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**TAXING MORE (LARGE) FAMILY BEQUESTS:  
WHY, WHEN, WHERE?**

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## **Abstract**

There is a capital taxation puzzle in most developed countries. Since the 1960s, revenues from wealth transfer taxation have been especially low and decreasing as a percentage of GDP, even to the extent of disappearing in quite a number of cases; by contrast, lifetime wealth or capital taxation generates much higher revenues and shows no decreasing trend. The full tax puzzle is certainly not easy to explain. Many usual explanations of the aversion to wealth transfer taxation also imply limited lifetime capital taxation: they cannot justify the very strong collective preference for lifetime capital taxation observed in most countries. On the other hand, capital market imperfections may explain higher levels of lifetime capital taxation, but not the diverging trends of the two components of capital taxation.

We think that a key explanatory factor of the tax puzzle in general and of the growing unpopularity of wealth transfer taxation in particular stems from the rising role of family values and links: the family appears to be the only safe investment nowadays in the face of risky globalized markets and the feared retrenchment of the welfare state. Any realistic reform must take this social and political constraint into account. Most reformist economists think that lifetime wealth or capital taxation could act as quite an efficient substitute for too unpopular taxes on wealth transfers. We offer an alternative solution which recommends heavier and more progressive taxation on family inheritances (only) while allowing for various legal loopholes to avoid the tax. It could hence prompt parents driven by family altruism to increase (early) inter vivos transfers to their progeny and people driven by social altruism to make more charitable gifts and bequests, and would bring in additional and welcome revenues

## Introduction

In most developed countries revenues from wealth transfer taxation have been especially low and decreasing as a percentage of GDP since the 1960s and 1970s, even to the extent of disappearing in quite a number of cases. The growing unpopularity of this tax is a well-known and well-documented fact. Less attention is paid, however, to the much higher and non-decreasing revenues (as a % of GDP) of lifetime wealth or capital taxation. The “puzzle” of capital taxation is therefore twofold: why are revenues from wealth transfer taxation typically a *tenth* or less of lifetime wealth taxation, and less than *one-twentieth* of lifetime capital taxation in a number of countries; and why have the two types of capital taxation shown such *diverging trends* over the last 40 to 50 years. The full tax puzzle is certainly not easy to explain.

The objective of this paper is to gain a better understanding of this tax puzzle and to help solve it by proposing innovative reforms designed to introduce more substantial taxes on wealth transfers.

Section 1 outlines the empirical facts on the tax puzzle and points out that many factors intended to account for the growing unpopularity of inheritance taxation would also imply – wrongly – a sharp decline in lifetime capital taxation.

Section 2 presents an informal theoretical discussion on the elements of the trade-off between wealth transfer and lifetime wealth taxation. On many accounts, inheritance taxation should be preferred as both more efficient and equitable. Only two (series of) factors counter this argument. Firstly, there are capital market imperfections such as borrowing constraints and random and uninsurable rates of return, which may explain higher levels of lifetime capital taxation. Secondly, there are family values and intergenerational links, which may explain an aversion to inheritance taxation.

Section 3 assesses, in that respect, the strengths and weaknesses of the theory of optimal capital taxation. Family aspects are mainly taken into account in the form of bequest motives, which prove to be a key determinant of the rate of optimal inheritance taxation: the stronger the magnitude and form of the altruistic motive for the bequest, the less inheritance should be taxed. Unfortunately, little is known, empirically, about the strength or distribution within the population of bequest motives in general, and specific forms of altruism in particular. On the positive side, there are two conclusions of note: realistic capital market imperfections may in principle lead to sizeable rates of lifetime capital taxation; and lifetime wealth or capital taxation could act as quite an efficient substitute for inheritance taxation

whenever the latter proves too unpopular. Yet reformist economists do not really understand the growing unpopularity of wealth transfer taxation.<sup>1</sup>

In our view, as discussed in Section 4, the problem stems from the fact that the economic literature does not fully grasp the particularity of inheritance, which is better understood by other social sciences. Historical and sociological tradition helps us see inheritance taxation as a trade-off between two contradictory, but incommensurable principles of P1 and Q2: P1 is based on *family morality* values opposed in principle to all family transfer taxation; Q2, based on specific equity and efficient *social justice* considerations, would put a high tax on inheritance, viewed as unearned income that raises inequality in life chances and helps reproduce wealth inequality. The growing aversion to wealth transfer taxation, which does not affect other forms of capital taxation (as much), could then be due either to an increasing role of P1 family values or to weaker Q2 values of social justice, or more probably both factors.

Possible reforms in support of wealth or wealth transfer taxation could then be seen as attempts to solve the P1-Q2 dilemma. Section 5 looks at some of them from that point of view. Our advocated reform is a *Taxfinh* policy, which amounts to taxing (much) more (large) family inheritances. We believe it is the only workable measure that endeavors to reconcile P1 arguments of family values and morality with Q2 principles of social justice, while also taking due consideration of the sharp increase in life expectancy in most developed countries.

By way of an illustration, Section 6 shows why the *Taxfinh* reform, which should create a comparative (tax) advantage for wealth behavior other than leaving large post-mortem family bequests, is especially relevant in the case of France today, where there is too strong a concentration of wealth among the elderly.

## 1. The impending demise of death duty?

A great many puzzles are raised by the empirical facts available on wealth or capital taxation. It is not just that revenues from wealth transfer taxation – defined by the OECD as estate, inheritance and gift taxes – are very low and have fallen sharply as a percentage of total tax revenues in GDP in most developed countries over the last 40 to 50 years at least (§ 1.1). It is also that the revenue of lifetime wealth or capital taxation is much higher and generally displays a non-decreasing trend as a percentage of total tax revenues in GDP over the same period (§ 1.2). Most explanations given in the economic literature to explain these puzzles are not really convincing, either because they cover too long a historical period or

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<sup>1</sup> Even the usual argument of more efficient lobbying today by the rich as they get richer is not entirely convincing: why would such strategies making other people bear policies that go against their own interests have proved so successful for estate taxation and not for other forms of capital taxation?

because they cannot account for the strongly diverging trends in wealth transfer taxation and lifetime capital or wealth taxation (§ 1.3).

### **1.1 Small and decreasing revenues (as a % of GDP) from wealth transfer taxes**

Economic inheritance is probably the leading, and least justified, vehicle for the concentration of wealth and the intergenerational reproduction of inequalities. The paradox here is that wealth transfer taxation yields little in the way of revenues: less than 1% of all tax revenues in the vast majority of developed countries and less than 0.5% of GDP virtually everywhere, with the exception of France (over 0.5% prior to 2007 at least) and Belgium (nearly 0.6%). The fact that governments take such a small cut would appear to point to a clear loss of potential revenues: why not tax wealth when it is transferred in a natural transaction where a change of ownership inevitably takes place?

Worse still, OECD statistics show that the yield of this increasingly disparaged wealth transfer taxation has been on the downturn in most of the OECD countries since the 1960s. Figure 1, for example, shows the growth in the share of inheritance and gift taxes in total tax revenues for a range of countries for the 1965-2010 period. Figure 1a displays the sharp drop observed for the United Kingdom and the United States, where wealth transfer taxation was initially highest. This drop is typical of the trend observed in the Anglo-Saxon countries. Italy and Sweden present another fairly representative case: the scrapping of wealth transfer taxation in recent years (Italy in 2001 and Sweden in 2004). Just to give an idea of this widespread phenomenon, the following is a non-exhaustive list of countries that no longer have wealth transfer taxation (with the date of abolishment in brackets): in Europe and Northern America; Canada (1972), Italy (2001), Portugal (2003), Sweden (2004) Austria (2008), Switzerland (at federal level), and thirty or so American States (since 1980); elsewhere, Australia (1977), New-Zealand (1992), Hong Kong (2005), Singapore (2008), Malaysia and India. It is therefore no wonder that total OECD figures show a sharp downward trend: revenues from wealth transfer taxation have fallen from more than 1% of total tax revenues in the 1960s to less than 0.4% in the last ten years.

So as not to paint too bleak a picture for the advocates of wealth transfer taxation, Figure 1b shows the four main nations that do not display such a downward trend: Japan, Germany, Belgium and France. However, there should be no getting the wrong impression from these exceptions. In the case of France, at least, the relative increase in wealth transfer taxation has been somewhat “inadvertent”: it is due primarily to rare and overly lax inflation-adjusted changes to the tax exemption and tax break thresholds,<sup>2</sup> combined with sharper growth in assets, especially real estate assets, than in income.

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<sup>2</sup> Figure A1 in the annex shows that exemption thresholds fell in real terms by a factor of nearly two and a half from 1960 to 2006 before leaping back up in 2007 to a level comparable with 1960.

Economists are the first to be concerned by this question of low inheritance taxation and the possibility of the impending demise of death duty or the “coming death of the death tax” – a dramatic expression that highlights the growing unpopularity of this tax – especially since the long-run historical statistics show that this has not always been the case. Figure 2, taken from Gale and Slemrod (2001), shows that this tax yielded much more in the United States during the Roosevelt years, especially if gift tax is included in the equation. Moreover, top marginal tax rates remained very high (above 70%) in the US through to 1980.<sup>3</sup>

Likewise, Figure 3, drawn from Bertocchi (2011), plots bequest tax revenues as a percentage of total tax revenues for a number of countries for the 1860-1970 period: Denmark, Germany, Italy, the Netherlands, Norway, and the UK. The peak of bequest taxation is reached around 1910, at more than 18% in the UK and 9.8% in the Netherlands, but less than 4% in the other countries. As the author points out:

“After a temporary plunge in 1920 following World War I, from 1930 we observe a marked, uninterrupted decline in the share of bequest tax revenues in all the countries involved [so that] by 1970, this share across all countries converged to a much narrower 0.5%–2.3% interval”.<sup>4</sup>

Figure A2 in the annex presents the share in the public “budget” of revenues from gift and inheritance taxes in France for the period 1870-1942. This trend confirms the hump-shaped pattern exhibited by other countries in Europe, with a peak around 1910, a temporary plunge in 1920, and a more gradual downturn from 1930.

Interestingly enough, it has been noted that the temporary plunge in inheritance tax revenues in Europe in 1920 went hand in hand with a *rise* in tax rates, especially top marginal rates – although it is unsure whether this increased tax pressure can be explained by the “war mobilization” theory put forward by Scheve and Stasavadge (2011): tax rates increased but the tax base shrunk owing to the devastation of war and capital losses.

## 1.2 Higher and non-decreasing revenues (as a % of GDP) from lifetime capital taxation

The plot thickens when we consider the significant quantitative importance of *lifetime* capital taxation. A broad definition of lifetime capital taxes includes taxes on capital stock (annual property) and wealth taxes, as well as taxes on annual capital income flows: corporate profits, rental income, interest, dividends and capital gains. Piketty and Saez (2012) note that revenues from total capital taxation (on lifetime capital + wealth transfers) currently amounts to an average 9% of GDP in the European Union (out of a total of 39% of GDP in total tax revenues) and about 8% of GDP in the US (out of a total of some 27% of GDP in total tax

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<sup>3</sup> See Piketty and Saez (2012). Top marginal tax rates also topped 70% in the UK from the post-war period through to 1980.

<sup>4</sup> Note that, contrary to Bertocchi (2011), our main interest is in the further drop in the share of bequest and wealth transfer taxation in the subsequent period, over the last forty to fifty years.

revenues). The two authors wonder, “Why do we observe small inheritance taxes and large lifetime capital taxes?”

Table 1, based on Eurostat data on total capital taxation, presents the example of the ratio of wealth transfer taxation to total capital taxation for six European countries over the 2004-2010 period. The ratio for Italy, the United Kingdom, Sweden and Germany is (almost) always below 0.032, such that lifetime capital taxation is at least 30 times greater than wealth transfer taxation! For France, the ratio of wealth transfer taxation to lifetime capital taxation is higher at around 1 to 20, and again for Belgium at approximately 1 to less than 15. Note, in addition, that the relevant figures for the US are around 1 to 32 for 2006-2007!

How have the relative revenues from capital taxation evolved over a longer period? Figure 4 provides the answer for the same six countries as well as for the 17-nation euro zone and the EU-27 (weighted average) over the 1995-2010 period. As a percentage of GDP, the share of capital taxation revenues is at least *non-decreasing*, being higher in 2007 than in 1995 (except for Italy), while the general drop between 2007 and 2009 reflects the deterioration of the tax base following the start of the Great Recession. Admittedly, there is no way of telling from these results the corresponding trend of capital tax schedules, nor the trend of the *effective average rate* of taxation per euro (say) of capital. The latter is a complex outcome of changes in tax exemption thresholds and tax ceilings, tax rates, distribution of capital (especially among the rich when taxes are progressive), avoidance and evasion. Nonetheless, it is still striking that the revenues from wealth transfer and lifetime capital taxation exhibit such diverging trends.

Some economists would object that capital taxation covers too large a tax base, including taxes paid by households and businesses, such that the comparison with tax revenues from households’ wealth transfers seems unfair. What happens if we focus solely on (non-professional) *household wealth* taxation, which excludes taxes on corporate profits and capital, and on business (including self-employed) income?

The difficulty, here, is that few statistics provide reliable data on wealth taxation *as such*. The OECD’s “taxes on property” is, admittedly, an imperfect proxy: it includes net wealth and wealth transfer taxes but also many other taxes, such as taxes that residents have to pay for local services and infrastructure. As claimed by Cremer and Pestieau (2012), this aggregate is probably too heterogeneous to be fully informative in international comparisons. In terms of orders of magnitude and time trends, however, the OECD measure could be hoped to provide sufficient reliable information.<sup>5</sup>

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<sup>5</sup> In France, the *Conseil des Prélèvements Obligatoires* (French Council on Compulsory Levies) produced a comparative study in 2006: revenues from household wealth taxation were estimated at 65 billion euros and OECD taxes on property at 66 billion euros. But this quasi-equality comes about in part by chance, since the two main differences offset each other: French residence tax – *taxe d’habitation* – included only in OECD taxes on property, and the taxation of savings income, included only in wealth tax, yield very similar revenues.

Table 2 shows the ratio of wealth transfer taxation to total wealth taxation, approximated by OECD taxes on property. It covers the same six countries as before and includes the US, Japan and the total for the OECD. The total OECD ratio is consistently less than 0.07 between 2004 and 2010, such that *lifetime wealth taxation* (excluding wealth transfers) is at least 13 times greater than wealth transfer taxation. In the US, the same ratio rose from a value of 12 in 2004 to almost 15 in 2011. Over the same period, it fluctuated between 18 and 25 in the UK, and between 9 and 10 or so in Japan. It increased from 6 to 9 in France and was at its lowest in Germany and Belgium, albeit generally over 5. In other words, wealth transfer taxation typically accounts for less than 10% of household wealth taxation, except in some countries in Continental Europe.

Moreover, there is found to be no decreasing trend in total wealth taxation as a percentage of GDP in the majority of countries since 1965 and especially since 1975 (see Figure 5a). This share shows a slight rise for total OECD and OECD Europe as of 1975, with the proportion increasing sharply for Belgium and France. Three notable exceptions are Germany, the US, and, to a lesser extent, the UK (Figure 5b). Note that the relative weight of wealth taxation rose slightly in the US during the Bush administration years: with progressive tax schedules, the impact of the sharply rising concentration of wealth more than offset the converse effect triggered by the reduction in tax rates.

### 1.3 Why has inheritance tax become so unpopular?

Some historical explanations focus on the long run. This is especially the case with Bertocchi (2011), who talks about the industrialization process and the growing role of labor income engendering a reduction in wealth inequality. Hence the “consequent shift of the tax base from easy-to-tax land to hard-to-tax capital”, implying that bequest taxation has fallen over time (see Figure 3 on the 1860-1970 period). Likewise, the “war mobilization” theory posited by Scheve and Stasavadge (2011) aims at explaining very long taxation trends (1816-2000) and applies mainly to top marginal tax rates, which effectively rose in the US and the UK after World War 1, but not so much in France or Germany. It has been also argued that inheritance tax is an old, increasingly outdated tax challenged by modern taxes such as income tax, social security contributions and consumption tax.<sup>6</sup>

The puzzle we need to solve, however, is: why has wealth transfer taxation fallen so far and become so unpopular over the last forty to fifty years, especially compared with the steady quantitative importance of lifetime wealth or capital taxation?

Many explanations offered in the literature are unsatisfactory in that they are *not* specific to inheritance tax, but can also apply to lifetime wealth or capital taxation. These

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<sup>6</sup> More generally, inheritance taxation might be seen as a problem of secondary importance once a number of other key issues have been “resolved” in modern developed countries: norm of equal sharing, equality of rights of brothers and sisters, and of legitimate and illegitimate children, and right of the surviving spouse (see § 4.4). The full process took some 150 years in France.



explanations include growing international tax competition, prompting a “race to the bottom”, and the anti-Keynesian Great Transformation since the 1970s, working against a strong state and taxation.

We are not alone in feeling this lack of convincing explanations for the decline of estate or inheritance taxation since the 1960s and 1970s. Brülhart and Parchet (2011) claim, in the conclusion to their critique of alleged tax competition between Swiss cantons, that “the case of the disappearing bequest tax remains unsolved”.

We shall see later (in Section 4) that inheritance taxation’s “recent” decline is better explained by two factors. The first stems from changing attitudes to the rich and wealth. Wealth is increasingly seen as a sign of “success” with less concern about where it has come from, whether inheritance or personal merit (Beckert, 2012). More efficient lobbying by the rich to impose such views could be the outcome of increasing wealth concentration (Stiglitz, 2012) and would explain why the dream to become rich one day has greater resonance. The second, more specific factor deals with the family (and existential) dimension inherent in inheritance: the family and its values appear to be the only safe investment nowadays in the face of risky globalized markets and the feared retrenchment of the welfare state, especially since social mobility appears low and education returns problematic.

Whatever the case, note that there are two different possible interpretations for the strong and growing aversion to bequest taxation in most developed countries from a political economy standpoint:

- Lobbying against capital taxation by the rich and the neoliberal school focuses first on the “weak link” in the system, i.e. inheritance tax, before attacking other capital taxes;
- For whatever reason, lifetime wealth or capital taxation has been used as a *substitute* for wealth transfer taxation in most developed countries since the 1970s.<sup>7</sup>

## **2. Taxing wealth ownership or transmission: informal theoretical discussion**

At this stage, it is useful to take a look at the arguments put forward in economic and public debates for and against wealth transfer taxation and lifetime wealth (or capital) taxation. Can we find sound reasons to tax the ownership of wealth more than its transmission? If so, can these reasons explain the tax puzzle described in the first section, namely low, dwindling inheritance tax compared to much higher, steady lifetime wealth taxation?

Let us first disregard the familial and existential aspects of inheritance: family values and intergenerational links, as well as the relationship to (own) death are deemed irrelevant.

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<sup>7</sup> We do not know, however, of any existing detailed empirical and econometric studies that test this conjecture over time and across countries.

In that situation, there are many theoretical reasons for preferring bequest taxation to lifetime wealth or capital taxation (§ 2.1). And many theoretical objections to bequest taxation also apply to lifetime wealth taxation, such that they cannot explain the diverging trends of the two forms of taxation (§ 2.2). The theory of optimal capital taxation suggests then that there is only one key factor in favor of lifetime wealth taxation, that is imperfect capital and insurance markets (§ 2.3).

The family and existential aspects of bequests appear to be the focus of the main objections to wealth transfer taxation, and thus form a further argument in support of lifetime wealth taxation as a possible substitute (§ 2.4).

## **2.1 Reasons in support of wealth transfer taxation over lifetime wealth taxation**

Many arguments put forward in the literature and political debates actually favor inheritance taxation over lifetime wealth taxation, making the empirical tax puzzle even more puzzling. Most of these arguments are typically grouped in two categories, depending on whether they take the angle of the donor or the beneficiary.

### *Donor angle: specific (efficiency) arguments against lifetime wealth taxation*

Lifetime wealth taxation wrongly taxes wealth that is *in the process of being built*, whether for young households' immediate security and use or for long-term investment. However, the wealth of the elderly, which has often become a *rent*, could be taxed more and inheritance taxation increased if needs be. One way of overcoming the problem would be to tax wealth more in old age. Yet *age-based* taxation of wealth or its revenue is only a second or third best solution and might even be unconstitutional: why tax Warren Buffett more than Mark Zuckerberg?

Wealth taxation creates distortions in the intertemporal allocation of consumption, since it changes relative (discounted) prices.

Total lifetime wealth taxation could well come to more than 100% of annual disposable income, especially in the case of residential property with a high market value: when credit constrained, should the property be sold? In addition, it is complicated and expensive to repeatedly evaluate wealth, especially in the case of an annual tax on property.

### *Beneficiary angle: specific (equity) arguments in favor of bequest taxation*

Wealth transfers received are seen as *unearned* income – if not a windfall gain – that has nothing to do with talent, hard work or merit, and creates unfair differences. Indeed, inheritance is a key factor in the inequality of life chances.

Bequests also play a major role in the concentration of wealth and the intergenerational reproduction of wealth inequality.

*Other arguments in favor of estate or inheritance taxation*

Inheritance often goes to incompetent or idle heirs (Mill) or tends to induce laziness in heirs (Carnegie effect) – efficiency argument.

The taxation of gifts or inheritance may be a powerful way to tax “unrealized” (latent) capital gains on property, provided exemption thresholds are not too high.<sup>8</sup>

## **2.2 Common objections to lifetime wealth and wealth transfer taxation**

Many other economic objections to inheritance taxation are equally applicable to lifetime wealth taxation.

The argument that capital mobility and tax or jurisdictional competition for mobile tax bases between countries and governments leads to reduced tax rates is just as strong an argument in the case of wealth ownership as it is in the case of wealth transmission. Brülhart and Parchet (2011) actually cast doubt on the empirical relevance of tax competition arguments in the case of bequests, whether in the US, between states or, in Switzerland especially, between neighboring “cantons”.

Distortions and disincentive effects are expected to be more or less the same for wealth transfer taxation as for lifetime wealth taxation. In any case, measures of the price elasticities of savings and bequests are similar: 0.1 to 0.2 (see Kopczuk, 2010).

Administrative cost arguments are directed more at the way the tax is managed than the actual idea of taxing wealth transfers. Moreover, in the case of inheritance, there are inevitable costs due to the legal act of transmission and the change of property ownership. It is arguably easier to tax wealth when an official transaction occurs than by means of an annual tax on property, for instance.

“Double taxation” is frequently put forward as an argument against savings and wealth taxation in general. It is used especially in the case of bequests on the basis that income and then savings and then again the wealth transfers are taxed. Yet taxes on inheritance are paid by the beneficiary, not the saver, and it seems debatable to then claim that the parents have already been taxed, unless the relevant taxable unit is taken to be the dynastic family. The argument appears more convincing for *inter vivos* gifts, though, at least when the donor pays the tax.

Lastly, there is the well-known argument that estate or inheritance taxation violates the principles of horizontal inequality: for a given estate or inheritance, the amount paid in taxes will depend on the asset structure and tax engineering (Cremer and Pestieau, 2012). This is true, but the same critique also applies to lifetime wealth or capital taxation.

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<sup>8</sup> High exemption thresholds would leave the door open for gifts to be used as powerful leverage for the rebasing of assets held at death to market value for capital gains tax purposes, with the upshot that capital gains tax would not be paid below a certain threshold.

In fact, it starts to look as if the objections to inheritance taxation on the premise of horizontal inequality or double taxation draw their strength from their implicit or hidden association with family considerations.

### **2.3 Imperfect capital markets: a key factor in support of lifetime capital taxation?**

Do economists then have any ways to explain the shift from a one-off inheritance tax to lifetime wealth or capital taxation? The issue is specifically and best addressed by Piketty and Saez (2012).

The two authors refer to *tax illusion*: “People prefer to pay an annual property tax equal to 1% of their property value (or 25% of their 4% annual return) for 30 years rather than pay 30% of their property value all at once when they inherit the asset”. This means that people are in a way “irrational”. The argument can be criticized in that it applies, once again, to a dynastic family with full intergenerational pooling of resources. It ignores the fact that the tax is paid by the beneficiary, not the parent. It therefore looks more like a ploy to explain away an unpopular inheritance tax without mentioning family values and links. Indeed, the reverse could be said to be true; that people prefer to get the taxation over with when they inherit, rather than pay a troublesome tax every year.

Piketty and Saez (2012) actually prefer to put forward another argument: the key and rational reason for the observed collective choice in favor of lifetime capital taxes is rooted in capital and insurance market imperfections, which justify taxes on both latent and realized capital gains. In that respect, they are fairly representative of pro-capital taxation economists.

The argument relies on a certain number of technicalities presented in the following section. The basic proposition states that if people are fully rational, under perfect capital and insurance markets, and also under perfect information (first best), then taxing inheritance and taxing lifetime capital are in a way *equivalent*, at least in a one-period model.<sup>9</sup> Hence, the lead role played by imperfect capital markets in order to explain higher wealth or capital taxation.

We will provide more detail below on these market imperfections, which include liquidity and borrowing constraints, background labor income risk and, especially, random and uninsurable rates of return to wealth over a generation. But the question in hand is whether they can fully explain the empirical tax puzzle discussed in the first section. The issue is twofold:

(i) Can these market imperfections really explain a *very strong* preference for lifetime capital taxation over bequest taxation? What has the theory of optimal capital taxation to say about this (see Section 3)?

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<sup>9</sup> When life-cycle savings are introduced, inheritance becomes preferable to lifetime capital taxation since the latter introduces future consumption price distortions.

(ii) Are they able to explain the *diverging trends* of the two forms of taxation, where inheritance taxes are increasingly unpopular while lifetime capital tax revenues are non-decreasing as a percentage of GDP?

An elaborate capital taxation model might well answer question (i) positively, as Piketty and Saez (2012) believe. Yet the issue raised by question (ii) is likely to pose a tough challenge: the importance and effects of capital market imperfections seem no greater today than forty or fifty years ago. In other words, a dynamic piece of the political economy is still missing from this explanation of the tax puzzle.

## 2.4 Family values and intergenerational links, and relationship to (own) death

We therefore need to explore the *specific* aspects of inheritance tax, namely its family and existential aspects, if we are to clear up the tax puzzle. As the French adage says: *toucher à l'héritage c'est comme toucher à la famille* – “interfering with inheritances is tantamount to interfering with the family”. From that point of view, a series of arguments can be put forward that have the advantage of focusing solely on the taxation of family transfers.

Inheritance taxation has been regularly criticized on many grounds.

First, it is seen as a “virtue tax” on the wealth that individuals accumulate for their children. As Nicolas Sarkozy put it during his campaign for the French Presidency in 2007, “I want 95% of the French people to be exempt from inheritance tax. When you have worked your entire life to build up capital, you should be able to leave it to your children tax free”.

It is also a “death tax”, which compounds the loss of a parent, and prevents the deceased from “living on” through the bequest to the children.

Thirdly, it is a tax on the family business, which could jeopardize the survival of the firm and its management by family members; and it is a tax on the family estate, to whom the family members are attached, and which ensures family cohesion and solidarity.<sup>10</sup>

Lastly, it generates double taxation since parents have already been taxed in their lifetime, and it generates additional horizontal inequality, since it depends on the suddenness of death – being a “sudden death tax” so to speak – but also on how close-knit the family is.<sup>11</sup>

Later on, we will discuss the validity of such arguments (see end of § 3.3): some of them have clearly ideological overtones, while others may have limited empirical relevance. But do they explain the tax puzzle?

(i) They can certainly explain a strong aversion to family transfer taxation and, consequently, a marked preference for lifetime capital taxation.<sup>12</sup>

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<sup>10</sup> More generally, inheritance tax has often been criticized as being an inheritance-grinding machine.

<sup>11</sup> Note, on this last point, that the government is not responsible for insuring (well-off) families against their own lack of harmony.

<sup>12</sup> Most of these arguments could justify an altogether different implication in favor of the tax reform we advocate (see § 5.4 and 5.5), i.e. tax inheritance *much more* than *inter vivos* gifts.

(ii) The family and related arguments above are by no means new: Beckert (2008) shows how their ranking can differ from one country to the next (between Germany, the US and France), but also how it has changed over time within the same country. The sharp downturn in inheritance tax since the 1960s and 1970s can consequently only be due to the *increasing strength* of these arguments, which are deemed more pervasive nowadays.

In other words, the growing unpopularity of inheritance tax is thought to be due primarily to changing and more significant family values and links. Any reform of bequest taxation would have to take this fact or conjecture into consideration.

### 3. Optimal wealth taxation and the family aspect of bequests

Looking at the way the theory of optimal capital taxation could accommodate the tax puzzle described above, the crucial point is to assess how family links and values are incorporated in its models (§ 3.1). Let us remember first, however, the strange turn taken by that theory. Admittedly under very specific conditions, its two reference models lead to zero capital taxation. Both well-known models assume perfect capital markets, perfect information, and homogeneous tastes from the outset:

- Atkinson and Stiglitz (1976) assume a finite life horizon and no inheritance. Wealth accumulation is limited to life-cycle savings. The only source of individual heterogeneity is productivity. Under additional restrictions, a non-linear tax on labor income is optimal; any tax on capital would be redundant.

- Judd (1985) and Chamley (1986) assume an infinite horizon (dynastic altruism). There is no inheritance tax in the long run of the steady state (where social welfare is measured by steady state utility), since the price elasticity of bequests is infinite.<sup>13</sup>

In order to obtain positive inheritance or capital taxation, more realistic models, starting with these benchmarks, would then have to incorporate imperfections in capital and insurance markets and various uncertainties, and/or introduce additional individual heterogeneities, whether observable or not. The simplest extension is thus to introduce observable unequal inheritance received into the Atkinson and Stiglitz model: this would justify a positive inheritance tax.

More realistic models would also have to consider intermediate situations, between purely selfish savings over the life-cycle and the infinite horizon with pure dynastic altruism: namely, finite lives with bequest motives, whether driven or not by family considerations.

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<sup>13</sup> Yet the result does not hold during the transitory period: optimal positive inheritance tax is still possible (Saez, 2002).

### 3.1 How economic theory incorporates family links and values

The family is introduced into intergenerational models of optimal taxation at (just) two different levels of the formalization.

#### *A three-generation family*

We have seen that, on the donor's side, efficiency and family arguments win out over capital taxation, whereas, on the beneficiary's side, equity arguments dominate in favor of bequest taxation. The models reconcile the two conflicting views: each generation is first a receiver of parental wealth and then a bequeather to its own children. The trade-off between the recipient's angle (tax more bequests) and the donor's point of view (tax less bequests) is thus fully taken into account... but operational results are obtained only in the steady state, namely in a long-run, fictitious perspective.

#### *Family and non-family oriented bequest motives*

The literature defines two broad categories of bequest motives, driven and not by family considerations.

Non-family motives include *accidental* bequests due to selfish precautionary motives against lifetime uncertainty in the absence of life annuities: utility depends only upon own consumption. *Capitalist* gifts and bequests are obtained when current wealth is a direct source of utility. Wealth transfer taxation is best justified in these two cases. Note, however, that the two motives presumably correspond to very different wealth strata: accidental bequests should be frequent among low and middle classes, whereas capitalist bequests should be concentrated at the top of the wealth distribution.

Family bequest motives can be driven either by exchange or altruism. There are few usable results in optimal taxation theory in the case of exchange-motivated bequests. The theory has considered different forms of altruism and the results obtained do crucially depend on the specific form considered, since the general conclusion is that the stronger the form of altruism, the lower the optimal tax on bequests (see below). Here is a short list of such different variants of altruism, from weaker to stronger forms:

- Simple *joy of giving*: parents derive utility only from the amount of bequest left. It can be a before-tax or after-tax bequest, whereby altruism is stronger in the latter case (see, for instance, Cremer *et al.*, 2003).

- 'Altruistic' joy of giving: parents derive utility from net-of-tax *capitalized* bequests, taking into account the rate of return on capital receipts for their children (see for instance Piketty and Saez, 2012).

- 'Beckerian' altruism: parents derive utility from their children's utility, taking into consideration the children's own resources.

- ‘Barro’ dynastic altruism: parents derive utility from the consumption of all their descendants, as if they had an infinite horizon (see, for instance, Chamley, 1986).

Of course, these stylized transfer motives have empirical relevance only if their distribution within the population is approximately known... Yet empirical tests of each motive are rather disappointing: for instance, they do not generally find any significant compensatory effects of children’s income on transfers as predicted by Beckerian or dynastic altruism. In short, no one model of altruism presented above appears to be compatible with the available data in the different countries, and the same holds true for the models of exchange-motivated bequests.<sup>14</sup>

### 3.2 Some useful, but limited contributions by the theory of optimal capital taxation

Is this somewhat crude modeling of the family aspect of inheritance enough to derive usable predictions concerning optimal capital taxation? Does it help to solve at least part of the empirical tax puzzle?

In that respect, we shall consider in outline three of the theory’s most important conclusions.

*The closer the intergenerational family links, namely the stronger the altruistic motive for the bequest, the less inheritance should be taxed*

This effect of family altruism as an argument against inheritance or capital taxation is tempered by the opposite effect of the inequality in received inheritance (see below). When the two factors are absent, as in Atkinson and Stiglitz (1976), we obtain zero capital taxation. When we add unequal inheritance into the model, the tax on inheritance is positive. When both factors are present, we again obtain zero inheritance taxation under dynastic altruism (see Chamley, 1986). When only family altruism is present, we should then logically obtain *negative* bequest taxation. This is precisely the conclusion of the two-period intergenerational model by Farhi and Werning (2010), assuming zero inheritance received and Beckerian altruism: bequests should be *subsidized* since they bring utility both to the donor and the beneficiary – “an externality that should be internalized when the transfer is decided upon” (Kopczuk, 2010). Even in the model put forward by Piketty and Saez (2012), assuming ‘altruistic’ joy of giving, a negative inheritance tax is possible where the bequest taste parameter is high enough and the inheritance is not too large or unequal.

This state of affairs is not very encouraging. Tax outcomes will depend on the form of altruism taken but, as we have seen, no one form has sufficient empirical relevance. Moreover, even for a given form of altruism, tax outcomes depend crucially on the value

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<sup>14</sup> See, for instance, Arrondel and Masson (2001 and 2006): three-generation models of bequests where parent-to-child transfers appear strongly influenced by the corresponding behaviors or transmission practices of the previous generation give much more satisfactory empirical results.



assigned the bequest taste parameter. Yet there are no reliable empirical estimates of such preference parameters.

The taxation models do, however, lead to a series of sound recommendations, including the following:

- Tax *inter vivos* gifts less than inheritance: they are presumably more often driven by altruism, are received earlier, when the beneficiary needs them most, since they are more likely to be liquidity constrained; also the ‘double taxation’ argument applies more to the case of gifts, at least when the tax is paid by the donor.

- Tax more *non-linear transfers*, because they are presumably less often driven by altruism.

*The more the inheritance received is observable, unequal and quantitatively important (compared to labor income), the more it should be taxed.*

We have already commented on this general prediction. The authors who go furthest in that direction are Piketty and Saez (2012). Under perfect capital markets, they arrive in the steady state at workable formulas for the optimal bequest tax rate,  $\tau_B$ , at national level. The latter take the following form in the simplest cases ( $\tau_B$  constant):

$$\tau_B = f(B/Y, \text{(inequality of } B), s_B, e_B, e_L),$$

+            +                            -    -    +

where  $s_B$  is the taste for bequest (the propensity to bequeath),  $B/Y$  the ratio of the bequest flow to national income,  $e_B$  and  $e_L$  the price elasticities of bequest and labor supply. Inheritance tax increases with the relative weight and the inequality of annual wealth transmissions – the larger, comparatively, and the more unequal the tax base, the more it should be taxed, other things being equal. Moreover, it decreases with the anticipated taste for bequest  $s_B$ : if  $s_B$  is high and  $B/Y$  low, the tax on bequests can even become negative!<sup>15</sup> Finally, it depends, in the tax mix, on the “race between the two elasticities”:  $e_B$  vs.  $e_L$ .

The authors have also considered the case of non-linear inheritance taxation in order to account for high top marginal tax rates. In any case, such formulas bring to light several national determinants of optimal tax on inheritance. They help to explain why bequest taxation should be higher in one country than in another.

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<sup>15</sup> An interpretation of a high  $s_B$  is that there is a strong hope of becoming rich one day, even in lower social classes.

*The greater the capital and insurance market imperfections, the more (lifetime) capital taxation is justified*

For instance, introducing lifetime uncertainty and very restricted annuity markets into the Atkinson-Stiglitz model generates accidental bequests that can be taxed, theoretically, at a 100% rate. Likewise, introducing borrowing constraints and uninsurable labor income (background) risk into the Judd-Chamley model produces a positive tax on capital income (see Chamley, 2001): this is a way to prompt redistribution from unconstrained wealth-owners to credit-constrained households. Intuitively enough, positive wealth or capital taxation occurs when wealth serves other motives than deferred consumption over the life-cycle and bequest, being for instance a precautionary buffer or a liquidity reserve – or again a source of direct utility for power, prestige or the like.

More importantly, capital market imperfections enable wealth transfer taxation to be disentangled from lifetime capital taxation and hence can reveal the optimal tax mix. They therefore constitute the key (and rational) factor that might address the empirical tax puzzle described earlier. The basic idea is to look for specific capital market imperfections that could justify the observed collective preference for lifetime capital taxation. Piketty and Saez (2012) advance two candidates that seem best suited to this mission.

The first is found in the existence of fuzzy frontiers between capital and labor incomes, especially for the self-employed and top executives who can take advantage of differential tax treatment of labor and capital.

The second, and more powerful, capital market imperfection is due to a random rate of return to wealth over a generation gap (some 30 years): there are unpredictable and uninsurable idiosyncratic shocks to rates of return over such a long period, such that “it is more efficient to split the burden between one-off transfer taxes and lifetime capital taxes”. Indeed, if future returns are characterized by great uncertainty and considerable variations over assets and across individuals, it would be “preferable to impose a moderate bequest tax at the time of receipt combined with an annual capital income tax on the returns”: for sufficiently risk-averse individuals, the reduction in average return could even be offset by the reduction in uncertainty.

In this context, note that ‘capital income’ should be interpreted in a broad sense to include realized or even latent *capital gains* as well as imputed rents for home ownership. Annual property tax is an indirect way to tax latent capital gains and imputed rent. Moreover, taxes on realized capital gains could be extended to taxes on capital gains at the time of death or gift. This brings to light one specific aspect of the trade-off between wealth transfer and lifetime capital taxation: abolition of inheritance tax but reintroduction of capital gains tax at death – and likewise for *intervivos* transfers (see Boadway, Chamberlain and Emmerson, 2010, p. 800-1).

Specific and realistic capital market imperfections could therefore potentially explain relatively high tax rates on lifetime wealth or capital. Yet, as we have already suggested, they cannot account for the full tax puzzle. Why is inheritance tax so low and even disappearing in many countries? The question remains unanswered. Equivalently, capital market imperfections cannot alone explain why the collective preference for lifetime capital taxation over wealth transfer taxation is so strong and has increased so sharply over the last fifty years.

### **3.3 Low and falling bequest taxation: perplexities**

Obviously, an additional explanation is called for to directly address the puzzle of low, falling inheritance tax.

In that respect, even public economists who are strong advocates of capital taxation are bemused: they do not really understand – nor in some cases accept – the growing unpopularity of inheritance taxation, but they do not know what to do about it. This bold and sweeping statement on our part may leave readers skeptical. Yet there is no better way to convince them than to quote the recent writings of some pro-capital taxation specialists.

#### *Quotations from supporters of capital taxation*

Piketty and Saez (2012) condemn the fact that “the zero capital tax result [of standard models] remains an important reference point in economics teaching and in policy discussions”. Indeed, they view:

“The large gap between optimal capital tax theory and practice as one of the most important failures of modern public economics”.

However, their statement concerns capital taxation as a whole (not just inheritance taxation) and they claim to at least partially remedy this shocking situation.

Cremer and Pestieau (2012) focus on the inheritance tax puzzle. The two authors conclude that:

“Our basic goal is to finance government services with a tax that is as efficient, fair and painless as possible. On all counts, it is difficult to imagine a better tax than the estate tax (...).”

Consequently, they see most academic and political attacks against inheritance tax as unfair or dubious... but successful.

Yet Cremer (2010, p. 815-6) has more to say on the conflicting positions in the debate on inheritance taxation. He acknowledges that (our italics):

“Clearly, death taxation more than any other generates controversy at all levels: political philosophy, economic theory, political debate, and public opinion. Opponents claim that it is *unfair and immoral*. It adds to the pain suffered by mourning families and it prevents small businesses from passing from generation to generation. Because of many loopholes, people of equivalent wealth pay different amounts of tax depending on their acumen at tax avoidance. It

hits families that were surprised by death (...). It penalizes the frugal and the loving parents who pass wealth on to their children, reducing incentive to save and to invest.”

However, the same author points out that:

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

This leads him to a somewhat indeterminate conclusion:

“The truth probably lies between these two opposite camps. For economists this tax *like all taxes* should be judged against the two criteria of equity and efficiency to which one could add that of simplicity and compliance.”

The solution would be then to return to the safe methodology of public economics. But as we have seen from the conclusion in the previous paper co-authored by Cremer, this does not lead to realistic predictions in the case of inheritance taxation...

Likewise, Kopczuk (2010) claims that (our italics):

“Despite large body of work on bequest motives, we have little consensus regarding reasons that people have for leaving bequests (...). The optimal estate tax rates at the top of the distribution are likely to be positive but precisely stating this point is *an open issue* (...). [Among] optimal taxation arguments for taxing estates, [those] having to do with redistribution for welfarist reasons are not strong”.

Yet, he shares the

“notion that concentration of wealth, i.e. the situation in which some individuals are ‘big’ relative to the state, has an adverse effect on political process or constitutes a danger to democracy”,

and concludes:

“If there are [such] negative externalities from wealth concentration, then estate taxation could be part of the optimal tax structure. Determining whether such externalities exist is an *ongoing research issue*”.

In other words, the danger of plutocracy justifies the taxation of (very) large estates or inheritances, but nothing more.

In short, even among pro-capital taxation economists, there is a tendency to accept, if not “rationalize” the present state of affairs: bequest tax is too unpopular to be defended, except in the case of the very rich.

### *Efficient lobbying as the rich get richer?*

More specifically, the theory of optimal taxation cannot easily explain the strong and historically increasing aversion to inheritance taxation among people who will never be

affected, themselves or their children, by a tax concerning only the top 2% or less of the US population for instance. This gives any welfarist approach, based upon the maximization of a social welfare function, a problem.

Of course, this is not to say that reformist economists cannot at all explain the growing unpopularity of inheritance taxation. Their understanding of the phenomenon is based upon (informal) political economy arguments. Lobbying by the rich against inheritance taxation has become more and more efficient owing to rising wealth inequality and concentration: as the rich get richer, the more they have to lose from planned redistribution reforms and the more resources they have to resist such attempts (Stiglitz, 2012).

In that line of thought, Piketty and Saez (2012) stress the role of *false beliefs*. In particular, the propensity to bequeath  $s_B$  (see § 3.2) would be way overestimated today by people who dream of becoming rich one day even if they have received little:

“The decline in top inheritance tax rates observed in the U.S. and the U.K. since the 1980s might reflect the fact that more individuals now believe that they have a large probability to leave a high bequest. The dynamics of beliefs might itself be influenced by the evolution of inequality (when the rich have a higher share of income and wealth, it might be easier for them to spread their view in the media and via lobbyists and think tanks)”.

In the same vein, Stiglitz (2012) points out that the rich try to manipulate information and the beliefs of other people to make them support policies that go *against their own interest* – in favor of the rich. He sees estate tax – “that its enemies call the ‘death tax’” – as the most striking (and successful) example of this strategy: under current US legislation, the tax exemption threshold now stands at five million dollars for a single person and ten million for a couple. Stiglitz is especially annoyed by the argument that estate tax in the US has become a tax against family businesses and farms: he recalls that, in 2009 (when estate tax was still higher than today), only 1.6 % of farm businesses paid estate tax and only 1.3% of taxable estates were family businesses.

There is, however, a problem with this defense of estate tax: the anti-taxation strategies of the rich should target lifetime capital taxation as well. Indeed, Stiglitz develops at length the different strategies used by banks and enterprises to avoid or limit capital taxation. The empirical tax puzzle documented in this paper then begs the following question:

- Why have the strategies of the rich proved so successful for estate taxation, and not so much for other forms of capital taxation?

Once again, economists seem to underestimate the particularity of inheritance where family values and intergenerational links as well as the relationship to (own) death play a crucial role. People tend to view inheritance taxation as a tax against their children; they do not believe (anymore?) in the public redistribution that a higher bequest tax on the rich would bring about, nor in the fact that such a bequest tax would alleviate other taxes they have to pay.

In other words, reformist economists are so concerned with destroying the widespread view in academic circles of zero capital taxation that they have come, more or less willingly, to overlook the specific issue of inheritance taxation which raises additional problems. Why is it so? What do they have in mind?<sup>16</sup>

### 3.4 An indirect way to remedy low wealth transfer taxation?

Pro-capital taxation economists have come up with a partial remedy to the (growing) unpopularity of the bequest tax: lifetime wealth or capital taxation could then act as quite an efficient *substitute* to wealth transfer taxation.

A broad or generous interpretation and extension of the results obtained in specific settings, notably by Cremer, Pestieau and Rochet (2003) and Piketty and Saez (2012), indeed reveals a central message conveyed by the recent literature on capital taxation. The latter can be understood more clearly in the form of the following “proposition”:

- If, *for whatever reason* – from unobservability to unpopularity, whether for administrative or political costs, for existential reasons (relationship to death) or family values – the taxation of wealth transfers does not appear to be easily feasible or seems too unpopular, it could be suitably replaced by a rise in lifetime capital taxes.

In the second best world in which we live, lifetime wealth or capital taxation could act as a reasonable proxy for inheritance taxation. In addition, as we have seen, lifetime capital taxation can be justified by strong capital market imperfections and large uninsurable uncertainties (possibly combined with individual heterogeneities).

Lastly, models of optimal capital taxation might consider the low revenues from wealth transfer taxation as an exogenous constraint in the optimization problem for the tax mix. In countries such as France, at least, where wealth-to-income ratios have sharply increased owing especially to rising housing prices, the best candidate to “replace” inheritance taxation could be taxes on latent or realized capital (as well as imputed rents).

## 4. Death, family values, and the intergenerational continuity of property

Yet, this way out for pro capital taxation economists is only *partial*: the reasons why inheritance tax is so unpopular remain unclear, and this issue is indeed recognized in the related literature.

The problem comes from the fact that the *particularity* of inheritance tax is largely underestimated in the economic literature: the objective is still to treat inheritance taxation “like all other taxes” in terms of the two criteria of equity and efficiency, “to which one could

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<sup>16</sup> In support of this interpretation, note that Stiglitz spends only five or six pages on the issue of estate taxation in his thick book *The Price of Inequality*.

add simplicity and compliance”. But this means that a lot of arguments against inheritance tax – such as its being a death duty or a virtue tax – are not dealt with in a satisfactory manner by the theory of optimal taxation (§ 4.1).

However, economic theory cannot be accused of all the ills: we feel that its problem justifying significant inheritance taxation has to do with a more fundamental ambiguity concerning the institution of inheritance itself. To demonstrate this, we need to step back from the economic approach. The informed view of the other social sciences proves key here in answering a twofold question:

- Why is it so hard to justify inheritance tax?
- How should we interpret this tax’s current decline and fall into unpopularity, to the extent that the crushing defeat of its advocates might appear inevitable?

Historical and sociological tradition answers the first question by referring to the two cardinal principles that guided the economic introduction of inheritance. The purpose of the first, denoted P1, is to guarantee the continuity of the deceased’s personal property *via* the family. This principle is based on *family morality* values opposed in principle to all family transfer taxation. The second, denoted P2, ensures this continuity of property by means of the hereditary nature of positions in society. It perpetuates and reproduces the social stratification irrespective of any *efficient social justice*, denoted Q2, which would put a high tax on this inheritance. Inheritance tax is particular in that it is hard to make a trade-off between these two basic principles of P1 and Q2 (§ 4.2), a difficulty that is brilliantly shown by French sociologist Durkheim (§ 4.3).

This great theoretical and philosophical indecision over the socioeconomic role of inheritance in general and the grounds for inheritance tax in particular is reflected in the ambiguous and controversial predictions of the economic optimal taxation models. It points to the answer to the second question by ascribing the current decline and unpopularity of inheritance tax to either the strengthening of P1 family morality values and arguments or the disintegration of the Q2 efficient social justice arguments and principles, or to both at the same time. German sociologist Berckert addresses this question (§ 4.4).

Lastly, note that a number of issues tackled in this paper were discussed by well-known social thinkers back in the 19th century, beyond the family aspect of inheritance tax and the central role of inheritance tax in countering the reproduction of wealth inequality. Marx and Bakunin, in particular, debated the trade-off between lifetime wealth and wealth transfer taxation in 1869 (§ 4.5).

#### **4.1 Appraisal: inheritance tax is not like other taxes**

Piketty (2010) deplores that capital taxation theory, being too abstract and unrealistic, is much less advanced than labor income taxation. Yet even within the field of capital taxes, inheritance taxation comes up against some serious problems.

Economists claim that inheritance taxation, “like all other taxes”, must be judged simply against the two criteria of: efficiency (on the saver’s side), i.e. maximizing revenue in the “least costly” manner – which means taxing wealth transfers more if there is low demand elasticity for bequests and few disincentive effects; and equity (on the beneficiary’s side) in order to reduce wealth concentration and inequality, and to limit inequality of life chances.

Contrary to what public economists say, this research program is hard to conduct owing to the *particularity* of the institution of inheritance with respect to the relationship to (own) death, family links and values, and continuity of personal property:

(i) *Change of property ownership*, associated with death (or transfer): how far does the right of property of the deceased or the donor extend? Is there a “right to inherit” in the family that makes “death duty” seem like a double loss? How can the issue of double taxation be handled in this setting, given that the deceased does not pay the tax? Moreover, apart from administrative costs of taxation, wealth transfers entail, inevitably, a costly legal act.

(ii) Wealth transfers are *unearned* income: this raises a complex equity problem, unless property is said to be collective within the family or at least the lineage right from the outset.

(iii) *Family values and intergenerational links*: the complex efficiency-equity trade-off raised by the successive situations of each generation over its lifetime – first a receiver, then a donor – is “solved” only by economic theory in the long-run steady state. And the literature assigns a key role to *bequest motives*, divided between non-family and altruistic reasons, but can reveal little about the empirical relevance and distribution of such motives (see § 3.2).

(iv) *Unpopularity*: there is apparently a general “aversion” today to any level of inheritance taxation across all social classes, but for reasons that are not very well known. This raises the issues of enforcement, avoidance and evasion – “avoidance” – of inheritance tax: low bequest elasticity (borne out by the accumulation of childless couples) is of little help here, when the tax is so unpopular.

Economic theory has gone some way on these four points, but remains unsatisfactory. Other social sciences (sociology, anthropology, law, psychoanalysis, and history) clearly have a comparative advantage in these matters of death, family values and individual property. The problem is that they have little to say, *per se*, about optimal inheritance taxation.

#### **4.2 The two contradictory, but incommensurable principles of P1 and Q2**

The idea is therefore to incorporate just part, as little as possible, of these other social sciences’ contributions in order to derive – albeit informally – working implications for the design of bequest taxation.

What role should be attributed to economic inheritance, as an institution that is an integral part of society? This means looking back at the two cardinal principles that historically guided the inheritance institution:



- The first, P1, comes from the fact that the individual has a finite existence while society survives him. This meant guaranteeing, *via* the family choice, the temporal continuity for society of the personal property, economic activity and production generated by the deceased. When property is no longer owned jointly within the extended family or the clan – as would be the case in ancient societies – but has become personal, the problem arises as to the social rules that govern the deceased owner’s estate.<sup>17</sup> *Family morality* plays a key role in this context, which praises the savings built up for the children, “his own flesh and blood”, by the sweat of the father’s brow: it refuses to impose such virtuous behavior.

- The second principle, P2, points to how to ensure this continuity of property, at the social level, through the right of inheritance of offices and occupations, titles and positions and, consequently, privileges: economic inheritance establishes the perpetuation and reproduction of social stratification. The institution is hence denounced in the name of social justice, equal opportunities and a necessary redistribution. Q2 *efficient social justice*, opposed to the P2 principle, sees inheritance as an undeserved windfall and a factor for inequalities of opportunity and the concentration of wealth. The inheritance institution is also criticized in terms of economic efficiency, since it does not necessarily select those most capable of managing the goods and encourages heirs to become idle and lazy. In this way, it constitutes a source of unproductive rent.<sup>18</sup> For all these reasons, then, the Q2 principle supports strong and progressive taxation of inheritances.

The problem with making the trade-off between these two contradictory, but incommensurable cardinal principles – whereby P1 is opposed to inheritance taxation and Q2 champions high, progressive taxation – explains the stalemates in the socio-philosophical debates of today and yesteryear, which justified as much the abolition of inheritance as the absence of taxation.

#### **4.3 Durkheim: an impossible trade-off between family morality and social justice?**

This vacillation took a hyperbolic turn when Durkheim stepped into the fray (1900).<sup>19</sup> In his history of family and contractual morality, Durkheim follows John Stuart Mill by stating that inheritance is born of personal property (whereas property was owned by the community in the traditional family). The right to personal property is actually a right to exclude the other from the goods concerned; it is acquired through trade, gift and inheritance.

Trade is governed by the contractual arrangement that now seals the agreement of two wills. Durkheim tracks the historical development of the forms of contract, from the solemn

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<sup>17</sup> This is clearly Mill’s or Durkheim’s view. The terse legal expression “*le mort saisit le vif*” (the estate is vested in the heir the very moment the owner dies) is a good reflection of this absence of vacuum or abeyance in the ownership of goods, even though the process for their ownership (‘appropriation’) by the beneficiary is not self-evident, as shown by the famous psychoanalytical discussions (Freud and Lacan) concerning Goethe’s sentence, “What from your father you’ve inherited, you must earn again to own it straight.”

<sup>18</sup> See § 2.1 for the arguments in support of bequest taxation.

<sup>19</sup> In *Leçons de Sociologie*, pp. 153-241.

(sacred) contract to the consensual, bilateral and freely granted contract. He points out that the accomplished contract form is actually not the free contract, but the equitable, fair contract.

It is in this respect that he criticizes the existence of inheritance: “As long as there are rich and poor by birth, there can be no fair contract.”

The institution of inheritance saps or “contaminates” the very foundations of the contractual system and therefore of a fair society. Intolerance of the fundamental injustice of the right to inherited property was to grow (in the early 20<sup>th</sup> century) with the emergence of a sentiment of increasing, egalitarian human sympathies when it came to those whose lot seemed undeserved. In short, “property begins and ends with the individual,” and we need to work towards a fair distribution of resources according to each individual’s social merits.

You could not dream of a better defense of the Q2 principle in support of high inheritance taxation. Yet Durkheim was equally against the Saint-Simonians, such as Saint-Amand Bazard and Prosper Enfantin, who championed the abolition of inheritance rights. His justification was that, “We work just as hard for our children’s happiness as for our own.” The point is that the right of inheritance “offends” the spirit of justice except when it concerns a direct line where “a sort of conflict sets up between our sentiment of justice and certain deep-rooted family habits.” By the end of the book, therefore, the P1 principle of family morality comes back to the fore:

“The fact is that there would be keen resistance to not being able to leave our goods to our children. [Today (in 1900), where there is] great original inequality at birth, (...), we seek to make this inequality the least possible disadvantage to those we hold dear; we even hope to make it a positive advantage to them [in the face of the danger due to the fact that] some are given a headstart in life, which places those who do not have these advantages in a position of obvious inferiority.”

This clearly shows up an undecidable conflict between the Q2 and P1 principles. To resolve this conflict, Durkheim proposes that, “The father of the family should have the right to leave his children specific shares of his estate [as a source] of inequalities small enough so as not to seriously affect the workings of contractual law.” More importantly, he already – wrongly! – believes that the weight of inheritance and family values will diminish: “The family is constantly disintegrating. It only lasts a certain time. It no longer has the strength to bind the generations together,” and family inheritance is “destined to gradually lose in importance compared with trade.”

#### **4.4. Beckert: can we explain the declining role of inheritance in public debates since the 1970s?**

The broad historical view adopted by sociologist Beckert (2012) is especially helpful to a better understanding of the growing unpopularity of inheritance tax in the light of the P1-Q2 dilemma. The author complains that the issue of the bequest of wealth from generation to generation, which has been,

“A major concern of social reformers since the Enlightenment (...) has lost much of its earlier significance in public debates [and today] stirs hardly any political controversy.”

Indeed, inheritance used to be seen as a key instrument of social reform since there were a lot of problems to “solve”: estate sharing rules (primogeniture, equal sharing or free will); children’s right of inheritance; comparative rights of brothers and sisters, and of legitimate and illegitimate children; the right of the surviving spouse; entails, and progressive estate and inheritance taxation, etc.<sup>20</sup>

In all these areas, Beckert views progress through to the late 20<sup>th</sup> century as increasingly concerned with “equal opportunities, individual freedom, social justice and the viability of the democratic order”. The turning point was perhaps George McGovern’s unsuccessful bid for the US presidency in 1972, when he called for a progressive inheritance tax (up to 100 % for inheritances over half a million dollars):

“Today, interest in the topic has largely vanished and, when the taxation of inheritances is debated, issues of efficient taxation dominate. This is but a small part of the issues involved in the regulation of transfers *mortis causa*.”

The author acknowledges that this radical change since the 1970s is certainly not easy to explain. Aside from standard arguments (globalization and growing aversion to strong state intervention), which cannot explain, as we have seen, the non-diminishing trends of lifetime capital and wealth taxation, he points out two key changes:

- The first change points to stronger P1 values:

“Attempting to protect one’s offspring from the vagaries of the market through inheritance is an individualized reaction to social conditions which expose actors to more and more insecurity. The taxation of inheritances is not perceived as a means of securing the provision of opportunities socially, but as a further threat”.

- The second change prompts weaker Q2 values:

“There seems to be a tendency for the distribution of wealth to find legitimation even if it is not based on achievement resulting from individual performance. Instead, ‘success’ (...) is the category according to which wealth and social status are allocated. Societies seem once again willing to allow prosperity to be disconnected from individual performance (...). It seems that structures that reproduce social inequality are much less a normative problem for the average person.”

Beckert does not try to rank these two explanatory factors. Note that reformist economists such as Stiglitz (2012) and Piketty and Saez (2012) place a strong emphasis on the weakening of Q2 values due to lobbying by increasingly powerful rich people, while saying almost nothing about the rising role of family values. We would rather rank first the changes

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<sup>20</sup> In this historical context, it is no wonder that Tocqueville wrote that the question of inheritance was so important to a society’s development that when, “The legislator has once regulated the law of inheritance, he may rest from his labor”; likewise, John Stuart Mill saw inheritance law as the most critical area of law, equaled in significance only by contract law and the status of workers – see Beckert (2012) for references and details.

in P1 values: the family appears increasingly as a safe haven against growing insecurity and declining economic growth: it reflects waning trust in capital markets, the Welfare State, returns to education, and possibilities for upward social mobility.

#### 4.5 A digression: the Marx-Bakunin debate on the right of inheritance

It is interesting to note that the debate between Marx and Bakunin at the Basle Congress of the First International (1869) shows that these P1 arguments of family morality were important even for socialist thinkers in the 19<sup>th</sup> century.

Cunliffe and Erreygers (2010) point out that the two thinkers agreed on many points. They considered that the *right to give* (and to squander) one's goods was most tolerable as an extension of the owner's right to property in his own lifetime, even if it had to be limited by redistribution imperatives. However, the *right of bequest* in all freedom was most reprehensible, since the deceased's desire to dispose freely of his goods is tantamount to an unjustified "legal fiction" that restricts the freedom of the living and jeopardizes family unity and cohesion. The father of the family was not a patriarch by divine right, "who had absolute discretion over the transmission of household property and could disinherit his children". As in the German right of inheritance, it was highly preferable to treat "an estate as a sort of co-proprietorship of which the father of the family was the manager; when this manager died the property fell to all the children". In short, "Whereas the right of bequest was seen as weakening the family unit, the right of inheritance was seen as strengthening it."

The focus of the debate concerned precisely the *right of inheritance* – reserved for children. Although "it was recognized as serving as an incentive to [parental] labor, to provide for [some needy] children, and as promoting the family unit as a cross-generational entity", Bakunin maintained that it was a *primary cause* of social inequality, that it was responsible for the perpetuation of inequality, the maintenance of class differences, and represented a permanent source of exploitation; therefore he called for its abolition "with an exception for personal goods of small value". Marx, however, considered the right of inheritance to be the *effect* rather than the cause of the existing economic organization, a symptom of the unequal distribution of private property that would wither away with collective ownership. Although he recommended, only as transitory measures, both higher inheritance taxes and a limitation of the right of bequest, he claimed that the abolition of the right of inheritance could "never be the starting-point of the [required] social transformation".

The central issue addressed in this paper, focusing on the level of inheritance taxation and the crucial trade-off between lifetime wealth and wealth transfer taxation, can be viewed as a distant echo of the Marx-Bakunin debate.

## 5. Possible reforms in support of wealth or wealth transfer taxation

Reforms designed to increase the taxation of wealth transfers could be seen as solutions to the P1-Q2 dilemma. Is it possible to circumvent P1 arguments advocating family morality, or to reinforce the Q2 criteria of efficient social justice? Are there ways to reconcile the two antagonistic principles?

The first solution relies on capital taxation as a substitute to bequest taxation: to a certain extent, it is the route taken by Sweden and Canada (§ 5.1). The other three are attempts at a higher taxation of bequests despite its present unpopularity: in order to meet this challenge, these reforms – which have never been fully implemented – have to tell “acceptable stories” to justify new designs of bequest taxation that differ from a simple uniform rise in tax rates on all wealth transfers. They propose either to tax more the part of bequests that can be traced back to the inheritance bestowed by own parents (§ 5.2), or to consider wealth transfers received as an additional resource subject to a progressive income tax (§ 5.3), or even to tax more bequests at death – provided it is not “sudden” death (§ 5.4).

### 5.1 Use higher lifetime wealth or capital taxation as a substitute to bequest taxation

P1 objections and the unpopularity of the wealth transfer taxes are viewed rather as a *constraint* in the optimal taxation problem that should otherwise be driven, as far as possible, by Q2 considerations. For lack of a better alternative, only the bequests of the very rich will be taxed.

For a lot of pro-taxation public economists, especially from the “French culture” (Piketty and Saez, 2012; Cremer and Pestieau, 2012; Allègre, Plane and Timbeau, 2012), as well as Boadway, Chamberlain and Emmerson (2010), bequest taxation can be efficiently replaced by lifetime capital taxation. There are good specific reasons, as such, for taxing lifetime capital, and especially *capital gains*: they are due to capital market imperfections, such as an uninsurable total rate of return to wealth over a generation gap (see § 3.2).

In a way, this view can be seen as a distant throwback to the Marxian point of view (see § 4.5). The objective is not to tax bequests *per se*, but to reduce the quantitative importance of the bequest in the long run. For that purpose, lifetime capital taxation can be very effective.

We have seen that there are two crucial problems with this solution:

- First, how to distinguish between rent-seeking wealth and productive investment capital? The composition of wealth is not always informative in that respect, at least for a tax base. Taxing wealth or its returns according to *age* is not very satisfactory and may come up against serious constitutional problems due to age discrimination – once again, why tax Warren Buffett more than Bill Gates?

- Second, and more importantly, wealth taxation ignores the origin of wealth, whether inherited or self-accumulated, due to inheritance, life chances, or personal merit and effort.

In other words, lifetime capital taxation does not fully satisfy the Q2 criteria, at least in the short to medium term.

## **5.2 Tax bequests according to their origin – inheritance or personal savings**

A natural way to remedy the shortcomings of the previous solution would be to tax inherited bequests much more than self-accumulated bequests. The measure, which has been proposed by Rignano (1901) and more recently by Nozick (1989), may be viewed as the implications of (extensions of) the Atkinson-Stiglitz (1976) model. It would notably prevent wealth from cascading down the generations.

This measure has the key advantage of *reconciling* family morality with efficient social justice. It would acknowledge parents' efforts and "sacrifice" for the sake of their offspring (P1) while avoiding the constitution of dynasties of "rentiers" – who lived on their private income (Q2).

There is only one problem: the breakdown of *individual* wealth between "inherited" and "self-accumulated" wealth is virtually *impossible*, at least for tax purposes, owing to the complex and idiosyncratic interactions of the two alleged components of wealth over the lifetime of their owner.

Notwithstanding this impossibility, Nozick's proposal remains a stimulating idea. In any case, the breakdown could be applied at the macro, national level: the more existing wealth has been inherited, the more wealth transfer taxation is justified (as well as lifetime capital taxation).

## **5.3 Do not directly factor in family values and intergenerational links**

P1 arguments based upon family values and intergenerational links are simply considered to be irrelevant for the design of optimal wealth transfer taxation.

Historically, advocates of the abolition of inheritance – a rather extreme variant of this view – put forward a number of reasons that were not always anti-familialist (see Cunliffe and Erreygers, 2010). Where Gracchus Babeuf viewed the inheritance of the property of the deceased by his family as a "great horror", Saint-Simonians were more concerned with the fact that inheritance was a "blind" way of redistributing the means of production among the members of society. And Bakunin did not criticize the "natural family" based upon "human respect and freedom" – instead the crushing powers of the state –, but only the "juridical family based upon personal inheritable property": the family should remain the basic cell of the society, but would no longer be institutionalized as the privileged vehicle of the perpetuation and reproduction of wealth inequality and concentration.

Nevertheless, the P1 arguments of family morality have now become so pervasive that any inheritance tax proposal that ignored them could sound very utopian today. This is not necessarily the case, however.

The best counter example is the concept of *social inheritance*, advanced by 1976 Nobel prize winner James Meade (1964), and later echoed by John Rawls (2001). Inheritance (as well as gifts) received is simply viewed as an *additional income for the beneficiary*, an additional (lifetime) income that should be taxed according to a progressive income tax<sup>21</sup>. On the other hand, this specific inheritance tax is surprisingly combined with complete freedom to bequeath for the donor – a liberal position. The donor has then only one means to reduce the taxation on his estate: disperse his wealth among a sufficient number of beneficiaries with limited *ex ante* income. This is what social inheritance means: a certain redistribution of wealth will regardless take place, whether it is made by the wealth owner himself or by the state.

Note that Meade’s proposal to tax wealth transfers more aggressively in order to reduce the inequality of life chances also leads, by compensation, to lower lifetime taxes on “new”, self-accumulated wealth, presumably due to merit and effort.

#### **5.4 The *Taxfinh* design: more tax on (large) family inheritances or *post-mortem* bequests**

In some countries, as in France, many senior citizens own comparatively large amounts of wealth, which may serve first for life-cycle or precautionary motives – given, in particular, the perceived future uncertainty of the welfare state. These amounts are, allegedly, also accumulated for altruistic reasons. Yet if that considerable wealth is kept by the elderly parents until their death, it increasingly becomes a rent and is received by their children in their fifties or even sixties nowadays, when the latter need it the least. Moreover, this concentration of wealth among the elderly has a tendency to reproduce itself over time (see the annex for France, Figures A5 and A6).

This situation is clearly inefficient both at the level of the parental generation and that of children. In addition, it is inequitable, since some children receive large (weakly taxed) inheritances, while others receive little or nothing.

To avoid this suboptimal situation, the solution should be, both on efficiency and equity grounds, to tax (much) more (large) family inheritance; hence the *Taxfinh* design. The progressivity of the tax is also justified by the fact that low- and middle-class parents do not make *inter vivos* transfers: gifts are a luxury good (see the annex for France, Figure A4). Note, incidentally, that the objective is not, as such, to give a comparative tax advantage to gifts over *post-mortem* bequests, as has been often done historically – generally by easing tax on gifts. It is rather to create strong *disincentives* to the transmission of wealth at death: for

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<sup>21</sup> Note that Meade ignores that this supplementary income is moreover unearned (which would justify a still heavier taxation), but also that it comes from the beloved parents (which would justify a lower taxation).

equity reasons, the tax on family gifts may even (moderately) increase, provided it remains much lower than that on family inheritances.

*Why* introduce this new *Taxfinh* fiscal system *now*? Because there has been an unprecedented historical change, namely the sharp increase in life expectancy in most developed countries. Combined with the parallel increase in the rights of the surviving spouse, this change means that full property of inheritance is received on average in our fifties, which is much later than before, be it merely forty years ago.<sup>22</sup>

This *Taxfinh* design does not, however, have universal relevance. *Where* or *when* should this fiscal system be preferably introduced? The previous discussion (see Piketty-Saez, 2012, and Nozick, 1989) shows that it would be most appropriate in countries found to have a series of features, which we shall call the *F-factors*:

- A heavy (and increasing) weight of an annual flow of bequests relative to GDP;
- A strong (and increasing) inequality in wealth transfers;
- A large (and increasing) share of “inherited wealth” in total wealth to the detriment of wealth due to own effort or merit;
- A strong (and increasing) concentration of wealth among the elderly at the expense of younger households.<sup>23</sup>

This new *Taxfinh* system moreover calls for increasing the range of opportunities for (well-off) parents to sidestep inheritance tax other than by making earlier gifts to children. One possibility is by fostering the development of *charitable* bequests or (preferably) gifts benefitting from partial or total tax exemptions. To encourage these donations in countries such as France would then call for an increase in the freedom to bequeath *outside* of the family, be it only for donations to duly registered charity works and foundations; the ‘family’ part of the bequest should still remain above a minimum given threshold and would still preserve the children’s “right to inheritance” and to a reserved portion of the estate (see Arrondel and Masson, 2012).

The *Taxfinh* system would still allow (and lead) people to look for other ways to avoid post-mortem family bequests: long-term care insurance; reverse mortgage or life annuity contracts (*viagers*) where the capital received could be directly transmitted to the children, etc. In order to be fully effective, this fiscal system should then be backed up by a sustainable (and sufficiently generous) welfare state and efficient insurance markets for old-age protection. Otherwise, the stepping up of capital transfers, within or without the family, could be curbed by concerns over the future of the state pension and health systems or by the desire by seniors to protect themselves against the risks of old age.

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<sup>22</sup> The rise in the intergenerational age difference has exerted only a limited offsetting effect towards a younger age of the heirs.

<sup>23</sup> To give a counter-example: it is possible that Sweden, say, does not meet these *F*-criteria. If this is indeed the case, lifetime capital taxation might be altogether preferable, justifying to a certain extent the choice of that country to rule out any wealth transfer taxation.



### 5.5 The philosophy and pitfalls of the *Taxfinh* system

The philosophy of the *Taxfinh* reform appears then more clearly. Taking somewhat of a “revealed preferences” approach, it endeavors to reconcile P1 arguments of family values and morality with Q2 principles of social justice. Large inheritances received from (elderly) parents will be severely taxed. Yet well-off parents driven by family altruism have a number of legal ways at their disposal to sidestep the heavy inheritance tax by making *inter vivos* transfers to their offspring: the earlier these transfers are made – when the children need it most –, the less they will be taxed: the family is hence treated more as an ally than an enemy. Moreover, (wealthy) people driven by “social altruism” may also sidestep the family inheritance tax by making charitable gifts and bequests. Lastly, the limited amounts on bequests left by low- or middle-class parents will be lightly taxed – whether prompted by precautionary or altruistic motives.

Of course, the problems raised by the introduction of a *Taxfinh* reform should not be underestimated. Let us briefly mention some of them:

- At the moment the reform is introduced, elderly people who do not want to make charitable bequests will have very limited options to react: at 90 years old, it is too late to make gifts that will appear as early inheritance, or to buy long-term care insurance, acquire a reverse mortgage, or again to sell the house in return for a life annuity (*viager*); some transitory clauses could be included.

- Sudden death may also be an issue, despite the fact that the full transmission of property to children often occurs only at the death of the surviving parent; age controls should be introduced.

- Although gifts are a luxury good, they will not be taxed as heavily as inheritances – a left-wing critique. Yet much heavier taxation on *all* wealth transfers could be seen as an excuse to do nothing: such a radical reform will not secure sufficient political support. Moreover, the heavier taxation on family inheritances will secure precisely the comparative tax advantage sought for gifts without having to reduce the tax on gifts.

- Horizontal inequality between families with comparable (high) wealth will be reinforced – a right-wing critique. This is perfectly true: in some families, liquidity-constrained children will receive lightly taxed early gifts that will help them a great deal in the fulfillment of their family and professional projects (home purchase and business start-ups); in other, less altruistic families, they will have to wait until their sixties to receive an inheritance greatly reduced by taxation. Yet, once again, the state cannot insure the children of well-off families against the lack of altruism on the part of their parents.

We think that these difficulties can be overcome. In countries suffering from the *F* factors – in short, a high and increasing share of strongly unequal “inherited wealth” with a concentration of wealth among the elderly –, the implementation of a *Taxfinh* reform appears

at first sight highly welcome, either because government revenues would be boosted by inheritance tax, or because the generational imbalance would be reduced somewhat by the increase in early family transfers, or again because private initiative would alone make investment deemed in the public interest and aimed at the most underprivileged.

## 6. The *Taxfinh* bequest tax at work: the example of France

In France today, the *Taxfinh* reform should create a comparative advantage for wealth behavior other than leaving large post-mortem bequests. It is expected to prompt household responses in the form of avoiding over-saving in old age and transferring family inheritances too late. It should reduce the large concentration of wealth among the elderly, curb the growing weight of wealth transfers to GDP (see Piketty, 2011), and could potentially reduce inter-age, social and life chances inequalities at the same time.

Yet the new *Taxfinh* reform should be viewed as an *experimental* design with implications that will depend on agents' behavioral responses. Tax incidence may not be a major issue here, since families are offered a range of options to sidestep the heavier inheritance tax. However, we do not have any really accurate information on the mix of the *Taxfinh* reform's three potential effects: What proportion of additional tax revenues will it bring in? How far will it increase and speed up the circulation of wealth to successive generations through *inter vivos* transfers? And to what extent will it foster charitable bequests? The cocktail remains unknown.

With these questions in mind, we shall focus on two issues raised by the *Taxfinh* system, taking France as an example (see Arrondel and Masson, 2012):

- Do French seniors respond to tax incentives for earlier transfers by substantially increasing the sum of gifts to their children? (§ 6.1);
- Do early transfers significantly facilitate children's plans to buy housing, start up a business, and so on by easing the recipient's cash constraints? (§ 6.2).

### 6.1 Do French households respond to tax incentives for early transfers?

Do senior households take advantage of a differential in the tax treatment of estates and gifts? In the US case, Bernheim *et al.* (2004) and Jouflaian and McGarry (2004) show that the frequency and amount of gifts compared with inheritance is highly sensitive, over the short run, to the relative tax breaks on gifts compared with bequests and inheritance. At the same time, Poterba (2001), McGarry (2001), and Jouflaian and McGarry (2004) claim that most US households fall far short of benefiting from the advantages of gifts to the full extent permitted by law – a significant number do not even make the most of US annual gift exemption. This is evidence that parents see wealth gifts and bequests as substitutes, but only

*partial* substitutes on average. There are a number of reasons for this: uncertainty over future health and longevity, desire to supervise children and have the last word, etc. Moreover, Kopczuk (2010) points up potentially substantial behavioral heterogeneity all the way up the social ladder. The extent of *inter-vivos* gift responsiveness to tax considerations is presumably much higher among well-off households.

All in all, we obtain very similar empirical conclusions across France. Arrondel and Laferrère (2001), for example, use estate data to show that the probability of gift-giving depends on the amount of wealth but especially, for a given level of wealth, on *taxable* wealth.<sup>24</sup> Arrondel and Masson (2012) obtain similar qualitative results from a different angle, drawing on various sources covering a long period – INSEE survey data and estate data, along with more recent US-style annual gifts (called “Sarkozy” gifts). We find that French households’ transfer practices have responded positively, in the short and long run, to tax relief on gifts: the efficiency of tax incentive measures has been considerable, albeit far from being as high as predicted by pure parental altruism. Lastly, we are likely to find strong heterogeneity across households’ responses. Gifts are more often made by farmers and other self-employed parents to farmers and other self-employed children – being used as a preferred means of ensuring an efficient transmission of professional assets (see Figure A3 in the annex). Gifts are otherwise concentrated among well-off households (see Figure A4).

## 6.2 Are early transfers useful to their beneficiaries?

In an ideal world, capital transfer timeframes would have little effect on the behavior of beneficiaries, who could always borrow at the market rate based on what they expect to inherit. In the real world, legislators and many donor parents try to help along young beneficiaries’ integration plans – forming a family, entering the world of work, and building capital (housing purchase) – by giving them “a leg up”.

Economists identify two cases at either end of the scale. The first, called the Carnegie Effect, is when the transfers received drive up current consumption only and may even prompt a downturn in the labor supply – why bother working when you can live off private income? Taking US data, Holtz-Eakin *et al.* (1993) have indeed found that large inheritances reduce labor force participation and even labor supply when participation is unaltered.<sup>25</sup> The opposite case is when an early transfer of assets furthers the young beneficiary’s longer term integration plans – be it a housing purchase, forming a family, a stable occupation or even a business start-up – by lifting credit constraints or providing the capital investment needed.

Based upon the biographical and recall data collected in INSEE’s 2004 *Patrimoine* (Assets) Survey, our previous study clearly finds that the second option is the case, arguing in

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<sup>24</sup> France has an exemption threshold on inheritance tax such that taxable wealth depends on the amount of wealth, but also on marital status and the total number of children.

<sup>25</sup> “For example, a single person who receives an inheritance of about \$150,000 is roughly four times more likely to leave the labor force than a person with an inheritance below \$25,000.”

favor of early transfers both for home purchases – on one’s own – and business start-ups and takeovers – non-family-run (see Arrondel and Masson, 2012).<sup>26</sup>

The still richer data set collected by the recent 2010 INSEE *Patrimoine* Survey is used to take the analysis a step further, by applying discrete time duration models for both home purchases and business start-ups and takeovers (see Arrondel, Garbinti and Masson, 2013).

These data show that intergenerational transfers enable their recipients to accomplish or advance their capital project. In general, financial help and particularly gifts received have much more of a positive effect on the accomplishment of the investment project considered than inheritances received and, especially, expected inheritance.<sup>27</sup>

#### *Early transfers foster first-time home ownership*

The estimated effects take into account a range of household characteristics in addition to the receipt of intergenerational transfers: income, expected inheritance, socioeconomic group, qualifications, presence of living parents, marital status, existence and number of children, etc. The purpose of this is to compare households that are differentiated only in terms of whether or not they receive an intergenerational transfer (excluding the usual residence).

Let’s take the case of a reference household with the following characteristics: a couple wherein both partners work, the parents are still alive, and the household head has two years of higher education. This couple receives no transfers from their parents.

We find (see Figure 6) that the cumulative probability of this household buying its own home when it has not received a transfer is 25% before 30 years old, 57% before 40 years old and 78% before 50 years old. Where the household has received a gift, the probabilities are found to be 39%, 76% and 92% respectively. The effect is similar, but less marked, between heirs and non-heirs: the respective cumulative probabilities are 34%, 71% and 89%. The role of one-off gifts of money is non-significant and the effect of expected inheritance is limited.

The positive influence of the different forms of wealth transfer on home ownership is therefore proven, with a particularly strong impact for gifts. The most important effects, however, are due to the usual covariates such as own resources, family composition and place of residence.

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<sup>26</sup> It is even close to the ideal situation for the purposes of our demonstration where the expected inheritance (“inheritance expectations”) has a negative effect on the accomplishment of the investment project considered, the inheritance already received has a fairly positive effect, and the financial help or gifts received have a much greater positive effect.

<sup>27</sup> We estimate duration models in order to measure the effect of intergenerational transfers on the probability of becoming a home owner and becoming an entrepreneur at the different ages. These models are the most suited to analyzing this type of event. Two variants are used. The first, standard approach is the Cox proportional hazards model. The second, more original approach is a “split” model that simultaneously analyses the probability of the event occurring over the period and, conditional on this decision, the person’s age at its occurrence. This second specification is more in keeping with the question put, since not all individuals are going to become self-employed for example. It is this specification that we use to present the findings.

### *Gifts received help with business start-ups and takeovers*

Do early intergenerational transfers foster business start-ups and takeovers (other than the family-run business)? Based again on the 2010 INSEE *Patrimoine* Survey, we test this assumption on a sample of non-farmer individuals aged 18 to 60 – the most likely to become entrepreneurs. The statistical methodology is the same as that used in the case of buying a first home. Our reference household is the same as previously, with the only difference being that the parents are or were wage earners.

Of all the different transfers (one-off gifts of money, regular transfers of money, loans of money, gifts and inheritance), only receiving a gift fosters the transition to become an entrepreneur. The probability of starting up or taking over a business before 30 years old without the help of a gift is 5.7%. This probability rises to 7.8% for gift recipients. Before the age of 50, the cumulative probabilities are respectively 19.2% without a transfer and 24% with a gift (see Figure 7).

These gift effects naturally need to be put into perspective since, for a given level of resources, other factors play a more important role. For example, sons and daughters of entrepreneurs have a much higher probability of starting up their own business than children of wage earners (Arrondel, Garbinti and Masson, 2013).

All in all, the 2004 and 2010 survey data lead to similar conclusions: the transfers received, especially gifts, help children set up home and become entrepreneurs. The more thorough methodology used in the case of the richer 2010 survey data shows, moreover, that the earlier the transfer, the greater the effects since the transfer lifts the credit constraints on the youngest households.

## **Conclusion**

Low and declining revenues from wealth transfer taxation over the last 40 to 50 years give pro-taxation reformers a tough challenge. We attribute this growing unpopularity first to the rising role of family values and links: the family appears to be the only safe investment nowadays in the face of risky globalized markets and the feared retrenchment of the welfare state, especially since social mobility seems low and education returns problematic. Any realistic reform must take this social and political constraint into account: it has to tell an acceptable story in order to justify a new design of bequest taxation that will necessarily differ from a simple uniform rise in tax rates on all wealth transfers.

We think that the *Taxfinh* design offers a suitable solution in that respect. It recommends heavier and more progressive taxation on family inheritances while allowing for various legal loopholes to avoid the tax. It could hence prompt parents driven by family

altruism to increase (early) *inter vivos* transfers to their progeny and people driven by social altruism to make more charitable gifts and bequests.

To give an idea of the types of figures we are talking about, in France, the annual flow of wealth transfers has risen to more than 200 billion euros, or 10% of GDP, from less than 5% of GDP 30 years ago (see Piketty, 2011). Revenues from wealth transfer taxation stand at roughly 10 billion euros or less, corresponding to an effective average tax rate of 5%. Raising this tax rate to 10% would not destroy family wealth. Yet it would already bring in additional revenues of 10 billion euros every year.

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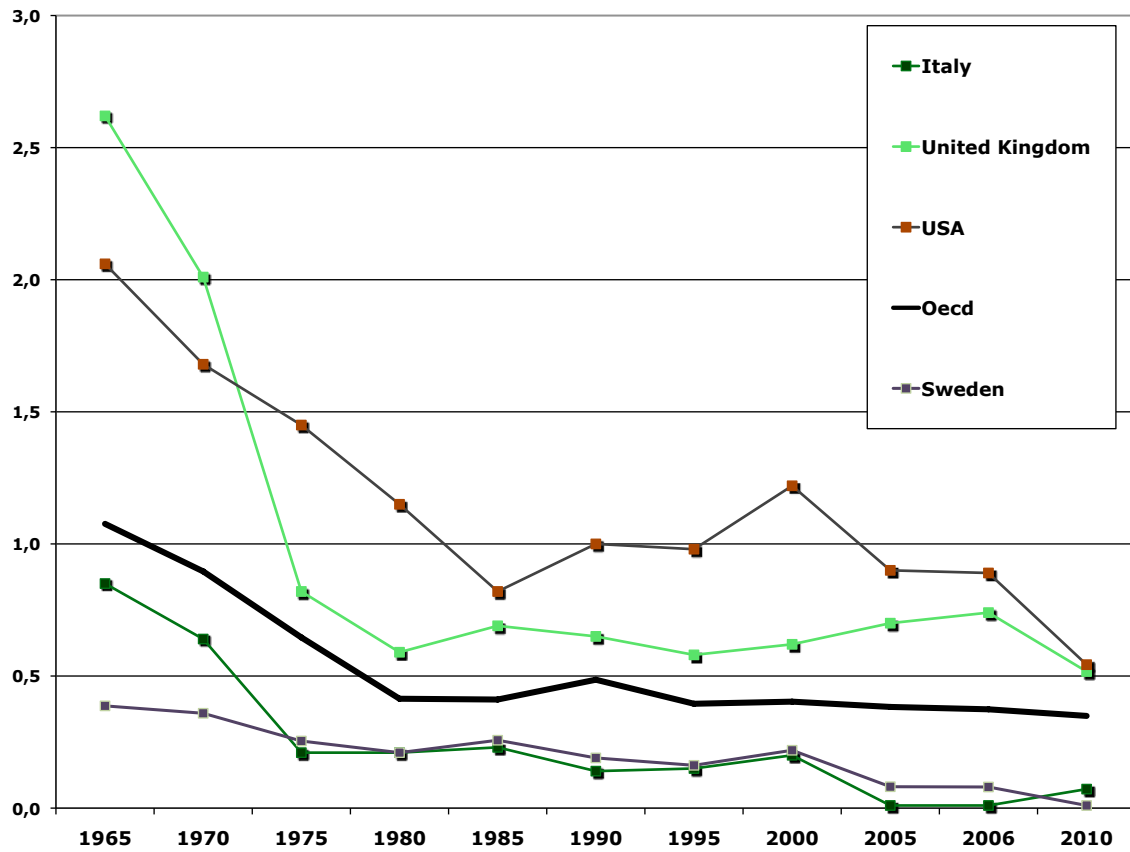
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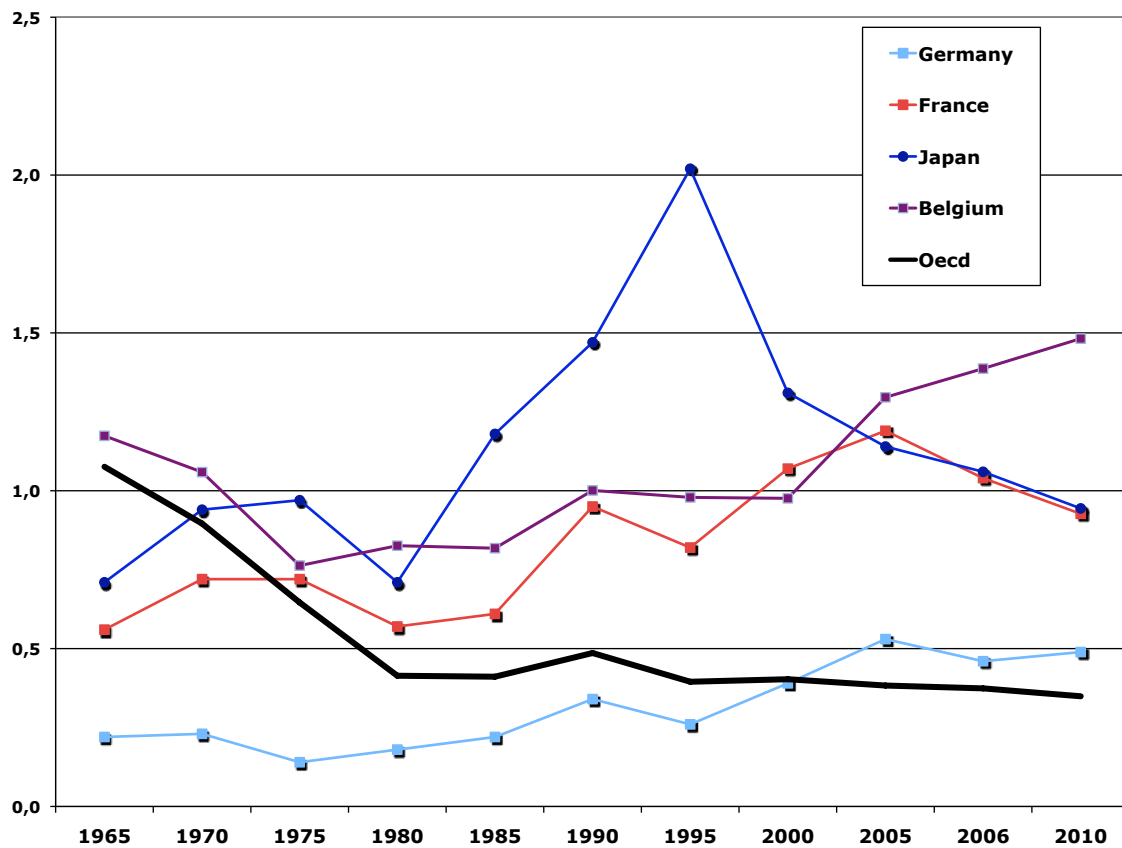
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**Figure 1a: Estate, inheritance and gift taxes (% of total tax revenue)**  
*A decreasing trend for a majority of countries*



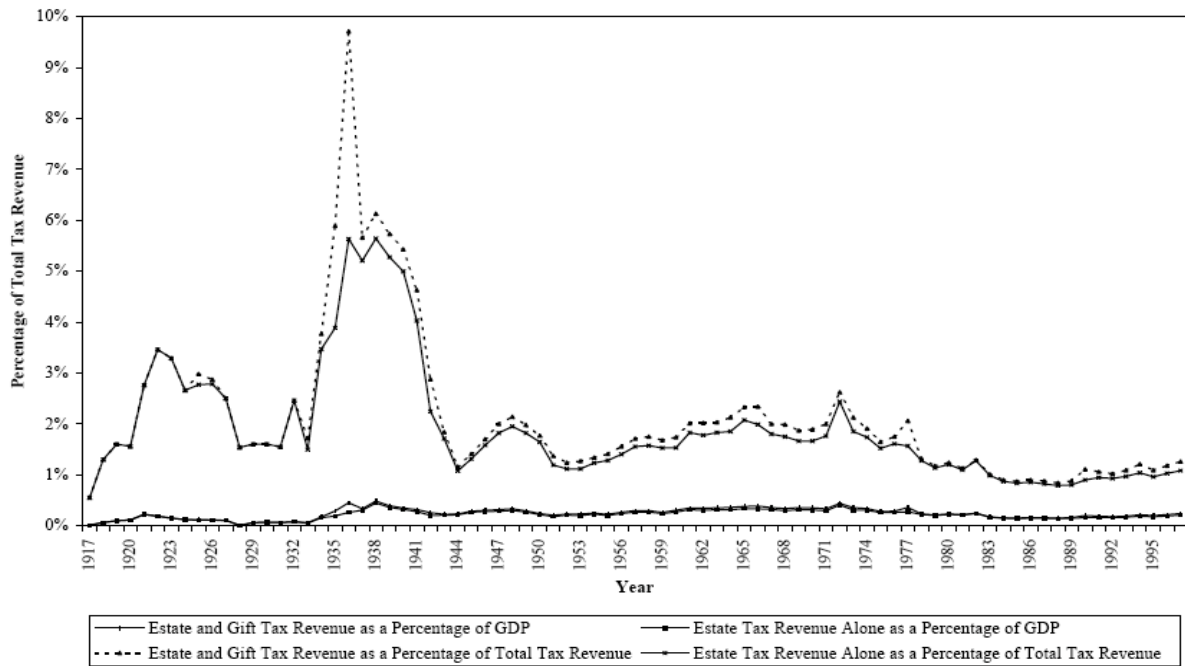
Source: OECD

**Figure 1b: Estate, inheritance and gift taxes (% of total tax revenue)**  
*Four exceptions with a non decreasing trend*



Source: OECD

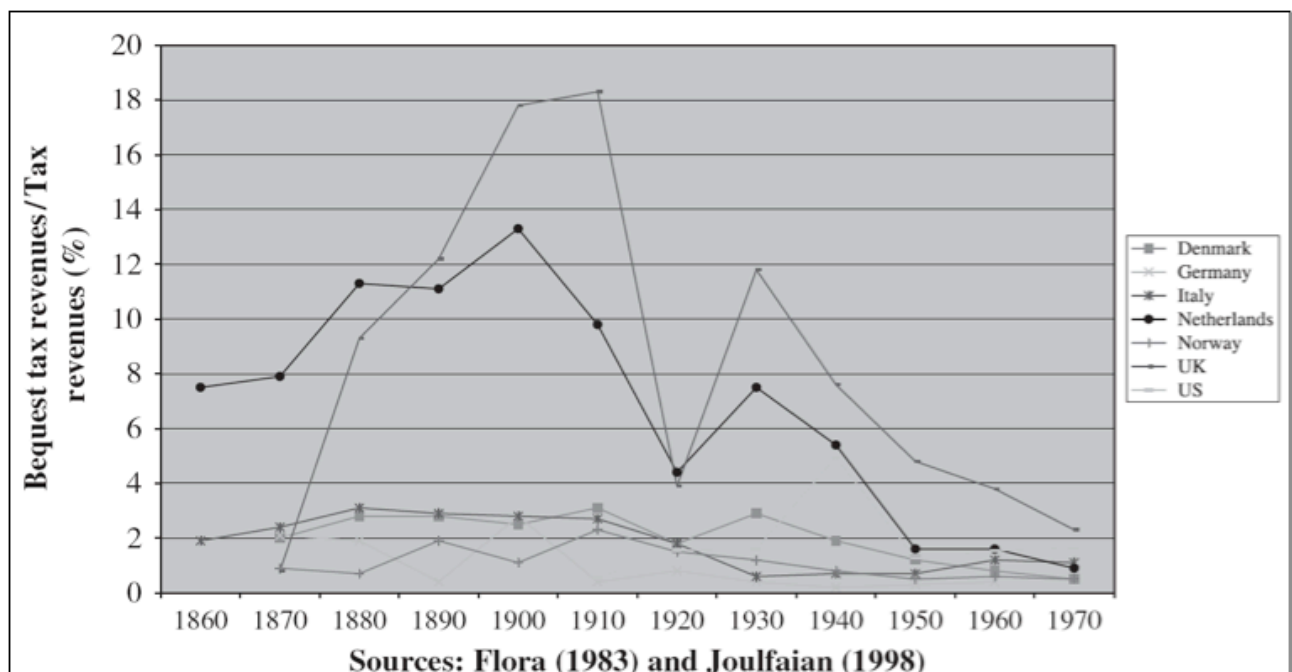
**Figure 2: Estate, inheritance and gift taxes in the US (1917-1997)**



Source: Joulfaian (1998), Slemrod and Bakija (1999) and authors' calculations.

Source : Gale and Slemrod (2001)

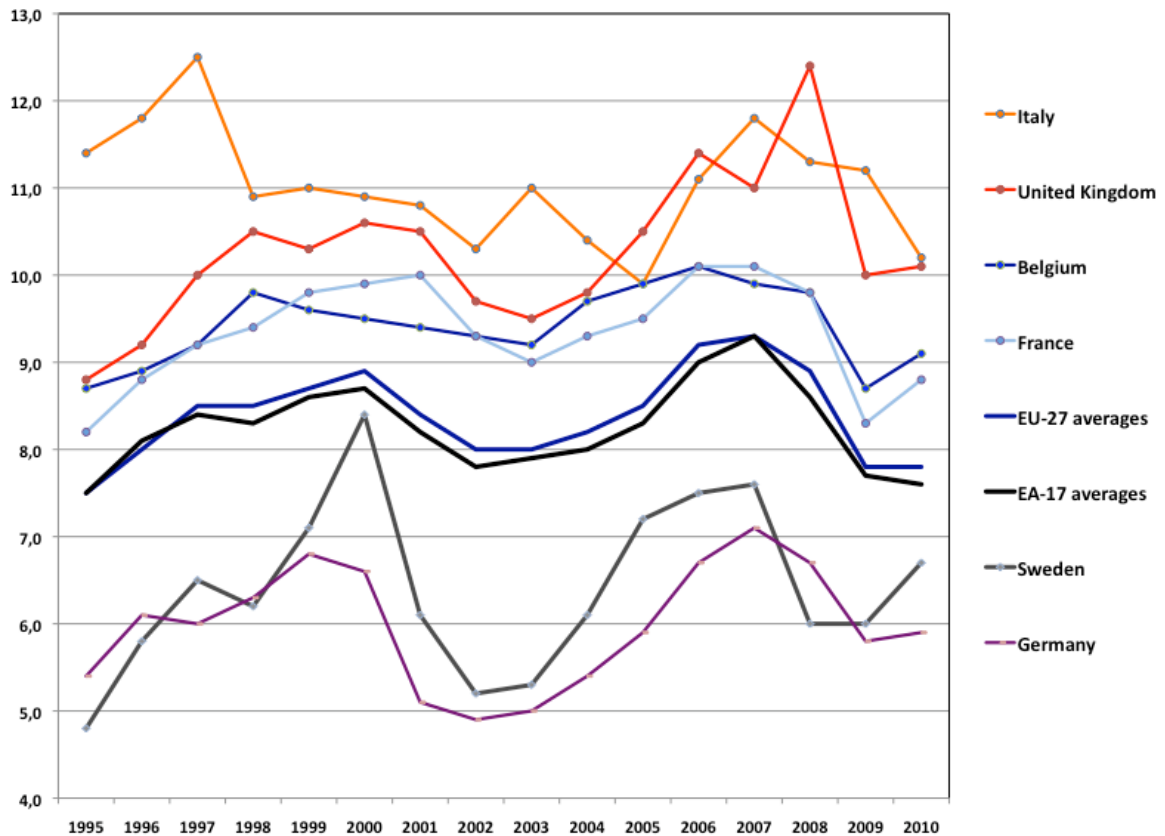
**Figure 3: Estate, inheritance and gift taxes (% of total tax revenue): 1860-1970**



Sources: Flora (1983) and Joulfaian (1998)

Source: Bertocchi (2011)

**Figure 4: Capital taxes (% GDP)**



Source : Eurostat

**Table 1: Ratio of “Estate, inheritance and gift taxes” to total capital taxes**

	2004	2005	2006	2007	2008	2009	2010
<b>Italy</b>	0,001	0,000	0,000	0,001	0,002	0,002	0,003
<b>United Kingdom</b>	0,024	0,024	0,024	0,025	0,018	0,017	0,018
<b>Belgium</b>	0,055	0,058	0,061	0,062	0,065	0,069	0,071
<b>France</b>	0,056	0,055	0,046	0,047	0,041	0,047	0,045
<b>Sweden</b>	0,033	0,011	0,001	0,000	0,000	0,000	0,000
<b>Germany</b>	0,036	0,031	0,024	0,024	0,029	0,033	0,030

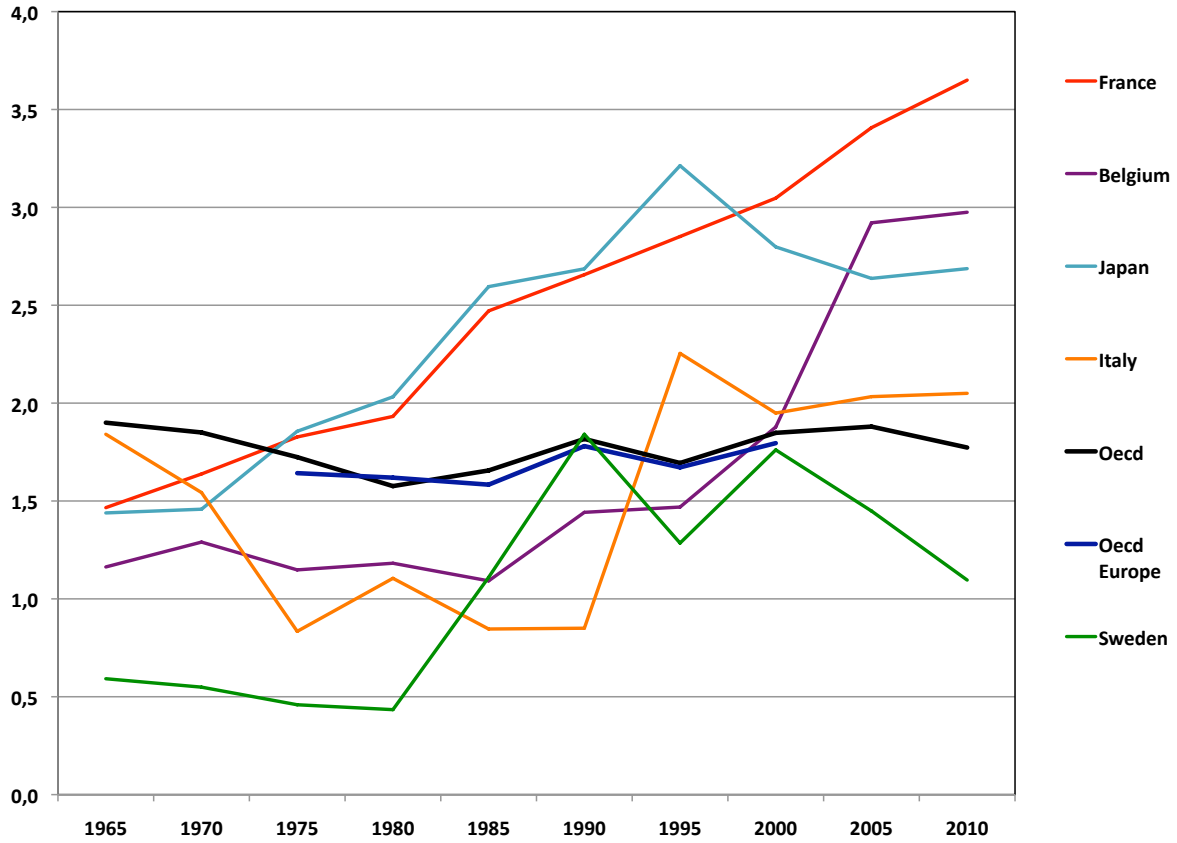
Source: OECD & Eurostat

**Table 2 : Ratio of “Estate, inheritance and gift taxes” to total wealth taxes**

	2004	2005	2006	2007	2008	2009	2010	2011
<b>France</b>	0,137	0,133	0,118	0,120	0,108	0,103	0,098	0,104
<b>Belgium</b>	0,200	0,165	0,167	0,169	0,177	0,174	0,178	0,178
<b>Germany</b>	0,184	0,175	0,157	0,161	0,183	0,183	0,173	0,157
<b>Italy</b>	0,004	0,002	0,001	0,005	0,013	0,011	0,015	0,014
<b>Sweden</b>	0,116	0,053	0,006	0,002	0,001	0,000	0,001	0,000
<b>Japan</b>	0,100	0,105	0,105	0,103	0,100	0,094	0,089	0,099
<b>United Kingdom</b>	0,054	0,055	0,056	0,057	0,051	0,039	0,041	0,044
<b>USA</b>	0,077	0,073	0,075	0,068	0,070	0,053	0,041	0,021
<b>Oecd</b>	0,069	0,067	0,065	0,066	0,068	0,067	0,064	

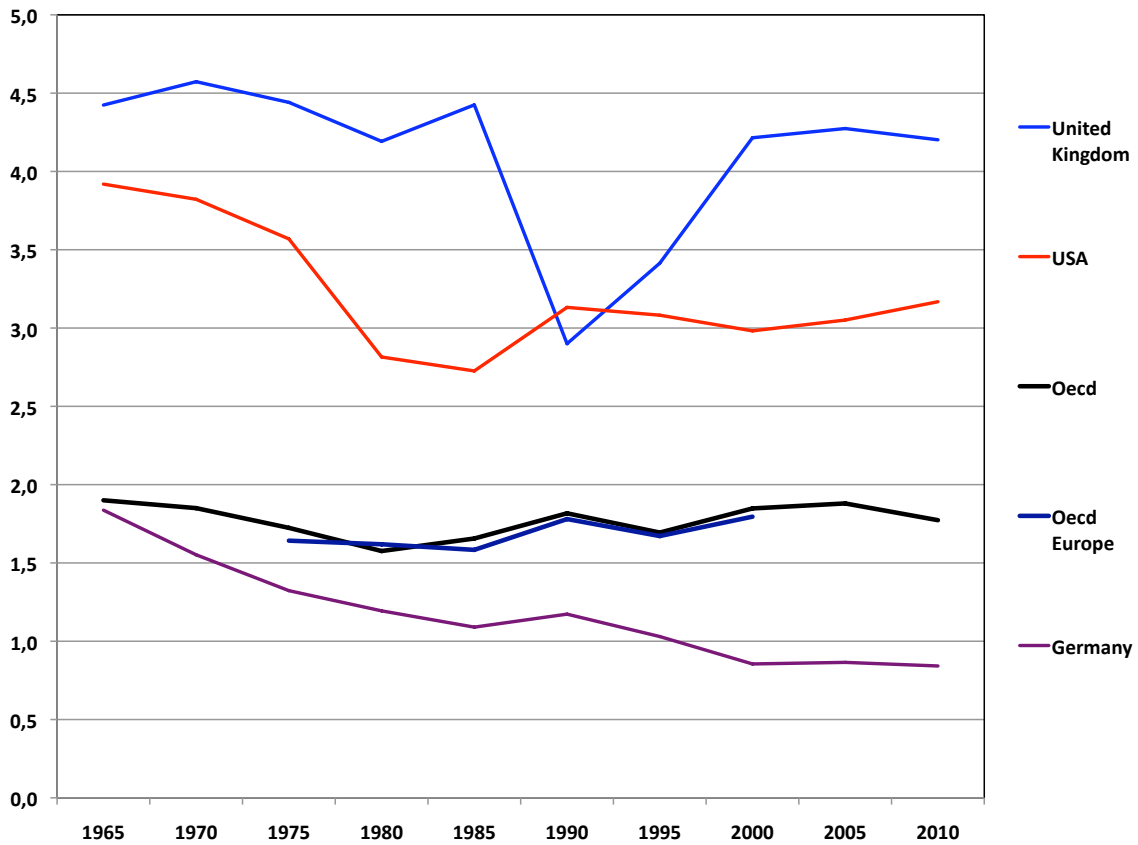
Source : OECD

**Figure 5a: Wealth taxes (% GDP)**  
*A non decreasing trend for a majority of countries since 1975*



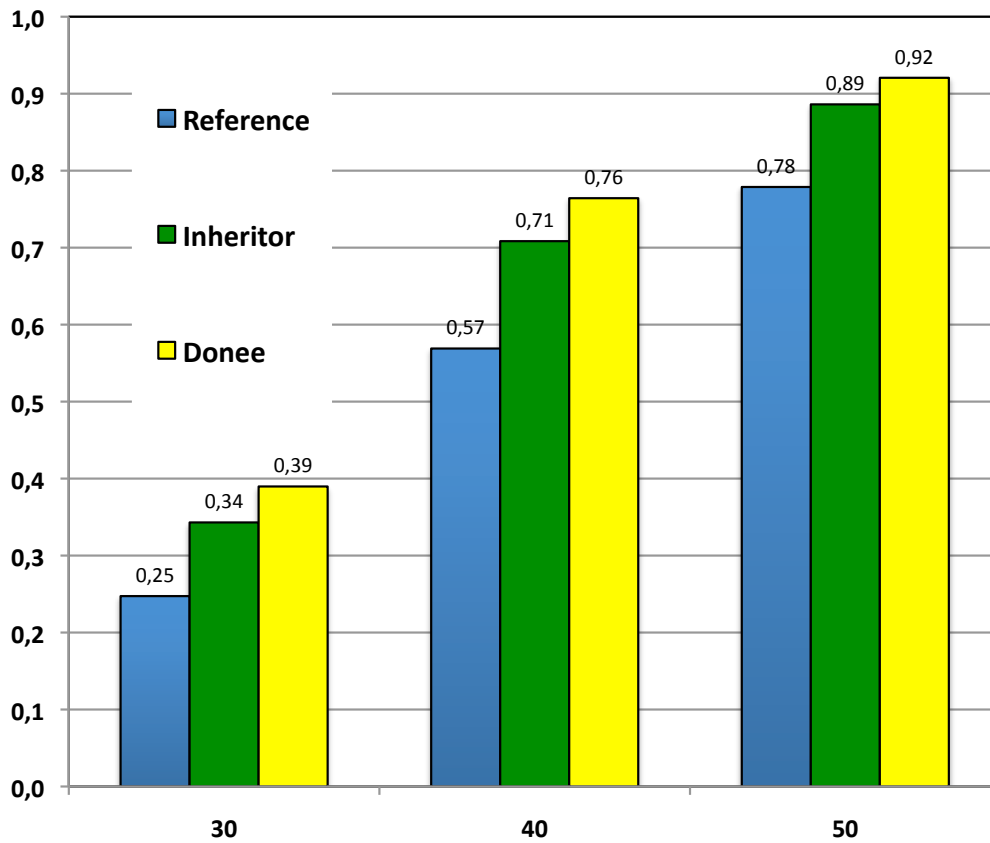
Source: OECD and Garelo (2003)

**Figure 5b: Wealth taxes (% GDP)**  
*Three exceptions with a decreasing trend*



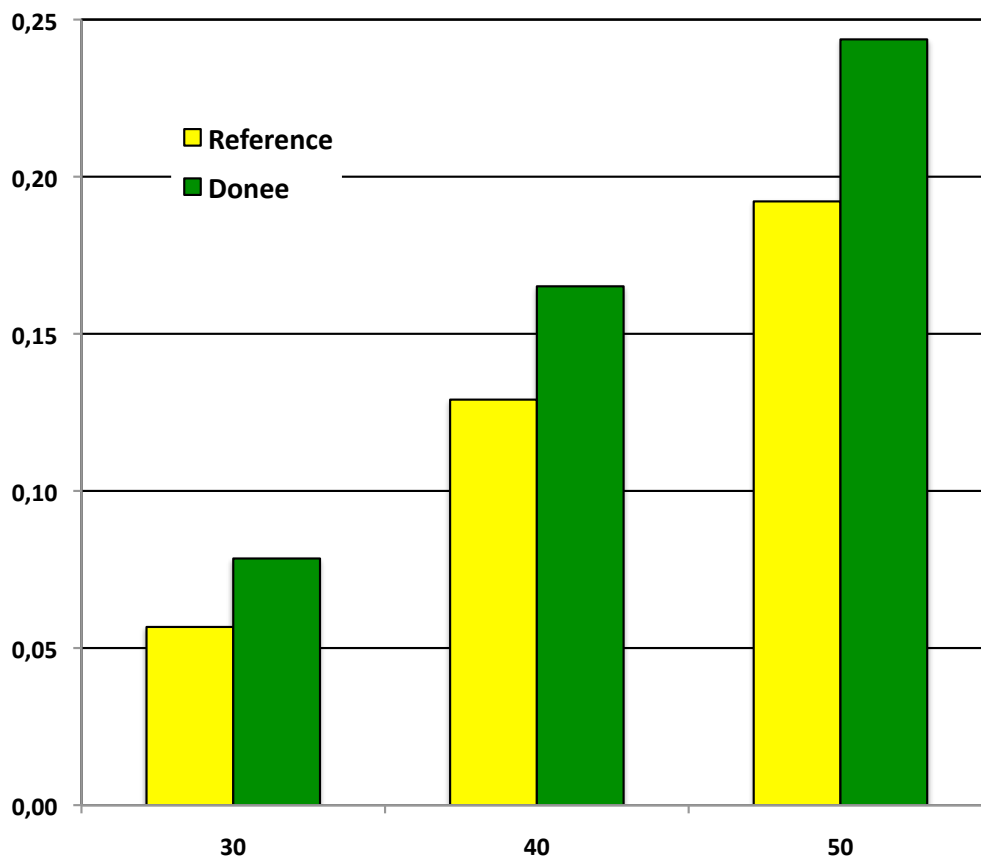
Source: OECD and Garelo (2003)

**Figure 6:**  
**Cumulative probability of buying a home over the life cycle (in %)**



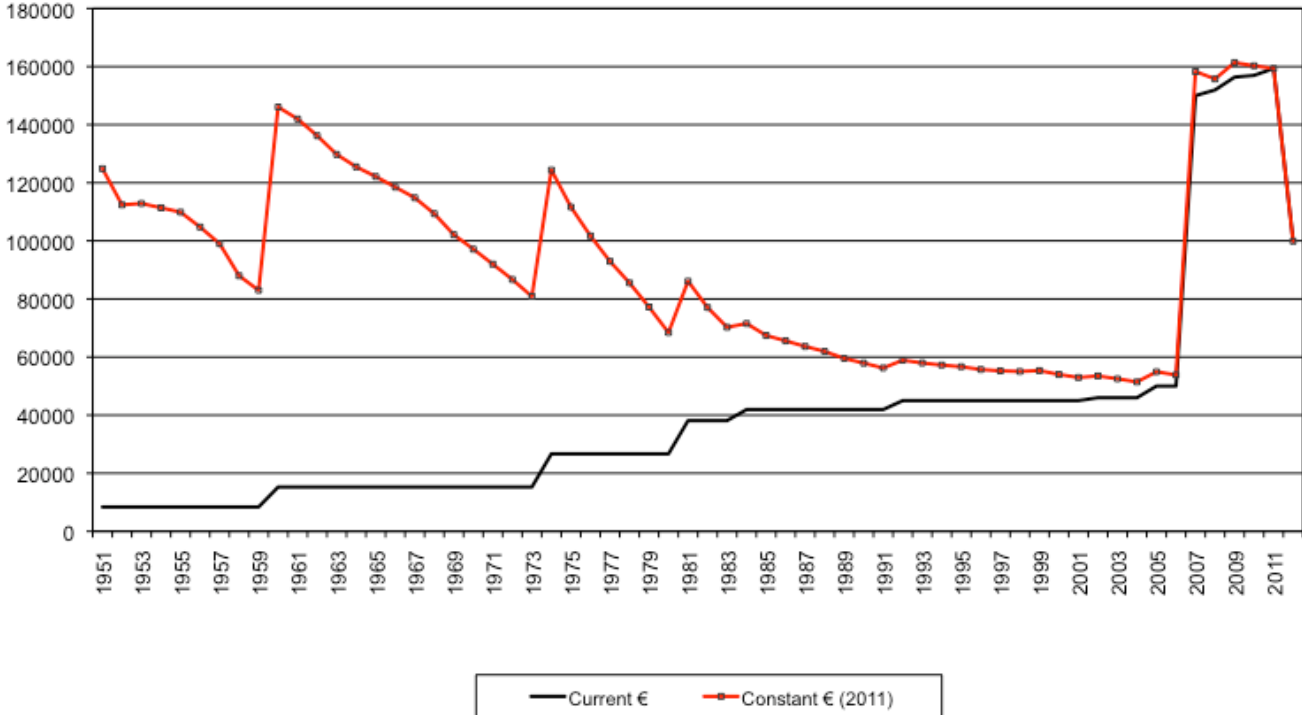
Source: "Patrimoine 2010" Insee Survey

**Figure 7:**  
**Cumulative probability of becoming self-employed over the life cycle (in %)**



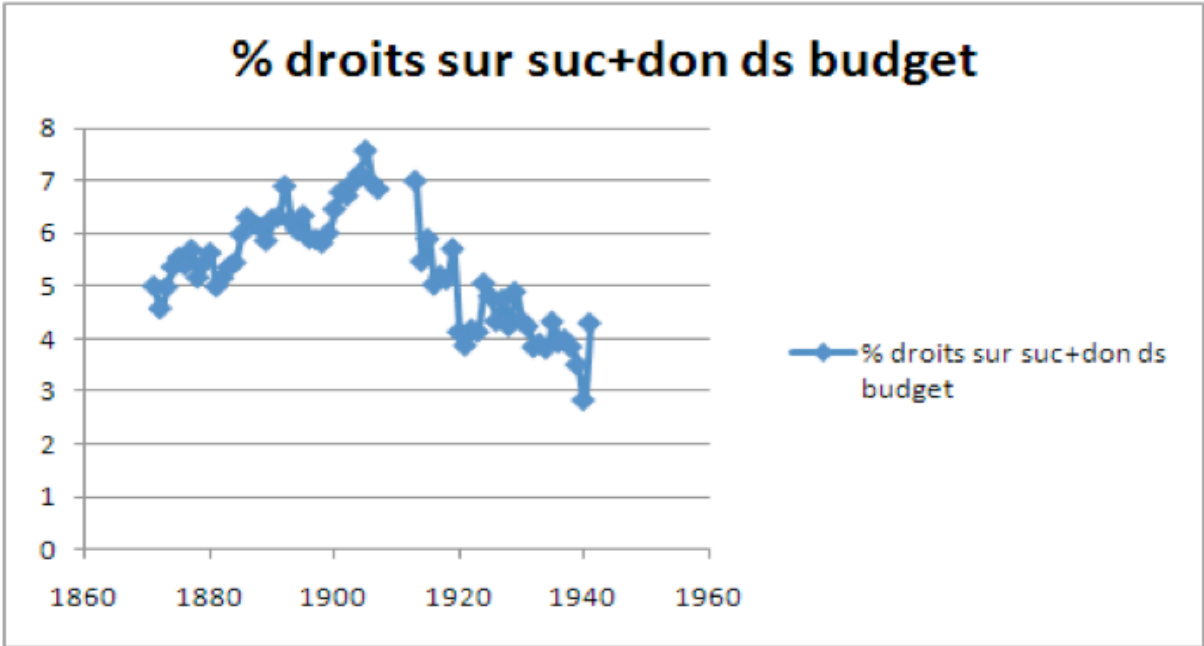
Source: "Patrimoine 2010" Insee Survey

**Figure A1: Exemption threshold in France (1950-2012)**

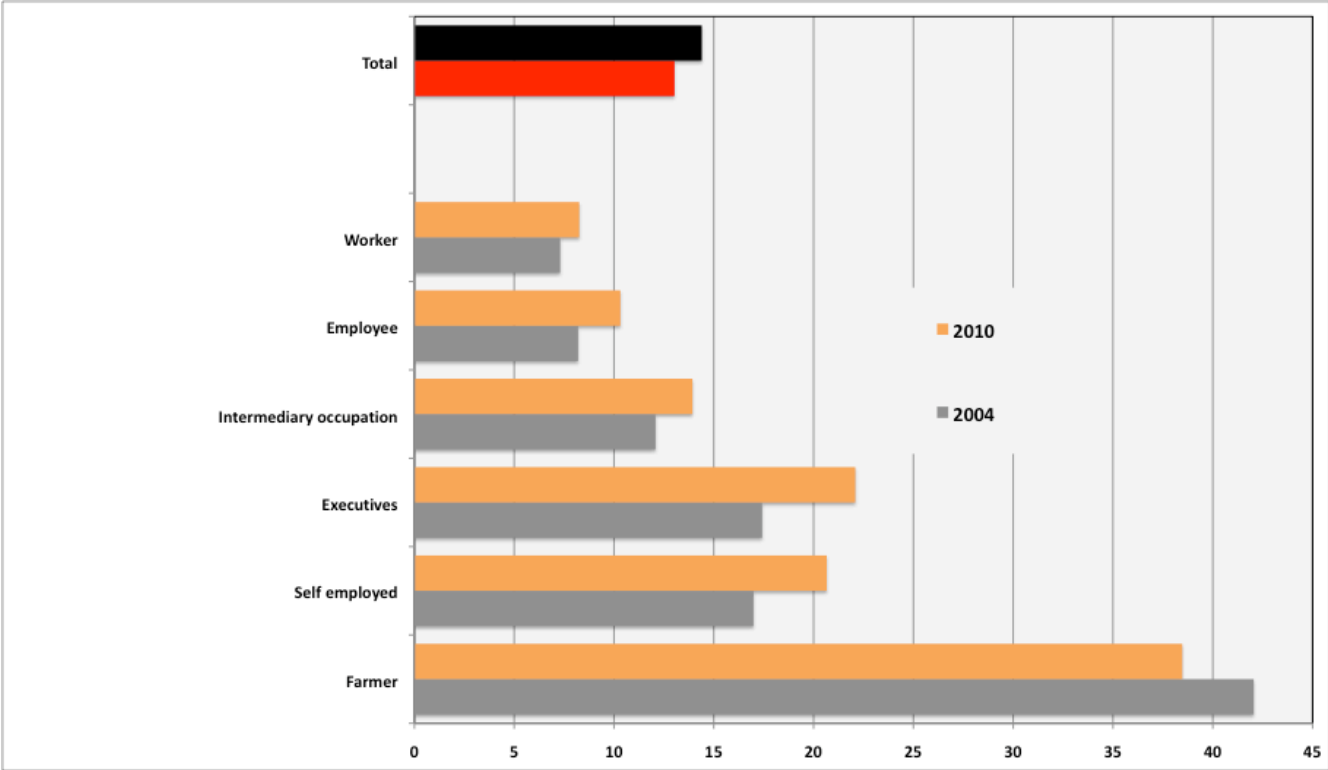


Source: our calculations

**Figure A2: Gift and inheritance tax in France as a % of public budget (1860-1960)**



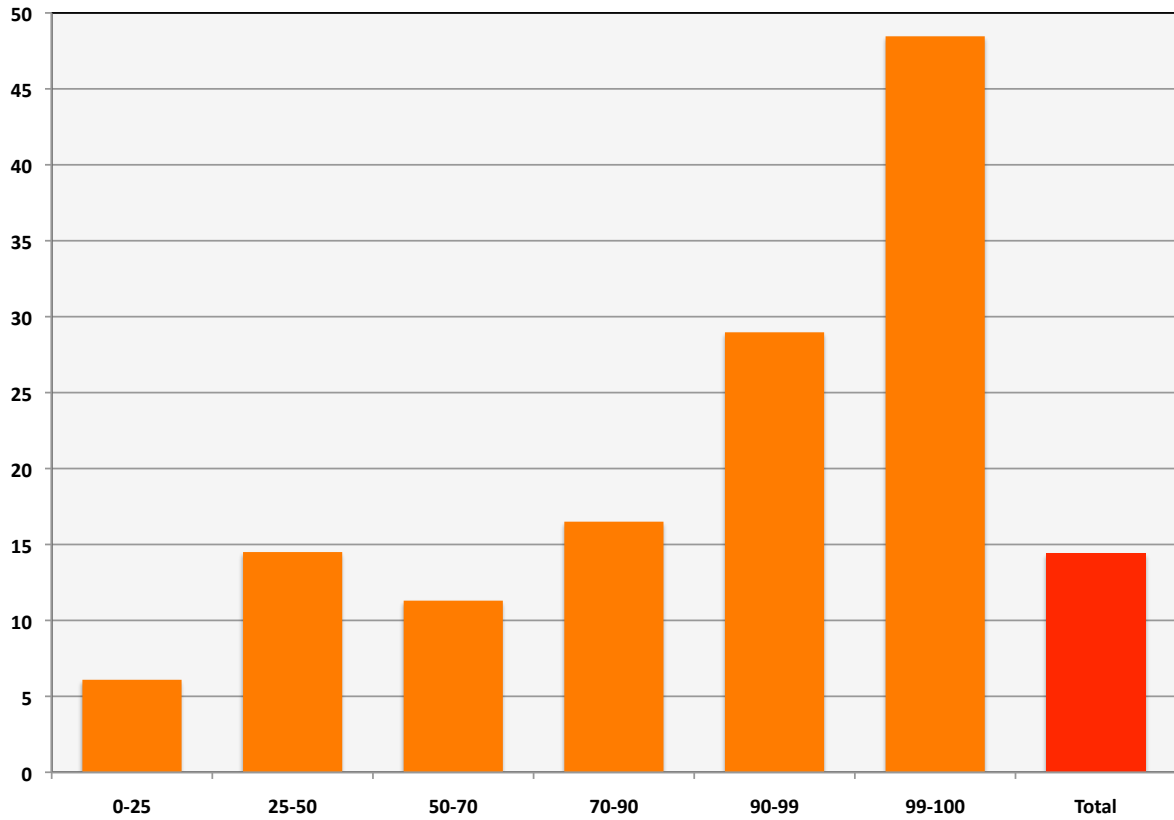
**Figure A3: Percentage of parents who have made a wealth gift to their adult children by occupational group (retired reclassified) in 2004 & 2010**



Source: "Patrimoine 2010" Insee survey

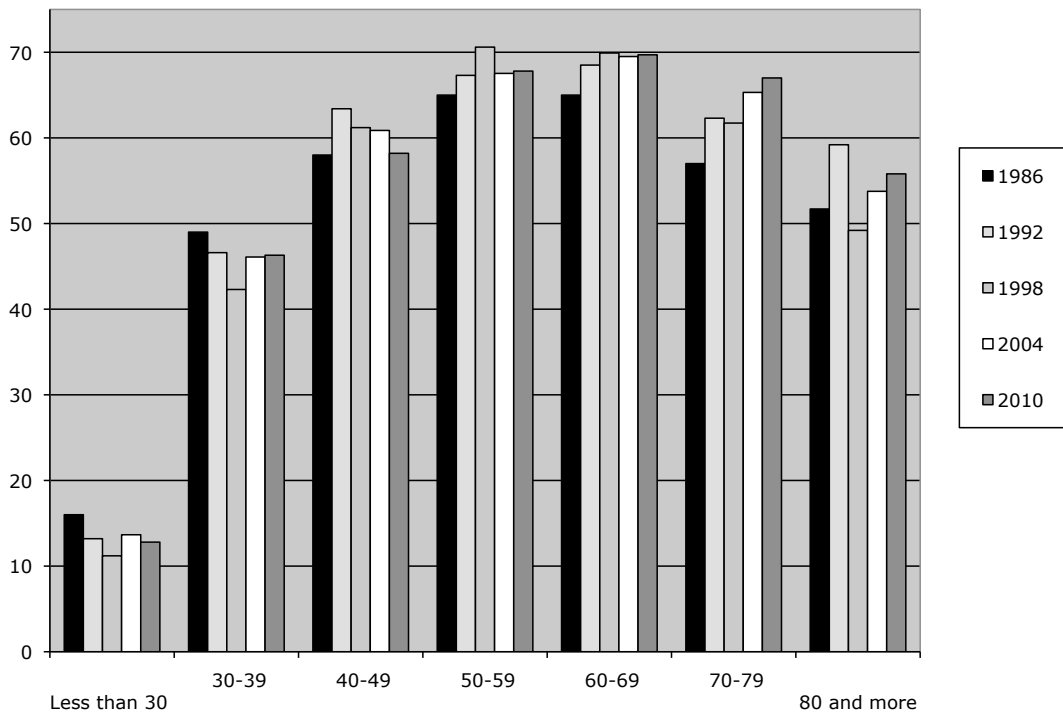


**Figure A4: Percentage of parents who have made a gift by wealth level in 2010**



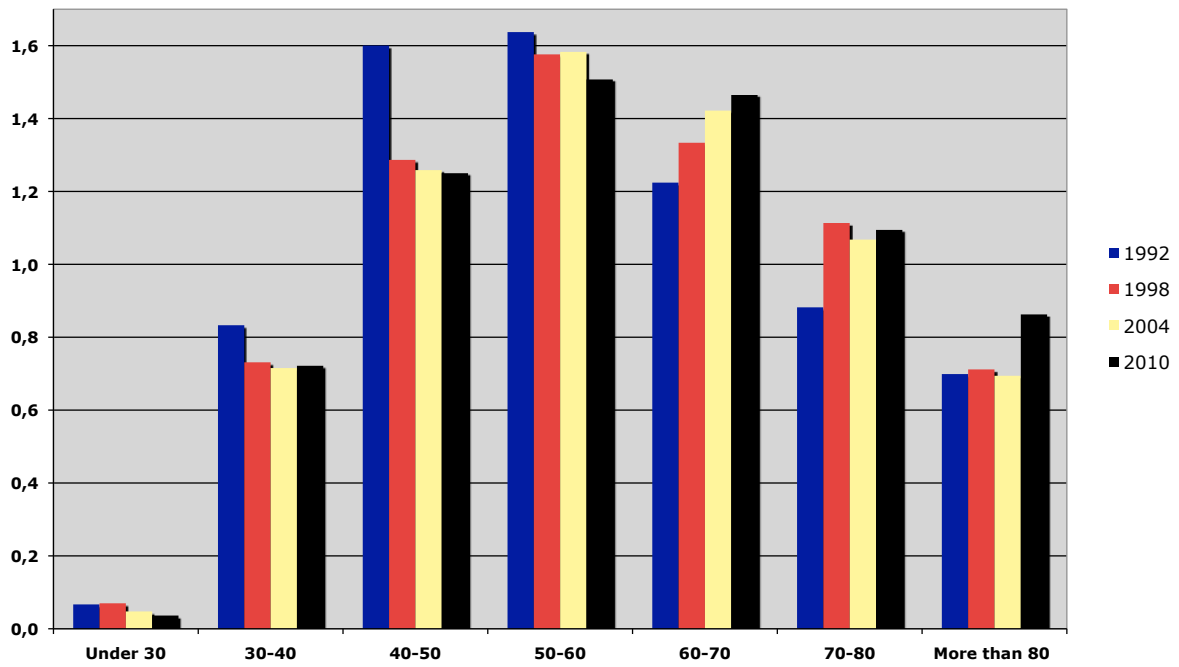
Source: "Patrimoine 2010" Insee Survey

**Figure A5: Percentage of homeowners by age**



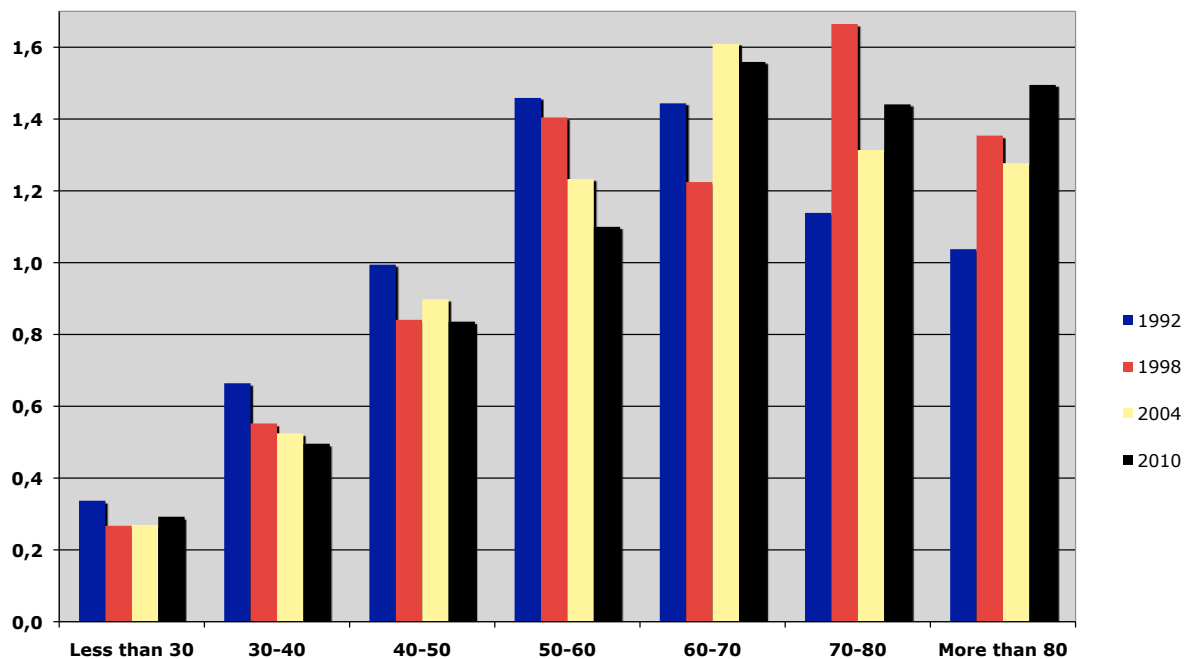
Source: "Patrimoine" Insee Survey

**Figure A6a: Average relative gross wealth by age**



Source: "Patrimoine" Insee Surveys

**Figure A6b: Average relative financial wealth by age**



Source: "Patrimoine" Insee Surveys