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Britain mulls a wealth tax

A Covid-19-ravaged government needs to raise more revenue and some propose that a wealth tax could fit the bill. It's unlikely to happen, but one way or another the rich face a squeeze.

The Covid-19 pandemic has blasted a £400bn hole in the UK public finances and has hit the poor far harder than the rich. The best way of addressing these dual imbalances – according to a group of academics and think-tankers calling themselves the Wealth Tax Commission (WTC) – is a 5% levy on personal net wealth above £500,000, spread out over five years. Many countries are re-examining wealth taxes in the wake of the fiscal havoc wrought by Covid-19, but the only large economy to have rushed one onto the statute book is Argentina. In December, the left-populist government announced a one-off "millionaires tax" on people with assets of more than 200m pesos (£1.8m). Under the scheme, wealthy citizens will pay a one-off levy of between 1% and 3% on net assets, with the aim of raising £2.7bn to help fund Covid-19 measures. In the UK by contrast, the WTC thinks the government could raise almost 100 times that – £260bn over five years.

The WTC is a group of academic economists from the London School of Economics and the University of Warwick, which formed last year, and has drawn on research and evidence from more than 50 tax experts from think tanks (including the Institute for Fiscal Studies), the OECD club of nations, as well as lawyers and policymakers. Its conclusion, in a paper published at the end of last year, is that the UK should introduce a one-off 5% "Covid-19 recovery tax" on all personal wealth above £500,000, net of outstanding mortgage or other debt. That includes wealth held in housing (including a primary residence), pension schemes, businesses and financial assets such as shares and funds. Levied over five years, the WTC projects this would bring in £260bn from just over eight million people, or one in six households. In terms of revenue raised, that's the equivalent (other things being equal) of a jump in the basic rate of income tax from 20p to 29p, or VAT from 20% to 26%.

Such a tax would seem unfair on someone who has thriftily accumulated wealth over decades out of taxed income in order to avoid relying on the state in old age. Nor, say, if you are asset-rich, but retired or approaching retirement with a relatively low income. And there's a particular unfairness when it comes to pensions. A wealth tax that included pension schemes, as proposed, would be doubly unfair to those with defined-contribution (DC) pensions, compared with those fortunate souls (overwhelmingly in the public sector) who have defined-benefit (DB) schemes. That is because, under the current tax rules governing lifetime allowances on pensions, the government assumes the value of a DB pension scheme is only 20 times the annual income paid out. So a £10,000 DB pension is valued for tax purposes at £200,000. In practice, however, a private sector DC pension would need to be far in excess of that to generate the same annual income (and potentially up to £1m depending on assumptions about annuity rates, inflation, and joint life requirements). In other words, a wealth tax on pensions would end up being wildly discriminatory against (overwhelmingly) private-sector workers.

With all taxes, there's a trade-off between revenues raised and entrepreneurial incentives blunted – or simply rich people leaving the country

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– at a cost to future overall growth. And the experience of almost all countries to have tried a wealth tax is that they prove counterproductive. Wealth taxes tend to encourage capital flight, discourage investment, and throw up distorting effects. For example, since debt is deductible, they tend to encourage the rich to borrow to invest in exempted asset classes (farmland or woodland, say), thus both shrinking the tax base and distorting the economy. For all these reasons, they are far less popular than they once were. Sweden abolished its wealth tax after nearly a century in 2007; France got rid of its version two years ago. However, four European countries still have versions of a wealth tax, namely Norway, Spain, Switzerland and Belgium.

It is unlikely to happen here, but it can't be ruled out. Denis Healey, the Labour chancellor between 1974 and 1979, wrote in his memoirs: "We had committed ourselves to a Wealth Tax; but in five years I found it impossible to draft one which would yield enough revenue to be worth the administrative cost and political hassle". That remains as good a summary as any and a wealth tax is not part of the current government's plans. "I do not believe that now is the time, or ever would be the time, for a wealth tax," said chancellor Rishi Sunak in July. Yet even so, argues economist Gus O'Donnell, the unpredictable politics of the post-Covid-19 era mean that

nothing should be ruled out. And if the Conservatives are serious about sticking to their manifesto promises not to raise income tax, NICs or VAT, then at some point they'll need to think seriously about new taxes.

The political reality is that Rishi Sunak and Boris Johnson will be quite happy to see the idea of a wealth tax gain traction if it means a sigh of relief from wealthy Tory voters when none is ultimately forthcoming. That way, they get a bit of political cover to put up other taxes post-Covid-19 – which they surely will. In addition, it may be that the wealth-tax proposal acts as a gateway to a return of the 'mansion tax' on higher-value homes, or to higher taxes on investment gains, or to big cuts in pensions tax relief. It may not come in the form of a Wealth Tax, but one way or another, wealthier Britons will soon be paying more.

Are markets overstimulated?

Assuming all goes to plan, the US economy is about to get another huge cash injection. American president Joe Biden's $1.9trn stimulus package, which looks set to become law, includes an extension of nationwide unemployment benefits alongside $1,400 cheques being sent to most American adults (the payments are means-tested, but the thresholds are well above the average US income). The scale of the stimulus has seen various analysts upgrade expectations for US growth this year, from already high levels. Investment bank Morgan Stanley reckons growth will now hit 7.3%, a level unseen since 1951, while the OECD group of wealthy countries "doubled its own estimate" to 6.5%.

The pay-outs are undoubtedly popular with the electorate, with strong support regardless of political persuasion (voters are split on lots of topics, but free money doesn't seem to be one of them). However, the big question for investors is: will the stimulus combine with huge levels of pent-up demand to create an inflationary surge once Covid-19 is truly behind us? And will that surge be more than temporary? And if so, what might that mean for markets that have grown used to disinflation?

On the inflation point, there are signs of nerves even among those who wouldn't traditionally be viewed as overly cautious on public spending. For example, economist and Bill Clinton-era Treasury secretary Larry Summers reckons the stimulus goes "way beyond what is necessary", meaning that we risk an inflationary collision of some kind. Economist and opinion columnist Paul Krugman on the other hand, who debated the topic with Summers in a Princeton University- hosted video call last month, basically conceded that while it's possible, inflation is not as big a risk as Summers fears – and in any case it's worth a shot to shore up the economic recovery.

No one really knows the answer. Economists favour a concept known as the 'output gap' to try to put a figure on how far an economy is from running at full capacity. But it's always been a controversial measure and it's of virtually no use in helping anyone in practical terms (in other words, it's useful for justifying decisions on a spreadsheet after they've been made, but hopeless in terms of predicting inflation).

One thing, however, is for sure. Due to a combination of earlier stimulus packages and extended benefits, US households have a lot of money set aside that could boost consumer demand later this year. US households have lost $490bn in income, but received $1.3trn in transfers. That's all before the latest stimulus. From an investor's point of view, the concern about inflation at this stage is that it might make central banks – led by the US Federal Reserve – tighten monetary policy.

The Fed keeps arguing that it will let inflation rise above the 2% target level, with its main focus now being a return to full employment. However, the risk is that inflation could overshoot the overshoot level the Fed is comfortable with. That might force the Fed to act more quickly than it currently expects, which could hit markets hard.

We've already seen bond yields rising and tech stocks falling this year, but so far it all falls into the category of a 'rotation'. Investors are selling the assets that were popular during the long slide in interest rates and the low-growth era that followed the financial crisis. They're now shifting that money into stocks that should benefit from stronger growth and rising inflation.

In other words, as an investor, you shouldn't panic. The tech-heavy US Nasdaq index has had a tough year, because it's the home of all the most expensive and popular stocks over the past year. But the broader-based S&P 500 has gained over the year, while the more value-focused FTSE 100 in the UK has outperformed both (if only a little).

What of the longer run? So far, markets only seem to be pricing in a return to something approaching 'normal', rather than a long-term rise in inflation. However, with central banks likely to be highly reluctant to tighten monetary policy and risk crashing the economy, longer-term inflation might well be what we get. If that's the case, bonds will first. Stocks will probably be fine up until inflation hits about 4% (and the UK markets is likely to do better due to the high weightings towards financials and commodity stocks). But if inflation really does take off, it would be wise to be holding some commodities and specifically, some gold.

IR35 reforms return

As if dealing with Covid-19 and its economic fallout were not enough, 2021 will bring another headache for thousands of small businesses and entrepreneurs. The widely despised IR35 reforms are to make a return.

The reforms had been due to come into force last April, but at the last minute, the government decided to delay their introduction, recognising

that businesses had more pressing priorities as the pandemic exploded. But ministers made it clear this was a postponement rather than a change of heart, and the new rules are due to take effect on 6 April.

The headline change is that from that date onwards, most businesses employing contractors will be required to assess the tax status of these suppliers – and in many cases to bring them on to their payrolls so that they pay income tax and national insurance through the PAYE system.

The aim is to crack down on disguised employment, when businesses take on contractors or freelancers to do a job where they are really just employing them, but calling it something different. The business makes a saving on employer's national insurance contributions in this way. The contractor, often set up as a personal-services company, may also be able to make a tax saving.

The new rules will bring the private sector into line with the way the public sector has operated since 2017. Each time a business enters into an agreement with a contractor or a freelancer, it will have to determine whether the supplier is a genuine third-party entity or whether it is caught within the scope of the IR35 regime. If the latter, the supplier must be paid through PAYE.

One big issue is that there is no watertight definition of which contractors fall inside or out of IR35. HM Revenue & Customs depends broadly on three tests: whether the contractor has control over where, when and how they perform the work; whether the contractor has to do the work themselves or is entitled to send someone on their behalf; and whether the employer is obliged to offer work and the contractor is obliged to accept it. But these are broad principles and there are plenty of grey areas.

So much so, in fact, that there are serious doubts about HMRC's ability to apply the new rules fairly and consistently. The tax authority has launched an online tool where businesses and contractors can check their tax status, but one in five such checks fail to report a conclusive result, according to one recent study.

If you're a freelancer or contractor currently working outside of the IR35 regime, it is important to talk to clients as soon as possible about how they intend to operate the new rules and whether you'll be affected. For those forced to move into the PAYE system, there may be larger tax bills to pay. Others may find that risk-averse businesses are now very reluctant to take on contractors and suppliers in the way they have done in the past.

If you run a business that uses contractors and freelancers, be sure you are ready to operate within the new rules. There is an exemption for small businesses, defined as meeting at least two of three criteria: having a turnover of less than £10.2m, a balance sheet worth less than £5.1m and no more than 50 employees. They will not be required to apply the new rules. But every other business must be ready to comply.

Can China hold the World to ransom?

Fears are growing that China's current high-level review of its rare-earths policy could presage export restrictions that will wreck the supply chains for strategically crucial sectors including electric vehicles and renewable energy. China currently produces about 70% of rare-earth elements globally, and has used its dominance in the past as geopolitical and economic leverage. Citing anonymous sources close to China's review, Bloomberg reports that Beijing could ban the export of rare-earths refining technology to countries or companies it deems as a threat. And although China has no imminent plans to restrict shipments to the US, it is keeping that option in its "back pocket" if Sino-US relations deteriorate further, the source said. A source quoted by the Financial Times similarly said that China is considering restrictions on the export of rare-earth minerals that are crucial to the manufacture of US F-35 fighter jets and other weaponry.

'Rare earths" are the 15 metallic lanthanide elements on the periodic table, plus two other closely related elements, scandium and yttrium – and they are an integral part of modern life, crucial to several high-tech sectors. Despite the name, almost all ofthe 17 rare-earth elements are actually pretty plentiful in the earth's crust. Sixteen of the elements are more abundant than gold. And one of them, cerium, is the 25th most abundant element on the planet. However, they tend to be widely dispersed, and their geochemical properties make them hard, environmentally damaging and expensive to mine and process, producing large quantities of toxic wastewater and radioactive residues. For that reason, there are very few places in the world where it has proved practical and profitable to mine them. Hence the name "rare".

They're used in high-tech equipment in crucial sectors including electric vehicles and wind energy, consumer electronics, defence and oil refining. For example, powerfully magnetic rare earths such as neodymium, terbium and dysprosium are used as magnets in electric-vehicle motors. Hybrid car batteries also use the rare earth lanthanum. Magnetic resonance imaging (MRI) scanners in hospitals use the rare earth gadolinium. Apple iPhones contain rare earth elements and they are crucial components in solar cells and lasers. Britain has high hopes of becoming a renewables superpower in the coming decades. But each of its vast Dogger Bank wind turbines will rely on tonnes of rare-earth elements.

China so dominant, in part, because of geology: China has an estimated 40% of global reserves, concentrated in the sparsely populated northern province of Inner Mongolia. But crucially, in recent decades, China has also had a far

greater tolerance for the environmental damage inflicted by their extraction. It overtook the US as the world's biggest producer of rare earths in the 1990, and has never looked back. It has also converted its control of the raw materials into dominance of the valuable next steps: turning oxides into metals and metals into products. In 1992 Deng Xiaoping quipped that "the Middle East has oil, China has rare earths". But as The Economist points out, China's position three decades on is "as if the Middle East not only sat on most of the world's oil but also, almost exclusively, refined it and then made products out of it".

In 2019, at the height of Donald Trump's trade war with China, Beijing threatened to cut off supply of rare earths. And in 2010, it did create a genuine global supply crisis – and massive price rises – when it cut export quotas to punish Japan over a territorial dispute in the South China Sea, and help domestic manufacturers. However, their plan was eventually foiled by a combination of market forces and global trade rules. Higher global prices made it profitable to open mothballed mines in Australia, California and elsewhere. Smuggling undermined the export controls. And a WTO case brought by the US ruled against China, which largely complied with the decision. Since 2010, China's proportion of rare-earths production has fallen from 95% to around 75%. However, a big slice of the difference is accounted for by just one player – the Japanese-backed Australian firm Lynas, which owns the Mount Weld mine in Western Australia and a vast processing plant in Malaysia.

Some commentators think the West has learned the right lessons from the 2010 scare. When Arab countries used their dominance of oil exports to push up the price of crude in the 1970s, the outcome was not a permanent Gulf stranglehold on energy but a rush to diversify. The same is happening with rare earths. They are important, but political restrictions on exports will only cause major importers to reconfigure their supply chains to be more resilient – and would ultimately prove self-defeating for a Chinese economy that is far more globally integrated than it once was.

The strategic and security implications mean that the West cannot afford to relax. While oil is a global industry, minerals processing and electric vehicle component manufacturing is almost exclusively Chinese. If left unchecked, this dominance will become a strategic vulnerability for the US and Europe, especially if they are to hit climate policy goals. We risk a scenario in which we swap our dependence on a chaotic oil market dominated by Opec countries that do not share our strategic goals, for a reliance on China for our future transportation needs. A critical mineral supply chain that is less dependent on China is a matter of national security.

World returning to life

The EU is a laggard, but Israel is partying, Britain is jabbed and the US is opening up.

Angela Merkel's Christian Democrats slumped to their worst-ever defeat in elections in two states last week. Germans don't appear to be very impressed by their government's response to the pandemic, whilst Britain's decision to pursue a successful, independent vaccine strategy has acutely embarrassed the EU.

In Britain, over 50% of adults have been vaccinated and the weekly death toll is down 33% over seven days. Real-life data shows that the AstraZeneca vaccine prevents about 85% of hospital admissions after a single dose, even in the elderly.

Israel, where almost 60% of its 9.3 million citizens have been vaccinated, provides a glimpse of post- lockdown life. Parties have spilled out on to the streets and beaches heave with families. Hospitals are emptying, new infections are down to 3% of those tested. Israel may be the first nation to tame the pandemic and open up its economy for good. Without overtly saying so, the government's policy has largely been to keep an eye on hospital admissions rather than new infections. If the young and unvaccinated catch it but stay out of hospitals, it's an acceptable outcome.

In the US, there are around 65,000 new cases a day and deaths are plateauing at around 2,000, President Biden is talking about Americans being allowed to gather in 'small groups' to celebrate Independence Day on 4 July. Most of the country, however, is almost entirely back to normal. California and some northeast states aside, lockdowns have largely ended and states are busy lifting restrictions. Globally, the price of these lockdowns has been extreme, and the repercussions will be felt for years.

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