

Inheritance tax still has a role to play, says Alan Auerbach in IFS annual lecture

Taxing inheritance may be unpopular, but it has an important role to play in the tax system, Alan Auerbach, Professor of Economics and Law at the University of California at Berkeley, argues in the Institute for Fiscal Studies' 2006 annual lecture.

Professor Auerbach notes that fewer economists now see a future for taxes on capital income, the returns people make on investments in businesses, property and other assets. (Taxes on capital income in the UK include corporation tax, inheritance tax, capital gains tax, and that part of income tax paid on income from investments.) But Professor Auerbach does not believe that capital income taxation is on the way out:

“Capital income is difficult to measure and capital income taxes are difficult to collect. Economic theory tells us that we should not tax the normal return to new saving, because it distorts saving and investment decisions. It might seem, then, that modifying our current system simply by eliminating capital income taxes would be desirable. This outcome, however, is not likely, nor is it particularly desirable.”

“In fact, only a small part of the measured return to capital represents the normal return to new saving. Eliminating all taxes on capital income gives up much more revenue than simply eliminating the tax on the normal return to new saving, and does little for the cause of equity, in fact and in appearance.”

Governments still raise a relatively large amount from capital income taxes, even though globalisation, the growing importance of the financial sector, and a blurring of the distinctions between equity and debt and between corporate and non-corporate activity, has made taxing the corporate sector more difficult.

Like other taxes on capital income, inheritance tax discourages saving. But it has important advantages relative to other capital taxes: it imposes a more uniform burden on the returns to different forms of saving, it taxes the unintended bequests people leave when they die earlier than expected, and by falling on individuals rather than companies it eliminates some important opportunities for avoidance.

Some people do avoid inheritance tax by transferring their assets to relations while they are still alive: “From some initial thinking on the subject, I believe there may be ways of attacking this problem. It’s worth a try, at least.”

One way to reduce the distortions created by existing capital income taxes and maintain a progressive tax system would be to raise VAT and use the revenue to reduce marginal tax rates on capital income and cut income tax for lower-income households. The distortion between debt and equity finance created by corporation tax could be eased by reducing the tax on returns to new equity. Capital gains tax could also be reformed to tax capital gains as they accrue, rather than when they are realised - or at least to simulate taxation on accrual.

ENDS

Notes to editors:

1. Alan Auerbach is professor of economics and law at the University of California, Berkeley. He will deliver the IFS annual lecture at 18.00 on Monday 4th September 2006. Contact Bonnie Brimstone (bonnie_b@ifs.org.uk) if you would like to attend. A copy of the paper will be available from www.ifs.org.uk/events.php?event_id=192. Please contact the IFS press office for an advance copy.