic crisis explain the periodic decrease in wealth concentration and in the importance of bequests in capital accumulation. These unfortunate events seem to have been more effective at equalising the wealth distribution than the array of redistributive taxation used since then in various countries. The period since World War II has been spared cataclysmic events that destroyed wealth. Wealth has become more and more concentrated and the importance of bequests as a proportion of wealth accumulation has increased. It is thus possible that to return to a more reasonable wealth distribution, the ideal instrument would be a significant one-off wealth tax. To work, such a policy would have to be unpredictable but also coordinated, as well as being politically feasible.

### 3. Wealth Taxation as Part of the Broader Tax System

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3 Source: <https://www.economicsobservatory.com/one-wealth-taxes-what-can-we-learn-history>

See also the recent failure of the one-time wealth tax in Argentina

<https://www.businessinsider.fr/us/one-time-wealth-tax-in-argentina-brought-in-24-billion-2021-5>

The case for taxing wealth depends upon the case for taxing capital income since as we shall see annual wealth taxation can be viewed as an equivalent to a form of asset income taxation. We therefore begin with an overview of the literature on the appropriate personal tax base, which in its starkest form concerns the choice of consumption versus income taxation or more generally the mix of consumption and income taxation. See also Banks and Diamond (2010) and Scheuer and Slemrod (2021) for more detailed expositions.

An annual wealth tax is one of a family of taxes that apply to asset wealth or its return. Other such taxes include capital income taxes, business income taxes, wealth transfer taxes and annual taxes on real property. These taxes generally exist alongside broad-based taxes on consumption and taxes on labour income. Different countries adopt very different mixes of tax bases, but virtually all are hybrid systems that combine elements of two benchmark tax bases. One is comprehensive income taxation under which the tax base is the sum of consumption and net changes in wealth, that is, net savings. The second benchmark base is consumption itself, and it can be taxed either directly by personal taxation or indirectly by taxed on consumption transactions. Neither comprehensive income nor personal consumption can be readily observed by the tax authority, but both can be indirectly measured using tax bases that are equivalent to them in present value terms. Using the consumer's lifetime budget constraint, the comprehensive income tax base is equivalent in present value terms to the sum of labour income, capital income and inheritances. By the same token, the consumption base is equivalent in present value terms to labour income, inheritances and that part of capital income reflecting windfall, or unexpected,

gains.<sup>4</sup> In what follows, it will be useful to fit annual wealth taxes into this framework of broad tax bases.

As mentioned, most tax systems are some hybrid of income and consumption taxes. To appreciate the potential for wealth taxes to be a component of these hybrid tax systems, it is useful to recount how various elements of standard tax bases contribute to the comprehensive income versus consumption balance. Consumption can be taxed explicitly and indirectly by a broad, destination-based value-added tax (VAT), but progressive rate structures are precluded. Equivalently, consumption can be taxed under the personal tax system using one of two approaches. Consumption expenditures can be directly and progressively taxed by a personal base defined as labour income, capital income and inheritances less savings. This corresponds with what the Meade Report (1978) called the registered asset approach, and it reflects roughly the way in which private pensions are typically treated. The alternative form of personal consumption tax, also identified by the Meade Report, is the tax-prepaid approach where the base is labour income and inheritances, that is, total income less capital income. The tax-prepaid

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4 To see this, consider the two-period case where an individual earns  $E_1$  and  $E_2$  in the two periods and receives an inheritance  $I$  in the first period. The budget constraints in each period are  $C_1 = E_1 + I - S$  and  $C_2 = E_2 + (1+r)S + k\dot{S}$ , where  $C_i$  is period- $i$  consumption (including bequests given),  $S$  is saving,  $r$  is the interest rate, and  $k\dot{S}$  is above-normal returns accruing on a portion of savings  $\dot{S} < S$ . Eliminating  $S$  from the two budget constraints yields the intertemporal budget constraint:

$$C_1 + \frac{C_2}{1+r} = E_1 + I + \frac{E_2}{1+r} + \frac{k\dot{S}}{1+r}.$$

approach captures consumption imperfectly to the extent that capital income includes windfall gains, such as unexpected returns or rents from monopoly circumstances.

There is evidence that the returns to investment are increasing in the size of a investors' portfolio, both institutional and individual. Analysing the returns of several American college endowments, Piketty (2013) observes that the very largest ones obtain real returns of close to 10 percent a year, while smaller ones must make do with about 5 percent. These results on the relevance of the size of institutional portfolios on their return have since been corroborated for individual portfolios. Kacperczyk et al. (2016) and Fagereng et al. (2020) have empirically verified that expected rates of return on private portfolios tend to increase with portfolio size. Of course, these results include both returns to risk and above-normal returns so to some extent might reflect owners of large portfolios being less risk-averse. Power and Frerick (2016) have also show that rents comprise an increasing proportion of corporate income in recent years. As a result, wealthier persons obtain higher rates of return on their savings. For that reason, the Mirrlees Review (2011) proposed a variant of the tax-prepaid approach whereby for savings in assets other than interest-bearing accounts and pensions, only returns up to a risk-free rate-of-return allowance (RRA) would be tax-exempt, while above-normal returns would be fully taxed. This would ensure that consumption financed by rents is taxed. As well, to the extent that above-normal returns accrue to higher-income taxpayers, taxation equity might be improved by taxing them differentially. More generally, tax systems defined using income as the base implicitly tax consumption since it is one of the uses to which income is put.

Actual tax systems do not include all consumption in the tax base regardless of whether they aim to tax income or consumption. In particular, some consumption financed by inheritances and windfall gains, or rents, escape taxation, and that is relevant for the assessment of annual wealth

and inheritance taxation. VAT systems typically exempt some types of consumption, such as food and other necessities. Tax bases that rely on the tax-prepaid approach do not include consumption financed from rents or windfall gains. And, personal tax bases do not include consumption financed from inheritances to the extent that the latter are not themselves taxed. Personal tax systems do implicit tax bequests made, despite the fact that they might not be regarded as consumption. When inheritances are taxed, they are usually only partially taxed and are taxed more favourably than ordinary income. High exemption levels apply, and some forms of wealth transfers are usually exempt, such as farms and family businesses. On the other hand, housing is often included in inheritance tax bases. Countries that do not have inheritance taxes nonetheless apply capital gains tax to accrued capital gains on inheritances: capital gains are deemed to be realised on death. In those countries having annual wealth taxes, they are typically an alternative to an inheritance tax, even though they fulfil very different functions.

Tax systems generally include various elements of capital income in their tax bases along with labour income or consumption. However, they do so imperfectly, so they remain far from the comprehensive income benchmark. The imperfections come in two types: a) some forms of asset income are not included in the tax base, and b) for those that are, capital income may be taxed at different rates than labour income. To illustrate these, it is useful to recount the number of ways in which capital income is sheltered from tax in what are otherwise called income tax systems. To the extent that the VAT is part of the tax mix, capital income is taxed at a lower rate than labour income since the VAT is roughly equivalent to a tax on labour income plus economic rents. Even where capital income is taxed, preferential rates may apply. This is the case for dual income tax systems in the Nordic countries and elsewhere as mentioned above, and for capital gains in many countries. In some countries, capital income from some specified quantity of

assets or savings can be sheltered. Saving in private pensions is typically fully sheltered by registered asset treatment, but only up to some limit. Some countries partially exempt capital income earned on financial assets, either by exempting a given amount of capital income or by exempting the capital income on some given amount of savings. Housing is typically treated as a tax-prepaid asset whose imputed rent, including capital gains, is tax exempt. (Some countries, such as Denmark, Luxembourg and the Netherlands, do tax imputed rents on housing, though it is administratively complex.) At the same time, property taxes apply to housing owners, albeit to finance local public services. More generally, assets whose return takes a non-financial form are usually tax-exempt, although they may be subject to capital gains taxation on realisation.

Business income tax treatment often mirrors that of personal income. Countries that nominally tax personal income (as opposed to consumption) also tax business capital income. For corporations, income earned on behalf of shareholders is the tax base, albeit often imperfectly defined, and the corporate tax may be at least partially integrated with the personal tax. The implication is that shareholder income earned in corporations is ultimately taxed at close to the personal rate. Unincorporated businesses also pay tax under the personal tax system on their full capital income. Income of corporations accruing to debt-holders is not taxed at the corporate level since it is taxed at the personal level. Some countries (e.g., Belgium, Italy) tax only above-normal capital income earned in businesses using a cash-flow equivalent tax such as the Allowance for Corporate Equity.<sup>5</sup> This aligns with what the Mirrlees Review recommended. The taxation of human capital tends to approximate consumption tax treatment: the cost of human

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<sup>5</sup> See <https://www.oecd.org/ctp/taxpolicy/corporate-and-capital-income-tax-explanatory-annex.pdf>.

capital accumulation, which is mainly forgone earnings, is largely tax-deductible, while the increase in earnings resulting from the investment is taxable.

There are many reasons for taxing capital income favourably compared with consumption or labour income, and for exempting some forms of capital income. On theoretical grounds, some taxation of capital income can be justified as an efficient way of redistributing from better-off to worse-off individuals (Banks and Diamond, 2010). Higher income persons may have lower consumption discount rates so tend to save more, future consumption and leisure might be complements, and as pointed out those with larger savings tend to earn higher rates of return. In addition, taxing capital income has been justified as a way of addressing the inefficiency associated with credit constraints and the absence of wage insurance when future wages are risky (Conesa et al., 2009). Typically, these arguments would support capital income taxation at lower rates than labour income taxation, and with rates that are higher for high-income persons.

At the same time, capital income tax rates are constrained by the possibility of avoidance through tax planning or capital flight. Some types of asset income would be difficult to tax from an administrative point of view, such as human capital and housing for which imputed income is hard to measure. Also, some assets are tax-sheltered on policy grounds, like saving for retirement for which encouragement might be warranted on behavioural grounds. Preferential treatment of investments by entrepreneurs and small businesses is a response to the high risk of failure and limited access to capital markets many of them face. Some have argued for capital income taxation on second-best grounds as a counter to tax distortions elsewhere in the tax system. For example, Jacobs and Bovenberg (2010) find that a positive tax rate on capital income is optimal to induce more investment in human capital when the latter is discouraged by progressive earnings taxation. Finally, it is argued that taxing capital income is desirable when inherited

wealth is not observable so avoids inheritance taxation (Boadway et al., 2000; Cremer et al., 2003).

Strong arguments also support the case for deploying an inheritance tax as a complement to consumption, labour income and capital income taxation, regardless of the extent to which capital income is taxed. From the point of view of recipients, inheritances represent a form of windfall gain that can be used to finance consumption over one's lifetime. Regardless of whether the personal tax system is based on consumption tax or comprehensive income tax principles, taxing consumption is an element. If consumption could be taxed directly, taxing inheritances that finance that consumption would be redundant. For example, a VAT will tax consumption expenditures regardless of how they are financed. On the other hand, taxing consumption at the personal level by using either the tax-prepaid approach or the registered asset approach will require that inheritances be taxed. Recall that the tax-prepaid approach exempts capital income from the base. It will be equivalent to consumption taxation only if all forms of non-capital income are in the base, including labour income, transfers and inheritances. Similarly, under registered asset treatment, the tax base is income less savings, where income includes labour and capital income including rents, transfers and inheritances. If the tax base is income rather than consumption, the same principles require including inheritances in the base since they are equivalent to income. Naturally, in choosing tax rates one must take into account behavioural responses, such as changes in labour supply, savings, and in the case of inheritance taxation changes in bequests, but the choice of base is separate from these considerations. The trade-off between equity and efficiency in the choice of bequest taxation is analysed in Cremer and Pestieau (2011)

The tax treatment of bequests given raises additional considerations. If bequests are considered equivalent to any other consumption choice, as revealed preference principles might suggest, they should be treated as such for tax purposes. This treatment would automatically be the case for personal taxes based either on income or on consumption using the tax-prepaid or registered asset approaches. Bequests would not be taxed under VAT systems: doing so would require that bequests be treated as taxable transaction. Matters would be more complicated if one took the view that bequests were not acts of consumption but reductions in the availability of income for one's own consumption. In this case, one might want to give a deduction for bequests from the tax base, similar to the tax treatment of charitable donations as discussed in Diamond (2006). This is not the practice in actual tax systems, so we ignore it as an option here. Taxing bequests left by donors might also be considered to be an alternative to taxing inheritances received in the hands of recipients, perhaps on administrative simplicity grounds. In this case, nothing of principle is added to what we have argued above, except that the tax rate applied to a tax levied on bequests cannot be conditioned on recipients' economic circumstances. In what follows, we take the position that the taxation of inheritances and not of bequests is desired.

One further consideration in bequest taxation has been raised by Kaplow (2001, 2008) and Farhi and Werning (2010). They argue that because a bequest benefits both the donor (by revealed preference) and the recipient, it will entail an externality. Donors will choose the size of bequest based on their personal benefit, which may include the altruistic benefit that motivates the bequest. It will not take separate account of the benefit of the recipient. Therefore, bequests should be subsidised the take account of this externality. This raises issues that are of limited relevance for us, given that we are concerned mainly with what to include in the personal tax base, and not how it should be taxed.

A wealth tax would add one more layer of taxation of assets to the existing patchwork of capital income and inheritance taxes. In principle and as discussed further below, the annual taxation of wealth is roughly 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. However, there are some differences. If wealth taxation is based on the market value of wealth, which is the expected present value of future returns possibly adjusted for risk, a capital income base will be more variable than a wealth base since realised capital income differs from expected capital income. A wealth tax does not tax the return to risk, whereas a capital income tax does. Moreover, investors can time capital losses to reduce the effective capital gains tax rate. If there is imperfect loss-offsetting a wealth tax may be preferable to a capital income tax on these grounds. Moreover, capital income taxation will tax unexpected, or windfall, gains whereas a wealth tax will not since the value of wealth is based on expected returns. Where returns to wealth take an imputed form, taxing wealth itself may be simpler than taxing the returns. This may be the case for housing and for valuables that give an intrinsic return. On the other hand, some forms of wealth are inherently more difficult to measure than the income streams to which they give rise, such as human wealth that either has been endowed in the individual or has been accumulated. We explore these issues further below.

Two final points can be made about wealth taxation versus other forms of asset taxation before analysing the case for and against it. First, some might argue that wealth per se should be taxed because of the benefit it generates for its owners. Wealth may yield an intrinsic benefit to its owners, such as the prestige and status associated with being seen to be wealthy. Moreover, wealth may confer power and influence to wealth-owners, particularly those with substantially

higher-than-average accumulations. For example, such persons might exert significant influence over political decisions of the government. If the wealth had been accumulated from above-normal returns due to windfall gains or monopoly rents, taxing them *ex post* might be justified to the extent that the tax system did not tax them as they were earned regardless of the power and prestige to which they give rise. To the extent that these considerations are true, they would reinforce the case for wealth taxation.

Second, while wealth taxation is analogous to the taxation of the returns to wealth, it is different than bequest or inheritance taxation. Bequests represent a cumulative accrual of wealth over the lifetime, and inheritances represent windfall increases in wealth during one's lifetime. In Europe bequests tend to occur when children are in their 50s, although many transfers occur earlier via *inter vivos* gifts, support for housing purchases and education and transfers in kind. Taxing either bequests or inheritances would be a once-in-a-lifetime event. In contrast, wealth taxation is a recurring annual tax on wealth over the lifecycle. Thus, a wealth tax applies to saving done partly for lifecycle smoothing purposes, while a bequest tax applies to wealth accumulated over and above that used for lifecycle 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. This would be the case to the extent that consumption is taxed on the income or source side of the budget rather than directly, since the budgetary source of consumption finance comes from both labour income and inheritances.

More generally, to understand the allocative and distributional effects of wealth and wealth transfer taxation, one needs to take account of the motives for accumulating wealth. Among these motives, one distinguishes between those which are purely selfish and those which concern

intergenerational transfers (gifts and bequests). Consumption smoothing is the traditional motive for saving over one's lifecycle, with or without uncertainty. It includes the need for replacement income after retirement, financing of children's education, precautionary saving and self-insurance. Economic principles suggest that this kind of saving decreases with social insurance as individuals have less need to save for their own retirement or health care. Retirement saving also tends to be smaller when individuals are short-sighted. In case of imperfect annuity markets and "premature" death, part of life-cycle saving is not consumed and leads to accidental or unplanned bequests. By their nature, these are unaffected by bequest or inheritance taxation. On the contrary, a tax on capital income or on wealth will have disincentive effects on this type of saving.

Parents might care about the likely lifetime utility of their children and hence about the welfare of future generations. Consequently, wealthier parents tend to make larger bequests, and holding parent's wealth constant, we expect parents to leave a larger bequest to poorer children or to children facing liquidity constraints that would make it difficult for them to buy a house or pursue higher education. Alternatively, parents might be motivated not by pure altruism but by the direct utility they receive from the act of giving, also referred to as the warm-glow effect. It can be explained by some internal feeling of virtue arising from sacrifice in helping one's children or by the desire of controlling their life. In either case, taxing that kind of capital accumulation either through an annual wealth tax or a tax on bequests will have a disincentive effect on saving that has to be taken into account. The advantage of taxing wealth at the end of the lifecycle is that it induces altruistic parents to make inter vivos gifts much earlier to children who are often liquidity constrained. The taxation of wealth, whatever its form, can also lead parents to invest in their children's education, which is not taxed and most often subsidised.

## 4. The Economic Arguments for Wealth Taxation

In this section, we probe in more detail the case for including wealth tax as part of the tax system. The arguments for taxing wealth are heavily influenced by the similarities between taxing wealth and capital income. Under certain conditions, these two forms of taxation are effectively identical. To see this, suppose that an individual has wealth consisting of a fully owned house and a portfolio of stocks. Suppose furthermore that the tax on capital income includes the imputed income of the home and the dividends plus the accrued capital gains of the stocks, and that there is full loss-offsetting. Let us also suppose that these capital incomes are such that their present value is equal to the value of the wealth to be taxed and furthermore that both taxes are flat rate. Under these assumptions, there would be equivalence between the two types of levy. (See also the recent summary in Scheuer and Slemrod, 2021.)

To show this equivalence between wealth and capital income taxation more precisely, let  $A_t$  denote the asset wealth of a household in tax period  $t$ , and assume for now that the tax authorities can measure it. In well-functioning asset markets, the value of an asset is the present value of its expected returns accounting for a risk premium. These expected returns can include 1) financial payments like interest, dividends, royalties; 2) capital gains; and 3) imputed returns like consumption benefits in the case of consumer durables, jewellery and artwork. The annual wealth tax liability would be  $\tau_w A_t$ , where  $\tau_w$  is the rate of wealth tax. The tax on capital income can be written  $\tau_k r_t A_t$ , where  $\tau_k$  is the tax on capital income and  $r_t$  is a composite return on asset wealth. The tax on capital income is equivalent to a tax on wealth at the rate  $\tau_w = \tau_k r_t$ .

Alternatively, a tax on wealth at the rate  $\tau_w$  is equivalent to a tax on capital income at the rate  $\tau_k = \tau_w / r_t$ . The higher the rate of return  $r_t$ , the lower is the equivalent capital income tax rate.

In practice, this equivalence is far from the case for many reasons. The two taxes do not have the same base. Some assets are exempt from the wealth tax and others from the capital income tax. The typical annual wealth tax base consists of housing net of debts, deposits, and most financial assets. Some assets are not included, like artwork, jewellery and consumer durables. Business assets may also be excluded either on political grounds or on grounds of valuation, although Luxembourg imposes a corporate wealth tax on private company wealth possibly because asset values can be measured better than income. As a consequence, this base represents only half of the wealth held by the less than one percent of taxpayers who are subject to the wealth tax. All sorts of exemptions reduce the tax base of both social security contributions and the income tax such that the tax on capital income amounts to one-half of what it could yield without these exemptions. Among these exemptions are the unrealised capital gains, the return to life insurance and the basic saving account. The French case illustrates well the fact that two taxes that could be theoretically identical end up quite different in their yields and their incidence.

Taxes on capital income apply to realised rather than accrued capital gains and typically at preferential rates. In contrast, accrued capital gains would be subject to the wealth tax assuming the value of assets is properly assessed. In that respect, there can be a huge discrepancy between the market value of a dwelling and its cadastral value. Also, capital income and wealth tax rates likely differ in level and progressivity, and in the exemption level.

Besides the above differences between wealth and capital income taxes, three others are often advanced in the discussion on the relative merits of the two taxes. The first one concerns the liquidity aspect. Taxpayers (such as the elderly) can have huge wealth but a small income that makes them unable to pay the annual wealth tax. In the political debate in France, opponents of the wealth tax used the example of a retired fisherman who had a small pension (€1000) but a

house that was worth €3 million because it was located in a place that over the years had become a fancy resort. Naturally, he was unable to pay the wealth tax. The government then introduced a ceiling of 75 percent of income on the sum of the income and wealth tax, which reduces the redistributive power of the wealth tax. Similarly, in Germany a court held that the sum of wealth tax and income tax should not exceed one-half of a taxpayer's income. Eventually the wealth tax was declared to be unconstitutional because of its confiscatory nature.

A second difference arises if taxpayers have some discretion over the rate of return on their wealth. In this circumstance, the wealth tax would encourage taxpayers to devote more effort to getting the highest possible return compared with a capital income tax.

A third difference arises if taxpayers differ in the rates of return  $r_t$  on their asset wealth. The literature has focused on two cases (Scheuer and Slemrod, 2021). First, as discussed above, taxpayers may obtain different returns on their assets. For example, they may have larger portfolios, they may have access to better expert advice, or they may be more skilled at making investment decisions, including in their own businesses. Recall from above that a wealth tax at the rate  $\tau_w$  is equivalent to a capital income tax at the rate  $\tau_k = \tau_w / \bar{r}_t$ . Since  $r_t$  varies among taxpayers, a wealth tax is not equivalent to a linear capital income tax: it implicitly applies a lower tax rate to the capital income of those whose assets earn higher rates of return. One might expect that on equity grounds, capital income taxation dominates wealth taxation since it applies a higher effective tax rate on capital income. However, Guvenen et al. (2019) show using a calibrated model for the US with rate of return heterogeneity that replacing a uniform capital income tax with a wealth tax significantly increases total output and reduces inequality. By favouring high-return taxpayers, the tax reform reallocates capital from low-productivity to high-productivity uses. The results are highly suggestive, but they are based on a model in which taxes

are linear with non-capital taxes being held constant. Moreover, the social welfare consequences of the reforms are not fully explored.<sup>6</sup>

Second, some taxpayers might earn more than the normal return to capital because of rents or windfall returns. This may reflect monopoly power, inside knowledge or simply unexpected gains arising from events that cannot be predicted, including government policy interventions (Rothschild and Scheuer, 2016). Since the wealth tax applies to the value of assets  $A_t$  based on expected future returns, it does not apply to windfall gains, whereas the capital income tax does. A capital income tax dominates the wealth tax in this case.

Recall the arguments for taxing capital income outlined above. The case for a capital income tax is stronger when any of the following circumstances apply: 1) high-wage taxpayers discount future consumption at a lower rate than low-wage taxpayers; 2) wage rate uncertainty exists which is not insurable; 3) credit constraints limits borrowing against future wages; 4) rates of return on wealth increase with portfolio size; and 5) future consumption is complementary with leisure. In addition, to the extent that returns to wealth take the form of windfall gains or rents, they should be taxed. Taken together, these arguments support the case for some capital income tax. The rate of capital income tax need not be high as that on labour income, and it should also be progressive if that is feasible administratively.

Given these arguments, a wealth tax might be viewed as a supplement to capital income taxation where the latter is imperfect. For some types of assets, the rate of return might be difficult to

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<sup>6</sup> The analysis is reminiscent of the literature that finds that if the rate of return to education is increasing in skills, devoting education resources to higher-skilled persons can be social welfare-improving even though it creates inequality of earnings since the latter can be addressed by progressive income taxation (Cremer et al., 2011; Stephens, 2012).

measure. Examples include owner-occupied housing, automobiles and other consumer durables, personal valuables, and cash. A wealth tax that targeted these assets could be beneficial, although valuation and compliance problems would be challenging. For some other assets, both the rate of return and the asset value might be difficult to measure. An important example of this is human capital. Its return can be implicitly taxed if the income tax system is progressive, but otherwise human capital tends to be a tax-sheltered asset. Personal businesses also yield capital income that can be challenging to measure, but measuring their asset value is no less difficult, especially intangible assets, which are increasingly important. More generally, capital income earned on behalf of shareholders by corporations can be taxed using a corporate income tax and integrated with the personal tax of shareholders. Arguably, it would be easier to tax corporate-source income using a wealth tax. The latter would apply to the value of corporate stocks held by taxpayers directly with no need to use a corporate tax at all.

Overall, the case for implementing a wealth tax as a complementary way of taxing capital income is limited. The argument is strongest for assets like 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.

At the same time, there are significant drawbacks to wealth taxation as a substitute for 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 desirable, this is a significant drawback to a wealth tax. By the same token, a tax on capital income will apply to returns to risk, while a wealth tax will not. As long as there is loss-offsetting in the income tax

system, this should not be an insuperable drawback to capital income taxation. As long as aggregate capital income is positive, fluctuations due to risk can effectively be immediately deducted. The issue of loss-offsetting only arises when there are aggregate portfolio losses (or personal bankruptcies). Indeed, in some circumstances taxing returns to risk can be a valuable form of insurance that increases risk-taking (Domar and Musgrave, 1944; Stiglitz, 1969; Buchholz and Konrad, 2014), although this is limited to the extent that market insurance is available but subject to moral hazard. Government insurance could potentially make matters worse in these circumstances.

As well, there are some assets whose returns can be measured more readily than their asset value. This is the case for intangible assets like intellectual property or goodwill both of which give rise to a stream of taxable earnings, typically in the hands of businesses. Taxing income generated by these assets is more feasible than taxing the asset values themselves.

There are various other arguments for wealth taxes that go beyond those based on the taxation of capital income. Piketty (2013) has proposed a wealth tax (albeit a worldwide one) to address the growing wealth inequality partly due to relatively high rates of return on wealth. Saez and Zucman (2019a,b) have proposed the same for the USA. A wealth tax can be designed in such a way as to focus on large accumulations of wealth, for example, by giving a generous deduction for low levels of wealth and imposing a relatively high tax rate on large accumulations. The issue is whether a wealth tax is the best way to address the issue of growing wealth inequality, given that it does not tax windfall gains directly. At best, it taxes wealth accumulated from past windfall gains. An alternative is to tax windfall gains as they accrue through the taxation of capital income. A capital income tax can be designed so that its base focuses on above-normal returns to capital. An example mentioned above is the RRA proposed by the Mirrlees Review

(2011) that would tax only returns to unsheltered assets in excess of a normal rate of return. Such a tax could be harmonised with the income tax system and be subject to progressive rates. Even so, it might not be possible to make it progressive enough to address extreme wealth inequality.

More generally, evidence suggests that the growing inequality of wealth is in turn reflected in a growing proportion of saving being done for bequests as opposed to lifecycle smoothing (Piketty, 2013; Alvaredo et al., 2017). In these circumstances, wealth inequality is of policy concern largely because high levels of wealth are transferred to succeeding generations.

Addressing this issue directly would involve a tax on inheritances rather than an annual wealth tax given that the latter also taxes wealth held for lifecycle smoothing purposes.

From a political economy point of view, wealth taxes in part might reflect commitment problems of the government. It is well-established in the literature that even (or especially) a fully benevolent government cannot avoid the temptation to tax existing accumulations of wealth, whether of households or corporations (e.g., Fischer, 1980). Indeed, a strong case can be made that the reason why capital income seems to be taxed at rates higher than optimal income tax analysis would suggest is precisely because governments cannot avoid taxing capital or wealth that has been previously accumulated. They are constrained only by the fact that such taxes discourage future capital accumulation. Whether governments can be constrained from the temptation to tax “old” capital is an open question. Such temptation might be more inviting if a wealth tax is in place than if it is not.

Capital income taxes also have some advantages of flexibility from a tax design point of view.

Capital income taxes can have exemption levels as in France and the UK. In addition, some forms of capital income are tax-sheltered, such as saving for retirement, and these tax-sheltered

savings can have an upper limit that restricts their availability to high-income persons. In addition, capital income tax can be designed so that it only applies to above-normal earnings, as in the case of RRA taxation proposed by the Mirrlees Review mentioned above. Capital income tax may not apply to certain asset returns, like housing, but it can be augmented by property taxation or taxation of housing capital gains. Finally, under a dual income tax a proportional tax rate can be applied to capital income. This tax makes evasion more difficult than ordinary income tax since financial intermediaries can be used to withhold tax. These aspects may be difficult to replicate using wealth taxation.

The upshot of this discussion is that a wealth tax is to a large extent an imperfect substitute for a tax on capital income. It has the advantage that it can tax assets whose return is difficult to measure for income tax purposes, especially consumer durables. At the same time, it is inferior to capital income taxation when rates of return are easier to measure than asset values, such as intangible assets, intellectual and knowledge property and personal businesses. But it has the significant disadvantage that it does not tax windfall gains. Moreover, it is no better than capital income taxation for taxing human capital returns and for taxing inheritances at rates reflecting their advantage to inheritors.

There is still the argument alluded to earlier that wealth may give direct benefit to its owners either as a utility benefit or as a source of power and prestige. Verifying such a benefit is virtually impossible, so it is hard to justify basing wealth taxation on this argument.

There are also various administrative problems with wealth taxation that make compliance and collection costly. For one thing, there is risk of capital flight and pervasive inequity arising from wide variety of loopholes (like change of residency). As well, measurement difficulties lead to

exemptions like artwork and durables, and family enterprises are often exempt on political grounds. These problems also affect inheritance and capital income taxation. The need to value assets frequently implies that the wealth tax has a low yield relative to administrative costs compared with inheritance tax.<sup>7</sup> Finally, wealth and wealth transfer taxes are surprisingly unpopular even though a majority of citizens would be net gainers from such a tax.

## 5. Concluding Comments

The discussion above emphasises the distinction among annual wealth taxation, capital income taxation and wealth transfer taxation (either on bequests given or inheritances received). Wealth and capital income taxes are analogous and fulfil similar functions. Under certain circumstances, they are equivalent. The ultimate rationale for taxing wealth is the same as for taxing capital income, and we have recounted the arguments underlying this rationale in detail above. Given that, the case for an annual wealth tax rests primarily on shortcomings of capital income taxation. There may be some assets for which the returns are difficult to measure, such as housing and other consumer durables. An annual tax on the value of such assets could in principle be a useful complement to capital income taxation. That must be weighed against the administrative and compliance costs of such taxes, which could be substantial. In practice, annual taxes on housing values are frequently used as instruments for financing local government. Given that, the case for taxing the imputed income of housing might be reduced. On the other hand, the property tax serves other objectives, such as benefit pricing for local public services or curbing crowding

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<sup>7</sup> Detailed discussion of the high administrative costs of an annual wealth tax may be found in Advani et al. (2020) for the UK, and Comité d'évaluation des réformes de la fiscalité du capital (2019) for France.

externalities, rather than redistributive ones. Moreover, the property tax may in part be shifted away from property owners.

Wealth taxes have some other, less compelling, advantages over capital income taxation. Unlike the latter, wealth taxes do not tax stochastic returns to risk, although they do tax any risk premium that is capitalised in asset values. However, to the extent that capital income tax regimes afford loss offsetting, the taxation of returns to risk is mitigated. A tax on substantial accumulations of wealth can address the possibility that wealth ownership yields privileges, status and power that some might deem worthy of taxation, especially where the wealth is a result of pure luck. As well, wealth taxation might make up for the shortcomings of actual capital income tax regimes, such as the preferential treatment of capital gains. On the other hand, this might be best remedied by reforming the capital income tax system.

By the same token, capital income taxes have some advantages over wealth taxes. For some assets, the value is more difficult to measure than the returns to the assets, such as intangible intellectual property. As well, capital income taxes include windfall gains, whereas these are not capitalised into asset values since they are unexpected.

Our judgment is that a well-functioning capital income tax dominates an annual wealth tax. The benefit of implementing the latter alongside a capital income tax do not compensate for the significant administrative costs that would be involved. However, this judgment comes with some caveats. The case for relying solely on capital income taxation (along with labour and consumption taxation) is strongest when the capital income tax includes all forms of capital income including capital gains. That is not to say that the rate of taxes applied to capital income should be the same as those applying to labour income. A dual income tax system with a uniform

rate applied to capital income has significant administrative advantages. At the same time, taxing housing wealth using a property tax rather than taxing imputed rent makes good sense, especially since property taxation is a well-established tax for financing local government.

Our lukewarm support of an annual wealth tax could be modified in a special case, namely the case of a one-off wealth tax when particular circumstances such a war or a pandemic leads to a drastic change in the distribution of both income and wealth. To be more specific, a number of economists have advocated such a tax following the upsurge of the Covid-19. It indeed appears that the pandemic caused lockdown policies that increased economic inequalities by sheltering rentiers and hurting self-employed and unskilled workers. Such a tax should be unexpected so as to avoid inefficiency and tax base erosion, and it should be big enough to finance part of the huge deficits caused by the pandemic. Its main advantage would be to reach accrued capital gains and to avoid most of the disincentive effects of traditional capital taxes that can be anticipated. It would be intergenerationally equitable since it would mainly hit people who did not suffer from the pandemics. However, to be effective, it would have to be unexpected, and that is difficult to achieve given the necessity of tax changes being debated and legislated by parliaments.

Various countries have used one-off wealth taxes to deal with revenue shortfalls, such as war-time spending shocks. Recently, at end of 2020, Argentina has adopted a wealth tax that will impose a one-off levy on people with large personal fortunes as the government tries to boost revenue hit hard by the Covid-19 pandemic. Notably, twenty years ago, in a plan aimed at erasing the national debt and bolstering the credibility of his own prospective candidacy, Donald Trump proposed a one-off 14.25 percent tax on the net worth of individuals and trusts.<sup>8</sup>

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8 See <https://www.vox.com/2019/1/31/18203999/donald-trump-wealth-tax-14-5-percent>.

The role of wealth transfer taxes is distinct from both wealth and capital income taxes. Inheritances represent a source of income to recipients from which consumption can be financed over one's lifetime. Even if tax design were based on consumption so capital income goes untaxed, inheritance taxation would be required as a complement to personal taxation. This would be the case under both tax-prepaid and registered treatment of assets. In principle, the same tax rate should apply to inheritance as to other elements of the tax base, but that poses difficulties since inheritances are received in lump-sums rather than annually. Some compromise would have to be found. Interestingly, both the Meade Report (1978) and the Mirrlees Review (2011) recommended an inheritance tax alongside a personal consumption tax system. In the case of the former, the personal tax system would be based solely on tax-prepaid and registered asset treatment. The Mirrlees Review differed in that income from shares would be taxed on an RRA basis so would include above-normal capital income.

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