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THE ECONOMIC EFFECTS OF INHERITANCE TAXES

The late Professor Patten was of the opinion that much of the present confusion of thought relative to taxation arises from an attempt to evaluate taxes in accordance with a melange of economic and ethical principles.[1] This is particularly true of recent writing on taxation, which is dominated by the ethical concept of ability to pay and neglects the economic aspects of taxation.

In this essay inheritance taxes will be considered without regard to the uses made of the revenues which they produce. All the expenses of government are equally binding obligations; and there is therefore no good to be derived from selecting some item of public expense which meets with our disapproval and then condemning the tax which raises the amount of revenue in question.

It seems unnecessary too to discuss the situation that might arise if inheritance taxes, or a large part of them, were payable in kind and thus necessitated governmental administration of property on a huge scale. Such a program has attracted considerable attention of late on account of the support given it by Professor Eugenio Rignano in *The Social Significance of the Inheritance Tax.* There is no more reason for utilizing the inheritance tax as a device for accomplishing the socialization of capital than there is for attaining the same end through a provision that all or a portion of the general property tax should be paid in kind.

The method employed in this study is, in the main, a deductive one. There seem to be no "facts" or data on which to base a conclusion. Moreover, it is to be noted that the "facts" of economics change from census to census and from survey to survey; but the principles of economics, concerning which there is the most unanimity, are those principles which Adam Smith, Ricardo and their successors formulated by deductive reasoning.

Direct Effects of Inheritance Taxes

It has seemed advisable to divide the effects of inheritance taxes into two classes, the direct and the indirect. The direct effects include such effects as necessarily ensue from the levy of the tax, apart from any change in the will or habits of the people subject to it.

The first and most obvious effect is a diminution of the share of an estate that would otherwise go to the heirs. It is equally obvious that if there is no need to increase the revenues of the state, such revenue as is raised by inheritance taxes will make it possible to reduce *pari passu,* the amounts raised by other forms of taxes.

[1]Patten, *Essays in Economic Theory,* p. 96.

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A more disputed point is the effect of inheritance taxes upon the supply of capital. Professor Taussig defines "capital" as follows:

Everyday usage is hazy and 'capital', like other common words, is used in different senses. For the purposes of economic study, we shall disregard the individual's point of view and shall consider the subject of capital, as we shall other subjects, from the point of view which is important for the community: It suffices here to say that in speaking of capital, we shall have in mind producers' capital,—those things which are part of the community's apparatus of production.[2]

If this definition is accepted, it follows that no tax, payable in money, directly affects the quantity of capital in existence at the time the tax is levied. This follows from the nature of capital as defined, that is 'producers' capital,' those things which are part of the community's apparatus of production. As Professor Taussig points out in his elaboration of his definition, most things are by their nature fit to be used once for all, either as capital or consumption goods; and it is seldom possible to divert them from the use for which they were intended. Iron may be made into shrapnel or boilers; but it will be a very rare circumstance which will result in making shrapnel from boilers or boilers from shrapnel. It is only in rhetorical writing that swords are beaten into plowshares and spears into pruning hooks; and if such were to occur, it would not be the result of levying taxes in a particular way. Neither the quantity nor nature of producers' capital is altered by a money payment from taxpayers to the state.

It should be noted here that the claim is not made that it is impossible to levy taxes in such a way as to affect the amount or form of future accumulations of capital. A tax on windows or automobiles may be made sufficiently high to reduce their number; but this will be an indirect effect of the tax, operating through the volition of individuals attempting to escape its burdens. When taxes work out their effects through a change in the volition or habits of taxpayers, such effects are considered as indirect and will be discussed later.

One of the most astute and helpful of the contemporary writers on taxation, Sir Josiah Stamp, points out that critics of inheritance taxes make a very superficial observation in claiming that, "when a payment out of an estate is made, the capital value of that estate is reduced,—the difference of capital has 'gone'."[3]

If a man inherits a factory having a cash market value of $10,000 on which he must pay $1,000 tax, it is true that his wealth is increased by only $9,000 instead of the $10,000 by which his wealth would have been increased but for the tax. But this in no way decreases the capital in existence at the time the tax is paid, as the factory is still

[2]Taussig, *Principles of Economics,* 2nd ed. vol. 1, p. 84.
[3]Josiah Stamp, *The Principles of Taxation,* p. 145.

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capital and is still worth $10,000 though it netted but $9,000 to the legatee.

However, there is a long line of most respectable authority to the effect that inheritance taxes do directly diminish capital. There is for example, the classic citation from Adam Smith:

All taxes upon the transference of property of every kind, so far as they diminish capital value of that property, tend to diminish the funds destined for the maintenance of productive labor. They are all more or less unthrifty taxes, that increase the revenue of the sovereign, which seldom maintains any but unproductive labourers, at the expense of the capital of the people, which maintains none but productive.[4]

This statement, while often cited by opponents of inheritance taxes, really shows little more than that Smith's thinking was tainted with adherence to the now defunct "wage fund" theory and that he was prejudiced against any increase in the "revenues of the sovereign" by whatever tax such increase might be raised.

Bastable states this objection to inheritance taxes as follows:

Succession duties first of all, possess the grave economic fault of tending to fall on capital or accumulated wealth rather than on income; they, therefore, may retard progress.[5]

He divides taxes into taxes on revenue and taxes on capital:

The former are paid out of the annual production; the latter encroach on the accumulated wealth of the society.[6]

But he apparently is not too sure of his position, for he adds:

But in qualification of this statement, it must be added that most of the actual property or capital taxes are so only in name, being paid out of the income of the persons subject to the charge. There is thus a discordance between the practical and scientific use of these terms as great as in the case of direct and indirect taxation.[7]

Bastable comes perilously near taking both sides of the argument at once; for example:

The distinction between capital and revenue is not indeed so rigid as Ricardo seems to have supposed, and thus there is some transference of taxation between these two categories of wealth. But this in no wise invalidates the proposition that the levy of duties directly on capital tends to reduce the amount of that aid to production.[8]

An examination of the actual process of tax-paying seems to reveal Professor Bastable in error both as to "taxes on revenue" and "taxes on capital." A tax on the salary of A, who has been working a year

[4] *Wealth of Nations,* bk. 5, ch. 2, Appendix to Article 1 and 2.
[5] C. F. Bastable *Public Finance,* 3rd ed., p. 591.
[6] *Op. cit.,* p. 272.
[7] *Op. cit.,* p. 272.
[8] *Op. cit.,* p. 591.

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on an irrigation ditch, may be taken as an instance of a "tax on revenue," which, according to Bastable, is paid "out of the annual national production." It is difficult to say what is meant by that statement.

The tax payment certainly does not result in a diminution of the product of A's labor, the ditch. All that actually occurs is that A turns over $100 in money to the state. But for the tax, A might have hoarded the money, loaned it, exchanged it for either consumption or capital goods, given it away or paid a debt. Now it is equally evident that with this sum, the state also will do one of these things. This illustrates how impossible it is to predict the effect of any kind of tax upon the quantity of producers' capital.

What Bastable calls a "tax on capital" occurs when A pays $100 inheritance tax on some stock which he has inherited. He may pay the tax with $100 which he has saved for an outing and forego the outing. The state may use the $100 in building an irrigation ditch. This is a tax on capital which Bastable contends has the effect of "encroaching on the accumulated wealth of society" when as a matter of fact the tax tended to, and did increase the supply of capital by aiding in the creation of a ditch instead of A's beach party.

If it be objected that taxes are seldom utilized for irrigation purposes, one may assume that the $100 inheritance tax is used in payment of a national obligation. The money may be turned over to B to retire a government bond. Is not B, a saver and investor, just as apt to use the $100 to increase the supply of producers' capital as is A, the favored but perhaps unthrifty child of fortune? If B, directly or by loaning to another, devotes the sum to capital production, while A would have lived it up, the tax will not "encroach on the accumulated wealth of society" but will do just the opposite of what Mr. Bastable assures us it will do.

Professor Taussig too is one of those who believe there is something in the nature of an inheritance tax which makes it particularly detructive to capital. He says:

> Such taxes tend to trench on capital. Unless kept within moderate limits, they are paid out of the principal of the estate, not out of income; and this lessening of the individual's 'capital' (quotation marks are Taussig's) presumably leads to a corresponding lessening of social capital.[9]

To be sure, Professor Taussig is here rather circumspect; he puts "capital" in quotation marks and presumably uses the word in a different sense than he does ordinarily when it means producers' capital—real concrete instruments of production. What it means in quotation marks is left to conjecture. He rightfully shrinks from

[9] *Principles of Economics,* (1924 ed.), vol. ii, p. 268.

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stating that a tax paid at the time of inheriting a factory diminishes either the utility or the exchange value of the factory.

For a consistent, bold and modern statement of the way in which inheritance taxes destroy capital, the reader may turn to the writings of Hon. A. W. Mellon. With him there is no vagueness of speech. He writes:

For instance, assuming that all inheritances, large and small, were taxed at 40 per cent, it would then be only two or three generations until private ownership of property would cease to exist. Since these taxes are used in the current operations of government, the result would be, not that the government had absorbed the wealth of the country, but that the wealth had been spent and none was left.[10]

With Mr. Mellon, the inheritance tax becomes a magic wand that may be used to wipe private property entirely out of existence. Its effect upon land is as disastrous as its effect on capital.

Under the high death duties, ownership of land (in England) has ceased to have value and large estates can now be purchased for less than the cost of improvements. In other words the land itself is rendered valueless by the death duties and no longer produces revenue.[11]

Frequently the most effective way to disclose an error in reasoning is to carry it out to its logical conclusion, and this Mr. Mellon has done.

The second contention, that any tax, even though nominally laid on income, may directly affect future accretions to the capital supply, is gaining increased acceptance, especially among the English economists. Sir Josiah Stamp, speaking of the immediate effects of inheritance taxes upon the supply of capital, says:

The money has to be raised. If it is not paid by death duties on the wealthy, assume that it may be obtained as income tax on the middle class. The tax may then prevent them from saving what they were in the habit of doing; they may be pushed out of the new investment field and we may thus get an equivalent prevention of immediately potential capital...... There is no proof that the immediate effect of taking revenue as death duty reduces immediately potential fixed capital more than an income tax which may equally trench upon potential savings.[12]

Long ago, Ricardo, who was more astute than some of his successors, observed that the real effect of a tax upon capital cannot be told by merely noting whether it is ostensibly laid upon capital or upon income. The real incidence might be quite different from the apparent one. He said:

Taxes are not necessarily taxes on capital because they are laid on capital: nor on income because they are laid on income. If from my income of 1000 Pounds per annum I am required to pay 100 Pounds, it will really

[10] *Taxation, the Nation's Business,* p. 119.
[11] *Op. cit.,* p. 121.
[12] *Op. cit.,* p. 148.

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be a tax on my income, should I be content with the expenditure of the remaining 900 Pounds; but it will be a tax on capital if I continue to spend 1000 Pounds.[13]

It is true that Ricardo was not friendly to the inheritance tax; but he did not oppose it on the naive ground that it diminished the amount of existing capital, or that, in a way different from other taxes, it prevented the creation of capital in the future.

Effect on the Distribution of Capital Goods

Inheritance taxes may influence, in an important way, the distribution of capital. Economic efficiency does not depend alone upon the supply of land, labor and capital, but is largely dependent upon the way in which they are utilized. To secure a maximum product, capital should be in control of those who can make the best use of it.

Society has taken little or no positive action to provide that capital be managed by the most efficient, but has perhaps unconsciously assumed that such distribution takes place automatically. Through the ordinary competitive processes, inefficient owners of property are eliminated; they sell their property voluntarily or lose it by forced sale. It is bought by those who fix the highest value on its ownership and are willing to back their convictions with their money. Property acquired by purchase tends normally to drift into the hands of those who can use it most productively.

On the other hand, there is nothing in the process of acquiring capital by inheritance which gives any assurance that its new owners are best qualified to use it. A good economic argument exists, therefore, in favor of an inheritance tax sufficiently high to force inherited property back into the competitive arena where its ownership may be determined in the normal fashion. Professor Pigou states the case as follows:

> Income depends, not on capacity alone, but on a combination of capacity and inherited property, and inherited property is not distributed in proportion to capacity but is concentrated upon a small number of people, not selected in accordance with their own or even, in many families, their parents' capacity, but owing their good fortunes, perhaps to their being only sons or daughters, perhaps to some other 'accident'.[14]

Effect of Inheritance Taxes on the Scale of Production

It has been charged that inheritance taxes result in the splitting-up of estates, the minute parcellation of land and the sub-division of large business properties in a way detrimental to economic efficiency. But the minute parcellation of land, found in France for example, is due,

[13] *Principles of Political Economy and Taxation,* 3rd ed., p. 165.
[14] *Economics of Welfare,* p. 696.

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not to inheritance taxes, but rather to the law requiring equal distribution in kind among the heirs.[15]

For property other than real estate, the corporate form of holding is by far the most important; and diffusion of ownership merely means an increase in the number of stockholders and has no effect upon the scale of the company's operations. There is no evidence to show that inheritance taxes tend to disintegrate productive units.

Indirect Effects of Inheritance Taxes

The indirect effects of an inheritance tax include such effects as it brings about through changing the volition or the habits of men. If an inheritance tax causes men to work less, its economic effect would be tremendous and yet indirect in that the result was made possible only because men chose to react to the law in a certain way. The term "indirect" as used here is not at all synonomous with unimportant; in fact, the indirect effects of inheritance taxes are the important ones and offer the most perplexing problems.

It is claimed that inheritance taxes lower production as they reduce the amount one may distribute at death and thus reduce to that extent his pecuniary incentive to labor. Here the economist is confronted with three perplexing psychological questions. First, is labor motivated only by pecuniary rewards? Second, are inheritance taxes, operating as they do only at death, such a subtraction from the reward of producers that they diminish their efforts? Third, if such taxes do restrict production, do they restrict in proportion to their rates?

Although William James remarked that nine-tenths of the world's work was done in emulation and Helen Marot suggests the importance of the "creative impulse" and Veblen writes of the "instinct of workmanship," there are really no data from which the three foregoing questions can be answered. It is certain that these non-pecuniary motives to work are found chiefly among those whose estates may be subject to an inheritance tax. One may well doubt their importance in motivating the digging of the world's ditches; but those who do this sort of work, are for the most part, quite indifferent to the rates of any inheritance tax that has ever been proposed.

Some authorities claim that the financial motive for working is unaffected by any contingency that reduces an estate only at death.

[15]"Causes du morcellement en France.—Le morcellement a pour cause principale le régime successoral actuellement en vigeur, qui établit le principe du partage égal et du partage en nature des biens (art. 832 C. civ.) entre les enfants, en le garantissant par l'obligation du rapport des donations entre vifs et des legs, et par la limitation du droit de tester."

Réné Foignet, *Manuel Elémentaire d'Economie Politique,* p. 260.

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Max West is of the opinion that "death is usually looked upon as a remote event and occupies no very prominent place in the minds of men."[16]

Professor J. A. Hobson is of the same opinion:

> But a good deal (of our indifference to inheritance taxes) is also attributable to the curious illusion which leads so many men to think, feel and act as though they were going to live forever. They simply refuse to take account of it in the play of motives that affect their earnings and savings. Putting the matter concretely, I do not believe that well-to-do people would accumulate and leave behind them less than they do now, if the state were to take one-half or more of their estates instead of the tenth which it now takes on the average.[17]

Our own heavy war taxes revealed how little the industry of a people is affected when the state takes an increased share of the product of their labor and saving. For, though there was popular talk to the effect that high taxes were discouraging business initiative and industrious habits, the charge gets no support from the statistics of production and saving for the period.

Effect upon Saving

There are critics of the inheritance tax who contend that although it has little effect on production, its effect on savings, if rates are substantially high, is disastrous. One must be cautious however, about forming too simple a notion of the motives which lead to saving. Sir Josiah Stamp says:

> The whole fund of saved capital is a resultant of many different psychological forces, which do not answer in the same way to changes in conditions. The behavior of those who are saving against risks or against being worse off, those who are saving to be better off, and those who are saving without effort or self sacrifice out of superfluity, will be very different.[18]

The complexity of the saving motives is definitely recognized by Professor Taussig[19] and would probably be denied by few, although many simplify the phenomenon of saving more than is justifiable.

There is a variety of motives to save that are unaffected by inheritance taxes. It is evident enough that in so far as one is prompted to save by the belief that he himself will enjoy the results of his saving, he is quite indifferent to what happens to his estate at death. It seems probable that most of the savings of the working class are of this character. Their saving is for the "rainy day," which means any

[16] *The Inheritance Tax,* p. 212.
[17] *Taxation in the New State,* p. 115.
[18] *Op. cit.,* p. 153.
[19] *Principles of Economics,* 3rd ed., vol. ii, p. 267.

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emergency. With them there is little urge to save that they may, in their wills, manifest their benevolence toward their heirs.

There are too, those who amass huge fortunes, neither for themselves nor their heirs, but because of the added power which wealth gives them in their game of business. Professor Carver has well described the motives of this group:

Accumulated capital becomes then one of the instruments of the game. So long as the player is left in possession of this instrument while he is one of the players, he is not likely to be discouraged from accumulation merely by the fact that the state, rather than his heirs, gets it after he is through with it.[20]

Andrew Carnegie thought that such taxes might increase the savings of this type of business man:

Nor need it be feared that this policy (inheritance taxation) would sap the root of enterprise and render men less anxious to accumulate, for, to the class whose ambition it is to leave great fortunes and be talked about after death, it will be even more attractive, and, indeed, a somewhat nobler ambition to have enormous sums paid over to the state from their fortunes.[21]

It is probable that the saving of the rich is much less influenced by a desire to save for their heirs than is customarily believed. The general public has long felt that the fortune which a rich man leaves to his son may be a doubtful boon; and this idea is apparently making gains among the rich themselves. Such, at least, is the opinion of Professor Irving Fisher:

The ordinary self-made American millionaire is rather disposed, I believe, to look on the inheritance of his millions by his children with some misgiving.[22]

The savings of young people must be peculiarly free from the influence of inheritance taxes, as, for all but the morbid youth, death and the consequent inheritance tax lie out far beyond the realm of things that matter. Then too, those who save from habit have become rather firmly fixed in their habits before they are old enough to be influenced by inheritance taxes. Their standard of living is maintained at about the same level; and neither their consumption expenses nor their earnings vary with rates of inheritance taxes.[23]

There is good reason to believe that for people in general, the influence of such taxes upon their economic activities is very slight; for, as Professor Pigou says, "people discount future taxes precisely as they discount all future events.[24] They are not only to be paid at a

[20]*Essays in Social Justice,* p. 323. This passage is cited approvingly by Professor Pigou in his *Economics of Welfare.*

[21]*Problems of the Day,* p. 5.

[22]*Journal of Political Economy,* vol. 24, p. 711.

[23]See Bastable, *Public Finance,* p. 312.

[24]*Op. cit.,* p. 641.

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future date which is never definitely fixed; but there is always the possibility that, through changes in the law or the size of the fortune, they may never have to be paid at all. It is for these reasons that Professor Sidgwick thought their effects are

> not likely to be at all equal in proportion to the similar effects that would be produced by extra taxes on income. In fact, the limits of taxation on inheritance will be practically determined rather by the danger of evasion than by the danger of checking industry and thrift.[25]

On this same point, Professor Cannan said:

> Perhaps on account of a certain obvious peculiarity of the time at which they occur, death duties discourage accumulation somewhat less than annual taxes.[26]

Inheritance taxes may even result in increasing the savings of those whose ambition it is to leave to their heirs a particular piece of property or a particular sum of money; for they must then save an additional sum to meet the tax. It is sometimes argued that this will not occur unless it can be shown that men will work as willingly for the state as they will for their families; but it is at no time assumed that people pay inheritance taxes any more than any other kind of taxes, because of their love for the state. The question is, what will a man do if he has saved $100,000 to leave to his son, when he hears that the state upon his death is going to take 10 per cent of it? Will he be so incensed at what he considers the injustice of the tax that he will squander his fortune; or will he endeavor to increase the amount of his savings so that after the payment of the tax his son may still have the $100,000 net? Evidently, if provision for his son is uppermost in his mind, he will do the latter.[27]

Effect on Savings Irrespective of Motivation

The extent to which the motives to save are consciously restricted by the inheritance tax has been grossly exaggerated by its critics. It may, however, affect the volume of savings without working through the motives of savers and may so redistribute the burdens of government that the spenders will have more to spend while the accumulations of the savers, which ordinarily would take the form of producers' capital, are taken by the government.

The inheritance tax, as Bentham said over a hundred years ago, is a way of getting money from the community without anyone's feeling the burden. If all the expenses of government could be provided for in this burdenless way, it might seem that the taxpayers' paradise was

[25]Stamp, *op. cit.*, p. 149.
[26]Stamp, *op. cit.*, p. 151.
[27]See West, *op. cit.*, p. 212.

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in sight. If, however, the aim of society be increased production, tax paying should not be made easy; but taxes, whether felt or not, should be so distributed as to permit a maximum increase of capital on which production so largely depends. A society concerned with increasing its product should shift the tax burden from the savers to the consumers until it feels that maintaining the level of consumption is as important as increasing the supply of capital.

The effect of inheritance taxes upon consumption is therefore of vital importance. Ricardo saw that this was the center of the problem which he illustrated as follows:

If a legacy of 1000 Pounds be subject to a tax of 100 Pounds, the legatee considers his legacy as only 900 Pounds and feels no particular motive to save the 100 Pounds duty from his expenditure, and thus the capital of the country is diminished; but if he had really received 1000 Pounds and had been required to pay 100 Pounds as a tax on income, on wine, on horses or on servants, he would probably have diminished, or rather not increased his expenditure by that sum and the capital of the country would have been unimpaired.[28]

If the inquiry had taken the direction which Ricardo gave it, it is likely that tax theory would be more advanced than it is at present. But instead of noting its effect on consumption, economists opposed the inheritance tax on such untenable grounds that it has grown steadily in favor. The attempt to show that, since it is called a tax on capital, it restricts the supply of capital, whereas a tax nominally laid on income is free from that objection, can hardly gain general acceptance among scholars.

Inheritance taxes must be considered along with the taxes which they would, in part, replace. In so far as they might be used to replace taxes on consumption, they would probably tend to increase the consumption of goods and diminish the supply of capital. It may be that a substitution of inheritance for income taxes tends the same way. Such is the reasoned opinion of Sir Josiah Stamp, who says:

On the whole, I think there may often be a tendency to curtail expenditure to meet an annual income tax and to keep on saving and thus in the long run add more to capital than would be the case under the death duty regime. In so far as this is true, death duties trench more upon the annual new investment fund and less upon the consumption expenditure than income taxes would do, but not to any marked extent.[29]

One may heartily agree with him that the final result as between income and inheritance taxes is only slightly in favor of income taxes, since both of these taxes fall largely on the group which saves. He concludes:

[28]*Op. cit.,* p. 166.
[29]*Op. cit.,* p. 154.

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People greatly exaggerate this matter, because they forget that the money must be raised somehow; and from the gross effect of the death duties on capital, they fail to take off the effect that other equivalent taxes would also have upon saving.[30]

But if the choice is between raising revenue from a consumption tax or an inheritance tax, the issue is clearer. An inheritance tax will reduce the savings of the wealthier classes; and the resultant loss of capital will not be made good through increased savings of the poor, who will, instead, increase their consumption of tax-free goods. The inheritance tax is objectionable then, not because it is a tax nominally laid on capital, nor because it reduces the motive to save but because, as compared with consumption taxes, it reduces the saving capacity of the wealthier classes. For the term "wealthier classes" one may, if he will, substitute "saving classes," for, as Professor Taussig says:

The greater part of the capital owned and maintained in modern communities, arises from the savings of the comparatively small number of the more fortunate classes.[31]

These conclusions will not impress those who are unconcerned about the future accumulation of capital. There are some who believe that the chief concern of society should be the increase of immediately available consumption goods rather than capital goods. There are too, those who believe that provision can be made for capital accumulation in some other way than private savings. The limits of the present subject will not permit a consideration of these contentions; and they are abandoned to more speculative writers.

In conclusion, it appears that most of the arguments thus far used against the inheritance tax are bad ones; that there is only a slight balance in favor of taxes on income; but that any large-scale attempt to substitute inheritance taxes for taxes on consumption would seriously restrict the supply of producers' capital and thus imperil the high level of well-being that characterizes the present economic order.

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[30] *Op. cit.*, p. 154.
[31] *Principles of Economics*, 3rd ed., vol. 1, p. 76.

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