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Taxing Inheritances, Taxing Estates

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Taxing Inheritances, Taxing Estates

JAMES R. HINES, JR.*

I. INTRODUCTION

Just about every living American knows that there is heated political controversy over the taxation of estates and inheritances. The controversy has several sources, prominently including both the absence of a shared concept of tax fairness and a tension between the universal dislike of being taxed and the government’s desperate need for revenue. Popular rallying cries and the tax reduction experiments conducted by the U.S. Congress and the Bush Administration since 2001 have kept the estate tax on the political front burner,¹ where it may remain for years to come.

How should those who are coolly detached from Washington politics think about the taxation of wealth transfers at death? The recent intriguing proposal by Lily Batchelder² to replace the U.S. estate tax with an inheritance tax offers a fresh opportunity to consider the underlying justifications for taxing wealth transfers, their implications for tax design, and the likely consequences of reform.

In analyzing possible reforms of the estate tax it is critical to bear in mind just what reform might entail, along with any potential alternatives. This is particularly important in the context of a reform that seeks to change the distribution of after-tax income, since the government has at its disposal many tax instruments that can and do influence income distribution. Thus, for example, if the goal of tax reform is to reduce the tax burden on low-income taxpayers while increasing the tax burden on high-income taxpayers, a very direct approach would be to increase income tax rates at higher levels of income and reduce tax rates at lower levels of income. The alternative of changing the structure of wealth transfer taxes may achieve some of the same

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¹ For assessments of the front burner’s estate tax temperature, see Michael J. Graetz & Ian Shapiro, Death by a Thousand Cuts: The Fight over Taxing Inherited Wealth 1 (2005); Edward J. McCaffery & Linda R. Cohen, Shakedown at Gucci Gulch: The New Logic of Collective Action, 84 N.C. L. Rev. 1159 (2006).

purely redistributive objectives, but in a far less direct manner, since estate or inheritance taxes apply only to a small fraction of taxpayers and have an aggregate base that pales in comparison to annual income. Furthermore, any wealth transfer tax reforms that redistribute income among taxpayers are likely to be accompanied by other reforms to income, excise, and other taxes also controlled by the federal government and that also have redistributive effects. One can imagine a situation in which a redistributive change in one part of the federal tax system triggers tax changes elsewhere that largely, if not entirely, undo its effect on the distribution of income.

A fruitful way to cast the problem of wealth transfer tax design is to ask what role such taxes would play if the rest of the federal tax system were optimally designed.\(^3\) Such an exercise serves to identify the potentially unique features of wealth transfer taxes, and their role as a supplement to other revenue sources, particularly income taxes. Realistically, at least some of the support for existing and proposed federal wealth transfer taxes comes from advocates who are concerned that income is for one reason or another not properly taxed as it is earned. The obvious implication of such concerns is to reform income taxes, but that could be difficult or politically costly in the current environment. Whereas from a reform advocacy standpoint it may then be sensible to call for reforms to that part of the federal tax system believed to be most malleable, from an analytic standpoint it becomes very difficult to understand how one should evaluate the properties of such piecemeal reform directed at problems that stem from other features of the tax system. Hence the most analytically consistent approach is to consider the role of transfer taxes in a system of optimal tax design. Establishing the place of transfer taxes as part of an optimal tax package clarifies extensions to more specific reforms that start from a baseline of inefficient or otherwise suboptimal taxes.

One of the many contributions of the Batchelder article is to renew the debate over whether transfer taxes should take the form of obligations of those who give or those who receive.\(^4\) Putting aside minor details of implementation and administration, much of the difference between the two forms of transfer taxation resides in the progressive nature of the tax rate structure. Estate tax obligations are unaffected by how taxable estates are divided among recipients, which is not true of inheritance taxes. A parent with five children of equal incomes


\(^4\) Batchelder, note 2, at 6-11.
facing a progressive inheritance tax minimizes aggregate tax liabilities by dividing the estate equally among the five, whereas the division of the estate would not affect tax liabilities under an estate tax. As an empirical matter, even under estate taxation families generally divide their estates equally among surviving children. Hence the much more consequential difference between estate and inheritance taxation is that two families of equal parental wealth but differing numbers of children may face very different aggregate tax liabilities under an inheritance tax.

This Article considers two aspects of converting the U.S. transfer tax system to one in which burdens are imposed on the basis of receipt rather than gift. The first aspect is the economic impact of distinguishing transfer tax liabilities by numbers of children in a family in addition to the total amount of transferred wealth. The second aspect is the nature of the event that triggers tax liability. Taxing on the basis of receipt raises complicated issues about generation-skipping transfers, transfers to trusts, and transfers that involve foreign as well as domestic parties, all of which are potentially influenced by the logic of taxing on receipt rather than gift.

Part II of the Article reviews the logic of wealth transfer taxation in the broader context of the federal tax system. Part III considers the ultimate incidence of wealth transfer taxes, which is to say, the distribution of their burdens, and Part IV analyzes the efficiency costs of taxing wealth transfers. Part V considers the impact of potential reforms on wealth concentration, and Part VI analyzes international aspects of wealth transfer tax reform. Part VII is the conclusion.

II. WHAT IS THE SCOPE OF REFORM?

It is natural to think of the existing estate and gift tax system as the alternative to any proposed transfer tax reform. The well-known difficulty with such a line of reasoning is that the entire existing tax system is imperfect, reflecting, as it does, conflicting interests, political infighting and compromises, past and present misunderstandings of economic reality, simple mistakes, perhaps at times even deliberate sabotage—in sum, the many facets of human nature. In such an environment, the rest of the tax system is likely to be affected if the estate tax were to be replaced with an inheritance tax, since the same com-

promises that produced the system as we see it today would doubtless continue to operate in a tax reform environment.

The integrated nature of the tax system raises two important conceptual issues in analyzing potential reforms. The first is how to cast potential wealth transfer tax reforms in a broader environment of tax reform and optimal tax design; the second is how to think about the behavioral impact of wealth transfer tax reform together with induced changes in other parts of the federal tax system.

A. The Place of Wealth Transfer Taxes

Despite any apparent shortcomings of existing U.S. federal taxes, it is worthwhile to consider the role and design of wealth transfer taxes in an optimally crafted federal tax structure. As a general matter, an optimal tax structure would look very different from what we see today, with more finely differentiated tax rates, far fewer concessions to entrenched political interests, and a considerably heavier emphasis on taxing expenditures rather than income. One way of framing the analysis of wealth transfer taxation is to ask how and to what degree an optimally designed federal tax system would tax wealth transfers.

Consider a system in which the federal government taxes lifetime expenditures using an optimally designed (generally progressive) tax rate schedule. If bequests were not treated as expenditures for tax purposes, then such a system would not distinguish tax burdens based on how expenditures are financed. Individuals with large lifetime expenditures would be subject to higher rates of taxation than those who spend less, although this system would disregard how hard someone had to work, how much they had to save, how wisely they had to invest in order to afford their spending. It is worth noting, however, that two otherwise identical individuals who inherit differing amounts from their parents, and who ultimately spend all that they have, would face different marginal tax rates on inherited wealth, since taxpayers who have more ultimately spend more, and therefore face higher tax rates.

Is there a potential role for wealth transfer taxes in such a system, and if so, what is it? It is safe to say that this problem has not been fully worked out in the way that the static optimal income tax problem has, due in part to the great complexity of the problem and in part to

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the difficulty of identifying a commonly accepted set of objectives for the government. As a result, it is very difficult to know just what role wealth transfer taxes might play in the optimal tax solution, and indeed whether transfer tax rates would be positive or negative. The choice between an estate and an inheritance tax base is a far more subtle concern than the basic problem of wealth transfer taxes, and one that begs information on what constraints are implicitly imposed on other aspects of the tax system.

In order to evaluate alternative optimal tax instruments, it is necessary to identify both the goal of the tax system and the constraints that the government faces. Generally speaking direct instruments are much more efficient at achieving policy objectives than are indirect instruments. If the goal of the tax system is to redistribute from the rich to the poor, and if affluence is understood in flow income terms, then an income-based tax serves this function very well. To say, as many do, that the existing U.S. federal income tax does not redistribute sufficiently, or that it does so inefficiently, is not to say that the income tax should be abandoned, or even supplemented by other taxes, but instead that its rates or bases might be changed.

If instead the goal of the tax system is to prevent or severely reduce the concentration of wealth in a small number of hands, then the obvious instrument to use is a progressive property tax, where property is understood to include all wealth. Such a tax has obvious drawbacks, including its distorting effect on economic activities such as earning, saving, and investing, the difficulty of administration and enforcement, and the rather blunt nature of the tax in not distinguishing one form of wealth from another. Most locations in the United States already have property taxes of one form or another, though these currently do not apply to all forms of property, and the U.S. federal government does not currently have clear authority to impose wealth taxes.

The redistributive goals of taxation may in principle be pursued by any of a number of possible means, including but not exclusively income taxation, property taxation, and wealth transfer taxation—although it is important to acknowledge that these various forms of redistributive taxation interact with each other in important ways. The most obvious form of interaction appears in the case in which just one of these taxes redistributes to the extent that other redistributive taxes are not needed or wanted; for example, the income tax might be adjusted so that the country achieves its distributional goals with income taxation alone. As a practical matter this may seem unlikely to

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happen, although it is worth exploring just why it seems unlikely. In
part, there appears to be an upper limit on acceptable income tax
rates, a limit that restricts the ability of the tax system to redistribute.
This limit may have political or social origins, or more likely, reflects
the reality of tax avoidance and the high economic cost of eking addi-
tional tax revenue out of already highly taxed individuals.

Limits to the redistributive potential of the income tax do not imply
that much additional redistribution is available by deploying supple-
mental tax instruments, due to the interactive nature of multiple taxes.
For example, the same tax avoidance that limits the redistributive po-
tential of the income tax also limits the redistributive potential of a
wealth transfer tax. In the Mirrlees model, higher rates of income tax-
ation discourage income production, and it is this incentive that ulti-
mately restricts marginal tax rates, even those applying to high-
income taxpayers. When an individual subject to a high income tax
rate produces a bit less taxable income, the individual forgoes eco-
nomic opportunity in return for greater leisure, generally equating the
marginal private value of each, but the government (and society) do
not value this choice indifferently at the margin, since the individual’s
pretax (and social) productivity exceeds the value of the leisure alter-
native by an amount equal to the marginal tax rate. Put differently,
the government loses tax revenue when an individual reduces work
effort. As tax rates rise, the amount of potential social loss for a given
amount of work effort reduction also rises, ultimately limiting the ex-
tent to which it makes sense to tax even high income individuals.

The same process applies not only to income taxes, but also to ex-
penditure taxes, property taxes, wealth transfer taxes, and any other
taxes on resources obtained by working. Furthermore, these taxes in-
teract with each other. If a higher rate of wealth transfer taxation
discourages working, then this induced labor effect reduces income
tax collections. Similarly, if a higher rate of wealth transfer taxation
reduces saving, then this behavioral effect reduces revenue that is col-
lected from capital income taxes. Of course, optimally designed in-
come taxes would adjust to the new wealth transfer taxes, presumably
by reducing their rates and adjusting their structure to offset many if
not all of the effects of the new taxes, but that leaves the question of
just what impact is left for the transfer taxes.

One potential objection to this analysis is that wealth transfer taxes
do not have behavioral effects in the way that other taxes do, since the
process of intergenerational wealth transfer does not entail the same
kind of rational calculation that working and saving do. This is a hotly
controversial line of argument, arguably with empirical foundation,

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7 Mirrlees, Optimum Income Taxation, note 6, at 207.
though it is important to start with an analysis of purposeful and rational action without uncertainty, which is the baseline of virtually all of the optimal taxation literature, and certainly of the analysis in the Mirrlees tradition. A utility-maximizing individual generally chooses a level of taxable income production that makes him indifferent at the margin between producing an additional dollar of after-tax income and instead forgoing that income and consuming leisure. The same rational individual selects a consumption and bequest profile that likewise equates marginal values of alternative uses of funds, so that the individual is indifferent between marginal consumption in every year of life, and indifferent between a marginal dollar of own consumption and saving that dollar to add to the ultimate bequest. Consequently, a bequest tax reduces the return to working, since it is equivalent to a tax on consumption. Hence the same economic forces that limit income taxation also apply to bequest taxation, and apply on a cumulative basis: What is limited is the sum of income and income-equivalent bequest taxation. To be clear, this implies that higher rates of bequest taxation would need to be accompanied by lower tax rates on income earned by the same individuals.

This analysis assumes that bequests are rationally anticipated and planned by those who earn income. It is certainly not the case that all bequests are rational, any more than it is the case that all working decisions are rational or all saving decisions are rational. The mere possibility of irrationality, however, does not carry an implication that wealth transfer tax rates should be high or low. Unfortunately, the empirical literature on the determinants of bequests (briskly reviewed in Batchelder), offers little guidance to wealth transfer tax design, since what matters is not how the population as a whole behaves, but instead how the part of the population affected by estate and inheritance taxation behaves. Since those with sufficient wealth to be subject to transfer taxes constitute a tiny fraction of the U.S. population, standard data sets do not contain large samples of observations of the behavior of relevant individuals.

One way in which the part of the U.S. population affected by estate and gift taxation surely differs from the U.S. population as a whole is that affluent families benefit the most from careful estate planning.

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8 See Batchelder, note 2, at 36-41.

Furthermore, precautionary saving motives are unlikely to have much purchase on marginal saving decisions of very wealthy individuals, since these individuals maintain large wealth stocks in any case, and have much better access to sophisticated financial products than do other members of the population. Hence to the extent that any individual economic decisions reflect rational choices, it stands to reason that carefully planned saving and bequests by the wealthy do so.

This leaves some scope for potentially irrational or accidental behavior on the part of those who leave bequests, since some irrationality is inevitable in economic life. Accidental or irrational bequests have some of the properties of windfalls, and there is a part of the optimal taxation literature that can be taken to imply that the optimal tax rate is very high, possibly close to 100%, on windfalls received by unusually wealthy individuals. Of course this implication is not unique to wealth transfers; the government has equal incentive to confiscate other windfalls, such as money found on the ground or resources found underneath the ground, unexpectedly high rates of return to financial investments, salaries that exceed what is needed to elicit the same work effort, and any other sources of economic rent.

In practice governments do not subject these or other windfalls received by the wealthy to 100% tax rates, and it is worth considering why not. The first reason is the difficulty of distinguishing windfalls from normal or expected returns to economic activity, which would apply with roughly equal force to any of these sources of return. But the second reason is that the shared sense of tax fairness does not include 100% tax rates on any kind of income, whether windfall or not. Concepts of tax fairness are subjective and therefore can be difficult to translate into certain types of social welfare functions, but they have significant effects on legislative outcomes, and it is worth bearing in mind that quite possibly they should influence the normative evaluation of tax policies.

The distinction between inheritance and estate taxation turns largely on the degree to which wealth transfers in large families might be taxed at lower rates than wealth transfers in small families. If adopted, this would not be the only aspect of federal taxes distinguishing taxes based on family size, since the federal income tax already offers certain limited tax breaks for large families, reflecting the notion that resources in large families are divided among more hungry mouths than are the same resources in smaller families. Examples of such provisions in the current U.S. federal income tax include deduc-
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ensions for personal exemptions,\textsuperscript{11} child tax credits,\textsuperscript{12} and credits and deductions for dependent care\textsuperscript{13} and schooling expenses.\textsuperscript{14} While under current law the tax benefits for large families are rather modest, and largely disappear for affluent taxpayers,\textsuperscript{15} in principle there is nothing to prevent income taxation from being more carefully tailored to family size. Hence it is worth considering the extent to which a suitably family size-adjusted income tax would be worth supplementing with wealth transfer taxes also differentiated by family size.

Finally, the well-documented intergenerational correlation of economic outcomes\textsuperscript{16} carries an instructive implication for the distinction between inheritance and estate taxation. Taking parent affluence to be correlated with the unobserved ability of children, an argument can be made in favor of supplementing income taxation with a tax based on parental affluence. Putting aside complex questions of whether innate ability is a suitable basis of taxation, and presuming that it is, it follows that conditioning income taxation on parental ability may improve the operation of income taxes by targeting tax obligations a bit more efficiently, thereby relaxing what are known as the self-selection constraints. To the extent that this augurs in favor of taxes on wealth transfers as indirect indicators of parental ability, it is noteworthy that this consideration generally is an argument for the use of estate taxes rather than inheritance taxes. The literature on intergenerational wealth transmission reports that a child's affluence is correlated with her parent's affluence, not the per-child parent affluence figure that would more closely be captured by an inheritance tax.

B. Behavioral Implications of Wealth Transfer Tax Reform

What behavioral responses are likely to accompany significant reform of wealth transfer taxes? In order to answer this question, it is necessary to consider the probable course of the tax reform process.

For reasons just described, reform of wealth transfer taxes is likely to be accompanied by reforms to other parts of the federal tax system, in particular income taxes. These other tax changes have the effect of largely undoing the distributional implications of wealth transfer taxes. The behavioral impact of wealth transfer tax reform therefore depends not only on any direct effects of wealth transfer tax changes,

\textsuperscript{11} IRC § 151.
\textsuperscript{12} IRC § 24.
\textsuperscript{13} IRC §§ 21, 129.
\textsuperscript{14} IRC § 25A.
\textsuperscript{15} IRC § 24(b); IRC § 25A(d).
\textsuperscript{16} Diego Restuccia & Carlos Urrutia, Intergenerational Persistence of Earnings: The Role of Early and College Education, 94 Am. Econ. Rev. 1354 (2004); Gary Solon, Cross-Country Differences in Intergenerational Earnings Mobility, 16 J. Econ. Persp. 59 (2002).
but also on the effects of induced changes to other parts of the tax system. Since it is difficult to predict the exact features of these induced changes, it is difficult to assess their impact on behavior, although the broad aspects are reasonably clear from first principles.

If wealth transfer tax reform is distributionally neutral, which it will be if income tax adjustments offset burden changes by income group, then the behavioral impact of tax reform comes from reactions to changing relative prices. In the language of the trade, these are substitution effects, or compensated responses to price changes. Strictly speaking, one observes pure substitution effects only if tax reforms are distributionally neutral at the level of the individual, but as long as taxpayers at the same income level display similar behavioral responses, and tax reforms are distributionally neutral by income class, then aggregate behavioral responses should very closely resemble substitution effects.

In the context of wealth transfer tax reform, substitution responses are likely to be considerably larger in magnitude than the uncompensated responses commonly estimated from cross-sectional studies. The reason is that income and substitution effects point in opposite directions, and the observed uncompensated responses represent the sum of income and substitution effects. For example, consider the effect of higher estate tax rates on a parent’s personal saving. A higher estate tax rate has two effects: It reduces the return to saving, since it reduces the rate at which a dollar saved today translates into final consumption by the next generation, and it makes the family poorer. The first, which is known as the substitution effect, depresses saving, whereas the second, which is known as the income effect, depresses consumption and therefore increases the parent’s saving.

As noted, there is very little evidence of the behavior of affluent taxpayers potentially subject to the estate tax, and to the degree that there is evidence, it generally reflects the sum of income and substitution effects. If the process of tax reform is such that it is reasonable to disregard income effects, then behavioral responses will be captured only by substitution effects, which are considerably larger in magnitude. For example, individual saving is likely to respond more sharply to the combination of estate and income tax changes than to estate tax changes alone, with accompanying implications for the distribution of tax burdens and the efficiency consequences of tax reform.

\[17\] Kopczuk & Slemrod, note 9.
\[18\] See note 9.
III. Who Bears the Burden of Wealth Transfer Taxes?

One of the critical elements in analyzing the impact of wealth transfer taxes is the distribution of their burden. Since there is enormous potential for confusion over this point, it is helpful to start with some elementary principles.

There are several possible measures of a tax burden, although what is known as the equivalent variation measure is generally, and correctly, thought to be the most useful and consistent.\(^1\) The equivalent variation measure of a tax burden is the amount of money that a well-informed and rational taxpayer would pay in return for eliminating the tax. Thus, if a person of means who understood all of the economic ramifications would be willing to pay $83,000 to abolish the U.S. estate tax, but would be unwilling to pay $83,001, it follows that the burden on that person is exactly $83,000.

The virtues of this definition of tax burden include not only its conceptual precision but also that it incorporates costs of avoidance. Consider the case of well-advised wealthy parents who make regular inter vivos transfers, purchase large life insurance policies, take up farming, consume excessively, contribute to charities about which they care little, and do other things in order to mitigate the effect of estate taxation under current rules. Their final estate tax liability to the U.S. government might be very small, but it does not follow that the tax is not burdensome to them, since much of the cost of estate taxation takes the form of inducing behavior that they would prefer to avoid absent a strong tax motivation. In concept, the equivalent variation measure of tax burden should capture these costs exactly.

Who then bears the burden of wealth transfer taxes? For the moment putting aside the effect of wealth transfer taxes on behavior and prices, it appears that in the canonical case of families with altruistic bequest motives both parents and children bear the burden of estate or inheritance taxes. Consider an altruistic family with a large estate subject to $2 million of estate tax liability, one that for purpose of illustration does not change its behavior in response to the tax. Parents would be willing to spend up to $2 million to avoid the estate tax, and children would also be willing to spend up to $2 million to avoid the tax. The total burden is then $4 million, equally distributed between those who give and those who receive.

As many observers note, there can be multiple motivations for intergenerational transfers. In cases of mercenary relationships between parents and children, intergenerational transfers serve the

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function of incentivizing and rewarding children for their actions on behalf of parents. In this setting estate taxes reduce the total amount available with which to compensate children for their services. This is costly to parents because it reduces the amount of child services they can afford to purchase, and is costly to children only insofar as parental payments exceed the amount necessary to elicit their behavior. In the non altruistic cases of parents who pay children exactly (or nearly so) what it takes to obtain their services, the estate tax is not burdensome at all to children, since they obtain virtually no net surplus from their inheritance in any case, and therefore would pay next to nothing to remove the tax. Hence the entire wealth transfer tax burden falls on the older generation.

There are other possibilities, including that intergenerational transfers reflect irrational or mistaken behaviors of various types. It is difficult to know to what extent these possibilities apply to affluent individuals potentially subject to wealth transfer taxes, and even if they do, irrational and mistaken behavior typically carries strong implications for parts of the federal income tax system other than wealth transfer taxes. For example, if some individuals seek to earn money not to spend it, and without regard to the purchasing power of what they leave to their heirs, but instead simply to have and hold the money as a strangely cherished item, then these individuals might leave sizeable bequests that are not influenced by rates of estate taxation. They would not pay anything to eliminate the estate tax, since they ignore it; the estate tax burden then falls entirely on inheritors. It does not necessarily follow, however, that the federal government should impose high rates of wealth transfer taxation in response, since the more direct implication is that the federal government should replace income taxes with excise or other expenditure taxes that capture the value of accumulated income without discouraging income production by these irrational individuals.

The simplifying assumption that behavior is unaffected by estate tax changes is used simply for illustration, since it is inconsistent with widespread observation of the various forms of avoidance for which the estate tax is famous. Avoidance adds to the cost of wealth transfer taxation, and is costly to all parties concerned, although the distribution of avoidance costs depends critically on the behavior in question and the underlying model of intergenerational wealth transmission. To the degree that high rates of estate taxation encourage altruistic parents to consume rather than save, the avoidance cost (as distinct from the cost of tax payments) is borne almost entirely by children who receive less from their parents. Yet if avoidance instead takes the form of parents making irrevocable transfers to their children at
younger ages than they would choose absent a tax motivation, the costs may be large to parents and negative to children. Consequently avoidance costs, which may be quite significant, take forms that are specific to individual situations. As a result, it is difficult to know just how the burdens of wealth transfer reform are likely to be distributed absent more detailed information on individual responses.

All of this analysis takes prices in the economy to be unaffected by wealth transfer tax reform. As noted in the previous Section, if estate tax reform is accompanied by compensating changes in other federal taxes, then the resulting behavioral responses are likely to be much larger in magnitude than are responses to estate taxation alone. An income-compensated increase in estate tax rates reduces the incentive to save, since the substitution effect works unambiguously in this direction. Reduced saving affects both labor and capital returns in a closed economy, potentially distributing the burden of wealth transfer taxes among all members of society. If, however, capital markets are open and the economy is a price-taker in world markets, which is an excellent approximation to modern conditions, then domestic prices are affected very little by induced saving effects, and there is no additional domestic distribution of the estate tax burden through general equilibrium effects. Finally, to a first approximation, an estate tax and an inheritance tax alternative have exactly the same general equilibrium effects on prices and the shifting of burdens through price changes.

IV. WEALTH TRANSFER TAXES AND EFFICIENCY

In order to evaluate the extent to which wealth transfer taxes efficiently collect and redistribute income, it is helpful to start by attempting to define the rate at which wealth transfers are taxed. One plausible candidate is the current effective estate tax rate, which for an individual a week away from certain death represents the rate at which resources not consumed this week but instead left for heirs to enjoy are lost to the government in the course of transfer. There are, however, other possible definitions, reflecting the many decision margins that bear on intergenerational transfers. A parent contemplating working another hour today in order to increase her bequest to a child ten years hence faces at least three layers of taxation: the tax on labor income, the tax on capital income as funds accumulate for ten years, and ultimately the estate tax on final transfer. Analogously, heirs typ-

ically do not spend all of substantial inheritances on the day of receipt, but instead husband at least some of their inherited resources, subsequently paying tax on capital income generated by these savings.

The combined effect of multiple taxes on inherited wealth makes high rates of taxation much more distortionary than they would be in isolation. This in itself is not necessarily an indictment of high wealth-transfer tax rates, since any tax is distortionary, and the net effect on efficiency depends in part on any induced behavioral responses. Since the component of behavior that is relevant to efficiency analysis is, however, compensated rather than uncompensated responses, it follows that the behavioral effects of wealth transfer taxation are potentially significant. As a result, there may be large efficiency costs associated with collecting revenue from wealth transfer taxes.

It is often the case that governments must set tax rates that strike compromises among multiple competing considerations, and it perhaps should be expected that wealth transfer taxes meet this description. In selecting compromise levels of wealth transfer tax rates it is important to consider not only the first-best rates of taxation, but also the cost of deviations from first-best levels. For example, if for some reason one-half the population would be best served by a transfer tax rate of 10\%, and one-half best served by a transfer tax rate of 30\%, it hardly follows that the government, if constrained to choose a single rate, should select 20\%, since what matters in determining the best compromise rate is equating the marginal costs of deviating from first-best alternatives. As a general matter, it is necessary in undertaking this type of calculation to place greater weight on preferences associated with greater behavioral responses to tax rate differences.

Related issues arise in comparing inheritance and estate taxes from an efficiency standpoint, where at least two considerations suggest that inheritance taxes are associated with greater deadweight losses than are estate taxes. The first consideration is that an inheritance tax regime creates a greater dispersion of transfer tax rates than does a bequest tax regime. Inheritance tax rates depend on the number of heirs among whom estates are divided, and these numbers differ widely, thereby creating differentiated tax rates. The deadweight loss associated with a tax rises approximately with the square of the tax rate, so a dispersion of tax rates is typically associated with greater aggregate deadweight loss. Consider, for example, two families with equal resources but very unequal numbers of children. With an estate tax these families would face equal transfer tax rates, whereas with an inheritance tax the smaller family might face a very high transfer tax rate and the larger family a very low tax rate. Since the high tax rate imposed on the small family in an inheritance tax regime induces
avoidance behavior that significantly reduces tax collections, this tax is particularly inefficient.

The second consideration that distinguishes inheritance and estate taxes is that tax liabilities under an inheritance tax are influenced by estate division as well as its total size, whereas tax liabilities under an estate tax are functions merely of the size of the estate. This additional dimension of tax-relevant choice somewhat broadens the scope of potential tax distortions, though in practice this choice may have little significance, given the common practice of dividing estates equally.

V. WEALTH TRANSFER TAXES AND WEALTH CONCENTRATION

A prominent justification for taxing wealth transfers is that doing so reduces the concentration of wealth holdings, thereby attenuating the social and political problems associated with an unequal wealth distribution. As noted earlier, if the social problem is concentrated wealth, then the policy answer is a tax on wealth concentrations, specifically, a tax at progressive rates on wealth holdings. While taxing wealth transfers may reduce the concentration of wealth, this conclusion is likely to depend on specifics of the way in which wealth transfer taxation is implemented.

The existing generation-skipping transfer tax was introduced in 1976 in reaction to the prevailing estate tax avoidance technique of bequeathing estates directly to grandchildren (or beyond), commonly using trusts for this purpose, thereby skipping transfers to one or more generations. For parents of considerable means, whose children were unlikely to spend all of their wealth, skipping a generation in this way offered the benefit of removing one or more stages of wealth transmission from estate taxation. Since the existing estate tax effectively distorted estate planning decisions by rewarding generation-skipping transfers, Congress in 1976 decided to remove much of the incentive to skip generations by instituting taxes on generation-skipping transfers.

Replacing the estate tax with an inheritance tax poses the question of what to do about the tax on generation-skipping transfers. The logic of inheritance taxation suggests removing the tax on generation-skipping transfers as part of a broader package of transfer tax reforms, but such a reform might have the paradoxical effect of promoting

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21 See Batchelder, note 2, at 5 n.16.
24 Id.
greater wealth concentration than that which would materialize in the
absence of any wealth transfer taxes. The reason is that encouraging
the use of generation-skipping transfers, often implemented with
trusts, reduces the opportunity for intermediate generations to dissi-
pate dynastic wealth.

The government is not the only stakeholder whose actions influence
the concentration of wealth in society; the government's partner in the
fight against concentrated wealth is the behavior of descendants. As
an illustration, suppose that a generation of wealthy inheritors spends
three-quarters of any marginal inheritance, saving the remainder for
transmission to subsequent generations. From the standpoint of
wealth concentration as measured in the generation of grandchildren,
permitting an intermediate generation to have access to inherited
funds is equivalent to an additional 75% tax on wealth transfers.
Hence if the goal of the government is to reduce wealth concentra-
tion, it should discourage if at all possible the use of generation-skip-
ning transfers, trusts, and other devices that prevent wealth
dissipation.

In the absence of generation-skipping transfer taxes, it is possible
that the net impact of wealth transfer taxes could be actually to in-
crease the concentration of wealth in society, since the direct effect of
wealth transfer taxes in reducing wealth concentration could be more
than offset by the impact of tax rules in encouraging the use of trusts
and other devices that retard the natural process of wealth dispersion.
While such an outcome may seem farfetched, it serves to illustrate the
potentially adverse consequences of tax policies that reward sophisti-
cated financial planning.

VI. INTERNATIONAL IMPLICATIONS OF WEALTH TRANSFER TAXES

One of the common features of wealth transfer taxation is its terri-
toriality. If an individual who is a resident and citizen of Country A
bequeaths $10 million of Country A wealth to a child who is also resi-
dent and citizen of Country A, there is very little that the government
of Country B has to say or do about the taxation of this transfer. In
part as an acknowledgement of this administrative reality, much of the
scholarly analysis of wealth transfer taxation is conducted as though
the world consists of a single country, or that developments in one
country do not affect others.

The single country framework is not an entirely satisfactory basis of
analysis in an economically integrated world. Given the realities of
international movement of people and resources, it is necessary to ap-
ply the logic of wealth transfer taxation to cases that include multiple
countries whose tax policies may be entirely independent of each other.

It is helpful consider the case of an elderly U.S. citizen whose daughter lives in France. Should any bequest from the parent be subject to taxation by the United States? If the goal of transfer taxation is to reduce the benefits of inherited economic privilege, where privilege is defined on a territorial basis, then it is difficult to see why the United States would want to tax this transfer, as France bears the cost of the inheritance. One problem, however, with exempting such a transfer from U.S. taxation is that the daughter might subsequently return to the United States, bringing her inherited wealth (and accompanying privilege). Perhaps even more troubling, a territorial-basis inheritance tax would give heirs incentives to relocate abroad merely for the period of time during which they expect to inherit.

A similar problem arises if a German citizen who inherits significant wealth from a German parent subsequently decides to relocate to the United States, since the logic of wealth transfer taxation appears to imply that this individual should be subject to significant inheritance taxation by the United States. Both this case and that of the child living in France could be addressed by imposing an immigration tax on inherited wealth, but such a tax would be associated with a host of problems. Perhaps the most obvious of these is the effect of an immigration tax on the flow of wealthy immigrants to the United States, although others include the difficulty of measuring inherited wealth and enforcing such a tax. If having wealthy individuals is in fact a problem, then once again the indicated solution is to impose a variable-rate property tax.

One possibly tempting policy avenue is to embrace an inclusive definition of taxable wealth transfers, one that taxes not only transfers received by U.S. citizens but also transfers made by U.S. citizens to individuals residing abroad, and possibly even transfers of U.S. assets made by foreigners to other foreigners. Such inclusiveness smacks of desperation, and would have the unfortunate and counterproductive effect of inefficiently discouraging foreign ownership of U.S. assets. If foreign-to-foreign transfers of U.S. assets are exempt from U.S. taxation, the biggest of these distortions would be removed, leaving only transfers in which at least one of the parties is resident in the United States. There is a separate question of what to do about citizens who

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amass significant wealth while still citizens but who then expatriate prior to transferring their wealth at death.

Quite apart from the obvious potential enforcement problem if the only living party to a transaction lives in a foreign country, the difficulty with residence and citizenship-based transfer taxation is that it distorts the location of residence and the nationality of citizenship. Current U.S. law includes a complex regime that for wealthy citizens and long-term permanent residents generally taxes assets as if sold at the time of expatriation, and taxes subsequent bequests to U.S. residents under the gift tax, but this system has a questionable policy foundation and does nothing about foreign citizens who stand to receive transfers from foreign citizens, or who plan to leave bequests to foreign citizens, and who would have moved to the United States but for the prevailing tax regime. Is it sensible for the United States to try to impose taxes on transfers from U.S. citizens to foreigners, or foreigners to U.S. citizens? The logic of estate taxation is consistent with the first, the logic of inheritance taxation consistent with the second, although both create problematic location incentives and realistically any location-based tax regime confronts challenges in an integrated world.

The wealth transfer tax difficulties posed by potential and actual international mobility of individuals reflect not only the flimsiness of nationality and residence as tax criteria, but also the arbitrariness of the moment at which assets are transferred. An American who accumulates a great deal of wealth while a resident of the United States, and who would like to transfer that wealth to his American child, can do so free of the U.S. tax net by renouncing his citizenship, moving abroad, and getting his child to do the same prior to the date of transfer. Well-advised parents and children who plan for this eventuality can live their lives in the United States prior to expatriation, confident that the U.S. government will not absorb a fraction of the ultimate transfer, and thereby enjoy whatever benefits there are to be had from anticipated and real inherited privilege. The logic of taxing inheritances suggests that it is the financial life one leads, rather than the inheritance per se, that the government properly seeks to tax; and again, as applied on a territorial basis, this argues much more strongly for a residence-based wealth tax than it does for a transfer tax based on nationality or residence at the time of transfer.

VII. CONCLUSION

It is important to understand the taxation of inheritances or estates in the context of a broader federal tax system that also taxes consumption, income production, business operations, and other activities. In-
interactions among the components of the federal tax system have the potential to increase greatly the normative and behavioral consequences of wealth transfer tax reform. As a result, potential reforms that appear attractive when viewed in isolation might look much less so in light of their effects on behavior and revenues produced by other federal taxes.

The United States would do well to ask itself to what degree the desire for wealth transfer taxation, and its reform, reflects dissatisfaction with the way that income is taxed when earned. Identifying just how much the income tax is the problem helps point the way to an efficient and sensible package of potential reforms. The thoughtful and provocative proposal by Batchelder to replace the existing U.S. estate tax with a specific form of inheritance tax draws attention to many of the issues surrounding the taxation of inherited wealth, hopefully in time leading to new and improved—and certainly better informed—public policies.