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The Theory of Taxation
and Public Economics

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Taxation of Transfers

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Private voluntary transfers, from one individual to another, may be subject to taxation under an income or consumption tax as well as under a tax regime aimed specifically at transfers. A typical income tax provides no deduction for donors' gifts, implicitly treating them as a form of consumption by donors, but excludes gift receipts from donees' tax base, which, as Simons (1938) argued, conflicts with the notion of comprehensively taxing "income." Under a cash-flow consumption tax, gifts could be deemed consumption of donors, donees, or both; the last option is not ordinarily proposed but nevertheless seems most consistent with the notion of taxing all "consumption," understood in the case of donors in accordance with revealed preference (by contrast to exhaustive use of resources).[1] Under a sales tax or VAT, gifts per se are not covered, with the result that only donees are taxed, when they use gifts to finance their own, direct consumption.

Independently, transfer taxation—levies on donors' gifts and bequests in the United States and on inheritances that donees receive in many other countries—is often applied to voluntary transfers involving fairly high levels of wealth. Note that, although sometimes considered together, the taxation of wealth transfers under any guise is qualitatively distinct from the taxation of wealth holdings, the latter having been examined in subsection 9.B.2 as a species of capital income taxation.[2]

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[1] On the use of such tax base definitions as if they were normative principles, see section 15.F.

[2] To reinforce this point, note that on one hand it is possible for a donor to transfer resources every period yet to hold no wealth (that is, all earnings are consumed directly or transferred each period), and on the other hand an individual can amass large wealth early in

Analytically, it is helpful to ignore these differences among possible forms of transfer taxation and simply to consider what net tax or subsidy, if any, should be applied to voluntary transfers. For convenience, the baseline (relative to which a tax or subsidy is measured) employed here is a pure labor income tax regime, and any tax or subsidy on transfers is taken to be levied on the donor.[3]

The analysis begins by applying the framework of chapter 6 on commodity taxation. Own-consumption and gifts may be viewed as two different commodities available to prospective donors (hereafter, simply referred to as donors). Specifically, as before, it will be supposed that any contemplated change in the treatment of transfers is accompanied by an adjustment of the labor income tax schedule that holds donors' utilities constant. Framed in this manner, the question is whether donors at any given income level should be taxed more or less on account of giving an additional dollar to a donee rather than expending it on own-consumption.

If gifts were qualitatively similar to consumption of any other commodity, the benchmark result would be that no tax or subsidy is optimal. In addition to noting the standard qualifications, more extensive attention will be devoted to distinctive features of gifts. First, gifts ordinarily entail external effects regarding donees, both directly and also indirectly on account of donees' labor supply responses. Second, gifts have implications regarding donors' and donees' utility levels and marginal

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life, hold it until retirement, and then consume it entirely, never making any transfers. Nor are these merely hypothetical considerations: A large portion of transfers involve sharing of contemporaneous earnings within the family, and a large portion of wealth holdings consists of life-cycle savings. As a consequence of this distinction, it is largely sufficient to consider transfer taxation in a static setting, even though transfer taxes are often seen in part as taxes on savings. To incorporate savings formally, one can imagine changing the level of transfer taxation while also adjusting not only the labor income tax, as noted in the text to follow, but also the tax on savings so as to keep the average effect of the latter constant, thereby isolating the question of optimal taxation of voluntary transfers. For further specification, see note 6.

[3] When taxes are nonlinear (and donors and donees may face different marginal tax rates), when there are different nonlinear systems potentially applicable to income and to transfers, or when utility functions are not insensitive to regime differences that have the same ultimate impact (see, for example, the discussion in subsection B.2), these simplifications may not capture all that is relevant.

utilities of consumption, which are pertinent to the marginal social value of redistribution.

The analysis then considers different transfer motives. Although the underlying impetus for consumption behavior ordinarily is irrelevant to optimal commodity taxation, in the case of voluntary transfers different motives imply different formulations of utility functions, which may affect the behavioral response to taxation as well as the welfare consequences of a given behavior. A final section will address other aspects of distribution (notably, intergenerational considerations), transfers of human capital in various forms, and charitable giving (in contrast to gifts to particular individuals, usually family members, which is the focus of most of the chapter). Some aspects of transfer taxation are further illuminated in chapter 12, on taxation of the family, since most voluntary transfers are between family members.[4] The presentation in the current chapter largely follows Kaplow (1998c, 2001a), where other issues are also examined.

A. Analysis

1. Taxation of Transfers as Differential Commodity Taxation

Consider a version of the model in chapter 6 in which each donor allocates disposable income, $wl - T(wl)$, between own-consumption c and gifts c_γ to some donee in order to maximize the donor's utility $u(c, c_\gamma, l)$.[5] The price of both commodities is normalized to one, the commodity

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[4] When each adult and child is considered as a distinct individual (which is particularly appropriate in studying transfers), rather than viewing the family as if it were one person, a large portion of transfers consists of the support of minor children by parents and sharing between spouses. (Of course, most ordinary bequests and large explicit inter vivos transfers are also to relatives, often members of the donor's immediate family.) Furthermore, since many of these within-household transfers may be difficult to tax or subsidize as a practical matter even if such measures were optimal, differences in the tax and transfer program treatment of different family units can be viewed in part as a sort of presumptive taxation (or subsidization) of transfers within the family. See also note 14 in chapter 12.

[5] Until subsection B.3, c_γ will be taken to refer to true gifts, disallowing the possibility that a transfer is in exchange for donee services of some sort.

tax on own-consumption to zero, and the differential tax or subsidy on giving is t_γ. A donor's budget constraint is[6]

$$c + (1 + t_\gamma)c_\gamma = wl - T(wl). \tag{10.1}$$

For concreteness, it may be helpful to imagine some particular donor-donee pair, such as a parent and a child.

In this formulation, if donors' utility functions were weakly separable in labor, so that they could be expressed as $u(v(c, c_\gamma), l)$, the optimum would be $t_\gamma = 0$.[7] (This result ignores the effect of gifts on donees, a subject explored in subsection 2.) As in the standard optimal commodity tax problem, this conclusion is independent of the elasticities of demand for the two types of consumption. It also does not depend on whether individuals at different income levels engage in different relative levels of consumption—perhaps lower-income individuals devote a higher fraction of their income to own-consumption—because the income tax is taken to be adjusted to keep the distribution of utilities the same.

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[6] If one wished to extend the model as mentioned in note 2 to the case in which transfers are given out of savings, one could instead consider a version of the two-period model in subsection 9.A.1, in which the utility function is now $u(c_1, c_2, c_\gamma, l)$, where c_1 is first-period own-consumption, c_2 is second-period own-consumption, c_γ is (second-period) giving, and l is (first-period) labor supply. In this case, the budget constraint (9.4) becomes

$$c_1 + \frac{c_2 + (1 + t_\gamma)c_\gamma}{1 + r(1 - t_r)} = wl - T(wl).$$

The optimal level of tax (or subsidy) on the return to capital, t_r, and on gifts, t_γ, could then each be determined, the former according to the prior analysis and the latter using the analysis to follow in the text. Relatedly, for any change in t_γ, one could change t_r in the opposite direction so as to keep constant the average tax on second-period consumption of both types and also adjust the labor income tax schedule to preserve the distribution of utility levels, so that the only effect of the change in t_γ would be on the relative treatment of own-consumption and gifts in the same (second) time period.

[7] As in chapter 6, this conclusion follows from Atkinson and Stiglitz (1976), as extended by Kaplow (2006c).

This conclusion is subject to the usual qualifications sketched in section 6.C. Notably, weak separability may well be violated. One possibility is that increasing gifts reduces the utility of leisure on account of the concomitant reduction in resources available for own-consumption, in which case a gift subsidy is optimal. Some gifts may have the opposite effect; perhaps transfers to grandchildren (in this case, inter vivos gifts rather than bequests) increase the relative value of leisure by raising the pleasure from spending time with them, in which case taxing gifts is optimal. Although potentially significant, this question has not been explored empirically. Perhaps the most important qualification to the no-differential-tax result in the present setting is that gifts typically generate externalities involving donees, which are considered next.

2. Externalities Due to Transfers

A gift inherently involves two parties, a donor and a donee. Subsection 1 focuses on donors. Consider now the situation of donees, who are assumed to choose labor effort to maximize $u(c,l)$ subject to the budget constraint

$$c = wl - T(wl) + \gamma, \tag{10.2}$$

where γ indicates the magnitude of the gift received.[8] (For a particular donor-donee pair, where each member does not give to or receive from anyone else, $\gamma = c_\gamma$.) As a consequence, donors' decisions give rise to externalities regarding donees. There is a direct, positive externality on donees and also an indirect, often negative externality on the public fisc.

a. Externality on donees. Gifts increase the utility of donees, which constitutes a positive externality to donors' gift decisions and thus, ceteris paribus, favors a gift subsidy, that is, $t_\gamma < 0$.[9] Observe that this is

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[8] A more complete analysis might consider an overlapping-generations version of the model sketched in note 6, in which the same individuals both receive gifts, γ, in the first period of their lives and also make gifts, c_γ, in the second period.

[9] This point is noted in Atkinson (1971, p. 222, n. 1) and Stiglitz (1987, p. 1035) and is developed in Kaplow (1995b), who characterizes the optimal subsidy to gifts in a simplified

true even if the donor's gift is motivated by concern for the donee, as will be elaborated in subsection B.1 on altruistically motivated giving. A private–social divergence exists because the donee's utility enters the SWF in two ways: once, directly, because the donee is one of the individuals of concern, and a second time, indirectly, through the effect on the utility of the donor.[10] The donor considers the latter but not the former. Put another way, suppose that c_γ is the donor's (privately) optimal level of giving. If this level were increased slightly, the donor would suffer no first-order utility loss, but the donee would realize a first-order utility gain. Hence, the donor's chosen level of giving is less than is socially optimal.[11]

b. Externality involving tax revenue. In the presence of a labor income tax (or many other forms of taxation), gifts also generally result in an externality on the public fisc. Ordinarily, the receipt of a gift will have an income effect that reduces the donee's labor supply.[12] Donees find such reductions privately optimal, given the gifts that they receive, but they do not bear the full cost of their behavioral adjustment on account of the labor income tax. For each dollar less that they earn, the fisc loses $T'(wl)$. To complete the argument, donors will be unconcerned about

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setting in which there is no taxation (other than to finance the gift subsidy). A further positive externality arises through the benefits of gifts to donees' spouses and their families (see, for example, Nerlove, Razin, and Sadka 1986).

[10] Some suggest that thus accounting for altruism in the SWF amounts to a double counting of the donee's utility. However, it is hard to see whose utility should not be counted. The donee is an individual in his/her own right and thus there is no basis for exclusion. For the donor, the utility achieved is real: Why should utility from giving, say, to one's children be ignored when it is revealed to be preferred to spending on own-consumption, the utility from which would be counted? Note that an implication of excluding such utility would be that those who give more would be deemed worse off rather than better off; moreover, under a strictly concave SWF, such individuals would deserve a greater allotment on that account. For further discussion, see subsection 13.B.3.

[11] Unlike with typical externalities, moving the level of the gift toward the social optimum cannot in principle be accomplished in a way that generates a Pareto improvement because this manner of raising social welfare requires a different distribution of income.

[12] For empirical evidence, see, for example, Holtz-Eakin, Joulfaian, and Rosen (1993), Imbens, Rubin, and Sacerdote (2001), and Joulfaian and Wilhelm (1994).

this effect on revenue when determining how much to give. Hence, there is a negative externality to donors' giving.[13]

Note that the extent of this tax revenue externality can be bounded from above by the donee's marginal income tax rate, $T'(wl)$. The reason is that in standard cases the income effect implies that the earnings reduction from receiving an incremental dollar will be less than a dollar. (If earnings fell by a full dollar, the marginal utility of consumption would be restored to its initial level whereas the marginal disutility of labor would decrease, which together imply that labor supply would have been reduced too much.) Accordingly, it would appear that the optimal level of taxation of transfers (even if positive) must be less than full taxation of the receipt of gifts at the donee's marginal tax rate—as proposed by Simons (1938) in order to tax income comprehensively, and as would arise under a cash-flow consumption tax if gifts were treated as consumption of both donors and donees. This suggestion combines the present result, that such a tax exceeds the level necessary to correct for the negative tax revenue externality, with the preceding results, that the simple benchmark involves no tax or subsidy on gifts

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[13] One might wonder about an opposing externality involving donors' labor supply. If c_γ rises, c must fall. This adjustment implies a higher marginal utility of own-consumption, which would seem to induce an increase in donors' labor effort. Moreover, the external benefit of such an increase on the public fisc would be ignored by donors (this is just an alternative statement of the standard labor-leisure distortion). However, when an increase in c_γ is induced by a subsidy (a reduction in t_γ) and is accompanied in turn by an offsetting income tax adjustment, as presumed here, there is no net effect on donors' labor supply in the basic case. Indeed, as the text in subsection 1 indicates, from a donor's point of view, a tax or subsidy on expenditures on gifts is no different from a tax or subsidy on any other expenditure, so the analysis in chapter 6 is fully applicable. (Specifically, a subsidy on c_γ would be accompanied by an increase in marginal labor income tax rates, which has the effect of raising the net cost of earning income to spend on c that just offsets the extent to which expenditures on c have a higher marginal utility than before. Similarly, the lower effective cost of earning income to spend on c_γ—the combined effect of the higher marginal labor income tax rate and the subsidy on expenditures on c_γ—will just offset the reduction in the marginal utility from gifts. We know that this perfect offset must occur because, with weak separability of labor, the tax adjustment is set so as to maintain the same level of utility from a given level of labor earnings, presumed to be allocated optimally among different commodities in the pertinent regimes. See subsection 6.B.1.)

and that the positive externality on donees favors a subsidy. Of course, other considerations could alter this conclusion.

It need not be the case, however, that the tax revenue externality from gifts is negative. To the extent that gifts themselves represent investments in human capital that donees would not otherwise make (see subsection C.2) or serve to relax liquidity constraints and thereby permit donees to invest, say, in entrepreneurship, the resulting tax revenue externality may be positive, favoring a gift subsidy.[14]

3. Transfers' Effects on the Marginal Social Value of Redistribution

Differences in donors' and donees' utility functions and circumstances also influence the optimal taxation of transfers through their effects on the marginal social value of redistribution. In this regard, one might think of gifts as a sort of localized voluntary redistribution. On one hand, this suggests that giving should be favored since redistribution tends to raise social welfare, assuming that gifts are from higher- to lower-income individuals, which is usually the case. On the other hand, to the extent that some voluntary redistribution takes place, the marginal value of further redistribution via taxation may be reduced. The preceding analysis of externalities is highly pertinent to the former consideration. To incorporate the latter requires further attention to the effect of gifts on donors' and donees' marginal utilities of consumption and also (for strictly concave SWFs) on their utility levels.

First, consider donors, and suppose that there are two donors with the same income-earning ability who give different amounts. One possibility is that the donor who gives more does so on account of receiving greater utility from giving, that is, has a higher $\partial u / \partial c_\gamma$, ceteris paribus. For example, one donor may fortuitously have a spouse or child toward

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[14] For empirical evidence on liquidity constraints, inheritance, and entrepreneurship, see, for example, Blanchflower and Oswald (1998), Cox (1990), and Holtz-Eakin, Joulfaian, and Rosen (1994a, 1994b). Donees' labor supply may also be affected for other reasons. There may be a reduction due to the Samaritan's dilemma, that is, if donees work less because they anticipate that altruistic donors will compensate through increased giving. Alternatively, there may be an increase if donees anticipate that donors view labor effort as virtuous and thus deserving of reward.

whom he has altruistic feelings, or the intensity of his altruism may be higher than that of the other donor. This donor will achieve a higher level of utility. Additionally, he will have a higher marginal utility of own-consumption because, as c_γ is increased, c must be reduced. The latter favors greater redistribution toward the higher-giving donor, which may be accomplished indirectly through subsidizing gifts. The former factor—the higher level of utility—would be immaterial to optimal redistribution under a utilitarian SWF but would favor less generosity, perhaps accomplished through less generous treatment of gifts, if the SWF were strictly concave. With sufficient concavity, this factor could dominate the opposing effect from higher marginal utility.[15]

These conclusions, however, are reversed if the donor gives more not on account of greater utility from giving but from a lower utility of own-consumption, that is, a lower $\partial u/\partial c$, ceteris paribus. In this case, we might imagine a donor who is less capable of enjoying the pleasures of ordinary consumption. This donor will achieve a lower level of utility and also will have a lower marginal utility of own-consumption. (Although as c_γ is increased, c must be reduced, which raises this marginal utility, it is the case that c_γ will not be raised sufficiently to offset the initially lower level of $\partial u/\partial c$, which is the force that drives the higher level of c_γ.)

Because donors' giving (when $t_\gamma = 0$) is determined by the first-order condition $\partial u/\partial c = \partial u/\partial c_\gamma$, any particular level of giving is consistent, for example, with both derivatives being high or both low, so the level of giving is not directly informative about which case is being observed. As with all redistributive judgments in the standard welfare economics framework, interpersonal comparisons of utility are required to move from observed circumstances to a distributive welfare judgment. It is not possible in the present setting, as is sometimes done, simply to stipulate that individuals' utility functions are the same; differences in giving behavior belie that assumption. However, there may be some practical basis for distinguishing among donors since we can also observe family configurations, the relationship between donors and their donees, and perhaps some other pertinent characteristics.[16]

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[15] The possibility of such a tradeoff is introduced in subsection 3.B.3.

[16] The relevance of these features reinforces the importance of the previously noted connection between the present subject and that of taxation of families, explored in chapter 12.

Donees' circumstances also may vary. In the present framework, it is natural to consider two donees with the same income-earning ability who receive different levels of gifts. Here, suppose that the donees have the same utility functions and that the difference in gift receipts is due to the fortuity of the donor (if any) with whom each happens to be paired. Then the only effect of gifts is on the budget constraint. In the standard case, a donee receiving a higher gift has a higher utility level and also a lower marginal utility of consumption, which is the reason for the reduction in labor effort (in the standard case) identified in subsection 2.b. The existence of a higher utility level and a lower marginal utility of consumption favors less generous treatment under any standard SWF.

Combining these conclusions regarding donors and donees with each other and with those of the earlier subsections is rather complicated. For example, in the first case for donors, in which the marginal utility of own-consumption of those who give more is higher, under a utilitarian SWF giving should be favored somewhat more than otherwise on this account, but there is also an offsetting effect due to the lower marginal utility of consumption of donees. Furthermore, on account of transfers, individuals with the same income-earning ability may choose to earn different amounts, due to differences in utility functions or in opportunities for giving or receiving transfers. Thus, at any given income level, a single marginal tax rate must be applied to individuals who differ on multiple dimensions. Compare subsection 5.C.2 on heterogeneous preferences regarding consumption and labor effort. Formal analysis and simulations seem necessary to obtain a full appreciation of the problem of optimal taxation of voluntary transfers. One of the most important challenges in doing so is the need to specify the form of donors' utility functions, the subject of the next section.

B. Transfer Motives

Before considering particular transfer motives, it is useful to begin by asking why donors' motivations for private voluntary transfers are relevant. As noted earlier, it ordinarily is immaterial why an individual chooses to consume some good or service. The optimal differential tax

rate does not depend, for example, on whether an individual chooses to go on vacation (rather than expend the same amount at home) because she prefers a change of pace, savors the beauty of the chosen destination, or cherishes revisiting a childhood haunt. With gifts, however, different motivations may imply differences in the functional forms for donors' or donees' utility that may be directly relevant to the welfare effects of gifts and also may carry behavioral implications for a tax or subsidy on transfers. For example, a tax on bequests will directly reduce the utility of altruistically motivated donors and also discourage their giving but will have neither effect on donors whose bequests are purely accidental (that is, due to leftover precautionary savings when complete annuitization is unavailable and there is no bequest motive). Also, a tax that reduces giving directly reduces the utility of donees who receive true gifts, but for those really exchanging services for apparent gifts, there is an offset to the extent that fewer services need to be provided.

Accordingly, it is important to consider the implications of different transfer motives. Observe, however, that even if the optimal treatment of each type of gift could be determined, normative implications for transfer policy remain uncertain for a number of reasons. Motives vary across donors in ways that are difficult to observe directly. (Thus, it may be optimal for transfer tax policy to treat differently inter vivos gifts and bequests, donor-donee pairs that have different relationships, gifts of human capital and cash, and so forth if these distinctions are correlated with different transfer motives, even though such distinctions may not per se be relevant.) Also, mixed motives may often be present for a single donor. Additionally, there is some evidence that donors' behavior is not entirely rational, perhaps in part because of a reluctance to contemplate and plan optimally for death.[17] These reasons undoubtedly contribute to the difficulty that researchers have had in determining actual transfer motives, despite substantial empirical investigation.[18]

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[17] See, for example, Kopczuk and Slemrod (2005), who model the effects of denial of death on economic behavior, and Poterba (2001), who finds that many donors subject to heavy transfer taxation fail by a wide margin to take full advantage of inter vivos giving opportunities that would reduce tax burdens.

[18] See, for example, Arrondel and Masson (2006), Davies (1996), Masson and Pestieau (1997), and Stark (1995).

In the discussion to follow, the analysis will be simplified to avoid excessive repetition of material in section A and to focus on the differences between transfer motives. It will be useful to examine the case with weak labor separability and, specifically, to consider only donors' subutility functions, $v(c, c_\gamma)$, because transfer motives will be reflected there and because, with weak separability, the presumed adjustment to the income tax schedule will hold donors' labor supply constant in any event.[19]

1. Altruism

An altruistic donor's subutility function can be formulated as

$$v(c, c_\gamma) = \alpha\mu(c) + \beta\upsilon(c_\upsilon + c_\gamma, l_\upsilon), \tag{10.3}$$

where α and β are weights on self-regarding and altruistic utility, respectively, μ is the donor's utility from own-consumption, υ is the donee's utility function, c_υ is the donee's expenditure on consumption from after-labor-income-tax income, l_υ is the donee's labor effort, and w_υ will denote the donee's wage. Note that $c_\upsilon = w_\upsilon l_\upsilon - T(w_\upsilon l_\upsilon)$ and $c_\gamma = \gamma$, so that the donee's budget constraint (10.2) is now incorporated directly into the donee's utility function.

The analysis of the optimal tax or subsidy, t_γ, for this case follows closely that outlined in section A. To consider the externalities identified in subsection A.2, it is useful for concreteness to examine a utilitarian SWF. The contribution of the donor and donee to social welfare is given

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[19] Implicitly, this construction assumes that it is possible to apply a different $T(wl)$ schedule to donors and to donees. Compare the general discussion of categorical income tax schedules in subsection 5.C.1 and the application to income transfer programs in section 7.C. If a single schedule must be employed, then, say, a gift subsidy would be associated with an adjustment to the income tax schedule that is less than that imagined in the foregoing analysis, implying that donors, subject to lower marginal tax rates than those that hold labor supply constant, would increase labor effort (assuming a positive uncompensated labor supply elasticity) and that donees, subject to higher marginal tax rates, would reduce labor effort relative to the adjustment discussed in subsection A.2.b. These effects would tend to be offsetting, though only by coincidence would they be precisely so, implying that some further subtle adjustment to the otherwise optimal transfer tax would be in order.

by $u(v(c,c_\gamma), l) + \upsilon(c_\upsilon + c_\gamma, l_\upsilon)$. In addition, we must consider any effect on tax revenue, weighted by the shadow price λ (see chapter 4).

The donor chooses c_γ to maximize u, with a marginal utility gain from increasing c_γ of $u_1 \beta \upsilon_1$, where subscripts denote partial derivatives with respect to the pertinent argument. However, the direct contribution of an increase in c_γ to social welfare is $u_1 \beta \upsilon_1 + \upsilon_1 = (u_1 \beta + 1) \upsilon_1$. This illustrates the positive externality to giving, in that the altruistic donor considers the benefit to the donee only to the extent that it contributes to the donor's own utility, $u_1 \beta \upsilon_1$, whereas society values this plus the direct benefit to the donee in her own right, υ_1.

Next, consider the tax revenue externality. Because any differential tax or subsidy, the source of any inducement on the donor to change c_γ, is assumed to be financed by an income tax adjustment that has the effect of holding constant the donor's labor supply, we can confine our attention to the donee (for elaboration, see note 13). This adds to the social welfare maximization a term equal to $\lambda w_\upsilon T'(w_\upsilon l_\upsilon)(dl_\upsilon/dc_\gamma)$, which is a standard income effect. The term is the shadow price of tax revenue times $w_\upsilon T'(w_\upsilon l_\upsilon)$—the revenue effect of a one-unit increase in the donee's labor effort—times the change in the donee's labor effort, the latter being the same as the change in labor effort from any exogenous change in disposable income. Each component of this term is positive except the last, which is negative, so there is a revenue loss (in the ordinary case) that reduces social welfare. Furthermore, it is apparent from the foregoing that this effect is ignored by the donor when choosing c_γ.

2. Utility from Giving Per Se

Suppose that a donor is not motivated by altruism but instead receives utility from the act of giving itself. This utility may be due to an internal feeling of virtue from aiding others (what Andreoni (1990) terms a "warm glow"), a desire for prestige, or some other phenomenon. Such a donor's subutility can be expressed as

$$v(c,c_\gamma) = \alpha \mu(c) + \beta \upsilon(c_\gamma), \tag{10.4}$$

where υ is now interpreted as the utility that the donor receives from giving per se rather than as the donee's utility, such as in the case of altruism displayed in expression (10.3).

Although this difference in the donor's subutility function has qualitatively different implications for behavior—notably, our present donor cares solely about how much he himself gives, not about other sources of consumption for the donee—analysis of the welfare effects of a tax or subsidy on giving is quite similar to that in the case of altruism. Again, the donor considers only the effect of his gift on his own utility, here $u_1\beta v'$, whereas social welfare also includes the effect of the gift on the donee in her own right. And, again, gifts affect the donee's labor supply, negatively affecting revenue.

Reflection on the hypothesis that the donor cares only about his own consumption sacrifice on behalf of the donee and not about the donee's overall situation suggests an alternative formulation of the present motive. Because the donor's actual sacrifice is measured by $(1+t_\gamma)c_\gamma$, not by c_γ alone, the donor's subutility might instead be taken as

$$v(c,c_\gamma) = \alpha\mu(c) + \beta v((1+t_\gamma)c_\gamma). \tag{10.5}$$

When t_γ is positive (negative), a gift of c_γ costs more (less) than c_γ and hence generates more (less) subutility. Consider the case in which there is a subsidy, that is, $t_\gamma < 0$. One can view the donor's gift as consisting only of $(1+t_\gamma)c_\gamma$, which is less than c_γ, with the difference, $-t_\gamma c_\gamma$, being provided to the donee by the government in the form of a matching grant. If the donor, unlike the altruist, is imagined not to care about what others give to the donee, then expression (10.5) reflects the assumption that the donor does not take personal credit for the $-t_\gamma c_\gamma$ portion of the donee's net receipt that is financed by the government.[20]

Under this version of the problem, the effect of a tax or subsidy on gifts is quite different. In addition to the effects described previously, raising a tax (subsidy) directly increases (decreases) the utility that the donor receives on account of a given level of gift, c_γ. From expression

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[20] This interpretation is also potentially problematic, for if donors do not care about what is transferred to donees, a confiscatory tax levied on donees' gift receipts would not affect giving, which seems implausible. Obviously, further empirical exploration is required to obtain a more precise understanding of the phenomenon of donors receiving utility from giving per se.

(10.5), $\partial v/\partial t_\gamma = \beta v' c_\gamma$ (holding c_γ constant). It turns out that the effect of changing t_γ in the present case is to induce a redistribution between the fisc and donees, under which donors serve merely as the conduit. Specifically, donors choosing c_γ to maximize (10.5) select a level of c_γ that results in the same level of c and of $(1+t_\gamma)c_\gamma$—and accordingly of $v(c, c_\gamma)$—independent of t_γ. This follows from the donor's first-order condition for this case, which is $\alpha\mu' = \beta v'$. Thus, if one reduces t_γ, which is to say reduces the tax or increases the subsidy on giving, donors' utility is unaffected, and because the cost of giving falls, they increase c_γ in a manner that keeps their expenditures on gifts, $(1+t_\gamma)c_\gamma$, constant. Furthermore, this implies that, as the subsidy increases, donees' gift receipts increase by the amount that government expenditures on the subsidy increase. Thus, as stated, raising the subsidy on giving does indeed entail a transfer from the fisc to donees. The assessment of such a change depends purely on the desirability of such a redistribution—that is, on whether the pertinent donees' marginal utilities of income (weighted by the marginal welfare contributions of their utility, in the case of a non-utilitarian SWF) exceed the shadow cost of government revenue (taking into account effects of the redistribution on donees' labor supply as well).

In sum, when donors are motivated by the act of giving per se, the assessment of a tax or subsidy on transfers depends on how this motivation is formulated, notably, whether donors' utility benefit depends on their gross gift, c_γ, or on their net gift, the amount they actually give up in transferring c_γ to the donee, $(1+t_\gamma)c_\gamma$. To the extent that the act of giving per se is an important motive, it is necessary for empirical work to identify which of these variants (or what other formulation) is applicable.
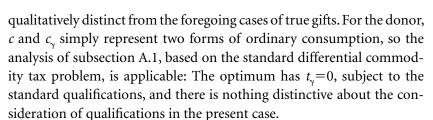
3. Exchange

Now assume that the transfer of c_γ from donor to donee constitutes payment for services rendered.[21] Analysis of this case is straightforward and

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[21] See, for example, Cox (1987) and, for a strategic analogue, Bernheim, Shleifer, and Summers (1985). Buchanan's (1983) argument that potential heirs engage in rent-seeking behavior to induce donors to make transfers is similar in this respect if such behavior involves

qualitatively distinct from the foregoing cases of true gifts. For the donor, c and c_γ simply represent two forms of ordinary consumption, so the analysis of subsection A.1, based on the standard differential commodity tax problem, is applicable: The optimum has $t_\gamma = 0$, subject to the standard qualifications, and there is nothing distinctive about the consideration of qualifications in the present case.

To complete the analysis, consider donees. Their receipt of γ (equal to the c_γ of their corresponding donor) is simply a form of labor income, albeit in an informal setting. Hence, it should be included (as part of wl) in determining total labor income subject to the tax schedule T. That some gifts in fact constitute payments for services was part of Simons's (1938) argument that gifts should be included in the income tax base of donees.

4. Accidental Bequests

Finally, consider donors who have no desire to make transfers but nevertheless leave bequests due to the incompleteness of annuity markets that may result from adverse selection.[22] In this case, although both aforementioned externalities—donees' utility gain in their own right and donees' reduction (or perhaps increase) in labor effort—are present, donors lack the affirmative motivation of altruistic donors or those who benefit from giving per se. Accordingly, t_γ would have no effect on their giving.[23] It is often suggested that, as a consequence of this final point, a

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providing something of value to donors. Note further that gifts sometimes involve reciprocal exchanges for which determining motivation (for example, altruism versus exchange for services) may be difficult. Additionally, some reciprocal exchanges over time may involve loans and their repayment or informal insurance arrangements. See, for example, Kotlikoff and Spivak (1981) and Lucas and Stark (1985). These apparent transfers do not carry the same tax implications of either true gifts or exchanges for services.

[22] For empirical evidence on adverse selection in annuity markets, see, for example, Brown, Mitchell, and Poterba (2002) and Finkelstein and Poterba (2004).

[23] For empirical evidence suggesting that a substantial portion of bequests are intended, see, for example, Bernheim, Lemke, and Scholz (2004), finding that inter vivos transfers are responsive to expected estate taxes, and Kopczuk and Lupton (2007), finding that most of the elderly have bequest motives that account for half of their bequests; however, Hurd (2003) is more skeptical. Furthermore, it seems plausible that, even with incomplete annuity markets,

confiscatory transfer tax on accidental bequests would be optimal, but it is worth elaborating why this might be true. This result, after all, is not obvious since gifts still benefit donees; also, alternative schemes should be considered in light of the presumed imperfection in annuity markets.

To illustrate the benefits of a confiscatory tax, suppose that all prospective donees are identical ex ante, including that they are paired with identical donors. The only difference is that different donors randomly die at different ages and accordingly leave different bequests. In such a simple case, the optimal scheme for donees (donors are presumed to be indifferent) is complete insurance, wherein each bequest is shared equally by all donees. Such an insurance scheme can be seen as a 100% tax on bequests, with the proceeds distributed pro rata among donees. As a pure insurance scheme, this result could be extended to cases of ex ante heterogeneity of donee prospects by retaining the 100% tax but adjusting distributive shares to reflect expected bequests (assuming ex ante differences could be observed).[24]

Such arrangements, however, are not necessarily optimal as a matter of insurance or social welfare (taking into account the possibility of redistributing bequests in other than an actuarially fair manner). One important consideration is that donees whose respective donors die at different

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many donors leaving accidental bequests derive some utility from the contemplation thereof. As in the preceding cases, however, only pure motives are under consideration in each subsection, with optimal treatment of mixed motivations presumably reflecting some combination of the separate analyses. Furthermore, it is important to distinguish accidental bequests—those by donors who wish to annuitize completely—from bequests by individuals who cannot bring themselves to engage in explicit planning. The latter group may nevertheless derive utility from anticipated bequests and also may be influenced by t_γ, even if not in accord with complete maximization.

[24] Kopczuk (2003) advances the interesting alternative view that, seen entirely from the perspective of donors, estate taxation itself can be thought of as a government-provided annuity scheme. One can think of all donors paying an initial tax constituting their entire wealth and consuming an annual annuity stream until they die. An equivalent outcome is produced if instead they keep their wealth and perhaps receive an up-front wealth supplement (all of which one may think of as being held by the individual on behalf of the government, in its capacity as annuity provider), consume the same annual annuity stream, and hand over the remainder upon death. An estate tax exhibits traits of the latter.

ages may no longer be identically situated. For example, those whose parents die earlier may be worse off, so their higher inheritances (under a regime with no transfer tax rather than a confiscatory one) are compensatory.[25] As a matter of optimal insurance (and social welfare, under a utilitarian SWF), all that matters is donees' marginal utilities of income, so their different utility levels may be irrelevant. Under strictly concave SWFs, however, this compensatory feature of bequests would be beneficial. Furthermore, those whose parents die earlier tend to receive bequests at a younger age, and they may accordingly have a higher marginal utility of wealth on this account, due to liquidity constraints, a longer planning horizon, and the ability to spread the inheritance over a greater number of years, which would disfavor confiscatory taxation.

Possible remedies to the apparent failure in annuity markets should also be considered. Suppose incomplete annuitization is due entirely to adverse selection—that is, all prospective donors would wish to annuitize fully, say, at age 65, if this were possible at actuarially fair rates. Then it may be optimal for the government to force complete annuitization. If that were done, there would be no accidental bequests to tax.

C. Additional Considerations

1. Other Aspects of Distribution

Although discourse on transfer taxation often is greatly concerned with distributive issues, the foregoing discussion sets them aside. The reason is that distribution—in particular, the distribution of utility among donors—is understood to be held constant by an adjustment to the income tax schedule. As with many other subjects explored in this book, distribution is substantially orthogonal. Questions concerning the concentration

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[25] If parents die substantially earlier, however, bequests would be lower, not higher. Note also that bequests may compensate not only for pure losses in utility but also for a reduction in inter vivos transfers that would otherwise have been received (although in some situations such transfers may have been negative).

of wealth are also ignored, in this case because taxation of wealth holdings is distinct from the present subject of taxation of wealth transfers, as mentioned in the introduction to this chapter.[26]

There are, nevertheless, distributive consequences of giving even in the present framework. Subsection A.3 considered the effects of giving on the marginal social value of redistribution. There is also a further distributive issue distinctly implicated by transfer taxation: Distribution among donees and, more broadly, intergenerational distribution (see also subsection 14.B.2).

Intergenerational issues can be examined using a two-period overlapping-generations version of the model presented in section A.[27] Many of the main ideas can be illustrated in a simple variant with just a first generation of donors and a second generation of donees. For concreteness, suppose that all of the following are true: In the donor generation, high-income individuals make disproportionately large gifts; taking the two generations as a whole, most giving is by individuals with above-average income; and the typical recipient in the donee generation has less income than the corresponding donor but more than the average second-generation member.

In the spirit of many prior discussions of this subject, consider first the effect of transfers on living standards rather than on utility levels. By this metric, the aforementioned pattern of giving reduces inequality within the first generation (because the rich give disproportionately more), increases inequality in the second generation (because the average recipient has above-average income), and reduces inequality in the

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[26] Nevertheless, some favor heavy transfer taxation of the very wealthy because it reduces concentrations of wealth over time, thereby limiting the extent to which a few individuals wield disproportionate influence on government and society. However, taking this objective as given, it is hardly clear why a wealthy individual induced to expend all his wealth during his lifetime (for example, under the prospect of a confiscatory estate tax on large bequests) reduces rather than increases the magnitude of such influence, by contrast to his spreading the wealth over generations and among multiple individuals who are likely to have differing agendas and also fewer resources with which to pursue them.

[27] See, for example, the sketch in notes 6 and 8 and also the analysis in Bevan and Stiglitz (1979).

two generations as a whole (because typical recipients have lower incomes than their donors).[28] The latter result indicates that, on net, transfers constitute a sort of voluntary redistribution.[29]

Returning to the standard welfare economic framework, consider now the effect on the distribution of utility levels (which in the present setting are not unambiguously related to living standards, that is, own-consumption). Regarding donors, although gifts reduce their standard of living, true gifts necessarily increase their utility. If transfers thereby disproportionally augment the utility of better-off members of each generation, they plausibly increase inequality in the distribution of utilities, taking the two generations together. However, in the present context (as in others, on which see section 15.A), measures of inequality in isolation are incomplete and potentially misleading indicators of overall effects on social welfare. To see this, note that, in a world with no income taxation (and thus no income tax revenue externality), the transfers under consideration increase the utility of both donors and donees while affecting no one else. That is, permitting transfers—by contrast, say, to prohibiting them, such as through confiscatory taxation—results in a Pareto improvement, raising welfare under any standard SWF, even though inequality in utilities is increased. Put another way, the analysis in sections A and B already takes into account the welfare effects of transfers on both donors and donees (and on the public fisc), and any further distributive concerns are reflected in subsection A.3's consideration of how transfers affect the marginal social value of redistribution. That analysis would seem to exhaust distributive concerns from a welfarist perspective.[30]

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[28] Depending on the precise pattern of giving and the measure of inequality, these characterizations need not be apt. For example, Wolff (2003) shows that, although richer households receive more private transfers than do poor households, transfers are a greater proportion of wealth holdings for the latter and thus help equalize the distribution of wealth; however, wealth transfers are essentially uncorrelated with lifetime earnings and thus do not equalize lifetime resources.

[29] As Bevan and Stiglitz (1979) and others have noted, it follows that analyses that confine attention to the steady-state extent of consumption inequality in an infinite, overlapping-generations model can be misleading. Such an approach is analogous to one that in the present example would measure inequality in the second generation alone.

[30] Farhi and Werning (2005) determine optimal income and estate taxation in an intergenerational context. They find that the average optimal estate tax rate is negative—a bequest

2. Human Capital

As noted in subsection 9.C.3, human capital constitutes a significant portion of all wealth yet is taxed very differently from the manner in which physical and financial capital is taxed. Likewise, contributions to human capital are a large fraction of all intergenerational transfers, broadly construed, but for the most part they are excluded from existing and proposed transfer tax schemes (and to some extent are additionally favored with income tax deductions or credits).

It should be apparent that parental transfers are indeed substantial determinants of children's human capital.[31] This is certainly true for innate ability, a product of parents' genes, and also holds for major environmental influences, including those within the home, in the neighborhood, and at school. In selecting residential locations or making expenditures on private provision, parents choose peer groups and the quality of formal instruction; they also are influential regarding postsecondary education and business opportunities. For all but the very wealthy, it seems likely that such factors are responsible for the lion's share of intergenerational wealth transmission. Nevertheless, it is not even imagined that most of these transfers might be subject to transfer taxation, and those that seem most plausible to tax (notably, payments for private education) are usually exempt as well.

The pertinent question for present purposes is whether transfers of human capital should be taxed or subsidized any differently from the treatment implied by the preceding generic analysis of gifts. A natural presumption is that they should not, for the analysis seems largely independent of the form of a gift, and, moreover, differential treatment tends to induce distortionary substitution.

There are, however, some pertinent differences. One concerns the tax revenue externality due to gifts. Although ordinarily negative, it was noted that this externality is positive when gifts contribute to donees' earnings and thus increase tax revenue. To this extent, human capital

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subsidy—because parents' weight on their children's utility is less than the social weight and that this tax rate is rising (that is, the subsidy is falling) with the income of those in the donor (parent) generation for subtle reasons relating to relaxation of incentive-compatibility constraints.

[31] See, for example, Taubman (1996).

transfers should be subsidized relative to other transfers. Some such transfers may be directly identifiable; furthermore, it may be inferred that such transfers are most significant in the case of inter vivos gifts made early in the life cycle. Another possibility is that different sorts of transfers are associated with otherwise unobservable differences in transfer motives that would call for different levels of tax or subsidy. Perhaps human capital transfers are more likely to arise from altruism than to be offered in exchange for services. Additionally, accidental bequests do not for the most part augment human capital. Accordingly, there may be further justification for relatively favorable tax treatment of transfers of human capital.
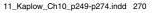
3. Charitable Giving[32]

Charitable giving constitutes a substantial form of private transfer activity, which Andreoni (2006) reports to be approximately \$240 billion in the United States in 2002. Although often viewed as sui generis, the subject of optimal taxation—or, as typically supposed, subsidization—of charitable contributions can readily be assimilated into the present framework. After all, charitable giving is a species of voluntary transfer. Donors presumably make contributions as a consequence of the utility they derive therefrom. And although donees are entities rather than people, in most cases the direct recipients may be viewed as representatives of groups of ultimate beneficiaries. Sometimes, charitable organizations are direct conduits, such as when their primary activity is to disperse donations to individuals in need. In other instances, this role is indirect, such as when donations are used to fund medical research that will benefit future individuals suffering from some disease. Accordingly, the foregoing analysis of donors giving to donees seems readily applicable to charitable giving. There are, however, a number of respects in which charitable gifts may differ.

First, consider direct gift externalities. The positive externality associated with gifts to identified individuals applies to charitable giving.

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[32] See Andreoni (2006) for a survey and Bernheim and Rangel (2007) for a discussion emphasizing non-neoclassical treatments.

That is, an organization's beneficiaries count in their own right in assessing social welfare, in addition to any utility that the donor receives as a consequence of making a gift. Furthermore, to the extent that ultimate beneficiaries are substantially less well off than donors (compare gifts to aid the poor to contributions to the symphony), the contribution to social welfare on account of voluntary redistribution would be greater. In addition, with charitable contributions it seems important to consider another sort of positive externality, that gifts from one donor to a particular donee may simultaneously benefit other donors.[33] This possibility would arise, for example, if multiple donors were altruistic toward a single set of donees, say, the poor or future sufferers from some disease. By contrast, a warm-glow donor would not, by definition, benefit from others' gifts, although such a donor's gifts would benefit other donors who were altruistic toward the same donee. Therefore, the aggregate externality from charitable giving may vary greatly by context, both because of potentially large differences in the number of other concerned individuals and because of possible differences in those individuals' utility functions.[34]

Second, tax revenue externalities may be implicated. When a donee organization gives to those in need, the standard negative labor supply effect may arise (compare chapter 7's analysis of government transfer programs).[35] Other forms of charitable giving may have different effects

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[33] See Saez (2004b), and also Karlan and List (2006), who offer evidence that individuals may be more motivated to give when others are as well (perhaps others' gifts provide information or affect the warm glow). This externality is also present with much individual giving, although to a more limited extent. One parent's transfers to children may benefit the other parent, and grandparents and other relatives as well. Parents' gifts to married children also tend to benefit grandchildren and the families of their children's spouses. These additional beneficiaries are ignored by the present model that looks at pairings of representative donors with representative donees.

[34] These factors, among others, should influence the extent to which one donor's giving crowds out or reinforces other donors' giving (including the case in which one donor is the government). See, for example, Bergstrom, Blume, and Varian (1986) and the survey by Andreoni (2006).

[35] Transfer programs generally have negative income and substitution effects, the latter due to the phasing out of transfers as income increases, tantamount to a higher marginal tax

on donees' labor supply. Improved medical research could reduce labor supply if it lowers the marginal utility of consumption in the future by reducing the cost of health care, but such gifts could increase marginal utility by making available more useful ways of spending disposable income or, by prolonging longevity, inducing individuals to work harder in anticipation of a longer retirement. Support of the symphony may make leisure more attractive to others who might attend performances, reducing labor supply. As with the direct (and ordinarily positive) externalities, there seems to be substantial heterogeneity regarding these additional effects of charitable contributions.

Third, different mixes of transfer motives should also be considered, especially because the unobservability of motives implies that transfer taxation must reflect averages for practically distinguishable categories of giving.[36] It was already observed that the mix of altruists and individuals gaining utility from giving per se may differ across types of charitable giving. In addition, exchange undoubtedly is often present and in varying degrees that may depend, in this case, on the form of the gift. Some contributions, such as for buildings to be named for the donor, have an aspect of purchasing a personal monument, and the charity's benefit may accordingly be significantly less than the face amount of the gift, the difference reflecting sums spent on gold-plating that may benefit the donor substantially more than the donee. Anonymous giving and contributions serving remote beneficiaries are less likely to fit the exchange model, although many donee organizations may provide their services in a form designed to be pleasing to donors even if less effective in helping donees. Finally, in contrast to the case of individual giving, purely accidental bequests seem unlikely because active estate planning is necessary to name charitable beneficiaries.

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rate. For voluntary transfers, the analogy is the Samaritan's dilemma, mentioned in note 14 and analyzed in subsection 11.B.2 on social security.

[36] The observable dimensions differ between the two contexts. For individual giving, treatment may be dependent upon the relationship between the donor and donee, either individual's age, whether a transfer is a gift or bequest, and whether the transfer is of human capital (although the fungibility of money may make such transfers difficult to distinguish). For charitable giving, taxes or subsidies might vary by type of organization, number of other donors, whether gifts are anonymous, and whether and how they are restricted.

Fourth, charitable organizations' competition for contributions may dissipate resources in the attempt to attract gifts from donors.[37] Another consideration is that solicitations—rather than increasing prospective donors' utilities by making them aware of additional giving opportunities or augmenting the warm glow from giving—may reduce their utilities by inducing guilt feelings that are at best assuaged by any contributions they are induced to make.[38] It should be noted, however, that these phenomena are not distinctive to charitable giving but rather are analogous to those raised by Buchanan's (1983) depiction of individual donees' rent-seeking behavior (see note 21) in competing for particular donors' favor. In addition, these possibly negative features of charitable solicitation are shared more broadly with product advertising by competitors.

Taken together, the foregoing brief examination of charitable giving indicates that the subject is well illuminated by the present framework but that significant variation regarding most pertinent factors renders generalization difficult. In practice, many tax systems prefer charitable giving over giving to individual donees. In the transfer tax system, charitable contributions are often exempt (in the United States estate and gift tax, through a deduction, and in countries with an inheritance tax, through exempting charitable organizations), which favors such gifts over transfers to individuals but puts gifts on a par with own-consumption expenditures. Under the income tax in the United States and many other countries, there is also a charitable contribution deduction or credit (for inter vivos contributions), which favors such transfers over both own-consumption and ordinary gifts. For individuals with enough wealth to be subject to transfer taxation, the combined benefits provide a substantial preference for charitable over ordinary gifts. Typically, there is little effort to distinguish among types of charitable contributions.

A final important point, suggested by the discussion of positive externalities involving other donors, is that a complete analysis of chari-

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[37] See, for example, Rose-Ackerman (1982).

[38] This factor and others lead Andreoni (2006) and Diamond (2006) to be wary of including utility that derives from giving per se (warm-glow utility) in the assessment of social welfare.

table giving requires that the alternative of direct government expenditure, the subject of chapter 8, also be integrated into the framework. In this regard, it should be noted that the objective is not properly formulated as inducing a given level of activity at the minimum cost to the fisc. First, if donors derive utility from giving, which itself may depend on how taxes on or subsidies to giving are formulated (see especially subsection 10.B.2 on alternative specifications of the utility from giving per se), social welfare may depend on who pays for public goods, independently of questions concerning the shadow cost of government funds.[39] Second, as section 8.C emphasizes, in the benchmark case the production costs of public goods determine their optimal provision, which implies as a first approximation that revenue costs as distinguished from resource costs are not the pertinent consideration.[40]

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[39] See Diamond (2006) and Saez (2004b).

[40] For both of these reasons, the familiar view that the optimal subsidy (if any) for charitable contributions depends on the elasticity of charitable contributions is at best incomplete and is likely to be quite misleading. Regarding the latter reason noted in the text, recall from section 8.G that, as in the current chapter, it is appropriate to consider a policy experiment that is revenue and distribution neutral, so that the only effect is allocative. Thus, on reflection, it is not surprising that in the benchmark case the optimal Pigouvian tax (subsidy in the case of positive externalities) equals the marginal external effect and that this result is true without regard to the level of the demand elasticity.

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