To tackle wealth inequality, reform inheritance tax

Wealth inequality has worsened over the past decades, with the top 10 per cent owning more than 40 per cent of all private wealth. At the same time, most wealth in the UK is inherited wealth . David Willets recently proposed a universal inheritance of £10,000 for all over 30, as a way of alleviating this disparity. But while a universal inheritance would help with issues such as accessing credit, only serious reforms to inheritance tax could help tackle wealth inequality, argue ***Nicolas Grimprel*** *and* ***Camille Landais****.*

David Willetts, a former conservative minister and member of parliament, recently proposed that the government should provide all 30-year-olds with a one-time transfer of £10,000 as a mean to tackle the rising wealth inequality in the UK. To finance this measure, David Willetts argues in favour of a reform of the UK inheritance tax system that would "*lower the threshold at which inheritance tax is paid*" and "*abolish exemptions, while also reducing the current 40 per cent tax rate*."

While we welcome the proposal for a universal, one-off transfer to the young to increase social mobility, and also agree on the need for an in-depth reform of the inheritance tax system, we argue that the exact design of such a reform should be thoroughly examined to prevent adverse redistributive effects as well as large behavioural responses.

This proposal comes in the context of the increasing role of inheritance, as opposed to labour income, in shaping individuals' ability to accumulate wealth. The value of wealth relative to the UK's national income has indeed steeply increased in recent years, going from 350 per cent in 1980 to more than 600 per cent today. The share of inherited wealth relative to total private wealth is also particularly high in the UK (close to 60 per cent), and larger than in most Western economies, such as France or Germany.

> The top 10 per cent of the UK population currently own around 43 per cent of total private wealth.

While wealth, and in particular inherited wealth, has gained importance relative to income, it is also becoming more concentrated among the richest. Parental wealth per heir did not evolve much across generations for the bottom of the wealth distribution, but it has doubled for the top 10 per cent between the generation born in the 1960s and the generation born in the 1980s. As a result, the top 10 per cent of the UK population currently own around 43 per cent of total private wealth. In the coming decades, inheritance is expected to gain even more importance, with a forecasted increase of 70 per cent relative to GDP by 2032. Taken together, these factors pose a serious threat on social mobility, with the very real risk of seeing most of the wealth being acquired through intergenerational transmissions, rather than through one's own lifetime work.

> One off, universal transfers alone would most likely have little impact on overall inequality if not accompanied with a reform of inheritance tax.

The need for progressive taxation of inheritance

An early, one-off, universal transfer to the young, as put forward by David Willetts, may enhance social mobility, while also alleviating economic efficiencies induced by credit constraints. However, such transfers alone would most likely have little impact on overall inequality if not accompanied with a reform of inheritance tax. Currently, the UK inheritance tax system is based on a threshold ("nil-band-rate") above which the value of transmitted estates is taxed at 40 per cent. That threshold is £325,000 for non-residential estates and £500,000 for residential ones, but given that the nil-band-rate allowance can be transferred to spouses, it can lead to an effective threshold of up to £1m. Additionally, tax reliefs are put in place for specific types of estates, such as businesses, agricultural land and defined contribution pensions, and generally fully exempts these types of wealth from inheritance tax.

In his proposal, David Willetts argues in favour of abolishing these tax reliefs, while decreasing both the nil-band-rate as well as the tax rate above that threshold. It is unclear however whether this proposal would maintain one unique marginal tax rate, as in the current system, or adopt instead a more progressive tax scale. This point is fundamental, as the effect of such reform on the distribution of the tax burden across the population may vary significantly depending on which type of tax scale is put in place.

According to estimations made by the IFS, a comprehensive reform that would abolish business relief and the residential nil-band-rate, include pensions as part of the estate, reduce the nil-band-rate to £200,000 and decrease the rate of taxation above that threshold to a unique rate of 20 per cent would greatly benefit large estates (£2m-£5m) by decreasing their effective tax rate from 28 per cent to 18 per cent. It would also leave the richest estate (+£5m) unaffected, with very similar effective tax rates than in the current system (around 20 per cent). Smaller estates (£500,000-£1m) however, would see their effective tax rate increase from 4 per cent to 10 per cent. This type of reform would therefore fail to effectively target the largest transmissions of wealth, while heavily relying on the upper middle class, which raises concerns both in terms of equity and political acceptability.

Instead, we propose a departure from the one-threshold, one-marginal tax rate system and implement instead a progressive tax scale, with increasing marginal tax rates across multiple wealth thresholds, just like income tax. Such a system would allow to better target the very large transmissions of wealth, while putting a smaller tax burden on the less wealthy, making inheritance taxation both more progressive and politically acceptable to the general population.

Taxing lifetime gifts differently

Additionally, one must also ensure that other means of wealth transmissions, such as lifetime gifts, are taxed equivalently to avoid large behavioural responses. Once again, it is unclear whether Willett's proposal would include such transfers into the reformed tax base. In the UK, lifetime gifts are currently completely exempted from taxation, with the only condition being that such transfers are made at least seven years prior to the death of the donator. This difference in tax treatment relative to inheritance could lead to large avoidance strategies on the part of the richest, with a significant portion of transmitted wealth escaping tax through lifetime gifts. Imposing a common taxation on both inheritance and gifts would prevent such tax avoidance schemes.

While one may argue that exempting lifetime gifts from taxation incentivizes early transmission of wealth, providing efficiency benefits by alleviating credit constraints for the young, in practice lifetime gifts, are extremely concentrated towards the top of the wealth distribution, which is arguably not the part of the population facing the most severe credit constraints. Considering individuals in their 20s or early 30s, the IFS finds that only 13 per cent of the bottom 20 per cent of the wealth distribution have received a gift in the last 8 years (versus 54 per cent for the top 20 per cent), and that 56 per cent of the value of all gifts being made are received by the top quintile.

> Inheritance tax should be mainly motivated by its effect on the distribution and concentration of wealth.

Progressive taxation isn't enough

Finally, while a progressive reform of the inheritance tax system may generate some public revenue which could help finance the proposal for a universal transfer (around £7bn for a £10,000 one-off allowance), it is our belief that any such reform cannot do the heavy lifting alone. In the IFS scenario mentioned above, the abolishment of all tax exemptions and reduction of the nil-band-rate to £200,000, with a marginal tax rate of 20 per cent would only generate £1.6bn in public revenue, while more than tripling the share of deaths that are taxed in the current system.

More generally, the extreme concentration of transmitted wealth at the very top of the distribution makes it very complicated to generate substantial public revenue from inheritance tax, even with very progressive systems. Hence, inheritance tax should be mainly motivated by its effect on the distribution and concentration of wealth. This could be complemented by an increase in taxation of the wealth held by individuals during their lifetime, allowing to further reduce wealth inequality while generating substantial public revenues to finance policies in favour of social mobility.

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