

Taxation of Wealth and Wealth Transfers*

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EXECUTIVE SUMMARY

The current system for taxing wealth and wealth transfers in the UK is unpopular. This is unsurprising given that certain features of inheritance tax, capital gains tax, stamp duties, council tax, and business rates are unfair or inefficient or both.

Problems with the current system

1. Inheritance tax is perceived as inequitable because the wealthy are better able to reduce the amount they pay by giving away part of their wealth tax-free during their lifetimes. The moderately wealthy tend to have capital tied up in their house, and anti-avoidance provisions in the tax rules make it hard to 'give away' all or part of the value of a house while you are still living in it.
2. Some assets obtain full relief from inheritance tax, for example, on certain businesses and agricultural land. These reliefs are not always well targeted.
3. Inheritance tax can lead to double taxation, because people may have paid tax on the earnings saved or the gains realized that generate the wealth bequeathed.
4. The single 40% rate of inheritance tax can seem unfair where the deceased was only paying the basic rate of income tax.
5. Inheritance tax is complex, illogical, and sometimes arbitrary in its effects. In some cases neither capital gains tax nor inheritance tax are paid on wealth transfers; in other cases both taxes can be paid.
6. Stamp duties on the transfer of both property and equities raise significant revenue, but distort people's behaviour in an economically costly way, discouraging mutually beneficial transactions and thereby hindering the efficient allocation of assets.
7. Using 1991 house values as the base for council tax in England is difficult to justify.
8. By contrast, business rates are based on up-to-date property values, but the rationale for this tax is not clear.

The rationale for an inheritance tax

The choice of a tax system should be based on sound principles; the fact that a wealth transfer tax involves double taxation must be justified. (However, the current UK inheritance tax system does not always impose double taxation since inheritance tax is often wrongly used as a substitute for capital gains tax.) The standard approach in the theoretical economic literature is to assume that the government chooses a tax structure that maximizes people's welfare, taking account of what makes people happy, how their behaviour is likely to respond, and the need to raise revenue to pay for public services. This approach suggests that intentional wealth transfers, which presumably benefit the donor as well as the recipient, should be taxed more heavily than accidental transfers, which may not. On the other hand, taxing accidental transfers does not distort people's behaviour in a costly way. Unfortunately the motives for, and satisfaction derived from, giving away wealth are not observable. It is sometimes argued that taxing transfers on death differently from lifetime gifts can help to distinguish between intentional and accidental transfers, but in many cases transfers on death are planned.

A better justification for taxing wealth when it is transferred is that this promotes equality of opportunity. On this view an individual should be compensated for disadvantages beyond his control, but not for disadvantages under his control. Therefore, a wealth transfer should be treated as a source of additional opportunity for the recipient that should be taxed, whether or not the donor has already paid income tax or capital gains tax on the assets concerned.

Options

There are a number of different options for the future of inheritance tax. One is wholesale reform with the introduction of a comprehensive donee based tax similar to that operating in Ireland. Under a donee based tax the rate of tax on transfers of wealth is governed not by the value of the donor's estate but by how much wealth the donee has inherited or been given during their lifetime. So each donee pays tax to the extent that transfers of wealth to him from any source exceed a certain limit over his lifetime. One advantage of this approach is that it accords more closely with the equality of opportunity rationale for taxing transfers, because those who have inherited more in the past pay tax at a higher rate on additional receipts. It could therefore be seen as fairer than the current regime. A donee based tax also encourages

donors to spread their wealth more widely, which might lead to a more equal distribution of inherited wealth. However, such a system may have higher administrative and compliance costs, in particular the need to keep a record of all lifetime gifts. In the absence of universal tax returns in the UK, a separate system would be needed to record lifetime gifts. In addition some political consensus is needed for this to be implemented successfully. If a government introduced a donee based tax system without Opposition support then many gifts might be delayed in the expectation that the tax would be repealed.

An alternative is to consider limited reform of the existing inheritance tax regime. The government recently introduced a transferable nil rate band, reducing the burden of the tax on many married couples but also its yield. If the current system is retained, other changes could include extending the seven-year limit for lifetime gifts to a longer period and better targeting of both agricultural and business reliefs. The family home should not be exempted, but if certain individuals (such as cohabitees or siblings who do not own other properties) occupy the home then the tax should be deferred until the property is sold. Consideration should also be given to increasing the threshold at which inheritance tax starts being payable or introducing a lower rate band at, for example, 20%.

It is difficult to cost such a package of reforms since the revenue raised from extending the seven-year limit for lifetime gifts is unknown: there are no data on how much wealth is transferred more than seven years before death. If the inheritance tax yield is reduced, retaining it would become harder to justify. If inheritance tax is retained, the case for keeping it needs to be put more forcibly.

Given that the justification for double taxation is arguable and that inheritance tax currently raises less than £4 billion a year, consideration could be given to abolishing it altogether. Regardless of whether or not a tax on wealth transfers is retained, the current rebasing of assets held at death to market value for capital gains tax purposes should be removed. In other words, capital gains should be taxed at death, although payment could be delayed until the assets are sold. This would make the double taxation implied by inheritance tax (if retained) very explicit, but double taxation is a natural feature of any taxation of wealth holdings or wealth transfers and, if justified in its own right, does not provide a rationale for not fully taxing the income (or capital gain) received by donors. Some design issues such as emigration and immigration, gains on business assets, private residences, and so on would need to be resolved if capital gains tax is imposed on death and are discussed in the chapter.

Wealth tax

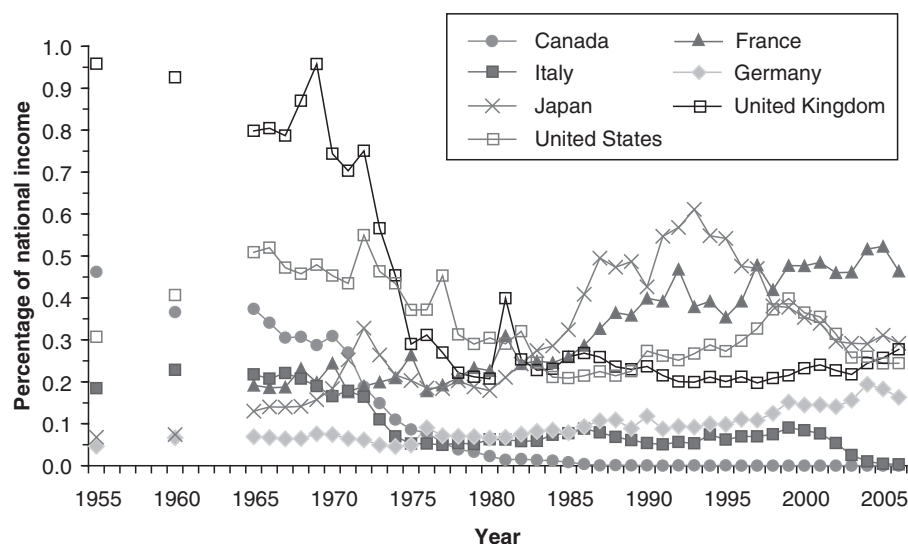
The chapter does not advocate the introduction of a regular wealth tax. It has been argued in the past that individuals benefit directly from holding wealth (as opposed to just spending it) and that the status and power it brings mean that additional taxation of wealth is appropriate. Even if one accepts this argument, it is debatable whether a tax on all wealth is the right way to tax such benefits. It is costly to administer, might raise little revenue, and could operate unfairly and inefficiently. It is less likely to work well in the current environment where capital is very mobile. Most OECD countries have abolished wealth taxes. One option that could be explored further is an annual tax targeted at very high value residential property with no reduction for debt. Perhaps the easiest way this could be implemented would be through the imposition of an additional council tax which would only affect occupiers of a residential property with a gross value above a large limit and would be paid wherever the occupier was resident or domiciled.

8.1. INTRODUCTION

The current UK system of taxing wealth and wealth transfers has been subject to significant and increasing criticism. Common complaints are that the system is overcomplicated, that the incidence of tax is unfair, that it represents double taxation, and that little revenue is raised. The result is that after twenty years of relative stability, inheritance tax has become the subject of intense political debate in the UK. Suggestions range from its abolition, significantly increasing the threshold, or replacing inheritance tax with a donee based tax based on the total sum of inheritances received by the donee over the course of his lifetime.¹

Most major economies raise relatively little from inheritance and gift taxes. None of the G7 economies has raised more than 1.0% of national income in revenue from Estate, Inheritance, and Gift Taxes in any one year over the last forty years, as shown in Figure 8.1. Whereas there is marked similarity in

¹ Abolition of inheritance tax, to be financed in part through the introduction of capital gains tax on death was proposed in the Forsyth Report (2006) although they proposed that no capital gains tax would be levied on assets held for more than ten years. The Conservatives proposed a threshold of £1million at their September 2007 party conference. The Labour government has introduced transferable nil rate band allowances between spouses and civil partners with effect from 9 October 2007. The replacement of inheritance tax with a donee based tax was proposed by Patrick and Jacobs (1999). The Liberal Democrats in 2006 favoured an accessions tax but in 2007 proposed increasing the threshold to £500,000 with a 15-year cumulation period.



Note: Data on France from 1955 and 1960 not available at time of writing. 'National income' refers to Gross Domestic Product.

Source: OECD, Revenue Statistics.

Figure 8.1. Receipts from estate, inheritance, and gift taxes, as a share of national income 1955 to 2006, across G7 countries

the system for the taxation of income and capital gains across the developed world, there has been no consistent approach taken to how wealth is taxed in the G7 economies.² This is partly because wealth and wealth transfer taxation are linked to different succession laws³ and partly because countries have differing views as to the role and merits of wealth taxation. There is a perceived tension between promoting entrepreneurship and redistributing wealth. A system of taxing wealth has to operate over a person's lifetime, and so is more vulnerable to changes in government. To be effective there must be some political consensus on how wealth is taxed.

This section begins with a brief description of the current taxation of wealth and wealth transfers in the UK before discussing common criticisms

² Italy has abolished tax on death albeit retained other gift taxes; Canada imposes only capital gains tax on death; the US has increased the exempt threshold sharply for taxes on death but retained gift tax; France retains wealth, gift, and estate taxes and, unlike the US (since 1999) and Japan (since 1991) where receipts have fallen sharply, receipts in both France and Germany have grown fairly steadily over the last quarter of a century. Receipts in the UK have been relatively stable since the early 1980s although they have been on a slightly rising trend in recent years. For fuller details see appendix B of the additional online material at http://www.ifs.org.uk/mirrleesreview/reports/wealth_transfers_apps.pdf.

³ Some legal systems have freedom of testamentary succession and others are based around forced heirship.

of inheritance tax. Section 8.2 sets out the principles of tax design in this area, in particular highlighting the lessons from the public economics literature. Section 8.3 discusses the pros and cons of wealth and wealth transfer taxation and the different options for such taxes. Section 8.4 mainly discusses property taxes. Section 8.5 concludes.

In considering the taxation of wealth, we also examine capital gains tax, stamp duty, and property taxes.

8.1.1. Brief description of the current taxation of wealth and wealth transfers in the UK

The main taxes relevant to the taxation of transfers of wealth in the UK are inheritance tax, capital gains tax, and stamp duty/SDLT.⁴ There is no wealth tax in the UK, although the idea has been advocated on a number of occasions, for example by Labour in 1975. There are, however, taxes on the occupiers of property, both domestic (council tax in England, Scotland, and Wales and domestic rates in Northern Ireland) and non-domestic (business rates in England, Scotland, and Wales and non-domestic rates in Northern Ireland). These are not strictly wealth taxes as tenants, as well as owner-occupiers, are liable. This section provides a very brief description of the operation of inheritance tax and capital gains tax.⁵

Inheritance tax, despite its name, is a tax on the donor rather than a tax on the inheritance received by the donee. It is levied at a flat rate of 40% on estates above a prescribed threshold, which in 2007–08 was set at £300,000 ('the nil rate band') which is approximately ten times mean annual full-time earnings. Transfers between married or civil partners, whether during lifetime or on death, are generally exempt, as are gifts to charities. Reliefs up to 100% for agricultural property and trading businesses can give full exemption from inheritance tax. All lifetime gifts to individuals (but not to trusts or companies) are exempt provided the donor survives the gift by seven years and gives up all benefit in the gifted asset. Such gifts are called 'potentially exempt transfers', or PETs. If the donor dies within seven years of the gift, the PET is taxed at rates of up to 40% depending on how long the donor survived the gift and whether or not the gift was within the donor's nil rate band.

⁴ Although capital gains tax should conceptually be regarded as part of the income tax system, it is often seen as complementary or an alternative to estate tax and similar issues arise in relation to valuation, exemptions, and rates.

⁵ For a detailed summary of all of these taxes, along with a brief history of inheritance tax, see appendix A of the additional online material (see footnote 2).

From 9 October 2007, the percentage of any nil rate band which is unused on the death of the first spouse or civil partner can be carried forward and used on the second spouse or civil partner's death. This applies to all married couples and civil partners where the death of the second spouse occurs on or after 9 October 2007 irrespective of when the first death occurred. The government hopes that this measure will reduce the unpopularity of inheritance tax and relieve political pressure on the tax. It does not, of course, apply to unmarried individuals (for example, cohabitees or siblings) living together at death unless the one who dies first has a transferable nil rate band available from a previous marriage or civil partnership. In that event he will be able to pass on (at current rates) £600,000 worth of assets tax free to the surviving cohabitee.

Capital gains tax is a tax charged on disposals of chargeable assets when a gain is realized. Annual realized gains above a certain threshold, set at £9,200 per individual in 2007–08, are subject to the tax. The tax is charged not only on sales but also on gifts since a gift of an asset is deemed to take place at market value. Capital gains tax operates on certain lifetime gifts. By contrast, there is generally no capital gains tax on death—assets are rebased to market value so all unrealized gains are wiped out—and this applies whether or not such assets are liable for inheritance tax. There are various exemptions on lifetime disposals of which the most important is an exemption on the principal private residence. In 1998, taper relief replaced indexation allowance, and taper relief taxed gains on business assets at lower rates than non-business assets. However, from 6 April 2008 taper relief was replaced by a flat 18% rate on all gains irrespective of the nature of the asset or how long it has been held. Entrepreneurs' relief gives additional relief for disposals of trading company shares or business assets on the first £1 million of lifetime gains.⁶

8.1.2. Criticisms of the current UK system—the unpopularity of inheritance tax

The current system of wealth and wealth transfer taxation in the UK is very unpopular. Criticisms are that the system fails to raise any **significant revenue**

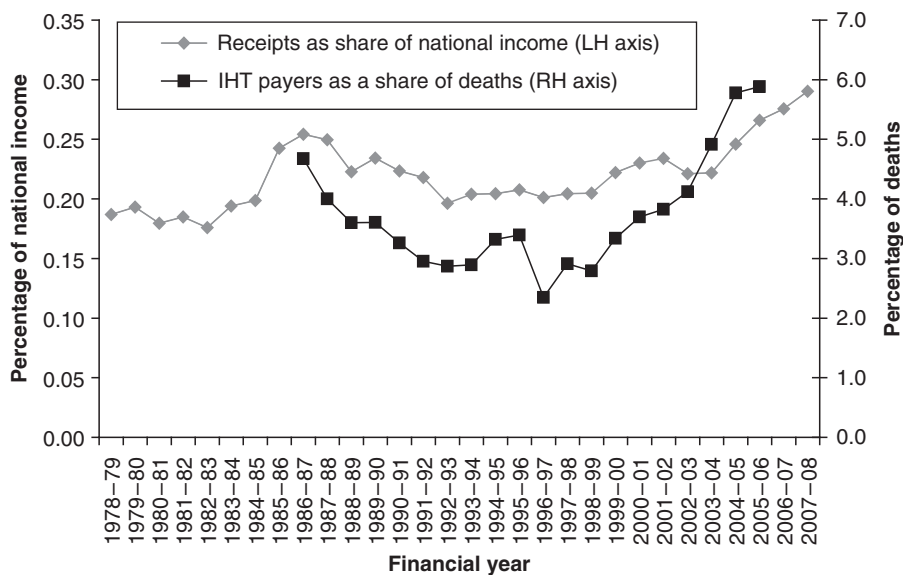
⁶ Specifically eligible assets are defined as either shares in a trading company (or holding company of a trading group) of which the shareholder has been a full-time employee or director, owned at least 5% of the shares, and had at least 5% of the voting rights, all for at least a year; or an unincorporated business (or share in a business) or business assets sold after the individual stops carrying on the business. Source: <<http://www.hmrc.gov.uk/cgt/disposal.htm>>.

so could be abolished without serious consequences, is **unfair**, and is overly **complicated**. This section examines whether such criticisms are justified.

Raising revenue

Neither inheritance tax nor capital gains tax currently raises significant sums. Inheritance tax revenues are projected by the Treasury to be £4.0 billion in 2007–08 (0.3% of national income), while receipts of capital gains tax are projected to be £4.6 billion (also 0.3% of national income). Stamp duty is a more significant source of revenue for the government. The Treasury projects a yield of £14.3 billion in 2007–08, with data from recent years suggesting that around 70% of this is likely to be from stamp duty on property transactions with the remaining 30% from stamp duty on share transactions.

Revenues from inheritance tax and its predecessor capital transfer tax have averaged about 0.22% of national income over the period from 1978 to 1979. In 2003–04, the yield reached the highest level seen over this period and, as shown in Figure 8.2 (lighter line and left-hand axis), the overall yield has continued to increase since then. The vast majority of these receipts came



Note: Capital transfer tax was replaced by inheritance tax for transfers on or after 18 March 1986. 'National income' refers to Gross Domestic Product.

Source: Table 1.2 HM Revenue and Customs Statistics http://www.hmrc.gov.uk/stats/tax_receipts/table1-2.xls. Forecast for 2007–08 from Table C8 page 281, of HM Treasury (2007).

Figure 8.2. Inheritance tax and capital transfer tax receipts and percentage of estates liable for tax

from transfers made on death (98% in 2005–06) with very little coming from either trusts or taxes on gifts made in the seven years prior to death. As is also shown in Figure 8.2 (darker line and right-hand axis), only 5.9% of estates paid inheritance tax in 2005–06, although this was the highest level since the tax was introduced in 1986–87 and has increased from 2.3% in 1996–97. In 1996–97, the average inheritance tax paid by taxpaying estates was £90,000, reducing by 2003–04 to £87,000, and has since risen again to £100,000 in 2005–06.⁷ Over 70% of taxpaying estates had a net estate of between £200,000 and £500,000 while only 2% had a net estate worth in excess of £2 million. However, the extent to which this reflects the true underlying distribution of wealth, as opposed to the ability of those with high net worth to avoid inheritance tax, for example by making lifetime gifts, is unclear. Although only 6% of estates actually pay inheritance tax, 37% of households now have an estate with a value above the threshold. This partly accounts for the potency of the issue—people feel themselves a potential inheritance taxpayer even if only a few estates will actually pay it.⁸

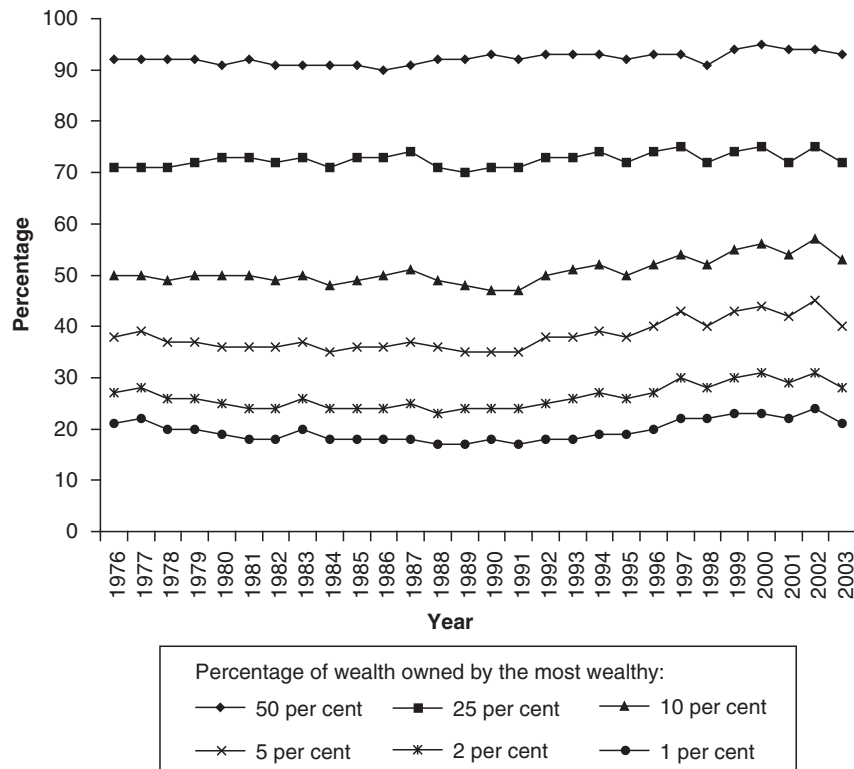
In summary, one can say that inheritance tax is not an important source of revenue. The revenue raised, £4.0 billion in 2007–08, is less than 1% of total government revenues and could, for example, be covered by a 1p increase in the basic rate of income tax (from 20p to 21p in 2008–09) or a 3p increase in the higher rate of income tax (from 40p to 43p in 2008–09). However, the incidence of such changes would be different. It has been argued that £4 billion would not in fact be lost on the abolition of inheritance tax because the money representing the tax might remain invested or be spent and would then bear income tax/capital gains tax or value added tax.

Fairness issues

The taxation of wealth and wealth transfers is frequently justified not on the basis that it will raise revenue for public expenditure but on the grounds of fairness. Taxing wealth and income has been seen by some, such as Meade (1978), as fairer than taxing income alone on the basis that the possession of wealth confers advantages over and above the income derived from wealth. Similarly, the taxation of wealth transfers could be justified on the basis that these are delivering benefits to both donor and donee, which is an issue explored further in Section 8.2. To the extent that an unequal distribution of receipts of large bequests is a source of inequality of opportunity, the taxation

⁷ Source: Hansard question from Michael Gove to Dawn Primarolo 129105, 16 April 2007.

⁸ Halifax press release March 2005 estimated that 2.4 million houses were worth more than the inheritance tax threshold.



Note: Personal wealth here refers to the value of individuals' marketable assets, such as houses, stocks and shares, and other saleable assets, less any amounts owed due to debts and mortgages. The value of occupational and state pensions is not included since they cannot be immediately realized.

Source: Table 13.5 of HM Revenue and Customs Statistics <http://www.hmrc.gov.uk/stats/personal_wealth/table13_5.xls>.

Figure 8.3. Concentration of personal wealth in the UK

of wealth transfers is sometimes justified on the basis that the government wishes to promote greater equality of opportunity or to redistribute wealth, although these are more controversial aims.

The distribution of marketable wealth appears to have become more unequal in recent years, as shown in Figure 8.3. Using information from inheritance tax records, HMRC estimate that the wealthiest tenth of the population own 52% of the country's total marketable wealth, which is an increase from 49% in 1982. However, these statistics probably do not reflect the true position. First, wealth held in the form of occupational and state pensions is not included, on the basis that these assets cannot immediately be realized. Second, as one might expect, human capital is not included. For many individuals, these assets will form the majority of their overall wealth.

Furthermore, a large guaranteed pension income might enable high wealth individuals to give away other assets during their lifetime in order to avoid paying inheritance tax on death. Third, since the data on the distribution of individual wealth are derived from inheritance tax returns, they do not take into account lifetime transfers of wealth made more than seven years prior to the death, nor in many cases the wealth of foreign domiciliaries living in the UK. These are significant omissions which might mean that the true distribution of personal wealth is more unequal than the official data suggest.

The fact that outright gifts made more than seven years prior to death do not have to be declared for inheritance tax purposes means that it is not straightforward to say how much wealth is passed on each year or determine how much inheritance tax is avoided through lifetime gifts. The new ONS Household Assets Survey (HAS), which will contain detailed information on borrowing, savings, household assets, and saving plans for retirement, should provide much valuable information on the distribution of wealth in the UK among the vast majority of individuals.⁹ However, a household survey is unlikely to be representative of the circumstances of the very wealthy due to high non-response among this group. If data on wealth transfers and wealth distribution were improved, this would make it easier to predict the effect or yield of particular policy changes.

The extent to which redistribution of wealth should be an objective of the tax system is likely to depend on which political party is in government. Moreover, even if redistribution of wealth is seen as a desirable aim, people differ on whether different forms of wealth should be taxed differently. There is some behavioural evidence that people may care more about suffering tax on their own inheritance and are less bothered about whether it is fair that their neighbour receives a much greater inheritance tax free. In other words, the negative aspects of the tax outweigh the positive.

However, one of the objections to the current inheritance tax system in the UK is not that it fails to redistribute wealth but that it is inherently unfair in its structure because it falls disproportionately on the middle classes to the benefit of the rich.

The UK's approach to inheritance tax has been to maintain a high rate but to mitigate this through reliefs and exemptions and to allow tax planning through lifetime gifts to reduce the impact of the tax. This approach appears to be failing because rising house prices have brought more and more of the middle classes into the inheritance tax net. Moreover, variations in house

⁹ The first wave covers July 2006 to June 2008 and individuals will be re-interviewed every two years. For more information see <<http://www.statistics.gov.uk/STATBASE/Source.asp?vlnk=1500&More=Y>>.

prices across the country mean that this problem is particularly concentrated in London and the South East where by 2005 31% of houses were worth more than the nil rate band (up from 4% in 1999).¹⁰ Such taxpayers are generally unable to take advantage of many of the tax reliefs because their main asset is the house. While they will be able to benefit from the recent introduction of transferable nil rate bands, the wealthy well-advised taxpayers with business and agricultural assets can also benefit from other exemptions and the ability to make lifetime gifts without affecting their standard of living.

The last Conservative government promised that it would abolish inheritance tax¹¹ but despite the recommendations of the Forsyth Report of the Conservative Tax Reform Commission¹² which includes abolition as a possible option, the Conservatives did not promise this at their autumn 2007 conference. However, the public support for their proposal to increase the inheritance tax threshold to £1 million demonstrates the unpopularity of inheritance tax.¹³

Even a former Labour government minister advocated the abolition of inheritance tax on 20 August 2006 saying it was 'a penalty on hard work, thrift and enterprise'.¹⁴ (This ignores the fact that the donee has never worked for the money and arguably inherited wealth encourages idleness. All taxes on wealth, income, or spending reduce the reward from work.) In 2001 George Bush repealed estate tax in the US on a phased basis; despite the fact that only 2% of Americans pay it, the repeal lobby was broad-based.¹⁵ Similar 'moral claims' using highly emotive language have been made in the UK.¹⁶ Narrative case studies are used to support abolition such as the Burden sisters case.¹⁷ Those with the least to leave appear to be most in favour of being able to leave their capital to the next generation and therefore most resistant to the possibility that it could be taxed.¹⁸

¹⁰ Halifax press release 'Inheritance tax revenues to double in 9 years', HBOS, 12 March 2005.

¹¹ Chancellor of the Exchequer Rt Hon Kenneth Clarke MP Budget speech 26 November 1996 Hansard HC Debs, vol. 286, col. 169.

¹² Tax Matters: Reforming the Tax System 19 October 2006.

¹³ The case for the abolition of inheritance tax is forcefully put by Lee (2007).

¹⁴ *Sunday Telegraph*.

¹⁵ For an analysis see Graetz and Shapiro (2005). See also Rowlingson (2007) for comparisons with the UK. Gay men and lesbians who were unable to take advantage of marital tax deductions (unlike in the UK since December 2005) were in favour of complete repeal along with the super-rich; they produced strong narrative case studies as well as moral arguments to bolster the case.

¹⁶ For example, an online petition submitted by a *Daily Express* journalist states, 'inheritance tax is an immoral form of taxation that penalizes hard work and thrift. By raising a 40% levy on earned assets it is also effectively double taxation. This is nothing less than grave robbery.' We outline later why no estate suffers inheritance tax at 40% and why it is not necessarily double taxation. See also the Taxpayers' Alliance comments on their website.

¹⁷ Further details can be found in appendix A of the additional online material (see note 2).

¹⁸ See Rowlingson and McKay (2005).

However, other research has found that attitudes to inheritance tax changed when research participants were given further information and asked to consider broader issues about the tax system as a whole, particularly if abolition was specifically allied to proposals to increase income tax by 1p.¹⁹ The Treasury has tended to respond to attacks on inheritance tax by pointing out that anyone who wants to abolish it needs to explain how the £4 billion revenue is to be raised. However, the recent October 2007 announcement introducing transferable nil rate bands at a cost of £1 billion suggests that the government feels on the back foot with inheritance tax. The pro-inheritance tax lobby has not developed any strong narrative case to increase public support for wealth transfer taxes.²⁰ Those who favour the retention of some sort of tax on wealth transfers are divided about what system they actually want and the objectives of such a tax so the pro-inheritance tax lobby is weakened.

Double taxation

A commonly stated objection to inheritance tax is that it is **double taxation**, that is, people have already paid income tax or capital gains tax on the income before it is used to purchase an asset which then suffers inheritance tax on their death. President Bush expressed this view in the 2000 election campaign. When asked why he favoured the total abolition of estate tax he replied: 'I just don't think it's fair to tax people's assets twice regardless of your status. It's a fairness issue. It's an issue of principle not politics.'

Multiple taxation is not peculiar to inheritance tax. People pay indirect taxes on goods and services out of their taxed income. However, inheritance tax applies discriminately on some assets (those that are held until death) and not on others. This issue of double taxation will be discussed in more detail in Section 8.2.²¹ Moreover, in some cases inheritance tax will be the first time the asset has been taxed. For example, increases in the value of the family home are generally exempt from capital gains tax (and there is no income tax on the imputed rental value). As a result, although the purchase price may well have been paid for out of taxed earnings, any subsequent increases in value—which in recent years have substantially exceeded normal returns—will not have been subject to tax. The current tax system is certainly not logical: at

¹⁹ Lewis and White (2007).

²⁰ Prabhakar (2008) discusses how much narratives and stories can enhance or diminish public support for inheritance tax.

²¹ Prabhakar (2008) also reports that focus group studies participants argued that in the case of VAT they had a choice as to whether to pay it because they could choose not to buy the goods. In the case of inheritance tax they had no choice as to whether to pay it.

present it is possible to avoid both inheritance tax and capital gains tax on lifetime gifts but suffer both taxes in other circumstances.²² In other words, the double tax objection is not universally valid in that it is not clear that inheritance tax necessarily does involve double taxation.

The double tax objection takes a different flavour if the wealth transfer tax is structured as a donee- rather than donor-based tax. In this case, the tax is paid by the recipient not the donor, so there is no double taxation of the donor. However, now the same asset gives rise to taxation in the hands of both the donor and the donee, which is another form of double taxation.

Equity objections

Proponents of the ‘virtue argument’ argue that inheritance tax is an unfair tax because it leads to unequal tax burdens on people with equal amounts of wealth but who choose to use their wealth in different ways. So the person who spends his fortune of £1 million prior to death may pay less tax than the person who saves it and leaves it to his heirs on death.

We have already pointed out that the inheritance tax in its current structure is perceived as inequitable because its burden falls disproportionately on the middle classes, not on the very rich who are able to avoid the tax. One could counter this objection by arguing that the inequity should be rectified simply by getting the very rich to pay their share of inheritance tax rather than abolishing the tax altogether. However, to achieve this, the reasons why inheritance tax can currently be minimized by the very rich need to be considered. The two main reasons are the exemption for most lifetime gifts; and the nature of the various exemptions, reliefs, and loopholes that tend to favour the wealthier individual.

Lifetime gift exemption

In contrast to capital transfer tax, inheritance tax does not tax lifetime gifts provided the donor survives seven years and gives up all benefit in the gifted asset. Therefore, the taxman now favours ‘the healthy, wealthy and well-advised’ as long as they are lucky enough to survive a further seven years.²³ Hence for the very rich who can afford to make large lifetime gifts, it is said that inheritance tax—or at least large payments of inheritance tax—is largely voluntary.²⁴ This is obviously an exaggeration but has some element of truth in that the middle classes bear a disproportionate burden. For those who are

²² A worked example is provided in appendix A of the additional online material (see note 2).

²³ Kay and King (1990), p. 107.

²⁴ Among many others see, for example, Burnett (2007), Patrick and Jacobs (1999), and Sandford (1988).

affluent but not very rich often their home is the main capital asset. Giving the house away tax free effectively is very difficult due to the ‘reservation of benefit’ rules; these rules mean that no inheritance tax is avoided if he or she continues to live there. While these families will be the main beneficiaries from the recent introduction of a transferable nil-rate band, it is still the case that the rich can more easily give away their assets seven years before death and hence can reduce their inheritance tax bill more effectively.

It seems difficult to argue on grounds of fairness that a person who inherits £1 million on the donor’s death, or in the seven years before a donor’s death, should be taxed more highly than the person who is given £1 million earlier in the donor’s life. As discussed in Section 8.2, if bequests on death represent accidental bequests, it is efficient to tax these more highly since they should not respond as strongly to financial incentives. However, the extent to which bequests on death *do* represent accidental as opposed to intended bequests is not known. Those with less wealth or more illiquid wealth are generally less able to make lifetime gifts and therefore have to give a higher proportion of their wealth on death but the bequests might be no less planned.

Since March 2006 the government has imposed inheritance tax of up to 20% on lifetime gifts into all trusts.²⁵ But there seems no considered policy on the taxation of wealth transfers behind this change. If the government objected to lifetime gifts in principle, then the natural course would have been to impose inheritance tax on all lifetime gifts, not just gifts into trusts. If the government’s target was to prevent individuals holding wealth through trusts, then it is difficult to see why trusts set up on death are still given limited favoured treatment compared with trusts funded by lifetime gifts.

If inheritance tax is to be retained, then it seems clear that the exemption for lifetime gifts needs to be re-examined. A simple reform would be to extend significantly the period of survivorship from seven years. In a number of countries, for example, Germany, USA, Switzerland, and Spain, gift taxes are imposed on lifetime gifts, although (as with the predecessor to inheritance tax namely capital transfer tax) the thresholds operate at different levels from transfers on death. In the UK the Liberal Democrats (2007) proposed an increase in the seven-year lifetime gifts limit to fifteen years.

Exemptions and reliefs

Although the UK’s inheritance tax system has a high marginal rate levied at a relatively low level, there are a number of important reliefs, including **spouse**

²⁵ Further details are provided in appendix A of the additional online material (see note 2).

exemption which was estimated by the Treasury to reduce the potential inheritance tax yield by £2.2 billion for 2006–07 at a time when the actual yield was £3.5 billion.

Business property relief/agricultural property relief Business and agricultural property is often entirely exempt from inheritance tax on the donor's death. These reliefs are justified on the basis that they promote enterprise and provide continuity because they ensure a family business is not sold on death to pay tax. However, the reliefs provide a complete exemption even if the heirs of the deceased subsequently sell the asset immediately after death. Moreover, no capital gains tax is payable. The problem is to ensure that any relief is properly targeted. Business property relief offers a complete exemption to a company which is 51% trading and 49% investment property on death but no exemption if those two figures are reversed.

Both business and agricultural property reliefs are vigorously defended on the basis that they help enterprise and prevent businesses being split up. However, evidence suggests that the retention of medium-size businesses within certain families might, through inferior management practices, actually harm the efficiency of the UK economy (Bloom (2006)). Furthermore, even if tax is payable on businesses, there is also the possibility of claiming instalment relief (in some cases interest free) which enables the tax to be paid over ten years. There are no data on how often a business is sold after death and therefore whether the reliefs do promote continuity or just provide a tax free break for heirs.

Options for reform include varying the value of exemptions by the length of ownership or making the relief conditional on continued ownership of the business for at least some minimum time after the transfer. Both would increase compliance costs and could distort investment decisions. An alternative is to abolish business property relief which would raise £350 million pa and agricultural property relief which would raise £220 million pa. Together these would be sufficient to increase the threshold from £300,000 to £350,000 or could be used to introduce a wider band on which inheritance tax was paid at the same rate as the basic rate of income tax. The inheritance tax bills of smaller businesses and farms could then be made payable over ten years at, for example, a rate of interest equal to standard Bank of England base rate. This proposal is discussed further in Section 8.3.

Foreign domiciliaries Although in theory foreign domiciliaries are liable to inheritance tax on their worldwide estates after seventeen tax years of UK

residence, in practice inheritance tax is relatively easy for this group to avoid altogether by use of trusts combined with offshore companies.²⁶

The family home In contrast to the reliefs for business and farming property, there is no inheritance tax relief for the family home—the most important asset for the middle class. Much of the debate in the press focuses on the home, not merely because it is many people's main asset and therefore the reason for paying inheritance tax in the first place, but also because of the strong feeling that a parent has the right to pass it to the next generation free of tax. Statistics from HM Revenue and Customs show that 58.5% of property in estates passing on death in 2003–04 comprised real property and the Public Accounts Committee highlighted the fact that house prices have grown more quickly than the tax threshold.²⁷

There is no strong case for exempting the family home, not least because doing so would provide a very strong incentive to reduce (or borrow against) chargeable assets in order to invest in a home. Furthermore, exempting the family home could lead to older relatives who should be in sheltered accommodation choosing to stay in their homes because of the tax break.

It is sometimes objected that inheritance tax 'forces' the sale of the majority of family homes. However, the home is usually sold on the last spouse's death not just to pay inheritance tax but because the children do not want to live there: they want the cash from the house. It is true that cohabitants and siblings living together will have no exemption on the first death and therefore may have to sell the house on the first death to pay inheritance tax. Although it is possible to pay the tax in interest bearing instalments over ten years, it may not be easy for the elderly with low income to fund this out of their income or obtain a mortgage to fund the payments and home reversion schemes may not be an attractive alternative.²⁸ Ireland has a relief that defers payment of tax until the sale of the home when it continues to be occupied by a cohabitee or sibling and something similar could be adopted here to deal with this particular problem.

As noted previously the family home is one of the hardest assets to pass on free of inheritance tax because of the reservation of benefit rules. The

²⁶ For further details see appendix A of the additional online material (see note 2).

²⁷ See 29th report of the Committee of Public Accounts Inheritance Tax 2004–05 and also Lee (2007).

²⁸ See the case of *Burden v Burden* 2007 involving two sisters who live in the family home and will pay inheritance tax on the first death which has attracted widespread sympathy (further details provided in appendix A of the additional online material (see note 2)). It would be possible to deal with the problem of forced sales by introducing a deferment of tax in certain limited circumstances. (See Section 8.3.)

donor cannot simply give away the house and continue living there: the house will still be subject to inheritance tax on his death (and when the house is eventually sold there is also a capital gains tax liability because there is no main residence relief if the owner does not live there; so the donor has made the tax position worse!). By contrast, in the case of gifts of cash and other liquid assets, the reservation of benefit rules are much more easily circumvented.²⁹ There have been a series of widely publicized schemes to save inheritance tax on the family home whose aim is to avoid the reservation of benefit rules so that the donor can give away his home and continue to live there. The success of such 'cake and eat it' schemes³⁰ led to anti-avoidance legislation by the government, culminating in the introduction of pre-owned assets income tax (POAT).³¹ Unless lifetime gifts are taxed (in which case the anti-avoidance rules such as POAT and reservation of benefit are not needed) such an approach seems necessary if the inheritance tax base is to be maintained in any meaningful way. But it leads to a justified sense of unfairness when contrasted with the possibility of inheritance tax schemes for more liquid assets.³² Families have a strong desire to pass wealth down to the next generation: to redistribute from the old to the young. Passing on the value of the family home is for many people the most tangible way of achieving this. The current legislation makes this particularly difficult.

Complexity

The current inheritance tax and capital gains tax legislation is very complex, and the reliefs and the interaction between the two taxes often seem arbitrary

²⁹ e.g. through use of discounted gift schemes and other devices.

³⁰ e.g. Ingram schemes—stopped in 1999; Eversden schemes stopped in 2003; reversionary lease schemes; home loan schemes now made unattractive by pre-owned asset income tax and SDLT charges.

³¹ This was a new approach which abandoned specific targeted anti-avoidance legislation and instead imposed an income tax charge with effect from 6 April 2005 on all such schemes, including all schemes since 1986. Although chattels and certain trusts holding intangibles were also targeted in the legislation, the main practical impact of the legislation has been to stop future inheritance tax schemes on the family home and to encourage the unravelling of past schemes. Although widely criticized, pre-owned assets income tax does appear to be curtailing inheritance tax schemes on the family home.

³² Even equity release schemes on the family home are problematic. For example, suppose a widow wants to release some equity by selling part of her home. She can go to a commercial provider or she can sell to a relation such as her son who has the money available. She may well prefer to sell to her son at full market value rather than pay the fees of a commercial provider. The son pays SDLT on the purchase price and the widow will be subject to inheritance tax on the unspent cash at her death. Nevertheless if the widow sells say half the house to her son, then since March 2005 she may be subject to an income tax charge on half the rental value.

and illogical. One of the objections often voiced when any change is suggested to the current system is that it would lead to unacceptable complexity.³³ However, there is already great complexity in the wealth taxation system and much of this seems to be arbitrary rather than based on any rational policy considerations. Moving to a system that is equally or nearly as complex cannot in itself be rejected if the complexity achieves a system that is more equitable with fewer unwelcome distortions.³⁴

Other criticisms of inheritance tax—rates

Once inheritance tax is payable, the marginal rate is relatively high: a flat rate of 40% on death for taxable assets in excess of £300,000. Of course, the average tax rate is much lower given the high threshold. On an estate worth £1½ million, the average tax rate is only 16%; on an estate of £1 million it is 28% and on an estate of £2 million it is still only 34%. However, the top marginal rate is high by international standards and the threshold at which this rate commences is relatively low.³⁵

The majority of estates paying inheritance tax are below £500,000 in value. Many such estates only suffer inheritance tax due to the value of the family home and many such deceased individuals have been basic- rather than higher-rate income taxpayers during their working lives. This suggests that a progressive banding structure might be seen as fairer, and would certainly provide a clearer link that inheritance was being treated as windfall income.³⁶ This could involve a lower rate equal to the basic rate of income tax (20% from 2008 to 2009) and a higher rate set at the higher rate of income tax (40%). It would also be sensible to index the thresholds to nominal growth in the economy, rather than the current approach of inflation increases, since at least over the medium term, this might be sufficient to remove fiscal drag.³⁷ While all these reforms would reduce the yield of inheritance tax, at least in part they could be paid for through a reduction or restriction in the number of exemptions (such as APR and BPR), and the inclusion of more lifetime transfers would raise revenue. These suggestions are discussed further in Section 8.3.

³³ See, for example, p. 20 of Maxwell (2004): 'collection costs would increase given the greater complexity, compliance costs would increase, due to the demands of record-keeping.'

³⁴ For worked examples see appendix A of the additional online material (see note 2).

³⁵ See 'An International Comparison of Death Tax Rates', American Council for Capital Formation, Washington DC, 1999.

³⁶ See, for example, Maxwell (2004).

³⁷ The Chancellor announced in the Pre-Budget Report on 9 October 2007 that he would consider linking the threshold to increases in house prices in future.

A related reason why inheritance tax might be disproportionately disliked is the highly visible way that it is paid. It is one of the few taxes where people actually write out a cheque to HMRC. Most people have their income tax on their earnings deducted through PAYE and any income tax on their savings deducted at source; indirect taxes such as VAT and excise duties on alcohol and cigarettes are included in the price of goods in shops. Anecdotal evidence suggests resistance to inheritance tax is increased by the way in which it is paid. The same may also be true of council tax, which is also often paid through one payment per year.³⁸ There are often additional expenses in paying inheritance tax given that probate cannot be obtained until the tax is paid. In some cases it will not be possible to use the deceased's cash or other liquid assets to pay the inheritance tax due (because until the grant is obtained the assets are effectively frozen) and therefore the personal representatives need to borrow to pay the tax, increasing resentment.

8.1.3. Summary of the current inheritance tax position

Inheritance tax arouses resentment and receives much adverse publicity. The desire of parents to pass wealth on to children is a powerful motivation. Those expecting to receive legacies have come to feel they have a right to inherit. In their survey, the Commission on Taxation and Citizenship commissioned independent research into public attitudes towards taxation. Many respondents of the survey were deeply resistant to the idea of taxing inheritances and half thought that no inheritances should be taxed while only one in ten were prepared to support taxation even in the case of estates of over £1 million. Those aged 65 and over were less likely to say that no inheritances should be taxed, and those most likely to benefit from future inheritances in the younger age group were more opposed to the inheritance tax. People in social classes IV and V were more opposed to inheritance taxes than those in social classes I and II even though they were likely to be least burdened by the inheritance tax system.

Until 2006, inheritance tax remained unaltered in structure for twenty years. Recent political events suggest this stability may not last. Unless the case for a tax on transfers of wealth is put more forcefully, the introduction of a new system of wealth transfer taxation is not likely; abolition now seems a serious possibility.

³⁸ The Taxpayers' Alliance argues that inheritance tax is regarded as the most unfair tax and council tax the second most unfair tax. See STEP Symposium VI, 27 September 2007.

If it is concluded that inheritance tax should be retained, a number of smaller-scale improvements could be made to the existing system that would improve perceptions of fairness and therefore make it more politically acceptable. This would involve a review of rates, reliefs, and tax on life-time gifts combined with some simplification of the system. The alternatives include more radical reform or abolition. The options are discussed further in Section 8.3.

Summary of main issues for the policy-maker to consider

The options for the policy-maker which are discussed in Section 8.3 are:

1. to introduce a new system of taxing wealth and wealth transfers;
2. to abandon any attempt to tax wealth transfers;
3. to improve the existing system so that the current inequities are rectified and the burden of the tax ceases to fall disproportionately on the middle classes.

We discuss these options in more detail in Section 8.3. However, before we proceed further, it is worth noting the most commonly discussed options for taxing wealth, which are:

1. Taxing the capital value of assets on a recurrent basis, for example, annually. A wealth tax of this sort has never been introduced in the UK although it was proposed by Meade (1978) and seriously contemplated by Labour in 1975. France, Spain, Norway, and Switzerland have a wealth tax. Most other European countries have repealed their wealth tax.
2. Taxing the capital value of assets when transferred. While Canada, India, and Australia do not have any form of capital transfer tax, most OECD countries do. Some (such as New Zealand) have no tax on death but tax lifetime transfers.
3. Taxing only the increase in value of an asset on a disposal, that is, a capital gains tax. Most countries have capital gains tax on sales but not necessarily on gifts or transfers on death. Canada has a capital gains tax imposed on death and on lifetime gifts. The UK exempts gains on death.

Within these options there are other considerations for the policymaker. In brief they include:

1. Should a tax on transfers of wealth be a donee based or a donor based tax? Should the relationship of the donee to the donor have any effect on the rate of tax—that is, should gifts to immediate family members be taxed more lightly than gifts to other individuals? The UK inheritance tax is misnamed—it does not generally take account of the circumstances of the beneficiary but like estate duty is based on the donor's circumstances at death. No inheritance tax is paid on assets left to a spouse or civil partner.³⁹ But the same inheritance tax is paid if an estate is shared among three children or if it is only paid to one child. Some have suggested that it is more equitable to consider the circumstances of the donee: the greater the level of previous inheritances received by the donee the greater his tax burden. The arguments for and against a donee based tax are considered later in Section 8.3. Should a tax on wealth transfers be levied only on death or also on lifetime transfers? Is there any justification for a different treatment of lifetime gifts and gifts on death?
2. What is the effect of international tax competition? Some countries such as Australia, Canada, Sweden, India, and Pakistan have abolished inheritance tax. Is it sensible for the UK to continue taxing wealth transfers at all?⁴⁰ Given that more people own assets in different countries and are more mobile, should the UK in conjunction with the EU, try to develop greater harmony in how capital is taxed?
3. Who should be chargeable for inheritance taxation? What is the best connecting factor? Should it be linked to the location of the asset and/or the residence of the donor or donee, or the domicile of the donor or donee or his citizenship?⁴¹ This point has become of increasing importance since the 1970s as individual mobility has increased.
4. Overall what rates and thresholds should apply?
5. What reliefs and exemptions should be given? For example, spouse exemption, charity exemption, business property relief, and agricultural property relief. The question of exemptions is also linked to rates. If there are fewer exemptions, rates could be lower and/or thresholds higher. Should certain types of assets such as real property be taxed differently?

³⁹ Note though that there is a restricted spouse exemption on transfers from a UK domiciled spouse to a foreign domiciled spouse.

⁴⁰ Lee (2007) argues for its abolition or substantial reform.

⁴¹ For brief explanations of domicile and residence and a summary of the rules as they affect foreign domiciliaries see appendix A of the additional online material (see note 2).

6. How should inheritance tax interact with capital gains tax? At present, as we have seen, it is possible to pay both taxes on a gift but equally the donor/donee may pay neither tax on a gift or bequest.⁴² The results can be quite arbitrary.
7. If one is considering a wealth tax should and could inherited wealth be taxed differently from other wealth?
8. How should trusts be taxed? This relates not only to transfers of capital to trusts compared with gifts to individuals but also to how capital is taxed when held by a trust.

We now turn to a broader consideration of the principles that might inform the design of wealth and wealth transfer taxes as a prelude to considering policy alternatives.

8.2. ECONOMIC PRINCIPLES OF WEALTH AND WEALTH TRANSFER TAXATION

The choice of a tax system should be based on some normative principles. In the case of wealth and wealth transfer taxation, there are a number of difficulties in enunciating and applying such principles. Unlike most other forms of taxation, such as income, commodity, and company taxation, there are few accepted principles and the theoretical (optimal taxation) literature provides relatively little guidance for tax policy. It is therefore not surprising that, as we have mentioned, countries vary widely in how they tax wealth.⁴³

In what follows, we first consider the normative criteria that could inform wealth and wealth transfer taxation and briefly summarize what the theoretical tax literature has said about wealth transfer taxation. We then consider the broad implications of these principles for tax design.

8.2.1. Criteria for evaluating a tax system

We begin by outlining the appropriate criteria that could be used to judge any good tax system. How these apply to the taxation of both wealth and wealth transfers will then be considered. Three key constraints in tax design

⁴² For example, if the donor dies within seven years of a lifetime gift he may end up paying both capital gains tax and inheritance tax. If the donor dies leaving business property to his heirs, neither inheritance tax nor capital gains tax is payable.

⁴³ See note 2 above and appendix B of the additional online material cited therein.

stand out. First, **efficiency**, since to the extent that a tax induces an unwanted distortion on decisions to work, to accumulate and dispose of wealth, and so on, that might temper the tax rate. Second, **administrative costs**, which can be considerable in the case of the taxation of wealth and wealth transfers.⁴⁴ Some forms of wealth are particularly difficult to measure and some are relatively easy to conceal, for example they can be moved offshore or their legal ownership transferred. Given the inability to tax certain forms of wealth and wealth transfers, the case for taxation of others may be compromised. Third, **political constraints**, since implementing or reforming taxes inevitably creates winners and losers, the latter of whom might be more politically influential than the former. A political consensus to support a coherent tax system on wealth transfers is particularly relevant to both wealth taxation, which has to operate consistently over the lifetime of an individual, and to wealth transfer taxation since otherwise transfers could be timed to take advantage of relatively attractive tax regimes.

Three main criteria underlie tax reform. The first of these is the **welfarist criterion**, which is the standard criterion used in previous tax reform deliberations, including those of Meade (1978). The other two are criteria that have been prominent in more recent literature. We refer to them as **equality of opportunity** and **paternalism**, and these can be especially important in the case of wealth and wealth transfer taxation. The three criteria are not mutually exclusive.

Welfarist criterion

The standard approach taken in the theoretical literature on optimal taxation can be referred to as the welfarist, or utility-based approach. Taxpayer welfare (utility) is taken to depend on the goods and services consumed, including leisure time. It is assumed that welfare increases with consumption but increases at a decreasing rate (that is, marginal utility is diminishing). Since welfare cannot be measured directly it is often summarized by a measure of after tax income or expenditure. The objective of the government is to choose the tax structure that maximizes social welfare (some aggregate of individual utility, such as the sum of utilities), taking account of how individual behaviour will respond to the tax system and the need to raise revenue to finance expenditure on public services. The result is that better-off individuals bear progressively higher tax bills, with the degree of progressivity depending

⁴⁴ HMRC Annual Report 2005–06 annex C lists the cost of collection of income tax as 1.27 pence per £ collected, corporation tax 0.71, capital gains tax 0.92, inheritance tax 1.01, stamp taxes 0.20. Moreover, the estate of a deceased taxpayer has to obtain valuations to assess the inheritance tax due.

on the size of behavioural responses (efficiency) as well as the aversion to inequality by the government, as reflected in the rate at which marginal utility of consumption diminishes (equity).⁴⁵

This is the approach that informs much of the tax policy literature, including Meade (1978), the Blueprints for Basic Tax Reform, and the Report of the President's Tax Commission in the USA. In the context of wealth transfer taxation, the welfarist approach has also been dominant (e.g. the recent surveys by Kaplow (2001); and Cremer and Pestieau (2006)). For our purposes, the point is simply that one person's tax liability relative to another person's is directly related to their relative well-being or income. This approach is typically called welfarism in the theoretical literature, a term that refers to the fact that only levels of individual well-being count in determining social welfare.

Following the welfarist approach would lead one to seek as a tax base an indicator of the level of well-being of the taxpayer. The rate structure to apply to the chosen base depends on efficiency and administrative considerations. Our main concern here is with the choice of a base. There are a number of general problems associated with applying the welfarist objective. One is the issue of measurability. An ideal tax base that reflects the well-being of a household contains elements that are difficult to measure, a prime example being leisure or the value of non-market time. The problems with choosing a tax base that takes such things into account are discussed by Banks and Diamond in Chapter 6. Related to the measurability problem is the problem of information. A good tax base, like income or expenditure, may be in principle measurable but not directly observable to the government. The need to rely on self-reporting constrains the scope of the base and the rate structure. There may also be collection and compliance costs arising from the inevitable complexity of any tax system and the incentives that might exist for taxpayers to minimize their tax burdens. The choice of a base and rate structure involves value judgements about both horizontal and vertical equity.⁴⁶ In the end, these must reflect some consensus that gets resolved by the political process. A further issue that might constrain the choice of a tax system concerns the fact that policymakers, even if they are perfectly benevolent and respond to what they perceive as social welfare objectives, may not be able to commit to

⁴⁵ The marginal utility of consumption should be interpreted here as marginal social utility as judged by government in its notional calculations of social welfare. It should not be interpreted as marginal utility in some objective sense.

⁴⁶ Horizontal equity is the principle that individuals who are equally well off should face the same tax burden. Vertical equity is the principle that one person who is better off than another should pay taxes that are appropriately higher reflecting the fact that their marginal social utility of consumption is higher.

tax policies over a reasonably long period of time. Policies that are optimal from a long-term perspective might be time-inconsistent, to use the technical term. Thus, long-run optimal policies will take account of the effect that the tax system has on decisions to save and invest in the future. But, once the future comes around, the savings/investment decision has been made and even a benevolent policymaker would want to tax its proceeds. The consequence is that taxes on capital income and wealth might be excessively high from a long-run perspective, and the policy response might be to attempt to tie the hands of future governments in order to prevent them being able to tax capital income or wealth excessively.

The problems outlined above apply to the design of any tax. However, there are two particular issues in the context of wealth and wealth transfer taxation. The first is whether all sources of individual well-being should 'count' from a social point of view—in particular should the benefits donors obtain from altruistic transfers count as well-being for the purposes of tax policy? If so, a form of double-counting can arise since the same transfers will also yield well-being to the donees. A related issue arises if my well-being is based on my position relative to yours in terms of wealth, income, housing, and so on. If so, increments in wealth have negative effects on others and, by welfarist logic, ought to be taxed. Second, a person might get well-being from holding wealth over and above that obtained when the wealth is used to generate consumption. If one takes the welfarist approach literally (as Kaplow (2001) advocates), all sources of well-being should count regardless of their source. We shall refer to this as the strict welfarist approach. Much of the literature in this area has focused on the taxation of transfers from parents to their children.⁴⁷ A number of special problems arise in this context. First, an intergenerational perspective must be taken. Social welfare will need to include, and suitably weight, the well-being of both the parent and the child. Moreover, a transfer from a parent to a child may lead to the child making a larger bequest, and so on down the line. This implies that in order to analyse the consequences of a wealth transfer tax, one must take into account potential impacts into the indefinite future (for example with an overlapping-generations model).

Next, the effect of a given wealth transfer on both equity and efficiency will depend on the motivation for giving it. Four different motives are distinguished in the literature. Even though it is not possible to observe motives and thus to tax on the basis of them, some motives might be more prevalent for some types of transfers (e.g. lifetime vs at death), and this may constitute

⁴⁷ A comprehensive survey of the optimal taxation of bequests can be found in Cremer and Pestieau (2006). Our discussion draws heavily on that.

a reason for taxing them differently. First, a transfer of wealth (whether made on death or lifetime) may be made because the donor gets utility simply from the act of giving to his chosen beneficiaries (the utility of bequest motive). Then, utility depends on the amount transferred. Second, it may be given because of altruism of the donor for the donee's utility (the altruistic motive), in which case the utility to the donor depends on how the transfer affects the utility of the donee. Third, it may be given in return for some favour or service, such as personal care (the strategic motive). Finally, it may be given unintentionally as a result of wealth held at death for precautionary or other reasons (the accidental motive). In the first three cases, since the bequest is intentional, it presumably benefits both the donor and the donee. Under the welfarist principle set out above, this could justify the fact that certain types of transfers should be taxed more heavily if they produce utility for both individuals. However, it remains a matter of judgement whether or not such double-counting of utility (i.e. considering the utility of both donor and donee) should be allowed in determining the tax base. One could decide that under both the utility of bequest motive and the altruistic motive it is not appropriate to count the increase in well-being of both the donor and the donee. In the case of strategic bequests, since these are effectively the same as any other transaction between a buyer and a seller, it is clear cut that the increase in well-being of both the donor and the donee should be counted. The transfer reflects a payment for service by the donor and income for the donee just like the purchase of a good. In the case of accidental bequests, since they are not a matter of choice, it is reasonable to think that only the donee benefits and that these transfers should not be double-counted.

A further complication occurs if the donee also cares about the consumption of the donor. In this case the increase in the well-being of the donee from the additional consumption arising from the bequest will be partially offset by the fact that the consumption of the donor is lower as a result of the bequest being made. In this case the welfarist argument for double-counting the bequest (i.e. taxing it more heavily on the basis that it produces greater overall utility) would be reduced.

From an efficiency point of view, only bequests that are a matter of choice—as opposed to those made by accident—could be expected to respond to fiscal incentives. Specifically, higher taxation of wealth transfers would be expected to lead to lower after-tax bequests, although the impact on gross bequests is ambiguous. Among the categories of voluntary bequests, the responsiveness of the bequest to changing fiscal incentives may well vary. In particular, the responsiveness of wealth transfers made for the utility of

bequest motive to their tax treatment will depend on whether well-being is derived from the pre-tax or the after-tax size of bequest.

The welfarist argument is that efficiency and equity effects of taxing transfers of wealth should depend on the motive and satisfaction obtained for donor and donee. Thus, it is sometimes argued that since bequests given before death will not have been made by accident while some of those made at death will be, this in itself justifies different tax treatment of lifetime and end-of-life bequests. However, under the welfarist criterion, it is ambiguous which should be taxed higher if the utility of bequests to the donor counts. Efficiency arguments support higher taxes on accidental bequests since such bequests are not responsive to bequest taxes. However, equity arguments suggest lower taxes on accidental bequests since the donor obtains no utility from the bequest.

Unfortunately, the motive for a transfer of wealth is not readily observable. It certainly cannot be the case that all bequests on death are accidental and should therefore be taxed less heavily because they only give satisfaction to the donee or more heavily because they have no disincentive effect. Nor can it be the case that bequests are entirely strategic or altruistic—a donor may be giving during lifetime partly in the hope that his heirs will look after him but also to safeguard their future.

These considerations confirm that even if the bequest motive is known, the theoretical prescriptions for wealth transfer taxation are ambiguous with the policy prescription varying widely with the government's preferences. This is illustrated in Box 8.1 based on the recent survey of optimal bequest taxation by Cremer and Pestieau (2006). The analysis is based on a simple model that has many shortcomings as a basis for making policy conclusions. Most importantly, little headway has been made in analysing the issue of equity, which arguably is the most important dimension of wealth and wealth transfer taxation. Since the focus of the optimal tax approach has been on redistribution across rather than within generations it does not take account of the fact that recipients within the same generation may well receive very unequal inheritances of wealth. A donee who has inherited more in the past will presumably receive lower utility from an additional gift made now. Once heterogeneity of individuals is taken into account, questions about donor- and donee-based taxation become relevant. The government now has a potential interest in addressing inequalities created by inheritances whose distribution affects the utility of donees.

Two lessons emerge from the optimal tax literature. First, the efficiency costs of wealth transfers can vary significantly with the motive for the wealth

transfer. Second, the appropriate objective for the government is more difficult to specify when wealth transfers are at stake.

A further serious difficulty with welfarism involves dealing with individuals who have different preferences. This makes it difficult to compare well-being levels in principle, let alone in practice. If otherwise identical individuals have different preferences for leisure, for saving, for family formation, or for uses of their income, they will have different economic outcomes. Should the tax system treat them differently? More to the point, if persons with equal means choose to make different amounts of wealth transfers, should they be treated differently because of these choices?

In conclusion, taking a welfarist approach to wealth transfer taxation leaves some important questions open. What weight should be given to the utility of donors and donees when both may benefit from the same transfer? How should lifetime transfers be treated relative to transfers at death given that different motives might apply to each? How should account be taken of the fact that different individuals have different preferences for saving, making bequests, and so on? We now look at other taxation criteria.

Box 8.1. Lessons from optimal tax literature for bequest tax design

Following the survey by Cremer and Pestieau (2006), a simple approach is to consider an overlapping-generations model, where each generation consists of individuals that live for two periods (working and retirement). There are four 'goods' that individuals can choose: present and future consumption, first-period leisure, and a bequest. They obtain an inheritance from their parent in the previous generation and use it along with earnings to finance current consumption and saving. Saving plus interest is then spent on future consumption and bequests. Population grows at some given rate, with each person having one or more heirs to whom bequests are made.

The government requires a given stream of revenues, and can use proportional taxes on labour income, capital income, and bequests. Given the proportionality of taxes, there is no distinction between a tax on bequests and a tax on inheritances. The government is also assumed to be able to use debt freely, which implies that it can control the level of capital accumulation.

The setting is basically a straightforward extension of the classical Ramsey optimal commodity tax problem with four goods to an overlapping-generations setting in which individuals are linked by parent–heir wealth transfers. Despite this apparent simplicity, the results are agnostic and turn on two key assumptions. The first is which of the four motivations for bequests applies. The second is whether the government gives weight to the utility of bequests to the donor in

its social welfare function, which takes the form of a discounted sum of utilities of all present and future generations of individuals.

Cremer and Pestieau report results mainly for the steady state (long run) when all variables have achieved their long-run values. A brief summary is as follows.

Utility of bequests If the government counts the utility of bequests in its social welfare function, the optimal tax may well entail a subsidy on bequests. The government counts not only the utility of bequests to the donor, but also the benefit of the inheritance to the donee. Since the donor does not take account of the latter, bequests are too low from a social point of view on that account.

On the other hand, if the government does not count the utility of the bequest to the donor (to avoid double-counting), taxes on labour, capital income, and bequests depend on compensated elasticities of demand for first- and second-period consumption, leisure, and bequests as in a usual optimal tax problem. The problem is somewhat complicated because the government and the individuals have conflicting preferences: individual bequests are determined by the utility the donor obtains from them, while optimal bequests from society's perspective are determined by the utility generated for donees.

Altruistic bequests When individuals benefit from the utility of their immediate heirs, they will also benefit indirectly from the utility of their heirs' heirs, their heirs' heirs' heirs, and so on (since the utility of their heirs' heirs affects the utility of their heirs). Taking account of this indefinite sequence of utility interdependency, one can represent the utility of a person in the current generation as a dynastic utility function that includes the utility of all subsequent heirs. This leads to the Ricardian equivalence argument that intergenerational transfers will be ineffective. Any attempt to redistribute from, say, the current generation to future generations will be undone by a reduction in bequests so any attempt to tax bequests will be ineffective since bequests will be adjusted to unwind the impact of this redistribution. What weight one should put on these results is not clear. There is no compelling empirical evidence to support the view that government intergenerational transfers are ineffective, and the theoretical underpinnings for the Ricardian hypothesis are very weak in a more realistic setting. (As Bernheim and Bagwell (1988) have shown, the hypothesis falls down once account is taken of the fact that dynastic lines are not linear given the fact that marriage is between two individuals in different families.)

Accidental bequests Accidental bequests occur because, in the absence of perfect annuity markets, individuals have to self-insure against uncertain longevity by holding wealth. When they die, this wealth is passed on to heirs. Since, by assumption, donors obtain no utility from the bequest, the issue of double-counting does not arise. Moreover, taxing it will have no effect on their bequest behaviour. On efficiency grounds, it is therefore optimal to impose as high a tax as possible on accidental bequests.

(cont.)

Box 8.1. (*cont.*)

Strategic bequests These bequests are analogous to a sale from one person to another. As such, no issue of double-counting arises if account is taken of the benefits to both the donor and the donee. The actual tax on bequests is complicated by the fact that the bequest is a voluntary exchange involving choice by both parties. Depending on the responsiveness of each, the optimal tax could be relatively high or relatively low.

As noted previously, wealth transfers may well be done from a mixture of these motives.

Non-welfarist criteria: equality of opportunity

In the theoretical redistribution literature, one approach to dealing with the fact that different individuals have different preferences is the so-called equality of opportunity approach, following Roemer (1998) and Fleurbaey and Maniquet (2007). In this approach, a distinction is made between the ‘principle of compensation’ and the ‘principle of responsibility’. Individuals ought to be compensated for disadvantages that they face that are beyond their control, as in the case of differences in innate ability or productivity stressed by the welfarist optimal tax literature. However, they ought not to be compensated for differences arising from things for which they are responsible, an example of which might be their preferences. Applying this distinction in practice is fraught with difficulties—for example if some individuals are innately hard-working or lazy—but one approach that has been fruitful is to equalize opportunities that households have, regardless of how they choose to use them. This might be taken to be an argument for equalizing, say, inherited wealth as an objective of policy. It might also be used to justify not taking special account of altruistic preferences. That is, if personal choice leads some individuals, but not others, to transfer wealth to relatives or to charities, no distinction should be made in the tax system between the two types. On this basis, freely made choices to make transfers should not attract favourable or unfavourable tax treatment in the hands of the donor, although the equality of opportunity argument might suggest that transfers should be differently taxed in the hands of the donee depending on his status. We referred in Section 8.1 to the equity objective—the idea that people should not be taxed more heavily if they choose to save their wealth rather than spend it before their death. Equality of opportunity provides some justification to this objection.

In the case of wealth taxation, as we have seen, the argument is made that wealth confers benefits to individuals over and above its role as a source of

income. It might confer status or power, or it might provide opportunities that are otherwise not available to other taxpayers. One has to be wary of double-counting here. To the extent that the benefits of holding wealth ultimately show up as income or expenditure, they will then be subject to direct taxation. For wealth to be a separate base for taxation, one must be persuaded that it does provide benefits over and above the consumption that the wealth finances, or that the benefits that confer utility do not otherwise end up being taxed. (The fact that individuals systematically make wealth transfers at death rather than during life might be *prime facie* evidence that there is some value to holding wealth, at least for those for whom lifetime transfers are an option.) One example of this is if having a large amount of wealth enables individuals to take a more high risk, high return, approach in their lives. Then, unless these returns are subject to an appropriate amount of tax (and these returns might not necessarily be financial returns and therefore are not taxed), this could be used as a justification for the taxation of wealth. However, it may be that the forms of wealth that do confer extra benefits are those that cannot be easily taxed, such as human capital (i.e. an individual's earning potential, which, among other things, will depend on their talents, education, and health) and other personal attributes.

There is no discernible consensus among experts in tax theory and policy that wealth should be regarded as conferring a benefit on its owners over and above its usefulness as a source of income or expenditure. Despite that, the Meade Report (Meade, 1978) simply assumed it to be the case. Much of the argument for the taxation of wealth—over and above the taxation of wealth transfers—rests on the assertion that wealth itself is a source of benefit.

Non-welfarist criteria: paternalism

Recent literature has stressed various ways in which individual decision-making may lead to outcomes that are not in the long-run interest of the individuals themselves, and the puzzle this poses for government policy (Bernheim and Rangel (2007)). Three general categories of problems have been stressed. Individuals may not be well enough informed to be able to take some types of decisions, such as those involving financial transactions or consumer contracts. To reduce the costliness of such transactions, governments may impose regulations on suppliers or may compel or default individuals into certain types of actions (health care, education, retirement saving, etc.).

Second, individuals might purposely make choices against their own self-interest for reasons of ethics or social norms. Donating to charity might be an example of this. The fact that these actions are against their own self-interest may warrant favourable treatment under the tax system, although it may be

impossible to detect the true reason for such donations—for example one could equally argue that large donations to charity can give a donor access to power, media popularity, and possibly non-monetary benefits such as honours. The merits of offering favourable tax treatment will also depend on how the price elasticity of charitable donations compares to the deadweight cost of supporting those donations that would have taken place in the absence of the favourable treatment.

Finally, personal decisions may not always be rational or consistent over time—for example, individuals might make decisions that they subsequently regret—as a result of myopia, self-control problems, or not anticipating the consequences of one's actions. This leads to outcomes such as undersaving for retirement, addictions, excessive gambling, and procrastination. Governments may react to such time-inconsistency problems by second-guessing personal decisions and purporting to correct them so that they align with long-term interests. Such paternalism is very contentious since it contradicts the usual norms of consumer sovereignty. In practice, wealth taxation may discourage saving (although it might have little effect on those not behaving rationally) and providing an incentive to make lifetime gifts (as at present) may lead to donors not retaining sufficient wealth to fund their future needs.

8.2.2. The tax treatment of wealth transfers

The issues surrounding the tax treatment of wealth transfers can best be revealed by considering the simple case in which one person, a donor, makes a voluntary transfer of funds to another person, a donee. We set aside for now the issue of whether there is a particular relationship between the two, focusing instead on the transfer in the abstract. If one takes a strict welfarist approach to tax design (following Kaplow (2001)), one would treat the transfer as yielding welfare to the donor and taxed as such, equivalent to any other spending since it was voluntarily undertaken. By the same token, the transfer constitutes an increase in taxable income to the donee. To evaluate how compelling this strict welfarist argument is, it is useful to consider various caveats that might apply, some of which we have already seen.

The standing of the donor's utility

As we have seen above the strict welfarist approach leads to a form of double-counting in the sense that the transfer is taken to give utility both to the donor

and to the donee, and thus calls for taxation in the hands of both. So by way of example if X gave away £1 million to his son Y, then X would receive no tax relief on that donation (even though it had been paid out of after-tax income) and Y would pay tax on it. Whether or not this is appropriate is a matter of judgement. One could equally well depart from strict welfarism and argue that a transfer of funds from one taxpayer to another should be treated like a transfer of the tax base and should only be taxed once.⁴⁸ To make this point more forcefully, the same double-counting will occur under strict welfarism even if altruism is not accompanied by a transfer: person A may get utility from person B's consumption without a transfer from A to B. Obviously, the tax system could not take such utility interdependency into account. Is then it appropriate to include the benefit to both the donor and the donee from the same transfer in their respective tax liabilities, even though such common benefits are not included as taxable in the absence of a transfer? So in the above example, if X benefits altruistically from Y's annual consumption of £20,000 financed by Y's own income, that benefit would somehow have to be included in X's taxable income as well as Y's if altruism is to count.

Altruism might not be the only motive for a voluntary transfer. As mentioned, a donor might be motivated by a 'joy of giving' (or a 'warm glow', following Andreoni (1990)) without regard to the benefit to the donee. Or, donors may obtain prestige value from the size of their charitable donations. Alternatively, there might simply be ethical motives involved. Since motives are not observable, it would be impossible to differentiate tax treatment by motive in the case of gifts.

However, there are other arguments in favour of not giving tax relief to donors for transfers. If donations are taken to be the free exercise of one's chosen preferences, the principle of responsibility would say simply that the tax system should treat no differently those who do and do not choose to make donations. By this argument, the only tax consequence of donations would be that they increase the opportunities available to donees and should be taxed as such. So in our above example, the £1 million that X gave to Y would be taxable income for Y but would have no tax consequences for X, albeit he would not receive a tax deduction. Thus, the tax treatment of wealth transfers would be the same under the strict welfarist system and the principle of responsibility, or equality of opportunity: donees should be taxed with no relief for donors. (Note these arguments are quite independent of the case

⁴⁸ The Meade Report discounted these arguments out of hand. But, it also seemingly argued against the simple principle of treating a transfer as taxable to both the donor and the donee, and suggested some separate treatment.

for taxing accrued capital gains on death. Since these capital gains represent capital income in the years before death, they should be taxed under an income tax system in any case.)

Transfers on death compared with lifetime transfers

We have already noted that transfers on death may differ from lifetime transfers in two ways. First, they may be involuntary, as in the case of unintended bequests. If donors have held wealth for precautionary purposes solely to self-insure against uncertainty in the length of life, transfers of wealth at death are involuntary in the sense that the wealth was not retained for the purpose of making a transfer. On the other hand, the holding of precautionary wealth does benefit the donor since it presumably yields some value in terms of risk reduction. A clearer case might be that in which the wealth held at death is simply a result of bad planning, myopia, or bounded rationality as has been stressed in the behavioural economics literature. Here it seems clear that there is no benefit for the donor associated with the wealth transferred, so the case for taxing a transfer on death simply on welfarist grounds is weak. On the other hand, the donor may in fact obtain satisfaction from knowing he is providing for his heirs in his will—in other words, many transfers on death are planned and do have a bequest motive. So it seems difficult on welfarist criteria to distinguish precisely between lifetime and death transfers given the difficulty in determining motive.

Second, transfers on death may represent exchanges for services obtained from the donee while the donor is alive. For example, the donor promises the donee a transfer of wealth in return for personal care or attention while alive. This case is no different from any other voluntary exchange where the seller of the service (the donee) is rewarded for the service performed and the donor makes a purchase just like any other consumer purchase although the consideration given for the services provided is less precise. If transfers on death do represent an exchange for past services, there is no double-counting from including the value of the transfer as part of the tax base of both the donor and the donee. This would mean that £1 million that X gave to Y in our example above would be the ‘price’ paid for services given by Y. To X it would be like any other purchase of a commodity so not tax-deductible, while for Y it would be like income from the supply of the service and therefore taxable.⁴⁹

⁴⁹ Of course, this case assumes the donor can commit to a transfer on death. As some UK court cases illustrate, the donee may provide the services but not be given the reward if the donor chooses to leave his assets elsewhere on death or in fact has no property to leave. In fact the court cases illustrate that the services provided by the donee or the detriment he has suffered may well be worth

It has been argued that transfers before death are more likely to be planned than those at death (since any unintended bequests almost certainly occur at death). For this reason lifetime transfers would be taxed differently from those at death. However, it is clear that motives cannot be observed with sufficient certainty so one cannot take them into account in deciding wealth taxation. In addition motive is not a relevant consideration when considering equity and equality of opportunity issues. Moreover, as mentioned in Section 8.1, high-wealth taxpayers are more likely to be able to give assets away during their lifetime yet may have no greater bequest motive than the person who cannot afford to give assets away during his lifetime. Why should they be taxed differently?

Transfers to heirs

Transfers of wealth to heirs, either at death or earlier, constitute a substantial share of wealth transfers. Although there may be no compelling reason for treating intra-family transfers differently from those made outside the family, some conceptual problems with the welfarist approach can be seen at their starkest in this case. Parenting obviously entails providing goods, services, and funds to one's offspring. Does one adopt the welfarist point of view here and treat the act of giving to one's children as yielding benefits to both the parents and the children? Such a position would have significant implications for the tax treatment of the family, implying, for example, a higher tax burden on a single-earner multi-person family than on a single person with the same income. A particularly important form of transfer from parents to children is human capital transfers. If transfers of financial wealth should be taxed because they yield utility to both the donor and the donee, the same should apply to these transfers. Given that it is difficult to do the latter, the question is whether taxation should apply to the former.⁵⁰ Many countries (e.g. France) tax a gift to a child more lightly than a gift to a more distant relative but there seems no logic to this unless it is felt that concentration of wealth in the hands of the next generation is to be encouraged. An equality of opportunity approach would suggest the reverse—that wealth should be taxed on the donee more highly where they inherit larger sums.

The case of intra-family transfers also makes the consequences of double-counting transparent. Suppose that as one goes down the line of a family, each

considerably less than any wealth that is inherited. See cases of proprietary estoppel. *Gillett v Holt* [2001] Ch 210; *Crubb v Arun DC* [1976] Ch 179; *Gissing v Gissing* [1971] AC 886.

⁵⁰ The consequences of human capital transfers not being taxed are mitigated to some extent by the active role the state plays in the provision of public education.

generation passes on to the next generation on average what they received from the previous generation. (Deviations from the average would occur, for example, if some generation had unusually bad or good luck.) The welfarist logic would imply that the wealth transfer is repeatedly taxed each generation under either an income or an expenditure tax system despite the fact that it had not been dissipated for consumption or allowed to grow. Whether this is reasonable is a matter of judgement, but it is a consequence of the strict welfarist logic. Most countries that have a wealth transfer tax do tax on transfers of the same wealth between each generation and some countries tax transfers which skip a generation more heavily.

More generally, intra-family transfers lead to more profound consequences if one takes the welfarist viewpoint seriously. A transfer from a parent to an offspring could conceivably give utility benefits to several individuals: the donor, the donee, the donor's spouse, the donee's siblings, and so on. There is certainly no practical way of taking these benefits into account in the tax system even if one wanted to do so. The point is simply relying on the strict welfarist principle has severe limitations, principally because it is impossible accurately to assess either motive or quantum of benefits, and leads to seemingly extreme prescriptions.

Externalities

Some forms of wealth transfers can be thought of as generating positive benefits beyond the donor–donee nexus. For example donations to charities and non-profit organizations benefit members of the public who are the object of the charities' help. Rather than subjecting these transfers to additional taxation, some fiscal incentive is usually given. The argument for this treatment arises if other individuals benefit from charitable donations. One might on these grounds argue that because external benefits are being generated by the donation, those benefits should be rewarded by sheltering the transfer from taxation such as through a credit or a deduction. That logic would be fine as far as it goes. However, the third parties who are obtaining the altruistic benefit from the transfers are themselves better off, so their tax liabilities should rise accordingly. Since that is practically impossible to do, the case for subsidizing the initial transfer might be tempered.

A more compelling case for subsidizing transfers to charities and non-profit organizations might be that the alternative for the government is to finance them directly. Given that it is costly for the government to raise revenue because of the distortions its taxes impose, it might be more efficient for the government to subsidize charitable contributions by giving tax relief

rather than financing them directly. These arguments do not apply to ordinary wealth transfers since the government typically has no policy interest in facilitating them. However, the evidence cited in Banks and Tanner (1998) for studies in the UK, the USA, and Canada indicate that, at least in the short run, the price elasticity of charitable donations is typically less than one, implying that the tax cost of increasing donations exceeds the size of the donations induced.

Alternative approaches

Alternative approaches are what we call the restricted welfarist approach and the equality of opportunity approach to wealth transfer taxation discussed earlier.

By the restricted welfarist approach, we mean that only benefit of the wealth transfer to the donee is counted. This means that under expenditure or income taxation, donors would receive a tax credit or deduction while donees would treat the transfer as a source of income. So in the above example of X giving £1 million to Y, X would receive a deduction for that gift against his taxable income or gains and Y would be taxed on it as income. In principle, under an income tax system, capital gains should be deemed realized on the gift and treated as taxable income for X since they were accrued in the hands of X.

Apart from possible disagreement in principle with this approach, it also has some drawbacks. For example in the case of transfers on death, the approach is hard to implement since it entails giving a tax deduction to a taxpayer no longer alive although his estate could benefit. Alternatively, one could simply give no credit to the donor and not impose tax on the donee, which if the tax rates are the same is equivalent to not taxing wealth transfers. A further problem is that the argument for not taxing the donor might apply to the case of transfers made out of altruism or joy of giving, but not those that are strategic or unintended. We have seen already the difficulty of varying tax rates by motive.

The equality of opportunity approach would neither penalize nor reward taxpayers according to how they choose to use their income. Those choosing to make wealth transfers would be treated the same as those choosing to spend all their income. At the same time, transfers received by donees would be treated as an advantage (source of opportunity) that should be taxed. Thus, donees would be taxed on transfers while no relief would be given to donors. Nonetheless, transfers would effectively be taxed twice: once in the hands of the donors as they accumulated the wealth and again in the hands

of the donees (and multiple times if the same transfer is in turn passed to subsequent heirs). So in our example above, a transfer of £1 million from X to Y would be taxable on Y with no tax relief for X. The equality of opportunity approach ends up in wealth transfers being taxed in the same way as under strict welfarism.

If one accepts the above arguments that wealth transfers constitute a legitimate base for taxation, with the treatment of donors and donees depending on whether one takes a strict welfarist, a restricted welfarist, or an equality of opportunity point of view, there are a number of design issues that must be confronted in implementing such a tax. These are discussed in Section 8.3.

8.2.3. The tax treatment of wealth

Periodic taxes on wealth may perform a different role from taxation of wealth transfers. One is as an alternative to income taxes since, at least for income generating wealth, an annual tax on wealth is roughly analogous to a tax on capital income from that wealth.⁵¹ To the extent that one wants to include capital income in the tax base, wealth taxation may be convenient for some types of assets, particularly those for which measures of asset income are not readily observable. For example, taxes on the value of owner-occupied housing (net of mortgage debt) are a way of taxing its imputed return, given that there is no tax paid on the imputed rental income from owner-occupied housing. In an open economy setting where capital income from abroad is not easily verifiable, a tax on wealth might be a rough-and-ready way of taxing presumed income. Of course, it may be even more practically difficult to measure the value of such wealth than it is to monitor the income it produces.

Wealth taxation may be a supplement to capital income taxation where the latter is constrained by policy design. Thus, in a dual income tax system where capital income is taxed at a uniform rate, wealth taxation may be used as an additional policy instrument to achieve redistributive objectives. These arguments for wealth taxation as a means of enhancing the direct tax system raise no additional conceptual issues that are not already dealt with in the design of a direct tax system. Countries such as the UK which did not introduce wealth tax in the early twentieth century tended to impose an additional tax on capital income. Denis Healey argued for a wealth tax in 1975 partly on the grounds that it would facilitate a reduction in income tax.

⁵¹ Thus, if A is the value of an asset and r is the rate of return on the asset (taking the form of dividends, interest, capital gains, etc.), the capital income on the asset will be rA . Imposing a tax rate t on capital income each year will be equivalent to imposing a tax rate of rt on the asset itself each year.

The more relevant question is whether there are cogent arguments for taxing wealth *per se* over and above those that inform the choice of a direct tax system. To put it another way, should wealth be subject to double or triple taxation, once when it is created, again when it is transferred, and also in its own right? If one takes a strict welfarist point of view and argues that the proper base for taxation ought to be the consumption of goods and services that generate well-being for the household, one might be led to argue against an additional tax on wealth. However, one can marshal other arguments, some welfarist in nature, to support wealth taxation.

Wealth as a source of utility

As we have already mentioned, and as the Meade Report held, taxpayers might obtain utility from wealth over and above that obtained from its use. Wealth might confer status and power on its owner, at least if held in sufficient and observed amounts. In addition, wealth might have some purely precautionary value as a device for self-insurance against unexpected future needs. To the extent that these things benefit the wealth-owner, it might be argued that they should be subject to additional taxation.

Even if one accepts that wealth bestows some benefit on its owner over and above its use for financing consumption, the issue arises whether that benefit should be taxed. The fact that the benefits of wealth-holding are not measurable would make it difficult for the tax system to take them fully into account in any case. Given these caveats, and given that the usually specified benefits from wealth likely accrue mainly to individuals who hold significant amounts of it, a separate wealth tax based on these arguments would only be justified, if at all, at the upper end of the wealth distribution.

Non-welfarist arguments

Another of the arguments given by the Meade Report for a tax on wealth was equality of opportunity. The objective of equality of opportunity seems to be a widely held one, but there is no consensus about its explicit meaning. The broad interpretation put on it by Roemer (1998), and the one that we drew on in discussing taxation of wealth transfers, is that individuals should be compensated for disadvantages they are endowed with, but should otherwise be free to exercise their choices according to their own preferences. Alternatively, Sen (1985) has stressed that individuals ought to have comparable opportunities to participate in society, both in the market economy and in social interaction, and that these opportunities involve the accessibility not

only to purchasing power but also to credit, skills, and so on. Wealth can be seen as an instrument for enhancing one's opportunity in society, and giving one a stake in it or feeling a part of it. Some have even argued that all individuals ought to be given a start-up grant or an ongoing basic income on these grounds, and more generally on the grounds of enhancing the freedom of individuals to participate in society, and reducing the stigma of being dependent (Atkinson (1972); Van Parijs (1995); Ackerman and Alstott (1999); Le Grand (2006)). Others have argued that an 'asset-effect' exists and that this justifies such a policy (Sherraden (1991)). It has also been argued that an observed positive association between asset holding at younger ages and better subsequent life events provides evidence of such an asset effect (Bynner and Paxton (2001)). But this empirical evidence is very weak not least because it is quite possible that some other unobserved characteristic, such as patience, causes both the holding of assets at earlier ages and better subsequent outcomes (Emmerson and Wakefield (2001)). Despite this, the empirical evidence was used to support the introduction of the Child Trust Fund in the UK, which is a lump sum payment to all newborns, with the funds locked away until age 18.

The main point here is that this argument for wealth being a determinant of tax design applies with special force for those towards the bottom of the wealth distribution. A wealth tax itself would do little to reach those with limited wealth to begin with. This might lead one to think of a progressive tax-transfer system for wealth, whereby those at the upper end pay a tax while those with limited or no wealth receive a wealth subsidy.

Arguments for discouraging or encouraging wealth accumulation

The suggestion of a progressive wealth tax might be given further support by the argument that wealth-holding leads to pure status effects whereby one's holding of wealth relative to others is what counts in generating pleasure. According to this argument, not only does an increase in one person's wealth have an adverse effect on other individuals' well-being (which may or may not count from society's perspective), but more important, individuals have an incentive to over-accumulate wealth in a sort of self-defeating rat-race. A progressive wealth tax would blunt this incentive. More generally, there seems to be some evidence that people have not become any happier as average incomes have increased rapidly in recent years (Layard (2005)) which might suggest lower welfare costs of taxing wealth.

At the same time, the behavioural economics literature suggests an opposing consideration. On the basis of psychological and experimental evidence, it has been argued that some individuals are inherently short-sighted and

tend to undersave against their own long-run self-interest (Bernheim and Rangel (2007)). This might also lead to them qualifying for more support targeted for low income individuals in retirement and therefore has a cost to other taxpayers. To the extent that this is the case, taxing the accumulation of wealth would be counterproductive. On the other hand, there are other policy instruments in place to deal with undersaving, such as compulsory pension saving. In addition, any 'undersavers' might be expected to respond less strongly to financial incentives, and therefore the presence of a wealth tax might not diminish the amount that they choose to save.

Design issues

If one accepts one or more of these rather weak arguments for a periodic tax on wealth, what problems would there be in implementing a wealth tax? These are discussed in more detail in Section 8.3 but a major problem of principle is that wealth is accumulated for more than one reason. Some wealth exists for purely life-cycle smoothing reasons to reconcile differences in the pattern of consumption spending and income. For example, in a society where all individuals had the same consumption expenditure in all periods, it is far from clear that individuals who received their income early in their life, and therefore who would choose to accumulate assets in order to finance their later life consumption needs, should be taxed more heavily than those individuals whose income profile happened more closely to match their expenditure profile. Presumably one would not want to subject life-cycle wealth to wealth taxation if the purpose of the latter is to tax individuals on the basis of the pure benefits they obtain from holding wealth. In practical terms, the fact that the expected value of defined benefit pensions depends in large part on expected final pensionable earnings and expected final pension tenure means that it is difficult accurately to estimate current wealth since an individual who expected to have a longer pension tenure and a more steeply rising earnings-profile would have more expected pension wealth than an individual who expected to have a shorter pension tenure/less steeply rising earnings-profile. Similarly, if wealth is accumulated largely to make bequests to one's heirs, other wealth-holding benefits might simply be incidental.

A strict welfarist tax designer might therefore want to tax only that wealth annually that was accumulated for reasons other than life-cycle smoothing and bequests, and this would be over and above the tax on the transfer of wealth to one's heirs (or to other donees). Designing a tax system on wealth and wealth transfers that accomplishes this is challenging as Section 8.3 illustrates. To do so perfectly would involve distinguishing between wealth accumulated during one's lifetime according to whether it was intended for

life-cycle smoothing or not, something that is extremely difficult. One might also want to be able to distinguish lifetime wealth accumulation that was done primarily for purposes of making a bequest versus wealth-holding per se, which is again impossible. The compromise proposed by the Meade Report was to tax, on a periodic basis, only wealth holdings that were obtained by transfers and not those that were the result of one's own accumulation. This would satisfy the wealth tax motive in part but is rather arbitrary in effect. After all, wealth is not kept separate according to its source. Someone may inherit £1,000 which they invest to start a business which is eventually worth £1 million. Is this £1 million to be subject to an annual wealth tax?

Section 8.3 outlines some of the practical problems with a wealth tax in unmodified form. As noted previously it might therefore be preferable to have an annual wealth tax targeted only at specific assets such as land, with no reduction for debt and set at a relatively high threshold. So, for example, it would only affect individual occupiers of real property with a gross value above a large limit. There would be no exemptions and hence the status of the occupier—whether resident or domiciled here—would be irrelevant. It would be targeted at high net value residential property. This tax then becomes relatively easy to collect since all local councils have a record of properties. This is discussed further in Section 8.4.

A wealth tax does not preclude a separate tax on wealth transfers with no relief granted to the donor and indeed the Meade Report proposed collapsing the wealth tax and the wealth transfer tax into a single tax, the PAWAT, which would be progressive in form. This suggestion is problematic since the two forms of tax are based on different economic principles. The advantage of keeping two systems is that they might differ in their coverage of wealth owners. For example, the wealth tax may affect only high values on specific assets within a relatively small class of individuals who otherwise may be exempt from other taxes.

Wealth tax has also been conceived as a more general mechanism for redistributing wealth along the lines proposed by Le Grand (2006). This sort of wealth tax would involve a fairly progressive rate structure with a negative component at the bottom based on the arguments above that the main direct benefits of holding wealth would accrue to the upper level of the wealth distribution, while the case for a basic wealth capital grant applies at the bottom. An anomaly that might affect this is that, while the argument for a wealth tax implies a periodic (e.g. annual) wealth tax the argument for a basic capital grant may apply only at the start of adulthood. In that case the capital grant would not be part of the general rate structure of the annual wealth tax. Separate decisions should be made over the taxation of wealth and any

grant that is paid, since it is highly unlikely to be the case that the appropriate amount of revenue raised through the wealth tax will always be equal to the appropriate amount of expenditure on capital grants.

Similar sorts of incentive problems arise with wealth taxation as with wealth transfer taxation. In the case of wealth taxation, the incentive would be to transfer the wealth early to avoid paying periodic tax. This might not be regarded as a serious problem. Once the wealth is transferred, it no longer yields the alleged benefits attributed to it. Moreover, the donee would—as long as they were resident in the same country—then be subject to wealth taxation, so the tax would not really be avoided. Of course, if the wealth tax is progressive, the donor could mitigate the future liability by dividing it up among donees. Some would regard this as a good thing since it should reduce the concentration of wealth. As the experience of other countries experience indicates, wealth tax has not been particularly successful in breaking up concentrations of wealth or redistributing wealth and has been a particularly inefficient tax to collect. Most countries are moving away from the wealth tax to a simpler model. We do not recommend a wealth tax except in so far as we consider in Section 8.4 whether a higher annual tax on occupiers of high value residential property is an option.

8.3. PRACTICAL AND DESIGN CONSIDERATIONS ARISING OUT OF THE TAXATION OF WEALTH AND TRANSFERS OF WEALTH

In Section 8.1 we highlighted the various points that needed to guide the policymaker when considering the taxation of wealth and wealth transfers. In particular the options for the UK are whether to introduce wholesale structural reform, to abolish inheritance tax, or try to improve the existing capital tax system. In Section 8.2 we considered some of the underlying principles that should be considered in relation to taxes on wealth or wealth transfers. In this section we look at the pros and cons of the various options, starting with a discussion of wealth tax and then looking at wealth transfer tax.

8.3.1. Should the UK have a wealth tax?

Wealth transfer taxes have existed for most of the twentieth century (if not longer) in most countries, whereas wealth taxes (i.e. taxing the **holding** of capital on a recurrent basis) have existed in less than half of OECD countries

and were introduced more recently. In fact wealth taxes have failed to live up to expectations and are generally in decline.⁵² The UK has never had a wealth tax despite the Meade Report's enthusiasm for one and Labour's Green Paper in 1974⁵³ which proposed a wealth tax 'to promote greater social and economic equality'. The suggested rates ranged between 1% on net wealth of between £100,000 and £300,000 to 5% on net wealth of over £5 million (for reference average male full-time earnings increased over twelve-fold between April 1974 and April 2006).

The proposals were not introduced. Healey (1989) reflected: 'you should never commit yourself in Opposition to new taxes unless you have a very good idea how they will operate in practice. We had committed ourselves to a Wealth Tax; but in five years I found it impossible to draft one which would yield enough revenue to be worth the administrative cost and the political hassle.' This has been the common problem for most countries with a wealth tax.

Issues to consider in relation to a wealth tax

The 1974 Green Paper is instructive in illustrating the difficulties which need to be addressed. These include the following issues.

The taxable unit

Should individuals be taxed separately or should the unit of taxation be the family which would then include spouses and minor children as one unit?

⁵² At the time of writing, France, Spain, Norway, some cantons in Switzerland, Greece, and India impose a wealth tax. France has an annual wealth tax levied at rates of up to 1.8% (as well as an inheritance tax and gift tax) although note that it is limited mainly to real estate when the owner is non-resident and is only charged on the net value of assets, so can be relatively easily circumvented by foreigners charging the asset with debt. Ireland, Austria, Denmark, the Netherlands, and most recently Sweden have all dropped theirs in an attempt to encourage entrepreneurial activity although the Netherlands soon replaced it with a 30% tax on theoretical revenue on capital so wealth tax there stands at 1.3%. In Germany it was ruled unconstitutional on the basis that various types of assets were not given equal treatment and therefore it was inequitable. It was removed in 1997 although there are plans to reintroduce it (see *Financial Times*, 28 March 2007). Their contribution to total government revenue is decreasing and it would appear that the tax did not meet the expectations of the countries that adopted it (see Kessler and Pestieau (1991)). Further details can be found in appendix B of the additional online material (see footnote 2).

⁵³ In 1974 the then Chancellor of the Exchequer, Denis Healey, presented a Green Paper for a wealth tax on the basis that income was not a sufficient measure of taxable capacity and a tax to redistribute capital could reduce income tax rates. The only exception were one-off levies—one in 1948 called a Special Contribution and the other introduced by Roy Jenkins as a Special Charge in 1968. It is sometimes argued that taxes on immovable property are a type of wealth tax as are stamp duties on registration of deeds to immovable property. However, this tax is typically applied to the gross value of assets without accounting for any liabilities. Property taxes are discussed as a separate subject in Section 8.4.

No firm conclusions were reached in the Green Paper but the issue is even more pertinent now given that family structures are more complicated. The tax credits system demonstrates some of the difficulties involved. Given that the tax system currently treats husband and wife as separate taxable units with independent reliefs and allowances, it is suggested that it is preferable for any wealth tax to follow this model rather than try to aggregate the wealth of husband and wife, civil partners or cohabitants. The wealth held by minor children and derived from the parent donor could be taxed on that parent in the same way as the income is taxed on that parent. Wealth held by minor children derived from other sources, for example from grandparents, would presumably be taxed separately as the minor child's. The Green Paper proposed that the wealth should be allocated to the parent from whose side of the family the wealth derived. But this can lead to sometimes arbitrary results if a grandparent or uncle leaves wealth to a minor and the parent is poor.

Chargeable individuals

Most countries limit wealth tax to assets held by individuals but trusts also need to be considered. Should only UK residents be taxed or should non-residents pay tax on UK situated assets? Should foreign domiciliaries be exempted? Most countries limit the wealth tax on non-residents to real estate and business enterprises actually carried on by the non-resident in the country.

On what assets should the charge be levied?

It is accepted that not all wealth can be taxed and therefore a wealth tax is an imperfect instrument. Human capital, that is, the present value of future earnings that an individual may earn, is not easily measured and is not taxed. Governments do not generally try to tax wealth held in the form of pension rights. Wealth tax can be more easily imposed on all real estate owned directly by the relevant person or indirectly through a company. However, should any reliefs be given for agricultural property or business property? If these assets are not subject to wealth tax then the desired social effects would not be achieved. On the other hand, a wealth tax on capital could prove an unacceptable burden for the owner of illiquid assets since the assets may well not generate sufficient income to enable the owner to pay an annual wealth tax on the capital. Presumably there would be some sort of exemption given for household chattels up to a certain value; if works of art are charged this could well lead to a dispersal of the national heritage. (France exempts works of art and the 1974 Green Paper proposed that assets of pre-eminent national importance should be exempted from wealth tax while made available for

public display.) While one could give a conditional exemption for works of art (not merely a deferment) provided the owners continued to meet appropriate conditions about public access there are particular issues of disclosure and valuation for works of art. It is easy to hide a picture. There would be very adverse economic results if wealth tax was imposed on holdings of UK quoted shares by non-residents but if wealth tax is imposed on any commercial enterprises here it is likely to deter foreign investment.

Valuations

A wealth tax requires regular valuations and therefore imposes compliance costs on the taxpayer and increases administrative costs for the revenue. In some cases, for example pictures, unquoted company shares, partnerships, it will not always be easy to value the taxpayer's interest since the underlying assets owned by the business will have to be valued, appropriate discounts for minority shareholdings given, and goodwill is not easily valued. What about hope value on land? Should this be ignored until planning permission is obtained? Valuations may be manipulated; the taxpayer would be entitled to know the extent of their tax liabilities with certainty and without delay and hence to be able to plan their finances. Annual valuations could be avoided by having an annual or biennial tax levied on valuations done every five years. This latter approach has been adopted under pre-owned assets income tax. However, the compliance issues remain considerable since a taxpayer may need to do a valuation of all his assets just to ascertain that he is not subject to the tax.

Deductible liabilities

It would obviously be equitable to charge only net wealth so that liabilities will be deductible from a taxpayer's gross wealth in order to establish the net amount on which he will be liable. On the other hand, this opens up opportunities for avoidance. For example, the foreign resident can charge up his UK property with debt and deposit the borrowed funds which are not taxed abroad. The UK person can charge up his house and invest the borrowed proceeds in an exempt asset such as farmland.

Thresholds

The 1974 Green Paper suggested a threshold of £300,000 which, if uprated in line with average full-time male earnings, would be equivalent to £3½ million–£4 million today.

Trusts

Measures have to be put in place to avoid fragmentation of wealth through trusts. The 1974 Green Paper came up with some crude proposals which highlight the problems. It was suggested that for an interest in possession trust (one in which the person is entitled to the income) the whole capital value should be attributed to the life tenant. But this could be very unfair if the asset produces little income and the interest in possession is revocable. It was suggested that a discretionary trust should be charged by reference to the settlor's circumstances whether or not he can benefit on the basis that 'this will usually be close to the realities of the situation in which the trustees may be expected to follow the settlor's wishes'. But what about trusts set up long before the introduction of the tax or where the settlor is excluded and what about the position where a settlor has died and attribution to the settlor is no longer possible? Alternatively wealth tax for a discretionary trust could be governed by the shares of income distributed to the various beneficiaries in their relevant year and attributed accordingly. However, this can be administratively difficult where income distributions vary each year. The capital position of every beneficiary would have to be examined; they would not necessarily have to make a return of their wealth every year once it was established that they were well below the tax threshold but trustees would still need to go through the process and ascertain each beneficiary's total wealth. Additional rules would be needed where a beneficiary derived income from more than one trust. What about trusts where income was accumulated rather than distributed? The Green Paper suggested that where there is an identified beneficiary for whom income is accumulated contingent on his reaching a specified age the contingency should be disregarded and the capital attributed to him. But a beneficiary may never receive that capital if he fails to satisfy the contingency or the trustees appoint the capital away from him. Similar problems arise with other entities involving 'trust like' relationships.

All these criticisms of the 1974 Green Paper were made by Sandford, Willis, and Ironside (1975) who comment that 'on almost any combination of the main possibilities suggested in the Green Paper, the rich in the UK would be taxed considerably more heavily than in Germany or Sweden. Marginal rates of combined income and wealth tax in excess of 100% would be very likely and carry serious threats to the incentive to save amongst the wealthy and possibly also to incentives to effort and enterprise. No attempt is made in the Green Paper to estimate net yields from a wealth tax or to assess its demand effects.' On the largest wealth holdings they estimated that the tax level in the

UK would be substantially above that of Sweden and some 50% higher than that of Germany. The authors were strongly critical of the particular proposals set out in the Green Paper and concluded that a wealth tax was probably not appropriate anyway for the UK system.

The economic principles for and against a wealth tax were briefly discussed in Section 8.2. Arguments often used by countries in favour of a wealth tax are:

1. Equity: that is, that taxing income itself is an inadequate yardstick for determining ability to pay taxes and does not take into account the benefits from holding capital over and above the income derived from it.
2. That a wealth tax can reduce inequalities.
3. That it can provide useful administrative data which can be cross checked with other information collected by tax authorities (a motive given considerable weight by Norway and Denmark).
4. That it may have a better outreach than other taxes in taxing non-UK residents who own assets here.

Conclusions on wealth tax

However, the experience of many continental countries which have adopted wealth taxes has not been a particularly happy one. As discussed in Section 8.2 the extent to which wealth confers benefits over and above the income it generates is far from clear anyway. In cases where returns are not taxed—such as the imputed rental income from owner-occupied housing or artwork—these do not provide a justification for a broad-based wealth tax that would capture both income generating and non-income generating wealth alike.

Moreover, in practice, wealth tax cannot provide fully comprehensive coverage and precise valuation. The wider the coverage the more fully in theory the tax promotes horizontal equity but the wider the coverage the more difficult it is to prevent evasion by under reporting and to secure uniform valuations. Wealth tax has a higher cost of administration and a higher compliance cost involving regular valuations, with special problems created for agriculture and business and the danger of a new set of inequities between taxpayers of different degrees of honesty. Cost and complexity appear to have been important factors influencing abolition in Austria and the Netherlands.

It is argued that wealth tax would need to be confiscatory in order to bring about any real redistribution while the complexity of wealth tax and

its perceived unfairness leads to avoidance.⁵⁴ Recent experience suggests that wealth taxes as they now exist have little effect on wealth distribution.⁵⁵

Such a major change in the tax system needs to be justified by a sufficient margin to outweigh the costs of change, and it is far from clear that the advantages of a wealth tax are sufficiently great to justify the risks of such a change. For example, the yield of wealth taxes in countries such as France has not been significant. One of the problems is that, as we have seen already, the UK data on wealth are unsatisfactory and therefore predicting how changes to the taxation of wealth will operate in practice is speculative and therefore risky. The majority of developed countries have abolished wealth taxes. For the UK a risk is that the introduction of a significant wealth tax would be that it gave the perception of being hostile to the creation of wealth which could lead to a flight of capital. The factor that most influenced the Irish and Dutch governments when they decided to do away with wealth taxes was the perceived harmful effect on the country's economic activity, causing productive capital to leave and discouraging foreign investment and entrepreneurship.

If it is to be implemented at all, it should perhaps follow an enhanced council tax, with significantly higher rates of tax for those occupying very high value properties. This is discussed further in Section 8.4.

8.3.2. Wealth transfer taxes

Design issues to consider

The design principles that need to be decided in relation to any wealth transfer tax are summarized below.

Integration

In principle, a wealth transfer tax could be integrated with the broader tax system. The form of integration with the direct tax system would depend on whether income or consumption expenditures were the base. From the perspective of strict welfarism or equality of opportunity, wealth transfers would be treated as income receipts of the donee and as taxable uses of income by the donor. Under both income and expenditure taxation, transfers would be included as taxable income to the donee, while no deduction or credit would be allowed for the donor. In the case of restricted welfarism, a tax credit would be given to the donor for transfers given in either tax system.

⁵⁴ See Heckly (2004).

⁵⁵ See McCaffery (1994).

In fact, a substantial proportion of government revenue comes from other taxes, especially the VAT. The VAT is like a proportional expenditure tax and ought to be treated as such from the perspective of the overall tax system. To the extent that one views the transfer of wealth as analogous to expenditure by donors, as strict welfarist and equality of opportunity tax designers would do, it should be treated like any other form of expenditure under the VAT. Thus, donors should be subject to VAT on their transfers over and above the direct tax liabilities they incur. This consideration certainly complicates the tax system, and might lend support to the argument of the Meade Report that wealth transfers be treated separately from the direct tax system.

Rates

Most countries operate a separate system of rates and thresholds for wealth transfers in order to avoid the problem of lumpiness and the taxation of wealth transfers therefore operates as a stand-alone system. Otherwise under an income tax system the size of a transfer in one year could be large relative to the donee's normal annual income and this might lead to unfairness. Under an expenditure tax system, this is less of a problem since the taxpayer can self-average by smoothing expenditure over their lifetime and varying their mix of registered and tax-prepaid assets holdings.

Comprehensiveness of tax

What assets should be exempted? We have already discussed transfers to charitable organizations and transfers of business and agricultural property that currently qualify for special reliefs. Some argue that special preference should be given to transfers of a family house or a family business on social or other grounds. For example, incomplete capital markets make it difficult for UK homeowners to release their housing equity at a fair price. Similarly, access to capital markets, leading to liquidity concerns, may be limited for those who own family businesses. For these assets, even if they are not exempted, it seems sensible to allow taxpayers to smooth their payments over a number of years with interest payable on the outstanding liabilities. This currently occurs under the UK system.

Status of recipient

Special considerations are often given to transfers to a spouse or civil partner given the financial interdependence. So, for example, transfers between spouses are not taxed in the UK whether this takes place during lifetime or on death. However, the old estate duty rules had no spouse exemption for some years and many countries still do not operate a spousal relief. If the

concern is that joint occupiers should not be penalized or forced to sell the house on the first death, the Irish proposal could be adopted which defers the tax where there are joint occupiers, irrespective of the relationship of the occupier to the deceased. The taxable status of the donee generally needs to be considered—will tax be payable irrespective of the residence of the donee if the asset is situated in the UK and is the tax avoided if non-UK situated assets are transferred to non-UK resident or domiciled donees by a UK resident or domiciled donor? If tax is imposed on transfers of UK situated assets it is relatively easy for foreign domiciled or non-UK resident donees to avoid this by ensuring the assets are relocated, through use of foreign companies.

Avoidance

The design of wealth transfer taxation must also take account of avoidance possibilities. Since the tax would be triggered every time wealth changes hands, there would be an incentive to minimize the frequency of such transfers. In the case of bequests, one way to do this would be to skip generations or to use trusts. The problems raised by trusts are discussed below. Higher transfer rates can be imposed on transfers that skip a generation (as occurs in the USA).

Efficiency

Like any other tax, wealth taxes affect incentives to work and save. In some countries the system imposes lower rates overall where an estate is split between more donees or where wealth is left to donees with lower incomes or who have received smaller inheritances in the past. This raises the issue about whether to have an estate duty or an inheritance tax? Some countries levy wealth transfer tax by reference to the circumstances of the donor and others by reference to the circumstances of the donee. The pros and cons of such an approach are discussed later in the context of accessions tax.

Interaction with capital gains

How should wealth transfer tax interact with capital gains tax? Should the transfer trigger a deemed realization or not? There are three main options. First, capital gains might be deemed to have been realized when property changes hands through a transfer. In this case, capital gains tax is payable at the time of the transfer, and the tax liability would be that of the donor. Of course, if the transfer takes place on death, the capital gains tax liability would have to be paid out of the estate and would be over and above any wealth transfer tax. The second alternative is not to deem capital gains realization

at the time of transfer, but carry forward the accrued capital gains until they are eventually realized by the donee (or his/her heirs). The third alternative is to have only wealth transfer tax on death but all assets are rebased to market value without any capital gains tax payable. This currently occurs in many countries including the UK and US.

Estate duty or inheritance tax?

Some countries apply the wealth transfer tax to the donor and others to the donees. The strict welfarist and equality of opportunity objectives inform this choice. In both cases, the donee should be taxed, and no relief should be given to the donor. This is true whether the tax on wealth transfers is integrated into the income tax or taxed separately. Under restricted welfarism where the benefit to the donor does not count for tax purposes, the tax should still apply to the donor but with no relief being given to the donee. Of course, if the tax rate on wealth transfers were strictly proportional, it would matter little whether donees or donors were taxed. But as soon as some element of progressivity is introduced, either in the rate structure or in the use of exemptions, they would no longer be equivalent.

Harmonization with personal tax reform

Much of our discussion has assumed that the personal tax system used income as its base and applied a single rate structure to that base. Two other personal tax systems are often proposed: a dual income tax and an expenditure tax. Suppose it is decided to tax wealth transfers as part of the personal tax system. No special problems arise under a dual income tax system where a separate rate schedule applies to capital and non-capital income. Wealth transfers should be aggregated with earnings and other transfers as non-capital income. If the personal tax base is expenditures, transfers on death should be treated as expenditure by donors.⁵⁶ For the donee, inheritances are simply treated as income received and treated as such for tax purposes.⁵⁷

⁵⁶ Specifically if they are made out of registered assets (i.e. those that are financed by tax-deductible saving that become taxable when drawn down), bequeathing ought to involve deemed deregistration. If they are made out of tax-prepaid assets (i.e. those financed out of after-tax savings whose capital income is untaxed under an expenditure tax) no further measures need be taken.

⁵⁷ Conceptual problems arise if the tax is not integrated with a direct expenditure tax. The tax on wealth transfers would have to mimic a separate tax on expenditures by both the donor and the donee. For the donors, that can be accomplished by taxing the bequest under the wealth transfer tax, but exempting it from personal expenditure taxation. For the donees, the inheritance should in principle only be taxed to the extent that it is being spent. That entails allowing for the possibility of its being registered separately from other assets. The implication is that deploying a separate wealth transfer tax that respects the principles of expenditure taxation is difficult when it applies alongside direct expenditure taxation.

Lifetime vs death transfers

Related to the issue of rates is whether lifetime gifts should be taxed at the same rate as transfers on death or indeed at all and if so should there be any principle of cumulation with previous transfers? Most countries which tax wealth transfers such as the US and France operate an integrated gift and death tax system. New Zealand is unusual in having gift tax for lifetime gifts but no estate tax; the UK is unusual in having no wealth transfer tax on many lifetime transfers but tax on death transfers.

International considerations⁵⁸

The lack of consistency worldwide in the connecting factors imposing capital taxation can result in double taxation for some individuals. For example, liability to UK inheritance tax other than on UK-situated assets is based on domicile in the UK as a matter of general law or deemed domicile in the UK by virtue of having been resident in the UK for seventeen out of the previous twenty years.⁵⁹ The US imposes a federal estate tax on the worldwide assets owned at death by a US citizen or by a US domiciliary; and the Netherlands imposes succession duties on those resident in the Netherlands at the time of their death. Different systems also adopt different approaches to migrating individuals. For UK purposes, an emigrant from the UK will remain within the UK IHT net notwithstanding that they acquire a domicile of choice outside the UK for the first three years outside the UK under the deemed domicile provisions while a person will remain within the scope of the charge to Dutch succession duty if he dies within ten years of leaving the Netherlands and remains a Dutch national.

Not only do the categories of individuals subject to a jurisdiction's capital tax system vary considerably, so do the assets against which those taxes are levied. Some systems such as the UK IHT regime and the US estate duty regime will bite on an individual domiciled in the UK or a US citizen (or domiciliary) respectively in respect of their worldwide assets. In contrast, Singapore estate duty, for example, only applies to moveable and immoveable property in Singapore. It is problematic for countries to devise effective ways of taxing the mobile person. In the UK the insertion of an offshore corporate entity can remove UK situated asset from the capital tax regime. For example, a foreign domiciliary can buy real estate in the UK via an offshore company. The asset will not be within the inheritance tax net until the foreign domiciliary has been resident here for seventeen out of twenty tax years (and even after seventeen years, inheritance tax can be avoided by holding the company shares in a trust).

⁵⁸ We are grateful to John Riches at Withers LLP for information in this section.

⁵⁹ S267 IHTA 1984.

While the world is now served with a comprehensive network of double tax treaties in respect of income and corporation taxes, generally now based on the OECD Model Treaty, the number of treaties relating to capital taxes is materially less. The effect of this, unfortunately, is to mean that there is material scope for double taxation or nil taxation in the event of an individual's death. In the UK, by way of example, there are currently eleven capital tax treaties in force as compared with 149 income and corporation tax treaties. Even where double tax treaties are available, there is much scope for double taxation because of the significant differences that exist in the worldwide approach to capital taxation.

What entity should be taxed?

Trusts and foundations are vehicles often favoured in succession planning because the creation of these structures avoids the formalities and expense of probate procedures—no transfer needs to occur on death. But such vehicles pose a conceptual challenge for revenue authorities because there is no identifiable individual in whom property ownership resides. Various responses to the taxation of these wealth holding structures can be identified.

Treat trust as transparent Many taxing regimes have rules providing for assets settled on trust to be included within the taxable estate of the settlor or the trust's beneficiaries on the basis they can simply 'look through' the trust to see them. In the US, for example, a grantor trust is a trust whose settlor is treated as the owner of the trust assets for tax purposes. As a result, distributions of income or capital to beneficiaries are treated as gifts from the settlor and not taxable to them as income. If the settlor is a US citizen, he will therefore be fully liable to tax on the income within the trust, whether or not he receives distributions and the trust fund will be included within his estate for US estate tax purposes. The same estate tax issues arise if UK property is owned by a foreign grantor trust.

Attribute ownership of capital to income beneficiary Until March 2006 this was the approach taken by the UK so that the capital interest in a trust fund was attributed to the individual entitled to the life interest.

Create a fictional taxpayer In most jurisdictions, as a matter of general legal principle, neither a trust nor a partnership has legal personality. For tax purposes, however, they are frequently treated as entities and taxed separately according to special rules. Since March 2006, almost all new UK trusts are taxed as separate entities and inheritance tax is levied at a rate of up to 6% every ten years on capital value with exit charges being applied pro rata when property ceases to be held on trust. However, there are no provisions to

limit the number of trusts set up by each donor so with care the 6% can be minimized.

Tax an actuarial value ascribed to the life interest/usufruct Under the French inheritance tax regime, a usufruct is, for example, valued on a sliding scale as is the value of the nue propriété with the valuations dependent on the age of the donor.⁶⁰

Political consensus

Labour introduced capital transfer tax (CTT) in 1975 which was a cumulative tax on death and on all lifetime gifts, not just those made within a stated period before death. However, Denis Healey acknowledged that four years later when he left office CTT was still raising less revenue than estate duty.⁶¹ This was partly due to a much more generous spouse exemption and a number of other reliefs such as BPR and APR, possibly because some wealthy people had fled the country but also because people delayed making gifts and waited for a change in government.

Donee or donor based tax system?

Taxes on wealth transfers may be broadly categorized as being donor based or donee based: a donor based 'or estate tax' system taxes by reference to the donor (i.e. the deceased). The current UK system is an estate tax system which charges tax on the value of property transferred by the donor, generally on death. It does not take into account the past inheritances received by the donee from any source, the relationship between donor and donee, or the notion that spreading wealth among more donees should be encouraged as a way of reducing the concentration of wealth.

A donee based or 'inheritance tax' system taxes by reference to the donee: the rate of tax on transfers of wealth is governed not by the overall amount held in the donor's estate but by the history of inherited wealth for the donee. So each donee pays tax to the extent that transfers of wealth to him from any source exceed a certain limit over his lifetime. The Capital Acquisitions Tax ('CAT') regime in the Republic of Ireland is an example of a donee based system.⁶²

⁶⁰ 'An introductory guide to French succession law and French inheritance tax', unpublished, Prettys Solicitors, Ipswich (2004).

⁶¹ See p. 404 of Healey (1989).

⁶² A number of European countries such as Switzerland also have a donee based system based on the amount received by the donee and the degree of kinship. See appendix B of the additional online material cited in footnote 2 for further details.

A donor based regime is generally regarded as simpler and easier to administer because it is tied up with the probate process and executors just file a single return. Donee based regimes are more prevalent in civil law systems where forced heirship rules tend to split assets between certain heirs in any event. Countries usually opt for one or other system.⁶³

In 1972 the Conservative government published a Green Paper suggesting the possibility of an accessions tax in place of estate duty.⁶⁴ The change of government in 1974 prevented any chance of that reform occurring. However, the donee based or accessions tax system was adopted by Ireland⁶⁵ in 1976 and has had strong advocates.⁶⁶ If adopted, the tax is generally levied not just on bequests but on lifetime gifts received at any time and from any source. The donee based system could look at the cumulative total of all accessions received in the donee's lifetime or over a certain period and so take account of all the recipient's inheritances, whenever received and from whatever source. Patrick and Jacobs (1999) suggested a lower exemption threshold than the current UK system and a more progressive rate structure. Ireland has a lower threshold but a flat rate of 20%.

So an estate left to four children would suffer less tax than an estate left to one assuming the four children had no previous receipts of capital. This is seen to be fairer because four children will necessarily inherit less than one anyway.

In Ireland various exemptions similar to those in the UK are retained: for example, transfers between spouses are entirely exempt; there are reliefs for heritage, business, and agricultural property. The treatment of trusts is relatively straightforward and pragmatic.⁶⁷

Advantages of an accessions tax

Redistribution It is argued that a donee based tax encourages private distribution of wealth and hence is more efficient than a wealth tax in reducing

⁶³ Tiley, John in *Death and Taxes* [2007] BTR 300 noted though that for a time the UK had both, since estate duty was donor based but succession duty and legacy duty also applied until 1949 and were both donee based taxes, taxing property by reference to the circumstances of the donee. A widow would pay tax at lower rates than 'a stranger'.

⁶⁴ See the Green Paper: 'Taxation of Capital on Death: a possible inheritance tax in place of estate duty', March 1972 Cmnd 4930.

⁶⁵ Although cumulation is for periods only rather than over the whole of the donee's lifetime.

⁶⁶ See Sandford, Willis, and Ironside, 'An Accessions Tax', and the Fabian Society Report, 'Paying for Progress', 1999. The Liberal Democrats favoured an accessions tax in their 2006 proposals but by 2007 had abandoned this as too complex. See also Robinson (1989).

⁶⁷ A one-off discretionary inheritance tax of between 3% and 6% applies to property held in a discretionary trust or becoming subject to a discretionary trust from 25 January 1984. An annual 1% inheritance tax applies to property held in a discretionary trust on 5 April each year commencing with 1986. Further details of the Irish tax system are provided in appendix B of the additional online material (see footnote 2).

inequality or at least constraining the growth in inequality. Donors have an incentive to divide their wealth among more people and moreover to disperse their estates among donees who have not previously received inheritances because the rate of tax on them will be lower. Sandford (1987) argued: 'It is large inheritances not large estates as such which perpetuate inequality and an accessions tax falls heavily on the person who receives most by way of gifts and legacies.' Some encouragement to spread wealth could be provided even under a donor based system by letting the donor give up to a certain amount free of tax to each individual, irrespective of the wealth of the donee but since it cannot take into account the other inheritances received by that donee from other sources it is a cruder method.

Equity It reduces the incentive to make lifetime gifts and removes the lottery of the seven-year rule. If applied over a donee's lifetime there is no difference in tax rates between those who make lifetime gifts and those who keep their wealth until death. The cumulation principle means that a person whose accessions come from one source or in one go is taxed the same as someone receiving the same value of gifts from many sources or at different times.

Flexibility It is more flexible than an estate tax in that it can take account of the particular circumstances of any beneficiary, for example, give a concession to a disabled child. By relating rates of tax to the amounts received by an individual it may be more politically acceptable, although this could come at the cost of greater complexity in the tax system.

Disadvantages of an accessions tax

Reduces incentives It is argued that any increase in inheritance tax or the introduction of a tax on lifetime gifts would reduce saving and provide disincentives to enterprise. Having said that, most lifetime saving is not initially undertaken with the purpose of bequest but simply for security and later consumption. It is also pointed out that a donor prepared to transfer his wealth to a wide range of people pays lower wealth transfer tax. The same arguments about disincentives can be used in respect of any tax on wealth transfers although at present most lifetime gifts are not taxed.

Higher administrative and compliance costs This is often cited as a major problem. All recipients of gifts above the exempt level have to declare them to the tax authorities and keep a lifetime record of gifts received. There are more forms to be processed where tax is related to the shares of the beneficiaries rather than to the total estate. However, the Irish CAT system is quite a complex system with a number of reliefs and different threshold levels according

to the relationship of donor and beneficiary⁶⁸ but is operated at about the same level of costs per unit of revenue as that of income tax on the self-employed.⁶⁹ Costs could be minimized if the rate of duty on the beneficiary is related only to the individual legacy rather than the aggregate received in gifts over his lifetime but this would be open to abuse. It may be sensible to set the initial threshold per donee at a high level above which receipts are taxed on a progressive basis rather than the current flat rate. Most families would then continue to be able to transfer wealth free of tax (although not free of capital gains tax). The existing capital tax system in the UK is complex and relatively expensive to administer. The main additional cost would be the need for each donee to keep a personal record of all lifetime inheritances over a certain limit (assuming all lifetime transfers are to be included) although cumulation could be restricted to ten or fifteen years.

Evasion and avoidance It may be easier to evade than inheritance tax which has to be paid before the grant of probate can be obtained. However, evasion can be cut down by prohibiting the distribution of legacies by executors until the tax liability of the legatees has been calculated. The tax could then either be paid by the legatee before receiving the legacy or by the executors of the legatee receiving the sum net of tax. Gifts of land are registered so presumably information could be sent to the Revenue to chase up on gifts that are not self-declared. On other assets the secondary liability could be placed on the donor if a donee does not pay the tax. Wealth could nominally be spread through a family albeit remain controlled by one person so avoidance provisions need to deal with this.⁷⁰

Rates It is difficult to predict yield because at present the value of lifetime gifts in the UK is not known and, of course, the structure of the tax itself may lead to a different pattern of giving by distributing legacies more widely. The Irish CAT is levied at a flat rate of 20% over the exempt thresholds. However, the Fabian Society 1999 report proposed a nil rate threshold of only £80,000 for the UK and progressive rates thereafter up to 40%.

Failure to redistribute wealth In practice Ireland has for practical reasons modified a pure accessions tax so that gifts between spouses are exempt

⁶⁸ In 2007 the threshold above which transfers to children became eligible for tax were €496,824 for transfers to children; €49,682 for transfers to parents, siblings, nieces, nephews, and grandchildren; and €24,841 for transfers to other individuals. A brief description of the Irish CAT system can be found in appendix B of the additional online material (see footnote 2).

⁶⁹ The Irish Institute of Taxation website.

⁷⁰ For example, the deceased could divide his wealth between his daughter, her partner, their children, and various trusts for these beneficiaries. The daughter's family has increased wealth overall.

and there are different thresholds for different relationships. All of this has increased complexity and lessened the redistributive effects although the tax has not been subject to the same level of criticism as in the UK.

Transitional provisions One would have to consider transitional provisions from the current UK system. Does everyone start at the cumulative total of nil ignoring all previous legacies and gifts? Or will donees have to take account of any capital receipts received in the previous seven years in calculating their tax liability? This again increases complexity.

Political difficulties Since much of the public at present appears to oppose the principle of taxing inheritance at all the introduction of an accessions tax which included lifetime gifts might be seen as politically difficult. Moreover, if one party supports the system and the other does not then donors will simply delay making gifts, as appeared to happen with capital transfer tax.

Conclusions on donee based tax

If the principles of wealth transfer taxation set out in Section 8.2 are taken into account, the donee based system seems more appropriate on fairness grounds than the donor based system. The thresholds could be set at a relatively high level to minimize compliance costs with a lower starting rate of tax, for example, 20% as in Ireland. It would then be clearer that only those who inherit significant sums (i.e. the richer person) will have to pay any tax. So the £1 million estate which is left to four children might suffer no tax under this system because they all inherit less than £300,000 each. Reliefs and exemptions could be similar to the present position or reformed along the lines suggested below.

The main practical difference from the current UK system would be the need for donees to keep records of all inheritances and to accept that lifetime transfers of wealth could end up being subject to inheritance tax depending on the recipient's previous cumulative total. However, there is a very different perception in how the tax operates and this might win a greater degree of acceptance for the principle of a wealth transfer tax. Whether this change is worthwhile unless the yield from any wealth transfer tax were to be more substantial than that raised by the current inheritance tax system is debatable.

Reform of the existing inheritance tax system

Is there a case for keeping the existing system which taxes the estate of the donor but simply improving it so it is perceived as fairer? This seems to be the preferred approach of the government at present. The following reforms could be considered.

Increase the nil rate band threshold

This would take more households out of the inheritance tax net. The threshold could then be raised in line with house prices rather than income or general inflation. The Conservatives proposed an increase to £1 million in October 2007. Labour have now introduced a transferable nil rate band which assists spouses and civil partners although does not actually raise the threshold. The Liberal Democrats have proposed a threshold of £500,000 and cumulation for fifteen rather than just seven years ‘to restore the essential character of inheritance tax as a charge on the really wealthy’.⁷¹

Rates

The 40% rate at which inheritance tax starts being paid is high compared with that in other OECD countries. As noted in Section 8.1, for families where the deceased was always a basic rate taxpayer, the perception that ‘their capital’ is now being taxed at a marginal rate of 40% is unpopular even though the average rate is much less than this. It might be preferable to have a starting rate of 20% rising to a maximum of 40%. This would result in minimal additional compliance cost given that tax has to be paid anyway, although obviously it would result in a loss of revenue. A more progressive rate structure might make particular sense for a donee based tax—a receipt of capital would initially be taxed at lower rates before the donee moved into higher rates.

An alternative is to have a flat rate but reduce it from 40% to 20% as in Ireland. At the same time, lifetime gifts made over a certain period prior to death, such as fifteen years or potentially longer, could be taxed if above the threshold. The difficulty is in predicting the effect of such changes. Will tax on lifetime gifts compensate for the loss of 20% at death? A tax on lifetime gifts may be more acceptable if it is a donee based tax based on a certain level of inheritances over the prescribed (high) threshold.

Agricultural and business property reliefs

The current reliefs are rather unsatisfactory and arbitrary in effect. These reliefs should be better targeted. For example in Ireland APR is restricted to individuals who are working farmers rather than those who simply own agricultural land (possibly for the tax breaks) but do not intend to pass it on within the family. BPR is available but on a more restricted basis. In both cases there is a clawback of reliefs if the business is sold within six years of death. Such restrictions do not adversely affect family businesses and farmers who

⁷¹ Liberal Democrats (2007).

wish to hand on the enterprise to the next generation but will prevent people buying AIM listed shares or agricultural land simply for the tax breaks. Some consultation and more research in this area would be worthwhile.

Heritage relief

The conditional exemption and *douceur* arrangements generally work well although anecdotally there have been problems recently in obtaining relief for pre-eminent chattels because museums have not always been able to arrange appropriate security. The maintenance fund regime is generally regarded as too prescriptive and the public access requirements can be rather problematic for smaller houses. Some improvements could be made to provide appropriate public access for smaller houses without their necessarily having to be open for the full 28 days each year. For example more people may visit if open days are run on specific weekends in the year for a number of houses within a particular locality rather than merely having the house open a minimum time each month.

Family home

We do not recommend exempting the family home for the reasons outlined in Section 8.1. However, a carefully targeted relief along the lines given in Ireland (which does not seem to be costly)⁷² would deal with the ‘hard cases’ such as the Burden sisters or cohabitees. Inheritance tax would be deferred for the co-occupant who owned no other property until such time as the property was sold or not replaced.

Foreigners

At present foreign domiciliaries pay inheritance tax on a worldwide basis only if they have been resident in the UK for seventeen years and even then the tax can be avoided by use of offshore trusts. We suggest that their inheritance tax position is re-examined albeit with appropriate transitional provisions and after proper consultation.

Payment of inheritance tax

It was noted in Section 8.1 that payment of inheritance tax can often be problematic because it has to be paid before grant of probate. The Liberal Democrats (2007) proposed ways of improving this and it is suggested that further work should be done in this area.

⁷² Further details are provided in appendix B of the additional online material (see note 2).

Recording lifetime gifts

It is difficult to formulate policy when one has little information about the extent of lifetime giving or the distribution and transfer of wealth. Requiring all donors to complete a simple form for lifetime transfers over a minimum annual limit whether or not tax is payable would help bridge this information gap and inform policy making. The form could be one page giving details of the asset, the recipient, his relationship to the deceased as well as values and could be sent to the Inheritance Taxes Office. Alternatively, an extra box could be inserted on the tax return requesting details of lifetime gifts which would at least provide some information from those who have to self-assess.

Abolition of inheritance tax; reintroduction of capital gains tax on death

The objections to inheritance tax were discussed in Section 8.1. In Section 8.2 we could see some case for taxing wealth transfers. However, if the more radical prescription of a donee based tax is not implemented then it might be difficult to justify the retention of either the current inheritance tax, or one that is modified along the lines set out in Section 8.3.2.

Canada, Australia,⁷³ and Sweden⁷⁴ have abolished their estates and gifts taxes. New Zealand abolished its estate duty in 1999 but gift tax remains in place.

As noted in Section 8.1, the lobby group in favour of retaining inheritance tax has been less effective than the group in favour of abolition. One difficulty is in working out what inheritance tax should achieve. Is the aim to redistribute wealth or at least to reduce wealth inequality or one of 'fairness': that is, that someone who inherits £300,000 should not pay zero tax when someone who earns it pays 40%? Supporters of an inheritance tax tend to be divided in what they want: the IPPR called for reform of the current system (Maxwell (2004)) while other organizations such as the Fabian Society (Patrick and Jacobs (1999)) have suggested an accessions tax.

One option is to abolish inheritance tax completely. A way of recouping some of the lost revenue from a similar (but not the same) group would be to reintroduce capital gains tax on death (which was the case in the UK until 1971), along the lines seen in Canada.⁷⁵ It is argued that this is simpler⁷⁶

⁷³ Both federal states where the competition between states and the lack of a comprehensive federal estate tax gradually resulted in abolition.

⁷⁴ In 2005 inheritance and gift tax was abolished.

⁷⁵ Further details of the Canadian capital tax system see Appendix B of the additional online material (see footnote 2).

⁷⁶ The replacement of inheritance tax with capital gains tax was recommended by the Forsyth Commission in October 2006. It was taken up by the Conservatives in Economic Competitiveness

because there are no longer two capital taxes with different conditions and relief and therefore the possibility of double taxation or avoidance is reduced. Moreover, capital gains tax is seen as fairer because only the **gain** arising from the deemed disposal of the asset at death is taxed not the entire value.

However, it is important to note that the two taxes have different rationales and are certainly not mutually exclusive. It is far from clear why assets should be exempt from capital gains at death (as they are at present in the UK) just because they are subject to wealth transfer tax: the aim of capital gains tax is to ensure that capital gains are treated on a par with other forms of income such as dividends and interest which will already have been taxed as they accrue (and are also then subject to a wealth transfer tax). Wealth transfer taxation has different ends. However, removing the exemption from capital gains tax on death but retaining inheritance tax might not be seen as politically acceptable simply because it would make the double taxation more explicit. See pp. 789–90 and p. 809 for further discussion.

Issues to consider in connection with the reintroduction of capital gains tax on death

Should the family home continue to be exempt? This is the asset that currently brings those with moderate wealth into the inheritance tax net. Retaining principal private residence relief on a lifetime transfer of the family home but not on death transfers would be very distorting—people would dispose of their house into trusts or to children while alive to secure the tax free uplift. It might be argued that a principal private residence relief on death would encourage everyone to invest in property. However, it is not thought that distortions would occur in the same way as giving an inheritance tax exemption to the main residence. If the main residence is exempt from inheritance tax then clearly everyone will invest as much money as possible in a large house. The entire proceeds of sale are then tax free. By contrast if capital gains tax is imposed on death and principal private residence relief is maintained there is far less distortion. The incentive is just the gain rather than the proceeds; the gain may not necessarily be greater on a larger house. Moreover, if a person decides to invest more money in a larger house to secure the exemption he will have to sell other assets that do show a gain—and so the capital gains tax is paid earlier. If the money is held in cash there is no capital gains tax to worry about anyway. It might be argued that the elderly person may be forced to stay in his house to ensure a tax free gain rather than move into a nursing home and live off the sale proceeds where future gains could be taxable. However,

Policy Group, 'Free Britain to Compete: Equipping the UK for Globalisation', Submission to the Shadow Cabinet by Rt Hon John Redwood MP and Simon Wolfson, pub. on 17 August 2007.

the investment of such cash will not usually generate sufficient gains over the annual exemption to worry about the difference. The very wealthy may have an incentive to stay in their homes but they can have only one main residence.⁷⁷

Thresholds Should the same capital gains tax exemption operate on death as during lifetime or should there be a higher threshold? (£9,200 for 2007–08).

Reliefs What reliefs should operate for trading businesses and farmland? One option is to allow a rollover provision so that these assets pass on death to the heirs on a no gain no loss basis but capital gains tax is paid at the point of later sale. The extent of the deferral would need to be considered carefully since this could provide an incentive for assets to be retained indefinitely.

International issues If capital gains tax is introduced on death one needs to consider the international context. What is the connecting factor—domicile or residence? Furthermore, would there need to be a revaluation of the assets when the foreigner emigrates from another state and comes to the UK, as occurs in Canada at present? This would rebase the asset and might be regarded as fairer in that gains accruing in the period of non-residence would not then be taxed. Without the former, the tax would be a strong disincentive to immigration of wealthy individuals who would object to paying capital gains tax on assets that had appreciated during a period when they had no connection with the UK. Presumably there would also need to be an exit charge, otherwise older individuals could leave the jurisdiction just before death. However, an exit charge may produce problems under EU law.⁷⁸

Entities How will trusts be taxed given that they do not die and continue for many generations? This is a common problem when considering the capital taxation of trusts and could be solved in one of the ways suggested, for example, charging trusts every ten years or when assets are distributed from the trust or the trust ceases to exist.

In summary, the reintroduction of capital gains tax on death deserves further consideration but the issues would need to be thought through carefully.

⁷⁷ Some of the current loopholes which allow people ‘to elect’ for the relief on residences which are not their main residence as a matter of fact would need to be examined.

⁷⁸ See, for example, *De Lasteyrie du Saillant v Ministerie* [2004] 6 ITLR 666—a restriction which deters outward investment or outward movement potentially infringes the freedoms. Exit charges are not therefore generally permissible but a government may retain the right to tax an emigrant’s gains insofar as the asset is disposed of within ten years of emigration and the tax is only payable then *N v Inspecteur* (2006) Case c-470/04.

8.4. PROPERTY AND OTHER TAXES—REFORM OPTIONS

So far the focus has been on direct taxes levied on individuals based either on their general wealth holdings or on transfers of wealth to or from other parties. In practice, there are various other taxes on wealth or wealth transfers either levied indirectly or on specific forms of wealth.

8.4.1. Property taxes

Issues to consider

An annual tax on some measure of the value of real property is used by local governments in many countries. The tax can be levied on tenants as well as owner-occupiers as in the UK, or it can be charged only on property-owners as in other countries (US, Canada). When rates are proportional, it will not matter whether the tax is levied on the owner or the occupier since the economic incidence, at least in the long run, should be the same. The tax is regarded as a suitable source of local revenue because the base is relatively immobile and tax liabilities can be related to benefits received from local public spending. Ideally, the tax facilitates local accountability for revenues without compromising efficiency or equity in the national economy. There are a number of issues with respect to its role and design that we briefly mention here. It should be noted though that tax revenues on property in the UK amounting to 4% of GDP are the highest of all the OECD countries and therefore caution should be exercised before taxing property even further.⁷⁹

One particular issue arises when considering the apparent immobility of the tax base. The use of land values rather than property values is preferable when considering taxation since land is relatively more immobile than property.⁸⁰ This is because the taxation of land, unlike that of property, does not provide a disincentive for individuals to add to the value of their home through extensions and other such changes. However, while calculating the value of land might be more difficult, and potentially less transparent, than using market property values these problems do not seem insurmountable.

While the benefit tax argument is one rationale for the local use of property taxes, in fact there is no evident one-to-one relationship between property tax

⁷⁹ See OECD Economics Department Working Paper No. 301, 2001.

⁸⁰ By land values we mean the value of the property less the value of the building.

liabilities and benefits from public services. On the contrary, empirical studies have shown that property taxes and the quality of local schools are capitalized into property values, which would not be the case if higher property taxes were offset by greater benefits from local services. That being the case, the tax can be viewed as one of many tax instruments for raising general revenues, albeit at the local level. The literature on property tax has focused largely on its incidence, arguing that it combines features of a capital tax borne by owners of property more generally with features of an excise tax arising from differences in rates across localities (Wilson (2003)).

From the point of view of tax design, the property tax as it applies to individuals can be considered as a tax on the consumption of housing, or on its imputed return. As such, it undoes, somewhat imperfectly, the sheltering of imputed rents from owner-occupied housing in the personal tax base. Whether this is a good thing or a bad thing depends on one's views of the appropriate personal tax base. However, one aspect of incidence analysis takes on a special importance in the case of real property, especially that part of it consisting of land as opposed to buildings. If the market for property is forward-looking, expected future property taxes should be capitalized into property prices. This implies that initial owners of property effectively bear the burden of all expected future taxes (Feldstein (1977)). To the extent that this is true, it detracts from the value of property taxation as a component of a broader tax system. (Similar arguments might be made about wealth taxes more generally, at least to the extent that they apply to long-lived assets and their prices are not pre-determined as in the case of internationally traded assets.)

Property taxation typically also applies to business property, both commercial and/or industrial. To the extent that the tax does not reflect benefits obtained from the use of the funds, this amounts to a form of wealth tax levied on businesses at source that is not closely related to profitability. As such, it affects business investment decisions and competitiveness with foreign producers in a presumably inefficient way, except to the extent that the tax is simply absorbed into lower land rents. The inefficiency of business property taxes is also mitigated by the existence of residential property taxes. Given these, business property taxes might be justified on second-best grounds as a way of removing the incentive that might otherwise exist to convert residential land into business land. To the extent that concerns over the inefficiency of business property taxes are valid, they have implications for the use of the property tax, and more generally for the manner in which local government is financed. A way of avoiding excessive property taxes is to adjust the size of grants to local governments from higher levels of government,

taking care to do so in a way that preserves local accountability and avoids soft budget constraints.

Techniques now exist for tax administrators to maintain reasonably consistent, precise, and up-to-date estimates of property values, and to use those as a basis for annual taxation. There is thus no particular reason why property taxes cannot be based on estimated current property values, as opposed to historic values. Furthermore the use of actual property values, or at least relatively narrow bands of property values, rather than broader and therefore cruder property value bands is desirable. In some countries, property valuation is done by a higher agency, and local governments are given discretion for choosing their own property tax rates. Local choice is important because average property values can vary substantially across jurisdictions for a variety of reasons (demand for housing, amenity values, weather, etc.). Different localities will choose very different tax rates, even if they are providing comparable levels of public services. Indeed, for that reason, revenue-raising autonomy at the local level will typically be accompanied by some form of equalization to compensate for the fact that different localities have different abilities to raise revenues.

The rate structure for property taxes is typically more complicated than simply choosing a tax rate. Different rates may apply to different types or uses of property. Different rates may apply to residential, commercial, and industrial property, although the principles that should inform that choice are by no means clear. Newly developed property may face differential rates to cover part of the cost of infrastructure. And there may be some relief afforded to low-income property owners, such as by a system of credits delivered through the direct tax system or through a separate benefit (which might be important in countries, such as the UK, where the direct tax system operates on an individual basis and the benefit and tax credit system operates on a family basis). This may be particularly important for low-income individuals for whom the house is their main asset, such as retired individuals.

Property taxes in the UK and possible reform options

Since April 1993 the only significant local tax across all of England, Scotland, and Wales has been the council tax (with a different system operating in Northern Ireland).⁸¹ Properties are placed into one of eight broad bands (nine in Wales) based on a measure of their value in 1991 (in England and

⁸¹ The structure of council tax is outlined in more detail in Appendix A of the additional online material (see footnote 2).

Scotland) or 2003 (Wales). It is forecast by the Treasury to raise £22.5 billion in 2006–07 (1.7% of national income), net of the outgoings on council tax benefit.

Business rates—or National Non-Domestic Rates—are levied on the annual rateable value (i.e. market rent) of the property occupied by business. Unlike council tax bandings, rateable values have been updated every five years with transitional arrangements smoothing gains and losses from the old to the new valuations. Some types of property are exempt or qualify for a reduced rate—for example some unoccupied buildings, agricultural land, and rural shops—and a reduced rate applies to businesses with a low rateable value. Charities receive a reduction or exemption in business rates. The Treasury forecasts that in 2006–07 it will raise £21.5 billion (1.6% of national income).

Improvements could be made to both council tax and business rates. Both are currently based (albeit loosely in the case of the council tax) on the value of the property (full or rental for council tax and business rates). It would be preferable if both tax bases could be moved to the taxation of the value of the **land** rather than that of the **property** so as to remove the distortion against making improvements (again, as noted above, while there may be some complications involved in calculating land values these should not be insurmountable).

To the extent to which taxes on business property are retained, careful consideration should be given to whether the reliefs that exist really are well-targeted at a sensible objective. While a lower rate for rural shops might be appropriate on environmental or distributional grounds, reduced rates for empty property, charities, and agricultural land seem harder to justify, and in all these cases it is far from clear that business rates are the best instrument to achieve these objectives. Unlike business rates, the existing council tax does not have regular revaluations and is based on banded rather than continuous valuations. Council tax could also be improved by moving to regular revaluations and the use of actual values rather than banded values (either based on property value, or preferably as discussed above, land value). This is an attractive feature of the system introduced from April 2007 in Northern Ireland and a similar reform in the rest of the UK would be welcome. If the actual value is used, a key decision is whether or not to have a simple linear tax rate. Given that the UK housing stock is valued at around £3,800 billion, an annual tax rate of around 0.56% would raise sufficient funds to cover the £22.5 billion that council tax currently raises (while retaining council tax benefit). Alternatives range from one that is capped (which is also a feature of the Northern Ireland system), to one that is progressive which would be one

effective way of taxing high wealth individuals if such an outcome is deemed attractive. So, for example, higher rates of tax could be charged on properties (or land) worth over £500,000, £1 million and £2 million.⁸²

Other potential attractions in having a higher rate of council tax include the fact that it is easily observed and likely to be positively correlated with wealth and capital income that may not be easily observed. If the threshold is high, it is a charge that may fall mainly on those living in central London though the threshold like the tax rates could vary by locality. The council tax is also relatively simple to collect since it can be imposed on the occupant of the property irrespective of how it is owned. Switzerland has an accommodation related charge of this kind in relation to foreigners living there. An alternative to this approach would be to have a separate tax on the occupation of high value housing that was not integrated into council tax—for example if it were deemed appropriate that this should not form part of the local tax base.

One important concern with any property based tax is that any such tax is likely to be incident fully on the current owners of these properties. Future residents of these properties would probably not face the incidence of the tax—rather they would be likely to be able to purchase or rent the property at a lower cost that reflects the payment of tax.

8.4.2. Stamp duties

Taxes on specific forms of asset transactions are used in many OECD countries. Many countries, including the UK, impose stamp duties on property transactions. The rate of duty may be related to the value of property. In the UK, stamp duties also apply to sales of shares in UK corporations regardless of where the transaction takes place and who does the transacting. The tax is proportional and based on the value of the transaction. The Treasury estimates that stamp duties will raise £12.7 billion in 2006–07 (1.0% of national income). In 2005–06 two-thirds of the revenue raised came from the sale of land and property and one-third from the sale of shares and bonds.

The argument for stamp duties is not at all clear, apart from a cost efficient revenue-raising motive. One might argue that the tax is a user charge to offset the costs to the state of maintaining ownership records in the case of real

⁸² The Liberal Democrats proposed a wealth tax on properties worth more than £1million in 2006. Recent studies on reactions to land taxes suggest that people were concerned about ability to pay—see Prabhakar (2008).

property or regulating the market for shares. However, the revenue raised far outweighs the costs. Presumably asset transactions of all sorts benefit from the general property rights and contracting laws enforced by governments. It is not clear why certain types of asset transactions should be singled out for a tax.

There are a number of drawbacks to stamp duties. Most important, they discourage asset transactions and therefore hinder the efficiency of asset markets. They may also discourage asset owners from investments that increase the value of their assets. In the case of share transactions, the stamp duty particularly hurts firms requiring finance for marginal projects by imposing a charge that is not related to profits. And, if, as in the UK, the duty applies only to shares of locally incorporated firms, it makes takeovers and mergers with non-UK firms more attractive (Hawkins and McCrae (2002)). For these reasons, there is a case for eliminating the stamp duty and making up the revenues from other sources, although it might be argued that this will create a windfall gain for existing asset owners to the extent that expected future taxes are capitalized into asset values. Perhaps this would be more politically palatable if it were done at the same time as reform of the wealth transfer tax to the extent that increases in the latter are seen as affecting roughly the same individuals who would obtain stamp duty relief. In practice this looks difficult to demonstrate since people who move house are not necessarily those who will inherit wealth.

There is currently no stamp duty or SDLT imposed in the UK on transfers of wealth (with a few limited exceptions⁸³) since these are by definition gifts. The argument for an additional stamp duty charge on transfers of wealth such as gifts of land (assuming that existing transfers of wealth are taxed) is not at all clear, apart from a revenue-raising motive.

In the UK, stamp duty land tax is set at different rates according to the value and type of the property.⁸⁴ If stamp duty is to be retained (and given how much revenue it raises with low cost this seems inevitable) then several of these features could be improved. The fact that the rate applies to the whole value of the property rather than the value above the last band causes distortions to the purchase price of properties. It also means that there is sometimes a very strong incentive for buyers and sellers of properties to collude to arrange a lower price for the property and a corresponding higher separate payment for the fixtures and fittings in order to evade the tax, which leads to the authorities having to engage in costly policing activities. A marginal rate

⁸³ Such as gifts of land to connected companies, i.e. broadly companies controlled by the donor.

⁸⁴ Further details are provided in Appendix A of the additional online material (see note 2).

structure would eliminate this first problem and should reduce the second. Furthermore there is very little justification for differences in the thresholds between different types of properties and, in particular, different parts of the country. Stamp duty land tax does not seem an appropriate instrument for tilting land use towards non-residential rather than residential use; council tax and business rates would seem a more obvious way of doing this, nor is it an appropriate tax to try to carry out redistribution. These features also complicate the tax system unnecessarily. In practice given its yield and the need to raise £14 billion by other means it is unlikely SDLT will be abolished in the near future.

8.4.3. Other taxes at death

At the time of death, other taxes may be triggered. In most tax systems, capital gains are taxed on a realization basis, that is, no tax is due until the asset is sold or otherwise disposed of. Most countries with an estate tax on death do not also charge capital gains tax and some such as the UK and US have an uplift to market value at death so eradicating gains but imposing estate tax on death. It would be possible to impose capital gains tax on death as well as inheritance tax or for the property to change hands on a no gain no loss basis. The transferee then pays the tax when there is a later sale after death (see Section 8.3.2 for options).

At present the UK subjects most lifetime gifts (other than gifts to spouses or civil partners) to capital gains tax since such disposals are deemed to take place at market value, but lifetime gifts are generally free of inheritance tax; transfers on death (other than to spouses and civil partners) are subject to inheritance tax and unrealized gains are wiped out. In other words, the UK seems to regard inheritance tax and capital gains tax as alternative taxes.

Taxing capital gains on death or indeed on lifetime transfers of wealth might be regarded as double taxation if the asset is also subject to an inheritance tax, especially if it is levied on the estate rather on the heir's inheritance. But, from a welfarist point of view, taxing fully the income or gains of donors while also taxing inheritances received by heirs is consistent. The double taxation is a feature of wealth taxation itself, rather than being due to the realization of capital gains. However, imposing capital gains tax on death would highlight the double tax argument, which in practice might make the introduction of capital gains tax on death alongside a retained inheritance tax (or other tax on wealth transfers) unlikely.

8.5. CONCLUSIONS

It is clear that the current system for taxing wealth in the UK cannot be sustained and is justly unpopular. Inheritance tax is complex and inequitable; those who are wealthiest have the greatest ability to avoid the tax. A disproportionate burden appears to fall on those who are moderately wealthy. The current system provides an incentive to make lifetime gifts, but this favours those with abundant non-housing wealth and may not always be in the best interests of the elderly donor who retains insufficient savings.

The current UK inheritance tax raises relatively little revenue compared with other taxes, does not appear to redistribute wealth (itself a controversial aim), and is increasingly inequitable given the current mobility of wealth and labour. It can be avoided by (generally wealthier) individuals who can make lifetime transfers or emigrate permanently to low tax jurisdictions, or those whose domicile remains non-UK. In other words, the negative effects of inheritance tax outweigh the supposed benefits. Administrative and compliance costs are high compared with some other taxes such as corporation tax and stamp taxes.

Proposals tend to range from a reform of the current regime or the introduction of a completely new system of taxing transfers of wealth such as the move to a comprehensive 'donee based' tax which would also tax lifetime gifts. However, the objectives of taxing wealth transfers are often highly political and therefore difficult to agree: should the aim be to promote vertical equity—to redistribute from rich to poor—or to promote horizontal equity—to tax similarly placed individuals in the same way? If there is no political consensus on how to tax wealth then any system that taxes transfers of wealth is unlikely to work as intended since people will simply delay transfers until a change of government (as appeared to occur under the capital transfer tax regime). Hence it is important to obtain some political consensus on how to tax wealth transfers because the system can only work effectively if it operates consistently over the lifetime of an individual. One of the problems with capital transfer tax and inheritance tax is that its effect has been rather arbitrary. Someone dying in 1978 would have paid considerably more inheritance tax on the same wealth in real terms than someone dying in 1989 and would have had far fewer opportunities to pass it on tax free.

We take the view that a wealth tax is not sufficiently justified and dismiss this option apart possibly from a tax on occupation of high net value property which should be considered further. Many of the advantages of a

wealth tax can be achieved by the taxation of capital income at appropriate rates within the personal tax system. A wealth transfer tax may have some justification based on the principles set out in Section 8.2 but these depend on a variety of principles which do not conclusively favour one particular system or the retention of a wealth transfer tax at all. If a wealth transfer tax is to be retained then a donee based tax combined with some reform of reliefs and rates, and the reintroduction of capital gains tax on death remains our preferred option particularly if political consensus over such a reform can be achieved. However, it could be that the payment of capital gains tax as well as inheritance tax on death is not politically feasible as it would make the double taxation created by any tax on wealth or wealth transfers very explicit.

If alternatively the current system of inheritance tax is to be retained, then it could certainly be improved. We set out in Section 8.3.2 some points that should be considered as the minimum required for improvement, although these would probably reduce the net yield further. As a result, making even these limited improvements to the current system of inheritance tax may not be preferable to the relatively straightforward reform of abolishing inheritance tax and reintroducing capital gains tax on death (without any wealth transfer taxes).

Therefore if a radical shift to a donee based wealth transfer tax is not deemed appropriate then the imposition of capital gains tax on death imposed only on **gains** not on the entire value should certainly be explored further and wealth transfer tax should be abolished. Now that capital gains tax has been simplified and is at a flat 18% rate, such a change would be relatively easy to implement although a number of issues such as emigration reliefs, and deferral of payment where the asset is illiquid would need to be considered carefully. It is only worthwhile doing this if some political consensus can be obtained but given the recent simplification of capital gains tax this may be inappropriate to consider. It is likely to be more acceptable than inheritance tax in that it is a tax on gains and is not double taxation. The rates are lower (18% compared with 40%), there would be no nil rate band of £300,000 so the yield may not be lower. See Section 8.3.2 for further details.

Finally, reform of the inheritance tax system is not independent of tax reform more generally. For example, the use of an investment income surtax as a surrogate for wealth taxation could not be introduced without regard to taxation of capital income in the rest of Europe. Similarly, the introduction of capital gains tax on death needs to be considered carefully where individuals are much more mobile, particularly within Europe. An exit charge may not be easy to enforce where individuals emigrate to another European country.

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Commentary by Helmuth Cremer*

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1. INTRODUCTION

Taxes are rarely popular, but wealth transfer taxes appear to be particularly and increasingly unpopular. A number of countries are already without an inheritance or an estate tax or, as in the case of France, have dramatically reduced its scope. Some others, including the United States, contemplate to phase it out.

Clearly, death taxation more than any other generates controversy at all levels: political philosophy, economic theory, political debate, and public opinion. Opponents claim that it is unfair and immoral. It adds to the pain suffered by mourning families and it prevents small businesses from passing from generation to generation. Because of many loopholes, people of equivalent wealth pay different amounts of tax depending on their acumen at tax avoidance. It hits families that were surprised by death (and it is therefore sometimes called a tax on sudden death). It penalizes the frugal and the loving parents who pass wealth on to their children, reducing incentive to save and to invest.

Supporters of the tax, in contrast, retort that it is of all taxes the most efficient and the most equitable. They assert that it is highly progressive and a counterweight to existing wealth concentration. They also argue that it has few disincentive effects since it is payable only at death and that it is fair

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since it concerns unearned resources. For a number of social philosophers and classical economists, estate or inheritance taxation is the ideal tax.

The truth probably lies between these two opposite camps. For economists this tax like all taxes should be judged against the two criteria of equity and efficiency to which one could add that of simplicity and compliance. Public economics (and more specifically taxation theory) provides a well-defined and rigorous framework to examine these issues. There exists by now a wide body of literature, some of which goes back to the pioneering age of optimal taxation models, while other contributions are newer and rely on recent developments in economic theory (like the modelling of multidimensional asymmetric information).

In their chapter Robin Boadway, Emma Chamberlain, and Carl Emmer-son (BCE) do mention this literature (which they refer to as the ‘welfarist’ approach), but only briefly and in a somewhat caricatural way. This is quite in line with their view that ‘the results are agnostic’. Instead, they use a different approach both when they discuss the ‘economic principles of wealth and wealth transfer taxation’ (Section 8.2) and when they consider design and administration issues (Section 8.3). These ‘non-utilitarian criteria’ include a variety of issues such as paternalism, equality of opportunity, externalities, status (provided by wealth), enforcement, and political support. Summarizing this wide range of arguments in a few paragraphs (or pages) would certainly fail to give them proper credit and I shall abstain from such an exercise. In any event, I am not convinced that a sequence of arguments based on general principles (like vertical and horizontal equity, equal opportunity, the pursuit of efficiency, and the avoidance of administrative cost, etc.) can give us a lot of guidance for the design of tax systems. Consequently, I will elaborate a little further on the optimal tax approach and try to make its results less agnostic. In particular, I will examine what this literature has to say about the main conclusions drawn by BCE and presented in their Section 8.5. My review of the literature draws heavily on a survey by Cremer and Pestieau (2006) which the current version of BCE highlights in Box 8.1.¹

I am not quite sure how to interpret BCE’s recommendations. From what I can see they recommend against wealth taxation which they argue should be abolished. However, it is not entirely clear to me how this relates to the arguments presented in the body of the chapter. As far as wealth *transfer* taxes are concerned they plead either for ‘a reform of the current regime or the introduction of a completely new system...such as the move to a comprehensive accessions tax which would also tax lifetime gifts’.

¹ I will provide only a minimal number of references here; detailed references are provided in Cremer and Pestieau (2006).

An important lesson emerging from the literature is that the appropriate tax structure depends on the relevant bequest model. One model states that bequests are simply an accident. People do not know how long they will live and so they keep more money than they turn out to need. If a significant share of bequests are accidental, estate taxation is quite efficient. However, if people are motivated to work and to save by the idea of leaving their families an inheritance, the tax will be distortionary. The impact of the distortion will depend on the bequest motive. If people have a specific amount they wish to leave to their children regardless of their needs and their behaviour, the outcome will be different from what it would be if the amount bequeathed is determined by a concern for the welfare of the heirs. Either way, it turns out that wealth and wealth transfer taxes are useful instruments in most cases. A zero tax is called for only in an extreme case, when individuals are perfectly altruistic (so that they effectively behave as if they were to live for ever). Even then, the result only holds in the steady state. This is true when only efficiency matters but also (and even more so) when redistribution is introduced.

The commentary deliberately adopts a theoretical and normative view. It studies how transfers between generations ought to be taxed along with other tax tools and according to some welfare criterion. The findings have to be qualified by a number of considerations including enforcement and political feasibility and most of the other issues discussed by BCE. From that perspective, BCE's analysis is a useful complement to the traditional optimal tax literature but it cannot replace it.

The rest of this commentary is organized as follows. Section 2 presents a brief overview of alternative bequest motives. Next, Section 3 focuses on efficiency aspects and views wealth and wealth transfer taxes purely as revenue raising devices. I examine the optimal tax structure under alternative models. Section 4 introduces inequality and the redistributive role of wealth transfer taxes.

2. BEQUEST MOTIVES

The role of gifts and estate transfers and their appropriate tax treatment depends on the donor's motives, if any. First of all it is possible that there is no bequests motive at all so that bequests are unplanned or accidental and result from a traditional life-cycle model. Accordingly, people save during their working lives in order to finance consumption when retired. Bequests occur solely because wealth is held in a bequeathable form due to imperfections in

annuity markets or the need to have precautionary savings. Either way, with that form of bequest, estate taxes (even at a rate of 100%) should not have any disincentive effect.

With regard to the *planned* bequests, several motives have been suggested in the literature.

2.1. Pure dynastic altruism: altruistic bequest

Parents care about the likely lifetime *utility* of their children and hence about the welfare of their descendants in *all* future generations (because the children in turn care about their children). Pure altruism may give rise to the Ricardian equivalence which occurs when parents compensate any intergenerational redistribution through matching bequests.² Observe that this form of altruism is ‘non-paternalistic’ in the sense that parents respect their children’s preference ordering. They care about their children’s utility and not (directly) about their consumption, income, leisure, and so on.

2.2. Joy of giving or paternalistic bequest (bequest-as-last-consumption)

Parents here are motivated not by pure altruism but by the direct utility they receive from the act of giving. This phenomenon is also referred to as ‘warm glow’ giving.³ It can be explained by some internal feeling of virtue arising from sacrifice in helping one’s children or by the desire of controlling their life. In rough terms this amounts to considering bequests as a good ‘consumed’ by the parents and contributing to their welfare. A crucial element is whether what matters to the donor is the net or the gross of tax amount.⁴

2.3. Exchange-related motives: strategic bequests⁵

Exchange-related models consider children choosing a level of ‘attention’ to provide to their parents and parents remunerating them in the prospect of bequest. The exchanges can involve all sorts of non-pecuniary services and they can be part of a strategic game between parents and children.

² Barro (1974).

³ Andreoni (1990).

⁴ One can argue that ‘warm glow’ and paternalism differ from that perspective. Specifically a warm glow donor can be expected to care about the gross (before tax) gift or estate while this is not necessarily true under paternalistic altruism.

⁵ Bernheim et al. (1985).

3. EFFICIENCY

Let us for the time being abstract from issues of redistribution and concentrate on the efficiency aspect. In other words, the different taxes are merely viewed as revenue raising devices. The underlying question is then how to raise a given tax revenue in the 'least costly' way. I follow Cremer and Pestieau (2006) who provide an overview of the taxation of capital income and wealth transfers and show how the answer depends on the underlying bequest motive.

The general result that emerges (except in the steady state under pure altruism) is that taxes on wealth and wealth transfers should not be equal to zero. The highest tax rates emerge under accidental bequests. When individuals do not care about the bequest they may leave and accumulated wealth only to smooth consumption over time or for precautionary motives, a tax on bequest has no impact on savings. Consequently, it is not surprising that accidental bequests should be taxed at a high rate (possibly at 100%).

A similar conclusion emerges when transfers are motivated by joy of giving and when the donee only cares about the gross (before tax) bequest. However, when the (paternalistic) donee cares about the after tax transfer, or when bequests arise from exchange (bequest for attention), a more complex picture arises. Tax rates now depend on elasticities according to Ramsey (or rather Atkinson and Sandmo (1980)) type rules. In rough terms, the more responsive a variable is to its price, the less it should be taxed. Bequests may now be subject to a 'double tax': first, the one on savings and then the specific tax on wealth transfers. Interestingly, the specific tax on transfer is, however, not necessarily positive! For instance, in the exchange scenario when demand for attention is more elastic than future consumption we obtain a negative specific tax on bequests. While the exact magnitude of tax rates is to some extent an empirical issue it is clear that the tax rates on planned bequests will not be anywhere near the high rate on accidental bequests. This has interesting implications in practice because it justifies a lower tax on *inter vivos* transfers (which are by their very nature not accidental) than on transfers at death. Similarly, it suggests that any explicitly planned form of transfer at death (like life insurance) should be taxed less heavily than other forms of bequest.

Taxes on capital may also be used to control the level of capital accumulation. This issue is often neglected in the literature by assuming that the government has other instruments to secure the appropriate level of capital accumulation. For instance, it is frequently assumed that public debt can be used to secure the modified golden rule. When this is not the case,

the analysis becomes more complicated. But this does not strengthen the case for leaving wealth (or wealth transfers) untaxed. Interestingly, in an overlapping generations model, insufficient capital accumulation does not necessarily call for a reduction in the tax rate on wealth or capital income. This is because saving depends not only on the interest rate but also on earnings.⁶

Finally, when bequests are motivated by pure altruism, the Chamley–Judd result implies a zero tax on capital.⁷ However, this result relies on strong assumptions and it applies only to the steady state. During the transition period wealth transfers and capital income are subject to taxation.⁸

The literature tends to concentrate on a single bequest motive at a time. In reality, however, we can expect all these motives to coexist. Taxation under mixed bequest motives has received less attention in the literature. However, since each of the coexisting bequest motives (except possibly one) calls for a non-zero tax on capital, one cannot expect that the optimal policy involves a zero tax. The few studies there are confirm this basic intuition. But this point certainly deserves further investigation.

How do these findings compare with BCE's recommendation? First, they do not support the claim that wealth taxes should be dismissed altogether. The theoretical optimal tax literature does not tell us precisely at what level wealth taxes should be set; this is an empirical question. However, what the literature tells us is that instrument of wealth taxation should not be given up altogether. Second, regarding the taxation of wealth transfers, they suggest a more complex structure of tax rates than that advocated by BCE. A bequest is not just 'consumption' or 'income' and wealth transfers should typically be taxed differently from consumption that occurs late in the life cycle. Finally, the analysis shows that to study a wealth transfer tax one cannot leave out the issue of wealth income taxation. The determination of optimal tax rates requires an integrated treatment of the tax mix.

4. EQUITY AND REDISTRIBUTION

Up to now, the discussion has focused on efficiency issues. However, it is clear that aspects of fairness and redistribution are at least potentially important to assess the role of wealth and wealth transfer taxes. To introduce redistributive concerns, one can simply revisit the setting considered in the previous section

⁶ Atkinson and Sandmo (1980).

⁷ Chamley (1986), Judd (1985).

⁸ See e.g. Saez (2002).

and allow for heterogenous individuals. It is then clear that the optimal tax rules will have to be amended. Roughly speaking, we move from simple Ramsey rules to ‘many households Ramsey’ rule that account for the redistributive properties of the different forms of wealth taxation. However, this exercise does not address the main question namely whether taxes on wealth and/or wealth transfers are the appropriate instruments to be used in the first place. It is by now well known that Ramsey type models which rely on linear (proportional) taxes may artificially create a role for some instruments. This is because they restrict labour income taxes to be linear even though there is no theoretical or practical argument to justify this assumption (except that it makes the model easier to solve). In practice, labour income taxes are levied according to sophisticated non-linear schedules. Atkinson and Stiglitz (1976) have shown that these restrictions on labor income taxes may artificially create a role for differential commodity taxes (and a tax on capital income is from a lifetime perspective a non-uniform consumption tax where future consumption is taxed more heavily).

To understand the implications of this for the subject matter of this commentary, I will consider a simple thought experiment. It is admittedly oversimplified but it allows us to avoid the technicalities of optimal tax models.⁹ Consider a world where individuals differ only in their productivity (their wage or more generally their ability to make money by supplying their labour). To make the problem realistic (and interesting) let us assume that productivity is not publicly observable. For the rest, all individuals are identical; they are all born with the same initial wealth (if any) and have the same preferences (including the discount rate), life expectancies, and so on. As individuals grow older their wealth will, of course, differ. However, this heterogeneity is solely due to the accumulation of past labour income. In such a world, a well-designed tax on labour income is sufficient and other taxes are not needed.¹⁰ In particular, taxes on wealth, or wealth income, are redundant. In rough terms, taxing wealth is just an indirect way of taxing past earnings (which have already been taxed) and the observation of wealth does not give us any new information.

The picture changes dramatically when individuals differ in more than one dimension. In other words, individuals differ not only in productivity but also in discount rates, longevity or initial (inherited) wealth. Particularly interesting from our perspective is the case where individuals differ in the

⁹ For a more detailed discussion, see Cremer and Pestieau (2006).

¹⁰ See Atkinson and Stiglitz (1976). To get the results some additional technical assumptions are necessary. We neglect them to concentrate on the main issue. The full implication of the Atkinson and Stiglitz result are also discussed by Cremer (2003).

bequest they have received which has been studied by Cremer et al. (2003). Consider first the case where bequests are not observable and thus cannot be taxed. Now, at a given age, individuals with identical productivity will have different levels of wealth. Not surprisingly, it is then no longer true that a tax on labour income is sufficient. The optimal policy now involves taxes on both labour and capital incomes. This is because making taxes dependent on capital income permits a better screening for the unobservable individual characteristics. Cremer et al. (2003) concentrate on the case where transfers are motivated by 'joy of giving' and when there is no correlation between wealth and productivity. In that setting the optimal tax is non-zero. When the joy of giving term is counted in social welfare the tax is necessarily positive. However, when there is laundering a negative tax cannot be ruled out. Interestingly though, the tax is more likely to be positive when we introduce correlation between productivity and wealth. And with perfect correlation it is always positive. To sum up, unobservable bequests introduce the need for wealth taxation especially when there is a positive correlation between wealth and productivity.

On the other hand, if bequests are observable they ought to be taxed. In the specific setting (with correlation) considered by Cremer et al. (2003), the appropriate tax is of 100%. A less extreme solution emerges when bequests are only imperfectly observable or when there are incentive effects. Then the optimal tax mix involves a tax on bequests (of less than 100%) along with taxes on labour and capital income. Intuitively this does not come as a surprise. When inequality is due in part to bequests, wealth (wealth income), and wealth transfers should be taxed.

In reality, the sources of heterogeneity go beyond those discussed by Cremer et al. (2003). Individuals also differ in their longevity, their time preference, and so on. This can only reinforce the role of wealth and wealth transfer taxes in the optimal tax mix. On these issues, the literature remains incomplete and there are plenty of open questions (some of which are discussed in Chapter 6 by Banks and Diamond).

To sum up, heterogeneity in several dimensions along with redistributive concern do provide a rationale for the taxation of wealth and wealth transfers. In a world of asymmetric information, where individuals differ not only on productivity, a tax on labour income (or equivalently a consumption tax) however well designed and sophisticated is not sufficient.

While BCE's analysis deals with a number of related issues (and in particular the issue of equality of opportunity), the optimal tax/multidimensional heterogeneity aspects do not appear to receive a lot of attention. As my discussion suggests, they are not just important to justify the existence of

wealth transfer taxes but they are also of crucial importance for their design. Specifically, it does not appear to be possible to disconnect the study of wealth and wealth transfer taxes from that of other taxes (and particularly income taxes). Their design has to be determined as part of an integrated study of the tax mix.

5. CONCLUDING COMMENTS

To sum up, the pure efficiency approach does justify the use of wealth and wealth transfer taxes. This is an empirical question and it depends in particular on demand elasticities (for savings and bequests). We can expect the tax to be the higher the larger the proportion of accidental bequests. When individuals are heterogeneous, wealth taxes are a useful instrument as long as individuals differ in more than one dimension. Whether the tax is positive or not depends on the issue of laundering (which may be considered as a technical point) but more interestingly on the degree of correlation between the characteristics. For instance, when individuals differ in productivity and wealth or in productivity and longevity, a positive wealth tax arises when the productive tend to have more wealth (or live longer).

My comments take a normative view and ask if wealth and wealth transfers ought to be taxed in order to maximize social welfare (given the information structure). Even though some issues remain open it seems to me that the literature I have reviewed overall makes a case for a positive answer to this question.

All these results are to a large extent at odds with the fact that wealth transfer taxes are very unpopular. There are, of course, a number of political economy issues I have neglected. For instance, there is the issue of avoidance and enforcement which does lead to a strong departure from horizontal and vertical equity. In addition, there is the phenomenon of tax competition which can put a downward pressure on wealth taxes. BCE do provide a comprehensive and nice discussion of many of these issues but it is not clear how this translates into precise policy recommendations (except maybe when it comes to arguing that wealth taxes ought to be cancelled). In any event, it does not seem to me that the political and enforcement arguments provided here and by BCE are suitable to tell the whole story. How, for instance, can we explain that very rich people are often in favour of estate taxation while many middle classes (whose wealth is below the million dollar benchmark under which the estate is exempted) oppose it? More work is needed on these issues.

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Commentary by Thomas Piketty

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This commentary offers a personal perspective on wealth taxation in the twenty-first century. Wealth taxation has been the subject of substantial policy action in recent years, with the implementation of large inheritance tax cuts in several OECD countries (e.g. US, Italy, UK, France). More generally, I believe that the issue of wealth and wealth transfer taxation is very likely to play an important role in the public finance debates of the coming decades, for at least two reasons: a theoretical reason, and an empirical/historical reason.

Let me start with the theoretical reason. In spite of the voluminous existing literature, the current state of optimal capital taxation theories is wholly unsatisfactory, and one can (hopefully) expect major developments in the future. Existing theories of optimal labour income taxation, as pioneered by Mirrlees (1971) and recently reformulated by Diamond (1998) and Saez (2001), are in a relatively satisfactory state. They offer formal models and optimal tax formulas that can be calibrated with estimated labour supply elasticities and other parameters (in particular the shape of the labour income distribution) and that can be used to think about the real world and possible tax reforms. These theories are of course imperfect and still need to be improved. But at least they provide normative conclusions about optimal tax rates levels and profiles that are not fully contradictory with what one observes in the real world. For instance, the Diamond–Saez U-shaped optimal profile of marginal rates is observed in most countries (i.e. effective marginal rates tend to be higher for low income and high income groups than

for middle income groups), for reasons that are probably to a large extent identical to those captured by the theory (i.e. it is less distortionary to have high average rates but moderate marginal rates on high-density middle income groups). The Diamond–Saez formula for asymptotic marginal rates is also remarkably simple and delivers results that are relatively reasonable.¹ Needless to say, wide disagreements still exist about the level of desirable labour income tax rates—in particular because of persisting disagreements about labour supply elasticities. But at least existing theories of optimal labour income taxation do offer a useful basis for an informed policy discussion.

Nothing close to this exists regarding theories of optimal capital taxation. To put it bluntly, existing models are completely off-the-mark if one tries to use them to think about real world capital taxation. For instance, most models prescribe 100% capital tax rates in the very short run and 0% capital tax rates in the very long run. How can one apply these results to the real world? Is today the short run or the long run? These extreme conclusions reflect inherent difficulties in the modelling of time and the choice of a proper time frame to study these issues. In the short run, capital income is viewed as a pure rent coming from past accumulation, so that the existing capital stock should be taxed at a 100% rate. In the long run, the elasticity of savings with respect to the net-of-tax interest rate is typically infinite,² so that even dynasties with zero-capital-stock would suffer enormously from any capital tax rate larger than 0% (i.e. even an infinitely small tax rate would have enormous, devastating effects). Unlike labour supply, capital accumulation is an intrinsically dynamic phenomenon, and economists have not yet found the proper way to develop useful dynamic models of optimal capital taxation, that is, models that can be used for an informed policy discussion.

Another major theoretical difficulty that needs to be addressed has to do with the necessity to distinguish between corporate profits taxation and household capital income taxation. In standard theoretical models both concepts are identical, but in the real world they are not. In order to address this issue, one would need to integrate a proper theory of the firm and retained earnings (as well as a theory of the real estate capital sector) into models of optimal capital taxation. Finally, one needs to introduce new theoretical ingredients in order to distinguish between capital taxation and capital

¹ For example, an uncompensated labour supply elasticity of 0.5, zero income effects and a Pareto parameter of 2 for the distribution of top labour incomes imply an optimal top marginal rate of 50%.

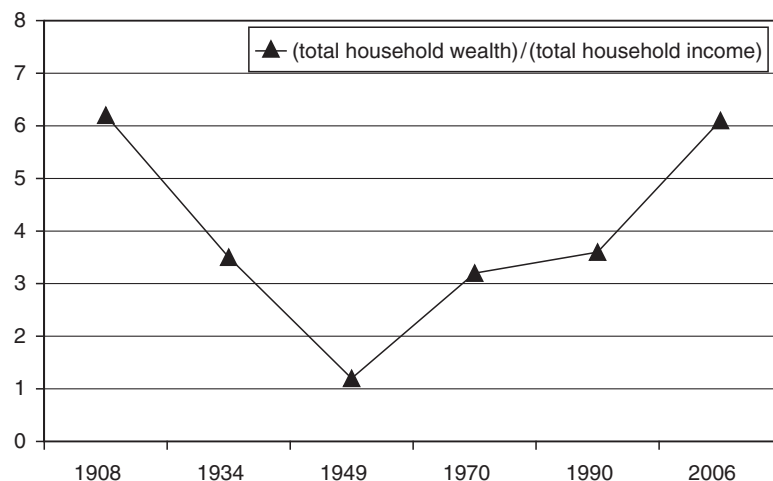
² e.g. in standard dynastic models, this follows immediately from the golden rule of capital accumulation, which requires the marginal product of capital to equate to the rate of time preference in the long run.

income taxation. In standard theoretical models, all agents obtain the same rate of return on their capital stock, so that both forms of taxation are fully equivalent. But in the real world they are not. In particular, the central—and fairly reasonable—political argument in favour of capital taxation has always been that taxing the capital stock (rather than the income flow) puts better incentives on capital owners to obtain high return on their assets. In order to address this issue, one would need to develop a model with heterogeneous returns to capital (presumably depending on effort put in by the capital owner, among other things). Capital taxation theory faces major difficulties and is still in its infancy. This is one of the main shortcomings of current economic theory. It seems likely (and highly desirable) that progress will be made in the coming decades.³

Second, and maybe more importantly, the issue of wealth taxation is likely to be a big issue in the future simply because wealth is going to be a big issue in the coming decades. In most OECD countries, and especially in Continental Europe, aggregate (household wealth)/(household income) ratios have increased substantially since the 1970s, with an acceleration of the trend since the 1990s. This is certainly a complex phenomenon. To some extent, it is simply due to the rise of asset prices (both property prices and share prices), which in a number of countries were historically low between the 1950s and the 1970s, and have increased enormously since the 1980s–1990s. In countries strongly hit by the twentieth century's World Wars (especially in Continental Europe), the rise of the wealth/income ratio also seems to reflect a long-term recovery effect. For instance, Figure 1 shows that the aggregate (household wealth)/(household income) ratio in France was around 6 at the eve of the First World War, fell as low as 1–1.5 in the aftermath of the Second World War, and then went back up again to around 3 in 1970 and 6 in 2006. Note that there is no strong theoretical reason why the long-term, steady-state wealth/income ratio should be stationary along the development process: it could go either way. However, this kind of long-term picture does suggest that the recent rise of wealth/income ratios is at least in part a structural phenomenon, that is, the capital accumulation patterns of cohorts hit by the wars were severely disrupted, and it took several generations to recover. Capital accumulation takes time.

It would be surprising if the kind of evolution depicted in Figure 1 had no long-term impact on the observed tax mix. On purely *a priori* grounds, the main impact of such an evolution should be to push the tax mix in the direction of greater reliance on capital taxation (broadly speaking), at least in

³ This (very) brief review does not do full justice to the extensive recent literature on optimal capital taxation theory (surveyed by Banks and Diamond in Chapter 6). However, it is fair to say that existing models so far do not provide plausible conclusions about optimal capital tax rates.



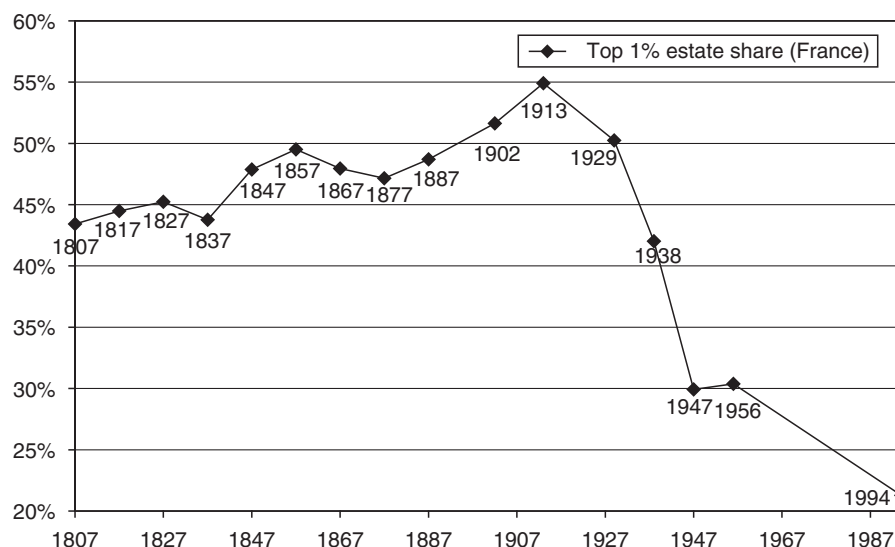
Source: Author's computations based upon Piketty (2003) and National Income and Wealth Accounts (INSEE).

Figure 1. The wealth/income ratio in France, 1908–2006

absolute terms. Other things equal, the share of capital tax revenues in total tax revenues should go up when the aggregate capital/income ratio goes up. It is hard to think of a normative model or a political economy model in which the rise in this ratio would be more than offset by a decline in tax rates on capital relative to other tax bases.

Note, however, that it would be misleading to make predictions about the future tax mix solely on the basis of the aggregate capital/income ratio. Many other effects are at play, for example, the changing distribution of wealth. In most political economy models, a less concentrated distribution of wealth would tend to make the median voter (or whoever is in power) less inclined to tax wealth heavily. If the wealth distribution became less and less concentrated, this could possibly undo the effect of rising capital/income ratios. There is evidence showing that wealth concentration has indeed significantly declined in the long run. For instance, in the case of France, and notwithstanding substantial measurement and time lag issues, the top 1% of estates accounted for over 50% of the total value of estates at the eve of the First World War, and for about 20% during the 1990s (Figure 2).

Whether this long-run decline in wealth concentration is going to continue during the first decades of the twenty-first century is, however, quite uncertain. In particular, it seems plausible that the rise in top income shares observed since the 1970s–1980s—especially in Anglo-Saxon countries, but also, more recently, in other developed countries—will eventually trigger a



Source: Piketty, Postel-Vinay, and Rosenthal (2006).

Figure 2. Wealth concentration at death in France, 1807–1994

rise in wealth concentration.⁴ Other factors, including changes in the income profile of savings behaviour and the age structure of the wealth distribution, might, however, play a key role as well.⁵ Note also that there can be some two-way interaction between wealth distribution and wealth taxation. A highly progressive system of wealth and income taxation certainly acts to reduce wealth concentration in the long run. For instance, it seems likely that the highly progressive estate taxes applied in most developed countries since the Second World War have contributed to the long-run decline in wealth concentration.⁶ This decline can then reduce political support for wealth taxation. In turn, large cuts in estate tax progressivity—such as the ones recently adopted in the US—are likely to contribute to a rise in wealth concentration a couple of decades down the road, thereby reinforcing the impact of rising top income shares.⁷ One can easily see how this kind of

⁴ For an international perspective on top incomes shares in the long run (and especially the key role played by top capital incomes), see the country chapters collected by Atkinson and Piketty (2007).

⁵ The recent study by Kopczuk and Saez (2004) found no evidence for a rise in US wealth concentration, in spite of the very large rise of top income shares. This might reflect time lag issues as well as complex demographic and asset price effects (e.g. middle wealth and elderly individuals have benefited a lot from the particularly fast rise in real estate prices).

⁶ For simple simulation results illustrating the long-run impact of capital tax rates on equilibrium wealth concentration, see Piketty (2003) and Dell (2005).

⁷ See Piketty and Saez (2003).

process can generate long-run cycles in wealth concentration and wealth taxation.

Quite independently from these long-run effects, the fast rise in asset prices can also have contradictory and non-monotonic impacts on the political economy of wealth taxation, at least in the short and medium run. For instance, because wealth taxes in many countries tend to use exemption thresholds and tax brackets that are fixed in nominal terms (not normally increased even in line with overall price inflation, and never in line with asset price inflation), the initial effect of rising asset prices since the 1980s–1990s has been a marked increase in the percentage of the population hit by these taxes, especially by inheritance taxes. This clearly contributed to a strong political demand for inheritance tax cuts. For instance, this is certainly in part what happened in the UK: only 2.3% of estates paid inheritance tax in 1986–88; this percentage rose to 5.9% in 2005–06, and 37% of households now have an estate with a value above the threshold.⁸ This is also what happened in France: the nominal exemption threshold had not increased since the early 1980s, which largely explained the huge rise in the exemption level that was implemented in 2007.

Finally, historical experience suggests that the political economy of capital taxation involves complex, country-specific and quantitatively important issues. For instance, a recent study has shown that diverging trends in capital tax progressivity (especially estate tax progressivity) largely explain why the US and UK tax systems have become less progressive overall than that of France during the past decades, while they were more progressive than France's until the 1970s.⁹ The central conclusion is that the contribution of capital taxation to overall progressivity—both in terms of level and trend—is larger than is commonly assumed. Capital taxation is a key and complex issue and should rank highly in the tax debate and research agenda of the coming decades, from both a normative and a political economy perspective.

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⁸ See Boadway, Chamberlain, and Emmerson, Chapter 8.

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Commentary by Martin Weale

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Having relied on the interim report of the Meade Committee as a basic public finance text for my finals thirty years ago as well as subsequently working very closely with its lead author, I have a strong affection for that report and also a strong interest in its successor. It is therefore a great pleasure to have the opportunity to write some comments on the chapter by Boadway, Chamberlain, and Emmerson.

Colbert described his aim when collecting taxes as being to pluck as many feathers as he could without the goose squawking. This chapter describes, in some detail, taxes which are currently associated with a great deal of squawking. As the authors point out, taxes which involve the act of making an explicit transfer are much less popular than those which are less visible. On these grounds taxes associated with wealth fail very badly since it is hard to envisage the sort of invisible collection associated with consumption taxes or PAYE income tax. The authors also argue that inheritance tax is expensive to collect, with the cost at 1.01% of revenues, although they do not follow this through to produce a strong argument for expanding stamp taxes with a collection cost of only 0.2%. Various other justifications for taxes are not dismissed as readily as they might be, for example that stamp duty on property covers the cost of maintaining the register. What, one asks, are Land Registry fees for and why was the tax collected on transfers in areas like Cambridge where property was not registered until 1975?

They point to an international drift away from both wealth taxes and inheritance taxes; this is not in itself as convincing as the argument that countries such as Sweden which abolished wealth taxes had found their

performance disappointing, in terms of both revenue and perceived impact on the distribution of wealth. Both France and Switzerland are on the list of countries which continue to tax wealth but there is no suggestion that anyone is planning to introduce such a tax.

On the taxation of wealth *per se*, the main argument produced against the suggestion is that, in the 1970s, the Labour Party was committed to implementing a wealth tax but found itself unable to design the tax sufficiently precisely. The authors do not discuss in much detail the argument that wealth confers advantages on its owners over and above the income it generates. The main economic advantage it offers is insurance against the effects of adverse shocks to human capital and family breakdown. Most other adverse shocks can be insured against, although wealthy people may, for example, choose to self insure a range of risks because (i) they see themselves as lower than average risk, (ii) with constant risk aversion, the ownership of wealth reduces the impact of a given absolute risk, or (iii) insurance markets are not perceived to be efficient. But, apart from the protection offered against uninsurable risks, it is hard to see that these effects can be important.

Are there advantages of wealth over and above the economic advantages associated with its precautionary characteristics? I suspect the authors of the Meade Report (Meade, 1978) thought so. Does ownership of wealth raise future returns by reducing unit costs of managing wealth? Does it offer a means of influence which can be used to raise the returns to human and non-human capital in the future? While both the second and third questions might be answered positively, it could still be argued that, with a tax on investment income, the case for a tax on wealth has not been made. Falling back on the precautionary argument, one might note that, if the main benefit is insurance against shocks to human capital, the tax should presumably fall more heavily on people of working age than on retired people and more on young workers than old workers. Since single people are not at risk of family breakdown, should they pay a reduced rate? Both survey-based findings and simulations suggest that precautionary holdings of wealth are low—with the possible exception of wealth held in old age to finance an uncertain life-span. If this is the case the precautionary argument for a tax on wealth cannot be very strong.

Perhaps the case for a wealth tax is at its strongest when there are other shortcomings of the tax system which do not seem to be properly addressed or when there are other market failures. For example, if income can easily be dressed up as capital gains and the latter cannot be taxed as income, as is perhaps the case current in the UK, then there may, for all its defects, be a case for a wealth tax in addition. Obviously a better solution would be to

remedy the primary defect with the tax system and for this reason a wealth tax cannot be considered in isolation from the rest of the tax system. A second strong argument for taxation of wealth or the income from wealth (which is equivalent provided the income is taxable) is that young people are wealth-constrained because credit cannot be easily secured on human capital. Taxes on wealth and income from wealth therefore allow them to defer part of their life-time tax bill to a stage when, to put the point sloppily, they can afford to pay it. In other words, wealth taxes are like a form of credit and, with imperfect private capital markets, the benefit that they offer may offset their deleterious effects in discouraging saving.

There are, however, reasons for thinking that the 1970s arguments might have been presented rather differently in the current circumstances. Income, and therefore presumably also wealth inequality in the UK has risen very sharply since then, and appreciably more so than in other similar countries. In the 1980s and 1990s the rise in inequality was driven by worsening of the low income deciles relative to the mean. In the last ten years or so, it seems to have been driven by a sharp increase in the numbers earning very high incomes and also in the levels of these incomes (Atkinson (2007)). Does this have any impact on the case for a general wealth tax? A general response to this question would probably be positive although at the same time the many practical objections raised by the authors would still be present. But one suspects that the 1970s Labour government would have been put off less easily than they were thirty years ago.

A second, perhaps related reason for seeing things differently is that the amount of wealth is, relative to income, now much greater than at any time since the start of the data series in 1920 (Khoman and Weale (2006)). This wealth has its origins in asset revaluations rather than resulting from past saving. In that sense taxes on wealth and on inheritance are not double taxation. Equally, given the source of the wealth, a more stringent capital gains tax might be more appropriate than a wealth tax.

It is with the discussion of property taxes, which are rightly distinguished from wealth taxes, that the authors come nearer to the dog they have not allowed to bark. They make a good case for a tax on property occupancy with a high threshold, on the grounds (i) that people who live in expensive properties may be missed by other aspects of the tax system, (ii) that they can probably 'afford' to pay more tax, and (iii) that owner-occupied housing is undertaxed relative to other forms of wealth (although their proposal would also apply to tenants). These are all powerful arguments and can be compared with the Council Tax whose threshold system imposes an effective cap. But they do not follow their argument through to the case for a land tax. The

argument for taxing land but not other forms of wealth is that the disincentive effects to the accumulation of wealth plainly do not apply to land; the stock is fixed and the tax is non-distortionary. Taxes on land are likely to increase the efficiency with which land is used and particularly so if as in the case of owner-occupation the benefit is currently not taxed. Obviously valuations would be required and they should be kept up to date. The legislation might include the requirement that the government would be obliged to buy any land at its valuation plus a safety margin of say 5% at the request of the owner within three months of the valuation.

Such a tax would depress land values. This objection could be met if it were introduced gradually so as to avoid disturbing the housing market. It, as with other property taxes, would be open to the objection that people who are house (and land) rich but cash poor could not afford to pay it. The authors point out that in the Republic of Ireland inheritance tax due on houses occupied by more than one unmarried person can be deferred until the other occupants die; in the same way the government could extend mortgages to people who did not have the cash to pay the land tax and did not want to move. Whether the tax is collected from the occupier or the owner of the land is probably not very important. At least I am not aware of any analysis of tax incidence which suggests that the burden is affected by the way in which the tax is collected, except perhaps as a result of market rigidities in the very short run—a point which also applies to the artificial distinction the authors make between taxing occupiers and owners of expensive properties.

Welfare would surely be increased if the revenue currently collected by stamp taxes on property transactions were instead collected by a land tax. The main argument against seems to be that the only good taxes are old taxes. Nevertheless, a carefully judged reform in which land tax replaced council tax, inheritance tax on property, and stamp taxes on property might well lead to less squawking than do the current arrangements. Whether a reform commanding bi-partisan support could be designed is less clear. But given the need for gradual introduction, there plainly has to be a consensus about it.

Moving on from these general issues to the more specific issues concerning inheritance taxes, the authors present a helpful account of the momentum against inheritance taxes. There is, however, no discussion of whether taxes, which presumably reduce inheritance through consumption of wealth as well as promoting transfers *inter vivos* mitigate or add to inequality. Tomes (1981) shows that the answer depends on what motivates bequests. The data collected in the new Wealth and Assets Survey may make it possible to answer this question in the UK.

The authors point out that attitudes to inheritance tax are affected by whether people's attention is drawn to the increases in other taxes which would be needed if it were to be abolished. Tax policy is not only about the advantages and disadvantages of any individual tax, but also the overall tax package. I argued above that the case for a land tax might be enhanced by the fact that it could be used to replace an array of unpopular and probably unsatisfactory taxes. The analysis presented here offers wide coverage of the advantages and disadvantages of wealth and property-related taxes. But it ends up suggesting some modest reforms to inheritance tax and a move to a more progressive property tax (although how much more progressive is not clear). Trade-offs between wealth-related taxes and other taxes are, with the minor exception above, not mentioned. The reader who would like a view on the Liberal Democrat proposal in the 2005 General Election to replace council tax with a local income tax will have to look elsewhere for an expert opinion on its desirability. (My own sense is that abolishing existing taxes on property would be a bad idea unless they are replaced by taxes with better structures.) But perhaps radical tax reform is doomed to failure whatever the case to be made so that a chapter of this type is right to focus, for the most part, on practical issues rather than try to offer a root-and-branch redesign of the British tax system.

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