

# Listen to Adam Smith: inheritance tax is good

**Irwin Stelzer** — no fan of taxation — says that this particular levy makes good economic sense and that both parties are wrong to be sacrificing sound policy to the politics of marginal seats

**P**olitics trumps economics. That's the best summary of the Tory and Labour competition to pander to those who until now have been threatened with paying to the Treasury a portion of the money they receive for just 'being there'.

Let's de-emotionalise this issue. An inheritance tax is not a death duty. The slogan 'No taxation without respiration' is too clever by half. Even a Chancellor of the Exchequer as powerful as the previous occupant of the office could not get a corpse to sign a cheque. It is a tax paid by the recipient of this income, the inheritor, the lucky winner in the sperm lottery.

Nor, finally, is it a tax on a lifetime of thrift. In most cases the wealth being taxed results from a rise in the value of houses — not something brought about by the acumen and hard work of the owner, but by a decade of low interest rates and economic growth, or the good fortune of having a public amenity plunked down in the neighbourhood.

That out of the way, let's consider why the rush to appease a few voters in a few marginals is bad economic policy.

Barry Bracewell-Milnes, a student and an opponent of these taxes, concedes that 'Inheritance without taxation weakens the beneficiary's incentive to work.' Surveys by the Economic and Social Research Council show that only a very small minority of people say they work for 'enjoyment'; most work for what ESRC researchers call 'mainly instrumental reasons' — to keep a roof over their head and food on the table. Studies by the Policy Studies Institute and the London School of Economics support this conclusion: 70 per cent of the men and half the women questioned say the main reason they work is to 'earn money for necessities'.

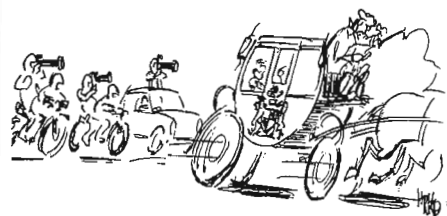
So it should come as no surprise that researchers at America's Syracuse University find (with appropriate caveats), 'An inheritance received by a family reduces the probability that both spouses will continue to work, and increases the probability that both will retire.' In short, Andrew Carnegie, the great Scottish philanthropist and a special Gordon Brown hero, had it right — '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 than he otherwise would.' Leave inheritances untaxed, and many of the young inheritors will exit the

productive workforce, not a good thing for an economy needing to encourage hard work in an increasingly competitive world.

We know, too, that inheritance taxes encourage parents to spend money enhancing their children's educational and social skills. Unable to leave a tax-free financial package, parents are more likely to pour some of their wealth into what University of Chicago economist Casey Mulligan calls 'educational and health expenditures, financial gifts, or time spent teaching or nurturing them [their children]'. It is a social misfortune that such an inheritance is not more widely available — but that's a policy discussion for another day. What is important here is that inheritance taxes encourage parents to invest in skills during their children's formative years.

Then there is the practical question: where will the money come from to replace the revenues lost when the take from inheritance taxes is reduced? Since the Tories have promised, cross their hearts and hope to die, that they will spend as much as the Labour wastrels, it won't come from reductions in government spending. No, it will come from pensioners, whose incomes will now be capped sooner than originally planned; employees who have invested in Save As You Earn (SAYE) schemes; higher taxes on farmers selling their farms; the military, which forfeits any prospect of a real increase in the funds available to defend the realm; small businessmen who had been encouraged by the last Chancellor to risk their meagre capital and ample sweat equity in the hope of selling out and paying only a 10 per cent capital gains tax; non-doms (of which I am one) who will pay £30,000 per year in addition to the taxes on the money they earn and spend in Britain; and hedge-fund operators who have been pretending that their ordinary incomes are capital gains, but who will still be allowed that pretence, their tax raised to 18 per cent from 10 per cent, but not to the 40 per cent that others pay on such incomes.

The non-doms and the hedge-fund operators are reasonable targets, if equity is all there



is to consider. But these financial types are the most mobile of the assets located in Britain. Not all will flee, but some will, and others eyeing Britain as a site for new businesses will now know it is less worthwhile than it once was to brave the mean streets of London by taking up residence in a town with one of the highest costs of doing business in the world.

But if it is equity that the Labour taxmen are after, why penalise pensioners (again) and small businessmen (again), and employee-savers, and all the other innocent bystanders? All to benefit a handful of taxpayers who happen to be concentrated in key marginals.

Which brings us to the final objection to this forgiveness of taxes on inheritance, which in the end is no different from any other income the beneficiary might receive — except that it is not earned by the sweat of his brow or the whirring of his brain. The tax cuts could have been better concentrated on lowering the marginal tax rate faced by all earners. Reduce taxes on the pay for that extra work, and you will get more of it; reduce taxes on the profits from risk-taking, and entrepreneurs will take more chances and create more jobs. Reduce the taxes on recipients of inheritances, on the other hand, and they will work less and be less likely to start up new businesses. Worse still, and perhaps most important, to abandon the laudable goal of trying to make opportunity more equal for all in order to favour the beneficiaries of perhaps the 6 per cent of estates that pay inheritance taxes is a terrible policy trade-off.

At least to an economist, whose policy role should be to tell politicians the cost of their decisions, and then leave it to them to decide whether a policy is worth its cost. Inheritance taxes make good economic sense, but against the economic advantages must be set the limitation they impose on the freedom of people to dispose of their lawfully earned wealth as they see fit.

In my view, that reduction in freedom — the cost of retaining inheritance taxes — is outweighed by the benefits: the economic advantages, especially when compared with other taxes, and their contribution to the drive for greater equality of opportunity. Which makes it too bad that politics trumped economics, since the result is neither greater overall fairness, nor the increased stimulus to economic growth that alternative tax cuts would provide.

Messrs Darling and Osborne would do all of us a favour if they would whip out their undoubtedly dog-eared copies of *The Wealth of Nations*. To meet the criteria of 'evident justice and utility', Adam Smith supported a tax on wealth inherited by children 'who have got families of their own, and are supported by funds separate and independent of their father'. Which is why the *Economist* classifies Smith as one of the political economists 'broadly in favour' of the estate tax. Pity that two Scots, both hailing from Kirkcaldy, differ on this policy question.

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