## Tax Policy and Gifts

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Voluntary transfers between individuals are potentially subject to income taxes and wealth transfer (estate and gift) taxes. With regard to the income tax, Henry Simons (1938) argued that it should be levied both on the donor, whose gift is a form of personal consumption, and on the donee, who directly consumes the gift. Others would limit income taxation to the donee, the only one whose act of consumption dissipates real resources. Most income tax systems do tax gifts only once, but the single tax is imposed in a different, more administratively convenient manner: the donee is exempt, and instead the donor is taxed, implicitly, by not allowing any deduction for gifts. Yet the rationale for simply applying the labor income tax rate—whether once or twice—to gifts is dubious because, as I will discuss, the incentive, distributive, and other welfare effects of taxing gifts and of taxing labor income are different.

Wealth transfer taxes, which in most developed countries are levied only on the estates of wealthy individuals, are often evaluated in terms of their redistributive effects. But such analysis is not usually integrated with that of the income tax, which is also a redistributive tool. Another factor suggesting the need for a more integrated treatment of transfer taxes and income taxation is that the effects of taxation on behavior and welfare will depend on the aggregate of taxes levied on a gift rather than on what portion of the tax is designated as a gift or estate tax and what portion is deemed to be an aspect of the income tax.

Accordingly, this paper considers a single, unified framework for analyzing the combined taxation of gifts, one that incorporates existing analysis of redistributive income taxation. Using such an approach, I sketch a mapping between types of gifts and optimal tax policy. It is helpful, however, to begin by discussing how gifts should be taxed if they were simply another form of ordinary consumption.

I. Gifts as a Form of Ordinary Consumption

A. Separability of Redistribution

The approach here is to begin with the standard optimal labor income tax problem in a world with no gifts and then to examine how that tax should be altered in the presence of gifts. Interestingly, under such a formulation of the transfer taxation question, redistribution becomes largely a separate issue. The reason is that redistribution is accomplished directly, by adjusting the tax schedule as a function of income. The transfer taxation problem involves determining whether, say, parents who give an above-average fraction of their income to their children should be taxed more or less relative to other parents at the same income level who instead spend a greater fraction of their income on themselves.

This preliminary study will not formally model this rather complicated optimal income tax problem. To gain some initial insights, it is useful to undertake a simpler thought experiment. Suppose that, at each level of income for donors, more (less) generous treatment of gifts is achieved by lowering (raising) the tax rate applicable to income expended on gifts and raising (lowering) the tax

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1 This inquiry abstracts from such questions as whether lifetime gifts and bequests should be distinguished; how the substantial majority of wealth, human capital (created in large part through different sorts of transfers), should be incorporated; what the effects are on savings and whether they may be ignored because they can be offset by other government policies; and what additional issues are raised by transfers to charities.
rate applicable to income expended on direct consumption, that is, labor income net of any gifts made. For example, a gift subsidy could be understood as a tax credit for gifts combined with a higher labor income tax rate, so that the tax on donors’ direct consumption would be higher and the net burden on gifts would be lower than under a uniform system. One can thus hold the total tax burden on each income class constant. (Although this may not be optimal, the approach focuses attention on the treatment of gifts relative to that of direct consumption.)

B. Optimal Relative Taxation of Gifts and Ordinary Consumption

As a benchmark, it is efficient to tax individuals’ expenditures on different goods and services in the same manner (i.e., there would not be differential commodity taxation) when there is an income tax. The standard qualification is that taxing more heavily (lightly) expenditures on commodities that make leisure relatively more (less) attractive would lessen the labor/leisure distortion caused by income taxation (see A. B. Atkinson and Joseph Stiglitz, 1976). Thus, viewing gifts for the moment as simply another form of consumption, it is efficient to tax them relatively more heavily if, say, donors need more leisure time to enjoy their utility from giving (such as by spending time with the children whom they support) than to enjoy other forms of consumption. On the other hand, it is efficient to tax gifts more lightly if, for example, much of the enjoyment is vicarious, deriving from contemplation of the gift. With bequests in particular, a donor may work harder in order to leave a larger bequest, whereas workers who instead spend their earnings on vacations would need more leisure time. The question of whether it is efficient to tax or to subsidize gifts, viewed as another form of ordinary consumption, is an empirical one that has not, to my knowledge, been investigated.

C. How Gifts May Differ

The remainder of this paper will focus on the manner in which gifts differ fundamentally from ordinary personal consumption: making a gift does not expend real resources, but instead shifts them to another individual. I will now explore the implications of this difference and how they depend on the type of gift that is involved.

II. Altruism

A. Positive Externality on Donees

Gifts convey a sort of positive externality on donees. To see this, consider the case of an altruistic donor who equally values the direct utility from his own consumption and the donee’s utility from her own consumption:

\[ U(x, y, g) = u(x - g) + v(y + g) \]

where \( g \) is the amount of the donor’s gift, \( x \) and \( y \) are the donor’s and donee’s pretransfer incomes, and \( u(\cdot) \) and \( v(\cdot) \), assumed to be strictly concave, are the donor’s and donee’s utilities from their own consumption. Observe that the donor counts the benefit to the donee as it enters the donor’s own utility function, whereas a social welfare assessment should also weigh in the benefit to the donee. Thus, under a utilitarian social welfare function, \( W(x, y, g) = u(x - g) + 2v(y + g) \). This discrepancy between the donor’s and society’s objectives suggests that treating gifts more generously than own consumption and, hence, a gift subsidy might be optimal.

To explore this point, consider the following formulation of the donor’s utility function:

\[ U(x, y, g) = au(x - (1 - s)g - t) + \beta v(y + g) \]

where \( \alpha \) and \( \beta \) are the weights that the donor gives to the direct utility from his own con-

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2 Other qualifications will not be explored here.

3 It is also relevant that gifts may involve a sort of voluntary redistribution, such as in the case of intergenerational transfers when there is regression toward the mean in earnings ability (see e.g., D. L. Bevan and Stiglitz, 1979).

4 This idea has been noted by Atkinson (1971), among others, and is developed in Kaplow (1995).

5 This is a special case of the model introduced in Gary Becker (1974).
summation and to the donee’s utility from her own consumption, \( s \) is a subsidy on gifts, and \( t \) is a tax (taken as given by the donor) that the government collects in order to finance the subsidy.

Now, consider the effects of marginally increasing \( s \), beginning at \( s = 0 \). First, this will induce the donor to increase his gift. This can be seen from the donor’s first-order condition:

\[
\alpha(1 - s)u'(x - (1 - s)g - t) = \beta v'(y + g).
\]

Raising \( s \) (and also increasing \( t \) to finance the increase in \( s \)) will, at a given level of \( g \), reduce the value of the left side; to restore equality, \( g \) must increase, given the strict concavity of \( u(\cdot) \) and \( v(\cdot) \).\(^6\) As a consequence, the donee’s utility will increase. Moreover, at \( s = 0 \), it can be shown that there will be no first-order effect on the donor’s utility.\(^7\) Finally, the donor’s net position vis-à-vis the government also is unchanged because the increase in the subsidy on gifts is financed by taxing donors. In sum, a slight increase in the subsidy will help the donee at no cost to the donor or the treasury.

**B. Externality with Respect to Labor Income Tax Revenue**

When considering possible tax-revenue effects in a world with a labor income tax (which is not explicitly modeled here), it is appropriate to take into account possible changes in labor supply. For donors, a small change in \( s \), beginning at \( s = 0 \), will have no direct labor-supply effect: because the donor’s utility remains the same for any given level of earned income, the choice of labor effort would be unaffected.\(^8\) (There is, of course, the qualification noted previously for the case in which changing the donor’s allocation of income between gifts and own consumption changes the relative value of leisure.)

Gifts may, however, result in a tax-revenue externality because they augment donees’ income. In conventional analyses, this externality would be negative: donees would work less because of the income effect and thus would pay less income tax. To combat this externality, one could tax donees on the gifts they receive (or, equivalently, tax donors’ gifts more heavily).

There are, however, other considerations. Gifts to donees might relax liquidity constraints that otherwise limit investments in human capital or entrepreneurship (see Douglas Holtz-Eakin et al., 1994). The net long-run effect of such gifts may be to increase donees’ earnings and thus donees’ tax payments, creating a positive tax-revenue externality. And there may be strategic effects that would influence donees’ earnings and, thereby, the income taxes they pay: donees might choose to earn less, knowing that their plight will induce altruistic donors to give more (the “Samaritan’s dilemma”), or donees might undertake activities that increase their income because donors might promise future gifts that are conditional on such behavior.

**C. Gifts’ Effects on Donors’ and Donees’ Marginal Utility**

Many models of altruism assume that

\[
U(x, y, g) = u(x - g) + \beta v(y + g).
\]

That is, \( \alpha = 1 \) and \( \beta > 0 \). First, consider how the marginal utility of consumption of donors compares to that of nondonors. Donors, as a consequence of their giving, would have lower

\[\frac{dU}{ds} = g'(-\alpha(1 - s)u' + \beta v' - \alpha su').\]

On the right side, the first two terms in parentheses, taken together, equal zero (from the donor’s first-order condition), and the third term is zero at \( s = 0 \).

\[\frac{dg}{ds} = \frac{-\alpha u'}{\alpha(1 - s)u'' + \beta v'} > 0.\]

\[\text{The derivative is}\]

\[\frac{dU}{ds} = g'(-\alpha(1 - s)u' + \beta v' - \alpha su').\]

On the right side, the first two terms in parentheses, taken together, equal zero (from the donor’s first-order condition), and the third term is zero at \( s = 0 \).

\[\text{At } s > 0, \text{ the induced increase in } g \text{ reduces the donor’s own consumption and thereby raises his marginal utility of consumption; ceteris paribus, this would tend to increase labor effort.}\]
own consumption than would nondonors at the same income level. As a result, donors would have a higher marginal utility of income than would nondonors who had identical functions \( u(\cdot) \) for utility of own consumption. (This case might arise, for example, when donors differ from nondonors only in that the former are fortunate enough to have found compatible mates or to have had children who please them sufficiently to induce giving.) In maximizing a utilitarian social welfare function, this difference in marginal utilities would warrant more favorable tax treatment of donors.9

Now suppose instead that donors are not individuals who place an unusually high value on others’ well-being, but instead are those who derive unusually low utility from their own consumption; that is, their \( \alpha \) is much less than 1 (even though, perhaps, still greater than \( \beta \)). Then, in spite of donors’ lower consumption, their marginal utility might be lower than that of nondonors whose utility from own consumption was given by \( u(\cdot) \), which would justify less favorable treatment under a utilitarian social welfare function.

Distinguishing these two cases requires making interpersonal utility comparisons. (A donor’s observable behavior depends only on \( \alpha/\beta \) and not on the absolute magnitude of \( \alpha \) and \( \beta \).) Analysts often elude this problem by stipulating that all individuals have the same utility function, but this assumption cannot be maintained in the present context because it is inconsistent with the heterogeneity in the behavior that is under consideration—namely, some individuals are donors and others are not. Hence, judgments about transfer policy, like judgments about general redistribution policy, must to some extent reflect views about different individuals’ utility functions that cannot be grounded in observable behavior.

Another factor is that donees’ own consumption will be higher than otherwise on account of the gifts that they receive. This implies that their marginal utility of income will be lower than that of individuals with the same earned income who do not receive gifts, which favors heavier taxation of donees (tantamount to heavier taxation of gifts). Nevertheless, it remains true that, abstracting from possible tax-revenue externalities, it will be optimal for objects of altruism (prospective donees) to receive more effective income and thus have a lower marginal utility of income than others because their utility from own consumption receives additional weight in the social welfare function due to altruists’ concerns.

III. Utility from Giving Per Se

Some donors may care only about the gifts that they themselves make, motivated by a need for self-sacrifice or a desire for prestige, as in James Andreoni (1990). Let

\[
U(x, g) = u(x - (1 - s)g - t, g).
\]

Analysis of this case, it turns out, is virtually the same as for altruism. It can be shown that introducing a positive subsidy will induce the donor to give a larger gross gift, and that this will increase the utility of the donee without reducing the donor’s utility (at \( s = 0 \)).\textsuperscript{10} Tax-revenue effects and other factors will be analogous as well.

The preceding formulation may, however, be inappropriate. If the donor really is moti-

\textsuperscript{9} Different social welfare functions may have qualitatively different implications. For example, under a maximin function, such altruistic donors are better off than others on account of their altruistic preferences and thus should be taxed more heavily (as should donees, who are better off on account of receiving altruists’ gifts).

\textsuperscript{10} The donor’s first-order condition is now

\[
(1 - s)u_1 = u_2
\]

where a subscript \( i \) denotes the derivative with respect to the \( i \)th argument. Differentiating this condition yields

\[
\frac{dg}{ds} = \frac{-u_1}{(1 - s)u_1 - (1 - s)u_2 - u_1 + u_2}.
\]

The numerator is negative, and from the second-order condition, the denominator is negative, so \( dg/ds > 0 \). Finally,

\[
\frac{dU}{ds} = g'(-(1 - s)u_1 + u_2 - su_1).
\]

Again, the first two terms in parentheses on the right side, taken together, equal zero (from the donor’s first-order condition), and the third term is zero at \( s = 0 \).
vated in a manner that depends on his own sacrifice and not on the gross gain to the donee from all sources (as with the altruist), then it seems reasonable that the donor’s benefit should not depend on the gross gift, g, as in the preceding model, but rather on the net amount that he himself gives up, \((1 - s)g\).  
 Accordingly, consider

\[ U(x, g) = u(x - (1 - s)g - t, (1 - s)g) \]

In this case, the effect of a gift subsidy on social welfare is quite different: raising \(s\) directly reduces the donor’s utility because he benefits only from his own sacrifice, \((1 - s)g\), which is reduced as \(s\) is increased. It turns out that when a subsidy induces the donor to increase his gift, he is in essence redistributing his own income to the donee; unlike the previous cases, here a higher gross gift induced by a subsidy produces a utility benefit to the donee but a utility loss to the donor (even at \(s = 0\)).

The limited empirical work on this transfer motive has not sought to distinguish between these two different formulations.

**IV. Exchange**

If donors’ gifts are in exchange for donees’ efforts (see Douglas Bernheim et al., 1985; Donald Cox, 1987), the transaction really consists of ordinary consumption by the donor and labor income earned by the donee, and each component should be taxed accordingly. A different form of exchange arises when transfers actually are loans (or loan repayments) or elements of various forms of insurance and annuity schemes (see Laurence Kotlikoff and Avia Spivak, 1981). In such cases, payments in both directions would generally be exempt from taxation.

Other posited transfer behavior has elements of exchange. Oded Stark and Ita Falk (1998) suggest that individuals may make gifts to engender gratitude in recipients, who may later return the favor. In this case, one of the preceding types of exchange may be present, depending upon whether the initial gifts or later “repayments” comprise labor effort. James Buchanan (1983) claims that potential donees will engage in rent-seeking behavior to elicit gifts from prospective donors, in which case perhaps gifts should be taxed, if donees’ efforts to induce gift-giving waste resources.

**V. Conclusion**

This paper offers a framework for assessing tax policy with regard to private voluntary transfers to individuals. The main elements are integrating the income tax and estate/gift tax’s treatment of gifts, taking a unified view of the distributive problem in the context of an optimal income tax framework, and focusing on aspects of gifts that distinguish them from donors’ ordinary consumption.

The present analysis reveals that the optimal tax treatment of gifts (relative to the tax treatment applicable to labor income that is expended on direct consumption for oneself) is extremely sensitive to the type of gift involved:

(i) **Altruism.** — Gifts involve a positive externality on donees, which favors a subsidy; there may also be a positive or negative tax-revenue externality, and donors may have higher or lower marginal utility than others, which tends to favor a larger subsidy or a smaller subsidy (or a tax), as the case may be.

(ii) **Utility from giving per se.** — This is
similar to altruism if the donor’s utility depends on the gross gift (i.e., including the subsidy), but there is no positive gift externality if the donor’s utility depends on the gift net of the subsidy.

(iii) Exchange. — If a gift is really compensation in exchange for labor, the “gift” should be taxed as part of labor income; if the exchange is financial (such as with loans and repayments or insurance arrangements), no tax or subsidy is appropriate; if gifts are induced by wasteful rent-seeking, a tax may be optimal.\(^\text{13}\)

These results indicate the policy relevance of further empirical work that distinguishes among transfer motives and identifies more precisely the form of donors’ utility functions. Because transfer motives no doubt vary greatly among donors, and in ways that the government cannot readily observe, it may be necessary to adopt tax policies based upon average behavior or to employ some simple categorical rules that, perhaps, distinguish among gifts between spouses, transfers to descendants, and contributions to public charities, based upon the typical characteristics of each class of gifts.\(^\text{14}\)

REFERENCES


Atkinson, A. B. “Capital Taxes, the Redistribution of Wealth and Individual Savings.”


\(^\text{13}\) Note also that purely accidental bequests (when individuals cannot annuitize), which were not examined here, might optimally be subject to confiscatory taxation.

\(^\text{14}\) Such distinctions are made in current regimes (e.g., in rules defining the tax and welfare treatment of various family units), although existing rules are not well rationalized in terms of the general distributive objectives of the tax system or the motives likely to govern sharing (transfers) within the family. For an initial study of this problem, see Kaplow (1996).