Commentary

'Death and taxes'
Social justice and the politics of inheritance tax

Martin O'Neill

In a letter to his friend Jean-Baptiste Leroy in 1789, Benjamin Franklin famously opined that 'in the world nothing can be said to be certain except death and taxes'. Franklin was surely right about this, just as his judgment was sound in so many other matters: – after all, this was the man who told us that 'beer is living proof that God loves us and wants us to be happy'. But it is astonishing how often passions become enflamed, and good sense goes out the window, when we encounter the heady mix of mortality and tax.

Recent events have borne this out. No matter when the next UK general election is held, inheritance tax (IHT) will be one of the key issues, with Tory plans to raise the IHT threshold from £300,000 to £1,000,000 promising to be their most popular single policy. David Cameron and George Osborne have found a policy that resonates with the fears and aspirations of many of their fellow citizens, who hold IHT in suspicion and opprobrium. IHT is seen as a despicable 'death tax', which hits families just when they're down. Moreover, it is seen as especially illegitimate, given that it is a form of 'double taxation' ('why should the government take my money, when they already taxed me when I earned it?'). IHT is viewed as the manifestation of government in its most sinister form: cold and rapacious.

But it is actually quite puzzling as to why IHT has quite such a bad image. It's a fair and progressive form of taxation, that should be popular with both social democrats *and* free marketeers, for reasons that I'll explain below. Labour should not be at all defensive about IHT and instead should be prepared to proclaim its myriad virtues from the rooftops. Most importantly, Labour certainly should not follow Blairite outrider Stephen Byers's eccentric advocacy of the wholesale abolition (Byers, 2006). Only by making the progressive case for inheritance tax forcefully and in a principled way can social democrats hope to wrest away this issue from the Conservatives.

In this discussion, I want to start by exploring some of the good reasons that exist for resisting the Tory attack on inheritance tax. Next, I will move on to an assessment of the changes made to the structure of UK inheritance tax by Alistair Darling in the Pre-Budget Report of October 2007. Darling's reforms were commonly viewed in the media as no more than a simple smash-and-grab raid on Tory proposals, but I suggest that the truth might be somewhat more complicated than that. Lastly, I want to outline some of the progressive options that exist for reforming inheritance tax, and for moving towards forms of capital taxation that would be more effective in achieving social justice. My overall argument suggests that the use of inheritance tax should be one of the central elements of a strategy for building a fairer society. Progressives and social democrats who want to create social justice need to be prepared to get off the defensive on this issue, and start making the case for IHT.

Why we should stop worrying and learn to love inheritance tax

There are positive and negative reasons favouring IHT, and against any reform which raises IHT thresholds, or otherwise limits the effectiveness of the taxation of wealth as it is transferred from one generation to another. I'll begin with some of the good 'negative' arguments against changes to inheritance tax, before moving on to some of the more substantive positive arguments that should be deployed by the left in support of IHT.

Most people pay nothing (or at any rate not very much…)

At the current £300,000 threshold, only the richest 6 per cent of estates pay anything. One common form of misjudgement is that many people who will not be affected IHT nevertheless think that they will be. A striking example of this kind of thinking comes from the US, where the Estate Tax threshold kicks in only at $2,000,000, or for the top 1 per cent of estates. Nevertheless, Bush's attempt at repealing the estate tax enjoyed widespread public support among the less well off. Surveys found that 20 per cent of Americans believed that they were in this top 1 per cent, with a further 20 per cent expecting to come into this bracket in the near future! (See Runciman, 2005; and Graetz and Shapiro, 2005)

Even those who fall within the threshold often don't pay as much as they worry they will. Is Granny worried that her house is now worth £500,000, and the grandchildren are going to lose out? Well, under current rules, Granny can give them £3,000 a year each without any tax implications. Short of liquid cash? Then she can release some of the equity in her property with an equity release mortgage. Moreover, given that the first £300,000 is zero-rated, even if Granny eventually departs leaving an estate valued at, say, £400,000, the tax liability at the 40 per cent IHT rate is only £40,000 – leaving a generous £360,000 for the grandchildren. So, even in a case such as this, where an estate does fall within the IHT threshold, the average rate of IHT paid is only 10 per cent across the whole estate. The generous zero-rated band means that, in reality, very few estates pay IHT at anything like the headline marginal rate of 40 per cent. (The effective average tax rate is, for example, only 5.7 per cent for estates that are the same size as the average London house price of approximately £350,000; and even for estates twice that size, valued at £700,000 the average effective IHT rate is only 22.8 per cent. Under the pre-2007 IHT regime, the average effective IHT rate is less than one third for all estates up to £1.8m). The complaint that IHT stops people from 'leaving something to make their descendants lives a bit easier' thus seem rather exaggerated.

Arguments about 'double taxation' are bad arguments

Perhaps the strangest, and yet most pervasive, aspect of opposition to IHT is that many people say that 'double taxation' is intrinsically unfair. But, if this were true, then it would be intrinsically unfair to levy any form of tax on the expenditure of post-tax income. Yet, we pay VAT, fuel taxes, alcohol duty, and stamp duty when we spend our hard-earned cash, without the same kinds of complaints about 'double taxation'. The way in which IHT is singled out as involving some illegitimate form of 'double taxation' therefore involves an oddly unmotivated exercise in selective attention.

There are other means of responding to 'double taxation' arguments against IHT. Firstly, one can point to the fact that, for most people, the element in their estate that will cause that estate to attract IHT after their deaths is the value of their house. For many people in the UK, their homes have increased massively in value due to the rampant inflation in house prices over the past twenty years. But this windfall increase in wealth has not, in itself, ever been taxed, even if the money that was used to buy an individual's home in the first place had been subject to income tax at the time when it was earned. So here, again, the 'double taxation' point becomes difficult to sustain. Secondly, it should be noted that, even in cases where IHT is designed as a levy on estates (as in our current system) rather than recipients, it is only ever levied after the death of the donor, and hence, in practice it is always paid by the recipient rather than the donor. Hence, the individual who pays inheritance tax is always a different person to the individual who was initially taxed on that wealth when it was earned as income. So, one might indeed point out that what distinguished IHT among other forms of taxation is precisely that it *never* involves anything that can be characterised as 'double taxation'. (On this last point, see White, forthcoming).

The core error of 'double taxation' arguments against IHT is that they imagine that it is bank-notes (or some other units of currency) that are the objects of taxation, rather than transactions. Indeed, this sort of objection to IHT, if carried to its logical conclusion, would preclude the existence of *any* kind of system of taxation. To see why, just think that any discrete amount of money might be involved in a plethora of separate transactions over time, being subject to different forms of taxation at each point, depending on the nature of that transaction (employing someone, buying a product, bequeathing in a will, etc.). The 'double taxation' argument suggests that, no matter how long this train of transactions, taxation can happen *only once* in the chain. The idea seems to be that once my money has been taxed once, it cannot be taxed again. Hence, we'd need to know the complete transaction history of the economy in order to know whether any element of taxation was legitimate or not. This is, I may hazard to suggest, a crazy way to think about taxes.

From 'double taxation' to the errors of 'everyday libertarianism'

An objection to the aims or level of some tax, including IHT, needs to be made in a way that's more careful than simply invoking this kind self-defeating 'double taxation' argument. Indeed, lurking behind the 'double taxation' argument against IHT seems to be a background picture that fails to take seriously the ways in which the tax system itself is part of the set of legal rules that constitute our overall system of property. Thus, it is only when we view the tax system as itself being in place that we can determine legitimate property holdings, and can make plausible judgements about what is rightly mine and what is not. Objections to a particular tax on the simple grounds that it takes away 'my money' make the mistake of getting things backwards – because we can know what really counts as 'my money' only once we know what a legitimate system of taxation looks like. As Liam Murphy and Thomas Nagel put it in their book *The Myth of Ownership*:

> Private property is a legal convention, defined in part by the tax system; therefore, the tax system cannot be evaluated by looking at its impact on private property, conceived as something that has independent existence and validity. Taxes must be evaluated as part of the overall system of property rights that they help to create. (Murphy and Nagel, 2002, 8)

Yet, this 'everyday libertarianism', as Murphy and Nagel call it, is pervasive, and difficult to budge. Many arguments against IHT involve the libertarian intuition that one has an independent moral entitlement one's current pre-tax wealth or income. But, as Murphy and Nagel put it, 'one can neither justify nor criticise an economic regime by taking as an independent norm something that is, in fact, one of its consequences' (Murphy and Nagel, 2002, 9). The money and property that we legitimately hold is in part defined by, and results from, the operation of the whole complex web of tax rules and regulations. We can criticise elements of that system, of course, for a wide variety of reasons, but a simple appeal to the illegitimacy of the government expropriating 'my money', simply short-circuits reasoned debate about tax. Clear thinking about IHT, as about all taxes, demands that we *do* budge this 'everyday libertarian' intuition aside.

If not inheritance tax, then what…?

Inheritance tax is a tax that falls disproportionately on the old (the typical case is of 50 and 60 year-olds inheriting from 80 year-olds) and the rich. If we wish to repeal it, or raise IHT thresholds, then, unless we want to reduce government expenditure, the shortfall needs to be raised elsewhere. The chances are that it will be raised to a greater degree from those who are younger and poorer than those affected by IHT. Many of the opponents of IHT would be less sure of their position if questions about IHT were framed in a different way. Instead of 'Would you like inheritance tax to be reduced?' the question should be 'Would you like to replace inheritance tax with increased income tax or corporation tax?'. Here again, thinking of IHT as part of a tax *system*, rather than in abstract isolation, helps to make the issues clearer.

David Cameron and George Osborne, in their current policy proposals, suggest that their reduction in IHT can be met by levying an annual £25,000 charge on 'non-domiciled' UK residents, who pay no tax on their non-UK sourced income. This is a problematic proposal in a number of ways. First of all, one may doubt that it would bring in anything like the £3.5b that would be lost by the IHT changes proposed by the Tories. Secondly, many of the UK's 'non-doms' are not Russian oligarchs, or well-paid City workers. Some are simply Polish plumbers, who don't want to pay tax on their non-UK income. So, some non-doms just could not pay the charge, or would de-register as 'non-domiciled' if the charge were imposed. Thirdly, the Tory position seems wholly unprincipled. Surely either non-doms should pay UK tax in the same way as domiciled tax-payers (in which case we should tax them in the normal way rather than imposing an annual charge), or they should be exempt (in which case current arrangements are fine). It is difficult to see what the justification for the half-way house of a £25,000 'residency levy' might be. Fourthly, let us assume that the Tories are right that we should be doing more to tax non-doms, in one way or another. Well, then, why don't we do so in order to reduce income tax rather than in order to reduce IHT; or, indeed, why not tax non-doms in order to invest more in health in education? Given these other options, reduction in IHT is not a reasonable priority.

Why (even) free market conservatives should love inheritance tax

Inheritance tax is often seen as a policy of the left rather than the right, and it's certainly true that there are lots of good egalitarian reasons that support IHT. But this is only half of the full picture. Those on the right, and especially those who believe in the usual justifications for the free market, should be just as enthusiastic as the staunchest socialist about the preservation of IHT. The fact that there are good arguments for IHT from across the political spectrum should embolden defenders of IHT to deploy the full range of arguments that can be given in its favour.

Here's why free marketeers should support IHT. Let us assume, first of all, that we believe in the glories of the free market economy. If we give people responsibility, and set them on their own two feet, then they'll work hard and prosper. A free market in trade and employment gives us, let us suppose, a dynamic, innovative and thriving economy. It does this by incentivising hard work, and letting economic rewards flow to those with the best ideas and the greatest capacity for hard graft.

But, if this is our vision of society, we surely must admit that the unearned windfall gains of inheritance tax distort this picture. Large inheritances distort the level playing field which would allow the dynamic and innovative to prosper. If welfare payments cause listlessness and sap dynamism, then we can only assume that large unearned windfalls will do likewise. Indeed, these were precisely the sorts of arguments given by Teddy Roosevelt when he proposed an American federal estate tax in 1906. As Andrew Carnegie (another proponent of IHT) put it 'the parent who leaves his son enormous wealth generally deadens the talents and energies of the son, and leads him to lead a less useful and less worthy life than he otherwise would.' One need hardly point out that neither Roosevelt nor Carnegie were approaching these issues from the left.

Arguments for IHT in terms of creating the meritocratic background for a thriving market economy can be further strengthened if a link is made between the revenue raised by IHT and how it could be spent to create the right kind of background economic conditions. Inheritance tax can be used to fund education so as to create that level playing field and broad opportunities, or, perhaps, used to fund capital grants to young entrepreneurs. This is exactly the sort of scheme favoured by Bruce Ackerman and Anne Alstott, in their book *The Stakeholder Society*, where they advocate capital grants to each individual of $80,000 at the start of their working lives, funded by a progressive estate tax (Ackerman and Alstott, 1999). One of the interesting features of this sort of scheme is that it is all about using the state to facilitate individual responsibility and to create opportunities, rather than simply doling out welfare. This is a much purer vision of a free market society than societies that are gummed-up and ossified by inherited advantage.

Why the left needs to be less defensive about inheritance tax

Just like the Democrats in the US, the Labour Party has tended to be somewhat defensive when reacting to proposals to abolish or reduce IHT. Rather than simply emphasising that not all that many people pay IHT, Labour should be trying the difficult task of transforming public opinion on the issue. Perhaps the strongest arguments for IHT appeals to ideas of reciprocity and fairness that are very commonly shared.

Teddy Roosevelt took the view that 'The man of great wealth owes a peculiar obligation to the State, because he derives special advantages from the mere existence of government.' There would be no good in being wealthy if one could not enjoy stable property rights, the protection of the police, and the peace of a well-defended country, all of which need to be paid for. And individuals do not make their money in a vacuum, but by building on a broad history of innovation and development. This sort of reciprocity argument is also made by Bill Gates, Sr., father of the Bill Gates of Microsoft, in *Wealth and Our Commonwealth: Why America Should Tax Accumulated Fortunes* (Gates and Collins, 2002). It is an argument that can get broad purchase with those of every political stripe, as is demonstrated by the fact that Roosevelt and Gates are hardly 'soak the rich' firebrands or loonie lefties. Their concern is simply to prevent the emergence of a permanent aristocracy of wealth.

Thus, there are strong and principled arguments that can be made in favour of IHT and which might be thought to merit support from across the ideological spectrum. Furthermore, it is surely plausible to think that IHT would command much stronger support if it the issues were framed so as to emphasise the contrast between the taxation of unearned windfalls such as inheritances, as against the taxation of earned income or savings. As the Institute of Fiscal Studies's 1978 Meade Commission on the Structure and Reform of Direct Taxation put it:

> inherited wealth is widely considered – and we share the view – to be a proper subject for heavier taxation [than taxation of individual earnings and savings] on grounds both of fairness and of economic incentives. The citizen who by his own effort and enterprise has built up a fortune is considered to deserve better tax treatment than the citizen who, merely as a result of the fortune of birth, owns an equal property; and to tax the former more lightly than the latter will put a smaller obstacle in the way of effort and enterprise. (Institute of Fiscal Studies,1978, 318)

When the options are framed more clearly, it becomes much easier to make the argument for IHT as being one of the fairest and most defensible methods of direct taxation. Beyond this, though, it is clear that a concern to promote the widely shared value of equality of opportunity should also mandate a massive reduction in the intergenerational transmission of wealth. Britain is an increasingly unequal society, and inequality of wealth is at a level even more worrying that inequality of incomes. As Ruth Patrick and Michael Jacobs of the Fabian Society point out

> In 1988 the wealthiest one per cent of the population owned seventeen per cent of total personal wealth; by 1999 this had grown to 23 per cent. The wealth of the top 2.4 million households is £1,300 billion; that of the bottom twelve million households just £150 million. Ten per cent of all households – up from five percent in 1979 – have no savings or wealth at all. (Patrick and Jacobs, 2003, 2)

Under these sorts of conditions, the creation of fair equality of opportunity is impossible unless the intergenerational transmission of unequal wealth is addressed and curtailed.

We may also care about other problems caused by material inequality, not just in terms of opportunities, but in terms of the distribution of political power, and in terms of its effects on status, health and self-respect. We may also worry about the effects of inequality in terms of social cohesion and solidarity (Rawls, 2001, §39; Scanlon, 1997; Nagel, 1977; Daniels, Kennedy and Kawachi, 2001; Marmot, 2004; Wilkinson, 2005). Here, one moves onto the ground of distinctively egalitarian reasons for limiting the transmission of unequal amounts of wealth from one generation to the next. These are good reasons, although they will appeal only to those who accept the independent significance of equality as a political value, whether for intrinsic or instrumental reasons. What progressives should be doing, I suspect, is to pursue a two-pronged strategy. They should make these sorts of distinctively egalitarian arguments for IHT, whilst also being prepared to make broader – but nevertheless still *principled* – defences of IHT in terms of equality of opportunity and economic dynamism.

When one looks clearly at inheritance tax in terms of a concern with fairness and opportunity, it's difficult to see why it has become so unpopular. Perhaps it is significant that many of those whose families would lose out most massively from a fair system of inheritance tax are precisely those who own some of our most influential newspapers, and who have the spare resources to exert political influence through lobbying and political donations. If so, that gives one more kind of democratic argument for why IHT is a vital policy in a fair and progressive country.

Policy changes in the 2007 Pre-Budget Report: good news and bad news

Unfortunately, Labour has been following the Tory lead on IHT rather than making a principled defence of the importance of limiting the transmission of wealth across the generations. Indeed, Alistair Darling's Pre-Budget Report (PBR) of October 2007 was generally regarded in the media as little more than a botched robbery of Tory policies.

The story of the 2007 changes to IHT in the PBR, though, is a story both in one way better and in one way worse than that of a botched robbery. It is better because, in fact, Labour's changes to IHT were far less pernicious than the proposed Tory changes. The Tory proposal was to increase the threshold for individuals to £1m. The headline-grabbing version of the Labour policy was that the married couple's threshold had been increased to £600,000 (rising to £700,000 by 2010), which *sounded* as if Labour proposals were to double the IHT threshold, rather than trebling it as the Tories wanted.

But, as some Tories were quick to point out, Labour's IHT changes were far less drastic, as there are already legal mechanisms (Discretionary Will Trusts and Deeds of Variation) that allow married couples to use each of their IHT allowances in full. This means that, for the well-connected and well-advised, the *de facto* married couple's IHT threshold was already £600,000; in effect, the PBR simply made it the case that every couple's IHT threshold was the same, whether they had access to pricy legal advice or not. This at least had the virtue of increasing 'horizontal equity' in IHT, whereby like cases are treated alike. (On 'horizontal equity', see Maxwell, 2004; and Murphy and Nagel, 2002).

It is plausible to assume that the distribution of financial and legal expertise within society tracks social class rather assiduously, and so the small print of Labour's IHT reforms actually reveals them to be mildly redistributive, at least insofar as the children of a working class couple whose house is now worth more than the IHT threshold are no longer disadvantaged relative to the children of a couple who have a solicitor in the family. Once things have settled down, and if clear thinking prevails, one may also hope that Labour really have 'dished the Tories' on this issue, insofar as what the Tories are now campaigning for is a *de facto* married couple's IHT allowance of £2m, which will be of any additional benefit only to that tiny proportion of couples who are likely to pass on more than £700,000 in capital.

That was the good news. The bad news is twofold. Firstly, given the many confusions that seem to exist in many people's thinking about IHT, most people won't notice the good news about Labour's 2007 PBR changes. The Tories may well still be seen as 'owning' the inheritance tax issue among an electorate who don't realise that the dispute is now simply over how to treat the *seriously* wealthy.

The second bit of bad news is much worse. It is that, whatever the real, concrete policy details regarding differences between Labour and the Tories on IHT, the moves made in the PBR have allowed the Tories to set the terms of the debate on the politics of taxation. If Labour had the courage of their convictions, they could make arguments about the fairness of IHT which would relocate the political battleground. As we have seen, such arguments can be made in a number of ways, on the basis of a variety of different values. Here, a recourse to political sincerity might actually prove to be surprisingly good politics. Refusing to speak the truth about social justice and taxation cannot possibly be a sustainable long term strategy for a party (and leader) who sincerely believe in progressive goals of fairness and equality.

Progressive options for reform of inheritance tax

In terms of concrete policy proposals, what should Labour do about IHT, in reaction to the Tory proposals? One answer comes from an unexpected direction. The American philosopher John Rawls, in his final book *Justice as Fairness*, suggested that a just society should have a system of IHT that taxed beneficiaries rather than estates. In that way, inheritance could be taxed much more like income, and hence inheritance tax could be made progressive, by orienting it towards receivers rather than donors (Rawls, 2001).

On Rawls's proposals, large estates need not attract any taxation, as long as they were dispersed among a number of relatively disadvantaged recipients. At the same time, even small estates could be taxed heavily if they were all left to others who were themselves already wealthy. Under this system of IHT, there could be no objection that the state was stopping middle-income families from 'setting something aside' for their children. But, at the same time, this form of IHT would prevent wealth-transfers which greatly widened existing inequalities. Best of all, under such a revised system, Granny need not worry at all, as she would be free to pass on her estate to her modestly well-off grandchildren (although not, perhaps, to those of her grandchildren who were already millionaires).

Here, Rawls takes his lead from earlier work on the idea of a 'property-owning democracy' as a radical extension of the welfare state, from the British economist James Meade. Meade saw that creating a truly fair and just society would involve addressing wealth inequalities, and proposed a number of mechanisms for doing so, including the extension of the principle of inheritance tax to cover gifts made between living persons ('gifts *inter vivos*') as well as transfers after death. An extension of IHT to cover such lifetime gifts would also have the desirable effect of avoiding the most common mechanism for avoiding inheritance tax (Meade, 1964).

Meade forms part of a rich tradition within British social democracy of addressing problems of wealth inequality with innovative policy proposals (see Jackson, 2005; Jackson, 2007). Indeed, one can trace the progressive politics of inheritance taxation on the British left at least as far back as Tom Paine's *Agrarian Justice* of 1797, which argued for the provision of a universal basic income, funded in large part out of inheritance taxation (see Paine, 1797). Up to the present day, there are good, progressive proposals for reforming IHT from the Fabians (Patrick and Jacobs, 2003), and ippr (Maxwell, 2004; Paxton, White and Maxwell, 2006). The Fabian proposal follows Meade and Rawls in suggesting the replacement of IHT with a broader 'Capital Receipts Tax' (CRT) analogous to the system of 'Capital Acquisitions Tax' (CAT) currently in operation in the Irish Republic. The ippr proposal, which is for progressive banding within the existing structure of IHT, is perhaps less radical than a CRT or CAT, but would carry a smaller administrative burden and be easier to institutionalise. Both proposals outline plausible and achievable ways in which reformed mechanisms for taxing the intergenerational transmission of unequal wealth might be enacted. Furthermore, with an eye to political mobilisation, both the Fabian and ippr proposals suggest that these progressive changes to IHT could be earmarked specifically for programs that could be seen as forms of 'socialised wealth inheritance', whether by means of funding the Child Trust Fund, SureStart, or capital grants to young adults (such as in Ackerman and Alstott, 1999).

Given that there are good progressive options for reforming IHT, progressives and social democrats should hope that the 2007 PBR changes will not be Labour's last word on the subject of inheritance. Any of the available options, whether a system of beneficiary-centred IHT, a comprehensive CRT/CAT, or a progressively banded revision of IHT, could command easier public support than the existing system, especially if linked to policies promoting 'social inheritance'. Moreover, each of the three options would be substantially more progressive in their effects than the existing system. A progressively reformed inheritance tax or

Capital Receipts Tax would be worth having, and worth arguing for. Such changes might also help to undercut some of our common irrationalities about death and taxes.

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