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On the Taxation of Private Transfers

Louis Kaplow[*]

Abstract

This essay considers the appropriate conceptual framework for assessing the taxation of private transfers to individuals. Although it is conventional to emphasize the role of estate and gift taxation or inheritance taxation in redistributing income from the rich to the poor, the revenue effects of transfer taxation, and its distortionary effect on labor supply and savings, it is suggested in line with some recent work that the dominant focus should be on positive and negative externalities attributable to giving. The fundamental reason is that transfer tax reform can be combined with adjustments to other aspects of the fiscal system, notably the income tax, so as to keep constant most effects other than externalities.

JEL Classes H21, H23, H24, K34

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I. INTRODUCTION

This essay revisits the question of the appropriate conceptual framework for assessing the taxation of private transfers to individuals.[1] Much analysis of transfer taxation emphasizes its role in redistributing income from the rich to the poor, its revenue effects, and its distortionary effects on labor supply and savings. The approach here instead follows some recent work[2] suggesting that the primary focus should be on externalities attributable to giving.[3] One might view these as distinctive effects of transfer taxation. To see why, any reform of the transfer tax system—including expansion, repeal, and replacing an estate and gift tax with an inheritance tax—may be combined with adjustments to other aspects of the fiscal system, notably to the income tax, that largely hold constant these other effects (redistribution, revenue, other margins of distortion). When this is done, what remains are the effects of the reform on the extent of giving and thus on the externalities attributable thereto. Many readers will recognize this conclusion as an application of the general principle of targeting, which suggests that various policy instruments are usually best focused on the objectives to which they most directly relate, leaving other objectives to other instruments.

In Part II, this general analytical approach is elaborated, including discussion of how this framework applies with regard to policies involving externalities. In Part III, this framework is applied to transfer taxation. This discussion emphasizes the underlying logic and why it implies that considerations unrelated to gift externalities can be addressed separately. It also examines particular gift externalities— a positive externality on donees, a negative externality on the public fisc, and an externality involving the concentration of wealth and power—and notes some important qualifications. Part IV addresses the relevance of certain additional factors, including different possible motives for private transfers, subtle redistributive considerations, transfers of human capital, equality of starting points, savings incentives, and charitable contributions.

II. ANALYTICAL APPROACH

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[1] Given the conceptual focus of this essay, no distinction will be made among various forms of transfer taxation, such as estate and gift taxation, inheritance taxation, and accessions taxation, although the form may matter for some objectives, including administrative considerations. Likewise, no separate attention (except for the brief discussion of exchange-motivated transfers in Section IV.A) is devoted to the treatment of private transfers in the rest of the tax system, for example, whether an income tax provides deductions to donors or requires inclusion by donees. Rather, focus is on the net tax or subsidy applied to a transfer, whatever form that may take. See Louis Kaplow, The Theory of Taxation and Public Economics 249–50, 264 (2008) [hereinafter Theory of Taxation]; Louis Kaplow, A Framework for Assessing Estate and Gift Taxation, in Rethinking Estate and Gift Taxation 164, 167, 179–80, 190–91 (William G. Gale, James R. Hines, Jr., & Joel Slemrod, eds., 2001) [hereinafter Framework]. Also, no attention is given to administrative concerns, especially pertaining to avoidance as well as the possibility that a transfer tax may in certain respects serve to backstop an income tax (although it can also reduce income tax receipts by heightening the benefits of schemes that reduce both taxes). See Kaplow, Framework, at 186–88, 189–90, and, for differing views on the magnitude of the revenue loss in the income tax due to estate tax planning, see B. Douglas Bernheim, Does the Estate Tax Raise Revenue?, in 1 Tax Policy and the Economy 113 (Lawrence H. Summers ed., 1987), and James R. Repetti, The Case for the Estate and Gift Tax, Tax Notes 1493 (March 13, 2000). Symbolic effects and other political considerations are likewise largely ignored (they receive some attention in subsection II.C and in Kaplow, Framework, at 193-94, 203).

[2] I developed this approach in Louis Kaplow, Tax Policy and Gifts, 88 Am. Econ. Rev. (Papers & Proc.) 283 (1998); Kaplow, Framework, note 1; and Kaplow, Theory of Taxation, note 1, ch. 10.

[3] Throughout, the terms "giving" and "gifts" are used to refer generically to private transfers to other individuals, without regard to whether the transfer is inter vivos or via bequest.

In a series of articles and a recent book, *The Theory of Taxation and Public Economics*, I have advanced a general framework for analyzing the optimal use of various fiscal instruments when other instruments are also available—notably the income tax and income transfer (welfare) system (hereinafter collectively referred to as the income tax). Because this approach greatly illuminates analytical discussions and also has direct practical relevance for those designing and advocating for particular policy proposals, including specifically regarding transfer taxation, this Part offers a brief outline of the most relevant features. Some patience is asked of the reader, for the application of this analysis, which may seem abstract at times, to transfer taxation does not begin until Part III.[4]

To begin, Section A contains the backbone of this framework, an analysis of what economists refer to as the problem of commodity taxation in the presence of an income tax. Commodities are taken as a shorthand for various ways consumers may spend their disposable income, and thus they can be interpreted to include various forms of gifts. Section B extends the analysis to account for the possibility of externalities. As will be seen, in a basic case, the general Pigouvian prescription that externalities should fully be internalized continues to hold true even when there are concerns for income redistribution, revenue raising, and minimizing tax-induced distortion. Thus, if an activity generates net negative externalities, that activity should face a relative tax rate (or equivalent regulation) that equals the net marginal harm. Likewise, if there is a net positive externality, there should be a relative subsidy at a corresponding level. Section C notes some practical political considerations.

A. Income and Commodity Taxation

The income tax will be taken to be the chief tool for redistributing income.[5] The familiar problem with income taxation is that redistribution involves distortion; in a pure labor income tax, labor effort is inefficiently discouraged. This distortionary cost makes the socially optimal and politically demanded degree of redistribution less than it might otherwise be. Accordingly, it is natural to ask whether other fiscal instruments might help take up some of the slack, allowing a given degree of redistribution to be achieved at less cost or, relatedly, a greater degree of redistribution to be feasible at a given cost.

Suppose that the government also has the ability to impose differential commodity taxation. Specifically, it may tax or subsidize particular sorts of expenditures on goods and services at different rates. Perhaps luxuries might be taxed. Or, in an otherwise uniform system such as a value-added tax (VAT), preferential rates (including the possibility of exemption) might be employed for some commodities, a frequent practice regarding expenditures on food (as distinguished from restaurant meals). Would differential taxation, such as through higher taxes on luxuries or preferential treatment for necessities, be desirable?

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[4]The current presentation aims to be concise and broadly accessible, avoiding technical language and, more problematically, complete statements of qualifications. Interested readers should consult Kaplow, Theory of Taxation, note 1, and Louis Kaplow, On the Undesirability of Commodity Taxation Even When Income Taxation Is Not Optimal, 90 J. Pub. Econ. 1235 (2006) [hereinafter Commodity Taxation], and for the application to externalities, Louis Kaplow, On the (Ir)Relevance of Distribution and Labor Supply Distortion to Government Policy, 18 J. Econ. Perspectives 159 (Fall 2004) [hereinafter Government Policy], and Louis Kaplow, Optimal Control of Externalities in the Presence of Income Taxation, NBER Working Paper 12339 (2006) [hereinafter Externalities].

[5]As mentioned, references here to the income tax are taken to include government-funded transfers, notably, to aid lower-income individuals. For present purposes, no distinction is made between forms of income taxation or the differences between an income tax and a consumption tax. For further discussion, see Kaplow, Theory of Taxation, note 1, chs. 4, 7, 9.

In a basic, benchmark case, Anthony Atkinson and Joseph Stiglitz gave a negative answer.[6] Specifically, they showed that, when the income tax is set optimally, it is best not to impose any differential taxation. Subsequent work, some utilizing the sort of approach elaborated here, has offered extensions, including importantly to settings in which the income tax has not been set optimally.[7]

Why is it that luxury taxes, for example, are not a good idea when we would like to redistribute more from the rich to the poor in order to make up for the limitations of the income tax, notably, concerning the disincentive to earn more income? To oversimplify, suppose that the rich spend 2% of their income on the luxuries, which in turn are taxed under the hypothetical scheme at 50%. Thus, they pay 1% of their income in luxury taxes—in addition to their income tax payments of, say, 35%. Notice that their ability to consume goods is reduced by the combination of the luxury tax and income tax to essentially the same extent as would be the case without a luxury tax but an income tax of 36%. Thus, the disincentive to earn income is the same under the two schemes.

But there is a difference: with the luxury tax, the consumption allocations of the rich are distorted (they are induced to spend less on designated luxuries, more on other goods). This makes them worse off, a loss with no offsetting gain. Note that, if one wished, one could slightly increase the income tax a bit more, say to 36.1%, making the rich no worse off than under the 50% luxury tax plus the 35% income tax. This alternative—using just the income tax—would raise more revenue to fund public projects or redistribute to the poor. In sum, by relying solely on the income tax, one is able to make members of society better off.[8]

It is not true, however, that we should never introduce a tax, subsidy, or other government policy that involves an additional distortion. The familiar principle of second best teaches that an additional wrong can help set things right. Thus, if the luxury tax (or subsidy, for that matter) somehow helped to offset the downward distortion of income-generating effort caused by the income tax, some degree of luxury taxation (or subsidization) might be desirable.

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[6] Anthony B. Atkinson & Joseph E. Stiglitz, The Design of Tax Structure: Direct versus Indirect Taxation, 6 J. Pub. Econ. 55 (1976).

[7] See, for example, Kaplow, Commodity Taxation, note 4; Guy Laroque, Indirect Taxation Is Superfluous under Separability and Taste Homogeneity: A Simple Proof, 87 Econ. Letters 141 (2005).

[8] This idea entered the legal academic literature in Louis Kaplow and Steven Shavell, Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income, 23 J. Leg. Stud. 667 (1994); it drew upon Aanund Hylland and Richard Zeckhauser, Distributional Objectives Should Affect Taxes But Not Program Choice or Design, 81 Scand. J. Econ. 264 (1979), and Steven Shavell, A Note on Efficiency vs. Distributional Equity in Legal Rulemaking: Should Distributional Equity Matter Given Optimal Income Taxation?, 71 Am. Econ. Rev. (Papers & Proc.) 414 (1981).

One long-recognized qualification is that it tends to be efficient to tax leisure complements and subsidize leisure substitutes on this ground.[9] For example, taxing beach attendance might make leisure less attractive, and subsidizing central city amenities might make work more attractive. Both policies would involve their own distortions, but because they would help induce individuals to work more, thus partly reducing the downward distortion of labor effort, there would be an offsetting gain. This possibility is considered further in Section III.A with regard to gifts.

Another qualification arises when individuals' consumption or other behavior depends on their type (earning ability) or their identity.[10] Suppose, for example, that higher-ability individuals at a given income level have a greater relative preference for classical music than do lower-ability individuals. In that case, taxing the consumption of classical music would enable greater redistribution with less distortion of the labor-leisure choice. This logic critically depends on the preference being due to higher income-earning ability at a given income level rather than to greater demand on account of simply having more income, such as is the case with luxury goods in general. As we have seen, taxing goods preferred because of higher income directly distorts the choice to earn more income; the point here is that taxing goods related to the ability to earn income rather than the choice to earn more income can help to reduce labor supply distortion. A variation on this subtle idea is examined further in subsection III.B.4.

Another particularly important qualification in the present context is that the taxed or subsidized activity might directly involve an externality; perhaps luxury goods produce high levels of pollution. This consideration is the subject of the next Section.

B. Externalities

A central maxim of economics is that, in a free market, activities involving negative externalities will tend to be overproduced and those generating positive externalities underproduced. For example, a tax on gasoline may be optimal because driving causes wear on roads, pollution, congestion, and not-fully-compensated accident risk to others.[11] And a subsidy to the purchase of flowers might be desirable because of benefits to passers-by.

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[9] This point derives from W.J. Corlett and D. C. Hague, Complementarity and the Excess Burden of Taxation, 21 Rev. Econ. Stud. 21 (1953). Analysis that takes account of the income tax traces to Atkinson and Stiglitz, note 6, at 67–68, and is further discussed in Louis Kaplow, Taxing Leisure Complements, Econ. Inquiry (forthcoming 2010).

[10] The seminal discussion of this qualification is James A. Mirrlees, Optimal Tax Theory: A Synthesis, 6 J. Pub. Econ. 327, 345–47 (1976).

[11] One might add that gasoline use creates energy dependence that can also have high social costs. Regarding a gasoline tax, other policy instruments may be more effective in addressing many of the stated objectives; however, the central point here is not which precise tax base or other mode of regulation is optimal but rather whether correction is appropriate.

Importantly, such policies to correct (internalize) externalities tend to be desirable regardless of the distributive incidence of the taxes or subsidies themselves, for the same reason that the undesirability of luxury taxes (in the absence of externalities or other considerations) is independent of their distributive incidence. The reason is that the income tax can simultaneously be adjusted in a distributively offsetting manner.[12]

Suppose that there is an uncorrected externality involving some good. In particular, suppose that the externality is a negative one, and that the aggregate social harm per unit consumption of the good is *h*. The simple (so-called "first-best") economic prescription is to levy a tax on the good of *h* per unit.[13] Accordingly, individuals would only purchase an additional unit of the good if its value to them exceeded the production cost (reflected in the pretax price) plus the external cost, which together constitute the full social cost of the good. A higher tax would excessively discourage purchases of the good (individuals with values in excess of the total social cost but below the producers' price plus the tax would be inefficiently deterred from purchasing the good). Likewise, a lower tax would insufficiently discourage purchases. The reasoning for positive externalities, optimally responded to with a subsidy equal to the marginal social benefit per unit, is analogous.

Now, consider the distributive effects of this corrective tax *combined with a distributively offsetting adjustment to the income tax schedule*. Perhaps the corrective tax is regressive. In that case, the distributively offsetting adjustment would involve a sufficiently large cut at the lower end of the income distribution to make up the difference. If the corrective tax had a proportional incidence overall, so would the corresponding income tax cut. This overall incidence, to be a bit more precise, is meant to be encompassing. That is, the incidence of the hypothesized offsetting income tax adjustment takes into account all effects of the corrective tax, including the cost of paying the tax and, notably, the distributive incidence of the benefit from correcting the externality. Accordingly, the distributive incidence of the latter is also rendered moot.

Consider now the policy package as a whole. It is distribution neutral; this is true by construction. Regarding revenue, the corrective tax raises additional funds whereas the income tax adjustment is a tax cut; these components are also designed to be offsetting. What's left? The correction of the externality. If indeed the reform is an efficient one, here, internalizing the externality, then there is a net gain from this component. Indeed, in a basic model of this problem, the gain can be distributed, say, pro rata, so as to make everyone better off. Full internalization of externalities then is indeed a sound policy. And this is so regardless of the distributive effects of the externality and regardless of revenue effects (when one views the corrective tax or subsidy in isolation from the offsetting income tax schedule adjustment).

C. Political Practicality

[12]The discussion to follow in the text is heuristic, but precise statements, demonstrations, and discussion of qualifications can be found in Kaplow, Externalities, note 4; for nontechnical but more complete elaboration, see Kaplow, Theory of Taxation, note 1, at 211–17, and Kaplow, Government Policy, note 4. For other perspectives on optimal taxation and externalities, see, for example, Helmuth Cremer, Firouz Gahvari, and Norbert Ladoux, Externalities and Optimal Taxation, 70 J. Pub. Econ. 343 (1998); Wojciech Kopczuk, A Note on Optimal Taxation in the Presence of Externalities, 80 Econ. Letters 81 (2003); and Jukka Pirttilä and Matti Tuomala, Income Tax, Commodity Tax and Environmental Policy, 4 Intl. Tax & Pub. Fin. 379 (1997).

[13]Importantly, this is a *relative* tax. Thus, if there is a preexisting uniform VAT of *t*, the total tax on this good would be $h + t$.

It is hoped that the foregoing analysis is analytically clarifying, allowing one to isolate the distinctive effects of a corrective tax from other matters—concerning distribution, revenue, and labor supply distortion—that normally are the focus of analysis of the income tax system. There remains the question whether this sort of analysis is realistic. Although not the focus of this essay, it is worth noting how the present framework helps to illuminate these sorts of questions as well.[14]

First, observe that it is roughly possible to enact distributively offsetting adjustments to the income tax, and, moreover, such policy combinations have been observed. For example, one could increase the gasoline tax and adjust the incidence of the income tax in a distributively offsetting fashion. This was an aspect of the U.S. tax reform in 1993.[15] On a broader scale, the U.S. tax reform in 1986 bundled myriad changes, with the package as a whole designed to be revenue- and distribution-neutral.[16]

Second, explicit packaging of reforms can be politically attractive. As explained in the previous Section, it is possible to combine a policy that raises efficiency by better regulating externalities with a distributively offsetting income tax adjustment that together generates gains for everyone. (Outside the world of the model, this result would not literally arise, but such a package would make individuals at each level of income better off on average.) Relatedly, groups objecting to the distributive incidence of an efficient reform can be bought off in such a fashion. By contrast, one cannot buy off all losers from an inefficient reform since overall losses exceed total gains.

Third, the foregoing analytical approach helps to illuminate reform packages that are not distribution neutral. Such packages, in principle, can be decomposed into two-step reforms: (1) implement the core policy change in a distribution-neutral fashion, as described above; (2) then immediately amend the package to shift the distribution to that of the actual reform under contemplation. Step 1 is to be analyzed as before. Step 2, by construction, holds the underlying core policy (say, the reform to internalize the externality) constant, leaving only the purely redistributive effect.[17]

Related to this last point, note that these two steps are severable. That is, if for political or other reasons, the distributive effects are undesirable whereas the step 1 efficiency effects are positive, one could enact just step 1. Likewise, if the step 2 distributive effects are really desirable but the step 1 efficiency effects are adverse, one could enact just step 2. Moreover, as explained, if step 1 is inefficient, by foregoing that step there is a larger pie that could be sliced so as to make all better off.

The foregoing discussion is obviously Panglossian, naive, or . . . choose your preferred

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[14]For further elaboration, see Kaplow, Theory of Taxation, note 1, at 29–34, and Kaplow, Government Policy, note 4, at 172–74.

[15]That reform was neither distribution- nor revenue-neutral. However, it was designed to increase redistribution and also to raise the tax on gasoline, which was seen as regressive. The higher gas tax was packaged with an expansion of the earned income tax credit and an increase in top income tax rates.

[16]It is unlikely that a legislature will tweak the income tax in response to each and every tax, expenditure, and regulatory program. If, however, there is a desire to maintain some given distribution of income, the income tax system is flexible enough and is adjusted frequently enough that one could, on average and over time, accomplish such an objective.

[17]One could add revenue effects as well, although in the long run deficits must be paid off, by the same individuals, with interest, or by future generations, in which case revenue effects can be seen as a species of distributive effects.

adjective. No suggestion is made that reality operates so predictably or efficiently. The only claim in this Section is that the analytical approach involving a distributively offsetting adjustment to the income tax schedule is helpful in thinking about political feasibility.

III. TRANSFER TAXATION

This Part applies the general analytical approach sketched in Part II to individuals' expenditures on gifts, where transfer taxation is viewed as a differential commodity tax on giving.[18] Section A begins by viewing gifts as ordinary expenditures, simply one of many choices available to individuals. Section B then extends the analysis to externalities. First, a number of particular externalities plausibly associated with giving are considered, and, second, the implications for the optimal taxation of private transfers are examined.

A. Gifts as Ordinary Expenditures

An individual might purchase pizza, a hair cut, or golf clubs for him- or herself. Or such goods and services might be purchased for another individual, say, a child. As an abstract matter, there is no difficulty in viewing purchases for others—or the giving of cash or other items of value to be used by others to choose their own purchases—as additional commodities from which one chooses. When economists describe individuals' options for expending their disposable income, it is conventional to suppose that all of their resources are expended on one of various commodities. By allowing such commodities to be in the future, one can incorporate savings, and by allowing transfers to other individuals, one can address gifts and bequests.

This seemingly mild abstract statement turns out to be a very powerful device for facilitating analysis because economists have devoted so much effort to understanding the problem of optimal commodity taxation, including importantly in the presence of an income tax. As described in Section II.A, a central result is that, in a simple baseline case, it is not optimal to engage in any differential commodity taxation. Hence, viewing gifts as just another commodity, it is not optimal to subject them to any relative tax (or subsidy). Moreover, as explained previously, this conclusion holds regardless of the distributive incidence of giving and thus of any tax (or subsidy) on giving and regardless of the revenue raised (or, in the case of a subsidy, expended) in doing so. Accordingly, the proper view of optimal transfer taxation appears to be radically different from what is commonly supposed.

The central question that will occupy most of the remainder of this essay is: How, if at all, are gifts different? Relatedly, what are the implications of these differences for the formulation of ideal tax policy?

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[18]As noted in the introduction, this program is pursued in Kaplow, note 2; Kaplow, Framework, note 1; and Kaplow, Theory of Taxation, note 1, ch. 10, in many respects with more depth and breadth. This Part both highlights key points, including some that are often overlooked even in work that adopts the same basic approach, and further develops certain ideas.

As mentioned in Section II.A, one qualification to the uniformity result arises when a form of expenditure interacts with the labor–leisure tradeoff, which is distorted due to income taxation. On one hand, suppose that individuals who give more to others, thereby having fewer resources to spend on themselves, now find leisure less attractive than otherwise. (Even with 1000 channels, television eventually gets boring, whereas long ski weekends are no longer affordable.) In this case, it would be optimal to subsidize giving. If individuals give more, they will be inclined to work more, which will reduce the labor–leisure distortion. On the other hand, suppose that if one gives more it becomes more pleasant to spend additional time with the recipients, perhaps children or grandchildren. In this case, it would be optimal to tax giving. (Bequests would seem to be neutral on this dimension.[19])

The relative importance of these and related competing factors is an empirical question, one that does not seem to have been explored directly. This issue (and others pertinent to different, more subtle qualifications[20]) suggests the need for some redirection in empirical work. There is substantial empirical investigation of private transfers and the effects of transfer taxation; yet, this central policy-relevant question does not seem to be on the radar screen of researchers.

B. Externalities from Giving

Perhaps the most straightforward justification for differential taxation (including the possibility of subsidization) involves externalities. Externalities are central to optimal transfer tax policy because much giving involves significant externalities.[21] This Section examines some important ones and their implications for policy.

1. Positive Externality on Donees

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[19]The same may also be true of gifts when the donor is already retired, although the anticipation of giving could render earlier retirement more attractive.

[20]For a nontechnical discussion of many of the more important qualifications to the uniformity result and further references, see Kaplow, Theory of Taxation, note 1, at 135–45.

[21]This point is emphasized in Louis Kaplow, A Note on Subsidizing Gifts, 58 J. Pub. Econ. 469 (1995), which focuses on the positive externality on donees, and it is substantially developed in the sources cited in note 18, which elaborate that externality and also examine the negative externality on the treasury. It has become more common to assess the relevance of this positive externality, but the negative revenue externality is not mentioned as often.

Private transfers ordinarily benefit donors; else, they would not choose to make them.[22] If a donor chooses between spending an additional dollar on more pizza or giving that dollar to his or her child, and ultimately makes the latter choice, the result reflects the fact that the donor valued making the gift by a greater amount than having more pizza. This benefit corresponds to the benefit of ordinary consumption expenditures and forms the core that lies behind the preceding analysis of commodity taxation. The donor's benefit to him- or herself is quintessentially not an externality.

However, donees are people too. No matter how large is the donor's benefit, altruistic or otherwise, from giving to a donee, that benefit to the donor is, well, a benefit to the donor and thus is part of the donor's utility. Society, in general, cares (or should care) about all people, including donees.[23] The benefit to the donee per se—that is, as an independent individual, and thus a benefit above and beyond the benefit in terms of the donor's utility—is external to the donor.[24]

The existence of this external benefit to donees thus provides a general basis for subsidizing gifts. The optimal subsidy depends on the magnitude of this externality, which in turn will relate to transferor's motives, as discussed in Section IV.A. (This connection may not strike the reader as immediately obvious, and for good reason, since the benefit of a dollar to a donee is typically one dollar, regardless of the donor's motive; yet, as will be seen, there are indeed important modifications in some cases.) Subtle but possibly important qualifications concerning optimal correction of this externality are elaborated in subsection 4 and also in Section IV.B.

2. Negative Externality on Public Fisc

When a donee receives a transfer, the donee's income (or, viewed long term, wealth) rises. This produces all manner of income (wealth) effects, as is familiar. For example, richer individuals may purchase more fine wine and less pizza. Such effects in themselves, however, tend not to have direct policy relevance. The reason is that, whatever is the resulting set of choices that individuals make, such choices are optimal given their new, higher income. There are, however, exceptions, specifically when there are uncorrected externalities regarding such choices.

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[22]Qualifications involving accidental bequests, nonmaximizing behavior, and other matters are considered in Section IV.A.

[23]It is sometimes suggested that taking into account the positive externality on donees entails double counting. See, e.g., Peter Diamond, "Optimal Tax Treatment of Private Contributions for Public Goods with and Without Warm Glow Preferences," 90 J. Pub. Econ. 897, 917 (2006). It is only double counting, however, if the same thing is counted twice, and as the text explains this is not the case. Specifically, if it were double counting, then it must either be the case that the donor's utility from giving should not be viewed as utility when computing social welfare (although all manner of selfish own-consumption, which the donor prefers less, is counted) or that the donee's utility is not part of social welfare, which is tantamount to not counting donees as members of society. It is not clear which point proponents of the double-counting view implicitly have in mind. In any case, failure to include both sources of welfare would also conflict with welfarism and thus can be shown to entail violation of the Pareto principle. See Louis Kaplow & Steven Shavell, Any Non-welfarist Method of Policy Assessment Violates the Pareto Principle, 109 J. Pol. Econ. 281 (2001).

[24]See Kaplow, note 21, at 474, for a discussion of how this is not a conventional externality in all respects; specifically, its distributive nature means that it is not susceptible to correction via bargaining, as per the Coase theorem.

A central externality of sorts[25] involves the income effect on labor supply, because labor supply affects the public fisc. Ordinarily, when individuals' incomes rise from external sources, they find it optimal to work less.[26] (In economics parlance, they generally choose to purchase more of what are referred to as "normal" goods, and leisure is taken to be such a good.) If this were the entire story, it would be unremarkable. In an otherwise undistorted economy, it is efficient to increase leisure as one's available resources increase. However, as mentioned numerous times thus far, there is a central preexisting distortion, namely, the income tax's depression of labor effort. Since labor effort is already inefficiently low, this indirect reduction of labor supply is costly. In particular, when an individual chooses to work an hour less, the individual only forgoes $1-\tau$ of his or her hourly earnings, where τ refers to the individual's marginal tax rate. The other fraction, τ, is forgone by the treasury. Thus, to the extent that receiving gifts depresses labor supply, there is a revenue loss to the treasury, a loss that the individual donor does not take into account.[27]

The tax revenue externality need not be negative. For example, consider gifts that enhance young individuals' human capital or relax liquidity constraints that enable entrepreneurship.[28] To the extent that donees' earnings will ultimately rise as a consequence, there is a positive externality to the fisc. In the discussion to follow, however, the tax revenue externality is discussed on the assumption that it is ordinarily and overall negative (but no empirical basis for this view is offered here, it being taken for expositional convenience).

3. Externality Involving Concentration of Wealth and Power[29]

[25]External effects on the treasury due to policies' indirect effects on labor supply are not generally discussed using the rubric of externalities, although the term is analytically appropriate.

[26]For evidence on the magnitude of this effect, see, for example, Douglas Holtz-Eakin, David Joulfaian, and Harvey S. Rosen, The Carnegie Conjecture: Some Empirical Evidence, 108 Q. J. Econ. 413 (1993); Guido W. Imbens, Donald B. Rubin, and Bruce I. Sacerdote, Estimating the Effect of Unearned Income on Labor Earnings, Savings, and Consumption: Evidence from a Survey of Lottery Players, 91 Am. Econ. Rev. 778 (2001); David Joulfaian and Mark O. Wilhelm, Inheritance and Labor Supply, 29 J. Hum. Resources 1205 (1994).

[27]Observe that this one aspect of the externality is easy to quantify in that the external cost per unit reduction in donee labor earnings is simply τ. It remains to determine the extent of reduction in labor earnings per dollar transferred, but economic theory suggests that the reduction in earnings will be less than the amount of the gift; hence, the externality per dollar given (rather than per dollar reduction in earnings) is strictly less than τ.

[28]See, e.g., David G. Blanchflower & Andrew J. Oswald, What Makes an Entrepreneur?, 16 J. Lab. Econ. 26 (1998); Donald Cox, Intergenerational Transfers and Liquidity Constraints, 105 Q.J. Econ. 187 (1990); Douglas Holtz-Eakin, David Joulfaian, & Harvey S. Rosen, Sticking It Out: Entrepreneurial Survival and Liquidity Constraints, 102 J. Pol. Econ. 53 (1994); Douglas Holtz-Eakin, David Joulfaian, & Harvey S. Rosen, Entrepreneurial Decisions and Liquidity Constraints, 25 Rand J. Econ. 334 (1994).

[29]See Kaplow, Framework, note 1, at 191–93.

Transfer taxation is often rationalized as a partial correction to the undesirable effects of the concentration of wealth and power. The first and most important point to note is that the logical structure of this argument suggests its immediate relevance. That is, the argument typically hypothesizes negative externalities. One suggestion is that concentrations of wealth lead to undue political influence. Perhaps the very rich can tilt government policies to their liking, use their might to limit redistribution, or take control for the sheer enjoyment of wielding power over others. On the other hand, private concentrations of wealth can also provide useful countervailing power against abusive government. It may be difficult to unseat entrenched incumbents without private wealth. Ownership of media outlets by various rich individuals may better enable them to resist government interference. Which effects are more important, and under what political conditions, is a complex question that does not seem adequately explored. In any case, it would be helpful to understand better the direction of the net external effect and its magnitude.

Suppose for sake of argument that there exists a significant negative net externality of this sort. How does this relate to transfer taxation? As an initial matter, most arguments about undue effects seem to relate to concentrations of wealth, not transfers per se. Hence, it would seem that wealth taxation rather than wealth *transfer* taxation would be a better suited instrument.[30] In addition, for certain means of influence, direct regulation of problematic uses of wealth (campaign contributions and lobbying) may be better targeted than generalized wealth taxation.[31]

Finally, one must consider the likely effects of transfer taxation, a point emphasized by Edward McCaffery.[32] Higher transfer taxation tends to induce lower transfers, which in turn implies greater expenditures by donors, who are likely to be wealthier than their more dispersed group of donees. Consider the extreme policy of confiscatory transfer taxation. Since it would no longer be possible to "take it with you" (in a sense), wealthy donors might more often attempt to use their fortunes to buy their way into high political office or otherwise attain power in the present.

4. Implications

[30]See also id. at 192 n. 59 (discussing respects in which wealth and wealth transfer taxation differ with regard to concentration of wealth). A rather different point is that heirs are often less effective at running businesses than were the founders, so a wealth transfer tax (in particular, one sufficient to disrupt passing on control of family businesses) may be efficient in avoiding waste. This argument is incomplete, for if founders are aware of limitations in their heirs' likely efficacy, then their decisions will take this into account. Keeping the business in the family thus may be viewed more as a matter of providing for intangible consumption in the family (perhaps by both donors, in anticipation for the case of bequests, and donees) rather than maximizing investment returns.

[31]A related question concerns the magnitudes of various effects and their relationship to the level and distribution of wealth. For example, in 2006, all of the U.S. Forbes 400 had a net worth over $1 billion, North America had nearly 40,000 households with a net worth in excess of $30 million (presumably mostly in the United States), and the United States had more than a million households with net worth over $5 million. See Jeff Daley, More Than a Million $5 Million-Dollar Households, PRWeb Press Release Newswire (July 13, 2007) (http://www.prweb.com/releases/2007/07/prweb539152.htm, accessed on September 29, 2008); Capgemini, World Wealth Report 2007, 3 Fig.1, 6 Fig.5 (2007). Are such numbers and levels more suggestive of abuse or of countervailing power? Would the matter be better if there were fewer such households but some held even greater wealth? Or vice versa? Regardless, absent tight restrictions regarding campaigns, lobbying, and so forth, would even substantial changes in these figures have a nontrivial effect?

[32]Edward J. McCaffery, The Uneasy Case for Wealth Transfer Taxation, 104 Yale L.J. 283, 312 (1994).

The foregoing three externalities and perhaps others suggest that it may well be optimal to have some system of transfer taxation or subsidization. The optimal direction of the correction depends on whether net externalities are negative, favoring taxation, or positive, favoring subsidization. And the optimal magnitude of tax or subsidy rates depends in turn on the actual magnitude of the net externality. According to the analysis in Section II.B, this would be the entirety of the story. Specifically, the distributive effects of transfer taxation and revenue considerations would be irrelevant. As noted in Section II.A, however, there are other potentially significant considerations, and some additional ones are mentioned in Part IV. These factors are largely set to the side in this subsection, although some are considered at the end with regard to the positive externality on donees.

It is useful to restate the underlying logic more concretely. Suppose that it turned out to be true that the only significant gift externalities were negative so that a tax was optimal.[33] Perhaps the negative externality on the public fisc is most important. Furthermore, imagine that the optimal tax was positive at even low levels of transfers and that the optimal tax rate was not very high even for huge transfers. Implementing this scheme may involve making the transfer tax scheme significantly less progressive (applying positive tax rates on many now exempted and lower tax rates on the wealthy). Furthermore, if the optimal tax rates were sufficiently low, this transfer tax reform would also generate less revenue. Do these consequences render the reform unattractive?

By this point, it should be apparent that neither effect is relevant in principle. Specifically, consider implementing such a reform packaged with a distribution-neutral adjustment to the income tax. This would entail raising income tax rates on the rich and lowering income tax rates on those formerly exempt from transfer taxation. The same revenue would be raised. And the same distribution would obtain (roughly; see Section IV.B for further discussion). Thus, whether this reform package would be desirable will have nothing to do with the direct revenue effects of the transfer tax reform and its distributive incidence. Instead, it will have entirely to do with externalities.

Put another way, if such a reform package were implemented, the only effect would be to change the desirability, at the margin, of making gifts. Furthermore, if there are net negative externalities of the form postulated, this effect would be desirable. And, importantly, this would be the only effect.

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[33]If it turned out that a subsidy was optimal, one might worry that, just as there is the problem with favorable income tax treatment of charitable gifts that private consumption may masquerade as a charitable transfer, so too might individuals feign private gifts to collect subsidies. It may well be that, as a consequence, subsidies could not be implemented in many contexts, in which case a hands-off regime, with neither tax nor subsidy, would be optimal in practice. Of course, it is well known that attempts to impose transfer taxation, even with large exclusions (larger than is generally appreciated, as discussed in Section IV.C), are subject to substantial avoidance, so much so that some consider this to be an important factor in the basic design of any such tax and in determining whether an otherwise desirable transfer tax ultimately makes sense. See, e.g.,, George Cooper, A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance (1979); Wojciech Kopczuk & Joel Slemrod, The Impact of the Estate Tax on Wealth Accumulation and Avoidance Behavior, in Rethinking Estate and Gift Taxation 299 (William G. Gale, James R. Hines, Jr., & Joel Slemrod, eds., 2001); Richard Schmalbeck, Avoiding Federal Wealth Transfer Taxes, in Rethinking Estate and Gift Taxation 113 (William G. Gale, James R. Hines, Jr., & Joel Slemrod, eds., 2001); Bernheim, note 1; Repetti, note 1.

An additional perspective is provided by contemplating who is paying, say, for the reduction in transfer tax rates on the rich. The answer is: the rich themselves. At any income level, income taxes are adjusted to cover the revenue effects (at that income level) of the transfer tax reform. Likewise, suppose instead that we wanted to significantly raise transfer tax rates on the rich, perhaps because there is thought to exist a large negative externality regarding the concentration of wealth and power. Where would the additional transfer tax revenue go? The answer again is: to the rich themselves. Under a distribution-neutral income tax approach, whatever the direction or magnitude of the reform, all the money is kept in the same place. After all, that is what "distribution neutral" means.[34] Accordingly, with a distribution-neutral income tax adjustment, we are left with the question: As between two donors with identical income, should we tax or subsidize (and by how much) the one who spends an additional $1 on gifts rather than on own-consumption? Similarly, how much more or less should we tax a donor at a given level of income compared to the situation in which an additional dollar is given to another rather than spent on own-consumption?[35]

Unable to resist yet further restatement (because this point seems to be quite elusive), it is quite useful to pose the question: taking as given some amount of revenue that we wish to extract from a given well-to-do slice of the income distribution, what is the best way to accomplish this? This question can meaningfully be asked whatever that amount is and whatever is the slice in the income distribution. As a first, crude approximation, the answer to this question will not affect revenue or distribution, for both are by hypothesis held constant. What it will effect is efficiency. And efficiency, as explained, depends on the direction and magnitude of net externalities associated with giving.

The irrelevance, in the basic case, of standard distributive effects to the desirability of transfer taxation (or subsidization) should also open our minds to considering forms of taxation that differ greatly from what is observed or usually proposed. Notably, most transfer taxation schemes apply only to fairly wealthy individuals. If the primary rationale is to correct an externality due to the concentration of wealth and power (and, moreover, transfer taxation is a sensible means), then limiting the regime to this group might make sense. However, the first two externalities mentioned, the positive externality on donees and the negative externality on the fisc, presumptively apply at all levels of the income distribution. It is, of course, possible that their magnitudes vary (perhaps greatly) as a function of income. Whether and the extent to which this is so (and, if so, in what direction) are empirical questions. But, a priori, it is entirely possible that careful study of the pertinent externalities could indicate the optimality of a very different regime: one involving taxes or subsidies, one with a much lower exemption (perhaps none at all, save for administrative considerations), and one with rates that rise or fall with income or with the magnitude of the transfer.

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[34]Combining this point with the discussion in Section II.C on political feasibility, note the following: If transfer tax opponents urge repeal and insist that the reason is not the desire to shrink government or to reduce taxes on the rich for its own sake, but rather because transfer taxation is a bad tax, then they should favor repeal funded by such a tax increase on the rich. (This may not be a first choice, but if it were the only choice, it should be attractive.) Likewise, for those believing that transfer taxes are a particularly good form of taxation, not just another way to tax the rich, they should willingly favor a transfer tax increase, with the proceeds used to finance an income tax cut on those same rich people. (Again, this need not be a first choice, but it should be viewed positively if it were the only choice.) Finally, if either or both groups balk, have we not then learned that their positions on transfer taxation really are about redistribution or revenue more broadly, and not about transfer taxation per se?

[35]Almost identical questions are posed in Kaplow, Framework, note 1, at 166, 182.

Before proceeding, more should be said about some distinctive features of the positive externality on donees.[36] It has been mentioned but not emphasized that the contemplated distribution-neutral income tax adjustment is designed to hold distribution constant for donors, but this would not ordinarily achieve distribution neutrality for donees. Relatedly, as will be mentioned in Section IV.B, donees' benefits from the receipt of gifts raises their utility and reduces their marginal utility of consumption, both of which affect the social desirability of redistributing to and from them. In particular, as the gifts a particular donee receives become large, the donee's utility will rise and marginal utility of consumption will fall, making the donee an attractive target for taxation. Furthermore, this point should be joined with an atypical feature of this gift externality: to a substantial extent, the gifts an individual receives depend on the individual's personal identity rather than on disposable income. This feature is due to the fact that most gifts are to relatives, the largest being from parents to children.[37] Accordingly, the discussion in Section II.A regarding type- or identity-specific differences is applicable and implies that the benchmark of uniformity needs to be modified in this case. These amendments to the analysis of more familiar externalities lessen the degree to which the positive externality on donees ultimately justifies a subsidy or, in offsetting negative gift externalities, a lower rate of tax.

IV. ADDITIONAL CONSIDERATIONS

Part II articulates a general approach for analyzing various fiscal instruments, and Part III applies this framework to the taxation (or subsidization) of private transfers. Although seemingly complete on its face, transfer taxation involves a number of further considerations that bear on the appropriate analysis, or at least that are sometimes perceived as relevant. Making no attempt to be comprehensive in scope or depth of treatment,[38] this Part briefly examines a number of additional issues, including the relevance of donors' motives for making gifts, some additional subtle factors bearing on the assessment of redistribution, the importance of human capital in private transfers, notions favoring equality of starting points, the bearing of transfer taxation on incentives for savings, and gifts that are to charitable institutions rather than to identified individuals.

A. Transfer Motives

In much economic analysis, individuals' motives are largely irrelevant. Whether an individual purchases a lamp because it fits nicely in a particular room, looks appealing, or illuminates well, or some combination thereof, is immaterial. All that matters is the individual's total valuation, which determines whether the lamp will be purchased and the amount of consumer surplus from doing so.

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[36]As mentioned in the opening footnote, I am indebted to Wojciech Kopczuk for extensive discussions pertaining to the ideas in this paragraph, which modify my prior thinking on the subject.

[37]If instead gifts were primarily to peers, who in turn tended to be individuals with similar earnings (think of contributions to a country club or other organization that primarily benefit others at roughly the same income level), then prospective beneficiaries' earnings would affect expected gift receipts directly, and the analysis would turn out to be similar to that of more standard externalities. To suggest part of the reasoning, suppose that giving rises with income; then, the prospect of receiving higher gifts from peers would induce individuals to earn more. Note that if parents were perceived by their children to give less if they underperformed relative to their abilities (the opposite of the behavior associated with the Samaritan's dilemma), then similar logic would apply to such gifts.

[38]Additional factors are addressed in Kaplow, Framework, note 1, and Kaplow, Theory of Taxation, note 1, ch. 10.

It turns out, however, that variations in donors' motives for giving often do matter, both for predicting behavior and for performing welfare analysis.[39] In the prior discussion of the positive externality on donees, for example, it was supposed that donors' gifts bring them pleasure. But such pleasure could come in different ways. One possibility is that donors are to an extent altruistic, which is to say that raising the utility of their donees increases their own utility. Altruism seems to be evidenced, for example, by parents' hard work aimed to improve their children's prospects in life.

Another motivation is that donors obtain pleasure not from the enhancement in their donees' well-being but rather from the fact that they, the donors themselves, have made the gift. That is, they get utility from giving per se.[40] In many respects, the implications of this motivation are similar to those of altruism: gifts continue to benefit both donors and donees. There are, however, differences in behavior, notably, altruists will give more as their prospective donees' situations worsen (and less as they improve) whereas those whose utility comes from their own giving may not. (In reality, one may suppose that many individuals' actual motivations are a mix of these two, as well as others.) Also, the literature has noted an important distinction within this latter motive concerning whether donors care about their gross or net gifts.[41] Notably, if a donor gives $100, but $30 is taxed so that only $70 reaches the donee, is the donor's utility based on the sacrifice of $100 or the effective transfer of $70? This question is obviously important to the behavioral and welfare effects of taxing or subsidizing gifts, but empirical research has not focused on which characterization is more apt.

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[39]The importance of transfer motives was advanced in Kaplow, note 2, and developed further in Kaplow, Framework, note 1, and Kaplow, Theory of Taxation, note 1, ch. 10.

[40]This motivation is sometimes called "warm glow" giving, following James Andreoni, Impure Altruism and Donations to Public Goods: A Theory of Warm-Glow Giving?, 100 Econ. J. 464 (1990), or utility from the "joy of giving." These livelier descriptions, however, can be misleading. Someone may give to relieve guilt or to be viewed more highly by others without experiencing a warm glow or sense of joy. Moreover, one suspects that altruists do feel a warm glow and experience joy as a result of their gifts even though the point of designating this separate category is to distinguish altruism.

[41]This distinction and its implications are presented and developed in Kaplow, note 2, at 286–87; Kaplow, Framework, note 1, at 178–79; and Kaplow, Theory of Taxation, note 1, at 261–63.

Another important possibility is that transfers are not true gifts but really only one side of an exchange transaction. For example, parents may give more to children as implicit or explicit compensation for services, such as in providing care and attention. (Also, significant private transfers that appear to be gifts may be components of loans or insurance arrangements, again implicit or explicit.) Since these transfers are not gifts but something else, the optimal tax treatment generally will reflect the actual nature of the transaction. For example, purchases of labor services that provide consumption to the purchaser should not give rise to any income tax deduction to the payor, should be subject to prevailing consumption taxation (such as a VAT), and generate taxable labor income to the recipient.[42] Presumably, many but not nearly all private transfers—especially inter vivos transfers—actually involve payments for services (or loans and the like) rather than true gifts, although the differences may be difficult both for researchers and tax authorities to detect.

Transfers in the form of bequests might in a sense be accidental, a possibility not present for most other forms of expenditure. After all, bequests consist of resources not expended during one's lifetime, so they can arise from inaction. An important source of such bequests is believed to be due to incomplete annuitization, which in turn may reflect imperfections in annuity markets or donors' failure to appreciate the value of such financial transactions. In a world lacking any possibility of annuitization, bequests would to an extent be random windfalls and thus might be subjected to confiscatory taxation and redistribution, the former not having any behavioral effect. With mixed motives (notably, if such donors also care about their descendants, which is implied by careful tax planning), this conclusion need not follow. Also, the most direct response would be to address the market imperfections responsible for such incomplete annuitization. In addition, it should be noted that donees who receive larger accidental bequests due to the earlier death of their parents are not obviously better off, suggesting the possibility of an insurance function.[43]

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[42]Some readers will note that this outcome with regard to income taxation corresponds to the view associated with Henry C. Simons, Personal Income Taxation, ch. 6 (1938).

[43]For further discussion of these issues, see Kaplow, Theory of Taxation, note 1, at 264–66, and Wojciech Kopczuk, The Trick Is to Live: Is the Estate Tax Social Security for the Rich?, 111 J. Pol. Econ. 1318 (2003).

A related explanation for bequests is that individuals may accumulate and hold wealth for its own sake, that is, because they obtain utility from doing so, independent of utility from its subsequent consumption value or from the bequest that ultimately results.[44] Once again, if this motivation is present in a pure, extreme form, confiscatory taxation of bequests would have no behavioral effects. Many of the points made with regard to accidental bequests are applicable, including those pertaining to imperfections in financial markets.[45] This motivation may be quite significant for some individuals; its importance and nature warrant further empirical study.[46]

Finally, it is important to consider the possibility that individuals' giving decisions are not purely the product of cogent maximizing decisions.[47] Individuals generally have difficulty with complex, long-run financial decisionmaking. Myopia or a heightened anxiety involved with contemplating one's death may infect such decisions. Or they may reflect inertia or social convention (although in the long run these may change in response to significant reforms in transfer taxation). The difficulty of obtaining clear, consistent explanations of giving behavior[48] may in part reflect such limitations and possible inconsistencies in individuals' behavior. Accordingly, transfer tax policy may be particularly illuminated by further research in this realm.[49]

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[44]See Kaplow, "Utility from Accumulation," National Tax Association, Proceedings of the 102nd Annual Conference (forthcoming 2010).

[45]To explain, consider an individual who obtains utility from holding wealth and nothing else. (Suppose that consumption utility is financed separately by an annuity.) If there was no asymmetric information on longevity, such an individual could enter into a contract with a financial institution wherein the individual would receive wealth while alive but give all wealth (that borrowed, in a sense, and the initial wealth) to the financial institution on death. This possibility and others raise questions about the actual nature of utility from wealth, notably concerning what counts as wealth in individuals' utility functions. For example, if annuities count (and at current market value or in some other fashion), if trusts controlled (directly or indirectly) count, and so forth, behavioral implications and, in particular, the likely responses to transfer taxation, would differ. To consider another variation, suppose that those who enjoy holding wealth while alive also relish the prospect of immortality, in the sense that they value their empires (perhaps intact companies, perhaps descendants, perhaps self-named foundations) continuing in some fashion into the future. In that case, transfer taxation may have effects on behavior more like those associated with other transfer motives, although the positive externality on donees may not be equally present in all such cases.

[46]In exploring this motivation empirically, it is worth noting that some common, intuitive explanations for this motive have difficulty. For example, wealth is termed a measure of success, but it is not clear why income would not be viewed as a better measure. (Sports and entertainment superstars are usually measured by what they are paid, not the size of their portfolios; likewise, jealous co-workers tend to focus on compensation, one suspects.) Furthermore, for outward perceptions of one's position in society, it might seem that consumption, particularly conspicuous consumption, would be better than wealth holdings, often in passive forms.

[47]See, e.g., Kaplow, Framework, note 1, at 201–03; Wojceich Kopczuk & Joel Slemrod, Denial of Death and Economic Behavior, 5 Advances in Theoretical Economics, art. 5 (2005); David I. Laibson, Andrea Repetto, & Jeremy Tobacman, Self-Control and Saving for Retirement, 1998 Brookings Papers Econ. Activity 91; James Poterba, Estate and Gift Taxes and Incentives for *Inter Vivos* Giving in the US, 79 J. Pub. Econ. 237 (2001).

[48]For empirical evidence on transfer motives, see, for example, Luc Arrondel & André Masson, Altruism, Exchange or Indirect Reciprocity: What Do the Data on Family Transfers Show?, in 2 Handbook of the Economics of Giving, Altruism and Reciprocity 971 (Serge-Christophe Kolm & Jean Mercier Ythier eds., 2006); James B. Davies, Explaining Intergenerational Transfers, in Household and Family Economics 47 (Paul L. Menchik ed., 1996); Oded Stark, Altruism and Beyond: An Economic Analysis of Transfers and Exchanges within Families and Groups (1995).

[49]One would speculate that such infirmities are less likely to afflict the wealthiest individuals; indeed, their success at complex, long-range financial decisions may have contributed greatly to their wealth. Moreover, to the extent that such individuals do engage in active tax planning, one suspects that calculation plays a great role, although it is still possible that sentiments such as a reluctance to admit mortality may significantly influence the decisions made.

Transfer motives and explanations vary. Many individuals no doubt have mixed motives that may explain particular gifts or different gifts to different individuals at different times. Furthermore, there is undoubtedly heterogeneity across individuals that may depend on underlying preferences or aspects of their situations (such as the number of children and the quality of their relationships with them).[50] Likewise, the degree of rationality in giving may vary across contexts, time, and individuals. If it were possible for a tax authority to identify the motivations underlying particular gifts, then quite different tax consequences would optimally be associated with different gifts. But such is not possible. It is feasible, however, to condition treatment on observable dimensions that may well be correlated with underlying motivations, such as the relationship of the donor and donee,[51] the timing of the gift (inter vivos versus bequest, age of donor and recipient), the wealth of the donor (the mix of motives may vary significantly with income), and the form of the gift (see, for example, Section C on human capital). Transfer tax systems, actual and proposed, often make significant distinctions along such dimensions, but query whether they can be rationalized in light of the foregoing analysis.

B. Additional Redistributive Factors[52]

The analytical approach in this essay indicates that to a substantial extent redistributive considerations are irrelevant to transfer taxation because income tax adjustments can essentially hold distribution constant, making it optimal to design transfer taxation solely with regard to the efficiency consequences of its effects on transfers. There remain, however, a number of potentially important yet subtle complications.

First, transfer taxation has effects across generations. If one wished to hold distribution constant, would the target be the current donor generation, the subsequent donee generation(s), or a combination? The latter is normatively most compelling but also more complex. Note that one could to a substantial extent hold distribution constant in multiple generations by allowing the income tax to be age dependent, which would tend to be optimal on other grounds as well.

Second, gifts affect donors' and donees' utility levels and marginal utilities of consumption, which are relevant to setting optimal income tax rates. More specifically, the making of private transfers tends to raise donors' and donees' utilities (as explained in subsection III.B.1), to lower donees' marginal utilities of consumption (which explains the effect on labor effort mentioned in subsection III.B.2 and the point at the conclusion of subsection III.B.4), and

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[50]Optimal redistribution in the presence of heterogeneous preferences is a complex and subtle problem, and optimal policy responses depend importantly on whether differences are observable (for example, numbers of children are observable, but the quality of familial relations usually are not). See Louis Kaplow, Optimal Policy with Heterogeneous Preferences, 8 B.E. J. Econ. Anal. & Pol., iss. 1 (Advances), art. 40 (2008).

[51]The importance of this point is great, for most existing and proposed systems treat quite differently transfers between spouses (often treated as if they are not transfers at all) and transfers to descendants, and sometimes transfers to later generations are treated differently (for example, under the generation-skipping transfer tax, I.R.C. §2601). More broadly, there is a close relationship between transfer taxation and taxation of the family since most transfers are among family members. See generally Kaplow, Theory of Taxation, note 1, ch. 12; Louis Kaplow, Optimal Distribution and the Family, 98 Scand. J. Econ. 75 (1996).

[52]For further, although still highly preliminary, discussion, see Kaplow, note 2, at 285–86; Kaplow, Framework, note 1, at 174 n. 16, 181–84; and Kaplow, Theory of Taxation, note 1, at 256–58.

also to raise donors' marginal utilities of consumption (for example, if gifts were prohibited, own-consumption would be higher so marginal utility would be lower). In addition, different levels of giving may signal different situations. (A donee might receive more because of higher need.) Finally, as mentioned at the conclusion of Section A, there is undoubtedly great heterogeneity among donors, suggesting possible differences in how they optimally should be taxed (see note 50). In all, a more complete analysis of optimal taxation as a whole (that is, both income taxation and transfer taxation) would be a daunting task—one that, with regard to many of the factors highlighted here, has not really been attempted.

C. Human Capital[53]

[53]See Kaplow, Framework, note 1, at 194–96, and Kaplow, Theory of Taxation, note 1, at 269–70.

There is an important sense in which much analysis of transfer taxation focuses on the tip of an iceberg, and, worse, a portion that is highly unrepresentative of that which lies beneath. For the vast majority of the population—all but the very wealthy—the overwhelming portion of their wealth and of the value of the transfers they receive from parents consists of human capital, broadly construed.[54] Most important, individuals' earning abilities are significantly determined by genetic inheritance, home environment, role models, schooling (influenced by neighborhood choice and private expenditures), and contacts. These factors, in turn, are very much a product of individuals' parents, directly or indirectly.[55]

If transfer taxation or subsidization is, upon analysis, important, one might have imagined that it would focus on these dominant forms of transfer. Yet this is not the case analytically: human capital is largely ignored. Nor is it true in the world: human capital transfers are largely exempt, implicitly or explicitly. Perhaps this practice can be rationalized because it may be impractical to reach many of these types of transfers and because such transfers may have positive externalities on the treasury (see subsection III.B.2), in which case subsidization may even be optimal.[56] Even if existing treatment ultimately makes sense and thus the omission of human capital from reform proposals is likewise justified, it is difficult to defend human capital's exclusion from analysis that is motivated to determine the optimal form of transfer taxation in the first instance.

D. Equality of Starting Points[57]

[54]See, e.g., David Bradford, Untangling the Income Tax 173 (1986) (indicating that if a 90th percentile male received at age forty the 90th percentile inheritance, his lifetime wealth would increase by only 4.2 percent); James B. Davies, The Relative Impact of Inheritance and Other Factors on Economic Inequality, 97 Q.J. Econ. 471 (1982).

[55]See, e.g., Paul Taubman, The Roles of the Family in the Formation of Offsprings' Earnings and Income Capacity, in Household and Family Economics 5 (Paul L. Menchik ed., 1996).

[56]Note, importantly, that through public schools, including higher education, and some other programs including forms of welfare assistance, there are significant public subsidies to the development of human capital. (And, due to the deductibility in the U.S. income tax of some state and local taxes that fund much public education, parents' choices in this regard are subsidized, although haphazardly in light of limits on deductibility, that not all itemize, and that the alternative minimum tax currently eliminates the value of deductibility for many individuals. See I.R.C. §§ 55, 63, 164.)

[57]See Kaplow, Framework, note 1, at 184–86, and Kaplow, Theory of Taxation, note 1, at 266-68.

The omission of human capital is not only central to the welfare analytic framework employed throughout this essay, but it is also critical for evaluating some purported nonwelfarist objectives of transfer taxation, including those concerned with equality of opportunity, often framed as equality of starting points.[58] The idea is that individuals at the start of their lives should be in equal positions to realize their potential, which in turn is taken to be something internal to the individual rather than determined by one's parents, social caste, or otherwise. Inheritance is seen as interfering with this equality, giving luckier members of the next generation a head start. Accordingly, this view is often invoked in favor of transfer taxation, possibly in aggressive, even confiscatory forms.

It should be obvious from Section C that, if inheritance taxation is substantially justified by this concern, taxation of human capital transfers should be the core of the tax base rather than almost universally exempted. After all, it is differential human capital inheritance that largely creates inequalities in starting points.[59] Instead transfer taxation and most proposals for reform (including radical expansion) tend to focus on large financial transfers, typically bequests, that are received by donees rather late in life, say, in their fifties. These may greatly influence equality of opportunity with regard to retirement consumption, such as expensive travel, but they do not significantly influence starting points, indeed, not even the third generation's starting points (for they will often be in their twenties or thirties by then).[60]

A final question concerning the objective of equal starting points concerns the nexus between it and various forms of transfer taxation. Because equal starting points focus on the position of donees, it is common to associate this objective with the desirability of an inheritance or accessions tax rather than an estate and gift tax. Relatedly, the use of graduated rates (including generous exemptions, which create a zero rate on an initial, substantial degree of inheritance) tends to encourage donors to spread their giving more widely. However, it is not obvious from the equality-of-starting-points perspective whether such an effect is beneficial or detrimental. Is it better (much better? or worse?) to be surrounded, say, by one hundred millionaires rather than ninety normally endowed individuals and ten hyper-millionaires?

E. Savings Incentives[61]

[58]The welfarist focus of this essay is common among economists and many other policy analysts, but it is not universally shared and is highly controversial. For competing views, see, for example, Richard M. Hare, Moral Thinking: Its Levels, Method, and Point (1981); Louis Kaplow and Steven Shavell, Fairness versus Welfare (2002); Kaplow and Shavell, note 23; and Amartya Sen and Bernard Williams, Utilitarianism and Beyond (1982). Note, however, that there may well be welfarist implications for inequality in starting points, although they are not usually the focus of those who advance this objective. Specifically, especially large inequality may cause unrest, and even lesser inequality may deaden initiative (particularly if mobility is perceived to be low) and reduce individuals' benefits from broader social and economic interaction and from a positive sense derived from living in a society seen as just. From a welfarist perspective, the importance of these considerations (like others) is an empirical question, not one to be determined through a priori philosophical reasoning.

[59]Social institutions, such as caste systems or other forms of discrimination, could also be significant, but they are not intergenerational transfers that may be subject to taxation (or, to the extent that they are, they are probably largely in the form of human capital in any event).

[60]The anticipation of large transfers may help, but individuals generally cannot borrow at age twenty against a likely inheritance at age sixty. (Individuals can, however, choose to save less for retirement in anticipation of an inheritance.) Also, as suggested in subsection III.B.2, inheritance—and by logical extension, the prospect of inheritance—may reduce labor effort, the familiar idea that inheritance deadens initiative. To this extent, those not anticipating large inheritances may better be able to catch up to their privileged competitors who are less motivated.

[61]See Kaplow, Framework, note 1, at 188–89.

Little thus far has been said about the possible effects of transfer taxation on savings, even though much analysis of and concern about transfer taxation focuses on this subject. The reason for the present lack of emphasis is that savings is largely a separate dimension that may be treated separately. First, savings are neither necessary nor sufficient for transfers. As just explored in Section C, many of the most important transfers are actually made by parents to young children (expenditures on schooling and neighborhoods; devoting time, which involves forgone earnings), and much of this expenditure is out of current (including currently forgone) earnings.[62] Likewise, one can save significant amounts to fund expenditures on own-consumption in retirement, and this motivation explains much of private savings by individuals who are not very wealthy. To be sure, if one focuses on bequests and only on the rich, then it does happen to be true that the transfers are from savings and, accordingly, that transfer taxation may well significantly affect savings.

Second, just as income distribution and revenue can largely be held constant in analyzing and enacting transfer tax reform by employing adjustments to the income tax, so too can one hold roughly constant the taxation of savings by adjusting capital taxation accordingly.[63] For example, if a higher transfer tax on the very rich tended to burden savings, one could package such a reform with a corresponding reduction on capital taxation of those in the same income group. Then the incentive to save would be largely the same, leaving the effect on the transfers themselves.

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[62]Indeed, additional amounts may be financed by borrowing rather than saving. This is also partly true in a sense with forgone earnings; for example, if a spouse stays home with young children and works part time until they are significantly older, not only are current wages sacrificed but the failure to develop human capital at a high rate depresses future earnings as well. In that respect, current transfers are funded by borrowing from potential future earnings.

[63]For this reason, questions bearing on the efficiency of capital taxation and savings are not addressed further here. For additional discussion, see Kaplow, Theory of Taxation, note 1, ch. 9. (For readers particularly interested in the application of the analysis of Atkinson and Stiglitz, note 6, to capital taxation, with the implication that a zero tax rate is optimal, see Theory of Taxation, at 222–25; on the different argument associated with the work of Chamley and Judd, among others, see id. at 224–25, 242–45; regarding numerous qualifications to the optimality of a zero tax rate, see id. at 225–30.)

F. Charitable Contributions[64]

The present analysis focuses on private transfers to particular individuals. Most mentioned and most practically significant are transfers to other members of one's family. The other major type of transfer is to charitable organizations. Furthermore, charitable transfers often receive special treatment. In the United States (and in many other jurisdictions), charitable contributions are favored over current own-consumption and inter vivos gifts by an income tax deduction, and charitable bequests are favored over bequests to individuals by an estate tax exclusion.[65]

It remains to be asked: What is the optimal transfer taxation (or subsidization) of charitable gifts? The analytical framework developed in Parts II and III is highly informative. To begin, one can view charitable gifts, just as noncharitable gifts, as another form of expenditure on a commodity. The factors discussed in Section III.A would be relevant here as well, although the relative empirical importance could differ, perhaps significantly.

Regarding gift externalities, the subject of Section III.B, it is useful to view charitable entities as intermediaries or conduits. A gift to a soup kitchen or to an international relief and development organization can be seen as an indirect gift to numerous, anonymous, poor recipients. A gift to a hospital or university for medical research is an indirect gift to the ultimate beneficiaries of such research, and so forth. Accordingly, the general analytical approach of assessing gift externalities is in order, but with possibly important differences regarding the particular effects. For example, positive externalities may apply not just to donees but also to myriad other donors; labor effort of poor ultimate beneficiaries may be suppressed but that of beneficiaries of medical advances may increase; and concentration of wealth may be irrelevant or at least have a different character if the concern is with powerful nonprofit institutions. Transfer motives may differ as well. Charitable gifts, including bequests, would not be purely accidental, but exchange may be involved, such as when a donor in essence purchases a personal monument, attention, or prestige from a nonprofit organization.

Suffice it to say for present purposes that charitable giving is significant and may be greatly influenced by transfer taxation. Effects can also arise indirectly. For example, some oppose repeal or significant reduction of transfer taxation because the subsidy for charitable giving via exemption would thereby be eliminated. Of course, in principle, if it was indeed optimal to subsidize charitable giving but not optimal to tax transfers to individuals, one could retain a direct subsidy. Relatedly, if a subsidy is optimal, it is probably optimal for individuals

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[64]For further exploration of charitable giving along the lines explored here, see Kaplow, Framework, note 1, at 199–201, and Kaplow, Theory of Taxation, note 1, at 270–74. For evidence on estate taxation and charitable giving, see Gerald E. Auten, Charles T. Clotfelter, and Richard L. Schmalbeck, Taxes and Philanthropy Among the Wealthy, in Does Atlas Shrug? The Economic Consequences of Taxing the Rich 392 (Joel Slemrod ed., 2000), and David Joulfaian, Charitable Giving in Life and at Death, in Rethinking Estate and Gift Taxation 350 (William G. Gale, James R. Hines, Jr., & Joel Slemrod, eds., 2001). On the economics of charitable giving generally, see James Andreoni, Philanthropy, in 2 Handbook of the Economics of Giving, Altruism and Reciprocity 1201 (Serge-Christophe Kolm and Jean Mercier Ythier eds., 2006); and B. Douglas Bernheim and Antonio Rangel, Behavioral Public Economics: Welfare and Policy Analysis with Nonstandard Decision-Makers, in Behavioral Economics and Its Applications 7 (Peter Diamond and Hannu Vartiainen eds., 2007).

[65]Note that inter vivos charitable gifts are tax preferred to charitable bequests because the former benefit from the income tax deduction and an implicit estate tax exclusion (because the funds were previously given, they are not part of the estate and thus not subject to estate taxation), whereas the latter only receive (explicit) estate tax exclusion. Furthermore, earlier charitable gifts may be invested by the recipient and grow tax free, whereas investment earnings on assets that continue to be held by prospective donors are taxed, even if at preferential rates.

below the fairly high thresholds for current (and often proposed reforms of) transfer taxation.

V. CONCLUSION

The central theme of this essay is that transfer taxation is best examined by making use of a general analytical framework that has been developed to assess taxation and related fiscal instruments. Individuals' expenditures on private transfers are in some respects like other private expenditures on goods and services and thus can benefit from the extensive existing analysis of that subject. An important feature of gifts is that they systematically involve externalities, including a positive externality on donees and (often) a negative externality on the public fisc. Typically, optimal taxation of particular forms of expenditure starts from a neutral (no tax/no subsidy) benchmark and makes adjustments, such as are necessary to internalize externalities. Net negative externalities favor taxation, and net positive externalities a subsidy, the magnitude of the tax or subsidy corresponding in certain basic cases to that of the net externality. Various qualifications to these conclusions were noted.

By contrast, many analyses of transfer taxation focus on its redistributive effects, the revenue it raises, and possible distortions, including of savings decisions. These effects are not emphasized here because they are not distinctive to transfer taxation. More precisely, reforms of transfer taxation—whether expansions or repeal—can be combined with adjustments to the income tax schedule such that the entire reform package is essentially distribution-neutral and also neutral with regard to revenue and savings. That is, at any level of income, we can ask whether it is better to extract a given amount of revenue (whatever that amount may be) through income taxation—maintaining neutrality toward giving—or in a manner that encourages or discourages giving. Whether expenditures on gifts should be treated differently from expenditures on own-consumption depends on the distinct features of gifts, notably, the externalities they entail.

This essay also explored a number of additional considerations bearing on the optimal treatment of gifts, including different transfer motives, certain subtle distributive consequences for donors and donees, human capital (the lion's share of intergenerational transfers for all but the wealthiest individuals), equality of starting points, and how charitable giving can be assimilated into the present framework. The more one analyzes various distinctive features of private transfers, the more complex the picture that emerges. But it should be kept in mind that, both conceptually and perhaps practically, the most relevant features of gifts for purposes of transfer tax policy are features that distinguish them from other expenditures by individuals, notably, on themselves. There is much empirical work to be done if the many open questions are to be resolved. Moreover, the present analysis suggests that the pertinent list of empirical questions is rather different from those that have received the most attention to date.