

Living off Daddy's wealth

Nadeem ul Haque

Lack of social mobility is very visible in Pakistan. Political power also seems to be coagulated as the chances of getting elected are tied into traditional wealth, land and family status. Power, privilege and wealth seem to remain in the family in Pakistan.

A few years ago a principal of an elite school told me that the students there were disinterested in serious studies as daddy's wealth was certain, and their elite status was guaranteed in society through inheritances. Discussing this with various members of our privileged class, it becomes immediately apparent that hard work is not an aspiration. Power and privilege is a right in our society, not something to be earned through hard work. An entitlement culture prevails not just in agriculture but also in business and politics.

Examine the elite and you find large cohorts who even if educated have never really used that education. Their lives largely have been of leisure made possible through inheritances and sources of rentier income. Such lack of social mobility and the preservation of privilege was the hallmark of feudal societies. For long periods this privilege preservation kept a large part of the population locked into the poverty trap. It took revolutions – some bloody – to break this system. Many of these revolutions involved land redistribution. It is not surprising then that most analysts think of rentier income as coming only from land and so ask for land reform.

However, we all know of industrial families that have done little to develop grandfather's industry but enough state subsidies and a liberal tax regime have kept their lifestyles of privilege alive. Similarly for large real-estate holdings! In its heyday, capitalism broke feudal privilege and replaced it with market-based merit.

Through innovation, entrepreneurs established a new meritocracy and amassed large wealth. In the process jobs and a new middle class was created. The need for skills in the process of innovation development and management allowed the educated and the talented to participate in the wealth that was being created. Such capitalism escaped Pakistan because of license raj, SROs and the government-industry-land nexus. Here privilege reigns supreme!

Childish economics thinks that some form of taxation can do this. Of course it is difficult to design a tax system focused on privilege and power without it impacting the rising middle class more adversely. The rich can find loopholes through exemptions. As capitalism matures, the nexus of money and politics has raised the same issue in advanced economies. Money is able to buy laws and escape taxation. Along with the global crisis this money-politics nexus has raised a new debate on social mobility and welfare policy among serious economists.

Inheritance tax has recently been revived in Thomas Piketty's new bestseller:

'Capital in the Twenty-first Century'. He has shaken up the economics profession by raising the issue that it may be inherent in the structure of capitalism that the rich will get richer at the expense of the rest. There are no natural mechanisms for correction of inequality. Hence policy intervention is required. He recommends taxing capital or wealth in a progressive fashion. Accompanying this is a progressive inheritance tax.

An inheritance tax is a generational reset. As Warren Buffet said:

Research has shown that people work hard to satisfy their needs. In the process they create wealth for others as well as for society. Winners of lotteries, whether of birth or otherwise, rarely use their talent. Inheritance tax could be beneficial for many reasons.

- First, it would set the generational incentives right. Children will be mindful of the generation reset and work hard to use their talents for developing a worthwhile life. Parents will make investments in their education and skills to make them competitive instead of handing them rental incomes.
- Second, people wishing to escape such taxation can in their lifetimes put some of their wealth to work through gifts and endowments in much-needed social-sector activities like universities, hospitals arts etc. This will alleviate the pressure on government to provide for such activities alone.

- Third, it will allow much-needed capital to come into the marketplace and flow to higher return activities instead of being locked away for generations into rentier incomes alone.

Counterarguments claim that the bequest motive is an important incentive for the entrepreneur to accumulate and must not be taxed. This must be balanced off by recognizing the adverse generational incentive effects that Bill Gates and Buffett have noted in saying that they don't want their children to inherit so much as to become "do-nothings". Moreover, society and government's contribution to the amassment of large wealth must also be taken into account and does entitle it to some part of the inheritance.

What then should be the rate of the inheritance tax? Piketty has argued for as much as 50-60 percent tax rate for the upper end of the wealth distribution. A substantial rate especially for the upper end of the wealth distribution is required for a meaningful generational reset.

Many complain of the spoilt nature of our elite children in this land of free bequests. The phenomenon has been celebrated in songs like 'Waderay Ka Beta'. Perhaps it is time to consider reintroducing this most important tax. It will also improve social mobility and establish greater competition in the marketplace as well as in politics. It is probably more efficient and doable than land reforms which some people still demand.

"A rich man should give his children enough money to do anything but not so much that they do nothing." Taxing wealth in someone's life is taxing savings and could be difficult. But when wealth passes from one generation to the next taxation can play a useful role. "It is a tax paid by the recipient of this income, the inheritor, the lucky winner in the sperm lottery."

Warren Buffet