INHERITANCE TAX - GS II AND III MAINS

Q. How does Inheritance tax could help reduce inequality in India? Discuss the challenges of inheritance tax in India. (15 marks, 250 words)

News: *Sam Pitroda controversy: How inheritance tax works*

What's in the news?

- 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.

Negative Impact of Inequality:

1. Affecting Growth:

- Inequality harms growth in the medium-to-long run by reducing firm productivity, lowering labor income, and diverting resources away from essential rights like education.

2. Unequal Opportunity:

- In unequal countries like India, where one is born greatly influences lifetime outcomes, with almost a third of consumption variation being explained by the place of residence (state, city, or village).

3. Concentration of Wealth:

- The richest 1% holding 40% of India's wealth underscores the vast wealth disparities that exacerbate inequality.

4. Skewed Distribution of Gains:

- Research indicates that the gains from India's growth over the last two decades have disproportionately benefited high-income urban residents, further exacerbating inequality.

5. Lack of Inclusive Growth:

- The Gini wealth coefficient in India has gone up from 81.3% in 2013 to 85.4% in 2017 (100% represents maximal inequality). The growth in India has not been inclusive.

Inheritance Tax:

- An inheritance tax is a tax levied on the assets or wealth passed down from one generation to another upon the death of the owner.
- Unlike a wealth tax, which is recurring and applied to all physical and financial assets an individual owns, an inheritance tax is a one-time tax specifically targeting intergenerational transfers of wealth.

How Does Inheritance Tax Could Help Reduce Inequality?

The Constitution mandates equality of status and opportunity, obliging the government to take steps to reduce disparities arising from accidents of birth.

1. Reduction of Wealth Concentration:

- By taxing large inheritances, an inheritance tax helps to redistribute wealth from the wealthiest individuals and families to the broader society.

2. Encouragement of Productive Investments:

- Inheritance taxes can encourage wealthy individuals to invest their wealth in productive activities rather than simply passing it down to heirs.

3. Incentive for Innovation:

- Critics may argue that inheritance taxes disincentivize innovation by reducing the incentive to accumulate wealth to pass on to future generations.

4. Funding for Public Expenditure:

- Revenue generated from inheritance taxes can be used to fund essential public services and social programs, such as education, healthcare, infrastructure, and poverty alleviation initiatives.

5. Historical Effectiveness:

- Historical examples, such as the estate duty in India between 1953 and 1985. It reduced the top 1% personal wealth share from 16% to 6% between 1966 and 1985.

Challenges in the Implementation of Inheritance Tax in India:

1. Difficulty in Evaluation:

- The government will have to incur large levels of expense and expertise in the valuation of property and collection of the revenues accruing from inheritance tax.

2. Risk of Closure of Businesses:

- Inheritance tax will create extra pressure on less profitable businesses and small businesses, as the recipient of the property may not have the money available to pay tax. This could also lead to situations of distress sale.

3. Flight of Capitals and Entrepreneurs:

- Inheritance tax can result in the outflow of entrepreneurial human capital and financial resources.

4. Dampening of Capital Asset Creation and High Inflation:
- Inheritance tax can discourage savings and increase consumerism. This can result in high inflation rates in the economy.
- The tax can also dampen the spirit of capital asset creation which can hamper economic growth.

5. Secondary Tax Leading to Double Taxation:
- Inheritance tax is criticized for double taxation as the property or money inherited has already been taxed as earned income.

International Practices:
- Developed countries such as England, France, Germany, the USA and India's Southeast Asian counterparts like Philippines, Taiwan and Thailand have been charging inheritance tax.

Way Forward:
1. Introduction of Higher Threshold:
- If the government intends to introduce inheritance tax, it should introduce it with a higher threshold.

2. Making Provisions for Donations to Hospitals and Universities:
- The endowments by the super-rich to the hospitals and universities should be exempted from the inheritance tax calculations.

3. Improving the Government's Tax Administrative Capacity:
- The tax agencies should draw strength from the information technology revolution to reduce the marginal cost of administering and monitoring compliance of inheritance tax.
- For example - Usage of Project Insight of the Central Board of Direct Taxes.

4. Changes in Complementary Taxes:
- The government must make changes in complementary taxes like the Wealth Tax and Gift Tax to ensure that inheritance tax is not evaded by the super-rich.
- For example - Increasing evidence of the creation of family trusts such as the Hindu Undivided Family (HUF) by high net-worth individuals for tax avoidance purposes.

Tackling wealth inequality requires a multifaceted approach that includes measures such as inheritance taxation, wealth taxation, and the Land Value Tax (LVT). These measures not only help to redistribute wealth and promote economic fairness but also contribute to fostering a more inclusive and prosperous society where opportunities are more evenly distributed.