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Notes for use in a Debate on**

The Future of Inheritance Taxes

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Many thanks for providing me with an opportunity to revisit positions I have taken in the past on the question of inheritance taxes.¹

I start with three propositions that I believe are unassailable and broadly consistent with Lord Forsyth's "principles of an efficient tax system" as stated in his recent Report :

1. Economic growth, properly measured, is the most certain source of rising living standards and of increased revenue for the government.

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** With Lord (Michael) Forsyth on the motion "Inheritance Tax Should Be Abolished".

¹ See My "From Grave to Cradle: Building a Meritocracy". London: The Social Market Foundation, 2002. I have borrowed from that pamphlet, and refer to it as SMF. See also my "For Once, I Say: 'Tax Them'", The Spectator, 30 January 1999.

2. Taxes that do not impede economic growth are to be preferred to those that do, other things being equal.

3. All taxes have social as well as economic consequences.

From the first of those two propositions it follows that inheritance taxes are superior to most others as a source of revenue for the government. They also survive review of their social consequences: inheritance taxes, by emphasizing merit over luck in the sperm game, meet any test of social desirability.

If we are to have a reasoned debate, we must first discard some of the perversions of the language that have come to characterise discussions of inheritance taxes. It has become fashionable on both sides of the Atlantic to call estate taxes “death taxes”, or “death duties”, or “a vulture tax”, or in one case a “death trap”,² as if they are levied on people who have the bad grace to die. “No taxation without respiration,” is the slogan of this crowd.³ Even the most thorough British Chancellor or American Secretary of the Treasury would find it difficult to extract a cheque from a corpse. It is not the dearly departed who pay these taxes; it is their very much alive heirs, a fact with which even

² Lord Sheikh referred to and rejected this phrase since “This is not a tax on the people whose estates it is paid on. ...It is a tax on their successors...”. Hansard, House of Lords Debate, 1 February 2007, col.458.

³ The Wall Street Journal, February 26, 2001.

opponents of these taxes agree.⁴ The moneys they receive are, to them, income, different in their source from wages paid for work, or profits earned from risk-taking, but income nevertheless. Which is why there is some sense to Lord Campbell-Savours' proposal that the inheritance tax be replaced by a "tax [on] the recipient at their marginal rate at the time of distribution."⁵

It is also common for inheritance tax opponents to complain of "double taxation", as Lord Burnett did in the recent debate in the House of Lords.⁶ True, some (but definitely not all, given the myriad exemptions written into the tax codes of both Britain and the United States) of the inherited money may already have been taxed when received by the person who originally earned it, and now wishes to pass it on. But the recipient is taxed once and only once, as is the case with all of his other income.

So let's begin this exercise without the emotive baggage of "death tax" and "double taxation". It would be well, too, to clear the intellectual underbrush by making two points:

⁴ See for example John Blundell, "Inheritance tax only makes the rich richer," The Business, 1-2 May 2005, "Inheritance taxes pretend to tax the person expiring. In reality, they dent the heirs..."

⁵Hansard, House of Lords Debate, 1 February 2007, col. 456.

⁶ Hansard, House of Lords Debate, 1 February 2007, col. 451.

- estate taxes in the US and the UK do not apply to wealth transferred from one spouse to another – a sensible approach since wealth accumulated by a husband and wife is the result of their combined efforts, whether the work was performed within or outside of the home.⁷
- the fact that more and more people are becoming subject to inheritance taxes as Britain becomes richer is irrelevant.⁸ The test of a tax is not how many people must pay it -- the income tax and VAT would fail such a test -- but the economic and social consequences of the tax. This is especially the case with inheritance tax. The rise in the number subject to it is due largely to the rapid increase in the value of homes, an increase too pervasive to be attributed to the effort or wisdom of the owners.⁹ This increase is in every sense a

⁷ For the details surrounding this provision see SMF, p.5, fn.12.

⁸ Lord Burnett cites studies showing that 850,000 individuals in Britain have assets in excess of £0.5 million, and that 3.25 million individuals and estates “are now potentially liable to pay the 40% rate of inheritance tax.” Col. 451. Lord Sheikh points out that only 38,000 taxpayers now pay IHT, but five million households are valued at above the £285,000 tax threshold and that another five million “are liable for inheritance tax when total household wealth is taken into account. Cols. 456-457. Payers of IHT represent about 6% of the 600,000 people who passed away last year, according to Lord Davies of Oldham. Hansard, House of Lords Debate 1 February 2007, col. 465.

⁹ Halifax calculates that the 2.3 million owner-occupied properties in the UK, 12% of the total, are valued at more than the 2007/2008 IHT threshold, up from 1.3 million and 7% above the then-existing threshold in 2001, and projects a that 4.3 million households will exceed the threshold by 2020. Press release, 24 February 2007.

windfall, and taxation of windfalls has none of the growth-stifling effect of most other taxes.

Let me turn now to the social and economic consequences of inheritance taxes.

It is the policy of your government and mine to equalise opportunity -- not outcomes, I would hope, although the Left in both countries has that as its goal. Since inheritances provide recipients with a head start in the race for material gains -- in short, unequal opportunities -- a tax on a portion of such inheritance contributes to equality of opportunity.¹⁰

Which is important. A general recognition that a society is open and characterised by economic and class mobility has significant economic consequences. It encourages entrepreneurship; it keeps envy of the rich and famous at a minimum; it encourages people to look to themselves rather than to government to improve their circumstances; it produces stability that keeps capital costs low.

So it is not unreasonable to argue that one of the positive results of estate taxes is that they contribute something to the desirable goal of equalising opportunity, with its attendant economic benefits. Billionaire Warren Buffett puts it this way, “Without the estate tax, you in effect

¹⁰ “Substantial inheritance is an arrow through the heart [of] equality of opportunity.” Hansard, House of Lords Debate, 1 February 2007, col. 459.

have an aristocracy of wealth, which means you pass down the ability to command the resources of the nation based on heredity rather than merit.”¹¹

Man, of course, does not live by economics alone when he sits down to devise tax policy. Notions of fairness must be satisfied if a tax regime is to survive in a democracy. As I shall point out below, such non-economic considerations have an important, perhaps determinative, place in policy making. Adam Smith, for example, argued that taxes must meet the criteria of “evident justice and utility”¹². Some tax on wealth inherited by children “who have got families of their own, and are supported by funds separate and independent of those of their father” struck Smith as meeting his standards.¹³ Which is why The Economist classifies Smith as “broadly in favour” of the estate tax.¹⁴

Added support for taxing inherited wealth can be derived from studies that emphasise the importance of non-financial assets in a person’s success in the capitalist market system. These assets are beyond the reach of any tax on

¹¹ The New York Times, February 14, 2001. Buffett was repeating Theodore Roosevelt’s argument that the transmission of large fortunes contributes to the creation of a permanent aristocracy. See The Economist, June 10th, 2006, pp.45-46.

¹² An Inquiry into the Nature and Causes of the Wealth of Nations. General eds., R.H. Campbell & A.S. Skinner, textual ed. W.B.Todd. This edition published in Oxford by Clarendon Press in 1976. V.ii.b.7.

¹³ Ibid., V.ii.h.4.

¹⁴ July 8th, 2000.

inheritance, which is levied only on the transfer of financial assets from the departed to the living. Such a tax cannot deny children what Nobel laureate economist Gary Becker calls “the reputation and contacts of their family, their genetic inheritance, and the values and skills absorbed through membership in a particular family culture.”¹⁵ Nor is an estate tax levied on what University of Chicago economist Casey Mulligan calls “Resources that are passed on to children – perhaps in the form of educational and health expenditures, financial gifts, or time spent teaching or nurturing them – [that] are important contributors to their economic success.”¹⁶ Nor can taxes on inheritances deny children the advantages of what another well-known economist, Glen Lowry, calls “networks of social affiliation”, or of the “inputs” that produce an “adult worker ... education, parenting skills, acculturation, nutrition and socialisation to which he was exposed in his formative years.”¹⁷

All of these wonderful things cannot be taxed; all are advantages that fly in the face of notions that a man can be entirely self-made in any meaningful sense; all suggest that

¹⁵ Gary Becker, A Treatise on the Family. Cambridge: Harvard University Press, 1993 (enlarged edition), p. 179. Becker adds, “Children from successful families are more likely to be successful themselves by virtue of the additional time spent on them and also their superior endowments of culture and genes.”

¹⁶ Casey B. Mulligan, Parental Priorities and Economic Inequality. Chicago: University of Chicago Press, 1997, p.2.

¹⁷ The Public Interest, Spring 1997, p.34.

complete equality of opportunity, in the sense of identical chances of success at birth, is beyond our reach; but none should dispose us to end inheritance taxes because they merely contribute to, but cannot completely produce, equality of opportunity.

Indeed, the non-taxable nature of the advantages inhering in those who have won the sperm lottery suggests that it is even more appropriate to attempt to equalise the financial resources with which we all start off in pursuit of success, or happiness, or whatever goal we might choose.

The economics of estate taxes begins with a simple fact: they yield revenues that are non-trivial and are heading upward. In the 2006-2007 fiscal year they brought £3.6 billion into the Treasury's coffers, up from £1.6 billion in 1996-1997, and equivalent to 1p on income tax.¹⁸ The Tax Reform Commission cites a Halifax study that estimates the take will rise to £5.6 billion by 2020, under certain circumstances.¹⁹ Eliminate this tax and you place a greater burden on other taxes to provide revenues, taxes that would have a lesser effect on economic growth. Conversely, leave inheritance taxes in place, and you allow for modest reductions in taxes on, say, incomes. In short, the trade- off

¹⁸ Estimate by Lord Davies of Oldham, Hansard, House of Lords Debate, February 1, 2007, col. 465.

¹⁹ "Tax Matters: Reforming the Tax System," The Report of the Tax Reform Commission, October 2006, p.102.

is this: tax already-accumulated wealth, or keep taxes on current economic activity higher than they would otherwise be.

The question that immediately arises is whether higher inheritance taxes will discourage accumulation of wealth. Here, the evidence is mixed. Those who might have a fixed target in mind for the sums they plan to leave their heirs might accumulate more so as to meet the net, after-tax goal they have set for themselves. (This is a version of what is supposed to happen in the case of taxicabs, where it is believed that an increase in fares reduces the hours cabbies are willing to work because they hit their daily income targets earlier in the day.)

Others might accumulate less wealth by relying more heavily on *inter vivos* gifts to reduce the pot available when the taxman cometh,²⁰ or by increasing their own consumption; or by bequeathing larger sums to charity; or by retiring earlier. Let's consider the economic consequences of each of these possible strategies.

Inter Vivos gifts: One way to reduce an estate tax liability is to make tax-free gifts to children and

²⁰ In the US, each parent may give each child a tax-free gift of \$11,000 each year. In the UK, gifts of up to £3,000 per year are tax-free, as are wedding gifts of £5,000 to each child and £2,500 to each grandchild, and gifts from certain income sources so long as they do not affect the lifestyle of the donor. For further details see SMF, p.9, fn.29.

grandchildren, directly or by exercising a variety of tax avoidance schemes too arcane to discuss here. But studies by James E. Poterba of the Massachusetts Institute of Technology reveal that “nearly two-thirds of the elderly households for whom the estate tax may loom as a potential burden are not making transfers....Most households, even those with net worth high enough to virtually insure that their estate will be taxable, do not make large inter vivos transfers....Even among households with net worth of several million dollars, and household heads over the age of 75, the probability of making *inter vivos* gifts is less than fifty percent.... Limited use of inter vivos gifts has been a persistent feature of transfer behavior by high net worth households”²¹

These data, of course, apply only to the American situation. But there is little reason to believe that the approach of Britain’s wealthy is markedly different. Professor Poterba reasons that what he calls “the low-wealth wealthy” fear they will need the resources for their health care or other retirement needs. That is certainly a worry on both sides of the Atlantic, increasingly so in the US as the cost of prescription drugs soars, and in the UK as the

²¹ James Poterba, “Estate And Gift Taxes and Incentives For *Inter Vivos* Giving In The United States.” National Bureau of Economic Research Working Paper 6842, December 1998, pp.16, 20 and 21.

problems of the NHS force increasing numbers of people to turn to private healthcare providers. And among the super-rich Poterba supposes “there’s just a reluctance to give up control of assets” -- a fact borne out by more recent studies²² -- “even if the transfer would lead to substantial tax savings,”²³ and that “some households may not be particularly altruistic with respect to their children.”²⁴ It would be inappropriate for an American to opine on the likely comparative degrees of parental altruism, but in the absence of definitive studies we can assume that any transatlantic difference in this regard is trivial.

These empirical findings suggest that the behaviour of people with accumulated wealth is not overwhelmingly affected by a desire to reduce the tax burden on their heirs. But even if the threat of impending estate taxes would lead the elderly to disappoint the tax collector by passing on large sums to their waiting heirs, before rather than after the donor shuffles off this mortal coil, all that would be happening is that the ownership of accumulated wealth would change hands, and the consumption of that wealth would be devoted

²² Christopher D. Carroll of Johns Hopkins University points out that “Many wealthy households ... say that providing an inheritance is not a principal motivation for saving and ... childless wealthy old people do not appear to dissave.” See his “Why Do the Rich Save So Much?”, 2007, www.econ.jhu.edu/Papers/Carroll/why.pdf

²³ Quoted in Business Week, January 11, 1999.

²⁴ Poterba, loc.cit., p.22.

more to the latest electronic gadgets favoured by the young than to a new set of golf clubs with which to wow other retirees. That might be of consequence to marketers of DVDs and golf paraphernalia, but should not concern policymakers.

Spend and spend: There are several ways that the elderly might cheat the tax man by spending more. They might simply indulge themselves in even more of the good things of life – things that would curl the hair of those who are repelled by conspicuous consumption. As Heffer engagingly puts it, failing to enjoy one's money "looks like the ultimate wasted opportunity. After all, life is not a rehearsal.... [By spending] We are saluting the link between our effort and reward."²⁵

Such beat-the-taxman, induced extravagance would, of course, mean that the next generation would have less to spend. But there is no reason to believe that the increased pleasure of the older folks would be more than offset by the lost pleasure of the younger generation, resulting in an aggregate reduction in happiness. In any event, economists don't have too much to say about what we call interpersonal and intergenerational utility comparisons – the costs and

²⁵ *Loc.cit.*

benefits of shifting income and wealth from one generation or person to the next, and so can't advise whether it is good or bad policy to shift consumption from the young to their elders.

An alternative to self-indulgence for those seeking to spend their way out of an estate tax burden would be to spend more on their heirs in the here and now. The studies cited above suggest that wealth transfers by giving tax-free gifts are for a variety of reasons not as widely used as they might be. But wealth can also be transferred by spending more on one's children. And such stepped-up spending on one's heirs during one's lifetime to avoid inheritance taxes might produce results that are quite beneficial to society. Studies in America show that the top 1% of the nation's wealthiest parents now contribute only 59% of their children's' graduate school expenses;²⁶ they obviously could do more to add to the nation's intellectual capital.

More to Charity: Faced with the prospect that the government will pocket a larger portion of their wealth, the wealthy might pare down their estate taxes by increasing their tax-deductible charitable giving. This notion that much, or at least some, charitable bequests are aimed at avoiding

²⁶ U.S. Trust, op.cit.

estate taxes is what prompted William H. Gates, Sr., to join America's Democrats in the fight against estate tax repeal, which he and others argue would increase the net, after-tax cost of charitable giving. Those who favour repeal respond that the link between inheritance taxes and charitable bequests is not significant. In the United States, estate tax opponents point out that such bequests account for only 1.5% of the total revenue of charitable groups, and that only one-third of non-profit organizations report income from legacies or bequests.²⁷ But data on the effects of taxes on lifetime giving are notoriously difficult to understand: clearly, the charities themselves think that higher estate taxes will increase donations and bequests -- one study puts the possible loss at \$10 billion annually -- they feared to antagonise many of their wealthy donors by lobbying against Bush's estate-tax phase-out.²⁸ UK charities now routinely highlight the tax-deductible advantages of generous giving in their appeals for donations.

From our point of view, it matters little what the exact relation is between charitable giving and tax rates. Certainly, tax avoidance is not the sole reason for supporting charities,

²⁷ Joint Economic Committee, op.cit., p.8.

²⁸ The New York Times, April 24, 2005; and The Wall Street Journal, August 10, 2000. Paul Newman and Robert Redford, with an organisation called Responsible Wealth, fought repeal of inheritance taxes because they feared such repeal would reduce the incentive to set up family foundations that fund good causes as an alternative to paying inheritance taxes. The Sunday Times, February 16, 2003.

as the generosity of people of quite modest means (and therefore little hope of major tax deductions) suggests. *But it is hardly a disadvantage of estate taxes if their avoidance takes the form of charitable bequests. Indeed, we should be delighted that the people who earned the money, rather than politicians, are deciding which good causes will benefit from their accumulated wealth. The Treasury, not society, will be the loser.*

Retire earlier and sharpen the golf game: The prospect of paying estate taxes might prompt older people to work less, rather than to spend more, as a way of reducing their taxable estates. Society will lose the labour of talented, elderly workers. But it will gain the labour of now not-so-rich younger heirs, whose incentive to work will be enhanced by the reduction in their inheritance – even if money is not the only reason people work.

That an inheritance can reduce the incentive to work is conceded even by a leading British *opponent* of inheritance taxes: “Inheritance without taxation weakens the beneficiary’s incentive to work...”.²⁹ Not only that, “It devalues the value of money by undermining understanding of the relationship between effort, wealth creation and

²⁹ Barry Bracewell Milnes, op.cit., p.24fn. The author adds that the receipt of an inheritance increases the legatee’s incentive to save.

earning through work. Therefore, it can, under certain conditions, destroy incentive, innovation and ambition.... Inheritance too often only generates idleness.”³⁰

And such data as we have support the view that the major motivation to continue working in Britain is to earn “money to live” and with which to “buy extras”, according to a survey by the Economic & Social Research Council. Only 16% of “higher professionals”, and a tiny minority of administrators (6%), routine non-manual (3%), supervisor/technician (4%), skilled manual (3%) and semi/unskilled manual (2%) say they work for “enjoyment”. Robert Taylor of the ESRC points out, “...[T]he figures for 2000 suggest that technological innovation and work reorganisation have actually increased rather than diminished the proportion of people who say they work for mainly instrumental reasons.”³¹

Other surveys in the UK confirm that, given a windfall, many in the UK would simply put up their tools, shut down their computers, and fail to show up at business meetings. Michael White of the Policy Studies Institute and Stephen Hill of the London School of Economics found that 70% of

³⁰ Lord Campbell-Savours, Hansard, House of Lords Debate, 1 February 2007, cols. 454-455.

³¹ Robert Taylor, “Britain’s World of Work – Myths and Realities,” Future of Work Commentary Series, Economic & Social Research Council, undated, pp.14-15. Taylor is Media Fellow on the ESRC Future of Work Programme.

the men and half the women they questioned say the main reason they work is to “earn money for necessities”. And Jeff Hyman, from Glasgow Caledonian University, surveyed several companies in Scotland and found, according to the ESRC report of their work, “Working is still seen as a means of securing enough pay to enjoy life outside the job...”³²

These findings are similar to those in the United States. Several studies by economists in America have found that the larger the inheritance a person receives, the more likely he is to drop out of the work force. Studies done for the Maxwell Center for Demography and Economics of Aging at Syracuse University, although very careful not to stretch the data beyond acceptable limits and therefore careful to ring their findings with appropriate caveats, conclude, “...An inheritance received by a family reduces the probability that both spouses will continue to work, and increases the probability that both will retire.”³³

After summarizing these studies, James K. Glassman, an economist/journalist affiliated with a conservative think

³² These studies are reported by Robert Taylor in “The Future of Work-Life Balance”, Economic & Social Research Council, undated, pp. 11-13.

³³ The income effect producing this result “is statistically significant, although its magnitude is small.” Douglas Holtz-Eakin, David Joulfaian and Harvey Rosen, “Estimating the Income effect on Retirement,” Aging Studies Program Paper No. 18, Syracuse University, April 1999. Other portions of this complicated empirical study suggest limitations on any conclusions about the effect of inheritance on retirement behaviour in many cases.

tank in America, is inclined to agree with Andrew Carnegie's much quoted statement, "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."³⁴ This argument in favour of inheritance taxes should have special appeal to conservatives who contend that welfare benefits paid to the poor sap their initiative and reduce their incentive to work. Surely, sap for the poor goose is sap for the rich gander.

A precise computation of the net effect on the available labour supply and on productivity is not possible, but there seems no reason to believe that trading some years of the labour of mature folks who retire early to avoid taxes for some years of more intense labour by younger folks whose inheritance is reduced by taxes will result in a net loss to society.

There you have it: economic data suggest that efforts to eliminate the estate tax are bad economics. Estate taxes contribute to the socially stabilizing view that opportunity is more rather than less equal; they reduce the incentive of the young to withdraw from the workforce; they might prompt those with potentially taxable estates to invest more in their

³⁴ James K. Glassman, "Inheritance and Sloth" Forbes, October 11, 1999.

children's education and bequeath more to various charities of their choice; and they enable the government to reduce other taxes, particularly the marginal income tax rates that are a deterrent to hard work and entrepreneurial daring, and to avoid raising capital gains taxes, as the Institute of Directors recently suggested.³⁵

As against these advantages must be set the limitation on the freedom of people to dispose of their lawfully earned wealth as they see fit, and "human nature", which is what prompted a close friend and colleague to dismiss my earlier articles with the expletive I have tastefully deleted from this essay. He was of course, merely stating in shortened and more ear-catching form what Frédéric Bastiat had said 150 years earlier, and which it behooves a defender of estate taxes to call to the attention of those who agree with several commentators that they are against human nature:

No theory, no flights of oratory can succeed in keeping fathers from loving their children. The people who delight in setting up imaginary societies may consider this regrettable, but it is a fact. A father will expend as much effort, perhaps more, for his children's satisfactions as for his own. If, then, a new law contrary to Nature should forbid the bequest of private

³⁵ Reported in the *Financial Times*, February 21, 2007. The IoD reckons that scaling back the £8,000 capital gains tax exemption would yield £1.3 billion, making the net loss to the Treasury of abolishing IHT £2.3, "small in the context of total tax revenue."

property, it would not only in itself do violence to the rights of private property, but it would also prevent the creation of new private property by paralyzing a full half of human effort.³⁶

Economic considerations do not necessarily trump other considerations that must go into the making of policy. But economics helps us to understand the costs of our decisions. In the case of estate taxes, economic considerations create a reasonable case for their continued use. Those who favor repeal have more than a little work to do to demonstrate that the economic advantages of repeal are outweighed by non-economic considerations. They might well succeed, which is why I continue to label my arguments a thought experiment, subject to change as new arguments and data emerge.

END

³⁶ Frédéric Bastiat, *Economic Harmonies*. Irvington-on-Hudson, New York: The Foundation for Economic Education, printed in 1996, written circa. 1850, p.29.