BACK FROM THE DEAD:

Australian Inheritance Tax

Australian Institute for Business and Economics

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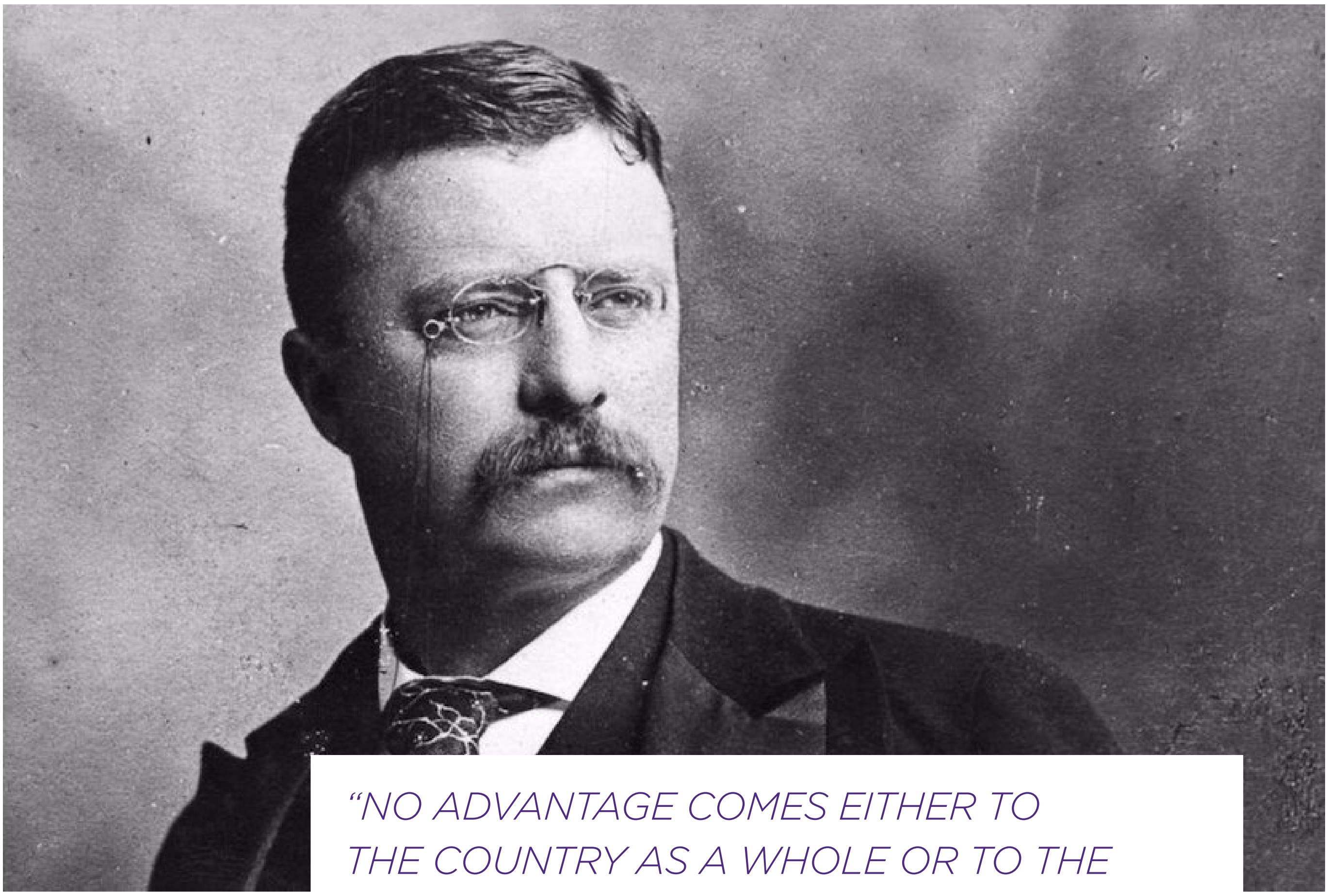
The University of Queensland
Australia
Create change



"NO ADVANTAGE COMES EITHER TO THE COUNTRY AS A WHOLE OR TO THE INDIVIDUALS INHERITING THE MONEY BY PERMITTING THE TRANSMISSION IN THEIR ENTIRETY OF THE ENORMOUS FORTUNES WHICH WOULD BE AFFECTED BY SUCH A TAX"

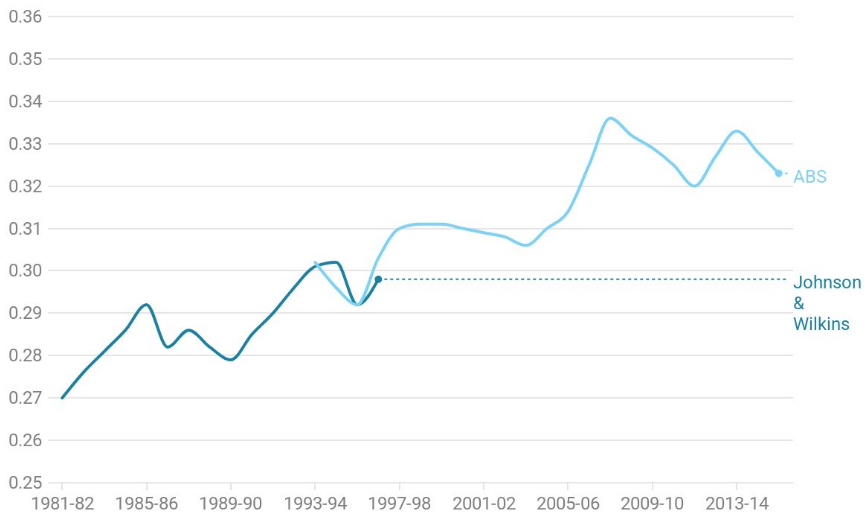
– THEODORE ROOSEVELT ADDRESSING THE U.S. CONGRESS, 1907

Australia has long been known as the land of the fair go; and for good reason. While Australia does not appear particularly egalitarian by conventional measures of inequality such as the Gini coefficient don't fully suppose this view, Australia is thought to have a high degree of social mobility and equality of opportunity (Argy, 2006). Equality of opportunity and social mobility are primarily measured by intra-generational and inter-generational mobility, that is, across one's lifetime and between generations, respectively. While evidence on **intra**-generational mobility in Australia is limited and mixed (Argy, 2006), studies have shown that in the 1970s and early 1980s, Australia was one of the more fluid societies[1] (that is, high **inter**-generation mobility) and there has been no strong tendency for this to increase or decrease (Leigh, 2006).

1 Studies include: Pressman (2004); Pech and McCoull (1998 and 2001); Bjorkland and Jantti (1997), Hout (2003); and Kangas (2000).

Despite strong social mobility since the 1970s, Australia must continue to take active steps to preserve its equality of opportunity. Social mobility has been found to be lower in countries with high inequality, such as the Italy, the United Kingdom and the United States, and higher in the Nordic countries where income is distributed more evenly. Further, greater inequality stifles upward mobility between generations (OECD, 2008). This is a concern as for at least the last 20 years, Australian income inequality has been steadily increasing, with a GINI coefficient of 0.27 (1982), 0.31 (1997/98), 0.34 (2007/08), 0.32 (2011/12) and 0.32 (2015/6).

Figure 1 - Australian GINI Coefficient



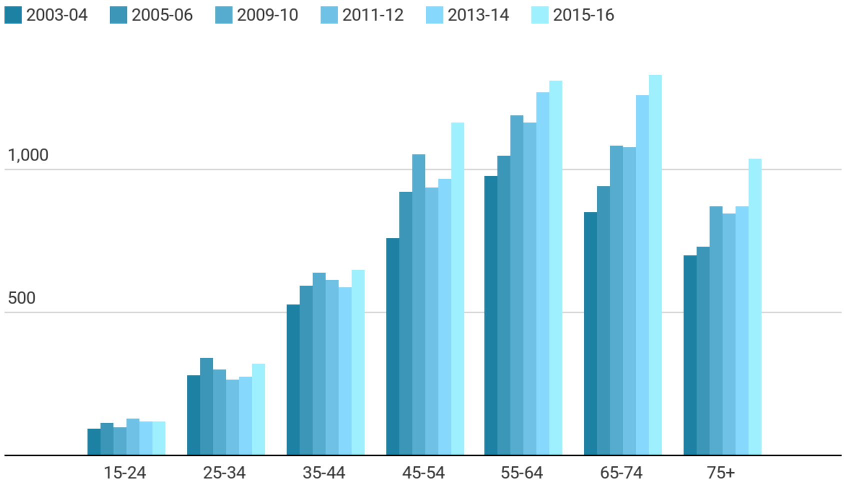
Source: Johnson & Wilkins, ABS

Argy (2009) argues that active social intervention is required to deliver equality of opportunity. This report argues for the reintroduction of inheritance taxes as a more efficient and equitable way to raise revenue and improve the intergenerational flow of wealth[2]. More recently, a report published by OECD suggested governments should consider an inheritance tax to reduce wealth inequality[3].

The slowing of the intergenerational wealth transfer has significant implications for welfare across generations and Australia's equality of opportunity. In recent years, there has been discussion regarding the re-introduction of inheritance taxes in Australia. The 2009 Henry Tax Review (Commonwealth of Australia, 2010) argues that an inheritance tax would fit well with Australia's changing demographic profile into the coming decades. As can be seen in **Figure 2**, the mean wealth by age has been rapidly shifting towards older households. Approximately 22.1% of households are headed by an individual over 65, and the proportion of total wealth held by these households is 29.5%. This is more pronounced in the age group approaching retirement, households headed by individuals aged 55-64, which make up 17.4% of Australian households, but hold 25.25% of the wealth share.

2 This report uses the terms estate tax and inheritance tax synonymously. However, a distinction exists, estate taxes are paid by the deceased's estate, while inheritance taxes are paid by the recipient. For the purposes of this report, both are used in general as a reference to a tax/duty paid on the transfer of wealth after death.
3 The Role and Design of Net Wealth Taxes in the OECD (2018)

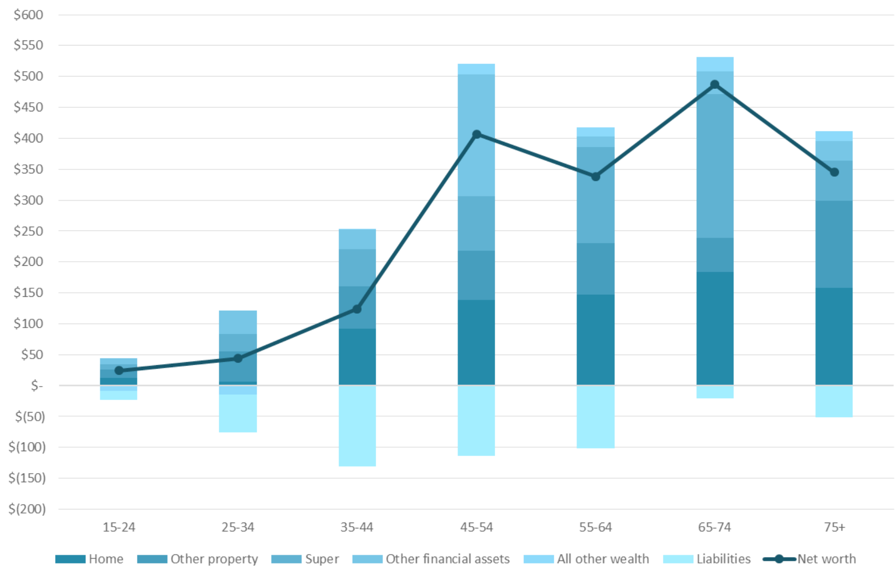
Figure 2 - Mean Wealth by Age of Head of Household



Source: ABS Survey of Income and Housing

A significant factor in the growing wealth of older Australians has been due to the effects of ownership of property and inflation of property prices (see **Figure 3**), with rising house prices and falling home ownership rates among young households (25-34 year old headed households home ownership rate fell from 60% in 1981 to 45% in 2016)[4]. Housing affordability concerns have become a national concern and a large potential barrier to equality of opportunity in Australia. If housing affordability concerns persist, inheritance of property can further drive wealth disparity. Inheritance taxes present an opportunity to capture a portion of this value and apply it directly to address housing affordability, reduce taxes with lower equitability or efficiency, or fund expenditure aimed at improving equality of opportunity, such as education.

Figure 3 - Change in Mean Wealth ($'000) per Household, 2003-04 to 2015-16



Source: ABS Survey of Income and Housing

4 Ibid.

In terms of where the wealth of Australian's is held, the age groups 15-44 hold more than half of their assets in property, and the rest in superannuation, financial assets such as bank accounts and shares, and other wealth, such as house contents, vehicles, and business wealth. Liabilities – primarily mortgages – are significant for the 35-54 age group households, whereas those over 65 have few debts, and typically own their homes outright (see **Figure 4**)

Figure 4 - Mean Wealth ($'000) per Household, 2015-16

Source: ABS Survey of Income and Housing

In this paper, we argue that the intergenerational flow of wealth has slowed in Australia and that the reintroduction of inheritance taxes would be an efficient and equitable method of raising government revenue and addressing the slowdown of wealth flow between generations. It is widely recognised that constrained public budgets have become global fixtures and governments are wrestling with budget priorities (Universities Australia, 2017). Within this environment, governments are also seeking to tax efficiently and equitably.

The Henry Tax Review outlines a guiding principle for taxation: "Raising revenue should be done so as to do least harm to economic efficiency, provide equity (horizontal, vertical and intergenerational), and minimise complexity for taxpayers and the community." The Review found that a bequest, or inheritance tax, would be a relatively efficient means of taxation. However, they main contain some efficiency costs, as they may affect motivations to leave a bequest. Section 3 considers the economics of this efficiency loss and discusses the design of an inheritance tax to minimise distortions. In Section 4, considers the public acceptance of an inheritance tax and whether it could be re-introduced as a progressive element of the tax system, whether as an integral part of the tax system or in a limited context, for example to fund the first-homeowners grant.

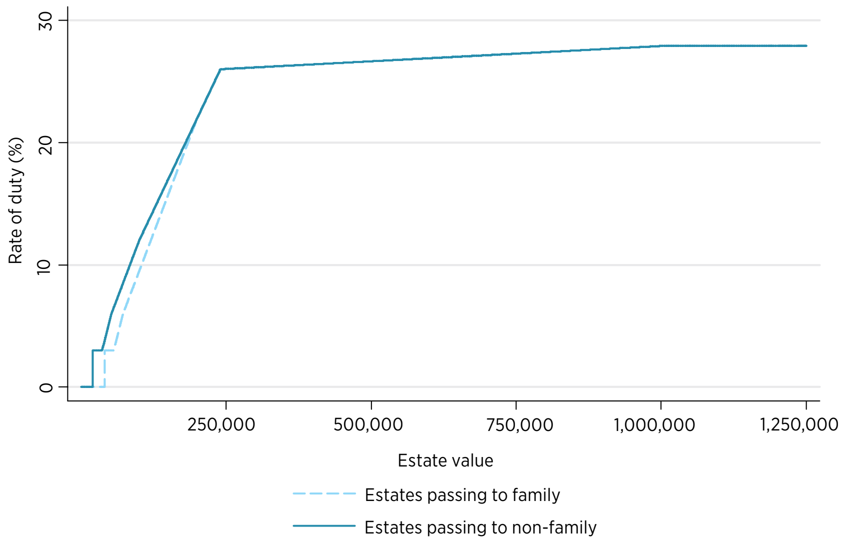
1.1 Historical context

Inheritance taxes were once a well-established part of Australia's taxation system, with all states having inheritance taxes at Federation. These taxes/duties were an important source of state revenue in the early 20th century, with their importance declining over time with the introduction of other forms of taxation. The

Commonwealth also began levying inheritance taxes in 1914, to assist in funding wartime expenses. (Reinhardt & Steel, 2006) Inheritance taxes became increasingly unpopular during the late 60s and 70s and in 1978 the Queensland Bjelke-Petersen Government abolished them, with the other states and the Commonwealth following.

At the time of abolishment there were a number of major criticisms that contributed to decline in popularity of inheritance taxes. Firstly, inheritance had been initiated with relatively low exemption thresholds. At the federal level, a basic exemption of only $40,000 meant that approximately twelve percent of estates were affected across Australia. However, at the state level, exemptions for estates and gifts were as low as $12,000, affecting approximately twice as many estates than at the national level. Furthermore, no adjustments for inflation were made on exemptions since the 1940s, exacerbating the problem of already low exemptions. As a result, many surviving widows who inherited relatively modest estates faced financial hardships. Though efforts were made to exempt inter-spousal transfers, the fear of death duties among those with modest or no inheritance became widespread.

Figure 5 - Commonwealth Inheritance Taxes Prior to Abolition[5]



Source: Gans, and Leigh (2006)

Secondly, farming interests were also among those that looked upon death duties unfavourably. The financial hardship, generated by farmland with high market value and low rate or return, meant that farms had to be sold, or agricultural holdings fragmented, to meet liabilities on death duties. Although there was little evidence for this and data was sparse, farming interests were certainly the strongest supporters for repeal of death duties.

Thirdly, a factor underpinning the abolition of death duties in Australia was the relative ease at which these taxes could be evaded. It was rightly criticised as a taxation system filled with loopholes. As the Asprey Committee observed in 1975: “[the Australian death tax] is certainly at present a tax which can be avoided by well-advised persons with ease, and which might also be said to be paid principally from the estates of those who died unexpectedly or who had failed to attend to their affairs with proper skill.” Cooper (1979) labelled estates taxes as a “voluntary tax”, as the tax was considered easy to avoid by sophisticated and well-informed

5 Gans, J & Leigh, A (2006) Did the Death of Australian Inheritance Taxes Affect Deaths?

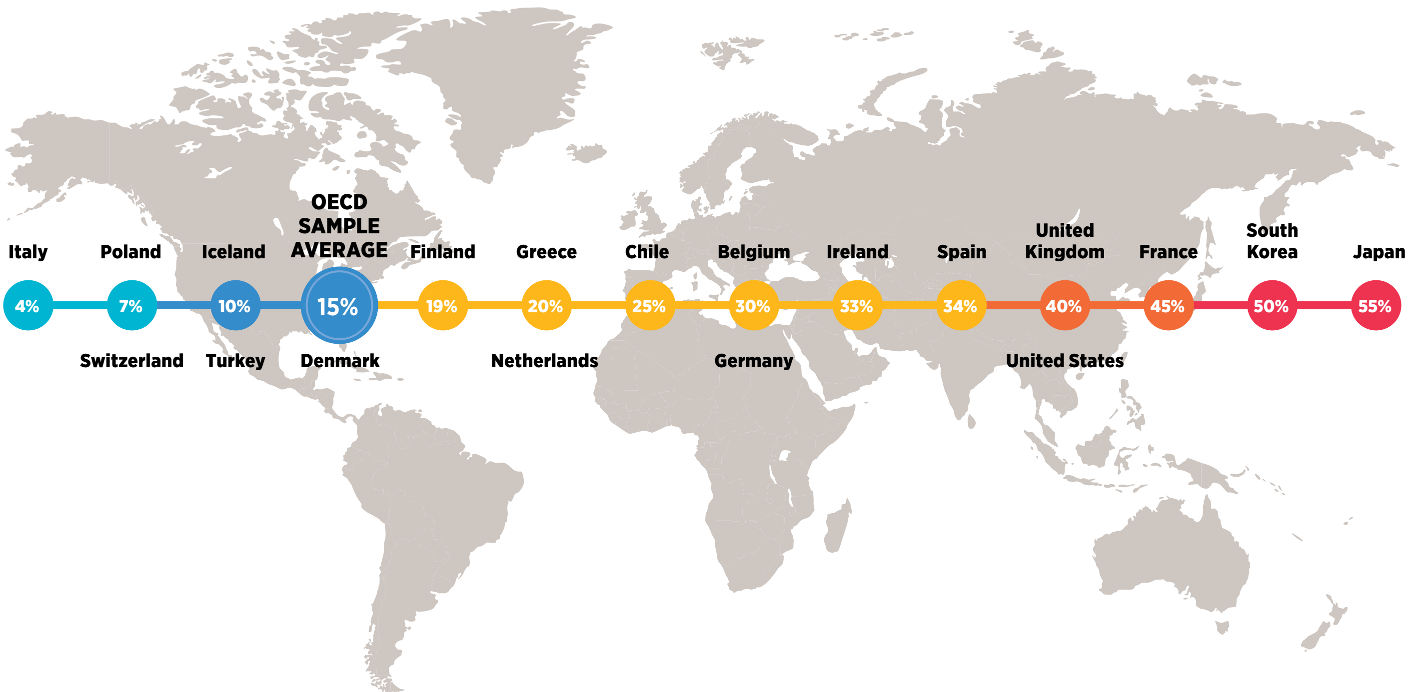
taxpayers, due to numerous mechanisms for exemption. For example, discretionary trusts were frequently used to pass on wealth between generations free from inheritance tax. Those with larger estates had greater incentives to plan ahead and seek professional advice, shifting the burden of the tax to smaller estates.

As popularity of inheritance taxes decreased, the reliance of the states and the commonwealth on these taxes had simultaneously declined. By 1973, the death duty only represented 0.7% of tax revenue for the Commonwealth Government and at the state level, death duties accounted for less than 9% of total tax revenue, lower than at any time in history. As inflation had caused modest estates to enter the tax net, the administrative and compliance costs had caused net revenues to decrease even further. A reinstated inheritance tax would need to consider these historical factors in the design of the tax, in order to avoid the issues and criticisms associated with its former versions.

1.2 International context

Inheritance taxes are currently still levied across the world (see **Figure 6**) at various rates, threshold levels, exemptions and at different times (prior or after a transfer). These differences greatly affect the effectiveness, equitability and efficiency of the tax, and are discussed in **Section 2 and 3**.[6]

Figure 6 - Inheritance Taxes Around the World[7]



The significant body of research on inheritance taxes relates to the United States, where it has been hotly debated. The United States has taxes bequests of some form since 1797 and has evolved into its current form, which is a high rate of tax on a high estate threshold for it to be liable (see **Table 2**).

6 This report does not consider the implications of the timing of the taxation, see Batchelder (2007) for a more thorough treatment of the issue.
7 Cole (2015) Estate and Inheritance Taxes around the World, Tax Foundation

Table 2 - Estate Tax Exemptions and Tax Rates, USA

Year	Exemption (dollars)	Initial rate (percent)	Top rate (percent)
	(1)	(2)	(3)
1916	50,000	1.0	10.0
1971	50,000	2.0	25.0
1918-1923	50,000	1.0	25.0
1924-1925	50,000	1.0	40.0
1926-1931	100,000	1.0	20.0
1932-1933	50,000	1.0	45.0
1934	50,000	1.0	60.0
1935-39	40,000	2.0	70.0
1940	40,000	2.0	70.0
1941	40,000	3.0	77.0
1942-1976	60,000	3.0	77.0
1977	120,000	18.0	70.0
1978	134,000	18.0	70.0
1979	147,000	18.0	70.0
1980	161,000	18.0	70.0
1981	175,000	18.0	70.0
1982	225,000	18.0	65.0
1983	275,000	18.0	60.0
1984	325,000	18.0	55.0
1985	400,000	18.0	55.0
1986	500,000	18.0	55.0
1987-1997	600,000	18.0	55.0
1998	625,000	18.0	55.0
1999	650,000	18.0	55.0
2000-2001	675,000	18.0	55.0
2002	1,000,000	18.0	55.0
2003	1,000,000	18.0	49.0
2004	1,500,000	18.0	48.0
2005	1,500,000	18.0	47.0
2006	2,000,000	18.0	46.0
2007	2,000,000	18.0	45.0

Despite applying to relatively few Americans, the tax has had fierce opposition for a long time[8]. While the revenue raising potential of the tax has been long into question (Bernheim, 1986), the tax has kept pace with US deaths, despite applying to an ever smaller proportion of households (see **Figures 7 and 8**). While estate tax has often been criticised as becoming irrelevant, the United States estate tax has over time kept a steady role in the revenue picture, with it representing 0.75% of tax revenues in 1984 and 0.80% in 2008. The United Kingdom inheritance tax follows a similar model to the US tax, with a high tax (up to 40%) applying to a small proportion of households (approximately 4% of deaths in 2015-16 were liable) – however, the proportion of UK deaths liable for the tax is approximately four times greater than US deaths[9]. UK inheritance tax receipts hit a record high of £5.2bn in 2017[10].

8 See https://www.theatlantic.com/business/archive/2016/02/resistance-estate-tax/470403/
9 HM Revenue and Customs (2018) Inheritance Tax Statistics 2015 to 2016
10 See https://www.ft.com/content/a19d0982-47a9-11e8-8ee8-cae73aab7ccb

Figure 7 - Taxable Estate Tax Returns, USA[11]

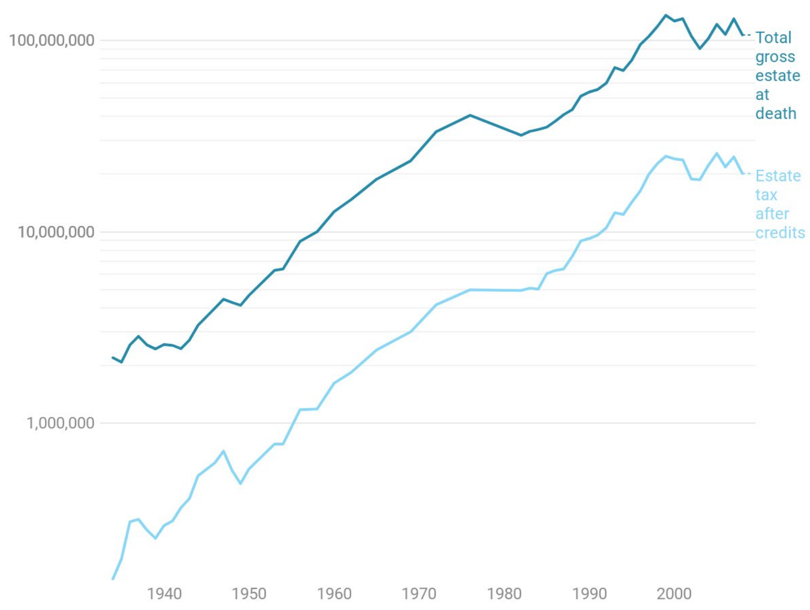
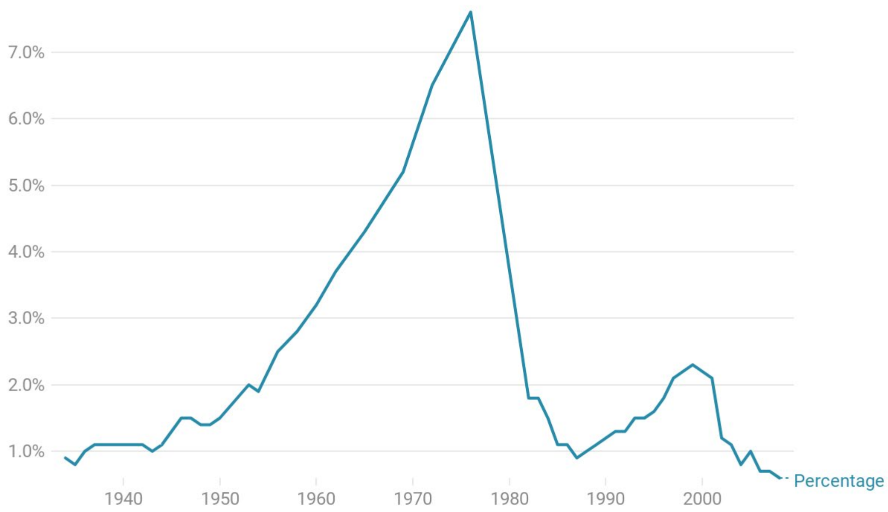


Figure 8 - Percentage of US adult deaths liable for the tax[12]



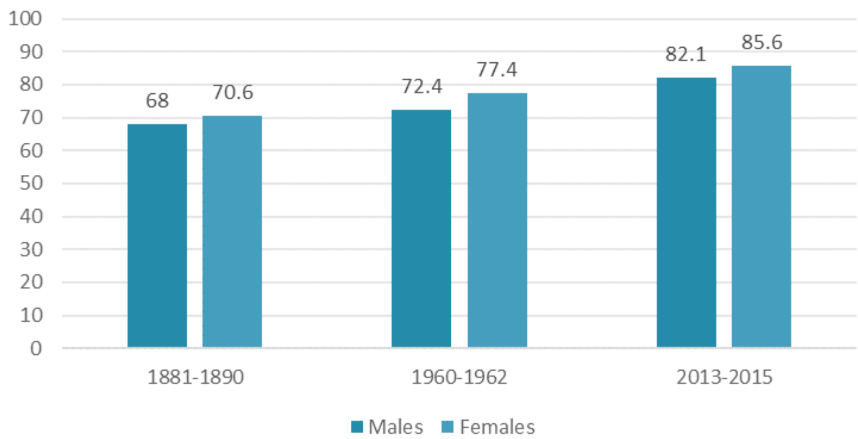
Other nations have followed significantly different models. Italy, for example, taxes a low tax rate (4%) on estates over €1 million. However, in the presence of significant tax expenditures, through exemptions, the tax has a less significant role in raising revenues in Italy (inheritance and gift taxes represented 0.09% of total Italian tax revenues in 2008) than in the UK (estate tax represented 0.68% of total UK tax revenues in 2005)[13].

11 IRS (2017) SOI Tax Stats - Historical Table 17
12 Ibid.
13 Copenhagen Economics (2010) Inheritance Taxes: Key Characteristics in the European Union; CESifo

A modern inheritance tax

At present, an Australian male aged 66 is expected to live for another 19.6 years on average. An Australian female aged 69 can expect to live for another 19.7. In the past half a century, Australian life expectancies have risen by 9.7 years for males and 8.2 for females. Accordingly, inheritance is increasingly being passed on later and therefore likely to more financially well-established children.

Figure 9 - Life expectancy at age 45 – trend[14]

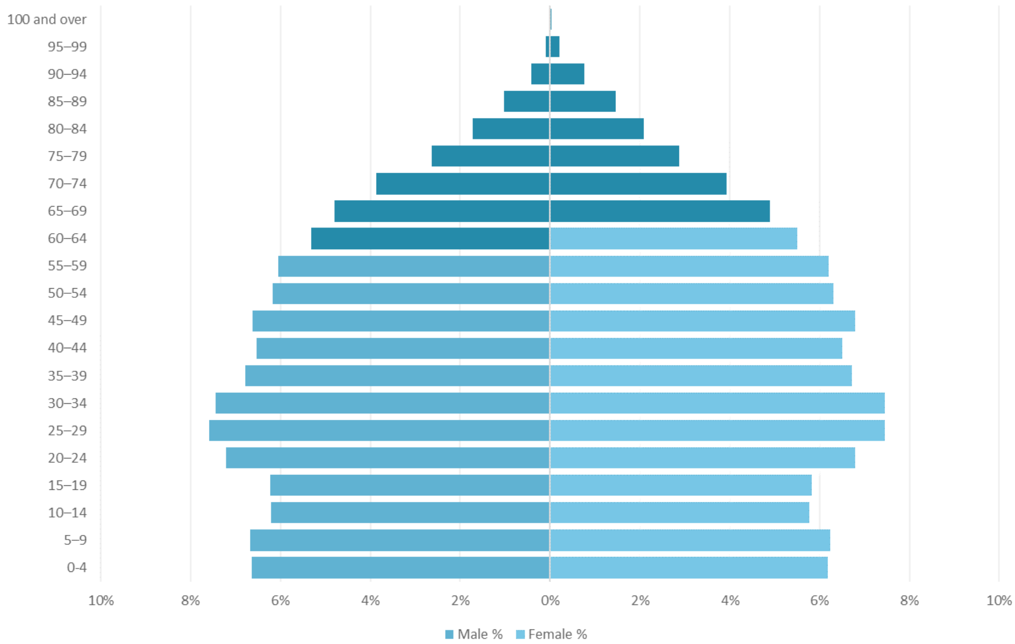


Accordingly, in June 2016 there were approximately 3.18 million Australians which are expected to pass away in the next 20 years. Accordingly, over the next 20 years, approximately 13 percent of Australia's current population are expected to reach their life expectancy age (as seen in **Figure 9**). In 2015-16, the mean net wealth in this

14 Australian Institute of Health and Welfare (2017) Deaths – life expectancy from age 45 is presented here as opposed to life expectancy from birth as this filters out infant mortality and early life deaths, which reduce the life expectancy from birth, however, largely do not represent the population gifting estates.

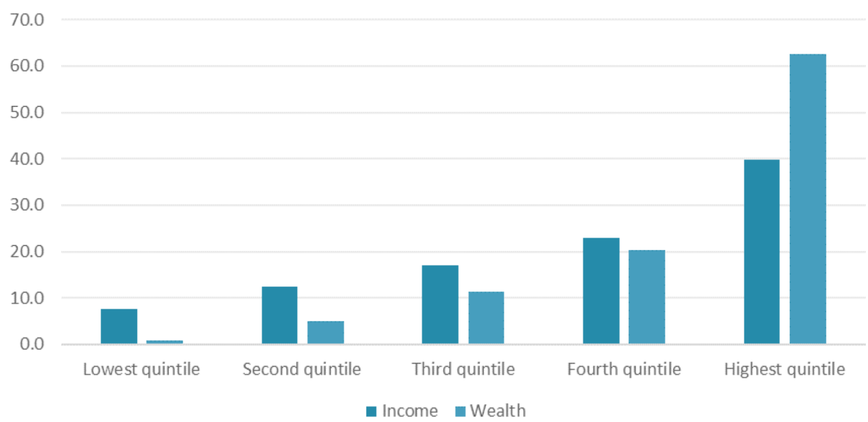
group was approximately $1.7-2.4 million, representing 27-37 percent of Australia's total wealth. The way in which this wealth is distributed to the next generation will have important implications for Australia's equality of opportunity, overall welfare and prosperity.

Figure 10 - ABS, Life expectancy reached within 20 years – highlighted in turquoise



Brimble et al (2017) estimate that that over the next 20 years, Australians over 60 will transfer $3.5 trillion in wealth, growing at 7 per cent per year, approximately $320,000 on average to be passed on to each child. Further, they find that approximately 78 per cent of the estimated transfer wealth will go to 20 per cent of recipients. As can be seen from **Figure 11**, Australia currently has a significantly more unequal wealth than income (the simplified GINI coefficient calculated by quintile is 0.29 for income and 0.56 for wealth).

Figure 11 - Share of EDHI and net worth per quintile in 2015-16 (ABS: 6523.0)



Australia's current tax system is a large contributor to the moderation of income inequality. The income tax reliant system (income tax accounts for approximately 72 percent of Commonwealth revenue), primarily targets redistributing income over

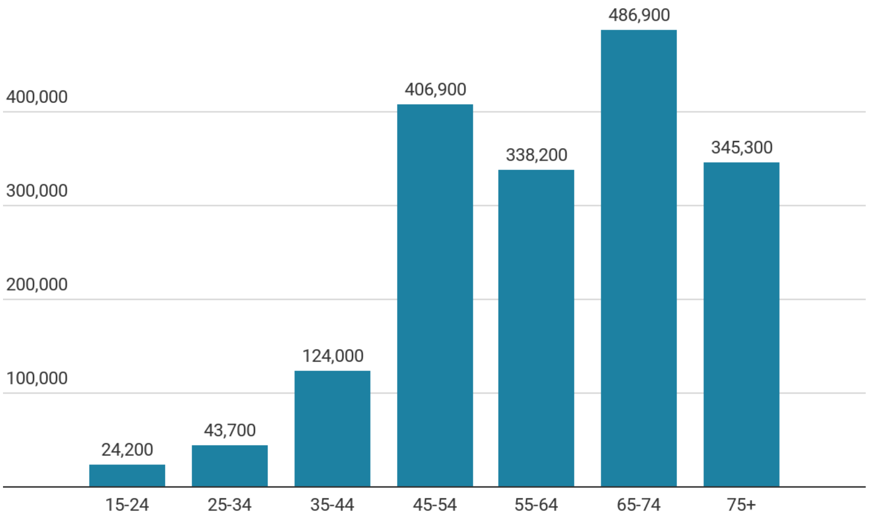
the redistribution of wealth. This is significant as Australia has been experiencing a prolonged bout of wage stagnation (RBA, 2016). Wages as a share of total income have fallen (see **Figure 12**) and households which are less dependent on salary are less adversely affected. With a great majority of estate values being inherited by a minority, wealth inequality will be exacerbated. As wages only represent approximately 54 percent of total income, this wealth inequality can also adversely affect income distribution also. A wealth-based tax, such as an inheritance tax, is a policy lever to target this growing inequality (OECD, 2018).

Figure 12 - Wages share of total factor income (ABS: 5204.0)

In addition to growing wealth distribution over generations, Australia currently faces a divergence in the distribution of net wealth across age groups. That is, older age groups hold an increasing proportion of Australia's wealth. **Figure 13** illustrates the change in mean wealth over the past decade has principally occurred in age groups

– 89% of wealth gain in this period has been to households headed by an individual over 45. As life expectancies increase, those inheriting wealth may tend to already be financially established, further exacerbating the trend. That is, if deceased pass the majority of their wealth to an increasingly older generation, which have had the opportunity to accumulate wealth, thus being already financially established, this would further drive wealth inequality between age groups.

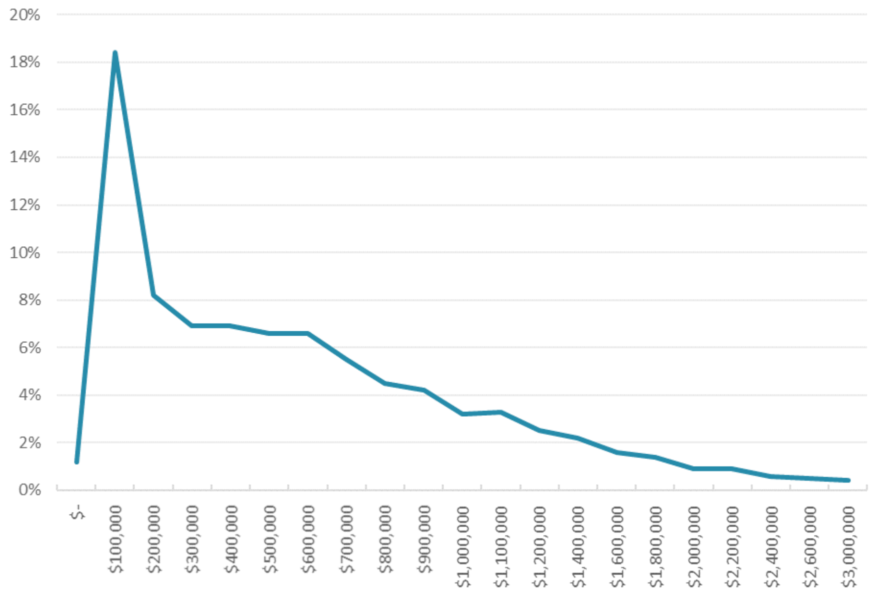
Figure 13 - Change in mean wealth per age group (2003-04 to 2015-16) – (ABS: 6523.0)



Inheritance taxes allow for the wealth from estates to be distributed in greater proportions benefiting younger age groups, reducing the cross-generational wealth divergence. This could be achieved directly, via transfer payments and grants, or used indirectly, for example by raising equality of opportunity through university scholarships.

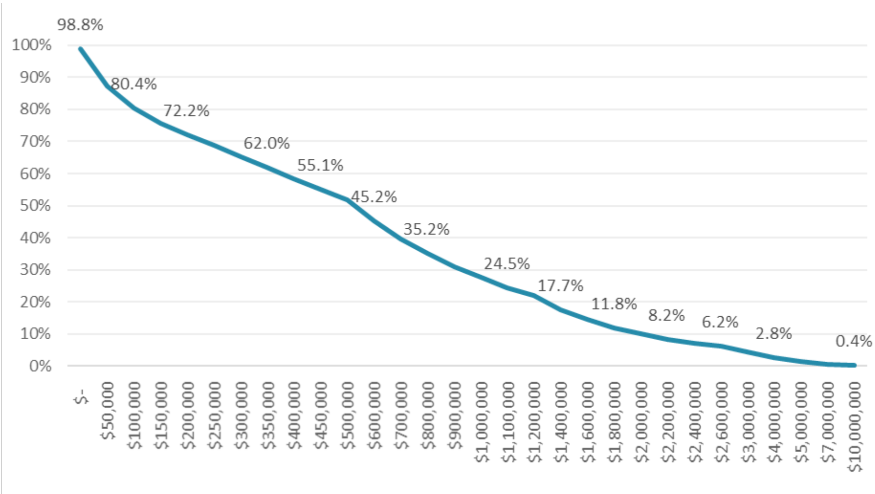
The potential revenue raising potential of an inheritance tax, which can primarily be thought of as a function of the rate of tax, as well as the minimum threshold for it to apply. The threshold is an important consideration, which will affect the effectiveness and acceptability of the tax. **Figure 14** illustrates the distribution of household net worth.

Figure 14 - Distribution of household net worth, 2015-16 (ABS: 6523.0)



By viewing the above results as a cumulative function, represents the proportion of households that would be affected by an inheritance tax for a given threshold (assuming all net worth is included in an estate):

Figure 15 - Proportion of households affected by threshold value (ABS: 6523.0)



Thus an inheritance tax threshold of $7 million would apply to approximately 7%, or 29,000, Australian households. The threshold and rate of tax will have implications for the behaviour of individuals, as well as the rate of non-compliance. These considerations will be developed in **Section 3**.

The economics of death duties

One of the strongest arguments in support of estate taxation is the merit of its economic efficiency relative to other forms of taxation. Tax systems often face the trade-off between efficiency and equity, such that the distortions in behaviour of the taxpayer and fairness should be balanced in considering an optimal tax system. For example, income tax strongly distorts the behaviour of workers, in particular those who are highly paid and typically the most productive, but also distributes tax burden "fairly" across the population. However, the case for death duties may be different. Arguments for whether this tax should be implemented as part of an efficient tax system depend heavily upon transfer motives. As is the case in any tax debate, the behavioural responses to such a tax must be considered. The inheritance tax potentially elicits two major behavioural responses, the choice between: savings and consumption; and labour and leisure.

3.1 Optimal taxation

Farhi and Werning (2010) first presented a model for optimal estate taxation with heterogeneous skills among parents. In the framework of the two-period model, they postulate that each parent is homogeneously altruistic toward his or her child.

The implicit estate tax, characterised using a utilitarian welfare within generations, is strictly negative and increasing in the parent's productivity:

$$\tau(\theta_0) = -R\frac{\nu}{\mu}u'\big(c_1(\theta_0)\big),$$

where progressivity is implied by the fact that $c_1(\theta_0)$ is increasing in θ_0. In this model, the optimal estate taxation always involves a subsidy on bequests, where parents with higher productivities face a lower net return on bequests, and less product parents require a higher net return on bequests.

The intergenerational transmission of wealth can also be characterised with a constant relative risk aversion example:

$$\log c_1(\theta_0) - \log c_0(\theta_0) = \frac{1}{\sigma}\log\left(1 + \frac{1}{\beta}\frac{\nu}{\mu}c_0(\theta_0)^{-\sigma}\right) + \frac{1}{\sigma}\log(\beta R),$$

where the right hand side of the above equation is strictly decreasing in $c_0(\theta_0)$. Therefore, the child's consumption still varies with that of the parent's but less than one-for-one in logarithmic terms.

This result illustrates that optimal estate taxation leads to mean reversion in the children's consumption. That is, future generations are insured against the heterogeneous skills, and thus income, realised by the parents in period 0.

However, the negative tax (subsidy) result is not applicable to the real word. In a complementary paper, Farhi and Wening (2013) consider the case of heterogeneous altruistic behaviour. Under a Rawlsian maximin criterion, optimal policy is constrained to be a positive tax on bequests. Intuitively, this result implies that children with bequests above the minimum are taxed to redistribute towards the children with the minimum bequest. These properties reproduce features of existing estate tax implementations in developed economies.

Heer (2000) introduces a general equilibrium life-cycle model to explain observed levels of wealth heterogeneity. Using a calibrated model to match the characteristics of the US economy, they find that inheritance taxes increase wealth equality and social welfare.

3.2 Transfer motives

An inheritance tax distorts the choice between consumption and bequests, and between leisure and bequests (Gale, 2001). If bequests are left accidently; that is, the person dies before they expect and are thus unable to consumer their wealth, a tax on bequests has no distortive effect. However, if bequests are transferred for altruistic motives, than inheritance taxes may have distortive effects that hinder its efficiency. However, in most cases bequests are a mixture of these two motives and empirical studies have had difficulty distilling the two components.

It is often argued that bequests are a by-product of saving for precautionary reasons, such as retirement, health-related spending expectations and financial stability (Kopczuk, 2010). More often than not, those who plan for these expenditures, usually die with part of their accumulated wealth unspent. In such a case, the behaviour of the individual cannot be distorted by the tax as bequests have no value to the individual. This makes such a tax fully efficient as it achieves the purposes of tax without effecting the donor. Though, the recipient of the bequest would be worse off.

Empirical evidence attempting to understand transfer motives has produced mixed results. In many cases, the proportion to which transfers are determined to be altruistic and accidental has depended on the approach they take and also observing the general population. However, this approach to thinking about a bequest tax may be limited. It is unlikely that the very top tranche of wealth distribution (i.e. the target population of inheritance tax) be characterised by the same motives as a general population.

Advocates of the tax argue that income received from inheritance has no bearing on the economic efforts of the recipient. They postulate that wealth is accumulated over a lifetime to achieve financial stability and insure against various risks. In this case, bequest motives are absent, and the transfer of any wealth at death would be an accidental bequest. Consequently, the re-introduction of an inheritance tax would have no adverse effects on an individual's decision to supply labour or accumulate wealth. In fact, some even argue that receiving inheritance reduces labour supply, though this effect is reasonably small (Holtz-Eakin et al. 1993). On the other hand, it has been argued that bequests are motivated by the altruistic behaviour of the donor. In the case of altruistic transfers, the utility of the donor is a function of the accumulated wealth and thus the value of the bequest after tax. In such a case, the incidence of the tax also falls on the donor, which disincentives wealth accumulation and distorts the behaviour of donors.

3.3 Effects on savings and wealth accumulation

The effect of an estate tax on savings depends strongly upon the transfer motives of the donor, as it elicits different behavioural responses. An individual who is not altruistically motivated is not impacted by the estate tax, and therefore does not change their savings behaviour. Under altruistic motives, the estate tax changes how the donor perceives the cost of capital, namely an increase in price. Theoretical works on the effect under altruistic motives have found reductions in savings as estate tax increases (Joulfaian, 2005). In Laitner (2000)'s simulation model, removing the estate tax raises savings under altruistic transfer motives, though this leads to an increase in the concentration of wealth, particularly among the top 1% of wealth-holders. Contrarily, simulations conducted under altruistic motives, have shown family savings to rise with increases in the estate tax rate (Gale and Perozek, 2000). Cagetti and Nardi (2007) also find in their model that eliminating the estate tax would not generate large increases in wealth and capital accumulation, in the case of the US. Though, further evidence to support this claim is limited.

However, to evaluate the overall effects of estate taxes on savings, the behavioural response from the recipients must also be considered. Given that after-tax transfers are lower in the presence of the estate tax, this encourages recipients to increase savings, or rather, stops recipients from decreasing savings. Empirical studies investigating the direct effect of estate tax on recipients' savings behaviour has been ignored. However, Weil (1994) shows that the anticipation or receipt of a bequest raises the individual's consumption, suggesting that a reduced after-tax bequest for the recipient would induce a higher savings rate. Moreover, Gale and Perozek (2000) postulates that the positive impact on savings on the recipient is large enough that the overall impact on savings may be positive.

Holtz-Eakin, Joulfaian and Rosen (1994) shows that a large inheritance increases the chance that a recipient starts a business, as well as allowing a business to survive or expand. Although minimal, it may be necessary for other policy tools to be used to offset the negative effects that an estate tax may impose on innovation and entrepreneurship.

3.4 Effects on labour supply

Diverging from the argument of transfer motives, labour supply has been found to be independent of these underlying motives. Academic consensus has stated that estate tax discourages labour supply of future donors by reducing the return to work (Holtz-Eakin, Joulfaian and Rosen, 1993; Hines Jr, 2013). However, the reverse is to be found for donors in which a burden is imposed as a recipient of an after-tax bequest and as those who plan to leave a bequest in the future (Hines Jr, 2013). If labour supply is responsive to a bequest tax, then the tax may be able to encourage labour supply more than it discourages, resulting in a net gain in labour supply.

These results are consistent with empirical studies. Holtz-Eakin, Joulfaian and Rosen (1993) find that receiving an inheritance of $350,000 reduces labour force participation by 12 percentage points. Hence, the introduction of an inheritance tax, where recipients face a lower after-tax return, may have positive labour force effects. However, Holtz-Eakin, Phillips and Rosen (1999) find that inheritance taxes disincentivise workers approaching age pension from continuing to work. Therefore, it is possible an intertemporal trade-off exists, by encouraging labour supply at an earlier age and discourage labour supply towards retirement.

As the baby boomer cohort approaches the expected lifetime, it seems to be a suitable time to reintroduce the estate tax. The cohort, which has predominately reached retirement, will only be subject to relatively minimal labour supply distortion. Future generations, those expecting bequests, will also be encouraged to increase labour supply. Thus, the contemporaneous shock on labour supply, if implemented as the baby boomer cohort enters retirement, may be significant.

3.5 The role of progressivity

In Australia, the growing concentration of wealth and lack of policy tools that have been used to prevent this, makes a strong case for the role of a tax on bequest to achieve progressivity in the current taxation system. Progressivity is achieved through the donor and the recipient of the bequest. Progressivity also applies to recipients based on empirical findings that the recipients of inheritances from estates valued between $2.5 million and $10 million had average adjusted gross incomes of almost three times that of other inheritance recipients, and four times that of mean incomes at the time (Joulfaian, 1998). By these means, it can

be understood that the estate tax achieves progressivity with respect to current income, and lifetime income (Gale and Slemrod, 2001).

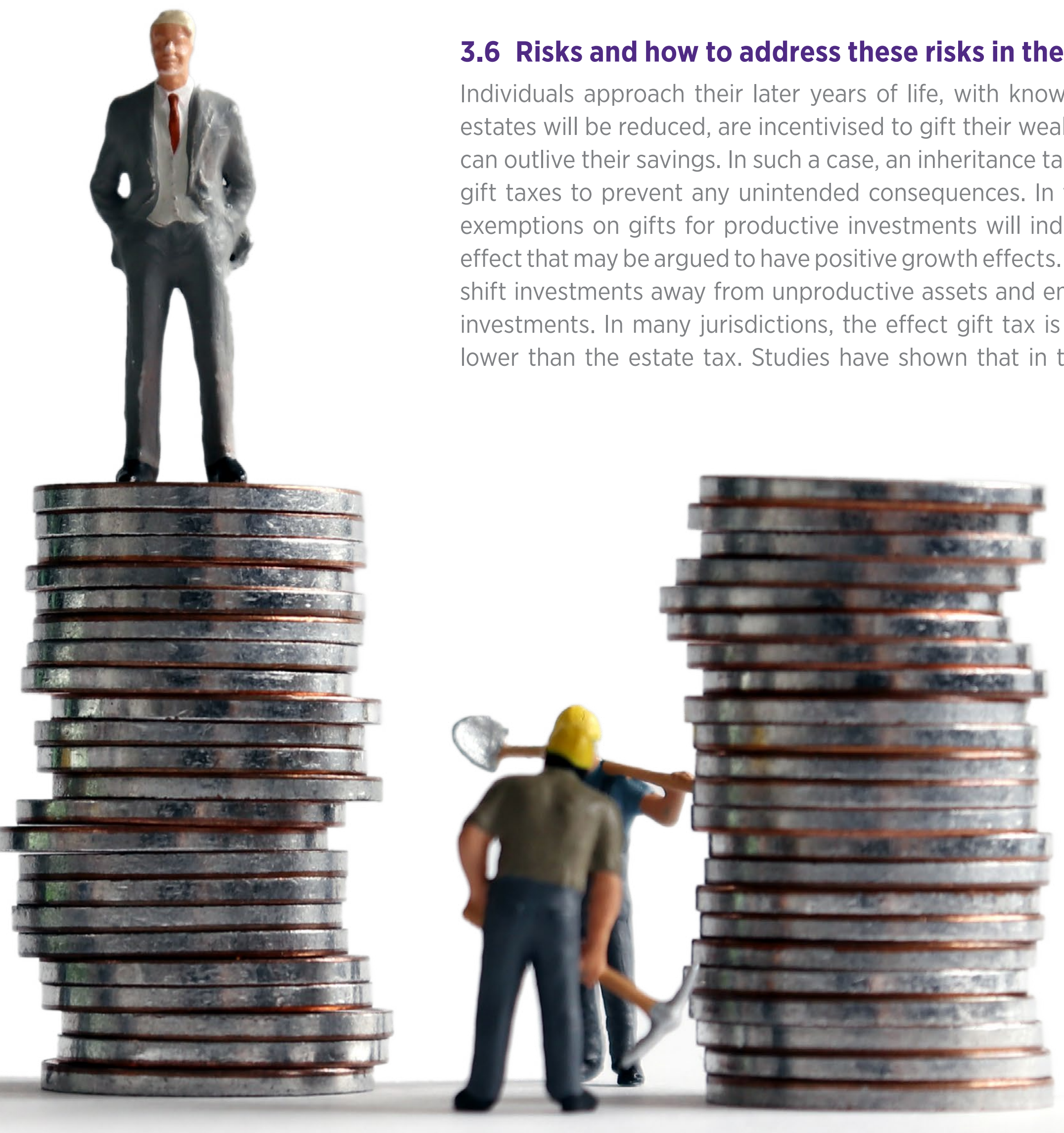
The estate tax might contribute in a number of ways to the progressivity of the current taxation system. The income tax and capital gains tax is limited in ways that the estate tax is able to provide progressivity. Firstly, capital gains are only taxed when the assets are sold as opposed to when the gains accrue. The implications of this are discussed in the following sub-section. Secondly, it may be best to not restrict the discussion of progressivity to the amount of income one earns. Shakow and Shuldiner (2000) find that wealth increases disproportionately with income. That is, the proportion of net worth to income steadily increases once it reaches $15,000 (in USD, 2000). Based on these empirical findings, the effective progressivity relative to income may not be to the same degree as it first appears. Therefore, the estate tax is another tool that government's may be able to use to achieve its desired degree of progressivity.

Tax avoidance and planning

While it was previously stated that bequests are often accidental, Kopczuk (2007) finds that the onset of terminal illness leads to a significant reduction in the value of reported estates. In fact, those who suffered from a lengthy (months to years) illness reported 15 to 20% lower estates and those who suffered shorter (days to weeks) illness reported 5 to 10% lower estates. While it may be argued that this is consistent with larger medical expenses following the onset of illness, empirical findings suggest this response directly reflected estate planning.

3.6 Risks and how to address these risks in the tax structure

Individuals approach their later years of life, with knowledge that net-returns on estates will be reduced, are incentivised to gift their wealth when they believe they can outlive their savings. In such a case, an inheritance tax needs to be aligned with gift taxes to prevent any unintended consequences. In this case, the provision of exemptions on gifts for productive investments will induce a particular distortive effect that may be argued to have positive growth effects. Such a tax structure would shift investments away from unproductive assets and encourage more productive investments. In many jurisdictions, the effect gift tax is generally observed to be lower than the estate tax. Studies have shown that in the absence of estate and



gift taxes, gifts decline significantly (Joulfaian, 2016). Hence, implementing a gift tax, complementary to the estate tax, will be essential to the structure, feasibility and fairness of the taxation system. It is important to note that cash transfers from parents to children will be captured under the gift tax. However, this accidental tax avoidance is a consequence of the altruistic human nature of the parent toward their children, rather than part of estate planning. While it is normal for parents to provide financial assistance to their children, the line between assistance and an avoidance opportunity is extremely fine. This observation presents the practical implications in implementation which must be addressed if a gift tax is to be made comprehensive (Cooper, 1979).

Boylan and Sprinkle (2001) investigate the relationship between tax rates and compliance. They find empirical evidence that when income is endowed, taxpayers view their income as a prior gain, and consistent with the prospect theory in behaviour economics, are more likely to exhibit risk taking behaviour. In other words, because taxpayers view endowed income as a prior gain, they are likely to offset the decrease in desired return by reporting less income. This poses a compliance risk for the re-introduction of estate tax in Australia. As such, it is necessary to consider the means to which wealthy individuals will reallocate resources to decrease the tax burden, creating a deadweight loss on society. Kopczuk (2007) finds that the onset of terminal illness leads to a significant reduction in the value of reported estates. In fact, those who suffered from a lengthy (months to years) illness reported 15 to 20% lower estates and those who suffered shorter (days to weeks) illness reported 5 to 10% lower estates. While it may be argued that this is consistent with larger medical expenses following the onset of illness, empirical findings suggest this response directly reflected estate planning. These findings imply that the benefits from earlier planning could be further exploited by the wealthy.

However, the structure of the tax system could be implemented in such a way that the costs for non-compliance would be extremely high for taxpayers. Firstly, the probate process reveals information about all of the deceased's assets, therefore making misreporting difficult and potentially costly. Secondly, previous methods of avoiding inheritance tax (i.e. through discretionary beneficiary trusts) should be captured in the tax net. Finally, implementing a low, broad-based tax would also help to disincentivise avoidance, by furthering increasing costs and decreasing benefits to do so.

A major criticism of inheritance tax in Australia, which eventually lead to its abolishment, was the financial burden it placed on assets with high value and low expected returns, such as farmland and small businesses. In addition, small businesses being transferred across generations can suddenly generate a large tax burden on the business and cause it to fail. Although the majority of wealth transferred consists of liquid assets, given the political obstacles posed by farmers and small business owners, strategies should be implemented to alleviate the financial pressures that may be caused on transfers with these characteristics.

Will the public accept the re-introduction of death duties?

"THE ART OF TAXATION CONSISTS OF PLUCKING THE GOOSE SO AS TO OBTAIN THE MOST FEATHERS WITH THE LEAST HISSING."

– JEAN-BAPTISTE COLBERT

4.1 Fairness of death duties in the suite of taxes

The idea of taxing wealth once, at death, adheres to the ability-to-pay principle, an important consideration in tax systems. An equitable tax system maintains vertical equity – those who are more able to pay taxes should contribute more – and horizontal equity – those with the similar income and assets should pay the same amount in tax. While an estate tax, free from loopholes and avoidance would satisfy the vertical equity consideration, horizontal equity may raise controversial issues. Much of the estate tax burdens families that wish to pass their fortune and wealth on to their children, whilst not burdening families that consume heavily during their lifetime. However, if the estate tax is viewed in the following generation; that is, the children who have simply inherited unearned income from their parents, then it may be viewed as horizontally equitable.

Critics argue that compounding the grief of the deceased's family with a "death tax", seems heartless. However, this does not mean that taxing at death is also ineffective, in fact it may prove to be an appropriate time to impose a taxation

on wealth Firstly, in the scheme of wealth taxes, a tax that is imposed at death is likely to have limited disincentive effects than one that is imposed during one's lifetime. Taxing the individual once, at the end of life, is expected to limit distortions of labour supply and wealth accumulation over the person's lifetime, since bequests are usually accidental. Secondly, at death, the probate process reveals information about lifetime economic well-being (Gale and Slemrod, 2001), more accurately measuring the individual's ability to pay.

The incidence of the estate tax again hinges on the transfer motives of the donor. Under altruistic motives, the burden of the tax is assigned to both the donor and the donee, the proportion to which depends upon how strongly these altruistic motives are. The stronger the motives, the more the burden of the tax is assigned to the donor. Under accidental bequests, the burden of the estate tax is solely borne by recipients as the donor faces no utility loss. The majority of the tax incidence falls on the recipient, the one who has done nothing to earn the wealth. In comparison to an income tax, where the burden is borne by the one who has worked hard to earn the income, an estate tax appears a more justly tax.

4.2 Negating double taxation

Estate taxes are often criticised on the grounds that they involve double taxation: once on the income used to accrue the bequeathed assets, and at the time it transferred to the donor. Though double taxation should not be looked at as a positive or negative (TaxReview). For example, in our current system, individuals will first be taxed on labour income through income tax and a second time when individuals consume with that same income, through the goods and services tax. There is not a strong reason to avoid double taxation in an attempt to adopt a system with a single tax. Rather, one should seek to implement a taxation system that raises enough revenue for government spending while limiting the economic and efficiency costs in doing so.

Additionally, some capital assets may never be subject to a capital gains tax. As capital gains are taxed if and only if they are realised, an individual who holds assets until they are deceased, may have a majority of wealth that is never taxed. In fact, in 1998, about 36% of all wealth held by the deceased consisted of unrealised capital gains. That figure rises to 56% for estates in excess of $10 million (Poterba and Weisbenner, 2001). This finding directly contradicts the argument that all wealth left in estates are taxed more than once.

4.3 Revenue raising issue

An estate tax can be argued to be implemented for two different functions in society. Firstly, an estate tax could be designed to break down large accumulations of wealth such that the amount of revenue raised is not of great concern. Alternatively, it could be designed to raise the most amount of revenue while imposing the smallest behavioural distortion and economic cost in doing so. In both cases, the estate tax aims to rectify wealth inequality and prevent future perpetuation of inequality.

One of the reasons that led to the abolishment of the estate tax in Australia was the criticism that the amount of revenue raised was insignificant compared to the administrative costs. Whilst true, this is not necessarily reason to abolish the estate tax. Rather, the presence of the estate tax can be seen to serve the function of breaking down large accumulations of wealth. If an estate tax is perceived in this manner, then the tax is most effective when it raises the least revenue, so long as large concentrations of wealth are no longer accumulated but transferred intergenerationally (Fennell, 2003). If the loss in utility incurred through behavioural distortions were less than the societal benefits gained, these distortions would be desirable. One requirement for this line of reasoning is that low revenue is due to reduced wealth accumulation and not avoidance. Kopczuk and Slemrod (2000) observe a negative correlation between estate tax rate structure and reported net worth of top estates, postulating that increased estate taxes either reduce wealth accumulation, induce avoidance or both.

4.4 Reframing the estate tax

The first step to achieving public acceptance of the estate tax is to provide individuals with a realistic view on who, and how it will affect certain people. Given a threshold of $4 million, this would mean that only 3% of estates would currently be subject to estate tax. On this basis, one would expect the estate tax to be a popular tax, as it would make the other 97% of people net winners. With the 97% of estates lowering the overall tax burden that the remainder of society faces to provide for government's planned spending, it is puzzling as to why so many oppose the tax. One explanation for this is that individuals are excessively optimistic about their future wealth. Of course, a small proportion are reasonably justified to be believe that they are, or eventually will be, subject to the tax, however, the majority of individuals will never reach the threshold. Furthermore, people may also be excessively optimistic in expecting a bequest in the future and oppose the estate tax on the grounds that it reduces the after-tax return on a bequest that is also less likely to be received than the individual perceives it. From this behavioural limitation, it may be beneficial, to the acceptance of the estate tax, to provide the public a realistic view of who it would potentially effect and to what extent.

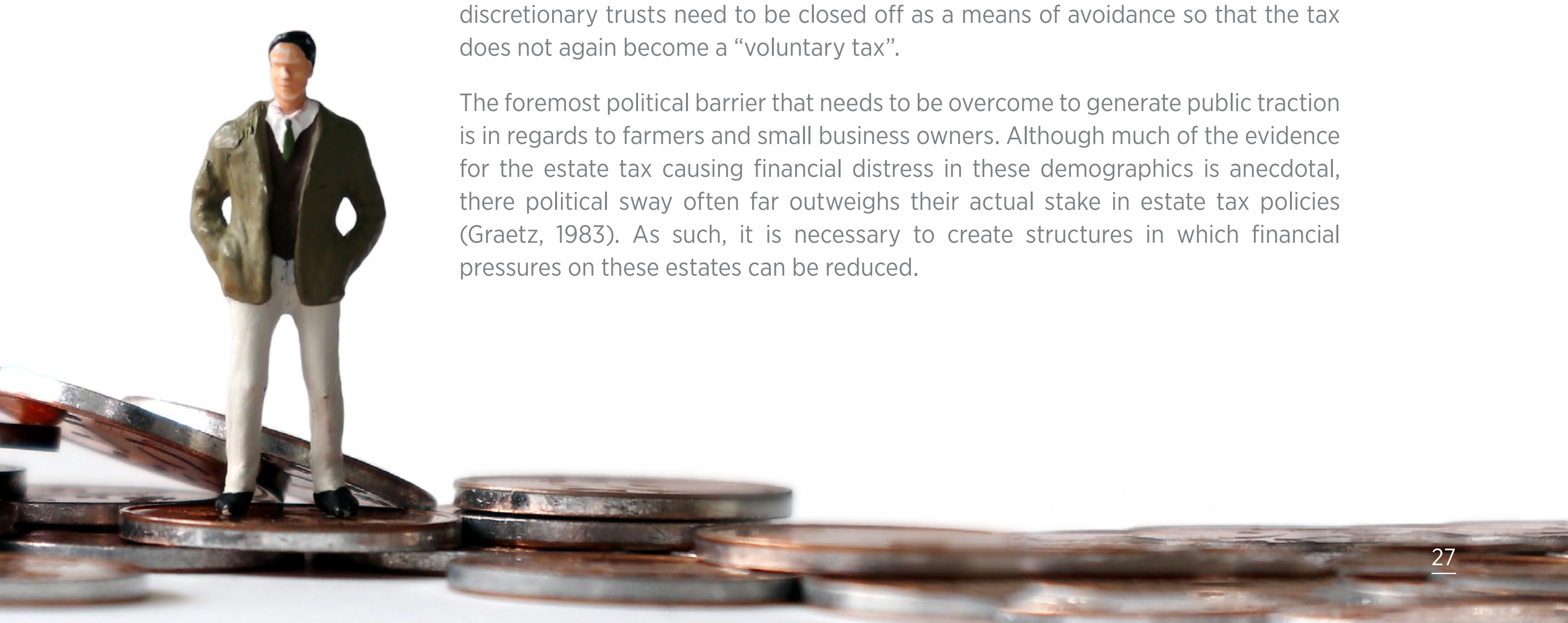
The next step is to reframe the estate tax from a destroyer of wealth, and replacing it with a focus on societal benefits through increased equality of opportunity (Fennell, 2003). This can be achieved through establishing specific governmental programs that promote equality of opportunity by targeting societal issues. In doing so, it helps to better sell the message by bringing transparency in how the raised revenue will be used to benefit society (for example using inheritance taxes are used to fund the First Home Owners Grant). From this, it would be reasonable to believe that the estate tax could fund a governmental program that would significantly aid in the developmental opportunities for the less well-off in future generations. Earmarking has been used by charitable organisations to much advantage. Those who may be reluctant to contribute towards a collection of vague charities, may well be inclined to contribute if it is framed in a way that provides assistance to a specific cause (Fennell, 2003). If desired, earmarking can be taken one step further and individuals may nominate to which governmental program that they wish to contribute towards. With these changes, individuals would be able to view the estate tax as a mechanism for promoting equality of opportunity. The more a tax can be perceived as a voluntary contribution rather than a mandatory confiscation, the more widespread and likely acceptance will be.

4.5 Proposals for change/implementation

Australia is in an ideal position in the sense that it has the benefit of observing the effect of estate taxes from many other nations around the world. Many empirical results have had mixed degrees of effects making it difficult to quantify, however, the direction of these effects are relatively consistent and useful to understand the potential implications of a particular tax structure. Particularly, the combination of a narrow base and high tax rates inducing strong behavioural responses to the estate tax in the US (Joulfaian, 2016), is a starting point in considering how the estate tax could be implemented in Australia. If the government decides to implement a policy in which they seek to collect as much revenue as possible with the intention of redistributing through programs that benefit the least well-off, then a broad-based tax with a low rate should be used to reduce any behavioural distortions. These behavioural responses may also include wealth transfers during life, and as such a gift tax would also need to be introduced. If intergenerational transfer was the policy objective, then the gift tax rate may be slightly below the bequest tax.

Furthermore, an estate tax with this rate and exemption may have the potential of lowering avoidance and evasion compared to a structure that the US has adopted. A broad-based tax being one which treats different assets in a similar way to reduce tax sheltering, making the tax simpler and fairer. Furthermore, loopholes such as discretionary trusts need to be closed off as a means of avoidance so that the tax does not again become a “voluntary tax”.

The foremost political barrier that needs to be overcome to generate public traction is in regards to farmers and small business owners. Although much of the evidence for the estate tax causing financial distress in these demographics is anecdotal, there political sway often far outweighs their actual stake in estate tax policies (Graetz, 1983). As such, it is necessary to create structures in which financial pressures on these estates can be reduced.



This paper highlights growing inequality and the slowdown of the intergenerational flow of wealth, which threaten Australia's traditionally strong equality of opportunity.

The reintroduction of inheritance taxes in Australia is presented as a policy lever to address these issues, which is worth further exploring to see how these taxes may fit into Australia's broader tax and transfer system. Inheritance taxes may be able to play a small but significant role in the overall tax system in Australia to improve the intergenerational flow of wealth and overall progressivity of the tax system. The effectiveness and acceptability of the tax will be highly influenced by the rate and the minimum estate threshold to be subject to the tax. Further, the paper outlines the major economic and behavioural considerations of death taxes. However, more work is required on transfer motives and behavioural responses, particularly on the extremely wealthy –who will be most impacted inheritance taxes.

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