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INHERITANCE JUSTIFIED

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ALTHOUGH the early economists were interested in investigating the desirability of inheritance, this issue has been subject to relatively little economic discussion in recent years. I have not been able to turn up any serious effort to apply welfare economics to the problem. Nevertheless the problem of justifying inheritance of wealth is still very much with us. A great many people who do not object to other aspects of the capitalist system take exception to the inheritance of wealth. It seems likely that the relative neglect of this subject in recent years has been because those who favored private property regarded inheritance as necessarily entailed in the concept and those who objected to private property felt that inheritance was obviously wrong. As we shall see below, neither of these two positions is apodictically certain.

There have been some what we may call traditional arguments for inheritance. The principal one, of course, is the conservation of capital. This argument, however, as far as I know has never been worked out in any detail nor have modern welfare economics techniques been used to discuss it.[1] There are two other arguments which are occasionally encountered. Some have argued that the heirs of great wealth are free from social pressures. Most of them presumably use this freedom from the burden which the rest of us carry in consumption of leisure time activities. A few, however, like Robert Boyle, use their opportunities to undertake activities which are of great benefit to mankind. It is conceivable that the payoff from this small group of people might be very great. So far as I know, no one has ever examined this matter in any detail.

A final argument, which in a way is related to the argument which will be presented later in this article, is that we permit people to leave their money

[1] The point has not been made as strongly in the literature as one might expect. Nevertheless, it is contained in: G. E. Hoover, The Economic Effects of Inheritance Taxes, 17 Amer. Econ. Rev. 38 (1927), and, Alvin H. Johnson, Public Capitalization of the Inheritance Tax, 22 J. Pol. Econ. 160 (1914). Professor Johnson's article is interesting because he proposes to offset the reduction in capital by having the government invest in the capital market the full receipts of the inheritance tax. For this to work, of course, the elasticity of the "demand for inheritance" would have to be less than one, a point which he does not emphasize.

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to whom they wish, not because of interest in the legatee, but because we are interested in the testator. We are, in this view, compelled by the mere logic of private property to permit a man not only to give it away while he is alive, but also to give it away on his death. In these forms, the argument is essentially metaphysical, but as we will see it is possible to put something very similar to this in strict welfare economics terms.

It seems likely that this lack of much rigorous discussion of what is clearly an important policy issue turns, to a considerable extent, on the fact that decisions with respect to inheritance have become mixed up with certain other problems. Firstly, a great many people favor income equalization as a government policy. Secondly, there are a great many people who favor a planned, centrally-run economy as opposed to a market economy; thirdly, many people feel that the government should have, at the very least, a policy as to the amount of capital invested in the economy. Normally, people in this category favor more capital investment, but there is no logical reason why one could not favor less capital investment.[2] These issues are, in fact, independent of the desirability or undesirability of permitting inheritance, as I shall shortly demonstrate. I believe, however, that they have been mixed up with the inheritance issue by most people who have thought about it. This makes the issue appear to be an extraordinarily complex issue and has resulted in restricting discussion.

Before turning to demonstrating that these issues are not necessarily involved in the decision as to whether or not inheritance should be permitted, I should like to digress briefly to explain what I mean by permitting or not permitting inheritance. In essence, we will discuss whether inheritance should be permitted, that is, whether 100 per cent tax on inheritance of wealth is desirable. We will not discuss whether such a 100 per cent tax would be administratively feasible in the sense that it might be possible for people wishing to leave money to evade it, nor will we discuss the taxation of inheritance for revenue purposes only. As will be demonstrated, however, the arguments offered in favor of inheritance are also arguments in favor of keeping the tax on inheritance at or below that tax which brings in the largest net revenue. If, as seems likely, a 30 per cent tax level on inheritances would bring in more revenue than a 90 per cent tax, then the argument offered in this article would indicate that the 30 per cent tax should be chosen.

Returning to our main theme, however, I should like now to demonstrate that the four issues which I have described are essentially independent of each other. As an extreme case, it is possible to have a socialist state which has definite policies with respect to the amount of capital which will be ac-

[2] Gordon Tullock, The Social Rate of Discount and the Optimal Rate of Investment: Comment, 78 Q. J. Econ. 331 (1964).

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cumulated and radically egalitarian objectives together with inheritance of wealth. In fact, I would argue that inheritance of wealth under these circumstances would increase the efficiency of such a state. On the other hand, it would be possible to have a completely laissez-faire market economy with no effort on the part of the government to affect the net rate of accumulation of capital or redistribute income in the direction of equality and, at the same time, prohibit inheritance. In this case, again, I would argue that prohibiting inheritance was inefficient. All of the other logical combinations of these factors are also possible and in all of these cases permitting inheritance is efficient. With four variables, each of which can take two values, we have a 16-cell matrix as shown in Figure I.[3]

FIGURE I

		Inheritance		No Inheritance	
		Market Economy	Government Operated Economy	Market Economy	Government Operated Economy
NO GOVERNMENT CAPITAL POLICY	No Income Redistribution	A	B	A′	B′
	Income Redistribution	C	D	C′	D′
GOVERNMENT CAPITAL POLICY	No Income Redistribution	E	F	E′	F′
	Income Redistribution	G	H	G′	H′

[3] In practice, of course, they can take many intermediate values, but for simplicity we will assume in each case there either is or is not a given institution.

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The eight possible combinations of the other variables with the retention of inheritance are shown to the left of the vertical double bar and those without inheritance to the right. Each possible situation with inheritance is shown by a letter and its corresponding state without inheritance permitted is shown by the letter primed. My argument is that, by standard welfare criteria, in each case the state with inheritance is superior. A is better than A′ and H is better than H′.

Before entering into the general discussion, however, I think it would be desirable to demonstrate that these four possible variables are, indeed, independent. Further, something should be said about the efficient method of administering certain types of government control. It is widely believed, for example, that a socialist economist economic policy in which the government operates the economy must, of necessity, be combined with government control of capital accumulation. This is by no means true. There is no reason why the government could not obtain its capital solely from the voluntary sale of securities while managing the rest of the economy.[4] Under these circumstances, it would be obtaining from the individuals in society information as to how much they wanted to invest, granted the physical productivity of investment at that time and using this data to obtain the optimum in amount of investment. The government itself would be deciding where the investment was to be spent.

The contrary policy—government control of the rate of capital formation without government control of the economy as a whole—is equally easy. A government could institute a subsidy for capital investment, if it thought capital investment was too low, or a tax upon capital investment, if it thought that it was too high. Note that for this purpose it would have to have some idea of what is the "right amount" of capital accumulation, independent of the ordinary equilibrium concepts. It would be, in a sense, overriding preferences of the citizens for investment. Whether we approve of this or not, however, raises no questions as to its theoretical possibility.

Finally, income redistribution can be combined with almost any set of policies on the other variables. In general—granted that the government has some policy for income redistribution, whether from the rich to the poor or from the poor to the rich or from all of us to farmers and oilmen—this income redistribution can be most efficiently managed if it is handled through direct taxes and payments rather than by attempting to change the structure of production in such a way as to bring indirect benefits and injuries to specified groups.

[4] Either a single general government bond or a series of different securities with different amounts of risk attached selling at different prices. Probably the former would be more efficient.

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Let us assume that the government has some capital policy, that is, it feels that the capital accumulation which "falls out" from the general situation including, of course, its policies in other areas is not optimal and wishes to change it. Let us assume for simplicity that it feels that more capital should be accumulated. There seems to be a widespread view that a policy of a government to increase capital investment must, of necessity, take the form of actual government management of all investment. This is untrue. Assume that people would, if left to their own devices, save 10 per cent of their money and the government, through divine guidance, knows that the correct amount is 20 per cent. One method of making this investment would be to tax the populace by 20 per cent of their income and use the money for direct government investments. A second technique would be to tax the populace some amount less than 20 per cent of their income and use the derived amount for subsidy upon new investment. A third possibility would be to tax the populace 10 per cent of their income and invest this directly in investments which, given prevailing rates of interest, are submarginal. If the government has infinite ability to discriminate in the size of its subsidies, it should be able to go even farther than any of these three techniques and offer discriminant subsidies on specific supermarginal investments in order to obtain its total 20 per cent investment from a tax revenue well under 10 per cent.

It is, of course, possible to combine the latter three techniques in various combinations. Clearly, any one of the last three techniques or any combination of them is better than the first. In each case, the degree to which the individual is permitted to make decisions about how his income will be spent and how it will be divided between saving and investment is greater than under a direct tax-financed investment of 20 per cent. Thus, each individual in society would be better off if the first policy involving direct government management of all investment were not resorted to simply because each individual acquires some additional freedom from this decision. The gain would be particularly great for those individuals who did not wish to invest exactly 20 per cent of their income. In general, a subsidy is the most efficient method of increasing the investment of capital, if large increases are desired and, if small increases are desired, direct investment in supermarginal areas is efficient.

Note that this would be true even if we did not believe in the market economy and had a totally government-run industrial and agricultural sector. Decisions by the government as to how much should be invested would be more efficiently implemented if the individuals voluntarily buy government securities with a suitable tax or subsidy to make certain that they bought the "right" total amount. Thus, an efficient socialist government would have (and the Soviet Union did have for many years) a market in its own bonds

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and would obtain the capital which is used for investment through this market. Only if the government is not concerned with providing optimal conditions for its citizens would it use its governmental powers to directly determine not only how much shall be invested but who shall invest it.

It might be thought, however, that an income redistribution program which was radically egalitarian requires, or at least is consistent with, confiscatory inheritance taxes. This is not true. Indeed, confiscatory inheritance taxes are a bad way of equalizing income. Any desired degree of income equalization can be obtained by suitable income taxes. Since the recipients of the inheritances will receive their inheritance by what amounts to a random time allocation, a tax which confiscates inheritances would amount to a random tax upon one particular source of income. A special tax on a single source of income combined with a general income tax is an inefficient method of equalizing income. The point can perhaps best be understood if we assume that the government of the United States not only has an income tax policy aimed at certain equalizations, but has, in addition, a $5,000 per year tax on economists on the grounds (quite correctly) that economists' incomes are above average. Clearly, this combination would be a less efficient way of achieving an income equality goal than a single tax because, in some cases, the special tax would fall on people who are already not too well off. Since any desired degree of equality can be obtained through the income tax with a negative range, the addition of a special tax for this purpose is both inefficient and undesirable.

It might be argued, however, that we want not only income equality but also a greater degree of equality in wealth. In this case, a direct equalizing wealth tax would seem to be the optimal institution. Indeed a tax on one particular form of wealth is almost of necessity an inefficient way of reducing the amount of wealth inequality in society. There has been a good deal of research in attempting to determine what tax on wealth would be equivalent to a given level of death duties. These very complicated papers derive their basic complications simply from the fact that any annual tax on wealth is vastly more efficient than the death duty as a technique of wealth equalization, and it is hard to compute the equivalent in an efficient tax for a highly inefficient tax.[5] Once again, a tax on a particular form of wealth, let us say houses, is an inefficient way of wealth equalization. Those interested in wealth equalization should approach the problem directly and use efficient tools, rather than indirectly through an inept set of methods.

[5] Cf. G. Z. Fijalkowski-Bereday, The Equalizing Effects of the Death Duties, 2 Oxford Econ. Papers (n.s.) 176 (1950); William S. Vickrey, The Rationalization of Succession Taxation, 12 Econometrica 215 (1944); Nicholas Kaldor, The Income Burden of Capital Taxes, 9 Rev. Econ. Stud. 138 (1942), reprinted in Readings in the Economics of Taxation, 393 (R. A. Musgrave & C. S. Shoup eds, 1959); A. C. Pigou, A Study in Public Finance ch. 13 (3rd ed., 1949).

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The last few paragraphs have been devoted to demonstrating that the four variables shown on Figure I are in fact independent. They can be mixed in almost any combination. It now remains to demonstrate that the inheritance tax is undesirable. I do not propose to go through all of the eight possible cases, but I think that if I can demonstrate that the inheritance tax is undesirable in the two extreme cases—A, A′, the market economy with no income redistribution and no government capital policy and H, H′ the government-run economy with income redistribution and a government capital policy—I will have made my point and may leave the filling of most of the other squares to the reader.

Let us begin with A, A′. Suppose, then, a free market government with no capital policy and no income redistribution which is considering the imposition of 100 per cent tax on all inheritances. Let us then discuss the effect of this tax first upon the situation before some given person has died and then, secondly, after he has died. The first consequence of the enactment of such a confiscatory inheritance tax would simply be that motives for accumulating capital would be much lower than otherwise. Indeed, everyone would plan to be dead broke on the day of their death. The market for annuities would become a very good one.[6]

Consider, then, some person who is now alive and realizes that he will die. Clearly, with the confiscatory inheritance tax, he would plan to leave no estate.[7] Clearly, this person has been made worse off by the tax because he has lost one possible degree of freedom. Before the tax was enacted, he could have saved money and left it to his heirs if he wished, and after the tax he no longer can do so. This reduction in his freedom is not offset by any gain to anyone else in society.

Indeed, as we have mentioned before, this reduction in his gains from accumulating money has been used as an argument *against* inheritance taxation. Surely with 100 per cent inheritance taxation, there will be less capital investment than there otherwise would be. But, in order to make this argument, it is necessary to believe that the amount of capital accumulated under institutions in which inheritance tax is permitted is superior to that in which it is not permitted. Granting this assumption, then the inheritance tax could, of course, be offset by a suitable subsidy on investment. This subsidy would not change the tendency of people to die penniless, but it would mean that people would save more money for the purpose of buying annuities to cover their old age than they otherwise would. The situation with inheritance

[6] It is of some interest that probably a good deal of current savings depends on the fact that for a variety of reasons annuities are not as widely used as they theoretically could be. A law against annuities would probably be an excellent way of increasing our investment ratio.

[7] Unless, of course, he wished to make a gift to the government. Such gifts are possible without the 100% inheritance tax.

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taxation and such a subsidy would be inferior prior to the death of some person simply because the same capital investment would be obtained as without the inheritance tax, but there would be an additional tax imposed on the general population for the purpose of paying the subsidy. Thus, the abolition of the inheritance tax would benefit the taxpayers who otherwise would be paying for the subsidy and injure no one. But all of this, as I said before, requires the assumption that we know the ideal amount of capital investment. Those people, however, who do feel that the amount of capital which would be accumulated without inheritance tax would be too small will find this point quite convincing.

But to continue with our example, now suppose that our selected individual dies. The state obtains no funds because he has been living on an annuity, so there is no tax receipt. The people who would have inherited the money which he otherwise would have saved are worse off than they would have been under the previous set of institutions. No one benefits. Indeed, once again, the fact that there is less capital in society might well be considered a quite general loss. I think that proponents of inheritance taxation at this point would say that the abolition of inheritance, however, *did* benefit those people who would not have received the inheritance since they are not now confronted with a wealthier person in the society. In other words, they would normally envy a man who had received an inheritance, and this is an externality which has been eliminated by the elimination of inheritance. As I pointed out above, if this is thought of as a good social reason for an institution, the appropriate institution is suitably graduated income tax or wealth tax, not an inheritance tax. For the moment, however, the society is assumed not to have a redistribution of income policy and, hence, we can assume that it is not one where jealousy of those wealthier than oneself is a dominant social motive.

Thus, we have demonstrated that A is better than A′. Our proof, however, has been a proof with respect to a confiscatory inheritance tax to which the taxpayer fully adjusts by not having any money left to tax. If we assume that the annuity market is not well enough developed so that individuals can afford to put their entire wealth into such an instrument, then the proof fails but the society is not in long range equilibrium.[8]

It has not been proved, however, that a tax on inheritance is undesirable. Presumably, if inheritances are taxed at any rate less than 100 per cent, at least some people would choose to leave at least some money to their heirs and, hence, there is a government revenue to offset the effects of the inheritance taxation.

[8] The role of annuities or other types of income which terminate at death is so dominant in controlling the amount of savings that such institutions as the Social Security Administration and private annuities markedly reduce total capital investment.

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Here, however, although we cannot prove that such taxes are unwise, we *can* prove quite readily that, if the tax is larger than that tax which brings the maximum revenue, it is unwise. Suppose, for example, that a 10 per cent inheritance tax would lead to a great many people choosing to leave money to their heirs with the result that the total tax collections were $100,000,000. On the other hand, assume that a 75 per cent inheritance tax would sharply reduce the number of people who wish to leave money to heirs so that the total income to the government was only, say, $75,000,000. The argument that we have offered so far would indicate that the first tax would clearly dominate the second. In other words, an inheritance tax in order to be even dubiously Pareto optimal, would have to be either at that rate which maximizes the return from an inheritance tax (which is, of course, not the highest possible rate) or at some lower rate.

Note that such a tax would continue to reduce the total capital available in society and, hence, if you believe that capital generates externalities, would be a dominated policy on that grounds also.

We might temporarily move from square A to square E in our figure in order to discuss the capital problem a little more. Assume that the government uses the receipts from the inheritance tax, at least in part, to subsidize investment. It might be (although I doubt it very much) that it would turn out that there was some net profit, that is, that we could obtain the same net level of investment after the imposition of a joint inheritance tax subsidy on capital as we had before and still have some money left over for state use. As a judgment of the relative elasticities of the demand for savings under the two circumstances, I doubt that this would be true, but we may as well explore the possibility. If it were true, then, once again, one could say that the optimal institution could not involve an inheritance tax and subsidy which jointly were higher than needed to bring in the maximum amount of money which could be obtained by this combination of policies. It would not, of course, have to be that high.

The other possibility in square E and E′, that is, that there is an inheritance tax offset by a subsidy on capital investment which turns out to cost more than the inheritance tax brings in, is clearly undesirable. If this situation occurs, square E clearly is superior to square E′. Note that these general principles will apply to all cases where the government has a pro-capital accumulation policy. In all cases, the reasoning which we have given above would indicate that not having an inheritance tax would be superior to having one, except in those cases where maximum revenue can be derived from either the inheritance tax or the combination of the inheritance tax and the subsidy; in such cases, the tax would have to be equal to or lower than the revenue maximizing level. In other words, there will be no independent

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reason for restricting inheritance. We would simply be choosing a tax by much the same line of reasoning as we would choose a tax on butter.

We now, however, switch to squares H, H′ where we have government which attempts to adjust capital, has an income redistribution policy (we shall assume it is an egalitarian rather than inegalitarian or horizontal income redistribution policy), and direct government control of the economy. Under these circumstances, once again, the institution of inheritance dominates the non-inheritance institution. I have previously demonstrated that it is desirable, even under these institutions, to have decisions as to who shall invest the money for capital projects left to the individual citizen by way of a government bond market (which may be selling bonds at a subsidized rate) rather than having the decisions made directly by the government on both how much should be saved and who should save it. Let us, however, temporarily disregard this proof and assume that the government we are dealing with is Maoist and does not permit its citizens to acquire any kind of capital asset except small quantities of items for personal use.

The arguments for permitting inheritance of this small amount of private property are, once again, fairly compelling. If inheritance was not permitted, individuals would be well advised to rent such goods rather than purchase them. The person who did rent them rather than purchase for this reason is injured to some extent, as is, when he dies, his potential heir and no one gains from the institution.

If, however, we assume that the government with these policies does permit individuals to decide how much each one shall save, then the arguments for inheritance are very much like those in the free market system. It should be noted that, with a highly egalitarian policy and a government security as the only income-bearing asset, individuals would save not for the purpose of increasing their income in the future, but for the purpose of obtaining leisure either for themselves or for their heirs at future times. It might turn out that this is a weak motive for saving and, hence, the subsidy on saving might have to be quite high. Still, the argument holds. Individuals before their death would be injured if they are prohibited from passing on their estate to their heirs because it eliminates one possible alternative which they might otherwise choose. Their potential heirs would be injured after their death and, assuming state annuities are available (their absence would be inefficient), no one would gain from these two changes.

We could go through all the other pairs of squares on Figure I, but this would be tedious. The general principles still apply: by strict welfare economics methods, we can show that permitting inheritance of wealth is a desirable policy. Further, we can show that, although there is no reason why inheritance should be any more immune than gasoline from taxes for revenue purposes, any effort to raise taxes above the revenue maximizing point is always a non-optimal policy.

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