Taxation of Transfers and Wealth

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What the chapter is about

- Taxation of bequests, inheritances and gifts; a little bit about wealth
- Overview of this type of taxation around the world and in the U.S.
- Reasons for this type of taxation
- Bequest motives
- Optimal taxation
- Empirical evidence
  - Real responses
  - Avoidance

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Bequest motives

- Accidental
- Altruism
- Exchange
- Joy-of-giving
- "Capitalistic spirit," wealth in utility
- "Behavioral" — inertia, denial of death
- Mix of some or all of the above

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Evidence — distribution

- Bequests an important source of wealth — see Davies and Shorrocks (2000) for survey
- Huge literature on modeling wealth distribution accounts for
  - uncertain lifespan
  - income risk, precautionary saving
  - interactions with taxation and social insurance programs
  - health and long-term care expenses
- Life-cycle model gets you far but starts failing toward the top (though not just at the very top, $\approx$ 80th percentile?)
- Adding altruism gets you further but fails to explain concentration within top 1% or so (Carroll, 2000; De Nardi, 2004 and others)
- So, you need something else — utility from bequests or wealth is usually assumed, $u(C, B)$

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Evidence — mixed motives

- Same reason as previous slide: accidental and intentional bequests coexist
- Control vs tax minimization

Gifts

- Joulfaian (2004) and Ohlsson (2011), massive temporal responses
- Bernheim, Lemke, Scholz (2004) — real effects
- McGarry (2000) and Poterba (2001) — underutilization of simple tax avoidance that relies on gifts

- It of course fits very well with evidence we have on importance of precautionary saving
- ...except that as Joulfaian and McGarry (2004) document it also applies to the very high income individuals. The flow of gifts appears too small to be consistent with tax minimization

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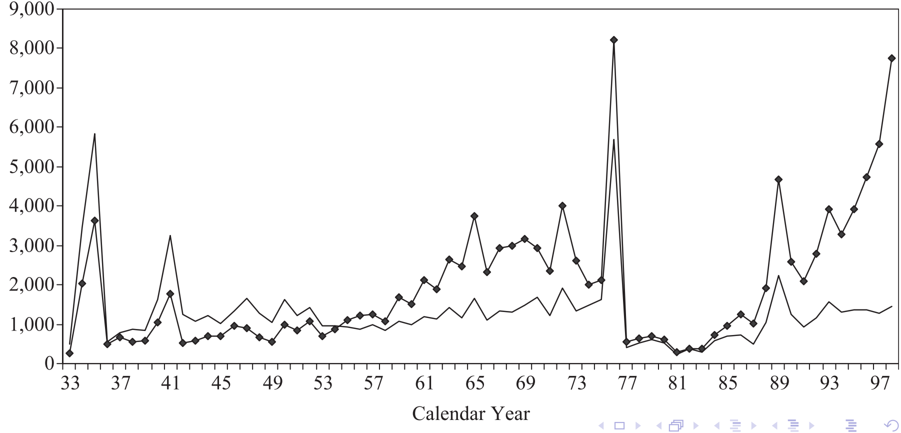
Gifts are responsive



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A bit more on control vs minimization

- Cooper (1979) — an estate tax is a voluntary tax
- Schmalbeck (2001) — yes, but you lose control over assets

Deathbed planning

- Kopczuk (2007) looks at the (cross-section of) estate taxpayers from 1977
- Wealth robustly increases with age starting when people are in their 60s until the maximum age of 98 observed in the data — 1 to 2% per year
- However, those who died from a lasting terminal illness have estates that are nearly 20% lower. The effect is there even for illness lasting "days to months"
- Evidence of importance of tax avoidance ("lifetime gifts" schedule responds, cash falls) beyond other factors (eg., loss of income or increased spending do not seem to explain much)

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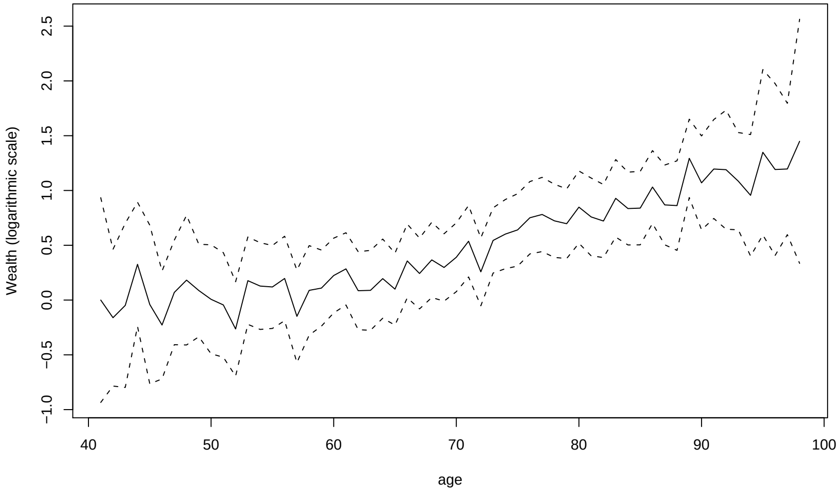
Age-wealth profile of estate taxpayers



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Heterogeneity

- Survey evidence: Laitner and Juster (1995), Light and McGarry (2004) — declared bequest intentions vary widely, somewhat but not very strongly correlated with things one would expect (like having kids)
- Charles and Hurst (2003) and others on importance of inherited tastes/habits in wealth accumulation
- Structural models of wealth accumulation — mixture of life cycle and bequest types, estimate % of each (Kopczuk and Lupton, 2007; Ameriks, Caplin, Laufer, van Nieuwerburgh, 2011)

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Main things to remember — bequest motives

Evidence on bequest motives is inconclusive in many ways

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However, we know that

- Understanding large wealth holding requires going beyond accidental motives, altruism and exchange
- Multiple motives are present at the same time, wealth plays dual role
- There is a trade off between control and bequests (or tax minimization)
- Heterogeneity is important

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Optimal taxation

- Models of capital taxation apply
- Redistribution is key, Atkinson-Stiglitz is the workhorse model (Kaplow, 2001). Bequests are a good like others as the first pass
- What is special? How generations are linked — bequest motives
  - Parent: $u(C^P) + \rho u(C^K)$ Kid: $u(C^K)$

Social planner:

$$u(C^P) + \rho u(C^K) \quad \text{or} \quad u(c^P) + \rho u(c^K) + \nu u(C^K)$$

  - If the latter — externality, and corrective taxation applies
  - Recent paper by Farhi and Werning (2010)

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Correcting externality from giving

- Pigouvian subsidy — first best: $t^P = -\nu \frac{u'(C^K)}{u'(C^P)}$
- Pigouvian subsidy — second best: correct price by $t^S = -\nu \frac{u'(C^K)}{\mu}$, where μ is the multiplier on the revenue constraint (principle of targeting: Sandmo, 1975, Kopczuk 2003, Micheletto, 2008)
- Alternatively: $t^S = \frac{1}{\mathrm{MCF}} t^P$ where $\mathrm{MCF}=\frac{\mu}{\lambda}$ is the marginal cost of funds
- With many people — many externalities. Correct each one separately if you can — nonlinear subsidy to bequests.
- ...but the corrective tax is a function of $u'(C^K)$ — it goes to zero as $c^K \to \infty$
- Correcting externality from giving by the very wealthy is not important

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- Pigouvian subsidy — second best: correct price by $t^S = -\nu \frac{u'(C^K)}{\mu}$, where μ is the multiplier on the revenue constraint (principle of targeting: Sandmo, 1975, Kopczuk 2003, Micheletto, 2008)
- Alternatively: $t^S = \frac{1}{\text{MCF}} t^P$ where MCF$=\frac{\mu}{\lambda}$ is the marginal cost of funds
- With many people — many externalities. Correct each one separately if you can — nonlinear subsidy to bequests.
- ...but the corrective tax is a function of $u'(C^K)$ — it goes to zero as $c^K \to \infty$
- Correcting externality from giving by the very wealthy is not important

Externality from giving in the long run

- Externality from giving was assumed separable from consumption and bequests are a consumption good here, not income
- Consider instead identical parents and children

$$u(C+X)+v(L)+g(B)$$

subject to

$$C+B=wL$$

where X is inheritance received, C is consumption minus inheritance, $B=X$ in the steady state

- Externality imposed on yourself, not separable from consumption, it interacts with incentive constraints and leads to positive tax on bequests (I think, unpublished chapter of my 2001 dissertation).
- Alternatively, as Piketty and Saez (2011) recently do — add more heterogeneity

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Main things to remember — optimal tax policy

The nature of the bequest motive is important for optimal tax conclusions

However,

- This is because it corresponds to *normative* assumptions about the externality from giving
- Given lack of consensus about the nature of bequest motives, relying on this type of externality is premature
- Externality from giving becomes irrelevant at the top of the distribution, which is where transfer taxes apply in practice

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Things to remember — normative analysis

Normative analysis should try to be either:

- agnostic about bequest motive
- or model mixed motives, heterogeneity and wealth distribution

On the other hand, important pieces are missing

- Implications of inherited wealth are poorly understood
- Implications of externalities from wealth concentration or accumulation are not yet incorporated

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- Direct effect on wealth accumulation hard to estimate, best (but not good) evidence suggests negative effects
- Effect on inter vivo gifts complicated
- Avoidance important but not free — tax minimization vs control
- Capital gains realizations, charity, migration
- Effect of inheritance on the recipient side
    - disincentives to work possibly important
    - entrepreneurship and ownership of firms affected
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Conclusion

- An important type of taxation in practice that just does not seem to want to die
- We still lack solid empirical evidence about some first order effects — impact on wealth accumulation or long-term effect on wealth concentration for example
- We also do not have a good framework for thinking about wealth accumulation of the wealthy though some pieces are there
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