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Alexander Krenek
Margit Schratzenstaller
Klaus Grünberger
Andreas Thiemann

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Alexander Krenek (WU Vienna)
Margit Schratzenstaller (WIFO)
Klaus Grünberger, Andreas Thiemann (European Commission, JRC, Seville)

Austrian institute of Economic Research,
Vienna University of Economics and Business Administration,
European Commission, Joint Research Centre, Seville

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Research assistants: Cornelia Schobert, Andrea Sutrich

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Abstract

Based on the most recent data from the ECB's Household Finance and Consumption Survey, the project models the future household-level wealth distribution in five selected EU member countries (Finland, France, Germany, Ireland, and Italy) to derive inheritances based on different demographic and wealth projection scenarios. On this basis, various inheritance tax scenarios are simulated to estimate potential inheritance tax revenues for a projection period of 30 years. Our results indicate that multiple factors coincide in favouring a growing revenue potential for inheritance taxation in the medium-term. Wealth accumulation and appreciation lead to higher average wealth levels. The shift of the baby boomer generation out of the labour force results in an increase of the older population both in absolute and relative terms. Eventually, this will lead to a rise in the number of deaths and the number of inheritances. Additionally, low fertility rates lead to a reduction of the average number of successors and thereby decrease the importance of exemption thresholds, as individual inheritances become larger. Overall, our simulations show that the future revenue potential of inheritance taxes may be substantial. In practice, it can be expected that the theoretical revenue potential demonstrated by our simulations will be reduced by tax avoidance, real responses, and general equilibrium effects on other taxes. A review of the empirical evidence shows that behavioural responses to inheritance taxes are less pronounced compared to a net wealth tax.

E-mail: margit.schratzenstaller@wifo.ac.at

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Medieninhaber (Verleger), Hersteller: Österreichisches Institut für Wirtschaftsforschung
1030 Wien, Arsenal, Objekt 20 | Tel. (43 1) 798 26 01-0 | https://www.wifo.ac.at
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Highlights

- Ageing societies in Europe challenge pension systems and the financing capacity of the welfare state, since the revenue from labour taxation decreases.
- Strengthening inheritance taxation is a promising option for alternative sources of tax revenue, not only for fiscal reasons, but also in terms of equity and efficiency.
- We expect both more and larger inheritances over the next decades because of the demographic change, as inheritances will be distributed over fewer donees. Inheritance taxes could help to compensate for lower tax revenue from labour.
- Our inheritance simulation model INTAXMOD is a flexible and extendable tool to simulate inheritances and their taxation in five European countries (DE, FR, FI, IE, IT) until 2050.
- The simulated increase of total inheritances from 2020 to 2050 ranges between 75% (DE) and 225% (IE) according to INTAXMOD. The variation across countries is largely due to different demographic paths.
- Inheritance taxes are unpopular in many countries. However, INTAXMOD can help in designing tax schemes that leave most inheritances tax-free, e.g. by granting generous personal allowances. This could increase public acceptance if beneficiaries are aware of it.

1. Background

Europe is ageing, which is challenging pension systems and the financing capacity of the welfare state. In countries, such as Italy, for instance, the baby boomer generation is dropping out of the labour force, leading to a substantially larger share of elderly over the next decade (Figure 1)[1]. Other EU Member States will experience similar demographic changes. This will decrease the labour force, further reducing the labour share in total income (see e.g. IMF, 2017). As a result, these developments question the sustainability of public finances and will require the identification of alternative tax bases to labour.

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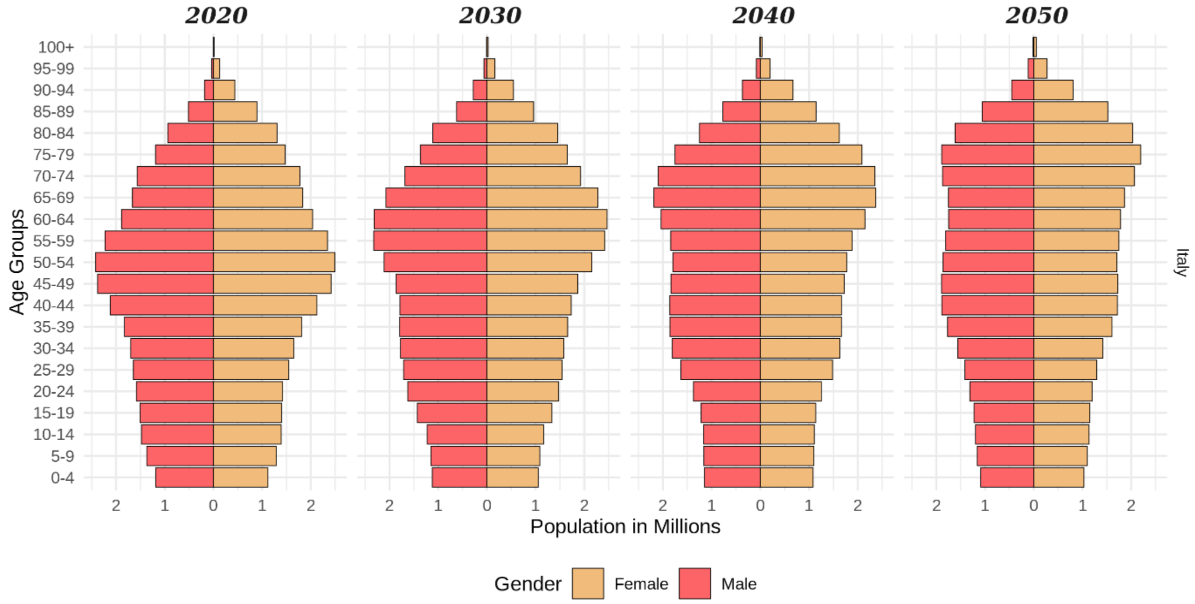
[1]) This research brief is based on Krenek et al. (2022). This WIFO research brief is also published identically as Krenek, A., Schratzenstaller, M., Grünberger, K. and Thiemann, A. (2022). The Revenue Potential of Inheritance Taxation in Light of Ageing Societies. European Commission, Joint Research Centre, (JRC129077).

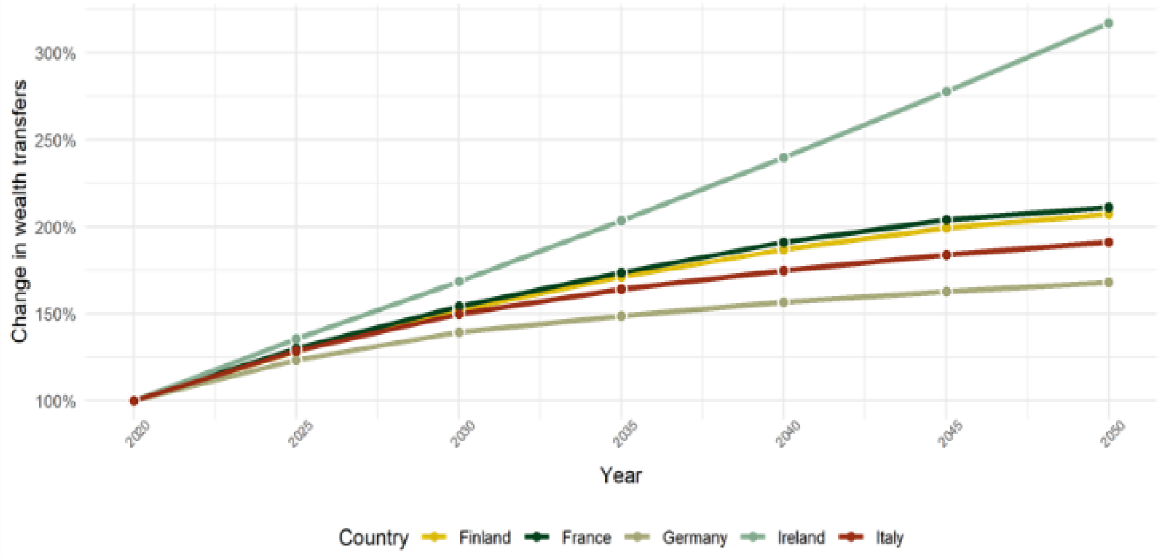
At the same time, accumulation and appreciation of wealth may lead to higher average net wealth. Combined with the demographic dynamics (which will lead to a rise in the number of deaths) we will observe both more and larger inheritances.

Figure 1: Italian population pyramids (2020 – 2050)



Source: Eurostat 2020 (id: proj_19np), own illustration.

Figure 2: Projection of wealth transfers (2020 – 2050)



Source: HFCS, adjusted for "missing rich" and underreporting, own calculations based on INTAXMOD.

Therefore, strengthening the taxation of inheritances and gifts represents a potential alternative source of public financing, which is also justified from an equity and efficiency perspective (see e.g. OECD, 2021). In particular, inheritance taxation can be an effective tool to support social mobility and equality of opportunity and to reduce wealth inequality, especially by addressing high wealth transfers.

Our study focuses on five countries, namely Germany, Italy, France, Finland and Ireland, which are especially relevant regarding the topic. According to our simulations, using our recently developed model INTAXMOD (see quick guide), the wealth transfers will increase considerably from 2020 to 2050 (Figure 2). They are expected to increase by 75% (DE) to 225% (IE), depending on the country. In addition, low fertility rates would reduce the average number of successors, which could increase economic inequality.

Quick Guide

Data: Our model INTAXMOD makes use of several datasets. We use household surveys, which collect information about inheritances and gifts. However, the number of reported wealth transfers per year is often small. Additionally, very large transfers – quantitatively important for taxation – are typically not covered.

Therefore, we combine the most recent data from the ECB's Household Finance and Consumption Survey (HFCS) with information from the Forbes billionaires list, Financial Accounts, and rely on a Pareto distribution to adjust the top tail of the wealth distribution for the "missing rich". Combining this adjusted survey data with mortality probabilities from EUROSTAT, we simulate the flow of inheritances over the next decades.

Model: Our inheritance simulation model INTAXMOD is flexible and extendable to simulate wealth transfers and corresponding inheritance tax revenues in five European countries (DE, FR, FI, IE, IT) until 2050. It is based on reasonable assumptions regarding demographic change, long-term asset appreciation of wealth components, age-specific saving rates and the distribution of inheritances among donees. All monetary values are expressed in 2020 terms. As an outlook, we will extend the geographical coverage of INTAXMOD by eventually adding all remaining HFCS countries.

Limitations: Our simulations suggest large potential tax revenue from taxing future inheritances. In practice, however, collected tax revenues are likely to be reduced due to tax avoidance, behavioural responses and general equilibrium effects impacting other taxes. Furthermore, projecting economic and social outcomes over three decades is naturally associated with a large degree of uncertainty. Therefore, INTAXMOD allows setting the path of wealth and its transfers in a flexible way. Users can change these settings and explore the impact on wealth transfers and their taxation.

2. The potential of taxing inheritances

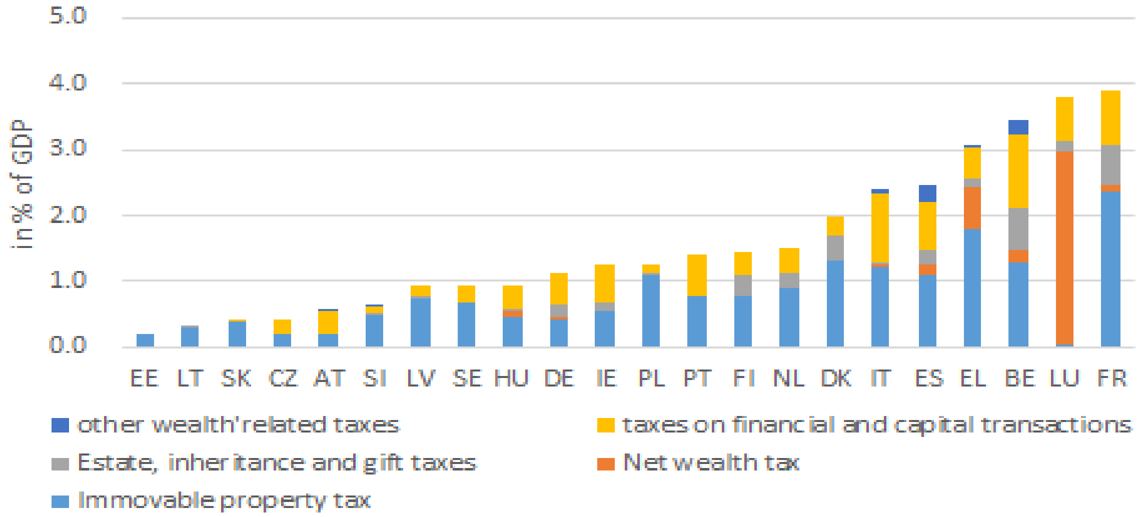
Inheritance taxation in 2020

In 2020, government revenues from inheritance and gift taxation are low in most EU Member States, compared to both GDP and revenues from other wealth-related taxes (Figure 3). This suggests that there is room for a moderately higher tax burden on wealth transfers over the next decades to compensate for the potentially lower revenue from taxing labour. Furthermore, from an optimality perspective, the inheritance tax is considered as the least distortive wealth tax. Hence it is a good candidate to shift the tax burden away from labour towards inheritances (see e.g. Thiemann et al., 2021)[2]).

Inheritance taxation potential 2020 – 2050

Our simulations suggest considerably higher inheritance tax revenues in all five countries over the following decades, assuming that the 2020 tax schemes remain constant (Figure 4). Inheritance tax revenue in France and Germany will be twice as high in 2050 compared to 2020, while Italy and Finland will double their revenue already by 2040. The larger Irish working-age population coupled with a dynamic wealth growth leads to a steep increase in inheritance tax revenue. Our simulations suggest the Irish inheritance tax revenue to double by 2030, and to more than quadruple by 2050.

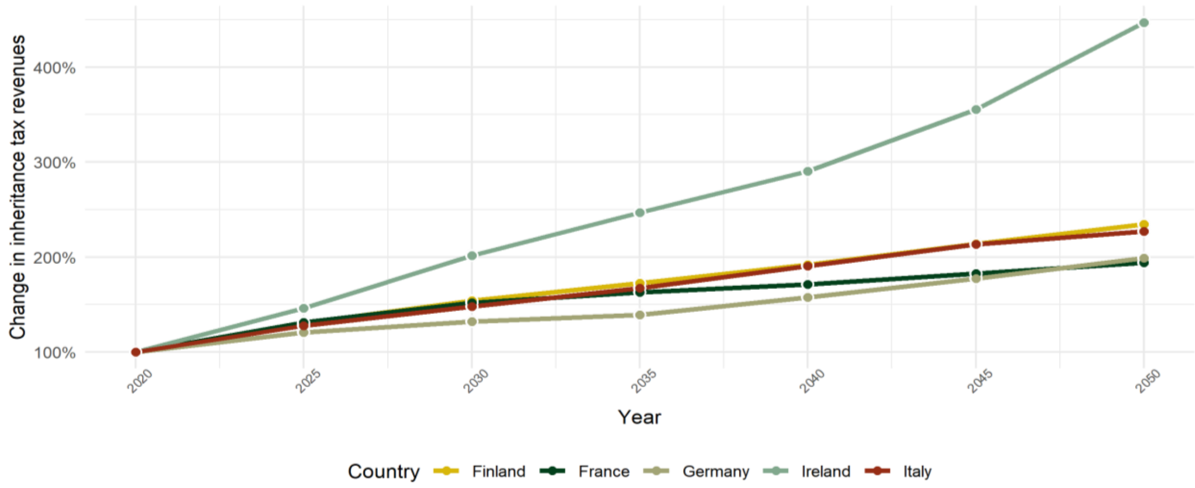
Figure 3: Revenue from wealth-related taxes, EU countries (2020)



Source: OECD Global Revenue Statistic, own calculation and illustration.

2) In some countries, however, inheritances as tax base might be very mobile. In Spain, for instance, relocating to other regions within the country can decrease the tax burden to 0% (see chapter V (section 4) in Ruiz-Huerta Carbonell et al., 2022).

Figure 4: Projection of inheritance tax revenue (2020 – 2050)



Source: HFCS, adjusted for "missing rich" and underreporting, own calculations based on INTAXMOD.

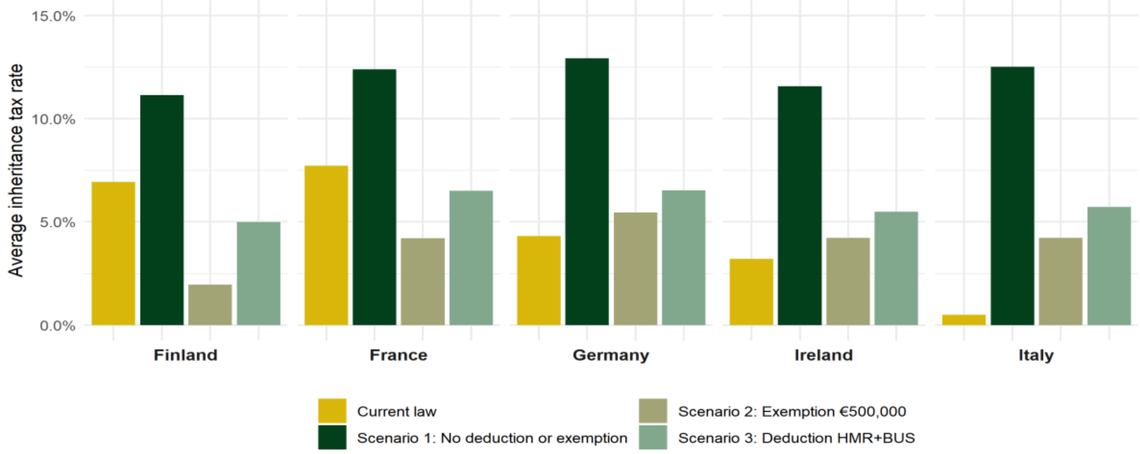
Inheritance tax scenarios

Figure 5 compares the potential revenue impact of three tax scenarios to the current national tax rules (baseline) in 2020. In particular, we introduce two major changes. First, we apply progressive tax rates on the taxable amounts in all scenarios: 10% on the first € 200,000, 15% until € 500,000 and 20% on the remaining share. Second, the scenarios differ in terms of tax exemptions: (1) No tax exemption: the tax base is the full market value of an inheritance, (2) the first € 500,000 are tax-exempt for close relatives (children and partner of donor/testator), and (3) a full deduction for a received household's main residence and business assets.

Figure 5 compares the effective tax burden under each scenario, illustrated by the average tax rates, i.e. inheritance tax liability divided by total inherited wealth. Under the current inheritance tax scheme (Current law, yellow bars), the average tax rates range from less than 1% in Italy to about 7% in Finland and France. Germany (4%) and Ireland (3%) lie in between. The effective inheritance tax burden differs across countries mainly because of the national valuation rules, effectively exempting parts of the inheritance, and less on differences in tax rates. The vanishingly low average tax rate in Italy, for instance, is mostly due to high exemption thresholds and generous valuation rules of assets.

The results of the first tax scenario, which does not consider any tax deduction, are illustrated by the dark green bars in Figure 5. The average tax rates range between 11% and 13% and would significantly increase the tax revenue in all countries. The second scenario, incorporating a persona l allowance of € 500,000, drastically reduces average tax rates in all countries. We observe the most significant drop in Finland, where the average tax rate falls from 12% to 2%, as many inheritances become tax-exempt. Finally, the third scenario (full deduction of the household's main residence and business assets) yields less tax revenue than scenario one. However, the average tax rates ranging between 5% and 8% would be higher than in scenario two.

Figure 5: Average inheritance tax rates, 2020 tax rules (current) and progressive scenarios



Source: HFCS, adjusted for "missing rich" and underreporting, own calculations based on INTAXMOD.

3. Final remarks

The INTAXMOD simulation results suggest that in light of demographic ageing and a decreasing labour share in total income, inheritances might be a well-suited alternative tax base to contribute more to the financing of the welfare state. The simulated increase of total inheritances from 2020 to 2050 ranges between 75% (DE) and 225% (IE). This represents a significant increase in the corresponding tax base.

Comparing several inheritance tax scenarios, we show the importance of tax exemptions and deductions. Granting a personal tax-free amount or exempting certain assets, like main residences, markedly lowers overall tax revenue. On the other hand, such deductions could increase public support for inheritance taxes whose public acceptance is relatively low in most countries. INTAXMOD can help in designing revenue-generating tax schemes that leave most inheritances tax-free. This could increase public acceptance if beneficiaries are aware of it.

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