“How Should an Ideal Consumption Tax or Income Tax Treat Wealth Transfers?”

_Lily Batchelder_

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How Should an Ideal Consumption Tax or Income Tax Treat Wealth Transfers?

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I. INTRODUCTION

Reform of the U.S. wealth transfer tax system is virtually certain within the next three years. The federal estate tax is scheduled for repeal in one year only, in 2010. Current law then revives it from its brief death in 2011, with higher rates and lower exemptions than those currently in effect. The next President and Congress are unlikely to allow this bizarre sequence of events to take place.

At the same time that wealth transfer taxes have, and will continue, to occupy the political spotlight, however, there has been a curious silence about them in the literature on optimal tax theory and the fundamental tax reform. Academic and policy debates regarding the ideal income and consumption tax have largely bracketed the question of

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how inheritances should be taxed.\footnote{See, e.g., President’s Advisory Panel on Fed. Tax Reform, Final Report 49 (Nov. 1, 2005), available at http://www.taxreformpanel.gov/final-report/; Joseph Bankman and David A. Weisbach, The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax, 58 Stan. L. Rev. 1413, 1436-1438 (2006); [optimal tax articles, others]. But see Louis Kaplow, A Note on Subsidizing Gifts, J. Pub. Econ. 469–77 (1995).} This silence is surprising because a critical question in the design and implementation of both systems, and the choice between them, may be whether and how each taxes wealth transfers.

This paper attempts to fill this gap. It considers the ideal treatment of wealth transfers from a welfarist perspective in the context of both an ideal consumption tax and ideal income tax. It reaches three conclusions that apply regardless of which tax base is superior. Tax burdens should be adjusted for gratuitous gifts and bequests. Assuming existing empirical evidence is roughly accurate, the ideal form of the tax on wealth transfers is predominantly an inclusion-accessions tax (a \textit{comprehensive inheritance tax}). Finally, once again based on existing evidence, the ideal tax should be positive—and probably raise a much larger share of revenues than is currently the case in the U.S. or cross-nationally.

These conclusions run counter to existing practices and trends. A comprehensive inheritance tax has never, to my knowledge, been proposed or enacted.\footnote{But see Joseph M. Dodge, Comparing a Reformed Estate Tax with an Accessions Tax and an Income Inclusion system and Abandoning the GST, 56 SMU L. Rev. 551 (2003) and Edward J. McCaffery, The Uneasy Case for Wealth Transfer Taxation, 104 Yale L. J. 283 (1994), both of which allude to the possibility that a comprehensive inheritance tax (in an income or consumption tax context respectively) may be the best approach.} The U.S. is expected to reduce the share of revenue it raises from wealth transfers over the next several years. Meanwhile, other countries typically raise an even smaller share of revenue from wealth transfers, and many do not tax wealth transfers at all.

A reasonable response, therefore, would be to ask whether it would be easier and equally effective to replicate the incidence of a comprehensive inheritance tax raising significant revenues by adjusting income or consumption rate schedules. Unfortunately it would not.

At least in the U.S., inheritance flows are substantial and do not mirror the distribution of income from labor and savings. In addition, different types of wealth transfer taxes have surprisingly divergent distributional effects.\footnote{See Lily L. Batchelder and Surachai Khitratakun, Who Bears the Burden of Wealth Transfer Taxes? (work-in-progress).} As a result, the...
incidence of a given type of wealth transfer tax differs fundamentally from its alternatives—and from more general taxes on income or consumption.

New evidence could change this paper’s conclusions. As our understanding of wealth transfer behavior evolves, it may become apparent that the ideal wealth transfer tax should include substantial estate tax features, or raise significantly more or less revenue. Nevertheless, this article’s general conclusions appear to be fairly robust to new empirical findings. They also appear to hold once political and administrability constraints are taken into account. A comprehensive inheritance tax is, if anything, likely to be simpler and more politically palatable than an estate tax. It could also raise a much larger share of revenue than current law, even if a majority of the population were exempted on administrative or political grounds.

In order to limit its length, this paper does not discuss the implications of the normative argument advanced for the design of other important elements of wealth transfer taxes, such as the treatment of accrued gains, gifts versus bequests, younger versus older beneficiaries, human capital transfers, charitable contributions, or the accounting period. I hope to address these questions in future work. It also does not offer a specific inheritance tax proposal, a task I have undertaken elsewhere.

The paper proceeds as follows. Part II provides some background on inheritance flows and the types of wealth transfer taxes, in the process showing why it matters how a jurisdiction taxes wealth transfers. Part III explains why, given existing evidence, the best form for any tax on wealth transfers is predominantly a comprehensive inheritance tax and the ideal share of revenue raised is probably much larger than current practice. Part IV considers whether a sizable comprehensive inheritance tax is still the superior approach once one takes into account implementation issues, such as political economy constraints, administrative challenges, and transition costs. Part V offers a brief conclusion.

II. Why Does it Matter How Gifts and Bequests are Taxed?

The taxation of wealth transfers has potentially important real world consequences. Nevertheless, relatively little research has examined who receives wealth transfers and what the incidence of wealth transfer taxes is, especially on heirs. Surachai Khitratakun and I have begun to address these issues and, unless otherwise noted, the following estimates are based on our joint work. We conclude that annual inheritance flows are large, and significantly alter the distributional of income and consumption. In addition, different types of wealth transfer taxes affect individual donors

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4 See id; Andrews, supra note __.
6 But see [Hendricks, Joulfaian, etc.]
7 An extensive literature considers the incidence of the estate tax if it is assumed to fall on decedents along. See [TPC, JCT, etc.].
8 Lily L. Batchelder and Surachai Khitratakun, Who Bears the Burden of Wealth Transfer Taxes? (work-in-progress). Details on our methodology are provided in Appendix A.
and heirs very differently. As a result, wealth transfer taxes are a potentially important source of revenue, and may be critical for accurately allocating tax burdens based on a household’s economic status.

A. Magnitude and Distribution of Wealth Transfers

In 2009, annual bequest flows in the U.S. will total about $700 billion, after excluding transfers to spouses and charitable organizations. To give a sense of the relative magnitude of this figure, Figure 1 shows that it represents about one-third of receipts from labor, saving and inheritances among households receiving a bequest that year, and about 6% of all household income. In addition to constituting a meaningful share of household income, gratuitous gifts and bequests (together referred to as inheritances or wealth transfers) are a tremendously important determinant of household wealth. According to the best estimates, between 35% and 45% of all household wealth is inherited.¹⁰

Despite these large annual inheritance flows, currently inherited income is taxed relatively lightly in the U.S. Figure 2 shows that the average estate tax rate on inherited income will be about 2.5% in 2009, while the average income and payroll tax rate on income from labor and saving will be about sevenfold higher, at 18.4%. Theoretically, this relatively minor taxation of wealth transfers would not matter if wealth transfers did

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9 Unless otherwise noted, the estimates in Figure 1 and the following charts are based on the adaptation of the Tax Policy Center Estate Tax Microsimulation Model described infra in Section IV. Further details on our methodology are provided in the Appendix. These estimates are very rough because of data limitations that require multiple levels of imputation and because they rely in part on data from 1992.

not alter the pre-tax income distribution. But, in reality, inheritances have important
distributional consequences.

As illustrated in Figure 3, bequests are more or less evenly distributed among
households with income from labor and saving (referred to as earned income)\(^{11}\) of less
than $200,000. But thereafter the average bequest increases rapidly as earnings rise. The
increase is even more dramatic if one considers a more comprehensive definition of
economic status. The specific alternate measure employed in this article is annual earned
income plus one-fifth of annual inheritances (referred to as economic income).\(^{12}\) While
this measure does not account for the fact that receipt of an inheritance tends to induce an
heir to work less, it does address the fact that, as an economic matter, a bequest is income
for the heir. It also partially smoothes bequests in order to address their inherent
lumpiness.\(^{13}\) Figure 4 shows that under this measure, the average bequest received rises
from less than $150,000 for heirs with economic income of less than $200,000, to over $5
million among the households that are the best-off.

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\(^{11}\) The specific measure of earned income used is cash income as defined at

\(^{12}\) [Note to readers: I plan to refine this definition by converting inheritances from a stock to a flow over the
heirs remaining life expectancy.]

\(^{13}\) Other sources of income, such as capital gains, are also lumpy but the recipient can at least defer
realization in order to smooth their income. Deferring death is a greater challenge.

Admittedly, the choice of five years is somewhat arbitrary. But it seems as reasonable as any
alternative, given the lack of data on longer-term measures of earned income, and the fact that people
generally appear to operate neither across annual nor across lifetime (or intergenerational) economic
horizons. See, e.g., Michael Landsberger, Consumer Discount Rate and the Horizon: New Evidence, 79 J.
POL. ECON. 1346, 1347 (1971) (finding support for a time horizon of roughly three years); Marjorie A.
Flavin, The Adjustment of Consumption to Changing Expectations about Future Income, 89 J. POL. ECON.
974 (1981) (finding that data significantly reject the permanent income hypothesis).
Figure 3 and 4 do not necessarily imply that inheritances widen economic inequality. For example, if all households received the same proportion of their income from wealth transfers, inheritances would rise with income, but would have no net effect on economic disparities. Instead, the key question for determining whether inheritances widen or narrow economic inequality is whether or not inheritances comprise a growing share of economic income as it increases.
Figure 5: Bequests as a Percentage of Economic Income of Heirs*

* One-fifth of bequests are included in both the numerator and denominator.

Figure 5 shows that the share of economic income derived from inheritances does increase with economic income for all households, except the most affluent. Among the top 1% of tax units with economic income of more than $500,000, inheritances constitute a declining share of income. This decline may, however, be overstated. Heirs tend to work less or retire early in response to receiving an unusually large inheritance so their potential earned income is probably higher than their actual earned income. In addition, Figure 5 does not include inter vivos gifts (referred to as gifts), which are highly concentrated among the wealthiest donors and heirs. If gifts and foregone earnings were

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The decline is also presumably due to regression to the mean, whereby children of the highest earners do not tend to earn as much as their parents. For children of the super rich, the gap between parent and child earned income may be especially large given the long tail of the income distribution that represents the top one percent.

15 [Check with Lek. Add prior taxable gifts or all.]

16 Such gifts include all gratuitous transfers during life that are not for made to one’s spouse, to a charitable organization, for education, for health care, or to support one’s minor child.

Taxable gifts comprise about 15% of wealth transfers. [Joulfaian & McGarry 439 tbl.5 (2004)]. In addition, in the U.S. a couple can make up to $24,000 in non-taxable gifts each year to each heir, which can add up to $5 million in gifts to each heir over the couple’s life. (This assumes the donor couple makes gifts over 50 years, the annual exemption remains constant, and the interest rate is 5%).
taken into account, the drop in Figure 5 among the top 1% of households would be smaller and possibly reversed.\textsuperscript{17} Thus, inheritances appear to widen economic inequality somewhat on net.

Inheritances also have important distributional effects along a second dimension: intergenerational economic mobility. Overall, the correlation between father and child income is about 0.6,\textsuperscript{18} which implies that about one-third of one’s financial success is determined the circumstances of one’s birth. At the ends of the income distribution, the correlation is even higher. For example, Mazumder has estimated that 50% of sons of fathers in the bottom income decile will have earnings below the 30\textsuperscript{th} percentile,\textsuperscript{19} while half of sons of fathers in the top decile with have earnings above the 80\textsuperscript{th} percentile. The net result is striking disparities in expected life outcomes—children born to the top decile of the income distribution are 53 times more likely to end up in the top decile than children born to the bottom.\textsuperscript{20}

There are many factors driving the high intergenerational correlation between parent and child economic status, and probably all could be considered a form of inheritance. Human capital transfers are a particularly large and growing factor and are not captured in data on financial inheritances.\textsuperscript{21} Nevertheless, this paper focuses solely on financial inheritances. While information is admittedly lost in this focus, much is gained. Such inheritances are much easier to identify, value, and tax. As a result, their ideal taxation is of both theoretical interest and practical import. Furthermore, the evidence to date suggests that financial inheritances are perhaps the most important barrier to intergenerational mobility. One survey of the empirical literature concluded that 25% of the intergenerational correlation of earnings is explained by the correlation between parent and child IQ, personality and schooling.\textsuperscript{22} By contrast, existing evidence suggests that wealth transfers account for about 30% of the relationship between parent and child economic outcomes.\textsuperscript{23}

\addcontentsline{toc}{section}{Notes}

\textsuperscript{17} [Add scatterplot of economic and non-inherited income.]

\textsuperscript{18} Bhashkar Mazumder, The Apple Falls Even Closer to the Tree than We Thought: New and Revised Estimates of the Intergenerational Inheritance of Earnings, in UNEQUAL CHANCES: FAMILY BACKGROUND AND ECONOMIC SUCCESS 80 (Samuel Bowles et al, eds., 2005). Mazumder 80 (80% are estimated to have income below the 60\textsuperscript{th} percentile).

\textsuperscript{19} Mazumder, supra note __ at 80 (68% are estimated to have income above the median).

\textsuperscript{20} Tom Hertz, Rags, Riches and Race: The Intergenerational Economic Mobility of Black and White Families in the United States, in UNEQUAL CHANCES: FAMILY BACKGROUND AND ECONOMIC SUCCESS 165, 184 (Samuel Bowles et al, eds., 2005).

\textsuperscript{21} E.g., [Langbein].


\textsuperscript{23} Thomas Piketty, Theories of Persistent Inequality and Economic Mobility, in HANDBOOK OF INCOME DISTRIBUTION (A. Atkinson and F. Bourguignon, ed., 1998). See also Samuel Bowles, et al, supra note __ at 18-19; Mazumder, supra note __ at 94. [More cites.]
In short, financial inheritances represent a substantial share of household income. They alter the income distribution. And they create sizable obstacles to intergenerational economic mobility. By setting aside wealth transfers, the literature on ideal tax systems therefore misses important direct and indirect information about the economic status of taxpayers. The net result is that this literature may systematically misunderstand how well-off taxpayers are relative to each other, and misconstrue a tax system’s distributional effects.

B. Approaches to Taxing Wealth Transfers

Any effort to begin integrating inheritances into the literature on ideal tax systems must start with an understanding of the different ways that wealth transfers may be taxed. There are several possibilities, each with different consequences. Before outlining these approaches, however, the term wealth transfer tax must be defined more carefully.

1. What is a Wealth Transfer Tax?

As noted above, this paper defines wealth transfers as gratuitous financial gifts and bequests that are not transferred to one’s spouse, to charity, or for certain other purposes that generally are not taxable. This definition accords with current law and the existing academic literature.

By contrast, there is no generally agreed-upon definition of a wealth transfer tax. Given the complexity and reach of modern tax systems, this ambiguity is perhaps understandable. Most countries raise the bulk of their revenues from a mix of income, wage and consumption taxes. Many apply different rates to income received from certain sources or employed for certain uses. As a result, it is misleading to determine whether a jurisdiction taxes wealth transfers based simply on whether it has a separate tax called a “wealth transfer tax.” After all, a “wealth transfer tax” may simply counteract the tax treatment of wealth transfers elsewhere in the tax system.

To be meaningful, the definition of a wealth transfer tax should not turn on formalistic terms, but on how the jurisdiction defines the base of its other taxes—and whether any of these taxes or its “wealth transfer taxes” result in wealth transfers being subject to differential rates. This paper adopts this more pragmatic and economic approach. Specifically, it defines a wealth transfer tax as any direct, additional tax (or subsidy) on wealth transfers, beyond the inclusion of the funds used for the wealth transfer in the donor’s income, consumption or wage tax base.

Typically, income, wage and consumption taxes all tax only one party to a gratuitous gift or bequest. Under an income tax, donors are not allowed to deduct wealth transfers (unless made to a charitable organization) and heirs can exclude wealth transfers from income. Similarly, consumption and wage taxes usually only tax one party to the transfer. While there are a variety of such taxes, for ease of exposition, the consumption tax model focused upon here is a “pre-paid consumption tax,” which essentially is a wage tax.

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24 See supra note __.
tax.\textsuperscript{25} (The paper’s analysis would not fundamentally change if it focused on other types of consumption taxes instead.)\textsuperscript{26} Like an income tax, a pre-paid consumption tax only taxes the donor on a wealth transfer because inheritances are not considered wages of the heir, and the donor is not allowed to deduct the transfer. Thus, both income taxes and the consumption tax discussed here include wealth transfers in the donor’s tax base, implying that a wealth transfer tax is any differential tax treatment of inheritances (positively or negatively) from this baseline.

2. Types of Wealth Transfer Taxes

With this definition established, we can now consider the four general approaches to taxing wealth transfers employed by various jurisdictions today. Some incorporate wealth transfer taxes into the jurisdiction’s income tax, and some apply separate taxes to wealth transfers. Notably none, to my knowledge, integrate the taxation of wealth transfers with a consumption tax.

The first approach is to have \textit{no wealth transfer tax}, beyond the basic level of tax described above. The second (and the approach of the U.S.) is to tax the donor or his estate through an \textit{estate and gift tax}, under which the rate depends on the amount transferred.

The third and fourth approaches are both inheritance taxes. A jurisdiction can tax the donee (or \textit{heir}) via an \textit{accessions tax}, under which the tax rate is determined solely by the amount he receives. Alternatively, wealth transfers can be taxed by including them in the income, consumption or wage tax base of both parties to the transfer. Under the income and consumption taxes considered here, this \textit{inclusion tax} would treat inheritances as income or consumption of the heir, thereby basing the tax rate on both the amount inherited and how well-off he otherwise is.\textsuperscript{27}

Both accession taxes and inclusion taxes are considered \textit{inheritance taxes} because (at least as defined here), the tax rate turns on characteristics of the beneficiaries, such as their number, how much each inherits, or how much other income or inheritances each has received or spent. By contrast, an \textit{estate and gift tax} is one that turns on characteristics of the donor that are unrelated to their choice of beneficiaries.

These four approaches are summarized in Table I.

\textsuperscript{25} It is often referred to as a consumption tax because, under certain assumptions, consumption and wage taxes are economically equivalent. See, \textit{e.g.}, Alvin C. Warren, \textit{How Much Capital Income Taxed under an Income Tax is Exempt under a Cash-Flow Tax?}, 52 TAX L. REV. 1 (1996). But see \cite{Hines & McCaffrey} for a discussion of some differences.

\textsuperscript{26} \textit{[Note to readers: I plan to add an appendix or long footnote on this point.]}\textsuperscript{27} Stated more technically, when referring to an inclusion tax in the consumption tax context, the paper is referring to a pre-paid consumption tax where the donor has already been taxed on the funds used for the wealth transfer. The inclusion tax then involves taxing the heir on the gift or bequest upon receipt as if it is labor income. If the consumption tax instead operates on a cash-flow basis, the inclusion tax would involve treating the transfer as taxable consumption by the donor.
Table 1: Approaches to Taxing Wealth Transfers

<table>
<thead>
<tr>
<th>Payor</th>
<th>Amount Subject to Tax</th>
<th>Base of Tax Rate Schedule</th>
</tr>
</thead>
<tbody>
<tr>
<td>No Wealth Transfer Tax</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Estate and Gift Tax</td>
<td>Donor</td>
<td>Amount Transferred</td>
</tr>
<tr>
<td>Accessions Tax</td>
<td>Heir</td>
<td>Amount Inherited</td>
</tr>
<tr>
<td>Inclusion Tax</td>
<td>Heir</td>
<td>Total Amount of Consumption or Income Including Amount Inherited</td>
</tr>
</tbody>
</table>

Readers should use these terms with some caution if operating in other jurisdictions or when reading other work. For example, the U.K. wealth transfer tax is referred to as an inheritance tax by statute, even though it is an estate and gift tax under these definitions. Meanwhile, the legal literature typically refers to an accessions tax that operates on a lifetime basis as an “accessions tax,” and to an accessions tax that operates annually as an “annual inheritance tax.” Perhaps most confusingly, the press frequently uses the terms estate tax, inheritance tax, and death tax interchangeably, glossing over important distinctions with real world consequences, as will be discussed.

All three varieties of wealth transfer taxes have sub-types. For example, each may vary in the period over which the tax is calculated, or whether gifts and bequests are treated differently. The revenue raised and effective tax rate of a wealth transfer tax system can also be affected substantially by the treatment of accrued gains on appreciated property that is transferred. While important, these sub-types and their desirability are not discussed here.

28 The prior literature typically refers to an accessions tax (under the definition of this paper) that operates on an annual basis as an “annual inheritance tax”. I find it clearer to define an accessions tax more broadly and without reference to the accounting period because there is a spectrum of options between annual and lifetime accounting periods—both theoretically and within existing inheritance taxes cross-nationally.

29 There are three possibilities. Such wealth transfers can be treated a realization event so that the donor is taxed any accrued gains on the property. Alternatively, a jurisdiction may allow for carryover basis, whereby the heir is taxed on the accrued gains but only when he sells or exchanges the asset. Finally, it may provide for stepped-up basis, whereby the tax due on any accrued gains at the time of the transfer is forgiven forever. All three approaches are applied in different jurisdictions. It is unclear whether realization or carryover basis should be considered the norm under existing income taxes because none have a coherent definition of a realization event. Nonetheless, stepped-up basis is clearly a subsidy for wealth transfers and should be considered another element of the wealth transfer tax system where present. Because the donor is not fully taxed on the income used for the transfer, it can reduce the wealth transfer tax rate below zero. In the U.S., stepped-up basis for bequests reduces the revenue raised by the wealth transfer tax system by roughly 10% relative to a carryover basis regime. (See Office of Management & Budget 112, tbl. 2.5 (2000); Congressional Budget Office 311, 312 (2000), citing JCT revenue estimate.) This percentage based on revenue estimate after reform is in effect for three years. Unfortunately, due to lack of data, the estimates presented in this paper do not include this final element.
3. Wealth Transfer Taxes in Practice

a. Wealth Transfer Taxes Cross-Nationally

These four approaches to taxing wealth transfers are all applied in various jurisdictions cross-nationally, as illustrated in Figure 6. Nevertheless, the most common approach by far is an annual accessions tax. Among the 34 countries for which I found information, roughly 20 apply this model. Austria and Ireland have accessions taxes that apply over a longer time horizon. Meanwhile, a few subject gifts to the income tax. (Further details on country’s approach are provided in Appendix B.)

![Figure 6: Type of Wealth Transfer Tax in 34 Countries](image)

The history of these wealth transfer taxes around the globe suggests that the pattern in Figure 6 may be path dependent and driven to some extent by colonial ties. It also suggests that inheritance taxes may be more politically resilient than estate taxes over time. Currently, the U.S., U.K. and some Swiss cantons are the only jurisdictions that apply a pure estate tax. Previously, though, Australia, Canada, New Zealand, and Ireland all had estate taxes. However, each repealed its estate tax in recent decades in the face of political opposition that strongly echoed the current U.S. estate tax debate. The only country identified that transitioned directly from one wealth transfer tax approach to another during the 20th century was Ireland, which replaced its estate tax with a lifetime accessions tax.

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Thus, this paper’s conclusion that the ideal approach to taxing wealth transfers is a comprehensive inheritance tax is both consistent with recent trends, and a challenge to the history and practice of wealth transfer taxation. On the one hand, it is relatively rare for a jurisdiction to have no wealth transfer tax, and estate and gift taxes appear to be on the wane. On the other hand, no jurisdiction applies this specific approach.

Similarly, the conclusion that the ideal tax system would raise a significant share of revenue from wealth transfers only weakly accords with current practice. Taxes on wealth transfer are not new. They date back to at least the 7th century B.C., and were employed both in feudal times and in England, France, Portugal and Spain by the end of the 17th century. Nevertheless, as illustrated in Figure 7, today wealth transfer taxes only contribute modestly to federal revenues in most jurisdictions, constituting between 0.5% and 2% of revenues. The U.S. is fairly typical in this respect. During most of the post-War period, the estate and gift taxes have been a relatively stable source of revenue, raising between 1% and 2% of revenues.

In the U.S., however, an opportunity is emerging to rethink the taxation of inheritances ideal. As illustrated in Table 2, currently the U.S. estate tax is being phased-out until it is repealed for one year only, in 2010. Then in 2011, it returns with a higher rate and lower exemption that current law. This bizarre sequence of events creates massive tax planning incentives (some fairly morbid), and almost definitely will not take place.

Most likely, Congress and the next President will respond by continuing on the trodden path and maintaining the estate tax at something around its 2009 level. But the necessity for change, combined with our dismal long-term budgetary outlook, creates an

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32 Id.
opportunity to break from this path—and potentially move towards a point that is closer to the ideal approach.

Table 2: Scheduled Changes to U.S. Tax Treatment of Gifts and Bequests

<table>
<thead>
<tr>
<th>Year</th>
<th>Tax Rate</th>
<th>Exclusions</th>
<th>Basis Provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Estate &amp; GST</td>
<td>Gift</td>
<td>Annual Gift</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Gift</td>
<td>Annual Gift</td>
</tr>
<tr>
<td>2007</td>
<td>45%</td>
<td>41-45%</td>
<td>$12,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2008</td>
<td>45%</td>
<td>41-45%</td>
<td>$12,000</td>
</tr>
<tr>
<td>2009</td>
<td>45%</td>
<td>41-45%</td>
<td>$12,000</td>
</tr>
<tr>
<td>2010</td>
<td>0%</td>
<td>35%</td>
<td>$12,000</td>
</tr>
<tr>
<td>2011 &amp; on</td>
<td>41-55%</td>
<td></td>
<td>$12,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

4. Differences in Incidence

At this point, one might ask whether a jurisdiction should bother considering whether to change its method of taxing wealth transfers, even if another approach is theoretically superior. Figures 3 through 5 above imply that it does matter what the level of wealth transfer taxation is. At least in the U.S., wealth transfers significantly alter the distribution of pre-tax income. As a result, taxing wealth transfers at a relatively low rate will tend to confer a windfall on individuals for whom inheritances are a significant share of their lifetime income, while raising tax burdens on others who are not so lucky. Nevertheless, if there is a positive tax on wealth transfers, a skeptical reader might have little interest in the other question posed here: what form that tax should ideally take.

For example, he might assume that all large inheritances come from large estates and small inheritances from small ones and that, therefore, there is no difference between an estate tax and an inheritance tax. This would be a mistake.

In fact, as explained next, so long as the tax rate is non-linear, the form of a wealth transfer tax does matter. While the incidence of all wealth transfer taxes appears to fall disproportionately on heirs and not donors, the incidence among heirs depends, to a surprisingly large degree, on the form of the wealth transfer tax employed.

a. Donor Motives for Working and Saving to Accumulate Wealth Transferred

The first step in understanding the incidence of a wealth transfer tax is to determine how it is allocated between donors and heirs. This allocation should not differ across different types of wealth transfer taxes because the remitter of a tax generally has

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33 The exclusion is inflation-adjusted so it may rise above $12,000 after 2007.
34 For estates between $1 million and $3 million, the marginal tax rate rises from 41% to 55%. For estates above $3 million, the marginal tax rate generally is 55%. However a surtax that eliminates the lower brackets technically results in an effective marginal tax rate of 60% on taxable estates between $10 million and $17.184 million.
no bearing on who bears the ultimate economic burden.\textsuperscript{35} It is important, though, for determining whether one should focus on heirs or donors when analyzing the tax’s distributional effects.

This allocation (and, we will see, the ideal taxation of wealth transfers) depends critically on why the donor worked and saved in order to accumulate the wealth that was ultimately transferred. The donor’s accumulation motive will affect how much she values the transfer itself, and how she responds to the tax. Thus, a brief explanation of the four possible motives is necessary.

The first possibility is that a donor’s wealth accumulation was exchange-motivated. In this case, the transfer is actually compensation for something the heir provided to the donor. A classic example would be a bequest to someone who took care of the donor in old age in exchange for the promised bequest. Such transfers are not actually wealth transfers within the meaning of this paper because they are not gratuitous. Nevertheless, they are empirically relevant because it is virtually impossible at a micro level to separate out gratuitous from non-gratuitous bequests.

The next two possibilities are that the donor accumulated wealth for egoistic or life cycle saving reasons—not because of a promise to, or concern for, another. A transfer would be considered egoistic if the donor accumulated wealth simply because she enjoyed working, or derived pleasure from being known as rich and wealthy, and not because she wanted to spend it in any particular way. Alternatively, she may have worked and saved in order to insure herself against various risks, such as outliving her savings or requiring expensive health care. If insurance markets were perfect, a person with such worries could simply purchase annuities and full health insurance and forget about the risks. But because insurance markets are imperfect, many people self-insure through saving. If fewer risks materialize than feared, such individuals will have savings left at death, and the resultant bequest will be the product of life cycle saving.

Finally, a donor may accumulate wealth for altruistic reasons; that is, because she experiences the well-being of her heirs as if it were her own. This is the only motive where the donor actually cares about how much her heirs receive, and it is the reason why we typically think people make wealth transfers.\textsuperscript{36} Indeed, at the moment of privately drafting a will, a donor’s decisions may always be based on concern for others. But the motive of interest when allocating tax burdens between donor and heirs, as groups, is not what drives a donor to divide up her estate in this way or that. Instead, it is what compels

\textsuperscript{35} [Cites]. One exception would be if a change in the burdens of a wealth transfer tax amongst heirs, in turn changes a donor’s wealth accumulation motives. There is little evidence to date, though, supporting such an effect. Another exception would be if people irrationally respond more strongly to a tax that they nominally pay, even if it is economically identical to another tax that they do not. If this were the case, a tax paid by heirs should create less excess burden than a tax paid by donors because all of the efficiency losses from wealth transfer taxes arise from the donor changing her behavior. But, assuming taxpayers are rational, it shouldn’t make any difference that an estate tax is technically paid by the donor and an inheritance tax by the heirs. Recently, some commentators have asserted that heirs probably bear most of the burden of the estate tax in reality, but with little discussion. E.g., Entin (2004); Mankiw (2003).

\textsuperscript{36} At the moment of drafting a will, a donor’s decisions may always be based on concern for others. But the size of the estate that a donor accumulates, which is the relevant issue, may have been driven very little by altruism.
her to accumulate an estate of that size in the first place. The above alternatives illustrate that the choice to accumulate wealth may be driven by altruism, but need not be.

In reality, these motives are generally mixed. Indeed, probably almost all wealth transfers are the product of some combination. Nevertheless, with perfect knowledge, one should be able to assign a single motive to a portion of each transfer. For example, suppose a wealth transfer is the product of both altruism and life cycle saving. Then, the portion that the donor would still have transferred if she knew the bequest was going to be expropriated would be life cycle savings because it is unresponsive to the tax rate. The remainder, which she would spend during life if bequests were expropriated and would never reach her heirs, would be altruistic.

b. Incidence on Donors versus Heirs

The reason wealth accumulation motives matter in allocating the burden of a wealth transfer tax is they affect the elasticity of the donor’s giving to the after-tax cost. If some share of a wealth transfer was accumulated for egoistic or life cycle saving reasons, the donor’s giving is inelastic, and the heir must bear the entire tax burden on that portion of the transfer. By contrast, if some share was exchange-motivated, the burden on that share should split between the heir and donor, depending on their relative elasticities of labor supply and demand.

In the case of altruistic transfers, the allocation of the tax burden is somewhat more complicated. It also should be split between the heir and the donor, but the heir should bear more of the burden. Interestingly, the incidence of the actual tax remitted on such transfers should actually fall on both the heir and donor—imposing a double burden—because, under perfect altruism, the donor’s utility equals the heir’s. But if the donor responds by transferring less on a pre-tax basis (as is the case, on average), the heir also is burdened by the full amount of this reduction. The donor is only burdened by this reduction to the extent that she values giving a dollar to the heir more than she values spending it on something else. Accordingly, her total burden is less.

Thus, the only scenario in which wealth transfer taxes could be borne predominantly by donors is if the vast majority were exchange-motivated and donor demand for such labor was relatively inelastic. Existing evidence does not support such a conclusion, but rather suggests that such transfers compose a very small share of gifts and bequests. Instead, the majority of bequests appear to be the product of egoism or life cycle saving. It therefore is reasonable, as a first approximation, to assume that heirs bear most—and perhaps the lion’s share—of wealth transfer tax burdens.

38 See infra note __.
39 See infra note __.
40 There is little prior literature on this question. The most recent article I identified on the subject, from 1940, concluded that donors bear the incidence. See James K. Hall, Incidence of Death Duties, 30 AM. ECON. REV. 36 (1940) (reaching this conclusion on the basis that heirs could not bear a tax burden on wealth to which they were never entitled). Brief theoretical discussions often consider the implications of both possibilities without taking a position on which is more likely. E.g. Gale & Slemrod 207-08 (2001).
c. Incidence among Heirs

With this assumption established, we can now consider whether the incidence of a wealth transfer tax varies depending on its form. Differences in incidence may occur at both an aggregate and individual level. However, for purposes of this paper, aggregate distributional analysis is less interesting because any two types of wealth transfer taxes can presumably appear similar in aggregate with sufficient tweaking to the rate structure and level of revenue raised.

Thus, in order to hone in on fundamental differences between different approaches, this section compares two stylized types of wealth transfer taxes designed to raise roughly the same amount of revenue, and have roughly the same aggregate distributional effects. It shows that despite their similarities in aggregate, their incidence differs markedly at an individual level.

The first stylized example is the 2009 estate tax, under which $3.5 million in lifetime transfers are tax-exempt. Transfers thereafter are subject to a flat rate of 45%. The second is a comprehensive inheritance tax with the same general structure of a large exemption. Under this alternative, $2.3 million in lifetime inheritances received are exempt. Thereafter, all inheritances are subject to a 15% tax and are included in the heir’s income (although the heir may spread his inheritances over five years). Accordingly, above the lifetime exemption, the marginal tax rate on inheritances ranges from 15% to 50%. Both taxes are estimated to raise approximately $17.5 billion in 2009.\footnote{The $2.3 million lifetime exemption was the adjusting factor.}

As illustrated in Figures 8 and 9, the average tax rate that heirs face on inheritances is fairly similar across these two taxes, whether heirs are grouped by economic income or inheritance size. To the extent that some of the burden is borne by donors, their aggregate incidence is also quite similar, whether viewed by estate size or decedent income.

However, when one focuses on individuals instead, it becomes apparent that the incidence of the two taxes fundamentally differs. Figure 10 plots the average estate tax rate and inheritance tax rate that each heir faces. Each point represents an heir and a circle represents multiple heirs. On average, the estate tax rate rises with the inheritance tax rate, and vice versa. But the figure shows that individual heirs often face dramatically different rates under one tax, versus the other.
Figure 8: Average Tax Rate on All Inheritances: By Inheritance and Estate Size

Figure 9: Average Tax Rate on All Inheritances: By Heir Economic Income
Figure 10 also illustrates, to some degree, the differences between an accessions and inclusion tax. The slight clustering of the points in diagonal lines results from the fact that the model imputes the amount inherited based on the estate size and various numbers and combinations of child and non-child beneficiaries. Each clustered line represents one possible inheritance size as a proportion of the estate. The space between the lines vertically thus shows the effect of inheriting different amounts from an estate of a fixed size. Meanwhile, the fuzziness of the lines illustrates the effect of the heir’s earned income on his tax rate. This first effect is in part a result of the inclusion tax, and the second is entirely.

Nevertheless, the figure also shows the effect of an accessions tax. The distance between the lines illustrates how the $2.3 million exemption (which is an accessions tax feature) affects the average tax rate for inheritances of different sizes. Moreover, the large number of heirs along the x-axis, who only pay estate tax, are also a product of exemption. Table 3 shows that these heirs comprise about half of all heirs subject to either tax.

<table>
<thead>
<tr>
<th>Number of Heirs Winning, Losing, and Taxed Under Each Option</th>
<th>Number of Heirs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxed Under Both Taxes</td>
<td>6,533</td>
</tr>
<tr>
<td>Taxed Under Comprehensive Inheritance Tax Only</td>
<td>7,335</td>
</tr>
<tr>
<td>Taxed Under Estate Tax Only</td>
<td>15,412</td>
</tr>
</tbody>
</table>
The difference between different forms of wealth transfer taxes can be understood still more deeply by looking at the correlation between the two tax rates in the stylized examples. Correlation is a measure of the tendency of two variables to increase or decrease together. The correlation between an heir’s average tax rate under the estate tax and the comprehensive inheritance tax is 0.23, which is quite low. Its square (the “r-squared”) implies that only 5% of the inheritance tax rate of an individual heir is directly accounted for by his estate tax rate, and vice versa.

The essential reason why these differences arise is all large inheritances do not in fact come from the largest estates, and all smaller inheritances do not come from smaller ones. For example, consider two taxable estates of $10 million where the donors have not made any prior gifts. Both would be subject to an average estate tax rate of 29%. However, one could be left entirely to one heir who is in the top income tax bracket and has received $1 million in prior inheritances, while the other could be left pro rata to five heirs with no prior inheritances. In the former case, the inheritance tax rate would be 44%, but in the latter it would be zero.

As a further example taking the opposite perspective, suppose two heirs both have economic income of $1.2 million. One might have earned $200,000 in income and inherited $5 million from an estate worth $5 million. The other might have the same amount of earned income and inheritance, but have inherited from an estate worth $30 million. Both would bear the same inheritance tax burden of 27%. But the estate tax rate on the former would be 14% while the latter’s would be 40%. In aggregate, if there were roughly the same amount of heirs of both types, the estate and inheritance rates would be quite similar, but at an individual level, their tax rates would vary dramatically.

Two objections might be made to this conclusion that the incidence of an estate tax and inheritance tax is fundamentally different. First, these estimates assume that donors allocate a fixed percentage of their estate to each different heir. If this assumption is incorrect, it could bias the correlation measure and Figure 10. One possibility is that donors instead tend to allocate a fixed dollar amount to heirs receiving a small share of their estate, with the remainder going to their children or most important heirs. In this case, such heirs bear no tax burden under both an estate tax and an inheritance tax. Another possibility is that donors respond to incentives created by an inheritance tax to give more broadly. Then, the inheritance tax will result in larger bequests for smaller heirs so they benefit rather than being burdened. Either way, it might not be appropriate to weight heirs inheriting small amounts as heavily as heirs receiving large inheritances.

To address this possibility, we re-plotted Figure 10 so that each observation is weighted by the size of the inheritance. For instance, a $100 million inheritance is weighted 1,000 times more heavily than a $100,000 inheritance. Figure 11 shows that the connection between the two tax rates tightens, but remains surprisingly low. The correlation statistic rises substantially to 0.68, but the r-squared is still only 46%. Thus, even if we adopt different assumptions about the static or dynamic incidence of an inheritance tax, it still appears to be quite different from an estate tax.
The other potential objection is that perhaps one could craft an estate tax that approximates the micro incidence of the inheritance tax with further tweaking. Recall that an estate tax is one that turns solely on characteristics of the donor and not the identity of her beneficiaries. As defined, the most obvious adjustment would be to grant additional lifetime exemptions based on the number of children the donor has, irrespective of whether she gives to them. We tested this option as well and, as shown in Table 4, the correlation actually fell relative to the normal estate tax. Other tweaks to the estate tax are certainly possible. But the differential incidence between the two systems seems robust to our best efforts to eliminate it.

Table 4: Correlation between Average Tax Rate under Estate Tax and Comprehensive Inheritance Tax, Heirs Subject to Tax under Each Option

<table>
<thead>
<tr>
<th>Tax Type</th>
<th>Correlation</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009 Estate Tax, Unweighted</td>
<td>0.23</td>
</tr>
<tr>
<td>2009 Estate Tax, Weighted by Inheritance Size</td>
<td>0.68</td>
</tr>
<tr>
<td>Estate Tax with Per Child Exemption, Unweighted</td>
<td>0.17</td>
</tr>
<tr>
<td>Estate Tax with Per Child Exemption, Weighted by Inheritance Size</td>
<td>0.65</td>
</tr>
</tbody>
</table>

42 [Under this alternative, the revenue-neutral lifetime exemption was $2.1 million. A donor received one exemption for the estate and additional exemptions for each child. The reason the correlation falls is the number of donor children is actually a very poor proxy for the donor's total number of heirs. As the number of children rises, the number of non-child beneficiaries declines. Indeed, the average number of heirs falls from 2.9 for donors with no children to 1.5 for donors with one child, and transfers from such donors comprise about half of all bequests. As a result, estates with no children will be subject to higher tax rates under this modified estate tax, even though their heirs on average receive small inheritances. This moves the incidence further from an inheritance tax.]
c. Pattern of Incidence

Ultimately, this discussion has illustrated that the distinctions between different types of wealth transfer taxes matter, not only theoretically but also practically. Nevertheless, such knowledge tells us nothing about which pattern of incidence is preferable. Doing so requires returning the fundamental question of what an ideal tax system is trying to achieve, the subject of the next Part.

As a preview, however, Figures 12 and 13 illustrate one final difference in the incidence of two stylized wealth transfer taxes—the connection between each approach’s tax rate and the economic income of heirs. Together, Figure 12 and 13 illustrate that the link between a comprehensive inheritance tax and economic income is indeed tighter than under an estate tax.\(^\text{43}\) For example, the correlation between its tax rate on individual heirs and heir economic income is 0.74; for the 2009 estate tax rate it is only 0.41.\(^\text{44}\) Moreover, both tighten the link relative to no estate tax, which disregards the effect of inheritances on economic income entirely.

Thus, if the next Part convinces the reader that the ideal tax system should allocate tax burdens based on a measure of economic status that includes some portion of inheritances in the tax base of both the heir and donor, we do know which pattern of incidence is preferable. A comprehensive inheritance tax is superior, both relative to an estate tax, and relative to no wealth transfer tax at all.

**Figure 12: Average Estate Tax Rate on Inheritances by Heir Economic Income\(^\text{45}\)**

\(^\text{43}\) The clustering of points into several lines in Figure 13 is due to the fact that the tax rate is based in part upon prior inheritances, which are imputed, while the economic income measure does not incorporate prior inheritances.

\(^\text{44}\) When the graphs are not restricted to heirs with under $6 million, see supra note __, the correlation falls to 0.16 and 0.26 respectively. [Explain.]

\(^\text{45}\) To improve readability, inheritances of heirs with economic income over $6,000,000, or roughly the top 0.5% of heirs, are excluded.
III. THE IDEAL TAX TREATMENT OF WEALTH TRANSFERS

The question of how best to tax wealth transfers can be approached from a number of normative perspectives. This paper adopts a welfarist approach and considers what different empirical assumptions and social welfare functions imply about whether and how we should tax wealth transfers. Under empirical assumptions that seem reasonable based on existing literature and an array of social welfare functions (but not all), it concludes that the ideal form of any tax on wealth transfers is predominantly a comprehensive inheritance tax. The ideal rate under this tax may be low or negative for low-income heirs of small inheritances, but it is most likely positive—and substantially positive—for all other heirs.

Intuitively, it makes sense that heirs should face a positive tax on gifts and bequests through a comprehensive inheritance tax and not an estate tax. Given that the economic burden of both types of taxes falls largely on heirs, it seems somewhat odd to base such a tax on the degree to which an heir’s benefactor worked hard and saved in order to give her money away, regardless of how broadly that money is distributed. Doing so bases the tax rate on the ability, effort, and generosity of the donor.

Yet, at the same time, it seems relatively straightforward that any tax on gifts and bequests should depend on the ability to pay of the recipient, by including the transfer in his consumption or income tax base. If anything, we might want to tax inheritances received at slightly higher rates than other consumption or income through an accessions tax. Doing so is a way to tax the privilege of not having to work as much (or at all) solely due to the lucky circumstances of one’s birth. It may also base tax burdens on a more accurate measure of earning potential and ability to support government functions.

46 To improve readability, inheritances of heirs with economic income over $6,000,000, or roughly the top 0.5% of heirs, are excluded.
Chances are that a single mother on welfare, who hasn’t inherited anything, has less ability to generate revenues for public programs than a woman who has inherited $10 million and spends her time as a socialite.

This Part explains why this intuition is borne out by theoretical and empirical analysis. It begins by considering the how we should treatment of wealth transfers in the context of an ideal consumption tax, and then discusses how the analysis should be adjusted in an ideal income tax environment.

A. Ideal Taxation Within a Consumption Tax

1. Fairness

Within a welfarist framework, the goal of the tax system and government is to maximize some function of individual well-being. A utilitarian, for example, aims to maximize total individual well-being. Meanwhile, a maximin social welfare function seeks to maximize the well-being of the least well-off person, while an egalitarian welfarist seeks to equalize the welfare of all. Achieving any of these goals, however, requires measuring how well-off different people are.

Welfarism has been criticized as a theory of justice on a number of fronts. For example, some argue that it is impossible to compare interpersonal well-being. Others argue that egalitarian welfarism implies rewarding those with expensive tastes and penalizing ascetics because people with expensive tastes are perpetually dissatisfied. Still others criticize utilitarianism for implying that people who seem to have an endless ability to convert money into more and more well-being—“utility monsters”—should end up with the lion’s share of society’s resources. The purpose of this paper is not to defend welfarism, which has been done elsewhere, but rather to consider what, under some reasonable basic assumptions, it implies.

The assumptions adopted in traditional optimal tax analysis are twofold. First, it assumes that all individuals have the same utility function for money. That is, two people with the same amount of money at their disposal are treated as having the same aggregate and marginal utility, even though they may (and do) choose to spend their money in different ways.

This assumption sidesteps some important issues. For example, it implies that a person with a curable terminal illness has the same marginal utility for money as a healthy person with identical wealth. But, assuming that the reality of curable illnesses generating higher marginal utility will subsequently be considered, an assumption of identical marginal utilities for money is a reasonable starting place from which to think about the ideal tax system. This assumption allows interpersonal comparisons of well-being. It effectively collapses several social welfare functions. And, by adopting a

\[\text{[Cites]}\]

\[\text{[Cites]}\]

\[\text{[Cites]}\]

For example, the utilitarian goal of equalizing marginal utility and the egalitarian goal of equalizing individual utility would be one and the same.
default assumption that there are no utility monsters or people with expensive tastes, it refines the social welfare functions under consideration in ways that some may consider normatively desirable.

Second, for reasons of analytic tractability, the optimal tax literature traditionally assumes that individuals differ only in one unobservable dimension that is determines the degree to which they are well-off. This dimension is variously termed endowment, ability or potential earnings.

This paper adopts the first assumption but partially relaxes the second. Instead, it posits that individual well-being or endowment depends, not only on ability or potential earnings, but also on a second factor that is imperfectly observable: financial inheritance.

a. What is Endowment?

Endowment is a core concept in any welfarist analysis. If there were no inheritances and everyone had the same utility function for money, the ideal base for measuring (and mitigating inequalities in) well-being would be endowment, which is traditionally defined as ability of potential earnings.

For example, suppose Kristina is a former investment banker who quit her banking job in order to work in a surf shop. For purposes of reducing inequalities in well-being, she should probably be taxed at a higher rate than her fellow surf shop employees because she has the potential to earn much more and must value working in the surf shop very highly, or she wouldn’t have given up her investment banking job. On the other hand, perhaps she should not be taxed quite as much as if she were still an investment banker. She may have left investment banking because she really, really likes surfing, in which case she must be just as well-off as her former colleagues under the assumption of identical utility functions for money. But she may also have left because she doesn’t have an innate ability to sustain such work or advance in a banking career. In that case, her leaving indicates that she was and is less well-off than her former colleagues, because it doesn’t stem solely from an inordinate love of surfing.

In these circumstances, and absent the ability to disaggregate preferences from ingrained capabilities, the fairest measure of her ability might be something between that of a regular surf shop employee and an investment banker. For simplicity, let’s refer to this ideal measure of her well-being, which is really her longer-term earning potential, as her earnings endowment.

So defined, earnings endowment is the fairest tax base and one of the most efficient if there are no inheritances. One can’t change one’s endowment, so taxing it does not generate any efficiency losses. Furthermore, unlike some other efficient taxes, such as a head tax, it is the most accurate measure of individual well-being if all people

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50 See [Shaviro, Stark].
51 [Is this correct?]
52 See Stark 54 (2005); [others].
have the same utility function for money.\footnote{Stark} In short, when it comes to tax bases, earnings endowment is the welfarist’s dream.

The problem, of course, is that earnings endowment is not observable and, even if it were, it probably wouldn’t be terribly popular politically, giving rise to images of enslaving Kristina at the investment banker rather than letting her be a happy surfer. This dilemma is the core of the optimal tax problem.

The basic question posed in the optimal tax literature is what the tax system should look like given the informational problem that we don’t know and can’t tax endowment. In response, this literature typically assumes that the best approach is to tax a proxy for earnings endowment—like market earnings, consumption or income. Unlike an endowment tax, though, one can respond to a tax on any of these proxies by earning or saving less, generating efficiency losses. Thus, the optimal tax problem is to determine what level and structure of tax will maximize social welfare given this equity-efficiency trade-off.

Initially, some optimal tax models found that the optimal tax was on consumption and involved a large transfer to all individuals (a “demogrant”) coupled with declining marginal rates.\footnote{E.g., [Mirrlees].} Later work concluded that the optimal tax might have rising marginal rates and also include a tax on capital income so that it was instead a hybrid consumption-income tax.\footnote{E.g., [Saez].} But this literature has generally always assumed that wealth transfers do not exist.

Once one assumes that people differ in two imperfectly observable dimensions—earning potential and financial inheritances—new questions emerge.

\subsection*{b. Inheritance as Endowment}

Let’s assume for the time being that the ideal underlying tax base is consumption. The fact that a consumption tax is only a second-best strategy for taxing endowment and well-being raises a critical question for this paper—whether both (a) the making, and (b) the receipt and spending, of a gratuitous wealth transfer should both be considered acts of consumption. That is, whether wealth transfers indicate two underlying consumption acts, or only one. They should be considered two.

Few would dispute that when an heir spends his inheritance, it is an act of consumption. This type of consumption seems to be just as relevant for measuring well-being as any other.\footnote{This argument has been made in the context of an income tax by, for example, SIMONS 125, 130 (1938); Dodge __ (1978); MURPHY & NAGEL 147 (2002).} But when a donor makes a wealth transfer, it is also an act of consumption in the sense of the word that is relevant for measuring how well-off individuals are. The donor is giving up the opportunity cost of spending the money on herself. As a result, she clearly values making the wealth transfer as much as if she

\footnotesize

\begin{itemize}
\item \[\text{Stark}\]
\item \[\text{E.g., [Mirrlees].}\]
\item \[\text{E.g., [Saez].}\]
\end{itemize}
consumed the funds in a market transaction. In fact, she must value the transfer slightly more—and gain more well-being from it—or she wouldn’t have made the transfer at all.

Many find this argument surprising because consumption, in the colloquial sense, typically involves using up resources, not sharing them. But actual use is irrelevant in a welfarist framework where the goal is to tax endowment and market consumption is only used as a proxy. Instead, the key feature of a wealth transfer making it an act of consumption by the donor is the fact that the donor is exercising his or her power to decide who gets these assets. If the donor uses her control to give the resources to someone else, she must get just as much well-being from that act as if she consumed them in the more conventional sense. Moreover, making a wealth transfer is one of the few instances in which an act of non-market consumption is easily identified, valued, and taxed.

Indeed, there is only one instance in which a wealth transfer should not be considered an act of consumption by the transferor: if she involuntarily loses all control over the use of her assets. But this scenario proves the point because it can only happen if the funds are confiscated irrespective of whether the donor planned to transfer them to another individual and the public decides how they are spent—that is, if they are taxed away. Even a voluntary confiscatory tax should be considered consumption act by the donor because it is voluntary. As discussed below, there may be efficiency reasons to subsidize such a decision. But, as a matter of fairness, any measure of well-being should treat a voluntary wealth transfer as two consumptions. As a practical matter, the way to achieve this result within the pre-paid consumption tax upon which this paper focuses is to count an inheritance as labor earnings of the heir in addition to taxing donors on their labor earnings regardless of use.\(^{57}\)

The reason wealth transfers should count as two consumptions can also be understood at a more fundamental level by returning to the initial rationale for taxing consumption. Consumption is merely a proxy for earnings endowment, which in turn is merely a proxy for individual well-being. In a world with no inheritances and identical individual utility functions for money, earnings endowment should equal well-being. But in a world with inheritances, it is an incomplete measure.

Once one recognizes that wealth transfers do exist, it becomes clear that a complete measure of endowment must consider them part of the endowment of both donors and heirs. For self-made donors, endowment should include all potential earnings, regardless of whether spent on wealth transfers or wellness retreats, because individuals are assumed to have identical utility functions for money absent compelling information to the contrary. Meanwhile, for heirs, it is even more clear that inheritances are part of endowment. If endowment is a measure of how well-off individuals are, it must include not only resources that individuals can earn but, especially, resources they receive for free.

\(^{57}\) Under a cash-flow consumption tax, the making of a wealth transfer should be considered dissaving, and the receipt of inheritances should be considered income.
c. Inheritances as “Tags”

Thus far, this Part has argued that a welfarist perspective concerned with mitigating inequality of well-being implies treating inheritances as part of the tax base of two people, the donor and the heir, purely on fairness grounds. Put differently, it has argued that an inclusion tax is part of the baseline of a fair tax before efficiency considerations are taken into account. This baseline may also, however, involve an accessions tax—taxing heirs at a higher rate on consumption from inheritances—for three reasons.

First, we might want to tax consumption from inheritances more heavily as a way of more accurately measuring endowment because consumption from inheritances presumably generates more well-being than consumption from labor earnings. Heirs generally don’t have to work in order to receive their inheritance. (If they do, the potion attributable to their work should be considered labor earnings and not an inheritance.) Most people don’t like working much.\(^{58}\) Accordingly, taxing consumption from inheritances more heavily should adjust for the fact that, in most cases, such consumption is associated with higher well-being.

Taxing consumption from inheritances at higher rates should also move us closer to the endowment tax ideal through a second channel—because financial inheritances are correlated with non-financial inheritances, and both are correlated with expected earnings.\(^{59}\) Thus, inheritances are a useful “tag” indicating unobserved earning potential, and taxing them more heavily can move us closer to the endowment tax ideal.\(^{60}\) Put differently, inheritances can serve as a proxy for aspects of earnings endowment that do not show up directly as market consumption (whether from inheritances or earnings). Some of these aspects of earnings endowment, such as race in a discriminatory society, may not be taxable politically. Others may be unidentifiable. But either way, counting inheritances more heavily than earnings may move us closer to an accurate measure of well-being by indirectly captures another fundamental aspect of endowment, unrealized earning potential.

This raises a final way in which a welfarist perspective may imply an accessions tax on fairness grounds: if the social welfare function is not focused strictly and measuring and mitigating inequalities of ex post well-being, but also or instead on measuring ex ante well-being and mitigating inequalities of opportunity.\(^{61}\) Depending on how on defines ex ante and ex post well-being, these measures may be identical. For

\(^{58}\) See supra notes ___ and accompanying text.
\(^{59}\) Akerlof; Logue & Slemrod
\(^{60}\) C.f., Alstott (2007); Alstott 369 (1996); Duff 48-51 (1993); Rudick 158-59 (1950). There is some debate about whether fairness concerns can be part of the social welfare function within a welfarist framework, or whether the social welfare function can only aggregate individual utilities without weighting them (although fairness concerns may still affect individual utilities). On the latter view, an approach in which the social welfare function incorporates independent fairness objectives is a consequentialist approach but not welfarist. If the reader shares this view, the approach of the paper is instead consequentialist.
example, theoretically, if ex post well-being is defined narrowly as potential consumption disregarding tastes like work aversion, it could be the same as expected well-being that is updated over time to account for changed circumstances, such as becoming disabled or bad luck in general. Nevertheless, assuming some distinction between the two objectives, financial inheritances necessarily impinge on equality of opportunity as well by creating an uneven playing field, where those with the largest inheritances receive the largest advantages, and those with none are, all else equal, the least advantaged.

If equalizing opportunity is an additional objective of the social welfare function, financial inheritances should again be subject to a separate accessions tax. The ideal magnitude of such a tax will depend on how it interacts with the other objectives of the social welfare function, and should take into account the fact that financial inheritances are a reasonable proxy for non-financial sources of unequal opportunity. However, if the sole objective of the social welfare function is maximizing opportunity subject to a constraint that the opportunity of all individuals must be identical, the ideal approach may be to confiscate all wealth transfers. Assuming no transaction costs, the resultant revenues could then be redistributed pro rata or they could be used to finance public goods that benefit all equally on an ex ante basis.

Personally, I find the objective of reducing ex post disparities in well-being more normatively compelling than the objective of equalizing opportunity, assuming a difference between the two. Each has its downsides. Taken to its logical extreme, a welfarist approach concerned strictly with equalizing starting points—and that doesn’t update opportunity over time—supports no compassionate response to suffering that was brought on solely by a person’s own actions. It implies taxing an heir on any inheritance he receives even if he is utterly destitute. Meanwhile, a welfarist function focused strictly on equalizing ex post well-being does not hold people accountable for their actions when taken to its logical extreme. It implies providing the same transfer to a person who recently blew a $10 million inheritance and one who grew up under highly disadvantaged if both now have nothing. In my mind, the former scenario is the most troubling. As a result, I prefer a welfarist approach that assigns some weight to expected well-being while focusing primarily on measuring and mitigating ex post inequality, but others may disagree.

If the reader also views such a social welfare function as the most equitable, the fairest way to tax inheritances within a consumption tax has two features. First, absent other concerns, wealth transfers should be treated as part of the consumption tax base of both the donor and the heir. Second, the heir should pay a separate and additional tax based solely on the amount he inherits to address his gains from not having to work as much for the same amount of consumption, his greater expected earning potential, and his advantages relative to others.

In other words, all else equal, the fairest way to tax his inheritances is a comprehensive inheritance tax.

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62 See Alstott (forthcoming).
63 [Acknowledge Ackerman/Alstott argument about trusteeship for future selves.]
2. Efficiency-Motivated Adjustments

All else is, of course, rarely equal. Most importantly for this discussion, and as noted, social welfare functions typically do not aim strictly to promote fairness by reducing inequality. They aim to maximize something, a weighted aggregation of well-being. This is where efficiency comes into play.

For example, a maximin social welfare function inherently must take efficiency into account because it is concerned not just with bringing the worst-off person closer to others, but also with maximizing his or her well-being, to which it effectively assigns an infinite weight. Even a egalitarian social welfare function that seeks full equalization of outcomes must care about efficiency to some extent. Presumably it would select a world in which all outcomes were equal and everyone was well-off over one in which all were equal but everyone was miserable.

An efficient tax is one that maximizes the size of the pie for a given distribution of tax benefits and burdens between those who are better-off and worse-off. It does so by reducing undesirable, tax-induced distortions to individual choices and by correcting for market failures, such as externalities, both of which result in less aggregate individual welfare.

Efficiency concerns imply a number of adjustments to the above analysis under any welfarist perspective. The main individual choices that are affected by wealth transfer taxes are those regarding work, saving, and giving. In addition, wealth transfers generate both positive and negative externalities. As hinted above, the presence and size of these externalities and effects depends critically on the donor’s motivation(s) for working and saving in order to accumulate the wealth transferred. While the welfare-maximizing tax treatment of wealth transfers is empirically-contingent and differs substantially from that which is simply the fairest, it appears to remain a comprehensive inheritance tax.

a. Exchange-Motivated Wealth Transfers

In the case of an exchange-motivated transfer, like all spending on personal services, such wealth transfers should be treated as consumption by the donor, and consumption by the service provider when his earnings are spent. No additional tax should apply on equity grounds, unless there is reason to believe that workers compensated by payments disguised as gifts or bequests are more likely to have larger endowments than workers with similar earnings who are not compensated in this fashion. To my knowledge, there is no such evidence. Thus, on both efficiency and fairness grounds, exchange-motivated transfers should be part of the tax base of both the transferor and recipient, but not subject to any separate wealth transfer tax.

b. Life Cycle Saving and Egoistic Wealth Transfers

By contrast, efficiency considerations imply that wealth transfers that are the product of wealth accumulated for egoistic or life cycle savings reasons should actually
be taxed at a 100% rate under a consumption tax.\textsuperscript{64} By definition, such a confiscatory tax has no particular impact on the donor’s motivation to work, save or give because she did not accumulate the wealth for anyone else in the first place. Indeed, wealth accumulation derived from egoism and life cycle savings is defined as the wealth that would remain if prospective donors knew that any wealth transfers would be subject to a 100% tax rate.\textsuperscript{65}

Moreover, with respect to heirs, confiscating life cycle saving or egoistic inheritances should indirectly reduce the distortions created by any consumption tax. Such a confiscatory tax does not alter the relative prices for various activities between which heirs choose—it does not create a substitution effect for heirs because they have done nothing in order to receive their wealth transfers. But it does create an income effect for them, and one that is ultimately efficiency-enhancing. Heirs tend to respond to receiving a large inheritance by working less,\textsuperscript{66} implying that taxing their inheritances will, on average, induce heirs to work more. As a result, a confiscatory tax on life cycle saving and egoistic transfers should raise revenue, both directly through the confiscated transfer, and indirectly through the consumption tax revenue generated by the heir’s additional labor. This new revenue can be used to lower consumption tax rates, thereby decreasing the inherent distortions to the labor-leisure decision that a consumption tax generates.

While efficiency considerations thus imply taxing both life cycle saving and egoistic transfers initially at a rate of 100%, these two accumulation motivations nevertheless differ in one important respect. Confiscatory taxation is a first-best solution for egoistic transfers, but only the second-best approach for those from life cycle saving. Instead, the first-best approach for bequests from life cycle savings would be to eliminate their existence altogether by correcting the market failures in the annuities and retiree health insurance markets that give rise to such transfers.

In practice, however, it is unclear how adequately government could fully correct for these market failures. Government intervention in private insurance markets through pooling arrangements and default rules might address adverse selection problems and inertia. But it is difficult for private insurers to insure against serially-correlated risks that extend far into the future, such as changes in the rate of growth of inflation, longevity, and health care costs. Individuals may therefore justifiably fear that the insurer will go bankrupt or cut back on their benefits once the time for payment arises.\textsuperscript{67} Meanwhile, mandatory governmental programs, such as Social Security and Medicare in the U.S., could be expanded to provide for all retiree income and health needs. But this may also reduce aggregate well-being by eliminating people’s ability to adjust the portion of their life cycle consumption that is spent in retirement. Thus, transfers from life cycle savings will likely remain in an ideal fiscal system, and once they exist, confiscatory taxation becomes the most efficient solution.

At the same time that confiscatory taxation of egoistic and life cycle savings transfers is optimal from an efficiency perspective, such a confiscatory tax also is not

\textsuperscript{64} Gale & Slemrod 35 (2001); Kaplow 180 (2001).
\textsuperscript{65} See supra note .
\textsuperscript{66} [Carnegie Effect].
\textsuperscript{67} See, e.g., [NYT on long-term care insurance; PBGC].
objectionable under the conception of the fairness described above. It should not lower the well-being of the donor. By definition, she did not care who received the life cycle saving and egoistic portions of the transfer.\(^{68}\) Meanwhile, the effect of the tax on the heir’s well-being is irrelevant. He has no intrinsic fairness claim to the inheritance. To be sure, if he grew up in disadvantaged circumstances or is currently poor, it might be fair to transfer money to him by allowing him to keep a portion of the inheritance. But the amount he receives should turn fundamentally on his level of well-being, not on his legal status as an heir.

Indeed, if anything, fairness considerations imply taxing relatively large life cycle saving and egoistic bequests at a rate slightly higher than 100%\(^{69}\) because doing so could narrow the gap between the proxy measure of consumption and underlying endowment. Just like all gratuitous transfers, receipt of an unusually large intentional or egoistic inheritance probably signals that the recipient has received other non-financial forms of inheritance that are part of his true endowment.

Thus, unlike exchange-motivated transfers, the efficient and fair approach to taxing life cycle saving and egoistic bequests is not an inclusion tax, but rather an accessions tax at an extraordinarily high rate of 100% or higher.

c. **Altruistic Wealth Transfers**

The final possibility is that the donor accumulated her wealth transferred for altruistic reasons. As discussed earlier, classically this “pure” altruistic transfer occurs because the donor values the heir’s welfare as if it were her own. That is, when her utility is by definition equal to his. Another alternative, however, is that she may have worked and saved in order to make the transfer because she selfishly seeks the prestige or “warm glow” that she experiences from making large after-tax transfers (as opposed to pre-tax transfers), and not because she cares about his welfare. Although the latter possibility is not altruistic behavior in the colloquial sense, (and is typically referred to as a “warm glow” transfer), the analysis of both is the same and together they are referred to as altruistic transfers.

As argued above, fairness concerns suggest that wealth transfers should be treated as consumption by both the donor and the heir and should also be subject to an additional accessions tax.\(^{70}\) However, efficiency considerations imply at least three substantial adjustments to this ideal tax treatment for altruistic transfers in order to correct for externalities.

First, such wealth transfers create altruistic externalities.\(^{71}\) Suppose the heir gains 100 units of well-being from a $100 inheritance and the donor values the heir’s well-being as if it were her own so she gains 100 units of well-being from the transfer as well. The donor would then make the transfer if using the money in any other way generates

\(^{68}\) If there was a will, a bequest cannot be life cycle savings to the extent of the cost of writing the will, but the remainder could be.

\(^{69}\) In practice, this could be accomplished by taxing a portion of the bequest that is not considered life cycle savings or egoistic.

\(^{70}\) \[Think about whether the donor’s inclusion should be adjusted for the heir’s tax.\]

\(^{71}\) \[Address concern that can’t possibly be fair to subsidize gift from Bill Gates to Warren Buffet. Explain how concern actually based on objection to underlying MTR on the two being too low, not the subsidy.\]
less than 100 units of well-being for her. But the transfer actually generates 200 units of well-being in aggregate—100 units for her because she thinks this is how much well-being her heir will gain, and 100 for the heir because that is how much he actually does gain. The 100 units of well-being that the heir actually gains are the altruistic externality that the donor does not take into account. The efficient way to correct for this externality is to provide the donor with a 100% subsidy (i.e., a $100 subsidy) so that she makes the transfer as long as spending the original $100 in any other way generates less than 200 units of well-being, not 100, for her.\footnote{Gale & Slemrod 35 (2001); Kaplow 470-74 (1995); Kaplow 178-179 (2001). In order to ensure that the subsidy is strictly efficiency-enhancing, it should correct the price of wealth transfers to reflect the altruistic externality but it shouldn’t alter the general distribution of tax burdens and benefits between those who are better-off and worse-off. This can be accomplished by financing the subsidy through what Kaplow terms a “benefit-offsetting tax.” It is one that mimics the incidence of the subsidy i.e., one that has the same incidence by level of well-being (or by consumption as a proxy) as the new consumer and producer surplus created by the subsidy and the new externalities it generates. See Louis Kaplow, The Optimal Supply of Public Goods and the Distortionary Cost of Taxation, 49 NAT’L TAX J. 513, 514, 517 (1996); Louis Kaplow, On the (Ir)Relevance of Distribution and Labor Supply Distortion to Government Policy, 18 J. ECON. PERSP., Fall 2004, at 159-60. It would not, however, be based on the amount of wealth transfers that individual donors choose to make.}

Altruistic wealth transfers can also create a second type of positive externality if the donor is better-off than the heir. In particular, if the heir would be an object of redistribution under the social welfare function, such private, voluntary redistribution permits lower consumption tax rates, thereby benefitting society as a whole.\footnote{Kaplow 474 (1995); Kaplow 200 (2001).} From an efficiency perspective, this redistributional externality should be corrected through an additional subsidy that is largest for the least well-off and declines to zero as consumption rises.\footnote{Once again, in order to ensure that the subsidy is purely efficiency-enhancing, it should be financed with a benefit-offsetting tax. See supra note __.}

Finally, altruistic transfers also create negative externalities. As discussed above, heirs tend respond to inheritances by working less, which in turn reduces the amount of revenue raised by the consumption tax. This amount of lost revenues is referred to as a revenue externality. It turns on the heir’s marginal tax rate and the elasticity of his labor earnings with respect to inherited income. The negative revenue externality can be corrected for by including slightly more than 100% of the inheritance in the heir’s consumption tax base, with the specific amount included turning on the amount by which his labor earnings are expected to decline in response to receipt of the inheritance.

The efficient and fair taxation of altruistic wealth transfers under the social welfare function described above is thus fairly complicated. To summarize, it has five components. On fairness grounds, such wealth transfers should first be included in the tax base of the donor, and second in the tax base of the heir. In addition, they should be subject to an accessions tax in order to move the consumption tax base closer to endowment. Fourth, on efficiency grounds, the transfer should be eligible for a large...
subsidy based on the amount inherited (essentially an accessions subsidy), with the size of the subsidy declining to 100% as heir consumption rises.\footnote{34} Finally, an extra portion of the inheritance should be included in the heir’s consumption base, with the actual percentage turning on his expected labor supply response and ultimately approaching zero.

To be clear, none of these efficiency-related taxes and subsidies are warranted when a wealth transfer is derived from wealth that was exchange-motivated, life cycle saving or egoistic. Each of these adjustments are intended to alter the price of wealth transfers relative to other consumption options so that the donor makes the choice based on all of the weighted well-being generated by her transfer, not just her own well-being. In the case of exchange-motivated gifts and bequests, the transfer is really compensation for services and should be treated like all other consumption. In the case of life cycle saving and egoistic transfers, the donor has not worked or saved in order to make the transfer, so correcting the relative price of the transfer would have no effect, and is unnecessary. These adjustments are only necessary in the case of transfers from wealth that was accumulated for altruistic reasons.

e. Summing Up

Table 5 summarizes the ideal approach to taxing wealth transfers depending on the donor’s motivation for accumulating the funds transferred—taking into account both efficiency concerns and the fairness objectives discussed above. It illustrates that, regardless of the donor’s motivation, the ideal tax treatment of inheritances under this view of fairness is an inheritance tax, which theoretically can be positive or negative. It is not an estate tax. And it is not disregarding wealth transfers entirely.

Moreover, as long as gratuitous wealth transfers are comprised of some mix of these four motives, it is a comprehensive inheritance tax. As discussed below, all the evidence to date suggests wealth transfers evidence this mix.

**Table 5: Fair and Efficient Wealth Transfer Tax Model by Donor Motivation for Working and Saving that Results in Wealth Transfer***

<table>
<thead>
<tr>
<th>Donor Motive</th>
<th>Wealth Transfer Tax Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exchange-Motivated</td>
<td>Inclusion Tax</td>
</tr>
<tr>
<td>Life Cycle Saving or Egoistic</td>
<td>Accessions Tax (100%+ rate for efficiency and to address correlation with endowment)</td>
</tr>
<tr>
<td>Altruistic</td>
<td>Inclusion Tax (include 100% in donor base, 100%+ in heir base on grounds of fairness and revenue externality) + Accessions Subsidy (altruistic 100% subsidy + subsidy for transfers to poor heirs – tax to address correlation with endowment)</td>
</tr>
</tbody>
</table>

* Assumes social welfare function concerned primarily with mitigating ex post inequality and secondarily with mitigating ex ante inequality.

The actual level and specific shape of this ideal comprehensive inheritance tax, however, depends critically on a number of further normative and empirical questions.

\footnote{34} [Is the 100% subsidy on the size of the inheritance pre- or post- inclusion and accessions tax?]
For example, it depends on the form of the underlying optimal tax. Assuming that optimal tax uses consumption as a base, it also depends on the extent to which the consumption tax is progressive and the way in which it redistributes. Furthermore, it turns on the pattern of wealth transfers, both in terms of the donor’s motives and the degree to which they are redistributive. A number of other empirical facts are also relevant, such as the extent to which the labor earnings of heirs falls in response to receiving an inheritance.

### 3. Applying Parameters

This Section begins putting these pieces of the puzzle together by explaining how one would construct the ideal wealth transfer tax if these factors were known. It also starts to paint a picture of what the ideal wealth transfer tax might look like under certain assumptions.

As mentioned previously, the analysis here assumes that the consumption tax operates on a pre-paid basis. Thus, the donor has already been taxed as if transferring the gift or bequest were an act of consumption because she “pre-paid” the consumption tax on the wealth transfer when she paid tax on her labor earnings used to fund it. The only remaining question, therefore, is whether and how to tax the heir. This assumption makes the following analysis somewhat easier to explain, but the conclusions would not change if the consumption tax operated on a cash-flow basis or through some other mechanism, such as an X-tax. The terms labor earnings and ordinary consumption (for market consumption from labor earnings) are used interchangeably because, under the assumptions specified above, a tax on labor earnings is equivalent in present value terms to taxing consumption therefrom.

#### a. Basic Model

To begin, suppose that all of the relevant parameters are known, the view of fairness embodied in the social welfare function is as outlined above, and the optimal basic tax system is a consumption tax. Then the ideal wealth transfer tax would take the following form (heir subscripts suppressed):  

$$  
Tw(I) = \sum_{h=1}^{N} \left[ (t_c(i, c + a + e) + acl(i)) - t_c + [i((s + g - a) + ar(i, c) + t_a(s + g + a) + t_{al}(s + g + a))] \right]  
$$

The ideal wealth transfer tax ($Tw(I)$) on the total amount transferred ($I$) and the total number of heirs ($N$) is the sum of the ideal wealth transfer tax ($t_w(i)$) on each heir ($h$). This individual tax depends on the proportion of the heir’s inheritance ($i$) that was exchange-motivated ($e$), life cycle savings ($s$), egoistic ($g$), or altruistic ($a$). It also depends on how his labor earnings change in response to receiving the inheritance ($l(i)$). In addition, it turns on how the amount of government transfers for which he is eligible changes as a result of the inheritance ($r(i,c)$). Finally, it depends on the underlying tax

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[Supra __.]

[Need to address the possibility that donor motives are correlated with heir ability.]
rate schedule he faces if the inheritance is treated as consumption \(t_c(c, i)\),\footnote{Technically the inheritance would be treated as labor earnings on which the consumption tax would be pre-paid.} and the ideal accessions tax he faces both to address ex post \(t_{a1}(i)\) and ex ante \(t_{a2}(i)\) equity concerns.

The identity illustrates that the actual wealth transfer tax for a given heir has two components: an inclusion tax (represented by the first bracketed section) and an accessions tax (represented by the second). The heir’s inclusion tax is the total consumption tax he owes \(t_c(c + i(a + e) + acl(i))\) minus the amount he owes on his ordinary consumption \(t_c(c)\) that is not financed by his inheritance. The total consumption tax he owes in turn is based upon the sum of his ordinary consumption \(c\), the portion of his inheritance that is altruistic or exchange-motivated \((i(a + e))\), which should be treated as consumption on equity grounds, and the revenue externality, which should be corrected for by adding to the consumption tax base the reduction in ordinary consumption as a result of his working less in response to an altruistic inheritance \((acl(i))\).

The heir’s accessions tax is the tax that applies to his inheritance that does not directly depend on the rate schedule he faces under the consumption tax. The first component is the confiscatory tax on bequests from life cycle saving \((si)\) and egoistic wealth accumulation \((gi)\) minus the 100% altruistic subsidy \((ai)\). The second is the subsidy for any redistributional externality, which is a function of his inheritance and his ordinary consumption and which only applies to portion of his inheritance, if any, that is altruistic \((air(i, c))\). The third and fourth elements are the accessions taxes that he faces in response to ex post equity concerns \((it_{a1}(s + g + a))\) and ex ante equity concerns \((it_{a2}(s + g + a))\) and which apply to altruistic, life cycle saving and egoistic inheritances because all may signal his endowment currently or at birth.

This formula implies once again that there are two fundamental features of the ideal treatment of wealth transfers within the context of a consumption tax. First, the ideal is certainly not to disregard them. Second, among the three wealth transfer tax options, the ideal appears to be a comprehensive inheritance tax. Nevertheless, both of these conclusions are, as a theoretically matter, contingent on the underlying parameters. Thus, this Section next explores what the ideal wealth transfer tax might look like once some reasonable assumptions about the underlying parameters are in place.

\textit{b. Form of Tax}

The first empirical question is what mix donor motives drive current wealth transfer flows. As a first cut, it is reasonable to assume that we cannot disaggregate the portion of each individual wealth transfer that is life cycle saving, egoistic, altruistic, or exchange-motivated, but only know these proportions at an aggregate level. This assumption is clearly implausible with respect to gifts because they cannot be derived from life cycle saving. But inter vivos gifts only represent about 16% of the present value of wealth transfers in the U.S. and data on them is much more difficult to obtain, so let’s set them aside and focus solely on bequests.\footnote{Joulfaian & McGarry (2004).} With respect to bequests, this assumption is plausible. The existing empirical literature is only beginning to reach a fragile
consensus about the relative proportion of donor motives at the aggregate level,\textsuperscript{80} and has not developed methods for disaggregating donor motives by characteristics of the individual donor or heir.\textsuperscript{81}

At the aggregate level, a recent study by Kopczuk and Lupton provides perhaps the best evidence of relative proportions of donor bequest motives. It concludes that 53\% of bequests are life cycle saving, while it is unclear what portion of the remainder are altruistic, egoistic or exchange-motivated.\textsuperscript{82} While it does find some evidence of exchange-motivated transfers, the results are not at a statistically significant level.\textsuperscript{83}

Another recent study by Kopczuk suggests that a sizable portion of bequests that are not generated by life cycle saving are egoistic.\textsuperscript{84} A very rough but reasonable assumption, therefore, might be that 45\% of bequests are life cycle saving, 30\% altruistic, 15\% egoistic, and 10\% exchange-motivated.

Other work by Joulfaian, based on actual estate and heir income data returns, provides some estimates of the labor supply response of heirs to receiving an inheritance. It suggests that heirs’ labor earnings tend to decline by roughly 2\% for each unit of the natural log of inheritance, with inheritance measured in millions of dollars.\textsuperscript{85}

Let’s suppose further that this labor response can’t be disaggregated by demographic characteristics of the heir, and that the underlying rate schedule for tax and transfers also does not vary characteristics of the heir other than his consumption. With these assumptions in place, the ideal wealth transfer tax for a given heir ($h$) is as follows:

\begin{equation}
(2) \quad [T_c(c + .4i + .008c(\ln(i_M)) - cT_c) + [.3i + .3ir(i, c) + .9it_{o1} + .9it_{o2}]]
\end{equation}

Stated in plain English, the ideal tax is now based on only two variables that are specific to the heir: his consumption and his inheritance. The heir should include 40\% of the inheritance in the consumption tax base, with that percentage rising to about 45\% as the amount he inherits increases. He should also pay a 30\% flat tax on the inheritance. In addition, he should receive a separate subsidy on 30\% of the inheritance that corrects for the redistributional externality, with the rate turning on the size of his inheritance and his marginal consumption tax rate. Finally, he should pay an accessions tax that addresses both ex post and ex ante equity concerns on 90\% of the inheritance.

As mentioned earlier, the three types of welfare transfer taxes only differ if their underlying rate structure is not flat. Accordingly, the next important question is whether the rate structure of this ideal wealth transfer tax is flat. One element clearly is: the 30\% flat tax on the inheritance. Thus, a portion of the tax could just as easily be implemented

\textsuperscript{80} See, e.g., Hurd (1987); Bernheim 900 (1991); Laitner & Juster 907 (1996); Page (2003).
\textsuperscript{81} [Check more thoroughly.]
\textsuperscript{82} Kopczuk & Lupton (2007). Technically, they estimate that the remainder are generally egoistic. However, I interpret their use of egoistic to imply that the donor cares about the size of the after-tax gift, in which case the ideal treatment is identical to that for altruistic transfers.
\textsuperscript{83} Id.
\textsuperscript{84} Kopczuk (2006).
\textsuperscript{85} Joulfaian [check].
through an estate tax as an accessions tax. Nevertheless, it is highly unlikely that the inclusion tax and the accessions tax addressing ex post and ex ante equity concerns exhibit flat rate structures. As a result, only a portion of the ideal wealth transfer tax could be imposed through an estate tax.

Beginning with the inclusion tax, its rate structure turns on the rate structure of the underlying consumption tax. Early work by Mirrlees and others suggested that the optimal consumption tax has declining marginal rates, with all the revenue used to finance a basic cash grant that everyone receives (a “demogrant”). By contrast, more recent work, deriving optimal tax rates from labor elasticities, suggests that the optimal consumption tax may have declining marginal rates between low and moderate levels of consumption, but rising marginal rates between moderate and high levels of consumption. If labor supply decisions tend to be made at the extensive margin (whether to work or not), the optimal rate structure may also rise at lower levels of consumption, potentially starting with a negative marginal rate for those with the least earnings. Regardless of which body of work the reader believes is more persuasive, the takeaway is that the optimal consumption tax is not flat.

The question of whether the accessions tax element of the ideal should be flat has not been explored in much depth. Most scholars just assume that any accessions tax should be progressive without explanation. Whether this assumption is correct, however, turns on the theory of fairness motivating the tax.

As discussed, one possibility is that the accessions tax is intended to allocate tax burdens more accurately based on current endowment, in light of the connection between inheritance and earning potential, and also the correlation between financial inheritance and other forms of inheritance. If this is the driving motivation, the ideal accessions tax would only be flat if the strength of these correlations did not vary with the size of the inheritance. In addition, the ideal accessions tax would only be flat if the optimal tax rate on potential consumption was flat. Neither of these conditions seems likely to hold.

The other possibility is that the accessions tax is intended to address concerns for ex ante fairness. The account of ex ante fairness can actually take at least three different forms. First, the social welfare function may be seek to minimize the extent to which there is an entrenched economic aristocracy where some individuals can consume extraordinarily large amounts by virtue of their birth. In this case, the accessions tax should be progressive because it should only apply to those receiving massive inheritances. Second, this aspect of the social welfare function may be premised upon the idea that for those to whom much has been given, much will be required. As a result, it may aim to minimize the extent to which people can live off inherited income without working at all. This implies a progressive accessions tax for the same reason.

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86 Mirrlees (1971); [others].
87 Saez, RES (2001); [others].
88 Saez, QJE (2002); [others].
89 [Cites]
90 It also can be framed as a negative externality that arises from the adverse effects of a society with unequal opportunity upon individuals’ well-being.
Finally, the social welfare function may seek to minimize the intergenerational correlation of economic status. That is, it may aspire to increase mobility from generation to generation. Theoretically, the ideal accessions tax could then be flat. For instance, on this account of fairness, the social welfare loss could be the same if 50 people receive no inheritance and 50 relatives of one donor receive $1 million, or if 95 receive no inheritance and her five children receive $10 million each. In practice, however, intergenerational mobility is most sticky at the ends of the economic distribution. As a result, the former scenario would probably be preferable to the latter under this view of fairness.

Thus, under the posited ideal wealth transfer tax, it appears that neither the inclusion tax nor the fairness-motivated component of the accessions tax would exhibit a flat rate structure. This implies that neither could be replicated through an estate tax. Meanwhile, the efficiency-motivated 30% flat tax could be implemented through an estate tax, but also through an accessions tax. To summarize, therefore, the ideal wealth transfer is necessarily a comprehensive inheritance tax, and only optionally could include an estate tax element.

c. Level of Tax

Notwithstanding the above, two final questions remain before concluding that the ideal treatment of wealth transfers within an ideal consumption tax has to be a comprehensive inheritance tax. First, it is possible that the ideal tax raises so little that it matters little if wealth transfers are disregarded entirely. Second, it is possible that the 30% flat tax comprises the lion’s share of the revenue raised from the posited ideal tax so it matters little if this tax is an estate tax. In order to address these questions and paint a fuller picture of what the ideal tax treatment of inheritances might look like under different scenarios, this Section concludes by adopting some purely hypothetical assumptions about the social welfare function and the optimal underlying consumption tax.

To begin, let’s implausibly assume that the level and progressivity of the optimal consumption tax mirrors the rate schedule on labor income for a married couple under our current income tax. Suppose further that the redistributional positive externality is 40% (the maximum EITC subsidy) for someone with zero other consumption, and declines linearly until it is eliminated at $40,000 of consumption (roughly the end of the EITC phase-out). In addition, let’s say hypothetically that the ideal accessions tax to address fairness concerns and bring the consumption tax closer to an endowment tax rises linearly from 0% to 15%, until it plateaus at lifetime inheritances exceeding $10 million.

The ideal marginal tax rate on the first dollar of inheritance that an heir receives in the current period, if he has no prior inheritances, would then be as follows:

\[
T_c(c + .4i + .0004c) - cT_c + 0i
\]

\[\text{See supra } __.\]
This ideal wealth transfer tax is illustrated in Figure 14. The lowest solid line represents his marginal tax rate on the first dollar of inheritance, depending on his level of consumption prior to the inheritance. Unlike the rate structure on consumption from labor earnings (the dotted line), it starts off with a very positive slope, due to the redistributional externality. However, it is higher than the underlying consumption tax rate on consumption because the combination of the 100% tax on life cycle saving and egoistic transfers and the 100% subsidy on altruistic transfers produces a flat tax of 30%, due to the greater prevalence of life cycle saving and egoistic transfers. In addition, 40% of the inheritance—the portion assumed to represent altruistic or exchange-motivated transfers—is included in the consumption tax base. The top two lines illustrate the marginal tax rate on the last dollar inherited for an heir of $5 million or $10 million, respectively. Both lines are higher due to a small inclusion tax that corrects for the revenue externality, and the accessions tax, which becomes significant for such large amounts of inherited wealth.92

Two features of Figure 14 are worth noting. First, the fact that the marginal tax rate rises with the size of the inheritance and the heir’s consumption from other sources indicates that the tax is a comprehensive inheritance tax. Second, the tax rate is quite high, ranging from 18% to 59%. To provide some perspective, recall that the average U.S. federal estate tax rate on inheritances is 2.5% and the average U.S. individual income and payroll tax rate is 18.4%. By contrast, according to the model used for this paper’s estimates, the average tax rate on inheritances under this hypothetical tax is 34%.

Thus, at least under the vaguely plausible assumption used to construct this tax, the ideal wealth transfer tax is certainly not so small that it is similar to disregarding wealth transfers entirely. To the contrary, the inheritance tax illustrated in Figure 14 would raise an astonishing amount of revenue if applied in U.S. As of 2009, we estimate that it would raise $237 billion per year. This is more than 13 times the amount of revenue ($17.5 billion) the 2009 U.S. estate tax would raise. And it is about one-fifth of the estimated revenue generated by the U.S. income tax in that year ($1.1 trillion).

This figure could be vastly different if other assumptions were adopted. For example the marginal tax rate structure of the ideal wealth transfer tax could look very different if the marginal rate structure of the ideal consumption tax were higher or lower, or more or less progressive. Nevertheless, the conclusion that a comprehensive inheritance tax is the ideal approach appears to be fairly robust.

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92 Because the inclusion tax to correct for the revenue externality does not rise linearly with inheritance size, however, the increase in the tax rate for $10 million of prior inheritance relative to no prior inheritances is somewhat less than double the increase for $5 million of prior inheritance relative for no prior inheritance.
For example, Figure 15 shows each component of the hypothesized ideal wealth transfer tax under the same assumptions as Figure 14 except that it assumes that the optimal consumption tax rate is instead a flat 20% tax, and the only heir shown has previously inherited $10 million. Under these assumptions, the redistributional subsidy initially is –12% because it is –40% and applies to the 30% of his inheritance that is altruistic. It phases out by $40,000 in ordinary consumption. The basic inclusion tax is 8% percent because the consumption tax rate is 20% and 40% of his inheritance is altruistic or exchange-motivated. In addition, about 5% of the first dollar of inheritance above $10 million must be included in the consumption tax base in order to account for the revenue externality, generating an one percentage point increase in the marginal tax rate. All inheritances are also subject to a flat 30% efficiency-motivated acquisitions or estate tax, as explained above. Finally, the fairness-motivated acquisitions tax is 13.5% because it applies to the 90% of the inheritance that isn’t exchange-motivated and is 15% due to his prior inheritances. Figure 16 continues with the example, adding up each of the components of the wealth transfer tax in Figure 15 in order to show the total tax rate that the heir faces on the first dollar of his new inheritance, and the relative contributions of each component.

Once again, these figures suggest that the ideal marginal tax rate on inheritances under an ideal consumption tax may be relatively high. At its peak, it is 52% in this example. Moreover, even if the most arbitrary parameter, the fairness-motivated acquisitions tax, is eliminated, a large portion of inheritances are subject to a 39% rate.

Figure 16 also illustrates that, at least under this hypothetical, both components of the comprehensive inheritance tax are important. While the efficiency-motivated acquisitions tax (the only element that can be replicated through an estate tax) comprises a sizable share of the total marginal tax, it by no means renders the other components inconsequential.
In short, applying some specific parameters does not change the conclusions that the ideal wealth transfer tax should raise a significantly larger share of revenue than current practice, and a comprehensive inheritance tax is necessarily part of this ideal, with the estate tax being only an optional, additional feature.

These conclusions could certainly change if there were further empirical evidence about the magnitude of the relevant parameters and how they are affected by
For purposes of this paper’s argument about the ideal level of tax, the most important finding would be that a much larger share or wealth transfers are the product of altruism. By contrast, the most important finding with respect to its arguments about the ideal form of the tax would be a link between the relevant parameters and characteristics of the estate or donor.

For instance, bequests stemming from life cycle savings are necessarily made by relatively young decedents so the age of the decedent may become relevant. There is also emerging evidence that the vast majority of bequests from lower-wealth decedents are the result of life cycle saving. Cutting the other way, though, there is emerging evidence that life cycle saving and egoistic bequests combined make up a relatively larger share of bequests among higher-wealth decedents. If such empirical evidence were to become clear either way, it is possible that a comprehensive inclusion-accessions-estate tax would emerge as the ideal.

So long as the evidence on the prevalence of different accumulation motives does not change dramatically, however, the above discussion suggests that the ideal tax would raise more revenue than current practice. Moreover, regardless of how the evidence develops, it appears that the ideal will always be a comprehensive inheritance tax to a large extent. So long as wealth transfers exhibit some mix of at least three of the four donor motives and the underlying tax is not flat, it will always entail some inclusion and accessions elements. If one also accepts the view of fairness offered by this paper, it will also always involve both features. Thus, the superiority of a comprehensive inheritance tax to no tax on wealth transfers—or to an estate tax standing alone—seems robust to however the relevant empirical parameters are expanded or modified.

B. Adjustments under an Income Tax

In the real world, many wealth transfer taxes operate in the context of an income tax. This is especially true in the U.S., which relies much more heavily on income tax revenues than other nations. Accordingly, before turning to differences in the incidence of a comprehensive inheritance tax and other wealth transfer tax approaches, it is useful to consider how the above analysis might change if an income tax were the optimal underlying tax system.

Within an income tax, three questions arise. First, there is the question of whether the ideal model for taxing wealth transfers changes. Second, one might ask how capital income earned on wealth transfers should be taxed, given that an income tax is simply a consumption tax plus a tax on capital income. Finally, there the question of whether implementation of the ideal wealth transfer tax would change anything about the ideal tax

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93 For instance, bequests received by intestacy from remote relatives may be more likely to be life cycle savings because the donor could have never known the heir. Cf. Waldron. In addition, because inter vivos gifts can’t be life cycle saving, at first blush they certainly should be treated differently under an ideal wealth transfer tax.

94 Scholz et al.

95 Kopchuk (2006); Kopchuk & Lupton (2007).
on non-inherited income. The answers to these questions turn on the reason for choosing an income tax over a consumption tax in the first place.

There are at least four potential reasons why the optimal tax system might be an income tax that are relevant for this discussion. First, we might think consumption is the fairest (realistic) tax base, but there are political economy constraints on how high nominal consumption tax rates can be. As a result, we might resort to an income tax as a second-best method for achieving the desired level of redistribution because consumption is positively correlated with savings and capital income. A second, related rationale is, ironically, that an income tax might be a second best way to tax inheritances if instead it is the ideal level of wealth transfer taxation that cannot be achieved politically.

Neither of these concerns fundamentally affects the ideal model for taxing wealth transfers. It remains a comprehensive inheritance tax, although inheritances should now be treated as income instead of consumption. In addition, both concerns imply that capital income that has accrued or is subsequently earned on inherited assets should be treated the same as capital income earned on other assets—that is, taxed once and at the same rate.

However, if the ideal comprehensive inheritance tax is implemented within the context of an income tax that is optimal on this basis, the ideal income tax itself would likely change dramatically. If the sole purpose of the income tax was to tax consumption more progressively and implementation of the ideal inheritance tax makes the tax system as a whole more progressive, then all capital income should be taxed more lightly. If, instead, the purpose was to get closer to the ideal level of taxation on inheritances, the income tax should actually be repealed, and replaced with a consumption tax.

A third potential reason why the optimal tax might be an income tax is if we think income is a more equitable measure of ability to pay than consumption. Advocates of consumption taxes often argue that an income tax unfairly penalizes savers. For instance, suppose two internet entrepreneurs each earned $1 million in labor income in year one and then only $20,000 in labor income annually thereafter. A spends his $1 million immediately and B saves it and spreads it out over his whole life. Even though they appear to be in identical economic positions, on a present value basis B would be taxed more heavily under an income tax because he would pay tax not only on his labor income, but also on the capital income he earns on his savings.

The claim that a consumption tax is fairer assumes that people have long economic horizons and, for a given a lifetime budget constraint, can choose their pattern of consumption over time. If this is not the case, an income tax may be more equitable.

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96 [Add discussion of income tax as way to get closer to endowment tax if tendency to save is correlated with endowment?]
97 [Auerbach.]
98 C.f. [Saez, JPE (2002)].
99 [Note need to lower interest deductions to address tax arbitrage possibilities.]
100 See Shavio (2007); [others]. [Myopia and self-control problems.]
People may instead have short economic horizons and may be unable to smooth their consumption, perhaps because they face liquidity constraints. For instance, suppose A instead earns his windfall of $1 million (in present value) at the end of his life. It is unlikely that he can borrow against these future earnings. He is then worse off than B, but under a consumption tax, the present value of taxes on the A and B would be identical.

If the rationale for an income tax is that it is inherently a more equitable tax base, once again, the ideal structure for taxing wealth transfers remains a comprehensive inheritance tax, with inheritances treated as income and capital income on inheritances taxed in the same manner as other capital income. Implementation of the comprehensive inheritance tax also has no particular implications for the ideal income tax.

However, one feature of the ideal comprehensive inheritance tax might change: its inclusion tax might be higher than it would be in a consumption tax environment. In the real world, income taxes tend to systematically undertax capital income relative to the nominal rate structure. This occurs in part because income taxes typically tax capital gains only when they are realized, and not as they accrue, in response to valuation problems. In addition, retirement savings incentives effectively eliminate the taxation of capital income. If these subsidies do a reasonable job of correcting for positive externalities, they may be justified on efficiency grounds, but a substantial literature suggests that do not.\footnote{Gale, Gruber, Orszag; Batchelder, Goldberg, Orszag; [others].} Moreover, in the U.S., a large portion of wealth transfers are composed of tax-preferred retirement savings vehicles.\footnote{[Cite].}

Wealth transfer taxes may be the most effective second-best approach for reaching such undertaxed capital income.\footnote{Graetz (1983).} The main alternative is a wealth tax but it generates similar valuation problems as an income tax. If wealth transfer taxes are the best approach, the portion of the inheritance included in consumption, as described in the previous section, should be treated as ordinary income. But an additional portion should be included in capital income as a second-best way of correcting for the undertaxation of capital income more generally.\footnote{This assumes that the heir’s tax rate on capital income is similar to the rate the donor would have faced if the capital income were taxed at the right time.}

A final potential justification for an income tax, advanced by the new dynamic public finance literature, is that it enhances efficiency.\footnote{Golosov et al (2006); [others]} Receipt of capital income may indicate unused earning capacity. For instance, the recipient might be Kristina, the former investment banker who saved large amounts of money and retired early in order to become a surfer. As discussed above, taxing her at her full earning potential might be unfair because the fact that she left investment banking might indicated that she derived less well-being from her earnings than her colleagues. But taxing her wealth used to fund her surfing adventures through a capital income tax might be one way to induce her to return to a job where her skills are more valued—to make her more “lean and mean”—without requiring her to do so. This would enhance efficiency by generating a positive
revenue externality over time, akin to the revenue externality generated by taxing inheritances.

If this is the rationale for an income tax, once again the ideal model for taxing inheritances remains a comprehensive inheritance tax. In addition, implementation of this ideal does not alter the ideal income tax. However, unlike the previous rationales for an income tax, it may support taxing capital income generated by inherited assets at differential and lower rates than other capital income.

To see how this is possible, let’s focus on heirs first. The ideal comprehensive inheritance tax addresses the effect inheritances have on an heir’s work effort and taxes paid. It also addresses the information that receipt of an inheritance tells us about the heir’s earning potential. If the heir chooses to save part of the inheritance and spread it out over time, that is a rational response, which does not necessarily imply that his earning potential is even greater. As a result, the reasons for having a tax on capital income have already been addressed. The heir is “lean and mean” enough, and capital income generated by saving amounts inherited should be tax-exempt.

For donors, by contrast, the tax on capital income earned on funds that are ultimately used for wealth transfers should be the same as the tax on funds ultimately used for consumption. The point of the tax on capital income in this literature is to induce a contemporaneous increase in work by the wealth holder, which should occur regardless of the donor motive underlying any subsequent transfer. If the donor has saved for his own consumption in retirement (i.e., any eventual wealth transfer will be the result of life cycle savings), taxing the capital income generated by this saving is still efficiency-enhancing because it will induce him to work more so that he can still meet his retirement income goal. Similarly, if he has saved for altruistic reasons, the capital income tax should induce him to work more so that he can still transfer the same amount of funds to his heirs. Thus, while capital income generated by gifts and bequests after they are transferred should be tax-free, capital income earned prior to the transfer (unlike stepped-up basis under current law) should receive no special treatment.

To summarize, consideration of how best to tax wealth transfers in the context of an income tax leads to four general conclusions. First, the amount of inheritances included in income under the comprehensive inheritance tax may be higher as a second-best way of taxing untaxed capital income—but only if income is seen as the fairest tax base. Second, capital income on wealth transfers should generally be taxed the same as capital income earned on other assets. The only exception is if the income tax is optimal due to efficiency considerations, in which case any capital income generated by the gift or bequest after the transfer should be tax-free. Third, implementation of the ideal inheritance tax can also have effects upon the ideal income tax. In particular, if the income tax is justified on political economy grounds, the progressivity of the income tax on non-inherited income should be reduced, or it should be replaced with a consumption tax. Finally, and most importantly, the ideal method for taxing wealth transfers remains a comprehensive inheritance tax.

\[106\] This conclusion only holds, though, if the ideal inheritance tax has in fact been implemented.
IV. IMPLICATIONS OF REALISTIC IMPLEMENTATION

[To come.]

[This Part will consider whether political economy and implementation considerations strengthen or weaken the case for a comprehensive inheritance tax, and argue that they strengthen the case. I’m thinking it would make the following points:

A. Political Economy Constraints

- If the ideal tax rate on wealth transfers is higher than it is in the U.S. or cross-nationally, an inheritance tax should make this higher tax rate easier to achieve. Its main political economy benefit is that people often confuse statutory and economic incidence and heirs are a more appealing target of taxation than donors.

- Among varieties of inheritance taxes, it is unclear whether an inclusion tax or accessions tax, standing alone, would garner more political support. Many do not realize that inheritances are not part of the income tax base of heirs so an inclusion tax may not be viewed as simply broadening the base of the income tax, but it would hit almost every taxpayer at some point in his life. An accessions tax is more likely to be seen as a double tax but could exempt heirs receiving small inheritances.

- In a consumption tax context, a comprehensive inheritance tax may garner political support more easily under some types of consumption taxes than others, depending on whether it is seen as more natural to treat the receipt of an inheritance as akin to labor income (pre-paid) than the act of giving as consumption (cash-flow), or vice versa.

B. Complexity

- Estate tax v. no wealth transfer tax:
  - No consensus on whether estate tax more complex or has higher elasticity of taxable income than comparably progressive income tax. Estate tax repeal may also generate more disguised compensation as gifts and bequests among those who are most likely to have good tax advisors.

- Estate tax v. inheritance tax:
  - Are lots of ways could simplify current estate tax through either estate tax or inheritance tax by, for example, harmonizing treatment of gifts
and bequests, establishing joint exemption for spouses, and eliminating Crummey trusts.

○ Assuming such reforms, inheritance tax could be more complex due to: (1) more returns filed, (2) complicated rules for generation-skipping transfer tax (although I don’t think there should be one), and (3) more opportunities for gaming due to larger number of valuation points (although if adopt withholding/credit approach for trusts, are cross-cutting incentives to undervalue total assets contributed and overvalue distributions).

○ On balance, though, think inheritance tax likely to be somewhat simpler overall due wait-and-see approach for split and contingent transfers. Can’t implement in estate tax and should substantially reduce transactional complexity.

C. Transition Costs

• When moving from lifetime estate tax to lifetime inheritance tax, as in U.S., recommend transitioning all at once, i.e., disregarding prior inheritances received and prior estate taxes paid, unless current distribution from trust already that was subject to estate tax. Effective date should be well before enactment to prevent gaming.

  ○ Transition costs should then be relatively small because people typically receive few large inheritances over lifetime.

• Most countries already have inheritance tax so transition costs clearly higher for estate tax. However, countries with inheritance tax typically have accessions tax that operates on yearly basis. Could aggregate prior reportable inheritances under new comprehensive inheritance tax, but given small number of large inheritances and likelihood of overhauling the rules of what is reportable (e.g., many countries exempt transfers to children), may not be worth the effort.

V. Conclusion

[To come.]
APPENDICES

A. METHODOLOGY FOR REVENUE AND DISTRIBUTIONAL ANALYSIS

The revenue and distributional estimates in this paper are based initially on the Urban-Brookings Tax Policy Center Estate Tax Microsimulation Model (ETMM). That model was built by imputing wealth on to micro data of individual income tax returns. The model then assigns a probability of death and imputes how much would be given to charities and a surviving spouse in order to create a dataset of taxable estates in the current year that matches published IRS data on taxable estates.

The ETMM was modified to estimate the revenue and distributional effects of an inheritance tax in the following ways. First, the number of beneficiaries in each relationship group (children and other beneficiaries) was imputed based on decedent’s marital status and estate size. The share of the estate allocated to beneficiaries in each relationship group was then imputed based on decedent’s marital status, the estate size and the number of beneficiaries. Next, each individual beneficiary was assigned a marital status based on the decedent’s marital status, the estate size, and the beneficiary’s relationship to the decedent. Each beneficiary was then assigned an income group based on the decedent’s marital status, the estate size, the beneficiary’s relationship to the decedent, and the beneficiary’s marital status. These imputations were based on restricted IRS 1992 Collation Study data.

107 For further details, see ROHALY, CARASSO & SALEEM (2005).
108 The marital status of decedents is their marital status before they passed away. Estates were grouped in the following categories: (1) less than $600,00, (2) at least $600,000 but less than $1,000,000, (3) at least $1,000,000 but less than $2,500,000, (4) at least $2,500,000 but less than $5,000,000, (5) at least $5,000,000 but less than $10,000,000, and (6) at least $10,000,000. The number of beneficiaries allowed in the imputation is 0, 1, 2, 3, 4 and greater than 4 (in which case an average value is imputed).
109 For example, the share of an estate allocated to children is 100% if it has two child beneficiaries and no other beneficiaries. If a similar estate has two children beneficiaries and one other beneficiary, some positive share was imputed as going to children and the remainder as going to other beneficiaries.
110 Beneficiary income was grouped in the following categories: (1) not more than $10,000, (2) more than $10,000 but not more than $25,000, (3) more than $25,000 but not more than $50,000, (4) more than $50,000 but not more than $100,000, (5) more than $100,000 but not more than $200,000, and (6) more than $200,000, in 1992 dollars. Income growth rates were based on a CBO data at http://www.cbo.gov/ftpdocs/70xx/doc7000/Spreadsheets.xls (tbl.1C). The measure of income in the IRS 1992 Collation Study includes wages, tax exempt interest, taxable dividends, alimony received, pension, taxable IRA distribution, unemployment compensation, social security, rents received, royalties received, partnership and S-corp income, estate and trust income. It also includes the following when positive: schedule C gross profit/loss (From first 3 schedules), schedule F profit/loss (from first 2 schedules) supplemental gains/losses, other income, farm/rent income/loss taxable interest income, net short-term gain/loss, and net long-term gain/loss.
Once these variables were imputed, the inheritance size for each beneficiary in a given relationship group was calculated by assuming that the portion of the estate going to that relationship group was bequeathed pro rata. Specifically, the inheritance size for each beneficiary was calculated as the product of the taxable estate (the estate after expenses and transfers to spouses and charities) and the portion assigned to the beneficiary’s relationship group, divided by the number of beneficiaries in that relationship group. Based on each beneficiary’s inheritance size, a ratio between the beneficiary’s prior and current inheritance size was imputed.\footnote{Current inheritances were classified into the following groups: (1) not more than $10,000, (2) more than $10,000 but not more than $50,000, (3) more than $50,000 but not more than $100,000, (4) more than $100,000 but not more than $500,000, (5) more than $500,000 but not more than $1,000,000, and (6) more than $1,000,000. A prior inheritance to current inheritance ratio was then assigned randomly from one of the following four groups, which were derived from the distribution of that ratio for heirs in the beneficiary’s current inheritance group: 0\textsuperscript{th}-40\textsuperscript{th} percentile, 40\textsuperscript{th}-60\textsuperscript{th} percentile, 60\textsuperscript{th}-90\textsuperscript{th} percentile, and 90\textsuperscript{th}-100\textsuperscript{th} percentile. The imputed ratio is the value of the middle percentile of the group, i.e. the 20\textsuperscript{th} percentile for 0\textsuperscript{th}-40\textsuperscript{th} percentile group.} Prior inheritances were then calculated as the product of the imputed ratio and the beneficiary’s current inheritance. These imputed ratios were derived from combined 2001 and 2004 Survey of Consumer Finance (SCF) data.

At this point the heir’s AGI, income, taxable income, capital gains, and other tax information were imputed by randomly assigning a micro record from the TPC data on individual income tax returns that matched the income group of the heir. The heir’s inheritance tax liability was then calculated based on his or her taxable income, current inheritance, and prior inheritance.

Estate tax burdens were calculated as under the ETMM, which includes an imputed value for inter vivos gifts previously transferred by the donor. For purposes of comparing heirs, the tax liability of estates was assigned to individual heirs in the same manner as described above. Any estate tax due was assumed to be borne by an heir in the same proportion as his inheritance bore to the inheritances of all other non-spousal heirs of the estate.

Two further assumptions underlying the model should be noted. First, the estimates of both estate tax and inheritance tax liability assume no state wealth transfer tax liability. Second, like most distributional analysis, the estimates assume no behavioral response, i.e., no change in the magnitude of wealth transfers or their allocation on a pre-tax basis. If donors do respond to the incentives created by an inheritance tax to give to more heirs or to those who are lower income and the change in inheritances is included in the distributional estimates, the inheritance tax should be even more progressive by heir economic income and inheritance size.

One question that may arise is why the inheritance tax lifetime exemption is so large relative to the revenue-neutral estate tax lifetime exemption. This is the result of three factors. First, a large portion of inheritances go to children, and the wealthiest decedents on average have between 0.68 to 1.20 children who are alive and receive some inheritance. Non-child beneficiaries typically receive amounts below the exemption threshold. As a result, the inheritance tax often taxes less than two children beneficiaries per estate, if it taxes any heirs at all. Second, the top marginal tax rate on gifts and
bequests under the inheritance tax is five percentage points higher than under the estate tax, and a large portion of inheritances above the lifetime exemption (86%) is subject to that top marginal rate. Finally, prior inheritances received are typically larger than prior inter vivos gifts transferred because most transfers occur at death, but both parents often give to their children at death. As a result, a larger share of the lifetime exemption has been used up by prior inheritances under the inheritance tax than has been used up by prior gifts under the estate tax. This is a relatively small factor, however. Eliminating prior inheritances and gifts from the model only reduces the revenue-neutral inheritance tax lifetime exemption by about $300,000.

The estimates should be treated with a high degree of caution. As should be clear from the discussion above, the model is based in part on data from 1992 and involves multiple layers of imputation due to the fact that there is no publicly-available micro data linking estate tax returns to the amount heirs receive and the heir’s tax return.
## B. TAX TREATMENT OF WEALTH TRANSFERS CROSS-NATIONALLY

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<th>Characteristics of Separate Tax</th>
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<tr>
<td>Sweden</td>
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<tr>
<td>Switzerland*</td>
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<tr>
<td>Turkey</td>
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<td>U.S.</td>
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</tbody>
</table>

* Denmark has a gift tax for gifts from relatives and requires income inclusion for gifts from non-relatives. It applies an estate/inheritance tax to bequests, where the estate is taxed and there is an additional tax on bequests to heirs who are not lineal relatives or children-in-law. Japan provides exemption per estate and per statutory (not actual) heir, making it a modified estate tax. All gifts are aggregated. Bequests are aggregated by relationship group. Portugal does not tax gifts and bequests to lineal relatives. The tax it imposes on wealth transfers to all others is flat, making it simultaneously an inheritance and estate tax. Russia requires inclusion only for gifts to non-relatives. Spain also imposes a progressive surtax based on the wealth of the donee. In Switzerland, whether the wealth transfer tax is an estate or inheritance tax varies by canton.

Sources: INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION (2006a); INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION (2006b); AULT & ARNOLD 184 (2004).