POINT OF VIEW/ Charles Yuji Horioka: Raising gift and inheritance taxes would kill five birds with one stone

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The Japanese economy remains in the doldrums, with the growth rate for real gross domestic product falling sharply from 1.0 percent in the October-December 2009 quarter and 1.1 percent in the January-March quarter to a meager 0.1 percent in the April-June quarter.

Moreover, the record strength of the yen in recent weeks threatens to further weaken the Japanese economy, increasing the urgency for additional economic stimulus measures.

At the same time, however, Japan's government debt-to-GDP ratio is the highest in the developed world and is rapidly approaching 200 percent. Thus, the reconstruction of government finances is an equally urgent task.

The problem is that these two goals--stimulating the economy and reconstructing government finances--are not necessarily compatible, and it has become exceedingly difficult to realize the two goals simultaneously.

A tax cut or an increase in government spending may stimulate the economy, but it may at the same time further deepen the government's debt. Conversely, a tax increase (for example, the consumption tax hike proposed by Prime Minister Naoto Kan) or a cut in government spending may help bring about reconstruction of government finances, but could also have a deleterious effect on the economy.

However, it is not impossible to achieve the two goals simultaneously. And in this essay, I would like to propose one feasible way--increasing gift and inheritance taxes.

Japan and most other developed countries impose taxes on gifts and inheritances, even those from parents to children.

If people pass on their wealth to their children while they are alive (in the form of inter vivos transfers) or at death (in the form of a bequest), they must pay gift and inheritance taxes.

However, if people spend all of their wealth on themselves, they can avoid gift and inheritance tax payments.

And if gift and inheritance taxes are raised, the people who spend their wealth on themselves can avoid even higher tax payments.

Rational people would increase their own consumption and reduce the amount of gifts and inheritance to their children if gift and inheritance taxes go up.

Thus, increasing these taxes would stimulate household consumption and the economy as a whole.

Moreover, higher gift and inheritance taxes could well lead to a rise in revenue from those taxes. And the increase in household consumption caused by hikes in gift and inheritance taxes could boost revenue from the consumption tax.

Thus, as stated earlier, increasing gift and inheritance taxes can simultaneously stimulate the economy and contribute toward the reconstruction of government finances.

Furthermore, an increase in gift and inheritance taxes will reduce the amount of wealth passed on to children, easing the extent to which wealth inequalities are passed on from generation to generation. This will enable all Japanese to start life on a more equal playing field and make Japan a fairer and more egalitarian society.

In addition, raising gift and inheritance taxes would allow "longevity risk" (the risk of living a long life) to be "socialized," or borne by society as a whole.

My recent research shows that bequests from parents to children are conditional on the children taking care of and providing financial support to their aged parents. Such conditions are more common in Japan than in the United States, India, China and other countries.

Thus, in Japan, children effectively bear the burden of longevity risk (the risk of parents living a long life).

However, if gift and inheritance taxes are raised, parents will use their own assets to cover their living expenses during old age rather than concluding a so-called implicit annuity contract with their children. Such a situation would free their children from the burden of longevity risk and improve their lives.

Moreover, if part of the increased revenue from higher gift and inheritance taxes is used to improve public pensions and long-term care insurance, the longevity risk can be effectively "socialized," obviating the need for both parents and children to bear this risk and making them both better off.

Raising gift and inheritance taxes will stimulate the economy, contribute to reconstructing government finances, reduce the extent to which wealth inequalities are passed on from generation to generation, and "socialize" longevity risk, thereby killing four birds with one stone.

But I prefer a different way to raise gift and inheritance taxes than simply increasing the rates.

In Japan, land is greatly undervalued for gift and inheritance tax purposes. Thus, pricing land at its full market value for gift and inheritance tax purposes will greatly increase the revenue generated by these taxes--even without an increase in the rates. Thus, increasing gift and inheritance taxes in this manner would make it more equitable across asset types and allow a fifth bird to be killed with the same stone.

My proposal to effectively raise gift and inheritance taxes by taxing land at its full market value would produce at least five benefits without any offsetting disadvantages. There seems to be no reason not to implement such a plan.

Why settle for measures that stimulate the economy at the expense of reconstructing government finances or that help rebuild finances at the expense of an economic recovery when both goals can be achieved simultaneously?

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