Economics focus

The case for death duties

How to improve an unpopular tax

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TAXES on estates when their owners die arouse passions that politicians ignore at their peril. In America there has been a long-standing campaign to get rid of the federal “death tax”. Thanks to George Bush's tax cuts, it is supposed to be repealed in 2010, though only for one year. In Britain a recent proposal by the opposition Conservatives to slash the burden of inheritance tax swung the polls their way to such an extent that Gordon Brown, the Labour prime minister, cancelled an election he had planned this autumn.

The current unpopularity of death duties is perplexing considering how long they have been around. America introduced its federal estate tax in 1916. Britain's death duty goes back further. Taking modern shape in 1894, it can be traced back to 1694 when probate duty was introduced. Since 1986 it has confusingly been called inheritance tax although it is nothing of the sort. Like America's estate duty it remains a levy on the amount left by the deceased and does not tax what individual beneficiaries receive.

The hue and cry about death duties is all the more puzzling since they affect few people. In Britain, 6% of estates pay the levy, which raised less than 1% of total revenues in the last fiscal year. In America, between 1% and 2% of estates have typically been subject to the tax over the past two decades and it has contributed only about 1% of federal revenues.

The gut dislike of death duties seems to arise because the tax clashes with heartfelt dynastic instincts. Until recently this was a worry only for the super-rich, but now many ordinary people fear that, thanks to rising house prices, they may be dragged into paying death duties. Given the low take from the tax, it is easy to see why politicians on either side of the Atlantic have been so receptive to public worries. Cutting estate or inheritance tax seems to offer a big electoral hit at small fiscal cost.

But good politics does not mean good economics. Taxes should be assessed on three grounds: how they affect incentives, how fair they are and how simple. Estate taxes score well on the first two, less satisfactorily on the third. Whatever their merits, however, a tax that targets beneficiaries, rather than the estate of the donor, would be more effective.

Any tax on capital will tend to dissuade people from accumulating the wealth in the first place, but a death duty is arguably one of the better options. As Alan Auerbach, an economist at the University of California, Berkeley, pointed out in a lecture given in London a year ago, it falls on unintended legacies—money put aside to pay for old age, for example—as well as intentional bequests. Since unintended bequests are, by definition, not planned they should be unaffected by the prospect of the tax.

Another argument for death duties is that big bequests make people less likely to work and to be enterprising. Winston Churchill put the argument succinctly in 1924 when he argued that the tax was “a certain corrective against the development of a race of idle rich”. Economic research published at Syracuse University in America suggests that the more wealth that older people inherit, the more likely they are to quit the labour market.

The fiscal cost of abolishing death duties may seem trifling, but it still means that for a given level of public spending other taxes must rise, which may harm incentives more. This was a point readily appreciated by both Churchill in his 1925 budget and William Harcourt, who introduced estate duty in 1894. Both chancellors of the exchequer used extra revenues from death duties to lower the income tax.

Death duties can also be justified in terms of fairness. A thriving economy will generate great fortunes, but there is good reason to check these becoming entrenched through inheritance. The estate tax offers a modest counterweight against the development of a new plutocracy to rival the industrial barons of America's Gilded Age. Furthermore it also taxes wealth built up through windfalls rather than thrift and effort. For example, recent gains in the housing market have accrued mainly to people who happen to belong to the right generation and who own property in the right places.

Death by a thousand cuts

The case for retaining estate taxes in Britain and America is weaker on grounds of simplicity. In principle, the tax is quite straightforward; in practice it is anything but. It may not raise much revenue but it has been a goldmine for the tax-advice industry. In Britain the tax has generally fallen on the not-so-wealthy and the ill-advised.

The complexity of death duties is not a reason to do away with them but rather to reform them. By sticking with a tax on donors' estates, Britain and America have become the exception. Other developed countries now tax wealth received by beneficiaries. One advantage of this approach is that it does more to tackle wealth inequality, which arises from large inheritances rather than big estates. It creates an incentive for wealth to be spread among several beneficiaries, whereas the estate duty simply reduces the wealth that it taxes in a direct transfer to the state.

Another advantage of a genuine inheritance tax (not a false friend like Britain's) is that the tax authorities can set different rates according to how close heirs are to the donor. In France, for example, distant relatives are taxed more than children. Because this seems fairer for families, taxes on beneficiaries may have more political staying-power than old-style death duties.

Days after Mr Brown's embarrassing retreat from an election, his chancellor announced measures that will enable more married couples and civil partners to pay lower death duties. As so often, however, hasty decisions are not the best ones. The right way to take the sting out of the “death tax” is not to tinker with it through piecemeal cuts. Rather, the solution is to turn it into a levy on inheritance.