COMMENTARY

THE CASE FOR INTRODUCING INHERITANCE TAX IN INDIA

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Abstract

In the post-liberalization era, while sustained economic growth in India has facilitated significant wealth creation, massive tax evasion and avoidance by the wealthy class had limited the government's capacity to distribute the fruits of growth, contributing to widening income and wealth inequality. This creates sufficient grounds for introducing inheritance tax to promote inter-generational equity. However, the government must tread with caution, weigh unintended consequences, and take a holistic approach to addressing issues of distributional inequity in the country.

INTRODUCTION

Several advanced economies have long relied on estate duty or its variants like inheritance tax[4], capital acquisitions tax, estate tax via stamp duties, or capital transfer tax to garner fiscal resources, and use such taxes as tools to prevent concentration of income and wealth in the hands of a few. Critics have however argued that such transfer or death taxes prohibit capital accumulation and adversely affects growth in national wealth. The contrasting views are reflected in sovereign tax policies around the world. Thus, while 19 OECD countries levy some form of inheritance tax, 15 OECD countries levy no taxes on property passed to lineal heirs. In 2015, the average estate or inheritance tax rate in all OECD countries was 15 percent - the top rates ranging between 4 percent (in Italy) to 55 percent (in Japan), indicating the relative importance that different countries assign to such tax to attain fiscal and distributional objectives.

Among developing Asian economies, estate duty or inheritance tax has not been used that extensively as compared to OECD countries. Relatively richer Asian economies such as Singapore, Brunei, and Hong Kong had estate duty, but have abolished it over the last decade (Table 1). Currently, Philippines and Taiwan levy estate tax, with the highest rates at 20 and 10 percent respectively.

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[4] In popular press, while estate duty and inheritance tax are used interchangeably, there is a subtle difference between the two. Inheritance tax is imposed on the assets inherited from a deceased person. The inheritance tax rate generally depends on the value of the property received by the heir, and his relationship to the decedent. In contrast, an estate tax is calculated based on the net value of the property owned by a deceased person at the time of death. The tax is collected only if the value exceeds the exemption limit as applicable by law.

Table 1: Brief overview of Estate or Inheritance Tax Globally

Countries with highest Inheritance or Estate Tax as of 2015				Countries that have repealed Inheritance or Estate Tax since 2000		
Sl.no.	Country	Tax rate (%)	Tax Type	Sl.no.	Country	Year repealed
1	Japan	55	Inheritance Tax	1	Macau	2001
2	South Korea	50	Inheritance Tax	2	Portugal	2004
3	France	45	Inheritance Tax	3	Slovak Republic	2004
4	United Kingdom	40	Inheritance Tax	4	Sweden	2005
5	United States	40	Estate Tax	5	Russia	2005
6	Ecuador	35	Inheritance Tax	6	Hong Kong	2006
7	Spain	34	Estate Tax	7	Singapore	2008
8	Ireland	33	Capital Acquisitions Tax	8	Austria	2008
9	Belgium	30	Inheritance Tax	9	Liechtenstein	2011
10	Germany	30	Inheritance Tax	10	Brunei	2013
11	Chile	25	Estate Tax	11	Czech Republic	2014
12	Venezuela	25	Inheritance Tax	12	Norway	2014

Source: Adapted from Cole (2015)

In India, policymakers have been toying with the idea of introducing inheritance tax for the last five years. Though speculations on its introduction gather momentum before the presentation of the Union Budget each year, it has been shelved thereafter. In this article, we argue why there is a strong case for introducing an inheritance tax in India now and why an undue delay in its announcement and implementation could lead to serious economic and social costs to the country.

BRIEF HISTORY

There is no history of the imposition of inheritance tax in India. However, estate duty was prevalent during the 1953-1985 period. The Indian Estate Duty Act of 1953 was modeled after the British Finance Act of 1894, with suitable modifications made to meet the requirements of various succession laws prevalent at that point of time in India (Bagchee, 1954). It not only encompassed the assets conferred to the descendants upon the death of an individual but also the assets transferred in contemplation of death up to two years prior to death. For individuals and Hindu Undivided Family (HUF), all assets up to a threshold limit of INR 0.1 million and INR 0.05 million respectively were exempt while determining the taxable value of the estate.

Though the purpose of the duty was to augment government revenues and remove extant inequalities in income and wealth, it failed to achieve the objectives due to the very low marginal benefit (in revenue terms) and the innumerable litigation into which the government found itself trapped, due to complex nature of the Act. The low threshold and progressively high duties led to evasion and avoidance, rendering it futile, as the yield from the tax was lower than the cost of its administration. The duty was therefore abolished in 1985. At the time of abolition, the duty was pegged at an abnormally high rate of 85 percent on an estate value exceeding INR 2 million.

THE RATIONALE

While it is true that estate duty in post-independence India was rendered ineffective in serving its objectives, there is a need to re-assess the potential role that it can play today, in a post-liberalized era[5]. The assessment also assumes importance given that India's impressive growth has also been accompanied by rising wealth and income inequality in the post-reforms period. Our argument that it is an opportune time to introduce the inheritance tax now rests on two crucial aspects of the Indian economy – fiscal and distributional.

On the fiscal side, India has been running a fiscal deficit consistently in the post-reforms period. Despite high economic growth in the 2000-2010 period, revenue remained less buoyant[6]. Since the beginning of this decade, as growth began to decelerate[7], massive government expenditure programmes were initiated at periodic intervals to reverse the slowdown. In the recent past, for example, the Union Government has undertaken bank recapitalization programme; announced massive expenditure plans to speed-up infrastructure development; and introduced various social sector programmes like farm loan waiver and a universal health insurance programme on the lines of 'Obamacare.'

The above suggests that while government expenditure rose rapidly, similar growth in government revenues was not evident. As a result, the government has failed to meet fiscal targets consistently. For example, in the current fiscal (2017-18), ending March 2018, and for the next financial year (April 2018 to March 2019) there is a clear indication of deviation from the path of fiscal discipline. The fiscal deficit in 2017-18 stood at 3.5 percent of GDP, and the budgeted deficit for 2018-19 projected at 3.3 percent of GDP. These numbers are significantly higher than the target rate of 3 percent of GDP, recommended under the Fiscal Responsibility and Budget Management (FRBM) Act[8].

The above makes it imperative that if the government has to follow the path of fiscal discipline, it needs to find out newer avenues of garnering resources. While recent implementation of the Goods and Services Tax (GST), considered a major indirect tax reform, could potentially improve the fiscal health, transitional complexities and implementation woes may mean that the benefits shall accrue only in the medium to long-term. In such a scenario introduction of inheritance tax could potentially augment government revenues, and bridge the fiscal deficit at least to some extent.

When the estate duty was abolished more than thirty years ago, it was premised on the rationale that the net benefits accruing from the tax were negative. Much of it was attributed to capacity

[5] India faced a severe balance of payments crisis in 1991, following which the country undertook structural reforms to unshackle the economy from heavy controls to market-oriented policies, following the principles of Washington Consensus. Among other things, it included privatization of domestic enterprises, interest rate deregulation, adoption of flexible exchange rate regime, trade liberalization, and reducing barriers for foreign capital flows.

[6] India compares unfavorably vis-a-vis its peers when it comes to garnering tax revenues. According to OECD Economic survey (2017), as of 2014, the tax-GDP ratio in India stood at 16.8 percent, much lower compared to Brazil (33.4 percent), China (24.8 percent), Russia (28.2) and South Africa (27.8).

[7] This was partly due to the risk-averse lending behavior of the banking sector, which became overburdened with non-performing loans. Weak investments only added to the woes, ultimately impacting the government's revenues adversely.

[8] The FRBM Act, 2003 was introduced in India to reduce revenue deficit, inculcate fiscal discipline and improve the overall macroeconomic management. The FRBM rule set a target reduction of fiscal deficit to 3% of GDP to be achieved by 2008-09. The targets were unmet. The most recent amendment in 2016 has set the fiscal deficit target at 3 percent of GDP for the years up to 2020.

constraints in tax administration involving such a complex tax. However, it is worthwhile to mention that the estate duty in India was prevalent and abolished in the pre-liberalization period. The ICT revolution that gained momentum in the mid-1990s had a significant role in modernizing and transforming the economy. Concomitantly there has also been a slow, yet discernible improvement in the government’s tax administration capacity.

The current government has laid much emphasis on moving towards a digital economy. In line with it, the Indian tax authorities are in the process of using technology to widen the tax net. For instance, under Project INSIGHT initiated by the Central Board of Direct Taxes (CBDT), the principal tax governing authority in India, an integrated Data Warehousing and Business Intelligence platform has been set up. It envisages using various analytics tools and techniques like descriptive, diagnostic, predictive, and prescriptive analytics to enable broadening the tax base, enhance tax compliance, and effectively monitor tax evasion. A simple and non-intrusive compliance module for broadening of the tax base is already in place and pilot projects like non-filers monitoring system (NMS), return mismatch verification system (RVMS), verification of foreign remittances, etc. are already yielding short-term results. Further, to ensure better tax governance and to cater to the dynamic requirements of tax administration, several capacity-building partnerships have been initiated with industry, academic, and research institutions. All such initiatives can significantly reduce the marginal cost of administering the inheritance tax, help effectively monitor compliance, and thereby contribute to enhancing government revenues.

From a distributional point of view, inheritance tax can be an effective measure to promote inter-generational equity. Recent research has indicated that India’s income and wealth disparity has been increasing alarmingly. Chancel and Piketty (2017), analyzing the dynamics of Indian income inequality between 1922 and 2014, had found that income inequality in India is at its peak since 1922 when the income tax was first introduced in India. While in the 1930s the top 1 percent of the earners in India accounted for less than 21 percent of total income, it dropped significantly to 6 percent in the 1980s, but thereafter steadily increased to a historical high of 22 percent in 2014. This suggests that although the per capita income of Indians have risen, growth in the post-liberalization period has failed to be inclusive. On the contrary, it has been highly skewed, favoring the rich as is evident from the rising number of Indian millionaires and billionaires.

The World Inequality Report 2018 pointed out that while the bottom 50 percent and the middle 40 percent recorded a meagre 89% and 93% growth in total income between 1980 and 2014, the top 10 percent recorded 394 percent rise in total income, which is more than twice the sum recorded by the rest 90 percent of the population. Further breakup shows that top 0.1 percent, 0.01 percent and 0.001 percent of the population received 1138 percent, 1834 percent and 2726 percent rise in total income respectively. This suggests high levels of income concentration in India.

The wealth inequality in India has also been alarming with the richest 1 percent owning 58.4 percent and the richest 10 percent accounting for 80.7 percent of the nation’s wealth. In contrast, the bottom 50 percent of the population own only a meager 2.1 percent of the national wealth (Credit Suisse, 2016). A report by consultancy firm Knight Frank points out that with 500 new additions per year, the rise in high net worth individuals (HNWIs) was about 290 percent in the period between 2006 and 2016, and is expected to double with 1000 additions per year between 2016 and 2026 (Knight Frank, 2017).

However, the tax revenue accruing from this section of the population has not increased commensurately. In a country with more than 1,250 million people, only 37 million filed their income taxes in 2015-16. Amongst those paying their taxes, 5.2 million showed income between INR 0.5 million and INR 1.0 million; 2.4 million people declared income above INR 1 million; 0.17 million people declared income above INR 5.0 million, and only about 43,000 have reported taxable income above INR 10 million! Even among the 7.6 million individual assessees with a declared income of above Rs. 0.5 million, 5.6 million (about 74 percent of the total) belonged to the salaried class. Juxtaposing this with the fact that in 2015-16, about 20 million Indians flew abroad for business and tourism purposes, and more than 12.5 million cars sold in the last five years in India, it is evident that while income and wealth of the rich has increased manifold, this section of the population has found innovative means to subvert the Indian tax system.

The strange case of Mauritius, which is by far the largest source country for inward FDI, has served as a tax haven and a breeding ground for money laundering and 'round-tripping' by wealthy individuals and corporates. According to a submission by the Finance Minister to the Parliament, only 28,667 companies have shown profit between INR 10 million to INR 100 million, and only 7,781 companies have profit before tax of more than INR 100 million. Three major global financial leaks in the last three years - the Swiss Leaks (2014), the Panama Papers (2015) and the Paradise Papers (2017), which documents large-scale money laundering activity by the rich and powerful in India bears credence to the fact that it may be an opportune time to address these issues.

If such high levels of income and wealth inequality continue to grow, and no efforts are made by the government to address this by compelling the rich to contribute a larger proportion of their income and wealth to achieve more equitable distributional outcomes, it could increase social, economic, and political tensions in the country. Inheritance tax, coupled with associated tax reforms, can aid in reducing intra-generational inequality, promote inter-generation equity, and serve a meaningful purpose to address the distributional gaps that exist in India today.

TREAD WITH CAUTION

While the above suggests that there is merit in levying inheritance tax now, the government needs to tread with caution. It is imperative to take a systemic view of the malaise, rather than to approach this in an *ad-hoc* manner.

First, the government needs to be mindful of the fact that levying such a tax can have only a limited impact in increasing government revenues. In developed countries like the United States, the estate tax itself comprises of a very meager amount (US$15 – 26 billion per annum) of the total receipts of the government. Considering India in light of such statistics, where the per capita GDP and tax compliance is much lower, it can only have a low marginal impact on improving the fiscals. This should however not deter the government, as the marginal economic (fiscal) benefits need to be seen in conjunction with the large social benefits (equity) that shall accrue from such a tax.

Second, to ensure the effectiveness of inheritance tax, other related or complementary taxes, like a Gift Tax and a Wealth Tax should be introduced to deter tax-avoidance. This assumes importance in India where the *'benami property'* is a menace and there is increasing evidence of the creation of family trusts like the Hindu Undivided Family (HUF) by the high net-worth individuals for tax avoidance purposes.

Third, from a redistributional perspective, imposing the inheritance tax per se is not enough to reduce inequality, without addressing the structural problems that aggravate the income and wealth divide. The evidence of rising inequalities in income and wealth in developed countries, where such a tax is present over a substantial period, bears testimony. For example, Saez and Zucman (2016) document the U-shaped form of wealth inequality in the United States for individuals in top 1% of the wealth distribution and further notes the constant share of wealth owned by the middle class.

Also, as pointed out by Chancel and Piketty (2017) the share of GDP accruing to the bottom 50 percent of the population in India and China are almost similar since the 1980s. However, the major difference arises from the fact that whereas only 23 percent of the increase in GDP accrued to middle 40 percent in India, the same constituted about 43 percent in China. The richest 1 percent captures the difference of 20 percentage points in India. The main implication of this is that distributional efforts by the government should focus on job creation in the modern sectors of the economy, and increase expenditure on education and health, which can significantly impact lifetime incomes, and wealth creation by those at the bottom of the pyramid. Unfortunately, the expenditure on education and health has been shrinking in India continuously.

Fourth, it is advisable that an inheritance tax, which targets the beneficiaries, is better suited to promote inter-generational equity rather than re-introducing estate duty, which targets the estate owner. This will have dual implications. On the one hand, it will not disincentivize capital formation and wealth creation in the economy (Seidman 1983), and on the other, by targeting the beneficiaries, it will avoid adverse labor market implications as a large bequeath can substantially reduce work effort. To start with, a high threshold value (targeting the ultra-rich) and a moderate tax rate, benchmarked to similar developing economies, should be set to ensure better compliance.

Finally, the imposition of such a tax should not serve only a symbolic value as a step against corrupt practices of the wealthy. Lack of adequate groundwork and preparedness to administer the tax can render the exercise futile, even if introduced with honest intentions.

CONCLUDING REMARKS

No question that the divide between the rich and the poor in India has increased, and needs urgent attention of the policymakers. Inheritance tax can serve a useful objective of reducing wealth and income inequality within and across generations. However, this will require earnest intent; massive efforts in planning, execution, and monitoring; and associated tax reforms to ensure that the real objectives of imposing an inheritance tax are realized. While inheritance tax can only have a marginal fiscal impact, it can nevertheless address the substantial distributional inequities that exist in India today.

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