

Taxation of Wealth and Wealth Transfers: Commentary

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Commentary on: Taxation of wealth and wealth
transfers¹

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1 Introduction

Taxes are rarely popular, but wealth transfer taxes appear to be particularly and increasingly unpopular. A number of countries are already without an inheritance or an estate tax or, as in the case of France have dramatically reduced its scope. Some others, including the United States contemplate to phase it out.

Clearly, death taxation more than any other generates controversy at all levels: political philosophy, economic theory, political debate and public opinion. Opponents claim that it is unfair and immoral. It adds to the pain suffered by mourning families and it prevents small business from passing from generation to generation. Because of many loopholes, people of equivalent wealth pay different amounts of tax depending on their acumen at tax avoidance. It hits families that were surprised by death (and it is therefore sometimes called a tax on sudden death). It penalizes the frugal and the loving parents who pass wealth on to their children, reducing incentive to save and to invest.

Supporters of the tax, in contrast, retort that it is of all taxes the most efficient and the most equitable. They assert that it is highly progressive and counterweight existing wealth concentration. They also argue that it has few disincentive effects since it is payable only at death and that it is fair since it concerns unearned resources. For a number of social philosophers and classical economists, estate or inheritance taxation is the ideal tax.

The truth probably lies between these two opposite camps. For economists this tax like all taxes should be judged against the two criteria of equity and efficiency to which one could add that of simplicity and compliance. Public economics (and more specifically taxation theory) provides a well defined and rigorous framework to examine these issues. There exists by now a wide body of literature, some of which goes back to the pioneering age of optimal taxation models, while other contributions are newer

and rely on recent developments in economic theory (like the modeling of multidimensional asymmetric information).

In their paper Robin Boadway, Emma Chamberlain and Carl Emmerson do mention this literature (which they refer to as the “utilitarian” approach), but only briefly and in a somewhat caricatural way. This is quite in line with their view that “the results turn out to be very agnostic”. Instead, they use a different approach both when they discuss the “economic principles of wealth and wealth taxation” (Section 2) and when they consider design and administration issues (Section 4). These “non-utilitarian criteria” include a variety of issues such as paternalism, equality of opportunity, externalities, status (provided by wealth), enforcement and political support. Summarizing this wide range of arguments in a few paragraphs (or pages) would certainly fail to give them proper credit and I shall abstain from such an exercise. In any event, I am not convinced that a sequence of arguments based on general principles (like vertical and horizontal equity, equal opportunity, the pursuit of efficiency and the avoidance of administrative cost, etc.) can give us a lot of guidance for the design of tax systems. Consequently, I will elaborate a little further on the optimal tax approach and try to make its results less agnostic. In particular, I will examine what this literature has to say about the main conclusions drawn by BCE and presented in their Section 5. My review of the literature heavily draws on a survey by Cremer and Pestieau (2006) which the current version of BCE highlights in Box 2.1.¹

I am not quite sure how to interpret BCE’s recommendations. From what I can see they recommend against wealth taxation which they argue should be abolished. However, it is not entirely clear to me how this relates to the arguments presented in the body of the paper. As far as wealth *transfer* taxes are concerned they plead either for “a reform of the current

¹I will provide only a minimal number of references here; details references are provided in Cremer and Pestieau (2006).

regime or the introduction of a completely new system [...] such as the move to a comprehensive accessions tax which would also tax lifetime gifts.”

An important lesson emerging from the literature is that the appropriate tax structure depends on the relevant bequest model. One model states that bequests are simply an accident. People do not know how long they will live and so they keep more money than they turn out to need. If a significant share of bequests are accidental, estate taxation is quite efficient. However, if people are motivated to work and to save by the idea of leaving their families an inheritance, the tax will be distortionary. The impact of the distortion will depend on the bequest motive. If people have a specific amount they wish to leave to their children regardless of their needs and their behavior, the outcome will be different from what it would be if the amount bequeathed is determined by a concern for the welfare of the heirs. Either way, it turns out that wealth and wealth transfer taxes are useful instruments in most cases. A zero tax is called for only in an extreme case, when individuals are perfectly altruistic (so that they effectively behave as if they were to live for ever). Even then, the result only holds in the steady state. This is true when only efficiency matter but also (and even more so) when redistribution is introduced.

The note deliberately adopts a theoretical and normative view. It studies how transfers between generations ought to be taxed along with other tax tools and according to some welfare criterion. The findings have to be qualified by a number of considerations including enforcement and political feasibility and most of the other issues discussed by BCE. From that perspective, BCE’s analysis is a useful complement to the traditional optimal tax literature but it cannot replace it.

The rest of this comment is organized as follows. Section 2 presents a brief overview of alternative bequest motives. Next, Section 3 focuses on efficiency aspects and views wealth and wealth transfer taxes purely as revenue raising devices. I examine the optimal tax structure under alternative

models. Section 4 introduces inequality and the redistributive role of wealth transfer taxes.

2 Bequest motives

The role of gifts and estate transfers and their appropriate tax treatment depend on the donor's motives, if any. First of all it is possible that there is no bequests motive at all so that bequests are unplanned or accidental and result from a traditional life-cycle model. Accordingly, people save during their working lives in order to finance consumption when retired. Bequests occur solely because wealth is held in bequeathable form due to imperfections in annuity markets or the need to have precautionary savings. Either way, with that form of bequest estate taxes (even at rate of 100%) should not have any disincentive effect.

Turning to the *planned* bequests, several motives have been suggested in the literature.

Pure dynastic altruism: altruistic bequest: Parents care about the likely lifetime *utility* of their children and hence about the welfare of their descendants in *all* future generations (because the children in turn care about their children). Pure altruism may give raise to the Ricardian equivalence which occurs when Parents compensate any intergenerational redistribution through matching bequests.² Observe that this form of altruism is “non paternalistic” in the sense that parents respect their children's preference ordering. They care about their children's utility and not (directly) about their consumption, income, leisure, etc.

Joy of giving or paternalistic bequest (bequest-as-last-consumption):

Parents here are motivated not by pure altruism but by the direct utility they receive from the act of giving. This phenomenon is also referred to as

²Barro (1974).

“warm glow” giving.³ It can be explained by some internal feeling of virtue arising from sacrifice in helping one’s children or by the desire of controlling their life. Roughly speaking this amounts to considering bequests as a good “consumed” by the parents and contributing to their welfare. A crucial element is whether what matters to the donor is the net or the gross of tax amount.⁴

Exchange-related motives: strategic bequests:⁵ Exchange-related models consider children choosing a level of “attention” to provide to their parents and parents remunerating them in the prospect of bequest. The exchanges can involve all sorts of non pecuniary services and they can be part of a strategic game between parents and children.

3 Efficiency

Let us for the time being abstract from issues of redistribution and concentrate on efficiency aspect. In other words, the different taxes are merely viewed as revenue raising devices. The underlying question is then how to raise a given tax revenue in the “least costly” way. I follow Cremer and Pestieau (2006) who provide an overview of the taxation of capital income and wealth transfers and show how the answer depends on the underlying bequest motive.

The general result that emerges (except in the steady state under pure altruism) is that taxes on wealth and wealth transfers should not be equal to zero. The highest tax rates emerge under accidental bequests. When individuals do not care about the bequest they may leave and accumulated wealth only to smooth consumption over time or for precautionary motives,

³Andreoni (1990).

⁴One can argue that “warm glow” and paternalism differ from that perspective. Specifically a warm glow donor can be expected to care about the gross (before tax) gift or estate while this is not necessarily true under paternalistic altruism.

⁵Bernheim et al. (1985).

a tax on bequest has no impact on savings. Consequently, it is not surprising that accidental bequest should be taxed at a high rate (possibly at 100%).

A similar conclusion emerges when transfers are motivated by joy of giving and when the donee only cares about the gross (before tax) bequest. However, when the (paternalistic) donee cares about the after tax transfer, or when bequests arise from exchange (bequest for attention), a more complex picture arise. Tax rates now depend on elasticities according to Ramsey (or rather Atkinson and Sandmo (1980)) type rules. Roughly speaking, the more responsive a variable is to its price, the less it should be taxed. Bequest may be now be subject to a “double tax”: first the one on savings and then the specific tax on wealth transfers. Interestingly, the specific tax on transfer is, however, not necessarily positive! For instance in the exchange scenario when demand for attention is more elastic than future consumption we obtain a negative specific tax on bequests. While the exact magnitude of tax rates is to some extent an empirical issue it is clear that the tax rates on planned bequest will not be anywhere near the high rate on accidental bequests. This has interesting implication in practice because it justifies a lower tax on inter vivos transfers (which are by their very nature not accidental) than on transfers at death. Similarly, it suggests that any explicitly planned form of transfer at death (like life insurance) should be taxed less heavily than other forms of bequests.

Taxes on capital may also be used to control capital accumulation. This issue is often neglected in the literature by assuming that the government has other instruments to secure the appropriate level of capital accumulation. For instance it is frequently assumed that public debt can be used to secure the modified golden rule. When this is not the case, the analysis becomes more complicated but this does not strengthen the case leaving wealth (or wealth transfers) untaxed. Interestingly, in an overlapping generations model, an insufficient capital accumulation does not necessarily call for a reduction in the tax rate on wealth or capital income. This is because

savings do not only depend in the interest rate but also on earnings.⁶

Finally, when bequests are motivated by pure altruism the Chamley-Judd's result implies a zero tax on capital.⁷ However, this result relies on strong assumptions and it applies only to the steady-state. During the transition period wealth transfers and capital income are subject to taxation.⁸

The literature tends to concentrate on a single bequest motive at a time. In reality, however, we can expect all these motives to coexist. Taxation under mixed bequest motives has received less attention in the literature. However, each of the coexisting bequest motives (except possibly one) calls for a nonzero tax on capital, one cannot expect that the optimal policy involves a zero tax. The few studies there are confirm this basic intuition but this point certainly deserves further investigation.

How do these findings compare with BCE's recommendation. First, they do not support the claim that wealth taxes should be dismissed altogether. The theoretical optimal tax literature does not tell us precisely at what level wealth taxes should be set; this is an empirical question. However, what the literature tells us is that instrument of wealth taxation should not be given up altogether. Second, regarding the taxation of wealth transfers, they suggest a more complex structure of tax rates than that advocated by BCE. Bequest is not just "consumption" or "income" and wealth transfers should typically be taxed differently from consumption that occurs late in the life cycle or. Finally, the analysis shows that to study wealth transfer tax one cannot leave out the issue of wealth income tax. The determination of optimal tax rates requires an integrated treatment of the tax mix.

⁶ Atkinson and Sandmo (1980).

⁷ Chamley (1986), Judd (1985).

⁸ See e.g., Saez (2002).

4 Equity and redistribution

Up to now, the discussion has focused on efficiency issues. However, it is clear that aspects of fairness and redistribution are at least potentially important to assess the role of wealth and wealth transfer taxes. To introduce redistributive concern one can simply revisit the setting considered in the previous section and allow for heterogenous individuals. It is then clear that the optimal tax rules will have to be amended. Roughly speaking we move from simple Ramsey rules to “many households Ramsey” rule that account for the redistributive properties of the different forms of wealth taxation. However, this exercise does not address the main question namely whether taxes on wealth and/or wealth transfers are the appropriate instruments to be used in the first place. It is by now well known that Ramsey type models which rely on linear (proportional) taxes may artificially create a role for some instruments. This is because they restrict labor income taxes to be linear even though there is no theoretical or practical arguments to justify this assumption (except that it makes the model easier to solve). In practice, labor income taxes are levied according to sophisticated nonlinear schedules. Atkinson and Stiglitz (1976) have shown that these restrictions on labor income taxes may artificially create a role for differential commodity taxes (and a tax on capital income is from a lifetime perspective a nonuniform consumption tax where future consumption is taxes more heavily).

To understand the implications of this for the subject matter of this commentary, I will consider a simple thought experiment. It is admittedly oversimplified but it allows us to avoid the technicalities of optimal tax model.⁹ Consider a world where individuals differ only in their productivity (their wage or more generally their ability to make money by supplying their labor). To make the problem realistic (and interesting) let us assume that productivity is not publicly observable. For the rest, all individuals are

⁹Reference survey

identical; they are all born with the same initial wealth (if any) and they have the same preferences (including the discount rate), life expectancies, etc. As individuals grow older their wealth will of course differ. However, this heterogeneity is solely due to the accumulation of past labor income. In a such a world, a well-designed tax on labor income is sufficient and other taxes are not needed.¹⁰ In particular, taxes on wealth, or wealth income are redundant. Roughly speaking, taxing wealth is just an indirect way in taxing past earnings (which have already been taxed) and the observation of wealth does not give us any new information.

The picture changes dramatically when individuals differ in more than one dimension. In other words, individuals differ not only in productivity but also in discount rates, longevity or initial (inherited) wealth. Particularly interesting from our perspective is the case where individuals differ in the bequest they have received which has been studied by Cremer et al. (2003). Consider first the case where bequests are not observable and thus cannot be taxed. Now, at a given age, individuals with identical productivity will have different levels of wealth. Not surprisingly, it is then no longer true that a tax on labor income is sufficient. The optimal policy now involves taxes on both labor and capital incomes. This is because making taxes dependent on capital income permits a better screening for the unobservable individual characteristics. Cremer et al. (2003) concentrate on the case where transfers are motivated by “joy of giving” and when there is no correlation between wealth and productivity. In that setting the optimal tax is nonzero. When the joy of giving term is counted in social welfare the tax is necessarily positive. However, when there is laundering a negative tax cannot be ruled out. Interestingly, though the tax is more likely to be positive when we introduce correlation between productivity and wealth. And with perfect correlation it is always positive. To sum up, unobservable bequests introduce

¹⁰See Atkinson and Stiglitz (1976). To get the results some additional technical assumptions are necessary. We neglect them to concentrate on the main issue. The full implication of the Atkinson and Stiglitz result are also discussed by Cremer (2002).

the need for wealth taxation especially when there is a positive correlation between wealth and productivity.

On the other hand, if bequests are observable they ought to be taxed. In the specific setting (with) considered by Cremer et al. (2003), the appropriate tax is of 100%. A less extreme solution emerges when bequests are only imperfectly observable or when there are incentive effects. Then the optimal tax mix involves a tax on bequests (of less than 100%) along with taxes on labor and capital income. Intuitively this does not come as a surprise. When inequality is due in part to bequests, wealth (wealth income) and wealth transfers should be taxed.

In reality, the sources of heterogeneity go beyond those discussed by Cremer et al. (2003). Individuals also differ in their longevity, their time preference, etc. This can only reinforce the role of wealth and wealth transfer taxes in the optimal tax mix. On these issues, the literature remains incomplete and there are plenty of open questions (some of which are discussed in the chapter by Banks, Diamond and Mirrlees in this report).

To sum up, heterogeneity in several dimensions along with redistributive concern does provide a rationale for the taxation of wealth and wealth transfers. In a world of asymmetric information, where individuals differ not only on productivity, a tax on labor income (or equivalently a consumption tax) however well designed and sophisticated is not sufficient.

While BCE's analysis deals with a number of related issues (and in particular the issue of equality of opportunity), the optimal tax / multidimensional heterogeneity aspects do not appear to receive a lot of attention. As my discussion suggest, they are not just important to justify the existence of wealth transfer taxes but they are also of crucial importance for their design. Specifically, it does not appear to be possible to disconnect the study of wealth and wealth transfer taxes from that of other taxes (and particularly income taxes). Their design has to be determined as part of an integrated study of the tax mix.

5 Concluding comments

To sum up the pure efficiency approach does justify the use of wealth and wealth transfer taxes. This is an empirical question and it depends in particular on demand elasticities (for savings and bequests). We can expect the tax to be the higher the larger the proportion of accidental bequests. When individuals are heterogenous wealth taxes are a useful instrument as long as individuals differ in more than one dimension. Whether the tax is positive or not depends on the issue of laundering (which may be considered as a technical point) but more interestingly on the degree of correlation between the characteristics. For instance, when individuals differ in productivity and wealth or in productivity and longevity, a positive wealth tax arises when the productive tend to have more weight (or live longer).

My comment take a normative view and ask if wealth and wealth transfers ought to be taxed in order to maximize social welfare (given the information structure). Even though some issues remain open it seems to me that the literature I have reviewed overall makes a case for a positive answer to this question.

All these results are to a large extent at odds with the fact that wealth transfer taxes are very unpopular. There are of course a number of political economy issues I have neglected. For instance there is the issue of avoidance and enforcement which does lead to a strong departure from horizontal and vertical equity. In addition, there is the phenomenon of tax competition which can put a downward pressure on wealth taxes. BCE do provide a comprehensive and nice discussion of many of these issues but it is not clear how this translates into precise policy recommendations (except maybe when it comes to arguing that wealth taxes ought to be cancelled). In any event, it does not seem to me that the political and enforcement arguments provided here and by BCE are suitable to tell the whole story. How, for instance can we explain that very rich people are often in favor of estate taxation while

many middle classes (whose wealth is below the million dollar benchmark under which the estate is exempted) oppose it? More work is needed on these issues.

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