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Bequests, taxation and the distribution of wealth in a general equilibrium model ☆

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Abstract

This paper examines the role of bequests and of taxation on bequests for the distribution of wealth. We investigate a model with overlapping generations and heterogenous households where parents derive utility directly from their bequests. We obtain all results analytically. Using the coefficient of variation as the measure of inequality, bequests per se diminish the inequality of wealth since they raise private savings and hence average wealth holdings more than the variance of wealth. From a policy perspective, taxing bequests and redistributing government revenue lump-sum among the young generation further decreases wealth inequality.

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1. Introduction

Most industrial countries levy a tax on wealth transfers. However, there are substantial differences in the legal framework of the tax system. In France and Germany, on the one hand, the

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tax is levied on inheritances. The institutional setting further forces donors to divide their estate equally among their own children (see Cremer and Pestieau, 2003). In the United States and in the United Kingdom on the other hand, there is a tax on estates and donors enjoy more freedom of bequests, although state rules might restrict disinheritance.

What many countries seem to have in common is an ongoing and controversial debate about taxation of wealth transfers. Some countries, including the US, contemplate to phase out taxes on wealth transfer in the near future.

One of the main arguments in the public and academic discussion is the role of wealth transfers for the inequality of wealth. Wealth is highly concentrated: in many industrial countries, the share of the richest 1% of households in net worth is estimated to be 20–30% (see Davies and Shorrocks, 2000), whereas an equal distribution would imply that any π% of the population hold π% of the total wealth. Wealth transfers in form of bequests or inter-vivo transfers are often seen as one of the major culprits for the inequality of wealth.[1] Since there is some concern about the level of concentration, the taxation of wealth transfers is frequently identified as an adequate policy to mitigate the concentration of wealth.

This paper investigates the role of bequests for the distribution of wealth and the effects of redistributive taxation.[2] We construct a simple model with stochastic individual income to analyse distributional effects by comparing properties of distributions in an overlapping generations setting. While focusing on steady states for our main results, we provide a complete analysis of transitional dynamics as well.

We find that intergenerational wealth transfers per se have an equalizing effect on the distribution of wealth when the coefficient of variation is chosen as the measure of inequality. Since this result can be seen in general equilibrium only, we consider general equilibrium analysis as being important. In our model, bequests have two effects. On the one hand, there is an increase in the variance of wealth. On the other, as these transfers imply that wealth holdings of a family at a certain point in time are determined not only by own income but by a weighted sum of own and ancestor's income, average wealth holdings increase as well. As the greater average wealth compensates for higher variance, the inequality of wealth, as measured by the coefficient of variation, falls. We further find that this result is robust when correlation across parent's and child's income, endogenous labour supply and a CES instead of a logarithmic specification of the utility function are introduced into the model.

When we turn to economic policy, we allow the government to tax bequests and redistribute revenue among the young. We find that the redistributive policy reduces the variance of wealth while keeping the average wealth holding constant. As a result, inequality of wealth – again measured by the coefficient of variation – falls.

Finally, we analyse how taxation affects the Gini coefficient. Our results are robust to the choice of inequality measure — taxation and redistribution decreases inequality. We are therefore confident that our results can directly be used for policy debates. Note that due to the simplicity of our modeling choice, we are able to derive all results apart from the Gini result in Section 5.3 analytically.

[1] See Charles and Hurst (2003) for an empirical analysis of the reasons for a positive relationship between wealth of parents and children *before* bequests. Bowles and Gintis (2002) discuss the various mechanisms through which economic status is transferred across generations. The effect of tax changes on the importance of gifts relative to bequests is analysed by Bernheim et al. (2004).

[2] We do not study efficiency aspects as e.g. Blumkin and Sadka (2004) who analyse the efficiency cost of estate taxation. See also Cremer and Pestieau (2001) and Cremer et al. (2003) for an optimal tax analysis under asymmetric information or Grossmann and Poutvaara (2005).