Taxing the Dead: an analysis of intergenerational transfers and levies*

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May 3, 2018

Abstract

The most recent United States election revealed large differences in beliefs about the optimal structure of the U.S. transfer tax regime. The main contribution of this paper is to consider the impact of taxation on intergenerational transfers, in the context of a general equilibrium overlapping generations model with differential fertility. This paper is the first to consider the impact of estate and inheritance taxes in the presence of differential fertility, and the fallout such tax mechanisms would have upon intragenerational wealth inequality.

Keywords: Intergenerational transfers, differential fertility, wealth inequality, life-cycle savings.

*I would like to thank Kai Zhao, Hyun Lee, Francis Ahking, Steve Ross, Kanda Naknoi and Oliver Morand for their comments and support

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1. Introduction

This paper finds the quantitative wealth effects of adjusting or eliminating the estate tax in the United States. It also estimates the potential impact of switching from an estate tax regime to an inheritance tax regime. This paper's unique contribution is to examine these options in an environment of a general equilibrium, overlapping-generations model with differential fertility, using the wedge of fertility disparity between high- and low-earning individuals to more accurately capture the reality of intergenerational transfers.

Recent U.S. data shows large increases in the concentration of wealth over the past 3 decades. For instance, the top 1 percent holds nearly 1/3 of the total wealth in the economy, and that share is growing according to Alvaredo et al. (2013). The top 5 percent holds over 1/2 of the wealth. This trend has accelerated in the years since the 2008 financial crisis (Saez and Zucman (2016)). In addition, wealth inequality is significantly higher than labor earnings or total income inequality. In 1995, the Gini coefficient for annual labor earnings was 0.63. The Gini for wealth holding was much higher, at 0.8 (Rodriguez et al. (2002)). Understanding the causes for this relatively greater level of wealth inequality is important for the economic consequences faced by highly unequal economies, such as greater societal unrest and lower intergenerational mobility.

Why is wealth inequality more pronounced than income inequality? This is a major puzzle surrounding the broader issues of inequality. Wealthy individuals act in a different way than traditional economic models would predict, relatively saving more and spending less, even as they reach the end of their lifespans (Dynan et al. (2004)). In addition to this, wealthier people are much more likely to give bequests to their children at the end of their lives, even when accounting for relative wealth. Standard dynamic models with heterogeneous agents have difficulty replicating this savings behavior. For instance, Aiyagari (1994) predicts in a calibrated simulation the top 1 percent will hold 4 percent of the wealth, while empirically the top 1 percent holds 30 percent. Why do the wealthiest people choose to possess such a high level of wealth instead of increasing their consumption?

One potential explanation for this behavior is a bequest motive, especially since intergenerational transfer is a significant flow of wealth. Historically, the amount of wealth derived from intergenerational transfer has varied between 1/10 and 1/5 (Modigliani (1988)), however, more recent estimates place it as high as 1/2 (Gale and Scholz (1994)). The bequest flow is highly unequal. The top 2% of households receive nearly 70% of lifetime inheritances (Hendricks (2001)).

Economists have argued there exists an inverse relationship between income and fertility.[1] For instance, Jones and Tertilt (2008) document a strong negative relationship between income and fertility choice for all cohorts of women born between 1826 and 1960 in the U.S. census data. They estimate an overall income elasticity of fertility for this time period of -0.38. I argue that this significant fertility difference between low and high earners can amplify the impact of bequests on wealth inequality, because not only do rich parents leave a greater amount of bequests than their poorer counterparts, but the children of richer parents tend to have fewer siblings to share their bequests with relative to the children of poorer parents.

If higher-earning couples have fewer children, as is consistently reported in the literature (Jones and Tertilt (2008)), this could significantly impact how transfer taxes are realized, and raises questions about which tax regime is most equitable and efficient. Transfers occurring at death may be taxed in the form of estate taxation, i.e. the tax may be imposed on the total amount of wealth left by the decedent. The taxes may instead take the form of an inheritance tax, in which case the base is defined on the level of the recipient, and reflects the transfers to that particular individual (Kopczuk et al. (2010)). Both forms of taxation usually have a supplemental gift taxation to ensure the tax is not simply avoided by a transfer given prior to the time of death. In the U.S. the gift and estate tax has been integrated since the Tax Reform Act of 1976.

The structure of the estate tax can lead to strange distortions in the progressivity of the tax burden. Batchelder and Khitatrakun (2008) estimate that about 22% of heirs burdened by the U.S. estate tax have inherited less than $500,000, while 21% of heirs who inherit more than $2,500,000 bear no estate tax burden. The quantity of heirs thus has a large impact on the distributional effect if the tax is progressive, as it almost always is. Many U.S. states and countries currently use an inheritance tax, such as Iowa, Kentucky, Maryland, Nebraska, New Jersey, Pennsylvania, Japan, France, U.K., South Korea and Germany. Understanding

[1]See De La Croix and Doepke (2003), De la Croix and Doepke (2004), Jones and Tertilt (2008), Zhao (2011), Zhao (2014), Cooke et al. (2017), among others.

the impact switching from a federal estate tax to a federal inheritance tax could have on the United States wealth distribution is an understudied element of U.S. tax policy.

The role played in increasing wealth inequality by reductions in the estate tax over the past few decades remains contentious, and this paper will offer a quantifiable estimate as to the results of rate and exemption changes on the distribution of wealth. According to the Internal Revenue Service, in the past 17 years the top rate has fallen from 55% to 40%, and the exemption level has risen from 675,000 to 11 million for individuals. The number of taxable estates declined nearly 90 %, from 51,736 in 2001 to 5,219 in 2016, primarily due to the increases in the filing threshold (IRS SOI Tax Statistics). Clearly these changes are nontrivial and bear analysis. In addition, as the baby boomer generation begins to pass away, wealth transfers are expected to increase. Estimated transfers total between $40 and $135 trillion over the next half century according to Havens and Schervish (1999).

This paper will do the following. First, build and run an overlapping generations model that includes differential fertility, intergenerational transfers, and a comprehensive estate tax regime. Second, to scrutinize the impact changing rates and exemption levels would have on wealth inequality in a steady state analysis. Third, altering the model to switch to an inheritance tax and analyzing the results such a change would have on the distribution of wealth.

The rest of paper is organized as follows. In section 2, I review the existing literature. In section 3, I describe the model and its stationary equilibrium. In section 4, I calibrate a benchmark specification using moment matching. In section 5, I discuss the results. In section 6, I use alternative formulation to answer the core questions of the paper. The final section concludes.

2. Literature Review

2.1. Inequality and Bequests

Inequality and its causes have become a political and economic touchstone in recent years. However, defining what dimension of inequality is being considered is often left unsaid by the bumper stickers. There exists unequal distributions of productivity, income, wealth, consumption, bequests, shocks, choices, etc. Some of these elements, especially income and wealth, are treated as if they are equivalent. But the data shows large differences in the distributions of income and wealth in the United States. As found by Diaz-Gimenez et al. (1997), the correlations between earnings and wealth and between income and wealth are surprisingly low: 0.230 and 0.321, respectively.

In 1992 the United States' Gini indexes for short-term labor earnings, income, and wealth were respectively .63, .57, and .78 (Diaz-Gimenez et al. (1997)), while in 1995 they were .61, .55 and .80 (Rodriguez et al. (2002)). The shares of earnings and wealth of the households in the top 1 percent of the corresponding distributions are 15 percent and 30 percent, respectively (Castaneda et al. (2003)).

Standard quantitative macroeconomic models have had difficulties in generating the observed degree of wealth concentration (De Nardi and Yang (2016)). Specifically, these models fail to account for the extremely long and thin top tails of the distributions and for the large number of households in their bottom tails (Castaneda et al. (2003), Quadrini and Ríos-Rull (1997)). However, if it is intergenerational transmission of wealth and ability that drives wealth inequality, as Kotlikoff and Summers (1981) have argued, then a myopic focus on life-cycle saving will fail to capture the relevant causes of wealth inequality. Overlapping generations show an improvement at mimicking the data. Using an OLG model,Huggett (1996) predicts that the top 1 % will hold 7% of the wealth. This model only accounted for accidental bequests, distributed equally to all individuals.

There have been multiple papers arguing that bequest giving is crucial to explaining wealth differentials. Most recently, De Nardi (2004), De Nardi and Yang (2016) and Cooke et al. (2017) incorporate bequest leaving into the utility function as a luxury good, allowing for rich parents to value bequests more. If bequests are a luxury good such that the rich gain greater utility from leaving them, then bequests will play an outsize role in generating wealth inequality. This is due to the emergence of large estates, or dynasties, where wealthy parents have well-educated, highly productive children to whom they leave large bequests. These persistent rich often have smaller families than the median, leading to greater relative concentration. This is consistent with jon (2010); smaller cohorts receive relatively large per child transfers from parents.

Bequests represent a large piece of intergenerational transfers. Gale and Scholz (1994) use the Survey of Consumer Finances to find the amount of inter-vivos transfers and inheritance from 1983-85. Between support given, college expenses paid, and inheritance given, the amount totaled over $350 billion. Of this, inheritance was nearly 40 % and over 60 % of those who reported receiving inheritance were in the top decile of wealth. Their central estimate is that intended life-time transfers (which they define as inter-vivos transfers, trust accumulations, and life insurance payments to children) account for at least 20 % of aggregate net worth, and bequests, accidental or intended, account for 31 percent more. Kopczuk and Lupton (2007) find that 3/4 of the elderly single population has a bequest motive and about 4/5 of their net wealth will be bequeathed, half of which is due to a bequest motive as opposed to accidental bequests. This ratio is consistent with Lee and Tan (2017) and Hendricks (2001).

There are six widely discussed motivations in the economic literature surrounding intergenerational transfers (Batchelder (2008)). The first is an overabundance of precautionary savings, leading to accidental bequests. The second is commonly known as ”money in the utility function”: the wealth of an individual directly impacts her utility function, and therefore she will have a positive balance at the time of death. The third is ”warm glow”: the individual likes the idea of giving to their heirs, but the actual status of those heirs, or how much that transfer is taxed, is unimportant. The fourth is the same as the third, but the individual only gets utility from the warm glow giving post-taxation. The fifth is direct altruism, and the sixth is a strategic motivation, given for some compensatory action like old age care or social insurance. For computational ease, this paper will focus on the third motivation, following De Nardi and Yang (2016).

2.2. Taxation

Taxes on wealth transfer have been a common theme throughout human history. Early examples include 7th century B.C. Egypt and 1st century A.D. Rome. The first American wealth transfer tax dates from 1797. This was a simple stamp levy on receipts for legacies and wills. Since then, multiple inheritance taxes have been put into place as short term funding mechanisms, usually for wars (Kopczuk (2012)). The modern day incarnation of the estate tax dates from 1916, and is much more complex and wide-ranging. Today, nearly every member of the Organization for Economic Co-operation and Development has some form of estate or inheritance tax (Gale and Slemrod (2001)).

Despite this ubiquity, there is substantial debate around both the size of this tax and whether it should exist at all. Opponents decry the morbidness of taxing corpses and the unfairness of ”double taxation,” as the recently deceased already paid taxes on their income before giving it to their inheritors. Conversely, supporters, ranging from liberals to libertarians, call large inheritances ”affirmative action for the wealthy” (Stelzer (1997)). Transfer taxes have several unique properties (Kopczuk (2012)). First, the transfer may be generating positive externalities. For example, if the transfer is intentional, the giver will be generating utility (whether from warm-glow, altruism, or some other motivation), while the recipient is gaining greater income to finance their own utility-enhancing choices. Second it is infrequent, ofttimes occurring just once, at time of death. Finally, it only affects a small, wealthy subset of the population.

Stiglitz (1978) raises a major concern with the estate taxes effect on the economy. If the estate tax lowers savings, this will lead to a reduction in the capital stock and the marginal product of labor. In short, abolition of the estate tax could raise wages and lead to an improvement in welfare. Laitner and Juster (1996) find that Stiglitz is correct, and a lowering or removal of the tax on bequests would raise savings. However it would also increase wealth inequality, specifically among the top 1 % of the distribution who are most affected by the estate tax. This also does not take into account the finding in Cooke et al. (2017), that expected inheritances reduce savings among beneficiaries by around 3%.

Concern that estate taxes unfairly impact small business and farms has led to provisions allowing transfers of closely held businesses to value themselves at use value rather than the higher market value. They can also spread their tax burden across many years. In addition, the amount of small businesses affected by the estate tax is small. Farm assets and real estate were just 1.7 % of taxable estate value in 2000 according to the Internal Revenue Service. Limited Partnership and ”other noncorporate business assets” were 2.6 %. Even generous estimates of the definition of a small business results in them being about 1/10 of the total wealth transfer affected by the tax (Gale and Slemrod (2001)).

The last decade has seen major changes in the estate tax, with the basic exclusion amount rising from 675,000 in 2001 to 5.5 million in 2016 and 11 million in 2018. The top bracket tax rates also saw major changes, decreasing from 55 % in 2001 to 35 % in 2010, and then increasing to 40 % in 2013, according to the IRS. Understanding the mechanisms and effects of this tax policy is therefore very important.

3. Model

Consider an economy inhabited by overlapping generations of agents who live three periods. In the first period individuals are children who are not economically active. In the second period they make labor supply decisions, have children and save for retirement. In the final period they receive bequests from their parents, consume some of their wealth, and leave the remainder as bequests to their children in the next period. These bequests are taxed, and the tax is distributed equally among that cadre of children. This allows the estate tax to redistribute wealth within but not across generations.

3.1. Consumer's Problem

3.1.1. Period One

An individual makes no economic decisions in the first period, but imposes a time cost on her parents. She inherits an ability level from her parents. An individual's ability ψ (effective units of labor representing human capital, luck or inherent ability) depends on their parental ability ψ^p, and the log of ability is assumed to follow an AR(1) process,

$$\log(\psi) = \rho \log(\psi^p) + \epsilon_\psi$$

where

$$\epsilon_\psi \sim N\left(0, \sigma_\psi^2\right), \quad \text{i.i.d.}$$

in which ρ is the intergenerational persistence of productivity. I discretize this into an 11-state Markov chain using the method introduced in Tauchen (1986), and the corresponding transition matrix I obtain is denoted by $M[\psi, \psi']$.

3.2. Period Two

Individuals in the second period differ along three dimensions: earning ability ψ, number of siblings n^p (or their parent's fertility), and current wealth of their retired parents x^p.

In this period, they jointly choose current consumption and save for period three. In addition, they have n children, which is determined as a function of their ability level, and have to reduce their labor market allocation as a result of this allocation. Therefore, the value function of an individual in period two can be specified as follows:

$$V_2\left(\psi, n^p, x^p\right) = \max_{c,a\geq 0}\left[\frac{c^{1-\sigma}}{1-\sigma} + \beta\left[V_3(x)\right]\right]$$

subject to

$$\begin{aligned} c + a &\leq \psi w(1-\gamma n) \\ x &= a + \frac{B^p(x^p)}{n^p} - \tau + g \\ n &= N(\psi) \end{aligned}$$

The individual can calculate an expected bequest value as a function of parental wealth and the number of siblings in the next period, $B^p(x^p))/n^p$, where $B^p(x^p)$ is the policy function for optimal amount of bequests given, dependent on wealth. Thus the total wealth the individual possesses going into period 3 is $x = a + B^p(x^p)/n^p - \tau + g$, where a is the life-cycle saving from period 2 to period 3, n is number of children, τ is estate tax and g is a governmental transfer payment, the equally divided share of all taxes.

3.2.1. Period Three

Individuals retire in the third period and jointly choose current consumption and the amount of bequests for their children. Their state in this period can be captured by a single variable, x, the amount of wealth held, which is simply the sum of life-cycle savings, the governmental transfer and the share of bequests received from their dying parents at the beginning of Period 3. Individuals in Period 3 face the following utility-maximization problem:

$$V_3(x) = \max_{c,b}\left[\frac{c^{1-\sigma}}{1-\sigma} + \phi_1\left(b+\phi_2\right)^{1-\sigma}\right]$$

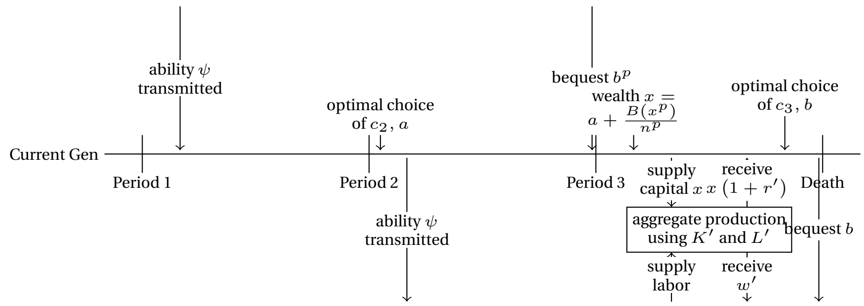

Figure 1: Sequence of Events for Current Generation

subject to

$$c + b \leq (1 + r)x,$$

where b is the total amount of bequests left for children in the next period. Here I follow De Nardi (2004) and assume that parents have "warm glow" motive, where they enjoy giving to their children but do not directly care about the children's wellbeing, and the bequest is assumed to be a luxury good. The term ϕ_1 measures the relative weight placed on the bequest motive, while ϕ_2 measures the extent to which bequests are a luxury good. From this maximization problem, I obtain two policy functions: optimal consumption $C_3(x)$ and optimal bequests $B(x)$.

Figure 1 contains the timeline summing up the sequence of events that happen throughout the lifecycle.

3.3. Firm's Problem

Firms are identical and act competitively. Their production technology is Cobb-Douglas, which combines aggregate capital K and aggregate labor L to produce output Y as follows

$$Y = zK^{\theta}L^{1-\theta}$$

in which θ is the capital share and z is the total factor productivity (TFP).

The profit-maximizing behaviors of firms imply:

$$r = z\theta K^{\theta-1}L^{1-\theta} - \delta$$

and

$$w = z(1-\theta)K^{\theta}L^{-\theta},$$

where δ represents the capital depreciation rate.

3.4. Government and Taxes

The government runs a balanced budget every time period. They levy taxes either on the estates of the deceased before distribution, or on the heirs directly, depending on whether it is an estate or inheritance tax.

Let Φ_2 represent the population distribution of individuals in period 2.

$$G = \int_{\psi}\int_{n^p}\int_{x^p}\left[\frac{(B^p\left(x^p\right) - \chi)(\tau)}{n^p}\right] d\Phi_2\left(\psi, n^p, x^p\right) \forall B^p\left(x^p\right) > \chi$$

and the individual payment g will be the equal distribution of all tax revenue.

$$g = \frac{G}{\int_{\psi}\int_{n^p}\int_{x^p}\Phi_2\left(\psi, n^p, x^p\right)}$$

In the benchmark model, the estate tax has a rate τ and an exemption level χ. All bequests below the exemption level are immune from taxation, all bequests above that level are taxed at a fixed rate on the amount above the exemption level.

This payment is distributed to the same generation that would have received the inheritance. This means it functions as a lump sum transfer, and the government payment will have a similar effect to bequests in that it will reduce savings rates among the recipients.

3.5. A simple comparison of the estate and inheritance tax

Consider a simple economy with 3 families: A, B and C. Family A has one child, family B has 2 children and family C has 3 children. In this economy there is an estate tax, with a rate and exemption level. In this example we will set both to 0.5. Each family's parents die,

Table 1: A simple example of the estate and inheritance taxes

Type	Rate	Exemption	A_1	B_1	B_2	C_1	C_2	C_3	Total Tax
Estate	0.5	0.5	0.75	0.375	0.375	0.25	0.25	0.25	0.75
Inheritance	0.5	0.25	0.625	0.375	0.375	0.29	0.29	0.29	0.75

leaving their children their remaining wealth, which is equal to 1 for all 3 families.

In this situation, all 3 families will pay the same amount in taxes, 0.25, and the remainder will be distributed to the children. So the child from family A will receive 0.75, the children in family B will receive 0.375 each and the children in family C will receive 0.25 each. The total government receipts amount to 0.75.

Let us now assume the tax regime switches to an inheritance tax with no changes to the rate or exemption level. Family A's tax burden will remain the same, but family B and C will pay no taxes because each child's share falls below the exemption level.

Then let us lower the exemption level to 0.25 so that the government receives the same amount of revenue. Now family A's only child is paying 0.375 in taxes and keeping 0.625, family B's 2 children are paying 0.125 each and keeping 0.375 and family C's 3 children are paying 0.04 each and keeping 0.29.

It is clear that the estate tax favors families with fewer children, which as we know are associated with higher-earning families.

3.6. Stationary Equilibrium

Let Φ_2 and Φ_3 represent the population distributions of individuals in period 2 and 3. A steady state in this economy consists of a sequence of allocations $[c_2, c_3, a, b]$, aggregate inputs $[K, L]$ and prices $[w, r]$ such that

1. Given prices, the allocations $[c_2, c_3, a, b]$ solve each individual's utility maximization problem

2. Given prices, aggregate capital and labor $[K, L]$ solve the firm's problem.

3. The Government's budget is balanced, $g = \dfrac{G}{\Phi_2\left(\psi, n^p, x^p\right)}$

4. Markets clear:

$$K' = \int_{\psi}\int_{n^p}\int_{x^p}\left[A\left(\psi,n^p,x^p\right)+\frac{B^p\left(x^p\right)-\tau(B^p\left(x^p\right)-\chi)}{n^p}\right]d\Phi_2\left(\psi,n^p,x^p\right)$$

$$L' = \widehat{n}\int_{\psi}\int_{n^p}\int_{x^p}(1-\gamma N'(\psi,n^p,x^p))\psi d\Phi_2(\psi,n^p,x^p)$$

where $\widehat{n}$ is the average number of children the current period two individuals have to account for population growth.

5. The distributions Φ_2 and Φ_3 are stationary in the steady state and evolve according to the following laws of motions:

$$\Phi_2\left(\psi',n^{p'},x^{p'}\right) = \frac{1}{\widehat{n}}\int_{\psi}\int_{n^p}\int_{x^p} I_{x^{p'}=A(\psi,n^p,x^p)+\frac{b^p(x^p)}{n^p}} I_{n^{p'}=n(\psi)} M\left[\psi,\psi'\right]n(\psi)d\Phi_2\left(\psi,n^p,x^p\right)$$

$$\Phi_3(x^{p'}) = \frac{1}{\widehat{n}}\int_{\psi}\int_{n^p}\int_{x^p} I_{x=A(\psi,n^p,x^p)+\frac{b^p(x^p)}{n^p}} d\Phi_2(\psi,n^p,x^p)$$

where $M[\cdot]$ is the Markov transition matrix, I's are the indicator functions. In the third period, an individual's wealth is what he has saved in the previous period, as well as what he has received in bequests from his parents. Note that the distribution of the wealth holdings is identical to the distribution of the next generation's parental wealth holdings (i.e., $x = x^{p'}$).

The rest of the paper focuses on stationary equilibrium analysis. Since analytical results are not obtainable, numerical methods are used to solve the model.

4. Calibration

I calibrate the model to match the current U.S. economy, and the calibration strategy I adopt here is the following. The values of some standard parameters are predetermined based on previous studies, and the values of the rest of the parameters are then simultaneously chosen to match some key empirical moments in the U.S. economy.

Table 2: The Benchmark Calibration

Parameter	Value	Source
z	1.0	Normalization
σ	1.5	Macro Literature
θ	0.36	Macro Literature
δ	0.04	Macro Literature
γ	0.2	Haveman and Wolfe (1995)
ρ	0.4	Solon (1992)
χ	5.5 million	IRS 2017
τ	0.4	IRS 2017
Parameter	**Value**	**Moment to match**
β	0.915	annual interest rate: 0.04
ϕ_1	-0.33	bequest/wealth ratio: 0.31
ϕ_2	0.086	pop. share with bequests ($<$ third of avg. income)
σ_ψ^2	1.15	Income Gini: 0.63

4.1. Demographics and Preferences

One period in my model is equivalent to 30 years. Individuals enter the economy when they are 30 years old (Period 2). They retire at 60 years old (Period 3) and die at the end of the third period at 90 years old.

The subjective discount factor β is calibrated to match an annual interest rate of 0.04, which gives an annual discount factor of 0.915. I calibrate my bequest parameters to ensure that the level and distribution of bequests generated from my benchmark model matches their respective data counterparts. Specifically, ϕ_1 is calibrated to match the aggregate bequest to wealth ratio: 0.31 according to the estimation by Gale and Scholz (1994). A positive value of ϕ_2 implies that bequests are luxury goods, and its value controls the skewness of the bequests distribution. According to the empirical estimation by Hurd and Smith (2002), about 90% of the population does not leave a significant amount of bequests (i.e. less than a third of average lifetime income)[2]. Gale and Scholz (1994) report that 96% do not receive inheritances above 3,000 dollars. In the benchmark calibration, I calibrate the value of ϕ_2 so that 90% of agents in the benchmark model receive bequests that are less than a third of median lifetime income.

I use the 1990 U.S. census data to calibrate the fertility choices for each group in my benchmark model[3]. I follow the approach in Jones and Tertilt (2008) and use "children ever born" as the fertility measure. Specifically, I use the sample of currently married women ages 40-50 (birth cohort 1940-50), and then organize the respondents into 11 ability groups corresponding to my model distribution by occupational income, corrected for a 2% growth rate.[4] The propensity of death on childbirth during this time period is low enough that the child mortality risk is not a significant issue. I take the mean fertility rate for each group and assign it to the corresponding group of agents in my benchmark model to generate the appropriate level of differential fertility by income.[5] The resulting fertility-income relationship from my calibration exercise is reported in Table 4, which is consistent with the estimation results in Jones and Tertilt (2008). For instance, the income elasticity of fertility is estimated to be -0.20 to -0.21 for the cohorts of women born between 1940 and 1950 in Jones and Tertilt (2008), while the implied income elasticity of fertility from my calibrated fertility distribution is -0.22.

4.2. Technology and Earning Ability

The capital share θ is set to 0.36, and the capital depreciation rate is set to 0.04. Both are commonly used values in the macro literature. The value of TFP parameter, z, is normalized to one.

I approximate the AR(1) process for earning ability ψ by an 11-state Markov chain using the method introduced in Tauchen (1986). The coefficient of intergenerational persistence, ρ, is set to 0.4 according to the estimates in Solon (1992). I calibrate the income variance σ_ψ^2

[2]In nominal terms, that value equals $187,600 in 1993 dollars or $324,700 in 2017 dollars.

[3]Courtesy of Steven Ruggles, Katie Genadek, Ronald Goeken, Josiah Grover, and Matthew Sobek. Integrated Public Use Micro data Series: Version 6.0 [dataset]. Minneapolis: University of Minnesota, 2015. http://doi.org/10.18128/D010.V6.0.

[4]Here I follow Jones and Tertilt (2008) closely and use the husband's occupational income to avoid the selection bias in the mother's employment status.

[5]Note that the fertility choice in my model is the per parent fertility so I follow the tradition in the fertility literature and halve these fertility rates calculated from the data when using them in the model.

so that the income Gini coefficient generated from the model matches the value of 0.63 that Castaneda et al. (2003) estimated using 1992 Survey of Consumer Finances data. I report the resulting ability levels in Table 4 and the corresponding transition matrix can be seen in Section A of the Appendix. In addition, I set the time cost of children γ to be 0.2 of parental time per child based on the empirical estimates of Haveman and Wolfe (1995).

The key parameter values and their sources are summarized in Table 2.

4.3. Taxation

The two taxation coefficients, τ and χ, are taken from the 2017 CFR 601.602: Tax forms and instructions. The section titled ”Unified Credit Against Estate Tax” states ”for an estate of any decedent dying in calendar year 2017, the basic exclusion amount is $5,490,000 for determining the amount of the unified credit against estate tax under S2010.” I combine this with table 5 - section 1(e) ”Estates and Trusts” which states that the rate of taxation for estates greater than $12,500 is ”$3,232.50 plus 39.6% of the excess over $12,500.”

This gives us an estimated value of τ of 0.4 and a value of χ of 5.5 million in my benchmark. Since my model is normalized, I set χ to match a multiple of median lifetime income, which I estimate as $1,180,000 which is $59,039 per household in 2017 (U.S. Census Bureau) times 40 years divided by 2 people. This means the 2017 estate tax exemption is 4.6 times the median lifetime income.

5. Quantitative Results

I start this section by reviewing the main properties of the benchmark model at the steady state, with special attention given to its implications for wealth inequality. I then run counter-factual policy experiments analyzing the abolition of the estate tax, an increase of the estate tax back to 2001 levels, and changing the structure of the intergenerational tax from a estate tax to an inheritance tax.

5.1. Some Key Properties of the Benchmark Economy

A key element of my theory is the negative income-fertility relationship, which is best measured by the income elasticity of fertility. The income elasticity of fertility implied by

Table 3: Benchmark Model Statistics

Name	Model	Data
Annual Interest Rate	0.04	0.04
US Aggregate Bequest/Wealth Ratio	0.31	0.31
Average fertility rate per household	2.3	2.3
Gini Coefficient of the US Income Distribution	0.64	0.63
Income Elasticity of Fertility	-0.22	-0.20/-0.21

my benchmark model is very close to its empirical counterpart estimated by Jones and Tertilt (2008). Another important characteristic of my model is the skewed distribution of bequests with a long right tail. I ensure the model matches the bequest distribution I observe in the data by modelling bequests as luxury goods in the fashion of De Nardi (2004) and De Nardi and Yang (2016). In addition, my calibration strategy implies that my benchmark model matches the bequest-capital ratio and the 90th percentile of bequest amount.

Table 3 contains some key statistics of the benchmark economy together with their data counterparts. As can be seen, my calibrated benchmark model matches the key empirical moments from the US economy fairly well. Table 4 summarizes the ability distribution generated by my benchmark model, along with how the average fertility calculated by ability groups match up against the data. The first row represents the relative value of the ability ψ_i for Group i, in which the value for Group 6 is normalized to unity. The second row is the share of the population whose ability is equal to or less than that group. Hence, Group 11—the highest ability group in my model—corresponds to the top 0.4% and the top two groups together correspond to the top 2% of the population. Of special note is Groups 8 through 11, as these are the ones that give almost all bequests in the economy.

6. Counterfactual Models

In order to determine the impact of the taxation regime that I have instated in this model, I run several counterfactual models. All these models are recalibrated to match

Table 4: Fertility-Income Relationship from the Benchmark Model

Ability Group i	1	2	3	4	5	6	7	8	9	10	11
ψ_i	0.02	0.04	0.09	0.21	0.46	1.0	2.19	4.81	10.56	23.16	50.80
Cumulative Mass	0.004	0.015	0.064	0.185	0.383	0.617	0.815	0.937	0.985	0.996	1.0
Fertility per Parent	1.6	1.6	1.4	1.4	1.24	1.15	1.08	1.07	0.96	0.86	0.89

Data source: 1990 U.S. Census

the bequest wealth ratio, the 90th percentile of bequest moment, the average fertility and elasticity of fertility, the interest rate and the Gini coefficient of the income distribution.

6.1. No Estate Tax

The first counterfactual model attempts to ascertain the quantitative effect of abolishing the estate tax. In this model the tax rate is set to zero, so no estates pay taxes no matter how large. No government revenue is generated. No transfer payments occur.

6.2. 2001 Estate Tax

The second counterfactual model changes rates and exemption level to match the estate tax law in 2001. This means a top rate of 55% and an exemption level of $675,000. This is an exemption level that is 1/8 the exemption level of the benchmark. The higher rate and lower exemption level will generate larger government revenues and the transfer payment outlays will be larger as a result. As with the benchmark model, this is an overstatement of the actual affects of the estate tax, as there are numerous avoidance strategies allowing individuals to not pay their full tax burden that this model does not take into account.

6.3. Inheritance Tax

The final counterfactual model will replace the estate tax with an inheritance tax. The rate will remain at 55%, and the exemption level is calibrated to match the total government revenue from the 2001 case. I chose 2001 as more individuals were affected by the tax and therefore the comparison will be more clear cut. This means the the transfer payment from the inheritance tax will be identical to the transfer payment in the 2001 estate tax case. The only difference is that a larger burden will fall on families with fewer children and a lighter burden will fall on families will more children relative to the estate tax.

7. Distributionary Effects

In this section, I examine the distributions generated by my benchmark model and compare them to the counterfactuals. I analyze the distribution of wealth, savings and bequests and mine these results for insights on the impact of fertility and transfer taxation on distribution of wealth.

7.1. Wealth

I compute the proportion of overall wealth held by each percentile group in my benchmark model and compare it against the data. Some key statistics of the wealth distribution are reported in Table 5. The richest 1% from my benchmark model hold less wealth than the data, but overall my model does moderately accurate job of matching the actual distribution of wealth in the U.S., especially among the top 20%. As can be seen in the last column, my benchmark model also matches the Gini coefficient of the wealth distribution closely. It is important to note that these statistics of the wealth distribution are not used as my targeted moments in the calibration.

The data comes from the Survey of Consumer Finances, which has an oversample of wealthy families and a weighting scheme that corrects for under-coverage at the top of the wealth distribution. This attempts to correct for the outsize role that non-respondents among the very wealthy would play in creating a non-representative sample.

Comparing my benchmark to the counterfactuals yield some interesting observations. As expected, abolishing the estate tax increases overall inequality. Specifically it increases the wealth holding of the top 1% by 12% and the wealth holding of the top 20% by 2.5%. This is not a very large amount due to the fact that very few individuals are actually paying estate taxes and they are clustered at the far end of the right side of the wealth distribution. So outside the extremely rich, few were affected by the estate tax.

The 2001 estate tax level has a much lower exemption (about one eighth) than the benchmark model. In addition it has a higher rate, .55 from .4. This means a larger amount

Table 5: Wealth Distribution

Percentile	$< 60\%$	60–80 %	$> 80\%$	90–95 %	95–99 %	>99%	Gini Coef.
Data	0.08	0.13	0.79	0.13	0.24	0.30	0.78
Benchmark Model	0.05	0.15	0.80	0.18	0.29	0.16	0.77
No Estate Tax	0.05	0.13	0.82	0.18	0.30	0.19	0.79
2001 Estate Tax	0.09	0.14	0.77	0.18	0.27	0.16	0.74
Inheritance Tax	0.10	0.15	0.75	0.17	0.27	0.15	0.71

Data source: Diaz-Gimenez et al. (1997)

of individuals will have to pay the tax, as well as the individuals already affected paying a much larger share. The impact of this is that the impact on the wealth distribution is no longer felt solely by the super rich. The top 1% drop their share of wealth from the benchmark model by 6% and the top 20 drop by 4%. Comparing the 2001 estate tax counterfactual to the no bequest counterfactual yields even more extreme results. Abolishing the estate tax from 2001 levels increases the wealth holdings of the top 1% by 19% and the top 20% by 6%. While the estate tax affects relatively few households, the fact that it affects the extremely rich means that its wealth distributional influence is significant.

The inheritance tax also leads to a drop in wealth inequality. This is because in the model, lower ability individuals have more children. So given an equally sized bequest, the children of lower ability individuals (who are themselves more likely to be lower ability) will pay relatively lower taxes than the children of higher ability individuals. However, because lower ability individuals rarely give large bequests in this model the influence of the taxation regime is limited. I do see a decrease in the wealth holding of the top 20% by about 2.5% though.

7.2. Bequests

I compute the proportion of overall bequests made by each percentile group in my benchmark model and compare it against the data. Some key statistics of the bequest distribution are reported in Table 6.

The bequest distribution comparison between the benchmark and the counterfactual

Table 6: Bequest Distribution

Percentile	$< 90\%$	90−95 %	95−99 %	>99%	Gini Coef.
Benchmark	0.01	0.29	0.40	0.30	0.93
No Estate Tax	<0.01	0.13	0.47	0.40	0.96
2001 Estate Tax	0.05	0.20	0.43	0.32	0.93
Inheritance Tax	0.05	0.23	0.42	0.31	0.93

models is largely what would be expected. Abolishing taxes increases the bequest share of the top 1% by nearly 30% compared to the benchmark model. As the tax rate is increased and exemption lowered to the 1990 counterfactual model, the share of the top 10% also drops by 4%, as more and more individuals have to pay the estate tax.

Changing to an inheritance tax does not alter the distribution of bequests very much, though there is a slight drop in the bequests given by the top 1%. This is intuitive, as the top 1% have the lowest number of children and would be more relatively effected by an inheritance tax.

7.3. Savings

I compute the proportion of overall savings chosen by each percentile group in my benchmark model and compare it against the data. Some key statistics of the savings distribution are reported in Table 7.

The savings distribution reveals the impact of the transfer payments. Because these payments increase an individuals wealth as they enter retirement, an individual saves less as a result. This means that raising the estate tax actually increases the savings share of the top 1%. Of special note is the inheritance tax, which increases savings among the top of the distribution. This is because these individuals are receiving a lower amount of bequests after taxes and therefore save more as a result.

Table 7: Savings Distribution

Percentile	$< 90\%$	90−95 %	95−99 %	>99%	Gini Coef.
Benchmark	0.41	0.13	0.27	0.19	0.75
No Estate Tax	0.42	0.14	0.26	0.18	0.72
2001 Estate Tax	0.37	0.17	0.28	0.19	0.75
Inheritance Tax	0.33	0.15	0.31	0.23	0.81

8. Conclusion

This paper pursued three goals. First, to build and run a simple overlapping generations model including intergenerational transfers and a simple representation of the estate tax. I achieved this using a three period model with childhood, adulthood and retirement, where individuals chose differential fertility and gave bequests to their children. Second, to match the wealth-income inequality disparity seen in the data, where wealth inequality is higher than income inequality. My result match this dispairity, though it must be noted that I am unable to match the wealth level held by the top 1%. Finally, to quantitatively analyze the policy experiment of switching from an estate tax regime to an inheritance tax regime. I did this, and showed a switch would generate a more equitable distribution of wealth. Overall, my results show that the estate tax exemption levels and rates have an outsized affect on inequality for how few household are affected.

I conclude the paper by drawing attention to a few potentially important issues from which this paper has abstracted. This paper simplifies the life-cycle savings process. A model with a larger number of time periods and income shocks would generate greater variance in life-cycle savings and thus more wealth inequality. This model also simplifies the bequest motive and how it interacts with taxes. I intend to pursue a more nuanced model in future research.

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Appendices

A Markov Matrix and Ability Distribution

In this section we show the Markov chain generated from our Tauchen (1986) process for the ability shock.

	ψ^p_{11}	$\psi^p_1 0$	ψ^p_9	ψ^p_8	ψ^p_7	ψ^p_6	ψ^p_5	ψ^p_4	ψ^p_3	ψ^p_2	ψ^p_1
ψ_{11}	0.05	0.03	0.02	0.01	0.0	0.0	0.0	0.0	0.0	0.0	0.0
ψ_{10}	0.11	0.08	0.05	0.03	0.02	0.01	0.0	0.0	0.0	0.0	0.0
ψ_9	0.21	0.17	0.13	0.09	0.06	0.04	0.02	0.01	0.01	0.0	0.0
ψ_8	0.26	0.25	0.22	0.19	0.15	0.11	0.08	0.05	0.03	0.02	0.01
ψ_7	0.21	0.24	0.25	0.25	0.24	0.21	0.17	0.13	0.09	0.06	0.04
ψ_6	0.11	0.15	0.19	0.22	0.25	0.26	0.25	0.22	0.19	0.15	0.11
ψ_5	0.04	0.06	0.09	0.13	0.17	0.21	0.24	0.25	0.25	0.24	0.21
ψ_4	0.01	0.02	0.03	0.05	0.08	0.11	0.15	0.19	0.22	0.25	0.26
ψ_3	0.0	0.0	0.01	0.01	0.02	0.04	0.06	0.09	0.13	0.17	0.21
ψ_2	0.0	0.03	0.0	0.0	0.0	0.01	0.02	0.03	0.05	0.08	0.11
ψ_1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.01	0.02	0.03	0.05

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