An inheritance tax will help reduce inequality

A remark by Chairman of Indian Overseas Congress Sam Pitroda on implementing an inheritance tax as a tool of wealth redistribution has sparked massive debates. In this article, we present rationale on why high inequality is harmful, and advocate for progressive taxes as a mechanism to reduce inequality.

Primarily, we underscore the need to take a view of citizenship where the poor and the rich can participate equally in democratic decision-making. However, in an unequal society, a handful of dominant individuals can wield a disproportionate amount of power through control of resources. This will likely lead to a few wealthy elites dictating the socioeconomic and political decisions aimed to benefit them at the cost of the majority. The recent electoral bonds scam bears witness to this. The citizenship of wealthy elites would then carry more weight than the majority of the country. This is ethically hazardous.

Why inequality matters

First, inequality harms growth in the medium-to-long run, by hampering firm productivity, reducing labour income, and diverting resources away from rights such as education. Second, in unequal countries, the place of birth holds inordinate power in directing lifetime outcomes. In India, almost a third of the variation in consumption can be explained by the place of residence: the State, and city or village. Third, high inequality is also associated with political polarisation and increased conflict. Fourth, inequality is likely to have a negative multiplier effect on the economy – diminished earnings for the poor lead to reduced consumption and savings and increased indebtedness. This reduces aggregate demand, limits production and investments, and leads to lower growth rates in the future. Using labour bureau data, Jean Drèze and Reetika Khera showed that while real wages of agricultural labourers grew by 6.8% between 2004-2014, they declined by 1.3% in the last decade. Using Periodic Labour Force Survey data, a Bahutva Karnataka report shows that 34% of households earned less than the recommended daily minimum wage of ₹375 in 2022-23. Using Reserve Bank of India data, Zico Dasgupta and Srinivas Raghavendra voice concern about the sharp reduction in household savings and increased debt. In contrast to these, the richest 1% holds 40% of India's wealth.

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Views are personal

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Some commentators argue that some inequality during growth is inevitable, and the priority instead should be towards reducing poverty. However, research by Tianyu Fan and co-authors shows that the gains from India's growth over the last two decades have been skewed towards high-income urban residents. Keeping everything else the same, there is nothing inherently special in the children of the wealthy compared to the children of the poor. The Constitution mandates equality of status and of opportunity. As such the government is obliged to take steps to reduce the disparities arising from accidents of birth.

An inheritance tax

A wealth tax is a recurring tax on all physical and financial assets an individual owns. An inheritance tax differs from a wealth tax in two ways: it is intergenerational and levied once in a lifetime. These taxes are meant to be applied to individuals having high wealth above a threshold. When implemented well, these taxes reduce the concentration of wealth and encourage shifting investments from non-productive to productive activities. Property of the elite being bequeathed to descendants implies that the descendants do no work to acquire it. There is no economic reason for it to be a freebie for them. Some might argue that inheritance tax will disincentivise innovations. But this disregards that innovation is needed to be competitive today and suggests that innovation is solely to propagate dynastic control of resources which is at odds with democratic ideals. On the contrary, revenue generated from inheritance tax can be used to fund a diversified set of innovations. An advanced country like Japan has up to 55% inheritance tax. A variant of the inheritance tax, called estates duty, was levied in India between 1953-1985 but this was abolished owing to administrative costs. However, the economist Rishabh Kumar shows that this was effective in reducing the top 1% personal wealth share from 16% to 6% between 1966 and 1985.

Another approach is the land value tax (LVT): this taxes the rental value of land, without considering the property built on it. This is borne by the landowner and not the tenants. Unlike labour, land is a natural resource and is unresponsive to changes in taxes, making the LVT an efficient source of revenue. Given the role of land ownership in perpetuating feudal caste relations in rural India and the pervasive politician-builder nexus in urban India, LVT can be a useful redistributive mechanism.

Detractors claim that tax evasion among the wealthy makes these taxes impractical. However, recent research by Natasha Sarin (in the U.S.) projects that sufficient investment in improving tax compliance can yield revenue up to 10 times the investment. Nathaniel Hendren and co-authors show that auditing the top 1% and 0.1% generated three to six times the return on investment.

Economists Jayati Ghosh and Prabhat Patnaik demonstrate that a 2% wealth tax and a 33.3% inheritance tax only on the top 1% in India can raise an additional public expenditure of 10% of the GDP. This can be used to ensure a bouquet of socioeconomic rights for the poor like living wages, right to health, employment, and food. Given technological advancements, these are possible if there is political will.