Fair Dues

Towards a more progressive inheritance tax

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Graphs

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Summary

At a time when there is growing evidence that wealth inequality contributes to unequal life chances, and the richest two per cent own almost a third of all the wealth in Britain, inheritance tax is under attack from both left and right. There are excellent reasons to defend it: inheritance tax, or IHT, is a crucial counter-weight to the accumulation of wealth, and as a tax it is relatively undistorting. But to secure its long-term future we must reform it, creating a more progressive structure that causes fewer difficulties for those who pay. Several ideas are looked at:

Replacing IHT with a capital receipts tax, so that the bill depends on the recipient rather than the estate, poses some serious challenges. Collection and compliance costs would be likely to increase, and the effect on revenue would be uncertain. Using a structure recently proposed by the Fabian society, the tax could actually be less progressive compared to IHT, and would probably reduce the yield from inheritance slightly. It should be seen not just as a reform of inheritance, but a as whole new tax on lifetime gifts. It would also impose a welfare cost on individuals, and it is not certain that the pattern of inheritance would be significantly changed.

But a progressive banding of inheritance tax is possible and desirable. The preferred option would keep the current tax-free allowance of £263,000, but the first £25,000 after that would be charged at 22 per cent, rather than 40 per cent. Almost one in five of tax-paying estates would pay only this starting rate, addressing complaints that IHT penalises the moderately wealthy who are unable to use complex tax-avoidance techniques. Matching the income tax rate would also help people to frame inheritance as windfall income, and would help prevent the misleading summary of IHT as a “40 per cent tax on inheritance”. This could be combined with a new top rate of 50 per cent, applied to that part of the estate that exceeds £500,000 after the deduction of exemptions and the tax-free allowance. Overall, 87 per cent of estates (18,000) would be better off under this system, and the 13 per cent (3,000) would have a higher tax bill. Total revenue would increase by about £147 million.

Other loopholes and exemptions could be closed. Tax on capital gains, currently waived, is the most obvious candidate. Tax must not be retroactive, so the only capital gains that can be taxed are gains after the policy change. This means no revenue would be available for some time – but it is otherwise an attractive possible complement to inheritance tax.

Resident dependents of the deceased should be given the option to defer the payment of IHT on their house. This would reduce the possibility of “forced” sales of family homes, and would have a negligible impact on revenue in the long run.

Public support for inheritance increases when it is linked to a specific spending programme. Formal hypothecation is undesirable and impractical, but an

informal linking of tax *changes* to a popular programme may focus thinking and increase support.

The Child Trust Fund is about the right size, and would reflect the idea of "socialised inheritance". It is an option worth pursuing, but qualitative research by ippr suggests public support for the link would not be automatic.

Long-term care for the elderly is also attractive, and has a much stronger link in the public's mind. There are two important risks: the costs could increase dramatically in the medium term, and public support could be drain away as it is absorbed in normal health and social services expenditure.

Introduction

Inheritance tax is under siege. From the right, angry headlines announce that "the average house owner is no longer safe", that "Gordon Brown's £2.8bn assault" penalises hard work, and that inheritance tax is "the curse of middle England" (Mail on Sunday, 16 May 2004; www.thisismoney.com). From the left, there is a growing unease at a widening distribution of wealth and widespread tax avoidance by the super-wealthy. In the words of John Whiting, tax partner at accountants PricewaterhouseCoopers, inheritance tax is "a slow-fuse time-bomb" (Interviewed by the author 18/05/04): if progressives don't produce clear ideas for reform, we can be sure that others will.

Fair Dues argues that we need to defend the principle of a strong inheritance tax, but that the current system has serious problems. The two go hand in hand: to defend a strong tax, we need to reform its errors; to reform its errors, we must defend its principles.

This paper is part of a larger project called *The Citizen's Stake: Exploring the Future of Universal Asset Policies*, carried out jointly by the Institute for Public Policy Research (ippr) and the Centre for Democratic Government in Oxford University's Department of Politics.[1] The project draws on political philosophy, economics, and innovative public attitudes research to explore how we can ensure that every child enters adulthood with a generous amount of capital. It joins a debate on ownership that stretches from early democratic revolutionaries, such as Tom Paine in the 1790s, to social democrats, like Tony Crosland in the 1950s. It is a debate reflected in the philosopher John Rawls' call for a "property–owning democracy" to realize social justice and, more recently, in the arguments that academics Bruce Ackerman, Julian Le Grand and others have made for the introduction of 'stakeholder grants' (Ackerman and Alstott, 1999; Nissan and Le Grand, 2000).

Reform of inheritance tax is a small contribution to this debate. The tax is important because reform could help pay for a "citizen's grant" of some sort, but also because in itself it affects the level and distribution of asset holdings. Governments have only a limited ability to affect how wealth is transmitted across generations, but the cumulative effect of a modest tax can be powerful.

How is inheritance taxed now?

In essence, tax is charged at 40 per cent on every pound of estate over £263,000, but there are important exemptions and additions.

First of all, the "*net estate*" is calculated by taking away debts and funeral expenses, and adding in a percentage of certain gifts that were made up to seven years before death.

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[1] See www.ippr.org/assets for more information.

Certain *exemptions* are also removed from the net estate, including charitable donations, “heritage assets”, agricultural land, unquoted shares and anything inherited by a surviving spouse.

If the net estate after exemptions is less than £263,000, no tax is paid.

If the net estate after exemptions is worth £263,000 or over, 40p tax is charged for every pound that exceeds the threshold.

Gifts are normally included in the net estate if they were given less than seven years before death. However, any gift less than £250 is ignored, as are all gifts if they total less than £3,000 in any tax year. There are more generous allowances for wedding gifts, amongst others, and the amount that any gift adds to the net estate is reduced according to when the gift was given. For example, if the gift was given in the year immediately before death, the full value is added to the net estate, but if it was six or seven years before death, only 20 per cent is added.

Structure of this paper

The rest of the paper is laid out as follows. The first section asks two key questions: why should we defend the principles of inheritance tax? And given that defence, why should we reform the details?

Section two presents several possible reforms: scrapping the tax entirely, and replacing it with a tax on capital receipts, rather than estates; creating bands, with higher rates for larger estates; removing exemptions around agriculture and capital gains; and helping people to pay the tax on “lumpy assets”, such as homes. Section two concludes with some potential packages of reforms.

Qualitative research carried out by ippr suggests that earmarking inheritance tax could increase support for it. Section three explores this argument. After summarising the theoretical arguments for and against earmarking, it examines the case for spending any increased revenue on two specific programmes: the child trust fund, and long-term care for the elderly.

Section four concludes, and identifies questions for future research.

Section 1: Defend and reform

1.1 In defence: why tax inheritance?

Periodic cries from the right call for "euthanasia for death duties" (Bracewell-Milnes, 2002) and President Bush's 2001 tax cuts will repeal all estate taxes in America by 2010. But inheritance tax should be defended. A strong case can be built on the grounds of efficiency, stability, and fiscal neutrality, and there are powerful egalitarian arguments for taxing inheritance.

We should tax inheritance to reduce the burden of other, less desirable, taxes. If inheritance tax, or IHT, were abolished, other taxes would have to rise in response. These would distort other incentives in more damaging ways. Income tax can penalise work, and VAT penalises spending and thus earning, but the distortionary impact of IHT is thought to be smaller.

Exactly how much smaller depends largely on the motive for bequests (Masson and Pestieau, 1997). To the extent that bequests are "accidental" – the result of savings held as a precaution by the elderly and intended primarily for that purpose – then the taxation of inheritance can in theory have a zero efficiency cost. In other words, there is no excess burden or substitution effect. This doesn't mean that the optimal tax is 100 per cent, as inefficiencies may still be caused through effects on labour supply – but the optimal tax is likely to be high (Blumkin and Sadka, 2003).

On the other hand, the taxing of "intended" bequests – where money has been saved specifically for that purpose – does affect incentives, and this "substitution effect" has a welfare cost.

Which of the two bequest types dominates? It is a matter of some debate. Several facts suggest that accidental bequests are common, and donors are not motivated merely by the desire to improve the welfare of their heirs: there is a strong need for precautionary savings, given an uncertain length of life and uncertain health costs; how an estate is split does not normally take account of inheritors' different incomes, whereas gifts during the lifetime do; and the distribution of wealth within extended families is highly dependent on the distribution of income within that family. Thus extended families are not a single unit, with resources shared selflessly within them.

There are also arguments in favour of intended bequests. The fact that lifetime gifts are common, as are inheritance tax planning and life insurance, suggests that there is a significant intended bequest motive. In the end, though, all we need to prove is that the accidental bequest motive is significant. Therefore a significant inheritance tax should be levied as part of a broad tax base, allowing lower marginal rates, more stability and "fiscal neutrality". This argument is illustrated further in Box 1.1.

An alternative way of viewing the argument for a broad tax base is to see IHT as a way of deferring normal lifetime taxation until death. This allows people to continue capturing the “use value” of their assets. Pensioners, for example, can continue to live in their own houses; higher consumption tax, income tax, capital tax or user chargers would all reduce their living standards in a way that IHT does not. This is particularly applicable to user charges for long-term personal care for the elderly, and is explored in more depth in section three of this paper.

Box 1.1: Myths and misunderstandings

Myth 1: inheritance tax hits the average homeowner

Very few estates pay inheritance tax – Inland Revenue estimates the number at 3.5-4 per cent (Inheritance Tax Introductory Note, C14; T12.3: note). It is worth remembering that the “net estate” must be worth more than £263,000 in 2004-5 *excluding* any inheritance by a surviving spouse, any debts, and any family-owned business (unquoted shares).

Myth 2: inheritance tax is unfair because it is “double taxation”

It is true that much of an inheritance may have been taxed when it was earned. But multiple taxation is common: in order to achieve a broad tax base, wealth is already taxed many times as it passes through the system, including when it is earned, saved, or spent. Transactions, not bank notes, are the proper subject of taxation.

Not only is multiple taxation common, in some circumstances it is also desirable. A system that taxes many sources of income is much more fair, stable and neutral to incentives than one that taxes only income. This was referred to earlier, when we argued that IHT is desirable because it allows other taxes to be reduced. Compare the two systems below. “Single taxation” would further penalise work, would also penalise the majority of people who rely on earned income rather than capital, and the revenue would be highly vulnerable to a cyclical drop in earnings.

“Single taxation”: distortionary		“Multiple taxation”: a broad tax base	
Income tax	80%	Income tax	40%
Capital taxes	0%	Capital taxes	20%
Consumption tax	0%	Consumption tax	20%
Inheritance tax	0%	Inheritance tax	40%

So even if IHT is double taxation, that may be no bad thing and no different from many other taxes. In many cases, though, IHT is the first time that an asset has been taxed. Capital Gains Tax, for example, is levied on most assets when they increase in value between being bought and being sold, but it does not apply when the owner dies. Nor does it ever apply on someone’s main residence. Without IHT, stock options and “stock swaps” (when companies merge by swapping shares) could be acquired and passed on without ever paying a penny of tax.

Furthermore inheritance tax is in effect paid by the recipient, not the donor – who is, after all, dead. So IHT can never be double taxation of *individuals*, but only of families.

Myth 3: inheritance tax takes 40 per cent of your inheritance

Each *extra* pound over the threshold will be taxed at 40 per cent, but the overall tax rate over the whole estate (the average, or effective, tax rate) will never be that high. On an estate worth £300,000, for example, the effective tax rate would be 5 per cent; on an estate of £500,000 it would be 19 per cent and on £1 million it would be 29 per cent. For the effective tax rate to be as high as even 35 per cent, the net estate would have to be worth more than £2.1 million.

Myth 4: inheritance tax is not an important source of revenue

Inheritance raises considerably less than, say, income tax, but that does not mean it could be abolished without serious consequences. Inheritance tax is thought to have raised £2.5 billion in 2003-4 (HM Treasury, 2004: p.246). To put this in context:

- £2.5 billion was substantially more than the total budget for either the Foreign Office (£1.8 billion) or the Department of Culture, Media and Sport (£1.6 billion).
- £2.5 billion was almost enough to pay for the entire capital budget of the NHS in England: the capital expenditure of the NHS in 2003-4 was £2.6 billion (Both ibid: p. 269)

Thus there are good administrative reasons to tax inheritance. There are also convincing egalitarian arguments.

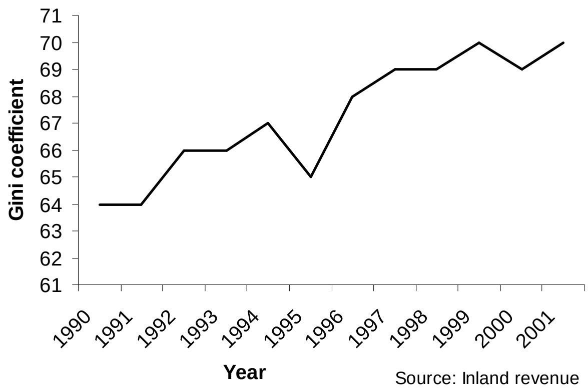
Inheritance and wealth are very unequally distributed. Inheritance tax is a small but important counter-balance. British Household Panel Survey data suggest that, of those who inherit, the smallest fifth of inheritances have a mean of £381. The largest fifth have a mean of £70,000 (Quoted in Future foundation, 2002: p.4). This inequality of inheritance could significantly contribute to wider patterns of wealth inequality: one study of America suggested that 35-45 per cent of total wealth is inherited (Davies and Shorrocks, 2000, quoted in Blumkin and Sadka, 2003).

And the wider inequality of wealth is considerable. For every millionaire, there are 60 people with a total marketable wealth of less than £5,000 each – 30 per cent of the adult population. The inequality of wealth in Britain is twice the inequality of income: the gini coefficient, a measure of inequality that gives total equality a score of zero and total inequality a score of one, marks the distribution of household income around 0.35, and inequality of wealth around 0.7 (Inland Revenue T13.5). Wealth inequality is not only high, it is getting higher: the gini coefficient of wealth has been rising steadily since 1992 (see Graph 1.1), and the percentage of wealth held by the richest one per cent increased from 18 per cent to 22 per cent between 1992 and 2000 (Inland Revenue, T13.5).

Against this background, IHT can only ever make a small difference. But it is still important. IHT acts as a once-a-generation wealth tax, marginally reducing the transmission of inequality. It may be desirable to enact a wealth tax itself, but that raises a series of questions that are beyond the scope of this paper.

1.2 Why reform inheritance tax?

Graph 1: Wealth inequality is high and rising



Source: Inland revenue

So if inheritance tax is worth preserving in some form, why should we reform it? Public opinion research on inheritance, carried out by ippr and Oxford University to be published in 2005, revealed a large degree of hostility towards inheritance tax. Attitudes were complex, often contradictory, and changed considerably over the course of deliberative workshops. But consistent themes still emerged, and criticisms focused on the idea that IHT is "optional" for the super-rich, so is mainly paid by those on moderate incomes; and that it forces the sale of family homes and so has a greater welfare cost than other taxes.

These criticisms give us our objectives of reform, though these two may at times conflict. They form two of the following headline goals, and are elaborated below:

- to make the tax more progressive
- to reduce the welfare cost that the tax places on those who pay it
- to increase revenue.

IHT could be more progressive. A "progressive" tax is one in which the proportion of income or wealth that is taken in tax increases with income or wealth: the rich pay a larger slice of their inheritance. In this technical sense IHT is already progressive, but it could and should be more so. Simply to be progressive is a low standard, and is satisfied whenever the marginal tax rate is above the effective tax rate; that is, the extra tax on an extra pound of estate is a higher percentage than the total tax over the whole estate. This is always true if there is a nil-rate band followed by an unchanging rate of tax. In the case of inheritance tax, the first £263,000 is exempt, so the tax rate over the whole estate will increase as estates rise, but never quite reach the marginal rate of 40 per cent.

Nevertheless, more progressivity is an important objective of reform because of tax avoidance at the top, and fiscal drag at the bottom. The use of trusts, lifetime gifts and careful planning allow the very wealthy to avoid a large tax bill: former Beatle George Harrison, who died in 2002, avoided almost £40 million of inheritance tax through the use of trusts. Meanwhile those of more moderate wealth – either unaccustomed or unable to use the same loopholes – are caught in the net. If your main asset is your family home, you cannot give it away before death, and trading down to a smaller house imposes a large transaction cost. At the bottom, the number of taxpayers has increased through fiscal drag: the tax-free threshold is indexed to consumer inflation, rather than faster-rising house prices. Between 1994 and 2004 the threshold increased by 75 per cent, while house prices increased 150 per cent (HBOS). A more progressive inheritance tax would therefore place a heavier burden on the very wealthy who are comfortably over the threshold, and a lighter one on reasonably wealthy homeowners.

It is worth remembering, though, that the poorest IHT-payers are still far from poor: an estate of £263,000 is considerable, even given recent house price increases. A recent article in the Financial Mail on Sunday (16 May 2004) attempted to show that "in towns like Windsor the average house owner is no longer safe. Under the headline "Is an Englishman's home still his castle?" the paper provided figures on the level of savings needed in addition to an average house to reach the IHT threshold in each part of the country. The results were startling: although in Greater London the average house only needs to be topped up by £315 savings to reach the threshold, in the South East excluding London the figure is £58,693; in the North East it is £160,671; and in Scotland £177,788. These are considerable sums. They serve to remind us that a more progressive IHT would shift the burden from the moderately wealthy, rather than the poor – who are already ineligible.

An ideal IHT would also be progressive in the sense of encouraging progressive behaviour and recognising progressive ideals. Thus we might expect IHT to promote wider asset ownership and recognise same-sex as well as married couples.

IHT should minimise the welfare cost to taxpayers. Not every pound of tax is as painful to pay. Minimising the welfare cost should be of interest to any benevolent tax reformer, but is doubly important in the emotive and politically-sensitive case of IHT. If the tax "forces" the sale of a family home for example, then it is presumably more burdensome than a tax which merely induces lower petrol consumption. Whether in fact IHT does force homes to be sold is an open question, and is explored in more detail later in the paper.

Finally, an ideal IHT would raise more revenue. Even as wealth inequality is rising, the Inland Revenue estimate that only 6 per cent of the value bequeathed per year is taken in tax. Furthermore the contribution of wealth transfer taxes to the total tax revenue has fallen from 2 per cent in 1971 to 0.65 per cent in 2001 (OECD 2003, quoted in Duff forthcoming:1). At first glance, this seems like a possible way to raise money for policies that will spread asset ownership and the life-changing opportunities that go with it. This point will be expanded in the final publication, as part of *The Citizen's Stake: Exploring the Future of Universal Asset Policies*.

The overall aim, then, is a more progressive, amenable and lucrative inheritance tax: a bigger pill that is easier to swallow. These political aims must be combined with administrative and economic ones; a summary of optimal tax design is in Box 1.2.

Box 1.2: Principles of tax design and tax reform

1. **Horizontal equity**

If people are the same, treat them the same way.

2. **Vertical equity**

If people are different, treat them differently. Which differences and similarities count as relevant is never clear-cut, but the general rule is to recognise and make allowances for involuntary differences in situation, but not differences that result from choice.

3. **Minimal deadweight loss**

When a tax is levied on a good, the price received by the seller is lower than that paid by the buyer. This prevents some sales from taking place, even if they would otherwise increase welfare. The net loss of utility is known as a "deadweight loss", or excess burden.

4. **Minimal distortion of incentives**

The tax wedge that creates a deadweight loss also distorts incentives. The degree of distortion depends on the marginal tax rate, rather than average rate.

5. **Minimal collection and administration costs**

The tax process should be as simple as possible for Inland Revenue.

6. **Minimal compliance costs**

The tax process should be as simple as possible for the taxpayer.

Adapted from Atkinson and Stiglitz 1980; Kay and King 1990.

The context of IHT reform is also important. The Fabians' Commission on Taxation and Citizenship proposed in 2000 that estates tax be replaced by a tax on the recipient; this is discussed more in Section 3. Meanwhile the Treasury has been steadily closing loopholes. In February 2004 the consultation period closed on removing a scheme that allowed couples to sell their home to a trust, but continue to live there; "gifts with reservations", where the donor retains the use of the gift, are becoming taxable; and from April 2005 so are "double trusts", whereby a home is sold to one trust in return for an IOU that is given to a second trust, allowing rent- and tax-free use of the house for the donor.

Section 2: Options for reform

The two biggest possible reforms of inheritance tax would be to replace it with a capital receipts tax (or CRT, discussed in section 2.1), or to introduce a progressive banding structure (section 2.2).

We could also look at tightening the exemptions. Section 2.3 considers removing the exemption of capital gains tax and agricultural property.

Moving in the other direction, we may want to introduce new exemptions: section 2.4 looks at inheritance tax on housing.

This is followed by a summary table of proposed reforms, showing to what extent they meet the criteria laid out above.

2.1 Replace tax on estates with tax on inheritance

What we call inheritance tax is not really a tax on inheritance at all: it is calculated and levied not on the amount received, but on the total estate regardless of who inherits it. A tax on inheritance could take account of the individual circumstances of the legatee.

The proposal is not new. The Fabian Commission on Taxation and Citizenship (2000), and the Institute of Fiscal Studies as early as 1973 (CT Sandford et al, 1973.), argued that IHT should be replaced by a tax on lifetime gifts, a Capital Receipts Tax (CRT, see Table 2.1 overleaf). The exemptions and rate of tax paid would depend on the cumulative total of gifts received by the individual over his or her lifetime, according to the schedule in Table 2.1. Since 1976 Ireland has had a similar scheme, the Capital Acquisition Tax (CAT). Tax is levied on recipients rather than donors, with the tax rate dependent on the relationship between the donor and the recipient. Yield has steadily fallen in Ireland as the tax rules have been simplified.

In theory a similar change in Britain could clarify a key principle of IHT, promote a more equal distribution of wealth and reduce tax avoidance. Linking tax to the recipient suggests that this is the taxation of unearned income, rather than accumulated wealth (although it differs from an income tax in that assets, such as houses, would have their values assessed and taxed). There are hopes that it could help encourage a wider distribution of estates. And most importantly, it could close the biggest loophole facing British IHT: the very wealthy are able to dispose of a large proportion of their assets during their lifetime, avoiding tax completely if they do so seven years or more before death. As already noted, those with more moderate wealth are generally unable to take advantage of this because they rely on their assets for housing, security, or income.

Table 2.1: Fabian Proposals for a Capital Receipts Tax (CRT)

Size of capital receipt	*Marginal tax rate*
Up to £80,000	Nil
£80,000 - £160,000	20%
£160,00 - £240,000	30%
Over £240,000	40%

Crucially, the tax would be levied on all lifetime gifts as well as legacies, and the rate depends on a lifetime accumulation, rather than simply the size of the latest receipt. For example, if an individual has already inherited or been given £240,000, then an additional inheritance of £10,000 would be charged at the top rate of 40%.

But a capital receipts tax faces three serious charges: the administration cost of a lifetime gifts tax could be considerable; revenue might drop, leading to a potentially regressive tightening of thresholds and rates; and the effect on giving patterns might after all that be negligible – few people would rewrite their will as a result of the tax changes.

To analyse these problems in more detail, we will look at the Fabian structure – but neither their rates nor their bands are inherent to a CRT, and their own proposals recognised that the exact configuration needed more debate. Criticisms of the Fabian proposals are damaging only if it can be shown that the point can be generalised.

Administration costs

The first charge against a CRT is the extra administrative burden, falling on both the Inland Revenue and individuals. As the Fabian pamphlet "Wealth's Fair Measure: The reform of inheritance tax" (Patrick and Jacobs 2003) pointed out, introducing CRT would require all tax payers to retain detailed records of gifts received. There would presumably be a threshold per donor, below which gifts would not have to be declared (say, £2,000 per year) but above that individuals would have to keep a running total *even if* they are well below the £80,000 level at which the tax would start. For administrative reasons, it may be necessary for individuals to have complete gift-by-gift records, rather than just a running total: the Inland Revenue must be able to check declarations, and checks would then range over the entire history of receipts, rather than just the most recent. There is a strong suggestion from Ireland that the collection costs of their own version of the CRT are disproportionately high (Declan Rigney, interviewed by the author 04/05/04).

Yield

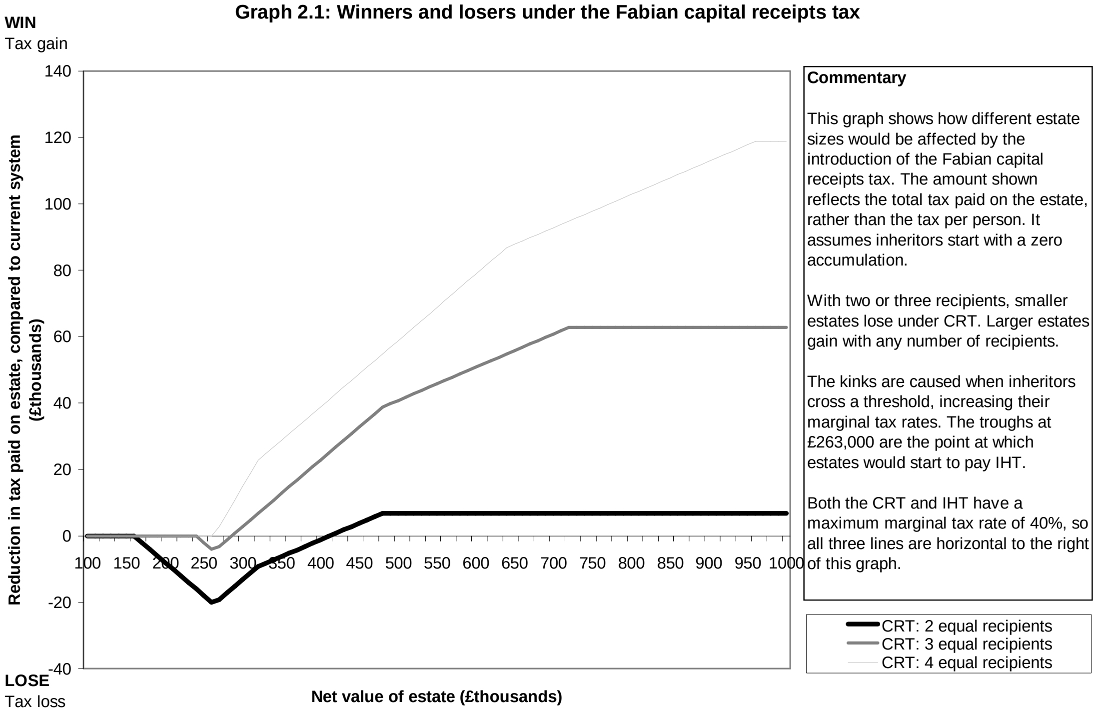
The impact of CRT on the yield is hard to predict. We are interested in two questions: what happens to the total yield, and what happens to the distribution.

On the question of total yield, it is possible to produce only very rough estimates. Nevertheless, the answer is illustrative: applying CRT to estates, assuming they are split equally between four equal inheritors, is estimated to raise £1.4 billion, compared with £2.3 billion under the present system. There are several important caveats, so that these factors mean that the figure of £1.4 may be a rough estimate of a lower bound. Appendix 1 explains assumptions about previous inheritance (none), gifts more than seven years before death (ignored), the division between inheritors (assumed equal), and the number of inheritors (assumed four, in line with BHPS data). Reducing the number of inheritors to two increases the yield to £2.1 billion – given the high margin of error, not significantly different to under IHT. As a minimum, the number tells us that if the Fabian CRT is to raise as much money as IHT, it would have to raise a significant sum from gift-giving that is not presently taxed. In other words, taxes on gifts more than seven years before death. This may or may not be problem, but any reformers must be aware that the losers will be vocal, and the winners undefined and unorganised. It is not so much a reform of inheritance tax, but a whole new category of taxation.

Winners and losers under a CRT

Graph 2.1 shows how estates of different size would be affected by the introduction of a Fabian CRT, depending on how many people inherit. It is clear that smaller estates with two or three inheritors would pay more tax, because the starting threshold is lower under CRT; and all larger estates would pay less tax than under the present system, as marginal tax rates are lower. For estates split between two people who have never inherited before, the breakeven point is £360,000. This falls as the number of inheritors increases. Once all exemptions are used up, both systems have the same marginal rate of 40 per cent on each extra pound of estate or inheritance, so that the total gain does not increase beyond a certain point.

Graph 2.1: Winners and losers under the Fabian capital receipts tax



The graph relates specifically to the Fabian proposals, but there are important points that can be generalised:

- First, moving the threshold so that inheritance that is currently exempt becomes taxable is a regressive change, even if it is taxable at a lower rate than the current one.
- Secondly, unless the top rate of tax is increased, any move to introduce bands will give a bigger absolute benefit to larger estates rather than smaller ones, because they are able to take full advantage of all exemptions.
- Finally, calculating exemptions per inheritor gives a significant tax advantage to estates with many inheritors.

Encouraging a wider distribution of inheritance

This last point goes to the heart of the Fabian proposals: new incentives would be created to spread inheritance more widely. But whether a CRT would in fact encourage a wider distribution of inheritance is uncertain. Hard evidence on how giving behaviour would respond to tax incentives is unsurprisingly scarce, but the response in ippr deliberative workshops was unequivocally discouraging. Patrick and Jacobs, in 2003, suggested that CRT “might in theory lead to donors leaving their wealth to a larger number of people…[but] evidence from tax practitioners suggests that donors’ behaviour is unlikely to change.” (p. xiv.) This is certainly the opinion of John Battersby, a KPMG tax partner who analysed the proposals in the same volume.

Even if a CRT does change giving patters, to justify a deliberate distortion of incentives we would have either to convincingly demonstrate the presence of externalities, or build an egalitarian argument based on diminishing marginal returns to wealth. Such arguments could be made. On externalities, we could say that there are negative externalities to wealth. In other words, the donor may want to give to his rich daughter, but letting the rich get richer makes us all feel poorer, so we should ignore his pain and pursue a broader common good (for example, Layard 2003).

Conclusion

What is our final conclusion on shifting the tax incidence to the recipient? Working through the three main objectives:

- The change would not necessarily be progressive, and the Fabian structure was actually regressive.
- The welfare cost to the inheritor, per pound of tax, is not changed.
- The effect on revenue is uncertain and hard to predict, but the Fabian version would probably reduce the total yield from inheritance. More money would be raised from lifetime gifts.

From the administrative criteria, laid out in Box 1.2 (page 15), we can say:

- Horizontal and vertical equity would probably be improved, by taking closer account of the recipients' circumstances. However it is not wholly clear whether the size of the estate should be considered as an "irrelevant difference".
- Artificial incentives to spread the estate between more recipients would be affected, and this would impose a welfare cost on the would-be donor. Whether or not this is a matter for concern depends on how strongly we believe that a more equal society is a happier one, and on how much we think donors would actually respond to tax incentives when writing their wills.
- Collection costs would increase, given the greater complexity.
- Compliance costs would increase, due to the demands of record-keeping.

This summary is mostly negative. We cannot rule out a beneficial and desirable CRT, and more analysis is needed – in particular on the distributive impact and the effect on yield, using different assumptions about the pattern of inheritance receipts over the lifetime. But as starting analysis, the arguments presented so far suggest that a progressive and effective CRT would be a difficult challenge. A whole new category of activity would be taxed, and that the hoped-for benefits in giving behaviour are far from certain.

2.2 Introduce bands

Breaking inheritance tax rates down into different bands is one of the simplest of possible inheritance tax reforms. It could have a big impact. While it is the average tax rate on an estate that is reflected in the cheque sent to Inland Revenue, the most visible summary of the tax is the marginal rate. It was to this that most people referred in the deliberative workshops organised by ippr and Oxford University, and, as phrased by Adrian Shandley of IFA Premier Wealth Management, "they see the potential of a 40 per cent tax bill and that sets alarm bells ringing" (Quoted in Womack 2004). In fact, because of the exemption at the bottom, the tax levied on an estate never reaches 40 per cent. Even a half-million pound estate will only be taxed at an effective rate of 19 per cent.

What would a banded IHT look like? This paper assumes that the basic rate would be kept at 40 per cent, but that an easier starting rate should be adopted at the bottom, and a tougher rate at the top. Thus the first part of a large estate would be charged at 0 per cent, the next part would be charged at a starting rate of, say, 30 per cent, the middle at 40 per cent, and the top part at, say, 45 per cent. Only the largest estates would be big enough to reach the top band, and a significant number would be charged only at the starting rate. This could be part of a package of reforms to appeal to the public, and follows naturally from the arguments laid out in Section 1 of this paper: there are robust egalitarian reasons to tax the transmission of inequality across the generations, and the increasingly unequal distribution of wealth, amongst other reasons, suggests a higher tax rate could be desirable; but the unpopularity, misunderstandings and rising number of taxpayers suggest that IHT could be loosened at the bottom.

The effects on revenue

Starting at the bottom, and still using 2000-01 data, Graph 2.2 (overleaf) shows the effects on revenue of introducing a starting rate. It varies according to both the rate (shown on the x-axis) and the threshold (show by different lines). The thresholds shown refer to chargeable estates, rather than net estates: in other words, they are the size of the estate after deducting debts, pre-tax reliefs and the IHT nil-rate band (£234,000 in 2000-01).

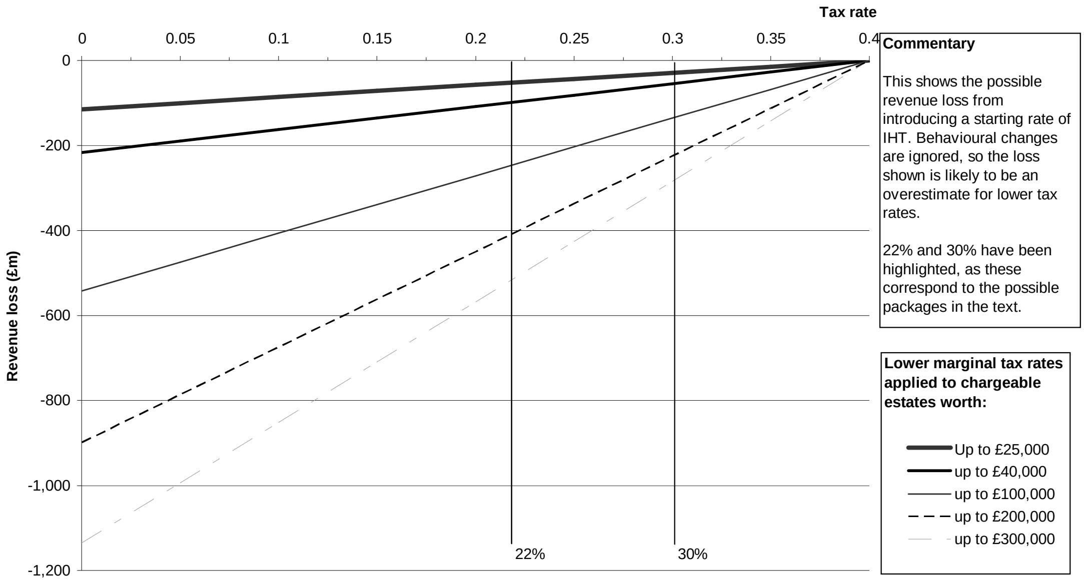
There are several points of interest. Firstly, increasing the tax-free allowance (the nil-rate threshold) is expensive: allowing an extra £25,000 tax-free would cost £115 million, and an extra £100,000 would cost £542 million.

Yet the cost of only partially reducing IHT at the bottom is (of course) much less, and arguably quite modest: charging the first £100,000 at 30 per cent would cost around £135 million.

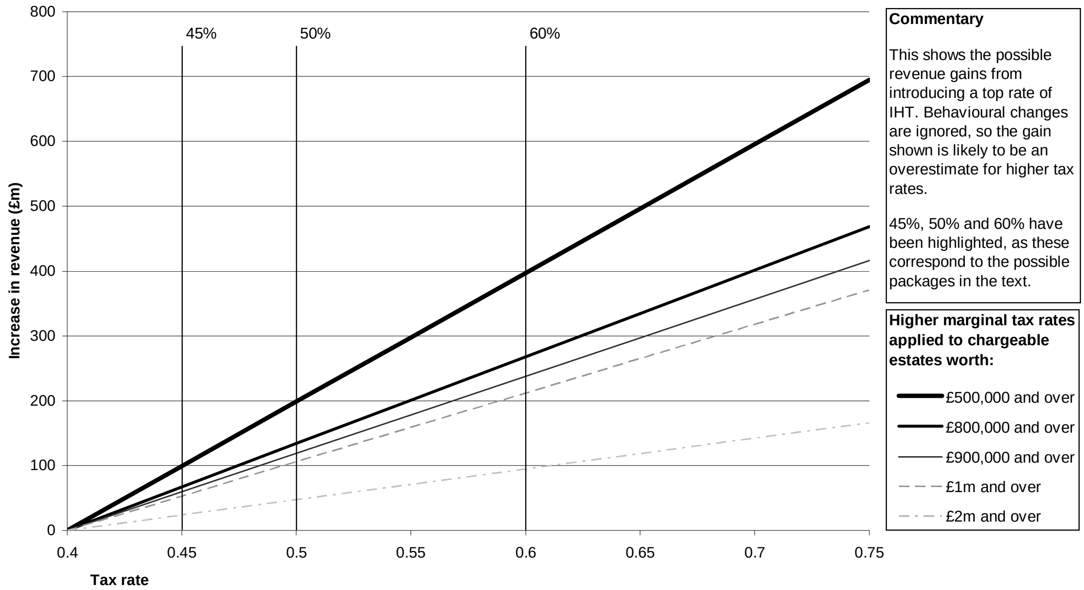
Finally, and also predictably, the yield is disproportionately sensitive to changes at the bottom. For example, doubling the size of a starting-rate band from £100,000 to £200,000 increases the cost by only 66 per cent.

Graph 2.3 shows the revenue impact of possible higher rates. Although significant changes are needed to bring in substantial revenue, it is possible to make changes that more than counter-balance the changes at the bottom.

Graph 2.2: the revenue loss from decreasing IHT at the bottom



Graph 2.3: the revenue gain from increasing IHT at the top



Possible packages

Table 2.2 gives some possible banding structures. The first two bands have been designed to be revenue-neutral to within £2 million. The last two have been designed to raise slightly more revenue, and collect an extra £147 million and £300 million respectively. These are small figures, but provide just enough to justify the tax by linking it to a popular spending programme (see section three).

It is clear that a progressive "topping and tailing" of IHT is achievable. Modest increases in revenue are also possible – the packages shown here are only some of the possibilities, and the source data for the revenue effects are given in the appendix (Table A7).

But the packages also show that most changes sound much more aggressive than they actually are – the revenue is more sensitive to changes at the bottom, so a package must have bigger changes at the top than the bottom to break even. For example, package D cuts the rate by 10 per cent for the first £100,000 of chargeable estate, and raises the rate by 10 per cent for any chargeable estate over £500,000. One would think that the latter change is much greater because it continues without limit, but the overall effect is negligible. This may be a problem when selling IHT reform to a public wary of "stealth taxation".

Table 2.2: Some ideas for banded inheritance tax

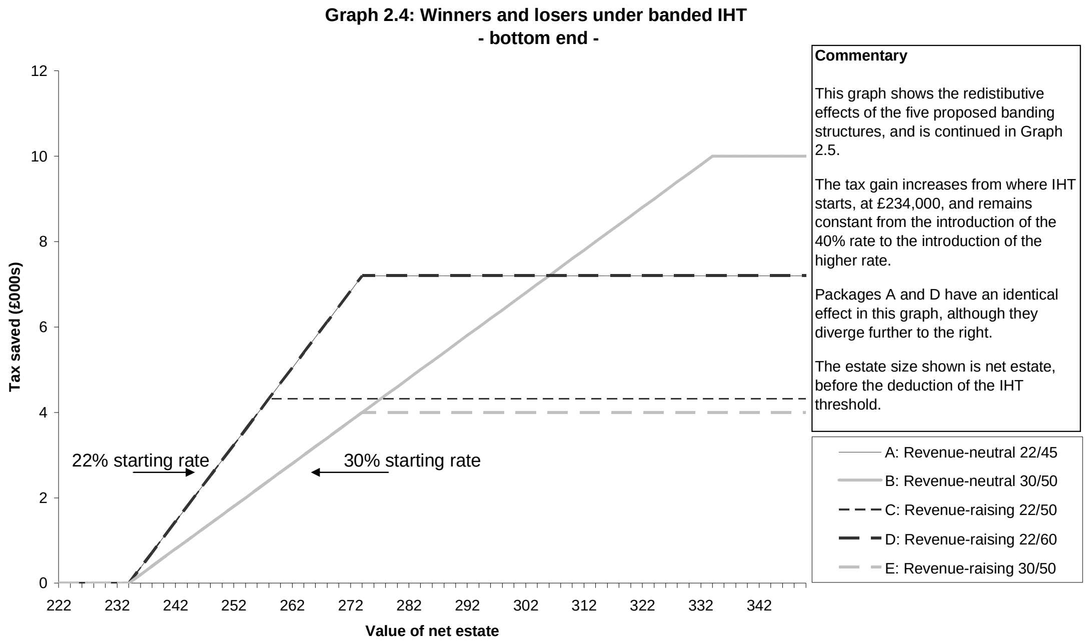
	Lower band	Upper band	Estimated revenue change
A. Revenue-neutral 22/45	22% on chargeable estate below £40,000	45% on chargeable estate above £500,000	+ £1.8m
B. Revenue-neutral 30/50	30% on chargeable estate below £100,000	50% on chargeable estate above £800,000	- £1.6m
C. Revenue-raising 22/50	22% on chargeable estate below £25,000	50% on chargeable estate above 500,000	+ £146.9m
D. Revenue-raising 22/60	22% on chargeable estate below £40,000	60% on chargeable estate above 500,000	+ £299.6m
E. Revenue-raising 30/50	30% on chargeable estate below £40,000	50% on chargeable estate above 500,000	+ £144.4m

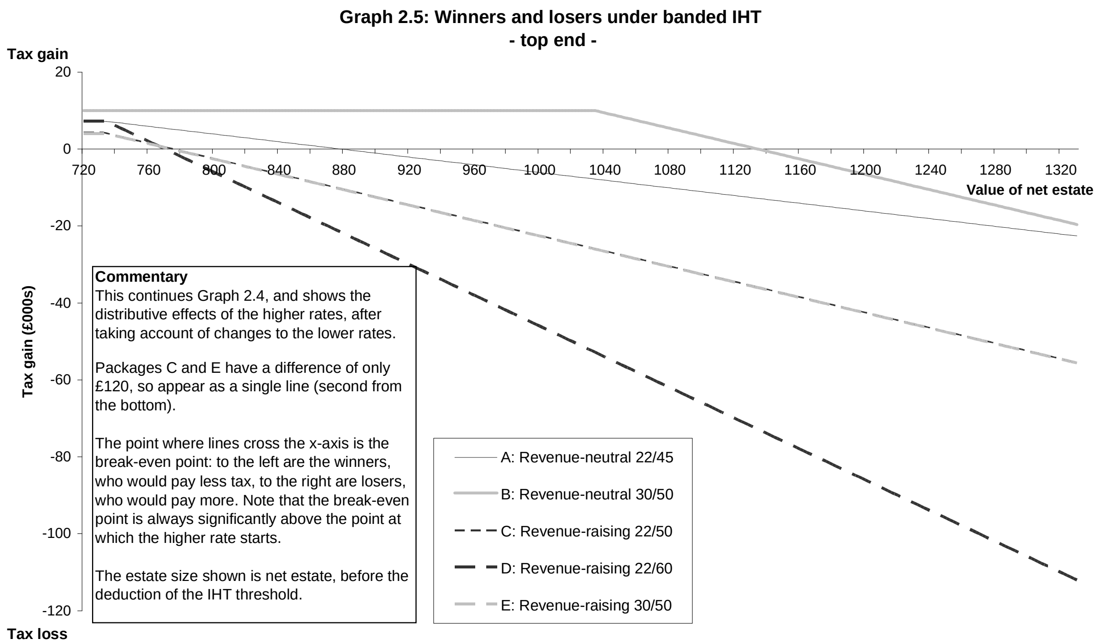
Notes:
1. All packages assume a middle rate of 40%.
2. Estate figures refer to chargeable estate, not net estate. In 2000-01 the nil-rate threshold was £234,000, so a chargeable estate of £100,000 would be worth £334,000 before deducting the threshold.
3. Build your own inheritance tax – see table A7 for source data.

Who wins and who loses?

Graphs 2.4 and 2.5 give more detailed analysis of who wins and who loses under the different banding structures. Packages which start with a 22 per cent starting rate are shown with black lines, and those with a 30 per cent rate are shown in grey; revenue-neutral packages have solid lines, and revenue-raising ones are dashed.

While the total revenue is more sensitive to changes at the bottom, Graphs 2.3 and 2.4 show that the possible gains and losses per estate are more sensitive to changes at the top: the maximum possible gain per estate is limited, whereas maximum possible loss is not. Yet the break-even points are high: under Package B, estates would be better off unless they were worth more than £1,132,000 (net). The smallest break-even point is under Package D, which would benefit estates up to £770,000.


Graph 2.4: Winners and losers under banded IHT
- bottom end -
Commentary
This graph shows the redistibutive effects of the five proposed banding structures, and is continued in Graph 2.5.
The tax gain increases from where IHT starts, at £234,000, and remains constant from the introduction of the 40% rate to the introduction of the higher rate.
Packages A and D have an identical effect in this graph, although they diverge further to the right.
The estate size shown is net estate, before the deduction of the IHT threshold.
Tax saved (£000s)
12
10
8
6
4
2
0
22% starting rate
30% starting rate
222
232
242
252
262
272
282
292
302
312
322
332
342
Value of net estate
A: Revenue-neutral 22/45
B: Revenue-neutral 30/50
C: Revenue-raising 22/50
D: Revenue-raising 22/60
E: Revenue-raising 30/50


Graph 2.5: Winners and losers under banded IHT
- top end -
Tax gain
20
0
-20
-40
-60
-80
-100
-120
Tax loss
Tax gain (£000s)
720
760
800
840
880
920
960
1000
1040
1080
1120
1160
1200
1240
1280
1320
Value of net estate
Commentary
This continues Graph 2.4, and shows the distributive effects of the higher rates, after taking account of changes to the lower rates.
Packages C and E have a difference of only £120, so appear as a single line (second from the bottom).
The point where lines cross the x-axis is the break-even point: to the left are the winners, who would pay less tax, to the right are losers, who would pay more. Note that the break-even point is always significantly above the point at which the higher rate starts.
The estate size shown is net estate, before the deduction of the IHT threshold.
A: Revenue-neutral 22/45
B: Revenue-neutral 30/50
C: Revenue-raising 22/50
D: Revenue-raising 22/60
E: Revenue-raising 30/50

Which package should we recommend?

Given that the reasons for introducing a lower rate are partly symbolic and psychological, removing the false notion of a 40 per cent effective rate, it seems preferable to introduce a lower rate in a shorter band, rather than a higher one for longer. The rate of 22 per cent has a strong magnetism. Using the same rate as income tax would help people to frame inheritance as windfall income, the taxation of which is thus comparable to income tax. It also gives a reasonable gain to relatively small estates: packages A and D give a tax cut up to £10,000, and package C gives up to a £4,300 cut.

At the top, it is important to emphasis again that the rate under discussion is a marginal rate: it applies only to the *extra* pound of inheritance, not to the whole estate – so, again, the effective rate will never be as high as the marginal one. Nevertheless, a 60 per cent rate is high, and would be hard to sell.

Package C gives an excellent compromise: the first £25,000 would be charged at 22 per cent, meaning that almost a fifth of tax-paying estates (3,500) would only pay the starting rate and 87 per cent (18,400) would be better off. Net estates over £775,000 in 2000-01 (13 per cent, or 2,900 estates) would be worse off.

Package C is a modest, progressive change to inheritance tax. It could increase public support and revenue in one go. It gives an easy “win” to middle income groups, and lays in place a structure, which if desired, could be incrementally tightened through fiscal drag. It is modest, but effective: it is strongly recommended.

2.3 Remove exemptions and close loopholes

Closing loopholes is a perennial favourite of IHT reformers, but is easier said than done. The major loophole (if it can be called that) is the exemption for lifetime gifts. That has been discussed above. Another important technique is to shift wealth into assets that are classed as exempt. These include:

- Agricultural land (and the farmhouse attached to it). Exemptions totalled £306.9 million in 2000-01.
- Business reliefs, totalling £208.9 million.
- Heritage assets, totalling £700.5 million in 2000-01 but only £14.3 million the year before. This figure is highly volatile because of a few very high-wealth individuals.
- Unquoted shares, totalling £207.6 million in 2000-01. Unquoted shares are primarily family-owned businesses (all from Inland Revenue, T12.2).

Notice that both agricultural land and family businesses are exempt, meaning that the specific exemption for agricultural land only covers that land which is not also a family business. The agricultural relief also provides an exemption for farmhouses, which anecdotal evidence suggests provides a cover for a large number of country cottages, "fake farmhouses", to be passed on tax-free. At the least, it may be desirable to tighten the definition of agricultural property to close this loophole.

Abolishing the agricultural land exemption entirely would be a difficult option. Most farm businesses are currently not companies, and in any case IHT exemptions provide a reasonable way of supporting farming and the countryside without distorting trade.

A graduated exemption?

One solution could be to fade in exemptions according to how long the asset has been held, in the same way that lifetime gifts are faded in according to when they were given. So, for example, agricultural land that has been held for more than seven years would still be 100 per cent exempt, but if it has been held for only three years it could be 50 per cent exempt.

This could catch assets that are transferred close to death in order to avoid inheritance tax, and make them taxable. The danger is that they would simply be transferred earlier: revenue would not increase, and incentives that are already perverse would be made more so. Both the collection and compliance costs would increase, and the effect on yield would be uncertain – judging by Inland Revenue figures on the previous page, it would not be great. Overall, this option does not seem a promising avenue for research.

Re-installing capital gains tax (CGT)

The final option for removing exemptions is about capital gains tax. At present, bequests are one of the few ways of disposing of an asset that does not make it liable for capital gains tax. When an asset is sold or given away at any time other than death, capital gains tax is normally paid on the increase in value since it was acquired, with an annual exemption (tax-free disregard) of £8,200 in 2004-5. The rate of tax is decided by treating the gain as marginal income: for 2004-5, this means 10 per cent up to £2,200, 22 per cent from £2,200 to £31,400, and 40 per cent over that.

The Inland Revenue estimate that levelling capital gains on death, with the exception of spousal transfers, would raise £650 million in 2004-5 (Inland Revenue: T1.5).

If the tax applied to all capital gains since the asset was purchased, it would in effect be retroactive: the tax would be introduced after the gains took place. Retroactivity is contrary to a key tenet of taxation, and, indeed, law – and in any case raises difficult administrative problems. If owners were not expecting to pay CGT, they cannot be expected to provide full records of the purchase prices of their assets. Wrong in principal and difficult to administer, applying CGT retrospectively, from purchase to death, must be ruled out.

So if CGT at death were to be introduced, it would have to tax only the gains since the policy change. Revenue would initially be negligible, building up over perhaps 30 years or more. This means that there would be very little initial gain – but also, perhaps, less initial protest.

To prevent the "double taxation" argument being made more forcefully, CGT could be deductible against inheritance tax. For example, the amount of inheritance tax charged on an asset would be reduced by the full amount of CGT paid on that asset (or half, or two thirds). As pointed out by Duff (1993), it is important for IHT advocates to keep the "political cost" of the tax as low as possible if it is to have a long-term future.

CGT from 2004, combined with inheritance tax, makes an attractive package. It is worth taking forward with one caveat: the distributional impact requires greater analysis, as CGT would be charged on estates below the threshold, and would furthermore not be deductible by them because they do not pay IHT.

2.4 Easier payment of tax on homes

Houses are the most valuable items in most estates, and the most emotionally significant. The deliberative workshops saw passionate complaints about IHT "forcing" the sale of a family home.

Yet the Inland Revenue has already gone some way to reduce the burden of IHT on houses. A surviving spouse would inherit tax-free, and for other inheritors (including partners from unmarried couples, and all same-sex couples until the Civil Partnership Bill comes into force) there is a well-established easy payment scheme. If the wealth is deemed illiquid then the tax owing on it can be paid over ten years or when sold, whichever is sooner. Illiquid assets also include land and unquoted shares, and are collectively referred to as "instalment property" in the legislation (Inheritance Tax Act 1984, Section 227).

So the problem of housing is not that inheritors cannot find the cash from available wealth (a liquidity problem), but that they do not have the wealth or do not value the house highly enough to sacrifice that wealth. The inheritor must pay a large tax bill, and this means that other consumption must be reduced or more money must be found – and one way of finding more money is of course to sell the house. The sale is induced by the tax, rather than forced. The fact that the inheritor's preferences change because of reduced wealth is known as an "income effect". For a more extended discussion of whether this is a legitimate problem for government, see Appendix 3.

Exempting or partially exempting houses would be to take this problem too far. House prices already are overheating, and the distortion of incentives would be considerable. Instead, Inland Revenue could allow unmarried partners to remain in the house for life, with the tax payable on death. To try and reduce the length of time that tax is deferred, entitlement to this would have to be restricted to partners – most children would, to put it bluntly, take too long to die. It could perhaps be extended to long-term dependents of the deceased, such as adult but severely disabled offspring. Given the inadequacy of state support for long-term carers, this could be a legitimate and popular move, but a question mark lies over what to do when (and if) dependency ends. Allowing live-in relatives/carers to defer tax, meanwhile, could distort incentives, and again there would be problems about the length of the deferment.

This move is worth recommending as part of a larger package. It is unlikely to be expensive, it would make a big difference for a small number of people, and it would be popular.

Table 2.3: A summary of reform options

Possible reform	Administrative Criteria	More Progressive?	Estimated effect on revenue	Lower welfare cost?	Priority for further work
Replace IHT with Capital Receipts Tax	More distorted incentives. Extra collection and compliance costs.	Mixed	-?	No change	Medium
Bands C: revenue-raising 22/50	**Slight increase in collection and compliance costs**	**More**	**+ £146.9m**	**Yes**	**High**
Remove the CGT exemption	**Slight increase in collection and compliance costs**	**More**	**+ £650m** (Upper bound)	**No change**	**High**
Remove the agricultural land exemption	Less distorted incentives	No change	+ £307m	Much larger welfare cost for some farmers	Low
Easier payment of tax on homes	**Extra collection costs**	**No change**	**No change in the long run**	**Smaller welfare cost**	**High**
	Total revenue change (Upper bound)		**+ £769.9m**		

The total package of possible reforms includes a more progressive banding, removing exemptions for CGT, and easier payment of tax on homes. Together, these achieve all our objectives of a fairer tax that is less onerous to pay but raises more revenue. There would certainly be winners and losers, as discussed above, but the net welfare impact should be significantly positive.

The total net revenue change in the long term would be an increase of up to £770 million. The main variance in this figure comes from behaviour changes in response to the tax changes, and the extent to which CGT would be deductible against IHT. Assuming that 50 per cent of CGT at death is deductible would reduce the net revenue change to £472 million.

The strongest recommendation, and the one that would produce an immediate revenue change, is the introduction of a progressive banding structure. This would raise £147 million per year using 2000-01 data.

Section 3: Spending it: should we earmark inheritance tax?

Evidence from the deliberative workshops showed that earmarking IHT for a particular purpose can substantially increase support for it, and for revenue-enhancing reforms. One participant at the deliberative workshops run by ippr and Oxford University commented:

"Initially I thought you should abolish it, but then had concerns about the 2.4 billion, I wouldn't want people to be hurt by stopping what only comes from a few." (female, 23, Oxford) (Lewis and White, forthcoming)

Another said:

"I might be more inclined [to support IHT] if I knew it was going on something, but at the moment, where's it all going? If the government says where it's going perhaps you'd be more inclined to pay it?" (female, 58, Stockport) (Ibid)

Strengthening the link between IHT and expenditure is well worth investigating for those who want to increase public support and secure the future of IHT.

3.1 Informal linking is better than strict hypothecation

Earmarking tax is a dangerous thing. On the one hand, it can help reconnect taxation with expenditure, win popular support for new revenue streams, and make funding appear transparent (Mulgan and Murray 1993). On the other hand, there is no reason to suppose that an earmarked tax will provide the optimal revenue: a depressed tax base can prevent sufficient expenditure, and a buoyant tax base can result in waste.

Furthermore, the fungibility of tax revenue means that earmarking can be illusory. Over time, it becomes harder to provide a counter-factual that shows a certain tax increase has provided more revenue for a certain expenditure programme. Unless that programme is funded entirely by the hypothecated tax, it becomes impossible to provide a benchmark.

So strict hypothecation is only advisable when the funding programme is entirely paid for by the tax, and where there is a clear link between the levels of tax raised and revenue needed – as in the case of the BBC license fee.

Yet there is still a strong case for an informal earmarking of *additional* tax revenue. If nothing else, it serves to draw attention to the impact on the margins of tax and expenditure, focusing public attention on *extra* spending. This is no mere PR trick. It is right that the public should think exactly what a proposed tax increase could pay for, and exactly what costs it would impose. An analysis of marginal impacts is the correct way to analyse spending decisions, and an opinion formed in this way is more considered and should be given greater weight than one formed in a void.

Given our starting objectives – remaking the case for a strong inheritance tax, and if possible raising more revenue – there is thus a clear benefit from informally earmarking a tax increase. The question is: earmarked for what?

3.2 Earmarked for what?

In looking for a suitable candidate to partner with inheritance tax, we need to find an intuitive link between the tax and the spending if it is to win public support. This points us in two directions: starting with the ideal of "socialised inheritance", we could pay for a beefed-up Child Trust Fund, possibly prioritising highly-deprived categories such as children in care or disabled children. An alternative starting point would be the idea that inheritance tax is a way of deferring pensioners' tax payments until after death, removing the need to break up lumpy capital by selling the family home. If estates tax is deferred lifetime tax, a way of easing liquidity constraints, then spending should benefit the legatee during life. In that way the would-be inheritor cannot in full conscience object to the introduction of the tax/spend programme. This could take us to long-term care for the elderly, an idea originally proposed by Howard Glennerster (1998). For each candidate we need to know:

- What could you buy with the money?
- How administratively appropriate is the link? Is there a clear tax-spend relationship?
- How robust is the link, according to the responses in deliberative workshops?
- What are the risks and disadvantages?

A more generous Child Trust Fund

A more generous Child Trust Fund (CTF) might mean larger deposits for all children, children in low-income families, children in care or disabled children.

Table 3.1 shows the total costs of a more generous Child Trust Fund, and the values of the deposits at maturity. Deposits are assumed to be at birth for ease of calculation. An extra £140 million per year, approximately the amount raised by the new banding proposed in section two, would give every child an additional £150, and £300 for the poorest third. After 18 years of investment, this would grow to £332 and £662 respectively, using the Inland Revenue illustrative assumption of 4.5 per cent real growth.

How attractive, then, is a link between CTF and IHT? The administrative criterion is promising: there is a very clear baseline of pre-tax expenditure, a well-defined spending programme, and relatively easy public auditing and accounting.

The programme could also be about the right size. The total package of reforms proposed above would raise up to £472 million, assuming 50 per cent of CGT is deductible and there are no behavioural changes. The banding options on their own would raise £147 million. The costs of these Child Trust Fund reforms range between £13 million and £233 million.

The problem is the strength of the link between inheritance tax and the CTF. The deliberative workshops, as discussed above, gave a poor reception to arguments based on inheritance as a social construct, and to the very idea of inheritance as transmitting inequality across the generations. The fair unit of analysis was thought by most to be the family, rather than the individual, so that any distribution between generations should not be of concern to the state. Furthermore, support for CTFs can drop as the size of deposit increases, although findings vary (see Gamble and Prabhakar, forthcoming). This may be sensible: as one of the motivations of the CTF is financial education, there is a strong argument that the impact also drops as deposits gets larger.

To conclude, linking the CTF with inheritance tax reform is attractive on most criteria, but must overcome the serious stumbling block of weak intuitive and public support.

Table 3.1: The costs of extending child trust funds

	Deposit	Total Value at 18 (1)	Annual cost to exchequer (2)	**Extra annual cost to exchequer**
CURRENT SYSTEM				
standard deposit	£250	£552		
bonus for children in low-income families	£250	£1,104	£233,333,333	**£0**
PACKAGE A: THE SAME STRUCTURE, BUT MORE GENEROUS				
Standard deposit	£400	£883		
bonus for children in low-income families	£400	£1,767	£373,333,333	**£140,000,000**
PACKAGE B: £500 FOR DISABLED AND LOOKED-AFTER CHILDREN				
Standard deposit	£250	£552	£175,000,000	
bonus for children in low-income families	£250	£1,104	£58,333,333	
bonus for children in care	£500	£1,656	£2,940,000	
bonus for disabled children	£500	£1,656	£10,000,000	
Total - maximum CTF	£1,500	£3,313	**£246,273,333**	**£12,940,000**
PACKAGE C: £500 FOR DISABLED, LOOKED-AFTER AND POOR CHILDREN				
Standard deposit	£250	£552	£175,000,000	
bonus for children in low-income families	£500	£1,656	£116,666,667	
bonus for children in care	£500	£1,656	£2,940,000	
bonus for disabled children	£500	£1,656	£10,000,000	
Total - maximum CTF	£1,750	£3,865		**£58,333,333**

(1) Uses IR assumption of 7% nominal return, 2.5% inflation.

(2) Excluding administration, assumed to be a fixed cost.

(3) Number eligible: 700,000 each year (HM Treasury/Inland Revenue 2003: p.30). Proportion low-income: One third (Ibid.: p.7). Number in care: 5,880 per year, based on 84 per 10,000 (Department of Health, 2002. For the purposes of working out total cost, we don't need to concern ourselves with the issues of transient care and sliding scales: an average deposit could be distributed however as is seen fit. Number disabled: 20,000 per year, based on a total of 360,000 disabled children in Britain (Sharma, 2002).

Long-term care for the elderly

The provision and funding of long-term care is a growing problem. The strange path of policy evolution has left us with a curious anomaly: whilst acute care and nursing care is paid for by the NHS, long-term personal care in England must be paid for by the individual, with only means-tested contributions from the state. This has led to divisive pathological boundaries, so that cancer sufferers, for example, can claim free care, but Alzheimer's sufferers cannot; and national boundaries, as Scottish residents can claim free care but English ones cannot (Brooks, Regan and Robinson, 2002)

Paying for long-term personal care sometimes forces pensioners to sell their (empty) homes, and the issue proved hugely emotive in the deliberative workshops. Could this be an ideal candidate for an earmarked inheritance tax?

The first question to ask is how much long-term care would cost. Working on figures in Brooks, Regan and Robinson (2002), a good starting figure is 0.16 per cent of GDP – or £1.6 billion in 2003. The problem, however, is that this figure is projected to rise and rise unpredictably: by 2051 it is 0.21 per cent of GDP (£2.1 billion in 2003 terms), but different assumptions give figures up to 0.45 per cent (£4.5 billion).

This means that the immediate cost of £1.6 billion is too big to be financed by the marginal revenue of reform. The expected future cost in 2051 is about the right size to be financed by the whole of IHT, but would be additional expenditure and another tax would have to be levied to pay for it. The maximum future cost in 2051 is far too big to be financed by IHT. This risk, with a variance of over 100 per cent by 2051, is unacceptable.

To make matters worse, the figures that produce the worst-case scenario would hugely inflate spending even without a policy change. The worst-case scenario of 0.45 per cent of GDP has expensive assumptions about life expectancy, dependency rates, and unit costs. Together these would add 0.88 per cent of GDP to the cost of long-term care, even under existing policy. The total cost, 2.28 per cent of GDP, is equivalent to £23 billion in 2003 – a huge figure.

What about the administrative criteria? Personal care is currently a separate policy area, giving it a relatively easy baseline figure. However it may become harder as the division between personal care and nursing care dissolves, and the fact that in Scotland it is already provided free of charge.

The link is highly intuitive, from the principle of IHT as deferred taxation. Legatees can be seen as faced with a choice: either the donor's personal care is free, but a strengthened IHT reduces your inheritance; or the donor's personal care is chargeable – so user charges and equity release schemes reduce your inheritance. The effect on aggregate legacies is the same, but the former is preferable for fairness, predictability, and, by removing the need for means-testing, dignity.

Anecdotal evidence suggests that the use of inheritance to pay for long-term care is already widespread amongst wealthier families. Some children of infirm parents are willing and able to pay for care now, knowing that they will soon inherit and recoup their expenditure. At present this requires considerable liquidity, but an earmarked IHT would open this option to all.

The intuitive link, however, could well be short-lived. Attendees at the deliberative workshops believed they already had a moral entitlement to long-term care, and resisted the idea of extra taxation to pay for it. In fact, some attendees of the deliberative workshops suggested that charging for long-term care is wrong precisely because "it has already been paid for through normal taxes". User charges are "disgusting" and "disgraceful". As mentioned above, the very fact that long-term care is not free is partly an anomaly of policy evolution. Once it becomes free, the public would quickly start seeing it as part of normal health and social care expenditure, and once again resent IHT.

In summary, the risks of exploding costs and imploding public support for earmarking mean that long-term care can only be recommended as a partner for inheritance tax in very specific circumstances:

- You must be sure that long-term personal care should be provided free, leaving aside the question of how to fund it. This is a more complex question than can be addressed here, but there is uncertainty over future costs.
- You must be aware that a strong link between inheritance tax and long-term care will only be temporary. This is both because the costs of care will increase beyond the capacity of IHT, and because the public may mentally readjust to see long-term care as part of normal NHS spending.

If you are prepared to embrace both the propositions above, then this is an ideal candidate for hypothecation. But it is a big "if".

Section 4: Conclusion

We have identified several reforms that are worth pursuing:

- Introduce progressive tax bands, with a rate of 22 per cent on the first £40,000 of chargeable estate (after exemptions and the nil-rate threshold), 40 per cent on the next £460,000, and 50 per cent on chargeable estate over £500,000. This would benefit 87 per cent of tax-paying estates, and would raise about £147 million.
- Introduce capital gains tax at death.
- Allow resident dependents of the deceased to defer IHT until death.

In the long run, perhaps 30 years or more, the net revenue change would be up to £770 million in 2000-01 prices. The actual amount would be less than this because an unknown amount of capital gains tax would be deductible against inheritance tax. Thus if 50 per cent of CGT at death is deductible, the total revenue change would reduce to £472 million.

In the short term, the introduction of a progressive banding structure would bring about an increase in revenue of £147 million per year using 2000-01 data. The introduction of progressive bands is the strongest recommendation.

A capital receipts tax, on the other hand, seems to face some serious challenges. The change would not necessarily be progressive; revenue from inheritance, though hard to predict, would probably fall under the Fabian structure; there could be an important welfare cost to distorting incentives; and compliance and collection costs would increase. It should be seen not just as a reform of inheritance tax, but as taxing a whole new area of activity: lifetime gifts. However, horizontal and vertical equity would improve, and it is possible (but far from certain) that inheritances would be more evenly distributed.

On the spending side:

- The child trust fund could be linked to reforms of inheritance tax. It is about the right size, would help spread ownership of wealth more widely, and the idea of socialised inheritance provides a robust link between tax and revenue. However, deliberative workshops run by Oxford University and ippr show that public support for these ideas would not be automatic.
- The payment of long-term care is in many ways an ideal candidate for earmarking, but suffers from two risks: the costs could increase dramatically in the medium term, and public support for inheritance tax could drain away as the programme is absorbed in normal NHS and social services expenditure.

Together these reforms would produce a fairer, more progressive inheritance tax. They would help address complaints that IHT primarily targets those with moderate wealth – enough to be above the tax-free allowance, but not enough to use tax-avoidance tools. At the same time, these reforms would help contribute to a more equal distribution of wealth. They are modest changes, and deliberately so, but they show that a more progressive structure is possible and desirable.

Some broader questions for discussion remain.

Rescuing a capital receipts tax. Tax-free lifetime gifts are the biggest loophole in inheritance tax. Is there a way to tax these, whilst avoiding the problems of the Fabian CRT? Should we move from an estate-based system to an inheritance-based system without including lifetime gifts? Should we look at an annual tax on the value of trusts, as in Ireland?

Inheritance tax "by stealth". Could the introduction of new bands in IHT ease the way for a future tightening of the thresholds? If that is what we want, is this the best way to go about it?

IHT and house prices. Rising house prices give a windfall to homeowners. Does this mean we should tax it more, or, because homeowners' income and other wealth are moderate, should we tax it less? How, if at all, should IHT respond to regional variations in house prices?

Linking reform of IHT with a new spending programme. Earmarking a tax may provide only a temporary increase in its support. This being so, are we ducking the argument if we use a spending programme to reform IHT? Would it be braver, and more successful in the long term, to make the case for IHT directly?

IHT and charitable giving. What new incentives could be created to encourage bequests to charities?

Appendix

1 Estimating the yield of a capital receipts tax

Chargeable wealth

The first step in calculating the yield of a proposed tax is to work out how much wealth is taxable.

Inland Revenue can provide data on how much wealth is chargeable, meaning that part of the estate which survives deductions for debt; for pre-tax reliefs such as agricultural, heritage, spousal transfers, and charitable donations; and of the nil-rate threshold.

However, the CRT requires that tax be levied on wealth that is currently below the nil-rate threshold. Thus we need to assume a proportion of wealth that would be chargeable; and, to provide an average chargeable average estate size, assume a number of chargeable taxpayers. Potential taxpayers may be entirely exempt either because the estate is wholly transferred to a spouse, because the donor was not domiciled in the UK.

The table below shows what proportion of wealth is currently chargeable in each band, and the assumed figures for the two lower bands. No calculations looked at estates smaller than £100,000, so figures below that level are unnecessary.

Table A1: Proportion of wealth and estates that were chargeable in 2000-01

Estate Size (lower limit)	Proportion of wealth that is chargeable (%)	Proportion of estates that pay IHT (%)	Assumed proportion of wealth taxable (2)	Assumed proportion of taxpayers(2)
100,000	-	0	58	60
200,000	-	31 *(1)*	58	60
300,000	58	59	-	-
500,000	57	60	-	-
1,000,000	60	65	-	-
2,000,000	39	67	-	-

Source: Inland Revenue, and author's calculations.
(1) This figure is low because a number of estates in this band were below the threshold.
(2) NB Assumed

Together, these assumptions produce Table A3, showing average chargeable wealth.

Table A2: calculated chargeable wealth of larger estates, 2000-01

Net value of estates			Tax paid		Taxable wealth under IHT		chargeable wealth
Band	Total net capital	Number	Number	Total Tax Paid	Total (1)	Average (2)	Average (3)
Lower limit	£millions	Actual	Actual	£	£	£	£
300,000	5,165	13,998	8,320	429,300,000	1,073,250,000	128,996	362,996
500,000	4,600	7,127	4,285	649,800,000	1,624,500,000	379,113	613,113
1,000,000	3,118	2,424	1,586	596,100,000	1,490,250,000	939,628	1,173,628
2,000,000	3,978	886	598	561,200,000	1,403,000,000	2,346,154	2,580,154

Source for total net capital, number of estates, number of tax payers, and total tax paid: Inland Revenue tables T12.3, T12.4
(1) = (Total tax paid)/0.4
(2) = (Estimated taxable Wealth) / (number of taxpayers)
(3) = (average taxable wealth under IHT) +(2000-01 threshold of £234,000).
(4) Assumes that 58% of total wealth is chargeable, and 60% of estates pay tax - see text above
(5) Figures for £100,000-£200,000 are not shown, because some estates in this band were under the threshold.

Table A3: estimated chargeable wealth of smaller estates, 2000-01

			Assumed proportions chargeable (1)		chargeable wealth	
Band	**Total net capital**	**Number**	**Proportion of wealth**	**Proportion of estates**	**Total (2)**	**Average (3)**
Lower limit	£millions	Actual	%	%	£millions	£
100,000	10,087	72,234	58	60	5,850	134,985
200,000	4,866	20,738	58	60	2,822	226,797

Source for total net capital and number of estates: Inland Revenue tables T12.3, T12.4
(1) Taken from Table A1
(2) = (total net capital)*(proportion of wealth chargeable)
(3) =(total chargeable wealth) / ((number of estates)*(proportion of estates chargeable))

Calculating the yield

The Fabian CRT formula (see Table 2) was applied to figures on chargeable wealth (see above). The answer has several weaknesses: based on BHPS data (quoted in Future Foundation 2002: p.4), it assumes four equal inheritors, when both the distribution between inheritors and the variance in the number of inheritors is important; specifically it fails to capture any of the tax that would be realised on estates worth less than the current threshold but split between one or two inheritors; and it assumes that the same exemptions would apply in both cases, for example on timber, works of art, and family businesses, so that taxable wealth is comparable. The main weakness is that it assumes there have been no previous inheritances, so each inheritors lifetime allowance starts at zero. Relaxing this assumption would significantly increase the yield.

Table A4: Estimated yield of a Capital Receipts Tax in 2000-01 with four equal inheritors

Band	Total T Paid under IHT (1)	Average chargeable wealth (2)	Gross inheritance per recipient (3)	Tax per recipient (4)	Estates chargeable (5)	Estimated total tax paid under CRT (6)
Lower limit	**£**	£	£		number	**£**
0	**0**					
10,000	**0**					
25,000	**0**					
40,000	**0**					
50,000	**0**					
60,000	**0**					
80,000	**0**					
100,000	**0**	134,985	33,746	0	41,896	**0**
200,000	**72,900,000**	262,086	65,522	0	12,028	**0**
300,000	**429,300,000**	362,996	90,749	36,417	8,320	**71,546,000**
500,000	**649,800,000**	613,113	153,278	76,899	4,285	**239,677,000**
1,000,000	**596,100,000**	1,173,628	293,407	213,221	1,586	**541,389,344**
2,000,000	**561,200,000**	2,580,154	645,038	437,427	598	**540,571,392**
TOTAL:	**2,309,300,000**					**1,393,183,736**

(1) Source: Inland Revenue Table T12.3. All figures refer to 2000-01

(2) See Tables A2 and A3

(3) = (average chargeable wealth)/4

(4) Based on the Fabian Structure, assuming no prior inheritance: 0% below £80,000; 20% below £160,000; 30% below £240,000; 40% above that

(5) = (number of tax-paying estates, taken from tables A2 and A3)*4

(6) = (tax per recipient)*(number of estates chargeable)*4

2 Calculating the yield of banded IHT

The Inland Revenue provided table A5, below, giving values of chargeable estates by band.

Table A5: Chargeable estate by band 2000-01

Estates notified for probate: Numbers and tax by range of estate for years of death 2000-01 [1]

Numbers: actual
Values: £ million

Range of net estate (lower limit) £	Total Net Value of Estates Passing on Death	Value of Estates Passing on Death after Deduction of Pre Tax Reliefs	Value of Estates Passing on Death after Deduction of Reliefs and IHT Threshold	Number of Estates Passing on Death after Deduction of Reliefs and IHT Threshold	Number not taxed	Number taxed[2]	Tax by range of Total Net Estate
0	72.9	112.5	8.0	1,712	41,477	-	-
10,000	606.1	621.4	31.0	1,833	36,944	-	-
25,000	831.1	854.8	48.3	1,495	25,942	-	-
40,000	779.1	799.9	42.7	954	17,485	-	-
50,000	869.2	884.4	49.5	906	15,966	-	-
60,000	1,880.4	1,920.8	120.5	1,731	26,950	-	-
80,000	2,441.6	2,504.2	119.4	1,332	27,446	-	-
100,000	10,086.7	10,441.5	606.2	4,234	72,234	-	-
200,000	4,865.5	4,525.7	511.9	2,089	14,249	6,489	72.9
300,000	3,111.0	1,936.0	452.8	1,309	3,608	5,655	226.9
400,000	2,053.8	1,162.1	372.9	833	2,070	2,666	202.4
500,000	1,510.4	823.0	299.5	546	1,240	1,636	178.3
600,000	1,074.3	617.4	216.9	338	643	1,075	156.1
700,000	813.1	460.2	253.3	339	449	684	120.3
800,000	680.6	364.4	195.4	231	326	503	104.1
900,000	521.8	301.3	230.8	242	185	387	91.0
1,000,000	2,100.5	1,249.2	751.2	626	626	1,184	404.0
1,500,000	1,017.5	556.3	388.3	228	212	402	192.1
2,000,000	3,977.7	1,313.7	1,074.5	300	288	598	561.2
Total	39,293.2	31,448.8	5,773.1	21,278	288,338	21,278	2,309.2

[1] Because of the time lags in notification, figures for more recent years are less complete than for earlier years.

All figures are subject to revision.

[2] Figures on the number of taxpayers are given in Inland Revenue Table T1.4.

Table A6 shows how much a new marginal tax would raise within each band. Notice that whereas Table A5 gives the total value of estates whose total chargeable value lies within each band, Table A6 gives the total value of that part of estates that lie within the bands. For example, an estate with a chargeable value of £30,000 would add £30,000 to the £25- £40,000 band in A5; but in A6 it would add £10,000 to the first band, £15,000 to the next band, and only £5,000 in the £25- £40,000 band. Note that the 40 per cent band raises a yield of £2.231 billion, representing an error of four per cent.

Table A7 adapts Table A6 to show the revenue relative to 40 per cent, and accumulated from both the top and the bottom. The threshold is given in terms of chargeable estate, not net estate. In other words, it is the size of the estate after removing exemptions and the tax-free allowance (£253,000 in 2000-01, or £263,000 in 2004-5).

Table A6: Expected yields of IHT by tax rate and band, 2000-01 (£m)

marginal tax rate / **Tax bands**	**0**	**0.05**	**0.1**	**0.15**	**0.2**	**0.25**	**0.3**	**0.35**	**0.4**	**0.45**	**0.5**	**0.55**	**0.6**	**0.65**	**0.7**	**0.75**		**0.22**
0	0	0.4	0.8	1.2	1.6	2	2.4	2.8	**3.2**	3.6	4	4.4	4.8	5.2	5.6	6		1.76
10,000	0.0	13.9	27.9	41.8	55.7	69.7	83.6	97.5	**111.5**	125.4	139.3	153.3	167.2	181.1	195.1	209.0		61.3
25,000	0.0	12.7	25.4	38.2	50.9	63.6	76.3	89.1	**101.8**	114.5	127.2	140.0	152.7	165.4	178.1	190.9		56.0
40,000	0.0	7.9	15.7	23.6	31.5	39.3	47.2	55.1	**63.0**	70.8	78.7	86.6	94.4	102.3	110.2	118.0		34.6
50,000	0.0	7.4	14.8	22.2	29.6	37.0	44.4	51.8	**59.2**	66.6	74.0	81.4	88.8	96.2	103.6	111.0		32.6
60,000	0.0	13.5	27.0	40.4	53.9	67.4	80.9	94.4	**107.8**	121.3	134.8	148.3	161.7	175.2	188.7	202.2		59.3
80,000	0.0	12.0	23.9	35.9	47.8	59.8	71.7	83.7	**95.7**	107.6	119.6	131.5	143.5	155.4	167.4	179.4		52.6
100,000	0.0	44.5	89.1	133.6	178.2	222.7	267.3	311.8	**356.4**	400.9	445.5	490.0	534.5	579.1	623.6	668.2		196.0
200,000	0.0	29.7	59.3	89.0	118.7	148.3	178.0	207.7	**237.3**	267.0	296.7	326.3	356.0	385.6	415.3	445.0		130.5
300,000	0.0	21.4	42.8	64.3	85.7	107.1	128.5	149.9	**171.4**	192.8	214.2	235.6	257.0	278.5	299.9	321.3		94.2
400,000	0.0	16.2	32.5	48.7	64.9	81.2	97.4	113.6	**129.9**	146.1	162.4	178.6	194.8	211.1	227.3	243.5		71.4
500,000	0.0	12.8	25.7	38.5	51.4	64.2	77.1	89.9	**102.8**	115.6	128.5	141.3	154.1	167.0	179.8	192.7		56.5
600,000	0.0	10.5	21.1	31.6	42.1	52.7	63.2	73.7	**84.3**	94.8	105.4	115.9	126.4	137.0	147.5	158.0		46.4
700,000	0.0	8.9	17.9	26.8	35.7	44.7	53.6	62.5	**71.5**	80.4	89.4	98.3	107.2	116.2	125.1	134.0		39.3
800,000	0.0	7.5	15.0	22.5	30.0	37.6	45.1	52.6	**60.1**	67.6	75.1	82.6	90.1	97.6	105.1	112.7		33.0
900,000	0.0	6.4	12.8	19.3	25.7	32.1	38.5	44.9	**51.4**	57.8	64.2	70.6	77.0	83.5	89.9	96.3		28.2
1,000,000	0.0	19.5	38.9	58.4	77.8	97.3	116.8	136.2	**155.7**	175.1	194.6	214.1	233.5	253.0	272.4	291.9		85.6
1,500,000	0.0	9.8	19.6	29.4	39.3	49.1	58.9	68.7	**78.5**	88.3	98.2	108.0	117.8	127.6	137.4	147.2		43.2
2,000,000	0.0	23.7	47.5	71.2	94.9	118.6	142.4	166.1	**189.8**	213.5	237.3	261.0	284.7	308.4	332.2	355.9		104.4
Total	**0.0**	**278.9**	**557.7**	**836.6**	**1,115.5**	**1,394.4**	**1,673.2**	**1,952.1**	**2,231.0**	**2,509.8**	**2,788.7**	**3,067.6**	**3,346.5**	**3,625.3**	**3,904.2**	**4,183.1**		**1,227.0**

Table A7: Cumulative relative yield of IHT bands, 2000-01 (£m)

Changes from the bottom																		
marginal tax rate	**0**	**0.05**	**0.1**	**0.15**	**0.2**	**0.25**	**0.3**	**0.35**	**0.4**	**0.45**	**0.5**	**0.55**	**0.6**	**0.65**	**0.7**	**0.75**		**0.22**
Upper threshold (chargeable estate)																		
10,000	-3.2	-2.8	-2.4	-2.0	-1.6	-1.2	-0.8	-0.4	**0.0**	0.4	0.8	1.2	1.6	2.0	2.4	2.8		-1.4
25,000	-114.7	-100.3	-86.0	-71.7	-57.3	-43.0	-28.7	-14.3	**0.0**	14.3	28.7	43.0	57.3	71.7	86.0	100.3		-51.6
40,000	-216.5	-189.4	-162.3	-135.3	-108.2	-81.2	-54.1	-27.1	**0.0**	27.1	54.1	81.2	108.2	135.3	162.3	189.4		-97.4
50,000	-279.4	-244.5	-209.6	-174.6	-139.7	-104.8	-69.9	-34.9	**0.0**	34.9	69.9	104.8	139.7	174.6	209.6	244.5		-125.7
60,000	-338.6	-296.3	-254.0	-211.6	-169.3	-127.0	-84.7	-42.3	**0.0**	42.3	84.7	127.0	169.3	211.6	254.0	296.3		-152.4
80,000	-446.4	-390.6	-334.8	-279.0	-223.2	-167.4	-111.6	-55.8	**0.0**	55.8	111.6	167.4	223.2	279.0	334.8	390.6		-200.9
100,000	-542.1	-474.3	-406.6	-338.8	-271.0	-203.3	-135.5	-67.8	**0.0**	67.8	135.5	203.3	271.0	338.8	406.6	474.3		-243.9
200,000	-898.5	-786.1	-673.8	-561.5	-449.2	-336.9	-224.6	-112.3	**0.0**	112.3	224.6	336.9	449.2	561.5	673.8	786.1		-404.3
300,000	-1,135.8	-993.8	-851.8	-709.9	-567.9	-425.9	-283.9	-142.0	**0.0**	142.0	283.9	425.9	567.9	709.9	851.8	993.8		-511.1
400,000	-1,307.1	-1,143.7	-980.4	-817.0	-653.6	-490.2	-326.8	-163.4	**0.0**	163.4	326.8	490.2	653.6	817.0	980.4	1,143.7		-588.2
500,000	-1,437.0	-1,257.4	-1,077.8	-898.1	-718.5	-538.9	-359.3	-179.6	**0.0**	179.6	359.3	538.9	718.5	898.1	1,077.8	1,257.4		-646.7
Changes from the top																		
marginal tax rate	**0**	**0.05**	**0.1**	**0.15**	**0.2**	**0.25**	**0.3**	**0.35**	**0.4**	**0.45**	**0.5**	**0.55**	**0.6**	**0.65**	**0.7**	**0.75**		**0.22**
Lower threshold (chargeable estate)																		
500,000	-794.0	-694.7	-595.5	-496.2	-397.0	-297.7	-198.5	-99.2	**0.0**	99.2	198.5	297.7	397.0	496.2	595.5	694.7		-357.3
600,000	-691.2	-604.8	-518.4	-432.0	-345.6	-259.2	-172.8	-86.4	**0.0**	86.4	172.8	259.2	345.6	432.0	518.4	604.8		-311.0
700,000	-606.9	-531.1	-455.2	-379.3	-303.5	-227.6	-151.7	-75.9	**0.0**	75.9	151.7	227.6	303.5	379.3	455.2	531.1		-273.1
800,000	-535.4	-468.5	-401.6	-334.7	-267.7	-200.8	-133.9	-66.9	**0.0**	66.9	133.9	200.8	267.7	334.7	401.6	468.5		-240.9
900,000	-475.4	-415.9	-356.5	-297.1	-237.7	-178.3	-118.8	-59.4	**0.0**	59.4	118.8	178.3	237.7	297.1	356.5	415.9		-213.9
1,000,000	-424.0	-371.0	-318.0	-265.0	-212.0	-159.0	-106.0	-53.0	**0.0**	53.0	106.0	159.0	212.0	265.0	318.0	371.0		-190.8
1,500,000	-268.3	-234.8	-201.2	-167.7	-134.2	-100.6	-67.1	-33.5	**0.0**	33.5	67.1	100.6	134.2	167.7	201.2	234.8		-120.7
2,000,000	-189.8	-166.1	-142.4	-118.6	-94.9	-71.2	-47.5	-23.7	**0.0**	23.7	47.5	71.2	94.9	118.6	142.4	166.1		-85.4

3 Should the government worry that IHT leads to the sale of houses?

In some circumstances, the government should be concerned that IHT causes families to sell an inherited house. On the one hand, if the inheritor's preferences change, so that they value the house less than its retail value and therefore decide to sell it, this sounds like an economically efficient sale. The market is working, and all is well. But imagine someone inherits a house. Before she receives the tax bill, she is only prepared to sell the house at, say, £200,000 or more. Its market value is £175,000, so she decides to keep it. The tax bill creates a need for money, so she is now prepared to sell the house at a lower amount – say, £150,000. She sells it for its market price of £175,000. Is she worse off or better? Looking purely at the situation after tax, she seems to have made a welfare gain of £25,000 as a result of the sale. From a pre-tax position, though, she has made a welfare loss of £25,000 – hence it is inefficient ex ante the tax. This quasi-inefficiency could be the cause of much resentment, and, in terms of framing "losses" and "gains", it may well be the relevant comparison to make.

So quasi-inefficient sales are theoretically possible. They are also reasonably likely: although some inheritors may already own their own home, and so would value a house below the market rate, others would value it significantly above. This could be because of the "endowment effect", which tells us that people value objects more when they already own them (Kahneman, Knetsch, and Thaler 1991); or because of the emotional significance of a family home. If either of these mean they value the home above the market rate, a forced sale will reduce aggregate utility.

On this logic, those who see themselves as forced to sell an inherited home will be those with lower income and wealth. They must firstly value the house highly (thus including those without a home of their own), and then suffer from a large income effect as the tax is imposed (thus including those with low income and/or wealth).

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