France's 2011 ISF wealth tax reform: logic, risks and costs

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Éric PICHET,
Professor, BEM Bordeaux Management School,
Associate researcher, LAREFI laboratory, University of Bordeaux IV

ABSTRACT

In a kind of double paradox, the French government started a major reform of the country's capital taxes during the final year of the current legislature, concurrently with its dismantling of the "fiscal shield" that symbolised the 2007 TEPA Work, Employment and Purchasing Power law (*Loi pour le Travail, l'Emploi et le Pouvoir d'Achat*) that had been enacted at the beginning of President Sarkozy's five-year term. This study seeks to highlight the political, economic and budgetary logic driving this reform; point out its legal and economic risks; and assess its budgetary and economic consequences. Following this analysis, we will conclude that although the capital tax reform is far from being the "enormous gift to the rich" that its critics allege, contrary to what the Government says it is also far from being "fully self-funded". If applied in its current state, once the reform is up and running it will likely constitute a direct cost to the public purse of around €300 million per annum– without forgetting an indirect cost of ca. €200 million due to the relocations that will inevitably follow the elimination of current tax capping measures. Hence our assessment that the total annual cost of this reform will be around €500 million.

Keywords: wealth tax, tax reform, capital tax, tax justice, tax efficiency.

Introduction

> "The only beautiful thing in this world is fairness,
> Without it, value, strength, goodness,
> And all the virtues that glorify the earth
> Are nothing more than shooting stars and pieces of glass",
> Boileau, *Les Satires*, "Satire XI", 1666-1668.

1 – It is in the name of fiscal fairness, competitiveness and attractiveness that the French Government has decided – even now as the present legislature draws to a close - to launch an in-depth reform of the nation's asset base.[1] A bill presented to Cabinet on 11 May 2011[2] is scheduled for debate in Parliament in June of this year. Essentially, this is a proposal to eliminate the tax shield, a signature policy

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[1] "The second reading of the 2011 budget translates the desire of many of our fellow citizens for a fairer, simpler and economically more suitable taxation of capital thanks to a general rebalancing of tax methods applied to the largest holdings", according to the *Rapport sur l'évolution de la situation économique et exposé général des motifs* published in the *Projet de loi de finances rectificatives pour 2011*, submitted to the French National Assembly Directorate on 11 May 2011, p. 10.

[2] *Projet de loi n° 3406: Dr. fisc. 2011, n° 20, texte 345.*

implemented during the first year of the current five-year term, and something that has been symbolically embedded in French Tax Code article 1, created in 2007 on the occasion of the enactment of the TEPA[3] law. An ancillary effect is to eliminate any other form of tax cap. Lastly, the measure would significantly modify – if not entirely eliminate - the country's ISF (*Impôt de solidarité sur la fortune*) wealth tax[4]. The main changes in this levy are to include simplifying the tax scale so that there are only two brackets (with an entry threshold starting at €1.3 million) and slashing rates to 0.3% and 0.5%. To ensure that these measures have a neutral effect on the public purse, the Government is both creating new levies and raising inheritance taxes - compensatory measures that are aimed at France's wealthiest fortunes.[5]

Without a doubt, it is the media circus surrounding the Bettencourt[6] affair that crystallised discontent with the tax shield and explains its rapid deterioration between March 2010 and March 2011 from a political favourite[7] to a new scapegoat. In this uproarious climate, an October 2010 appeal by 100 members of Parliament to eliminate the ISF wealth tax merely exacerbated the tensions associated with the two main symbols of the French system for taxing the country's wealthy. After a few trial runs and some intense debate between France's National Assembly, Prime Minister and President,[8] serious thought was given to the possibility of taxing unrealised capital gains (baptised a "tax on the income from wealth"). This idea was soon relegated to the museum of fiscal utopia,[9] as was another proposal to tax life insurance policies.[10] The Government then decided to embark upon a much more sober and transparent reform characterised by the simplication of thresholds and lower rates. This culminated in two brackets (0.25% and 0.5%), with taxpayers in the

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3 The current draft of article 1 of the French Tax Code enacted via Law n° 2007-1223 dated 21 August 2007 (the so-called TEPA law) and destined to disappear entirely from the books states that, "Direct taxes paid by taxpayers may not exceed 50% of their income. The conditions of application for this right are defined in article 1649-0 A of the French Tax Code."

4 Page 181 of the *Projet de loi de finances rectificative pour 2011* states that, "For budgetary constraint reasons, the option that consisted of eliminating the wealth tax was rejected." For obvious political motives and after much hesitation, President Sarkozy rallied to the pragmatic approach advocated by his parliamentary majority and declared that it is impossible to purely and simply eliminate a tax that generates nearly €4 billion and whose popularity among many citizens is based on the fact that it is only paide by the rich (with 560,000 households having come under the aegis of the ISF wealth tax regime in 2010 out of a total 36 million tax households).

5 In 2010, 50% of the French population paid no income tax, with 98% paying no ISF wealth tax and 95% no inheritance tax.

6 In the conflict between Mme Bettencourt and her daughter, it became apparent that the former had received a €30 million cheque from the French state in 2008 due to the shield.

7 At the time, the French President said, "We are not going to touch the tax shield."

8 "We participated throughout the reflection stage, having attended something like a dozen meetings. This was a far too rare example of cooperation between the executive and legislative branches," in the words of Michel Piron, a French parliamentarian speaking to *Les Échos* newspaper on 11 May 2011.

9 Ultimately, it is the complexity of this method of taxation (requiring the implementation of a tax credit system and the state's reimbursement of excessive payments in case asset values subsequently fall) that heralded the end of this idea.

10 As everyone knows, the main domestic source of public deficit funding is life insurance, encapsulated in funds that account for more than 80% of all fiscal revenues. The French state was very careless to deprive itself of this manna from heaven. Hence the obvious interview that Budget Minister François Baroin gave to the *Le Figaro* newspaper on 13 April 2011 (p. 9): "Let tell you what won't be used to fund it: life insurance. The French are very fond of this and they are right" - the epitome of wisdom at a time when the Eurozone states are suffering a major funding crisis.

lowest bracket (between €1.3 and 3 million) now dispensed from having to fill in a detailed return.[11]

Even before its official presentation to Cabinet on 11 May, the ISF wealth tax reform had been subjected to a plethora of evaluations and estimates that are as surprising as they are divergent.[12] Such allegations - often made by lawyers with a personal interest in the matter[13]- seriously complicated the general debate about what is essentially a technical topic and therefore something that requires calm and serious analysis of the causes, costs, risks and consequences of any reform. The present article seeks to clarify and elucidate public debate about a polymorphic issue whose many facets (fiscal of course, but also economic, political, social, symbolic and always ideological) continues to confuse people. Without any ideological preconceptions, we will try to audit this bill and highlight its strengths and weaknesses - basically injecting some subtlety into the otherwise Manichean vision that prevails far too often in an arena that is both polemic and impassioned.

Exploring the logic, risks and costs driving this major capital tax reform, our study is divided into three sections. The first analyses the spirit and detail of a reform whose architecture is based on three pillars. The second highlights the legal and economic risks associated with this project. The third is a fully costed audit of the reform using the latest government estimates.[14]

Conclusion

“Nothing resembles mythical thinking more than political ideology”
Claude Levi-Strauss, *Anthropologie structurale I*, 1958

42 – Applied its current form, the capital tax reform that the French Parliament is currently examining should amount to a total direct cost for the public purse of

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[11] A recurring criticism by small taxpayers regarding the ISF wealth tax has been that the return is very complicated to fill in.

[12] As the economist Thomas Pikettty scoffed in *Le Monde* newspaper on 23 April 2011, “The biggest tax giveaway to the rich of this whole five-year term [is that] they are replacing one tax gift (the shield) with another that is three or four times greater.” In *Les Échos* on 29 April, François Baroin announced that, “The reform of the ISF wealth tax is fully funded, there is no gift.”

[13] It should be entirely clear that being a spokesperson for a group a coalition of interests in no way prevents competent intellectuals (in this instance, tax specialists or economists) from participating actively in the general debate and specifically does not prevent them from assessing the consequences of the policy that they may in part be commenting for ideological reasons. As Joseph Aloïs Schumpeter said *(J. A. Schumpeter, Histoire de l’analyse économique, t. I, L’âge des fondateurs: Gallimard, 2004, p. 35)* “We have no respect for the mediocre tricks of political combat –which unfortunately are far too frequent, even amongst economists – that consist of reasoning about a proposal by criticising or extolling the motivations of the parties supporting it, or its usefulness in supporting or attacking the conclusions that it seems to impose.” Unlike politicians fighting with one another, social and natural scientists must fight one another’s ideas, not personalities.

14 *Le projet de lois de finances rectificative pour 2011*, submitted to the French National Assembly Directorate on 11 May 2011 contained, in application of article 53 of Budget Law n° 2001-692 dated 1 August 2001, a section entitled “Pre-assessments” (*Évaluations préalables*) indicating “the impact of the provision in question, distinguishing between economic, financial, social and environmental consequences for different categories of physical and legal persons concerend by this measure, versus the budgetary, public employment and administrative cost implications for the public bodies that if affects.” c.f. *Le Projet de loi de finances rectificative pour 2011, p. 176*

around €300 mio annually when it is in full flow, plus the indirect costs associated with the relocations that will inevitably be generated by the elimination of various tax cap mechanisms, estimated here at €200 mio. Thus, the overall cost of the reform can be evaluated at around €500 mio per annum.

There are two important lessons to draw from these conclusions. The first is that it is totally wrong to talk about the "biggest gift to the rich of this five-year term" - often the way that (the many) critics of this reform describe it. After all, the costs of modifying the TEPA capital tax law,[15] i.e. the cost of lowering inheritance taxes (at least €2 bio per annum), of increasing the main residence discount from 30% to 20% (more than €100 mio a year), of the tax shield (€720 mio) and of reducing the amount of ISF wealth tax paid when an SME buys shares in another SME (€700 mio) more or less amounts to a "gift" of at least €3.5 billion or more than 10 times the direct cost of the reform in its current shape and around seven times its global cost as estimated here.

The second lesson is that, contrary to the Government's reassuring statements, it is not at all certain that the reform is fully funded. There has been insufficient study of the associated legal risks; the methodology used for some estimates (like the exit tax, where economic and legal risks have been amalgamated) is highly doubtful; and the Government reasons as if taxpayers are not going to adapt to changes in their environment (an ethological mechanism that has been amply analysed and demonstrated for the past 150 years by a myriad of researchers ranging from Darwin to Crozier). Taxpayers' responses to the reform, whether they leave the country or modify their behaviour (gift giving, for instance), will inevitably affect future proceeds. Under these conditions, the self-proclaimed equilibrium that the reform's designers find between its twin goals of social justice and budgetary and economic efficiency remains more than ever the inaccessible holy Grail of French capital taxation.

15 The Economics Minister submitted a report to the French Parliament on 17 March calculating the State's opportunity cost due to the TEPA law's different provisions.