Verena Kley

The Taxation of Capitalistic Bequests

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LATIN SYMBOLS:

a	wealth threshold for capitalistic preferences (modified Stone-Geary parameter)
A	descendant's attention
b	private bequest
c	private consumption
d^f	minimum capital stock required to install a foundation
e	gross labor income
E^b	inheritance tax effect on future inheritances
E^l	inheritance tax effect on labor income
f	government spending per capita
$F(\cdot)$	children's preference distribution under a fixed budget
g	government budget per capita
G^*	optimal non-linear tax system
$G(\cdot)$	distribution of initial ability
$h(\cdot)$	utility
H	high income individual
$H(\cdot)$	initial wealth distribution
i	individuals
I	inheritance
k^f	proportional costs required to run a foundation
l	time used for labor
L	low income individual
m	number of parents
M	median voter
n	rate of population growth
o	old individual
p^A	price for descendant's attention
p_L, p_H	earning abilities of high and low type individuals
q_L, q_H	social planner weights given to high and low type individuals

r	interest rate
r_f	rate of return of a foundation
s	private savings
$S(\cdot)$	children's preference distribution under a fixed labor income tax
t	period indicator
T	transfers during lifetime
$u(\cdot)$	utility
$U(\cdot)$	lifetime utility
$v(\cdot)$	indirect utility
w	wealth holding
$\bar{w}$	wealth level in the social environment
$\widetilde{w}$	wealth level at which consumers begin to bequeath
$\hat{w}$	wealth level at which consumers begin to install a foundation
x	net labor income
y	young individual
z	political weight of an individual

GREEK SYMBOLS:

α	social rate of discounting the welfare of future generations
β	rate of altruism
χ	degree of homogeneity within a pressure group
ε	intensity of weighting paternalistic bequests
ε	voting costs
η	number of pressure group members
ϕ	relative risk aversion of wealth
γ	intensity of capitalist spirit
λ	Lagrange multiplier
τ^b	tax on bequests
τ^l	tax on labor earnings
τ^r	tax on capital earnings
μ	relative risk aversion of consumption
$\nu(\cdot)$	utility
θ	survival probability
σ	time preference rate
ψ	social status
ξ	interest rate for intra-family credits

1 Introduction

1.1 Problem definition

A tax on bequests, like any tax on personal wealth, is fundamentally motivated by the aim to counterbalance wealth inequality in society.[1] The question thereby arises, whether bequests to future generations contribute to society's wealth distribution, and hence are justified being taxed, or whether the inequality in wealth can solely be attributed to the inequality in earnings. In Germany, for example, it can be observed that the wealthiest 10% of the population receive 25% of the total income. However, indicating a significant difference in saving behavior, they possess a substantially even higher percentage of almost 60% of the entire national economy's wealth.[2] This distribution is similar in almost all industrialized countries.[3] Recent work has therefore focused on intergenerational wealth transfers, implying widespread agreement that these transfers account for a significant fraction of household wealth. The quantitative estimates, however, vary widely: Kotlikoff and Summers (1981) conclude that roughly 50 to 80 percent of total wealth is generated by gifts and bequests, whereas Aaron and Munnell (1992) or Gale and Scholz (1994) estimate this figure between 25 and 50 percent.

Anticipating that intergenerational wealth transfers convey benefits above the recipients' abilities, the taxation of bequests hence can contribute to achieve equality of opportunities by redistributing wealth within society. Thereby, it mainly affects those individuals who transfer considerable amounts of wealth to future generations.

Thus, as a result, a taxation of wealth transfers, on the one hand, is able to balance the unequal distribution of economic, social or political power. On the other hand, it is considered as a form of double taxation, which undermines the incen-

[1] Whereas in some nations the testator is levied by wealth transfer taxes directly, in others it is the recipient who is charged. Normally, the former is levied by an *estate tax*, whereas the latter pays an *inheritance tax*. However, this distinction is not always respected. For example, the 'inheritance tax' in the UK is a tax on personal representatives, and is therefore, strictly speaking, an estate tax. Both terms are used interchangeably for bequest and wealth transfer taxation in the theoretical analysis of this study. A detailed differentiation is given in Chapter 5.

[2] See Frick et al. (2007).

[3] See e.g. Hindricks (2004) observing data for the United States.

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tive to save, impedes the continuation of family-owned businesses and welcomes strategic tax planning.[4]

The redistributive character of wealth transfer taxation suggests that the more concentrated society's wealth, the more likely and the more intense bequest taxes are. However, it can be observed that almost all developed countries rely extensively on progressive personal income taxation, whereas none derives significant revenue from the taxation of wealth transfers.[5]

Table 1.1: Wealth transfer tax vs. income tax revenues of selected OECD countries in 2007

Share of total revenues generated by ... (in %)	DE	ES	FR	GB	IT	SE	US
bequest taxation	0.48	0.73	1.08	0.77	0.02	0	0.81
income taxation	31.21	33.37	23.86	39.51	33.73	38.74	49.02

Source: Revenue Statistics 1965 - 2007 OECD (2009); own calculations.[6]

Instead of a moderate taxation of all wealth transfers, most OECD countries have resorted to high tax rates levied solely on large bequests. Due to high exemption levels, the larger part of the population is able to transfer wealth to future generations free of taxes, whereas a minority of rich individuals is fully affected by excessive taxation which they naturally seek to avoid. As an outcome, tax revenues are negligibly low, inducing that the taxation of bequests has long been and still is subject to extensive discussion, with supporters demanding much higher taxation and opponents calling for its abolition. At the same time, the economic analysis of an *optimal* bequest tax design arouses growing political interest.

In general, current systems of taxing wealth transfers have been subject to significant and increasing criticism, and deliberations on bequest tax reforms are observable in many industrialized countries.[7] The discussion is basically triggered

[4] See Gale and Slemrod (2000) or Donges et al. (2007).

[5] See OECD (2009) or Aaron and Munnell (1992).

[6] Country names are abbreviated according to two-letter code elements of the International Organization of Standardization (ISO).

[7] A brief outlook: In the US, estate taxes were given a "one year repeal" in 2010 (effectuated by a temporary tax rate of 0%) in order to reintroduce an estate tax, scheduled with higher top rates and reduced exemption amounts, in 2011. In December 2010, President Barack Obama, however, has signed legislation that exempts estates smaller than 5 million US-dollars from the federal estate