CURRENT & QUOTABLE

Capital Levies: A Solution for the Sovereign Debt Problem?

by Daniel Shaviro

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As an American speaking to Europeans, I don't want to overassume common cultural knowledge. But perhaps many of you recall the fable "Who Will Bell the Cat?" It features mice who don't know what to do about a marauding cat, until one of them proposes placing a bell around his neck, so everyone will hear him coming. All applaud the idea, but then someone asks who would like to place the bell on the cat. No one volunteers.

As Wikipedia explains, belaboring the obvious: "[This] story is used to teach the wisdom of evaluating a plan not only on how desirable the outcome would be, but also on how it can be executed. It provides a moral lesson about the fundamental difference between ideas and their feasibility, and how this affects the value of a given plan."

I have been put in mind of "Who Will Bell the Cat?," and its all too blunt lesson, by recent discussion in the EU of a plan to pay down rising levels of sovereign debt through the use of capital levies — that is, putatively one-time taxes on high-end private wealth. Now, the underlying idea here is really good. Another common English expression is to "kill two birds with one stone" — that is, to achieve two objectives at once. Un-belled cats, of course, would regard this as spoiling all the fun. But in the case of the capital levy, the idea is actually to kill *three* birds with one stone.

First, the capital levy aims to fund a significant paydown of sovereign debt. This is desirable even in countries that are very far from having to worry about default. High debt levels can reduce both economic growth and policy flexibility. The challenges of managing a stateless currency like the euro make it more desirable still, and the proposal gets bonus points for avoiding contractionary austerity. Whether a capital levy is a good approach in the end or not, at least it avoids reducing the current resources available to cash-constrained and economically insecure consumers while unemployment remains unacceptably high.

Second, the capital levy responds to the dramatic increase that we have seen, in recent decades, in high-end inequality across the developed world. The big craze in the U.S. these days, although I gather it initially made less of a splash in Europe, is Thomas Piketty's *Capital in the Twenty-First Century*. This book gathers extensive historical data in support of the proposition that high-end wealth inequality, after easing in advanced Western countries from the time of World War I through the 1960s, has since then taken off again. It further argues that high-end inequality is likely to keep on increasing absent either unpleasant shocks or major policy changes.

Consider Germany. A recent paper by Stefan Bach and others indicates that the bottom half of the distribution owns only 2 percent of total net wealth. The top 1 percent of households own 23 percent of the wealth, and the top tenth of a percent hold almost 9 percent of the total. Piketty offers similar data for France, as well as for the U.S., the U.K., and numerous other economically advanced countries around the world.

My own view is that pronounced high-end wealth inequality can be dangerous, weakening social cohesion and democratic responsiveness while risking the creation of a rent-seeking and/or rentier society — two different things, but both bad. In the U.S., recent political science research suggests that only economic elites and organized interest groups have any significant political influence in Washington. Indeed, the attitudes of median voters have so little bearing on U.S. policy outcomes that Princeton's Martin Gilens calls the U.S. more of an oligarchy than a true democracy. Recent decisions by the U.S. Supreme Court pertaining both to campaign financing and voting rights have the potential to make this problem both absolutely worse and harder to address.

Proponents of a one-time capital levy want to get the distributional benefits of wealth taxation while steering clear of the adverse incentive effects. This ambitious effort at sleight of hand brings us to the third bird that ostensibly can be slain with just the one stone. In tax policy debate, the Holy Grail is a perfectly efficient tax that prompts zero avoidance behavior — like a uniform head tax — and yet that has attractive distributional properties. The best-known hypothetical example is a lump-sum ability tax. If ability could be observed, and were in fact entirely innate rather than something one chooses to develop, then taxing it would be progressive and yet wholly non-distortionary. But of course these conditions don't hold. Thus, in the optimal income tax literature, a lump-sum ability tax appears purely in the role of an unattainable first-best ideal.

In the U.S., a couple of Harvard economists recently wrote an article about a height tax, which they argued would be progressive and yet lump-sum, since adult height is close to being a fixed attribute and apparently is well-correlated with earnings. I myself was ready to endorse the height tax, so long as there is an exemption for people under 1.85 meters. But alas, these economists wrote not to urge the adoption of a height tax, but to hold it up as an example of why optimal income tax theory, which seemingly would recommend it, is intuitively offensive and must be wrong.

Enter capital levies, to the apparent rescue of highly or even perfectly efficient taxes with attractive distributional properties. Again, a capital levy is a one-time wealth tax. At least in the textbook example, no one sees it coming. Instead, it arrives overnight by complete surprise, with an immediate or even retroactive effective date for measuring taxable wealth. Thus, in principle, no one responds to it in advance. In addition, because it is supposed to happen just once, in the textbook case there is also no behavioral response afterwards.

A successful capital levy therefore really does do it all. It pays down sovereign debt, improves distribution, and has no effect on incentives. To be sure, it isn't a free lunch, since wealthy individuals actually have to pay it. But if there is positive social value to reducing high-end inequality, this loss to them may be viewed as a gain to everyone else, even apart from the fiscal benefit. So in the end a textbook capital levy is as close to a free lunch as belling the cat would be, if you don't attach much social value to the cat's perspective.

Unfortunately, however, imposing a textbook capital levy, no less than belling the cat, is tricky in practice. One set of difficulties relates simply to getting it enacted. The wealthy people whom it would target are not exactly powerless. Indeed, the rising high-end inequality that helps to motivate a capital levy may actually harm its political prospects. Real-world politics often has an anti-insurance quality in that, even if you want to help the losers, the winners are the ones who keep gaining power and influence. Perhaps it's easier to ''soak the rich'' when they are relatively weak — as they were, for example, in the 1930s — than when they are relatively strong — even if the actual merits regarding when best to do it are precisely opposite.

It's also plausible that the very unavoidability of a textbook capital levy would make its enactment more difficult. After all, if low-cost avoidance strategies work well enough, there may be little reason to oppose a tax that's aimed at you. At the limit, a tax so easy to avoid that its enactment amounts to little more than cheap populist symbolism has the best political prospects of all. I know this, because we've actually done it in the U.S. a few times.

Another set of difficulties relates to administration, measurement, and collection. High-end private wealth is often hard to find, and even if found it can be hard to value accurately. There could also, in some cases, be liquidity issues with paying a wealth tax on unique assets, such as a rapidly growing business that doesn't throw off much free cash. But the main set of implementation difficulties I have in mind are those that pertain directly to the textbook scenario for an efficient capital levy.

Again, this claim, or rather hope, of perfect efficiency rests on two premises. The first concerns anticipation ex ante, which won't be an issue if the capital levy is enacted overnight by surprise. The second concerns incentive effects ex post, which won't be an issue if everyone believes that it was a one-time extraordinary measure, won't be happening again, and doesn't even offer significant evidence about other likely future political outcomes.

Do these claims need to be perfectly true in order for enacting a capital levy to be a good idea? Of course not. They only need be true enough for the capital levy to be a relatively efficient fiscal instrument. But even that is open to doubt.

Starting with the ex ante aspect, it should be clear how unrealistic it is to think that any modern democracy would enact a large-scale capital levy on a surprise, overnight basis. Any proposal of this kind that had a realistic chance of adoption would likely be debated for years. Even in parliamentary systems that lack the radical dysfunction of U.S.-style presidential systems with a separate legislature, there would likely be a slow march to the finish line, with blaring newspaper headlines and TV news reports along the way if it was a big enough story. Few of the capital levy's targets would be taken by surprise, and depending on the design they might even be able to turn a one-time effective date to their advantage.

This is why political opposition to a capital levy matters even if it can ultimately be overcome. Indeed, the one classic example of a textbook capital levy that was imposed overnight comes from Japan in 1946. There, however, it was imposed by occupation authorities amid the post-World War II suspension of ordinary Japanese domestic political processes.

Levying a tax just once also can be disadvantageous from an administrative standpoint. In the case of a recurring levy, taxpayers are not the only ones who can react creatively over time. Government policymakers and administrators also typically have a learning process, in which they discover what works and what doesn't. One-time taxes cannot be given operating upgrades.

But the ex post perspective raises concerns as well. Let's start with the case where all you have to do is solemnly promise that you will never do it again. In that scenario, once you've imposed a capital levy on Day 1 and everyone took it in stride, the obvious thing to do is impose another one on Day 2. Unfortunately, however, few statements in life are harder to sell than ''This time, we really mean it.''

Given this problem, the public economics literature addresses not only efficient capital levies, but also time-consistency problems. In the extreme form, at Time One the government urges you to invest, even though at Time Two you'll be vulnerable to expropriation. Then at Time Two it expropriates. In other words, it implements a surprise 100 percent capital levy that is perfectly efficient at Time Two. But of course, even leaving aside the problem of Time Three, investors who anticipated the problem at Time One will respond in advance by not investing. Indeed, even if the government genuinely is not going to expropriate at Time Two, persuading investors of this at Time One can be a challenge, unless it can credibly bind itself in advance — which often is hard for governments to do.

The issue boils down to one of reputation. Enacting a surprise capital levy almost inevitably weakens one's reputation for not enacting surprise capital levies. But on the other hand, it is just one piece of information that investors will evaluate against a broader background of knowledge. That broader background can result either in magnifying or in reducing the expectational effect of the act as considered in isolation. In evaluating how this might work out in the case of a capital levy that was enacted by an EU country in the near future, I believe that the following four questions are especially relevant:

First, how good is the enacting country's reputation? Suppose North Korea newly opened its doors to outside investment, without major internal political reform. As any potential early investors would likely be extremely skittish, the North Koreans would have to be very careful. Even the slightest misstep could cause investors to panic and flee.

Within the EU, a country like Germany would surely have considerably more leeway to impose a capital levy without seriously undermining investors' confidence. The worst-case scenario would probably involve the capital levy's being viewed as equivalent to the enactment of a periodic, recurring wealth tax of similar scope.

EU countries may differ in this regard, however. I note that a recent report by the Deutsche Bundesbank mentioned the possibility that countries with serious sovereign debt problems might consider imposing capital levies if they face an imminent risk of default, especially before they petition for rescue by other EU countries. While default is certainly a dire enough scenario to call for extraordinary measures that one wouldn't otherwise contemplate, this is in a sense exactly the wrong time for enacting a capital levy that you want people to believe is once and once only. Desperation sends the wrong message. All else equal, a country that is on a stable course is likely to be more able to reap the efficiency payoff from a surprise capital levy.

Second, how repeatable is the rationale for the capital levy? Just because you have had a good reputation to date is not reason enough to think that a capital levy will be accepted as likely to be imposed once and only. After all, it inevitably supplies new information. That being so, the perfect excuse is non-recurring hardship — something that went wrong in the past that investors have reason to think will not happen again.

For this reason, it makes perfect sense that a number of European countries either adopted or at least seriously considered capital levies in the immediate aftermath of World War I. The war had wreaked disastrous harm on both their finances and their economies, but it was over, and accordingly there was reason to hope that fiscal peril was not going to be a recurrent problem.

This factor does not similarly weigh in favor of current adoption of a capital levy by an EU country with high sovereign debt. Even if we regard the 2008 financial crisis as a one-time extraordinary event — which would certainly be optimistic — long-term budgeting problems both in the EU and around the world have fundamental ongoing causes, such as population aging. Absent a similar reason to that from the World War I era for thinking that high sovereign debt levels won't recur, the claim that this is just a one-time effort to place one's finances on a sounder footing may not be especially credible. Note also that another key rationale for enactment, that of reducing high-end wealth inequality, likewise would involve an ongoing issue, rather than one that was expected to go away.

Thus, while it probably remains a gross exaggeration to say that people who observed the capital levy would immediately fear the worst, such as imminent expropriation, it certainly is plausible to think that they would view it as possibly just the first installment in an ongoing series of wealth taxes.

Third, what would enactment demonstrate about the internal political equilibrium? Once again, this depends on the country. Germany, for example, eliminated its wealth tax in 1997 and has not reintroduced one since, although I gather that the Social Democrats are now calling for such a tax. Against this background, the enactment of a capital levy might suggest to observers that the political balance of forces in Germany was less favorable to the wealthy than they had previously been inclined to believe.

In France, by contrast, while a capital levy would make no sense since they already have a recurring wealth tax, not to mention a newly approved 75 percent marginal tax rate on high-earners, at least it is already well known that policymakers there are interested in doing something about high-end wealth accumulation. So perhaps the new informational content would be less in France.

Fourth, how would enactment of a capital levy affect policymakers' incentives and subsequent choices? So far, I've mainly suggested that, even absent any reason for thinking that enactment of a capital levy would be downright disastrous, there is also a strong case that it would be viewed much like a wealth tax that, while unannounced, was nonetheless likely to recur. There is a countervailing factor, however. When you announce a capital levy, you are deliberately creating a reputational hostage. You are claiming, at least implicitly, that wealth taxes are going to be off the table for a while. This makes subsequently enacting one costlier than it would otherwise have been. By contrast, simply not having a wealth tax today does not inherently involve claiming that you don't plan to have one tomorrow.

If you'll forgive another animal reference, consider the one-bite rule for dogs. At least in U.S. states that follow a negligence rule, dog-owners are not liable in tort for their animals' biting someone unless the event was reasonably foreseeable. Once your dog bites someone, however, you are on notice, and the next bite is definitely going to cost you money damages. One thing this means, however, is that the first bite isn't actually free. It means you've used up your free bite option. Another thing it means is that I might actually be safer near your dog if I know it has already been caught biting someone. That way, I know you have more of an incentive to be vigilant. Similarly, and paradoxical though it might sound, there is a sense in which enactment of a capital levy could reassure investors by using up the state's free first bite. Indeed, this might actually be part of its appeal in some circles.

Consider Germany again, with respect to the annual wealth tax that the Social Democrats have proposed. Enacting a capital levy, and thus creating a reputational hostage against at least near-term wealth taxation, might weaken not only the merits of this proposal, but perhaps also its actual prospects of being adopted.

To be sure, none of this would matter very much if we assume that wealth taxes are still mainly an instrument of the past. However, my own guess is that, despite the large number of EU and other countries in which wealth taxes have recently been repealed, it is possible that the pendulum will start to swing back. Obviously, the answer to the question of whether this is good or bad depends on what one thinks about wealth taxation.

In sum, I believe that, for many EU countries, enacting a one-time capital levy would not be as different as one might have thought from simply enacting a recurrent wealth tax. However, if you compare the two under the simplifying assumption that they would lead to the same actual expected level of wealth taxation in the future, it seems clear that the putatively (but not entirely credibly) one-time capital levy is likely to yield considerably greater uncertainty about future wealth tax rates.

That uncertainty is potentially a very bad thing — although, once again, it depends on the broader circumstances. But in the case of wealth taxation, uncertainty may be bad for more than just the standard reason that it imposes disutility on risk-averse taxpayers without offsetting benefit to the public fisc. Wealthy individuals are often highly mobile. Offering them a stable regime may therefore make sense even if it isn't in all respects the regime they want. In addition, uncertainty about future wealth taxes may tend to encourage wealthy taxpayers to engage more intensively in seeking to dominate the political process, and that is not necessarily a good thing. To return to my animal theme, it's the opposite of letting sleeping dogs lie.

My sense, therefore, is that the issue should be wealth taxes, not capital levies. The three-birds-with-one-stone reasoning is unpersuasive both because the third bird — achieving the Holy Grail of a lump-sum tax with attractive distributional policies — seems out of reach and because the first two birds are not sitting close enough to each other. Or more precisely, the idea of bundling sovereign debt reduction into the same package as addressing high-end wealth inequality proves not to have strong positive synergies, even though each aim, considered alone, might be worthwhile.

The need to address sovereign debt levels provides an argument for higher tax revenues generally, but not for targeting the rich in particular. And if concern about rising high-end wealth inequality merits a tax policy response, the issue raised is independent of sovereign debt levels, and would continue to be with us even if they receded on their own.

Two last points that I want to mention are as follows. *First*, so far I have mainly emphasized the scenario in which a country with high sovereign debt decides to impose a capital levy on itself. But there has also been talk, such as from the Deutsche Bundesbank, of urging fiscally troubled EU countries to impose capital levies on their own people before they seek any sort of outside bailout. There might be some hope, on the proponents' part, that this would ease moral hazard concerns, by inducing the wealthy in a given country to make sure that a capital levy never becomes necessary. But this assumes that they will respond by exercising voice, rather than exit. Again, countries that are teetering fiscally must generally be more careful with their reputations, not less so.

I also don't see bright prospects for this counsel being welcomed by the countries with acute sovereign debt problems. As history shows, capital levies are hard enough to self-impose, and the urgings of outside parties seem unlikely to be welcomed. If potential bailout is in part a chicken game between sovereign debtors and prospective rescuers, it's unclear to me how much the latter group can actually strengthen its position by floating this proposal in advance.

Second, given my conclusion that the real issue is wealth taxes, perhaps I should say something about how I view them. Let me start with a bit of background regarding my perspective. In the U.S., a national wealth tax is not even on the table. It would probably require a constitutional amendment unless apportioned between the states, which really is not feasible for a federal tax instrument. Even without that issue, however, one can't easily imagine a U.S. wealth tax being enacted or even seriously proposed. In recent years, we have scaled back our estate and gift taxes — although at one time they were supposed to be eliminated, and this ended up not happening. But I don't expect those taxes to rise significantly in the U.S. any time soon.

At the local level in the U.S., we have the widespread use of property taxes, mainly on real estate. But these taxes often have really bad features even apart from their limited reach. Their defects may include capricious valuation, poorly rationalized tax distinctions between different uses of real estate, and, in some cases, built-in incentives against selling appreciated property that would then receive a higher tax valuation. What is more, the main reason local governments in the U.S. favor property taxation is that they can actually see the land and improvements sitting right there in plain view. They would have an extremely hard time finding, say, financial assets. Also, given the ease of moving within U.S. state and local jurisdictions, U.S. property taxes are not meant to be a significant distributional tool. Rather, they function as very rough benefit taxes that charge residents for local amenities such as public schools, parks, police, and sanitation.

While we therefore, in the U.S., tend not to spend much time thinking about wealth taxes, we do have a longstanding academic tradition of debating the relative merits of income taxes and consumption taxes. Of course, the reason we tend to think of this as an either-or choice is that we don't have a VAT, and are unlikely to get one any time soon.

Writing about income taxes versus consumption taxes is a bit like writing about whether a stand-alone consumption tax should be supplemented by a wealth tax. After all, the theoretical difference between income taxation and consumption taxation is that only the former reaches the normal return to saving. For that reason, at least in principle, having, say, a 33 percent income tax is a lot like having a 33 percent consumption tax plus a 1 percent wealth tax, if the normal rate of return on wealth is 3 percent.

In the income versus consumption tax literature, I have a track record of writing fairly sympathetically about replacing the existing U.S. income tax with a progressive consumption tax. The replacement might, for example, be a consumed income tax that hits personal-level net cash flow. Or it might be an X-tax, which is basically a VAT plus a progressive wage subsidy. In particular, I have argued that direct or personal-level consumption taxes can be just as progressive as income taxes, while also potentially being less distortionary and easier to administer.

I also have noted with sympathy the line of analysis that treats saving as merely deferred consumption that there is no particular reason to target. But my writing on this topic came before I had become as concerned as I am now about the issue of rising high-end wealth inequality. This concern potentially modifies my view of the ultimate overall merits of a capital income tax and/or a wealth tax.

Suppose one agrees with Piketty that there is a significant chance that high-end wealth concentration will continue to increase. And suppose one further believes, as I do, that this would be both politically and socially unhealthy. It may also be economically unhealthy, such as for a country's growth and full employment prospects, but that I consider less well established. Then in effect wealth accumulation has a significant negative externality. This in turn could weigh in favor of corrective Pigovian taxation, aimed at reducing high-end inequality rather than just raising revenue. But how to think about that aim, and whether to pursue it (if at all) through a wealth tax or by other means entirely, is clearly a topic for another day. ◆