The case for taxing death

How to balance people's desire to bequeath assets with the unfairness of inheritance

NO TAX is popular. But one attracts particular venom. Inheritance tax is routinely seen as the least fair by Britons and Americans. This hostility spans income brackets. Indeed, surveys suggest that opposition to inheritance and estate taxes (one levied on heirs and the other on legacies) is even stronger among the poor than the rich.

Politicians know a vote-winner when they see one. The estate of a dead adult American is 95% less likely to face tax now than in the 1960s. And Republicans want to go all the way: the House of Representatives has passed a tax-reform plan that would completely abolish "death taxes" by 2025. For a time before the second world war, Britons were more likely to pay death duties than income tax; today less than 5% of estates catch the taxman's eye. It is not just Anglo-Saxons. Revenue from these taxes in OECD countries, as a share of total government revenue, has fallen sharply since the 1960s (see page 21). Many other countries have gone down the same path. In 2004 even the egalitarian Swedes decided that their inheritance tax should be abolished.

Yet this trend towards trifling or zero estate taxes ought to give pause. Such levies pit two vital liberal principles against each other. One is that governments should leave people to dispose of their wealth as they see fit. The other is that a permanent, hereditary elite makes a society unhealthy and unfair. How to choose between them?

When the heirs loom

Some people argue for a punitive inheritance tax. They start with the negative argument that dead people no longer enjoy the general freedom to disburse their wealth as they wish—as the dead have no rights. How could they, when they are not affected one way or the other by what happens in the world?

That does not ring true. The logic would be to abrogate even the most modest of wills. But inheritances are deeply personal and the biggest single gift that many give to causes they believe in and loved ones they may have cherished. Many (living) people would feel wronged if they could not provide for their children. If anything, as the expression of their last wishes, bequests carry more weight than their passing fancies do.

The positive argument for steep inheritance taxes is that they promote fairness and equality. Heirs have rarely done anything to deserve the money that comes their way. Liberals, from John Stuart Mill to Theodore Roosevelt, thought that needed correcting. Roosevelt, who warned that letting huge fortunes pass across generations was "of great and genuine detriment to the community at large", would doubtless be aghast at the situation today. Annual flows of inheritance in France have tripled as a proportion of GDP since the 1950s. Half of Europe's billionaires have inherited their wealth, and their number seems to be rising.

However, in 2017, it is not clear exactly how decisive a role inheritance plays in the entrenchment of the hereditary elite. Data from Britain suggest that people tend not to lose their parents before they reach the age of 50. In rich countries the advantages that wealthy parents pass to their offspring begin with the sorting mechanism of marriage, in which elites increasingly pair up with elites (see leader on page 16). They continue with the benefits of education, social capital and lavish gifts, not in the deeds to the ancestral pile.

Even if the link between inheritance-tax rates and inequality were clear, wealth can pay for a good tax lawyer. In the century since Roosevelt, Sweden and other high-taxers discovered that if governments impose a steep enough duty, the rich will find ways to avoid it. The trusts they create as a result can last even longer than the three generations it takes for family fortunes to go from clogs to clogs.

Armed with such arguments, some leap to the other extreme, proposing, as the American tax reform does, that there should be no inheritance tax at all. Not only is it right to let people hand their private property to their children, they say, but also bequests are often the fruits of labour that has already been taxed. And a large inheritance-tax bill is destructive, because it can cause the dismemberment of family firms and farms, and force the sale of ancestral homes.

Yet every tax is an intrusion by the state. If avoiding double taxation were a requirement of good policy, then governments would need to abolish sales taxes, which are paid out of taxed income. The risks that heirs will be forced to sell homes and firms can be mitigated by allowing them to pay the duties gradually, from cashflow rather than by fire-sales.

In fact, people who are against tax in general ought to be less hostile to inheritance taxes than other sorts. However disliked they are, they are some of the least distorting. Unlike income taxes, they do not destroy the incentive to work—whereas research suggests that a single person who inherits an amount above $150,000 is four times more likely to leave the labour force than one who inherits less than $25,000. Unlike capital-gains taxes, heavier estate taxes do not seem to dissuade saving or investment. Unlike sales taxes, they are progressive. To the extent that a higher inheritance tax can fund cuts to all other taxes, the system can be more efficient.

Transfer market

The right approach is to strike a balance between the two extremes. The precise rate will vary from country to country. But three design principles stand out. First, target the wealthy; that means taxing inheritors rather than estates and setting a meaningful exemption threshold. Second, keep it simple. Close loopholes for those who are caught in the net by setting a flat rate and by giving people a lifetime allowance for bequests; set the rate high enough to raise significant sums, but not so high that it attracts massive avoidance. Third, with the fiscal headroom generated by higher inheritance tax, reduce other taxes, lightening the load for most people.

A sensible discussion is hard when inheritance taxes prompt such a visceral reaction. But their erosion has attracted too little debate. A fair and efficient tax system would seek to include inheritance taxes, not eliminate them. ■

Death of the death tax

STOCKHOLM AND TOKYO

Inheritance taxes have fallen out of favour around the world

THE marks left by inheritance tax are apparent all around Japan. Bookshops are filled with tomes on how to avoid a hefty bill when a loved one dies. Near the ancient Shimogamo shrine in Kyoto, a lady shows off her old house, which will soon be bulldozed. With her parents getting on, she needs to ready herself to pay an inheritance-tax bill. To reduce it, she is splitting the plot and selling one part, which means destroying the family home and building a smaller one. Back in Tokyo, a barman mixing a whisky and soda gruffly recites a Japanese version of a common saying: "a fortune does not last three generations".

Inheritance tax is unpopular everywhere but the Japanese have more reason to complain than most. The country's regime is the toughest of any big, rich country. The top rate of tax is 55%, compared with 40% in Britain and America. After recent reforms, roughly 8% of deaths are subject to tax, the highest proportion since records began in 1958. Data are poor but on a rough estimate up to a tenth of everything left behind by the dead each year goes to the government, compared with perhaps 4% in America. In the past two years budgeted revenues from inheritance tax in Japan have risen by a fifth to some $20bn a year, around 0.5% of GDP.

This trend of swelling receipts marks Japan out. Revenue raised through taxes on inherited wealth was once a big contributor to governments' coffers. It has since shrunk significantly. In OECD countries the proportion of total government revenues raised by such taxes has fallen by three-fifths since the 1960s, from over 1% to less than 0.5%. Over the same period Australia, Canada, Russia, India and Norway are among countries that have abolished death duties. More than 20 American states binned wealth-transfer taxes between 1976 and 2000; in 2010 the federal estate tax was abolished for a single year.

The final reckoning

President Donald Trump wants America to eliminate it for good. "No family will have to pay the death tax," he said as a presidential candidate. "It's a double tax; it's a tax on death," according to Steven Mnuchin, the treasury secretary. If House Republicans get their way on reform proposals currently making their way through Congress, the tax-free exemption on the estate tax—currently $5.49m—would double, followed by full elimination in 2025 (see page 45).

As inheritance taxes have lightened, some people have gained enormously. In 1976 roughly 8% of American estates filed a taxable return; that has since fallen to around 0.2%. But not everyone benefits from cutting inheritance taxes. Indeed, the wider advantages of reducing such taxes have been overestimated. And the costs are evident.

Inheritance tax is levied on the people who get the money after someone dies, estate tax on the money itself. They are some of the world's oldest taxes. In 6AD the *vicesima hereditatium* or "20th of inheritance" was imposed by Augustus, the first Roman emperor. An inheritance tax of sorts was introduced in Britain in 1694. Around the same time French peasants were required to cough up *lods et ventes*, a version of an inheritance tax, to their lords.

Classical liberal thinkers seem to favour taxing inheritances. Adam Smith said that "a power to dispose of estates forever is manifestly absurd." Political philosophers were guided by arguments appealing to fairness. Mere accident of birth, the thinking went, did not amount to entitlement to acquire wealth. Jeremy Bentham rejected the notion that descendants had an absolute right, based in natural law, to the property of relations: "who is this same Queen, 'Nature,' who makes such stuff under the name of laws?" he sniffed. John Stuart Mill wanted to encourage equality of opportunity, rather than the creation of an elite that would endure for generations. He also believed that taxing the rich, who often lived off inherited properties and landed estates, would permit lower taxes on the poor, allowing them to save more.

Reformers turned the early 20th century into the golden age of taxing inheritances (see chart 1 on next page). In 1906 Theodore Roosevelt demanded that Congress pass a graduated inheritance tax. America introduced its estate tax in 1916, ▸▸

and by the 1940s the top rate was 77%. In France until 1956 every single bequest was subject to a tax. Until the second world war Britons were less likely to pay income tax while living than to have their estate taxed after their deaths.

However, in subsequent decades an anti-tax movement gathered steam around the world. The price of housing in rich countries began to rise in the 1970s as population growth ran up against restrictive planning policies. As home-ownership increased and a higher proportion of households accumulated wealth, inheritance tax was seen as more of a burden. Meanwhile, as foreign-exchange controls were dismantled, politicians feared that high taxes on wealth would prompt rich folk to up sticks and move elsewhere.

Dead hand of the state

In their book "Death by a Thousand Cuts", on the politics of the American estate tax, Michael Graetz and Ian Shapiro describe the emerging consensus that taxing inherited wealth was unfair and unwise. But much as advisers in the administrations of Ronald Reagan and George H.W. Bush wanted to abolish estate tax, they believed doing so was politically impossible.

In 1992 something happened which changed the terms of the debate. Two Democratic congressmen proposed reducing the tax-free exemption from $600,000 to $200,000, thereby increasing the number of people subject to the tax. They did not foresee the unpopularity of the proposal, which was hurriedly withdrawn—but not before, according to Messrs Graetz and Shapiro, "conservatives became alert to the possibility that they might have missed something."

A highly effective political campaign against the estate tax followed. Adherents insisted that the estate tax was unfair since it amounted to double taxation. After all, bequests are often financed from earnings that have already been subject to income tax. They also devised a devastating nickname—the "death tax".

Advocates of the tax were unable to counter with anything nearly as powerful. A few pointed out that double taxation occurs on a daily basis in the form of sales taxes (people buy things with taxed income), or that it is what the person leaves behind, rather than the person, which is subject to the estate tax. Calling it a "windfall tax", as Bentham might have, could have helped, but only so much.

Characters such as Chester Thigpen, an African-American tree farmer in his 80s, were crucial to the campaign. In 1995 Thigpen, a descendant of slaves, settled into the witness chair in front of the House Ways and Means Committee. He had come from Mississippi to Washington, DC, to talk about the damage the estate tax would inflict on his family. On his farm were "beautiful forests and ponds that can live on for many, many years after my wife and I pass on," he said. Yet when he died "my children might have to break up the tree farm or sell off timber to pay the estate taxes."

Thigpen's testimony came to symbolise the idea of government overreach. Jennifer Dunn, a Republican, referred to the Thigpen example as she argued in the House of Representatives that the tax system should "reward savings, investment and hard work". In 1998 the joint economic committee, a congressional panel, used Thigpen's farm as an example of "the burdensome nature of the estate tax" to argue for its repeal.

Ordinary people were receptive to these arguments, perhaps because Americans are an optimistic bunch. According to Messrs Graetz and Shapiro, surveys at the time suggested that around 40% believed that they were in the top 1% of the wealthy or would be there "soon", making them fearful of a hefty tax. The prospect of repeal was popular, even if in reality most of the benefits would go to the richest.

As the pressure built, politicians eventually had to act. Before the presidential election in 2000 George W. Bush proclaimed that he wanted to be "rid of the death tax", which he saw as something "that taxes people twice" and "penalises the family farmer". An act passed in 2001 made big reductions to the estate tax, culminating in the one-year repeal in 2010. Even in its current diminished form, however, it is still hated. Over half of Americans agree with the idea of eliminating it; Mr Trump found on the campaign trail that his promise to abolish it was just as popular as it had been for Mr Bush.

Messrs Graetz and Shapiro imply that the circumstances which led to the decline of the estate tax were peculiarly American. In an already highly unequal society, this interpretation goes, rich people hijacked the political system and shaped tax policy to their own ends. Yet countries quite unlike America have also seen big cuts to wealth-transfer taxes.

Sweden, which is usually seen as egalitarian, has gone one step further. In 2004 its inheritance tax was repealed, with the support of a former communist party, among others. What prompted such a radical transformation from the 1960s, when the largest estates could face an effective tax rate of 60%? By the end of the 1970s there was a growing sense that the Swedish state was bloated; a turning-point came when Astrid Lindgren, the creator of Pippi Longstocking and a national hero, revealed that she faced marginal tax rates of more than 100%. A financial crisis in the early 1990s reinforced the sense that the country needed to become more competitive.

Politicians noted the special disgust that Swedes reserved for inheritance tax. According to Swedish Enterprise, a lobby group, entrepreneurs such as Ingvar Kamprad, the founder of IKEA, were leaving the country to avoid high taxes. Stories abounded of family firms broken up to pay the bill. At first, tweaks were introduced to the Swedish system. Yet the resulting complexity met with disapproval. Sweden is a small country with high levels of social trust; people are allergic to bureaucracy, says Janerik Larsson of Timbro, a think-tank. "It was easier to get rid of it entirely." After abolition Mr Kamprad returned to Sweden. The economy has grown quickly in recent years, and anti-tax advocates claim they have been vindicated.

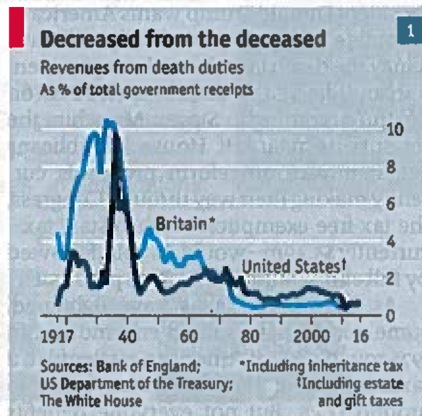
Heir conditioning

It is clear that antipathy to inheritance taxes is widely shared among politicians and their electorates. Yet the economic benefits of cutting such wealth-transfer taxes may have been overplayed and the drawbacks underappreciated.

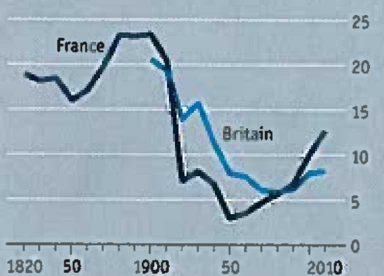
Start with migration. Arash Nekoei of the Institute for International Economic Studies in Stockholm is sceptical that abolishing inheritance tax really did encourage many entrepreneurs to move back to Sweden. Although migration from Sweden happened to rise in the second half of the 2000s, after the tax was abolished, other factors were clearly involved.

A paper by Jon Bakija of Williams College and Joel Slemrod of the University of Michigan studies the impact of changes in state inheritance-and-estate taxes on the migration of elderly Americans between states, as approximated by changes in federal estate-tax returns by state. It suggests that reducing these taxes does not do much to attract outsiders. The richest folk seem most likely to move to tax-cutting states, but even here the numbers are small. And tax-cutting states seem to lose out overall: the additional revenue resulting from more people moving to a state may be not enough to offset the impact of the lost revenue from lowering the estate tax.

Second, what of the argument, made by the likes of Dunn, that cutting wealth-transfer taxes encourages work and saving? The logic goes that people are motivat-



Sources: Bank of England; US Department of the Treasury; The White House
*Including inheritance tax †Including estate and gift taxes



ed by the prospect of leaving large amounts of wealth to their children. So if they are allowed to pass on more, they may try to accumulate more, benefiting not only their family but the economy as a whole. As an additional benefit, if wealth-transfer taxes are cut, people need not waste time on tax planning.

Again, there is not much evidence to support these propositions. Akira Kawamoto, an investor who used to work at Japan's economy ministry, dismisses the idea that increases to the country's inheritance tax have undermined enterprise. "No one at the start of their career is thinking about such a tax," he says. Indeed, it is noteworthy that many of the world's richest self-made people, such as Warren Buffett and Bill Gates, advocate wealth-transfer taxes.

The academic evidence is also revealing. If all bequests were intentional you might expect people with children to be more enterprising and to save more than those without. But this is not supported by the data. You might also expect a child's earnings to have a big effect on the size of a bequest left by a parent. A poor child, after all, is in greater need of money than a rich one. Observations from Sweden and America, however, find only weak evidence that a child's earnings affect a parent's plans for a bequest.

That suggests that a large proportion of inheritances are "accidental". People save to insure against personal risks, rather than to pass on wealth when they die. (Bentham mulled a 100% tax on the estates of people dying without a will, reasoning that the entire bequest could be considered accidental.) Research also suggests that some bequests are "egoistic", meaning that a parent derives happiness from the pre-tax amount bequeathed, rather than what a child will receive after the tax is applied.

Cutting wealth-transfer taxes would surely reduce the need for wealthy folk to engage in tax-planning, freeing them up for more productive activities. But there are few estimates of how much time and money this activity actually takes up. A study published in 1999 suggests that the overall cost of estate-tax compliance is 7% of estate-tax revenues. Yet a chunk of those costs, such as selecting executors and drafting documents, would still be paid even in the absence of the tax. So it is hardly clear that the rich would be left with much extra time for more productive undertakings.

The third justification for cutting or abolishing inheritance taxes—that it will prevent the break-up of family firms—is in many countries the most politically important one. The Thigpen story is one of many told by anti-tax campaigners. Sweden may now have the world's most generous tax system for family firms. Even Japan offers them exemptions from inheritance tax.

But is it sensible for the state to privilege family firms? There is something reassuring about entering a shop that has had three generations of the same family behind the till. Descendants may use an inheritance to expand the family firm, potentially creating more jobs along the way.

Family ties

Yet keeping things in the family has costs. By excluding family firms from inheritance tax, and therefore stopping some from breaking up, means boosting their numbers. A paper by Francisco Pérez-González of the Instituto Tecnológico Autónomo de México finds that "nepotism hurts [firm] performance by limiting the scope of labour-market competition". Firms that promote family CEOs see declines of 14% in operating return on assets, a measure of profitability. Research by Nick Bloom of Stanford University and others finds that family firms are the worst-managed of any type. Poor management of firms is one of the main reasons why productivity growth in rich countries has been so depressed in recent years.

The problems associated with family-run firms point to another risk: that people with inheritances work less hard or drop out of the workforce altogether. In an essay in 1891 Andrew Carnegie, an industrialist born in Scotland, argued that the "parent who leaves his son enormous wealth generally deadens the talents and energies of the son, and tempts him to lead a less useful and less worthy life." Research suggests that lottery winners work less. And according to a paper published by Douglas Holtz-Eakin, formerly of the Congressional Budget Office, and two colleagues, Carnegie was right. A person coming into an inheritance above $150,000 is four times more likely to leave the labour force than someone who inherits less than $25,000.

Such inefficiencies are set to deepen as payouts increase. After peaking in the 19th century, the stock of wealth in rich countries tumbled during the first half of the 20th. That was in part the result of two world wars, which destroyed factories and shrank savings through high inflation. Yet according to work by Thomas Piketty of the Paris School of Economics, in recent decades the growth in the stock of wealth in advanced economies has outpaced income growth.

The data are patchy. Yet it appears that, as wealth has bounced back, the size of inheritances has, too (see chart 2). The annual flow of inheritances in France has tripled from less than 5% of national income in the 1950s to about 15%, not all that far from the 19th-century peak of 25%. Research suggests that though inheritances can reduce short-run wealth inequality by giving a windfall to poor households, the long-run effect is to increase it. This is in part because richer folk tend to save their windfall, in contrast to poorer folk, who spend it.

If the importance of inheritance continues to grow, and Mr Piketty's calculations suggest that it will, some worry that it could foreshadow the return of an inheritance society in which marriage ends up being a surer route to riches than starting a company or working hard. The incomes attained by the top 1% of French inheritors are already higher than those attained by the top 1% of workers. Across North America, Europe and East Asia, the number of billionaires who have inherited their wealth seems to be rising, according to research from the Peterson Institute for International Economics, a think-tank.

Such considerations suggest that the shift away from wealth-transfer taxes ought to be the subject of more public debate. Instead, it looks set to continue inexorably. Britain's budget on November 22nd confirmed that by 2020 a couple will be able to pass on £1m ($1.3m) tax-free, if it includes a house, up from £650,000 today. Just 22,000 estates will be subject to the tax this year, compared with 30,000 in 2016. And in America, estate tax will fall even further if Mr Trump gets his way. After a long life, the death tax is in failing health. ■