



Alleged tax competition: The mysterious death of bequest taxes in Switzerland[☆]



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ABSTRACT

Interjurisdictional competition over mobile tax bases is an easily understood mechanism, but actual tax-base elasticities are difficult to estimate. Political pressure for reducing tax rates could therefore be based on erroneous estimates of the mobility of tax bases. We show that tax competition provided the most prominent argument in the policy debates leading to a succession of reforms of bequest taxation by Swiss cantons. Yet, canton-level panel data spanning multiple bequest tax reforms over a 36-year period suggest the relevant tax base, high-income retirees, to be relatively inelastic with respect to tax rates. The alleged pressures of tax competition did not seem in reality to exist.

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1. Introduction

Governments, it is often argued, are finding it increasingly difficult to raise revenue, as people and capital are becoming ever more mobile. This would mean that tax bases are increasingly elastic, and that revenue-maximising as well as welfare-maximising tax rates are falling. The logic and relevance of this tax competition mechanism are not in doubt, underpinned as they are by large bodies of theoretical and empirical research.¹

Existing research does not, however, address a potential corollary of this fiscal phenomenon. While the conceptual logic of tax competition is simple, the practical estimation of tax-base elasticities and optimal tax

rates is fraught with uncertainty. When tax competition becomes a dominant theme in policy debates, policy could overshoot by lowering tax rates beyond what would be the optimal response to changing tax-base elasticities. This may be called “alleged tax competition”: political pressure for reducing certain tax rates that is based on upward biased estimates of the inter-jurisdictional mobility of the concerned tax bases.²

We study the case of bequest taxation in Switzerland, where the relevant tax base is constitutionally assigned to sub-federal governments (cantons). Bequest taxes have been repealed or significantly lowered by a majority of cantons in a domino-like process that began in the late 1980s. We document that the first and by far the most important argument invoked by the (almost always successful) proponents of reform was tax competition: with wealthy taxpayers becoming increasingly footloose, they argued, tax burdens had to be lowered in order to retain the tax base and, possibly, to expand it. In this sense, recent Swiss policy changes mirror a broader trend. Over the last three decades, more than 30 US states have eliminated their bequest taxes – a development which Conway and Rork (2004) considered “a prime example of intense interstate tax competition”.³ The same

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¹ For overviews of the theory, see e.g. Wilson (1999) and Haufler (2001). Empirical evidence on international tax competition is provided e.g. by Griffith and Klemm (2004) and by Hines (2007).

² The opposite scenario, whereby taxes are insufficiently responsive to changes in the mobility of tax bases, is of course conceivable as well.

³ In subsequent work, however, the same authors detected no statistically significant evidence of a link between bequest tax burdens and migration flows of elderly residents (Conway and Rork, 2006, 2012).

logic is invoked at the international level. When Hong Kong abolished its estate tax in 2005, the government's official justification was that "a number of countries in the region, including India, Malaysia, New Zealand and Australia, have abolished estate duty over the past 20 years. Hong Kong must not lose out in this race".⁴ In 2008, Singapore followed suit, in order to "encourage wealthy individuals from all over Asia to bring their assets into Singapore".⁵

The erosion of bequest taxes, however, is not a universal phenomenon. As can be gleaned from Table 1, the share of bequest tax revenues in total tax revenues decreased in 20 OECD countries but increased in 12 other OECD countries over the period 1995 to 2010. Table 1 also suggests that the contraction of bequest tax revenues has not been stronger in countries with some degree of sub-federal bequest taxation than in countries where bequests are taxed solely by the federal government. Given this variety of policy choices, research on the elasticity of the bequest tax base appears particularly relevant.

We explore this issue in panel data for Swiss cantons spanning four decades. Using a range of econometric specifications, we fail to uncover a statistically significant within-sample relationship between bequest tax rates and the relevant tax base, high-income elderly individuals. The alleged pressures for tax reforms due to mobile tax bases therefore are not apparent in the available data.

Our work is related to a number of previous studies. First, several researchers have estimated tax-base elasticities with respect to bequest taxation in the United States. Bakija and Slemrod (2004) find that state bequest taxes have a statistically significant negative effect on the number of federal estate tax returns filed in a state, inferred from stratified samples. The estimated effects, however, are economically small, in the sense that they are well below the elasticities that would imply a potential for revenue-raising tax cuts. A similar verdict emerges from the work of Conway and Rork (2006, 2012), who find no statistical evidence that bequest taxes (nor indeed any other fiscal measures targeted at the elderly) affect inter-state migration patterns of elderly Americans.

Could it be that the United States is too large, and/or intra-national variation of tax rates too limited, for significant mobility responses to differences in bequest taxation? Data on Switzerland allow us to examine this question in a much smaller country with somewhat heavier and more heterogeneous sub-federal bequest taxation. Our study differs from US-based analyses in two additional respects: we can formally document the weight of the tax competition argument in tax-setting policy decisions, and we have access to data on local changes in federal income tax revenues from the full population of taxpayers.

A second related literature investigates strategic interactions in bequest tax setting at the sub-national level.⁶ Conway and Rork (2004) have estimated reaction functions among US state-level estate tax rates. They find evidence of correlated changes in tax rates among states with large inter-state migration flows of elderly residents. They interpret this as evidence of inter-state tax competition. It is, however, difficult to infer competition over mobile tax bases from tax reaction functions. Spatially correlated tax changes could be a manifestation of other types of policy interactions or of correlated unobservables (see, e.g., Brueckner, 2003). One way of identifying the presence of competition over mobile tax bases is by estimating the mobility of tax bases directly (Brett and Pinkse, 2000; Buettner, 2003; Bakija and Slemrod, 2004; Conway and Rork, 2006, 2012). This will be the central focus of our study, which aims to estimate the effect of changes in estate tax rates on inter-jurisdictional movements of the most directly concerned tax bases.

The paper is structured as follows. In Section 2, we describe bequest taxation and fiscal policy making in Switzerland, we document the erosion of bequest taxes, and we quantify the dominance of the tax competition argument in the associated policy debates. We set out our empirical strategy and data in Section 3. In Section 4, we report our estimates of behavioural responses to changes in bequest tax rates. We conclude by summarising and discussing our findings in Section 5.

2. Bequest taxation in Switzerland

2.1. Decentralisation and reforms

The Swiss political system features a high degree of fiscal decentralisation and considerable variability in tax burdens across sub-federal jurisdictions. This makes Switzerland a well suited empirical testing ground for questions related to tax competition.⁷

Bequest taxation is a case in point. It is constitutionally assigned exclusively to the 26 cantons, and cantonal bequest tax codes differ substantially.⁸ Bequest taxes on assets other than real estate are due by the heirs to the canton in which the deceased had their last fiscal residence. Like in most countries, including the United States, the transfer of real estate, representing around one third of the value of bequests, is taxed in the jurisdiction in which the property is located.

25 of the 26 cantons levy bequest taxes (the exception being the canton of Schwyz). In 23 of those 25 cantons, bequest taxes were introduced between 1884 and 1918, the remaining two cantons, Valais and Obwalden, taking that step in 1977 and 1981, respectively. In most cases, bequest taxes are levied on inheritances, such that tax rates vary in two main dimensions: the amount inherited (progressive taxation) and family ties with the deceased (the closer the ties, the lower the tax rate).⁹ On average, spouses and direct descendants represent some three quarters of all heirs.

In our sample of tax data, which spans the period 1973 to 2008, the highest average tax rate for spouses and direct descendants is 9%, whereas unrelated heirs have been taxed in some cantons at up to 60%. Table 1 shows that bequest taxation weighed more heavily as a share of total tax revenue in Switzerland than in most other OECD countries. In 1995, for instance, Swiss bequest taxes accounted for some 1.8% of consolidated tax revenues, significantly more than in the United States (1.3%), and three times the OECD average of 0.6%.¹⁰

Of the cantons that have at some point within our sample period levied bequest taxes on direct descendants and/or spouses, the time-averaged representative tax rate is around five times higher in the highest-tax canton than in the canton with the lowest (non-zero) rate. These differences, however, have narrowed significantly in recent years. A wave of canton-level reforms has been implemented since the late 1980s with the result of markedly lowering bequest tax burdens across the country. Of the 17 cantons that had imposed an inheritance tax on direct descendants and/or spouses in 1973, only three still applied a tax on direct descendants in 2008, and none taxed inheritances by spouses. This is illustrated in Fig. 1, which shows the evolution of the average bequest tax rate in each of the 26 cantons.¹¹ Table 2 provides details on the 32 largest reforms. 29 of these reforms implied cuts in the average bequest tax rate, with reductions in representative

⁷ For additional detail on Swiss sub-federal taxation, see Brülhart and Jametti (2006).

⁸ In four cantons (Fribourg, Graubünden, Luzern and Vaud), municipalities can in addition levy their own bequest taxes.

⁹ Estate taxation is or has been applied in three cantons (see Section A.2 in the Appendix A).

¹⁰ Despite generally lower top marginal tax rates, the share of bequest tax revenues in total tax revenues has been higher in Switzerland than in the United States since the early 1980s. This is likely explained by greater wealth concentration in Switzerland and comparatively low exemption levels.

¹¹ Details on how we calculate average bequest tax rates are given in Section 3.4 and the Appendix A.

⁴ www.lowtax.net/lowtax/html/hongkong/jhkpetx.html#estate.

⁵ www.prlog.org/10051481-singapore-abolished-estate-duty-tax-with-immediate-effects.html.

⁶ On the economic and political forces behind the erosion of bequest tax rates, see Gale and Slemrod (2001) and Graetz and Shapiro (2005) for the US, and Bertocchi (2011) for a theoretical explanation. On the broader question of the optimal level of bequest taxation, see Cremer and Pestieau (2006), Kopczuk (2010), and Piketty and Saez (2013).

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