

Taxes on wealth: what kind of reform?

By [Guillaume Allègre](#), [Mathieu Plane](#) and [Xavier Timbeau](#)

Why and how should wealth be taxed? Are France's wealth taxes fair and efficient? In an article entitled, "[Reforming the taxation of wealth?](#)", published in the [special Tax Reform issue](#) of the *Revue de l'OFCE* [in French], we examine these issues and propose some possible ways to reform the taxation of wealth.

We show that in recent years real economic income from capital has been very substantial. The visible income from capital (interest, dividend, rents received, etc.) exists alongside less visible income (capital gains net of the consumption of fixed capital and inflationary tax). As only a portion of potential capital gains are realized, this less visible income forms a significant part of average personal income. Between 1998 and 2010, despite two financial crises, capital gains increased real per capita income by an annual average of 12% (33% on average from 2004 to 2007). This growth was due in large part to the sharp rise in property prices.

We also show that the actual tax rate on income from wealth is low, even though the nominal interest rates on capital income are high, and the tax rate *on income that is actually taxed* is even higher due to not taking into account inflationary tax in the calculation of taxes [\[1\]](#). After taking into account all taxation based on household wealth, including wealth which is held ("ISF" wealth tax, property tax) or which is passed on (property transaction taxes *i.e.* "stamp duty") and income from wealth (income tax, "CSG" wealth tax, etc.), the actual rate of taxation on economic income from capital [\[2\]](#) comes to an average of 11.1%. This low rate for the actual taxation of capital income is due to the fact that a large portion of this

income fully or partially escapes taxation: real property gains on principal residences are totally exempt, and secondary residences are partly exempt; the housing enjoyed by owner-occupiers ("imputed rent") is not taxable, even though, net of interest, it constitutes income; gifts serve to "purge" any capital gains, even when these are not taxed (there is a tax allowance of 159,000 euros per child for gifts to direct heirs, which is renewable every ten years); and some financial income avoids income tax (life insurance, tax-exempt bank accounts, etc.).

Next we discuss possibilities for reform that would lead to taxing all income from wealth. We believe that income from wealth (net increased income from wealth) should be taxed in the same way as labour income. This principle is fair (in the sense that households are then taxed on their contributory capacity, regardless of the source of their income), and it would also help to combat tax avoidance. In an increasingly financialized economy, the interface between labour income and capital income has become porous. Taxing capital income differently opens the door to tax schemes. Any reform of wealth taxation should make it a priority to tax all real capital gains, in particular real property gains, which currently are subject to specific rules. In addition, since property is a fixed asset, the existing rules cannot be justified as due to tax competition in Europe. They are occasionally defended based on the need to take account of inflation or due to the unique character of the principal residence. But taking inflation into account cannot justify the total exemption of real property gains on secondary residences after they have been held for a certain time (currently 30 years, previously 22 years): not only does the exemption on capital gains seem unfair, but it can also prompt some households to keep their property, in particular during speculative bubbles. Furthermore, the specific character of property cannot be invoked once there has been a definitive withdrawal from the market. The taxation of realized capital

gains, net of inflation, of the consumption of fixed capital and of renovation costs, would thus be preferable to a system of allowances based on the period of ownership. This could take place when the sale is not followed by another purchase – so as not to penalize mobility – and during inheritance (taxation of unrealized gains, before calculating inheritance tax). The taxation of real property gains upon a definitive withdrawal from the market could gradually replace the system of property transaction taxes or “stamp duty”, which would promote mobility and greater horizontal fairness.

In light of these arguments, what do we make of the proposals by the new French President François Hollande with regard to the taxation of wealth? He proposes (1) to tax capital income at the same rate as labour income is taxed; (2) to roll back the tax breaks on the ISF wealth tax and to raise the rate of taxation on the top income brackets; and (3) to reduce the inheritance tax allowance from 159,000 euros per child to 100,000 euros (it was raised from 50,000 euros to 150,000 euros in 2007).

(1) The first point would also involve eliminating the flat-rate withholding tax and the various tax loopholes that permit tax avoidance. It is similar to our proposals, so long as the income subject to tax takes into account inflationary tax and the consumption of fixed capital. This kind of proposal would involve taxing imputed rent, which constitutes an imputed income from capital. Nevertheless, given the difficulty of estimating the tax base, imputed rent has not been taxed since 1965 (see the article by [Briant and Jacquot](#)). One solution to this difficulty is to permit renters and first-time buyers to deduct their rent or loan interest payments from their taxable income, while increasing the average income tax rate to offset this.

(2) The second point departs from our proposals, but the ISF tax offers one solution for taxing large estates bit by bit, *even when they do not procure any taxable income* (when there

are unrealized capital gains but an absence of dividends or earned rent, for example). In a situation like this, the ISF tax makes sense *only if it is not capped based on the taxable income (or a similar notion)*. The ISF tax on wealth makes even more sense when the actual yields, including the unrealized gains on the assets, are not very heterogeneous (but it is then equivalent to a tax on the income from the assets) or when the supervision of the asset owners can improve their yields (taxation based on holding the wealth, and not on income, then serves as an additional incentive “to owners to ‘activate’ their estate,” in the words of Maurice Allais). In contrast, if the asset yields are heterogeneous and strong incentives to optimize the wealth already exist, then a tax on the income from the wealth is preferable from the viewpoint of fairness and not undermining economic efficiency.

(3) Higher inheritance taxes seem legitimate from the perspective of equal opportunity. We feel, however, that this should go further, at least by eliminating the purge of capital gains, in particular when the goods have been exempted from inheritance tax.

* *This text is taken from the article [Reforming the taxation of wealth?](#) published in the special Tax Reform issue of the *Revue de l'OFCE*, available on the [OFCE website](#).*

[1] As [Henri Sterdyniak](#) points out: “It is thus erroneous to claim that capital income is taxed at a lower rate. When it is *actually* taxed, this is at higher rates.”

[2] Defined as the ratio between the sum of taxes based on wealth and the net increased income from the wealth after having subtracted the consumption of fixed capital and inflationary tax.

Fiscal reform: Now or never*

By Nicolas Delalande (*Centre d'histoire at Sciences Po*)

While the question of taxation was one of the major economic issues of the presidential election, it must not be forgotten that there often exists a gap between the political and media attention received by a set of campaign promises (what political scientists would call the “politics”) and their practical implications in terms of public policy (the “policies”). It is also worth asking whether any such tax reform will actually take place.

For over a year, commentators and politicians have repeatedly argued that taxation would be a key question in the presidential election. Many saw it as one of the only real issues distinguishing the outgoing majority, which with the TEPA law of August 2007 had bet on a strategy of “fiscal shock” to unleash growth (50% cap on taxes, reduction of inheritance taxes, exemption of overtime, etc.), from the Left opposition, which has been quick to denounce the injustice and inefficacy of measures that undermine progressive taxation without obtaining the expected economic benefits, while deepening the deficit. The promise of reform, or even a tax “revolution”, was high on the political agenda, particularly for the Left. However, intense conflicts and debates over taxes do not guarantee that the election of Francois Hollande will be followed by a genuine transformation of the French tax system. There may very well be a gap between the political and media attention received by campaign promises (the “politics”) and their practical implications for public policy (the “policies”). However much tax reform may be touted during the campaign, it may well be distinctly less popular when it comes time for implementation, when political will runs up against

varied forms of sometimes unanticipated resistance.

There has, nevertheless, been a felt need almost everywhere in Europe to increase the taxation of the wealthy, not so much to solve the problem of government deficits as to restore a semblance of fairness and shared effort in a time of economic crisis. A number of countries have embarked on this path (the top marginal rate of income tax is 57% in Sweden, 50% in Britain, and 45% in Germany), even though some have already sounded the retreat (David Cameron's Conservative government has proposed cutting the top marginal rate back to 45% in 2013). Even billionaires like Warren Buffett in the United States have called for raising taxes on better-off strata to put an end to the most blatant inequalities. This kind of reform actually consists of backing off the policies of the last fifteen to twenty years by reversing the trend to erode the progressivity of the tax system: strictly speaking, this is less a matter of reform than of cancelling previous reforms. Increasing tax revenue no longer results as before from creating new tax measures but from removing the tax reductions and exemptions enacted in recent years. Hence the debate, both in the US and Europe, over the real nature of the "tax increases": the Republicans accuse the Democrats of increasing the tax burden, while the latter claim to be merely reversing exemptions that they consider unwarranted and inefficient. Reform thus amounts to nothing more than the restoration of the situation *ex ante*. In France, for example, the Socialists have pledged to cancel what remains of the tax package of 2007 (after having removed the tax cap in 2011), to significantly reduce tax loopholes and to establish a new income tax bracket: the reference point for these proposals is in fact the actual system as it existed only five to ten years ago, with the exception of the promise added during the campaign to create an exceptional 75% bracket on incomes of over 1 million euros.

A more ambitious structural reform, for example along the

lines proposed in the recent [book](#) by Camille Landais, Thomas Piketty and Emmanuel Saez, would involve an entirely different scale. Opening the “black box” of the redistribution machine actually implies a much wider debate on the missions of the tax system, its administrative organization and its relationship to social and family policy. This is where the “costs” of policy reform, such as the eventual cancellation – or modulation – of France’s “family quotient” tax-splitting system, may be felt most directly. In any case, the erosion of the belief that the only reforms that could possibly be any good involve reducing the tax burden means that the current environment has never been more favourable for initiating this debate. The political, social and financial implications of this new configuration will certainly be complex and demanding in terms of democracy, but, in light of the numerous critics of the failings of the existing system, there is little doubt that 2012 offers a unique opportunity for undertaking ambitious reform. Tax reform implies the need for an effective political coalition to overcome the various social, institutional and technical obstacles that are likely to arise and to be able to take advantage of the favourable circumstances in which ideologies and beliefs that were thought to be firmly established are now on shaky ground. From a historical standpoint, it should not seem absurd that the current economic crisis, which is often compared to the 1930s, calls for and indeed even requires a renegotiation of the fiscal pact on a scale as significant as that experienced by Europe and America in the first third of the 20th century. The process of reform will, however, inevitably be more complex than before: the systems for collection and redistribution, now more sophisticated than ever, are based on an array of measures that have arisen in different periods and in unique political, economic and social contexts.

* *This text is taken from the article [“The political economy of tax reform: a historical analysis”](#), which was published in a special Tax Reform issue of the OFCE Revue and is available*

on [the OFCE web site](#).

Replacing the “Prime pour l’emploi” benefit by a reduction in employee social security contributions on low wages

By [Guillaume Allègre](#)

Nicolas Sarkozy has announced plans to replace the “prime pour l’emploi” benefit (“PPE”) by lowering the social security contributions of workers earning between 1 and 1.3 times the minimum wage (“SMIC”). The reduction on contributions would amount to 4 billion euros and would benefit 7 million low-wage workers. The gain announced (just under 1,000 euros per year) would necessarily be regressive. The elimination of the PPE (2.8 billion euros according to the [2012 Budget Bill](#), p. 76) would be supplemented by higher taxes on financial income.

This proposal is very similar to the original proposal of the Jospin government in 2000 that provided for a reduction on the CSG social contribution for workers earning less than 1.4 times the SMIC. That reform, which was passed by Parliament, was blocked by the Conseil constitutionnel because the decline in the CSG provided to low-income earners depended on wages alone, and not on individual family circumstances. As the CSG is considered a tax, the high court held that progressivity

required taking into account taxpayers' ability to pay, and therefore their family responsibilities. To deal with this ruling, the Jospin government created a new instrument, the PPE benefit, which closely resembled the CSG reduction, but which was calculated, to a very small extent, on the family situation (high income ceiling at the household level, with a small increase for children). But unlike the CSG reduction, the impact of the PPE does not show up on the pay-slip: the benefit is calculated from income tax returns and reduces the tax payable by the household, with households who do not pay tax receiving a cheque from the Treasury. This means that there is a one-year lag in the receipt of the benefit. The PPE was approved by the Jospin government and then increased under the Villepin and Raffarin governments, and by 2008 amounted to 4.5 billion euros ([2010 Budget Bill](#), p. 53). At that point a full-time employee on the minimum wage received 1,040 euros per year. The PPE was then frozen by the Fillon government. This freeze, together with the fact that the RSA benefit was deductible from the PPE benefit, led to a 1.7 billion euro reduction in the value of the PPE between 2008 and 2012, from 4.4 billion euros to 2.8 billion. By 2012, a full-time employee on the minimum wage now received only 825 euros a year. Moreover, the lack of a boost in the minimum wage has greatly reduced the number of households eligible for the full rate (as well as the number of employees eligible for the full-rate reduction on employer contributions). This effect comes on top of the impact of rising unemployment, which is reducing the number of eligible employees. A 4-billion euro scheme, for which the maximum gain would be just under 1,000 euros, would amount to a little less than the PPE did in 2008. If we add in the cost of the RSA income supplement (1.6 billion in 2012), and if we take into account the previous RMI and API-related incentive schemes (600 million), we conclude that these various support mechanisms for low-income employees would total 5.6 billion euros in 2012, against 5.1 billion in 2008, an increase that barely exceeds inflation: the new policies that have been proposed since 2008 have been funded

mainly by shuffling instruments targeted at the same population.

The replacement of the PPE by a reduction in social contributions would represent progress in administrative terms, since the government would cease to levy contributions and then repay a smaller tax credit to the same people 6 to 12 months later. The benefit of lowering contributions would be immediate and strongly linked to employment. This would also clarify the fact that low-paid employees are contributors to and not beneficiaries of social assistance. The proposed merger of the CSG tax and income tax (with the PPE as one element) has precisely the same goal. This reform nevertheless raises several questions. What would happen if the Constitutional Council were approached? And, employees working part-time currently benefit from an increase in the PPE; will this be renewed?