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The President's Advisory Panel on Federal Tax Reform
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RE: Preferential Treatment of Capital Income Taxation and Human Capital Formation.

Dear Dr. Lazear and the President's Panel on Tax Reform,

Thank you for the opportunity to clarify and extend upon our comments at the Tax Reform Panel's meeting on May 11, 2005.

We feel that the current preferential treatment of income from accumulated wealth and physical capital at the expense of income from work and human capital is both unfair and economically unwise.

In our testimony, we highlighted the fact that shifting the tax share away from capital income and onto wealth could have negative consequences for human capital formation.

When looking at revenue neutral changes to the tax code, setting low tax rates on physical capital—through the preferred tax treatment of capital gains and/or dividends—necessitates setting marginal income tax rates at higher levels than would otherwise be the case.

There has been much discussion in the economic literature about the impact of marginal income tax rates on human capital formulation. An early insight of this literature was that, in theory and under some restrictive assumptions, changes in the tax rate in a proportional tax rate regime might not impact human capital formation. The reasoning is that the main cost of human capital formation through additional years of education is from forgone earnings. As such, an increase in a proportional tax leads to a decrease in after-tax earnings during working years, but also decreases the opportunity cost of spending time acquiring additional education and skills.

When the tax regime is progressive, however, the opportunity cost of spending time building human capital is lower, relative to after tax earnings while working, than in a proportional tax regime—creating a marginal disincentive to spending time accumulating

human capital. Thus, overall marginal income tax changes in a progressive regime can therefore impact the accumulation of human capital.

Furthermore, taxes can have an impact on human capital if there are costs to human capital formation beyond lost taxable wages, or if taxation reduces the number of hours worked (and hence the return to skill investment, either through schooling or through on-the-job training.)

The theoretical possibility that higher and progressive tax rates can impede human capital formation has been used to justify a switch away from a progressive tax regime to some form of a flat tax. However, we believe that a fair tax code ought to be progressive, and therefore the goal ought to be to keep labor tax rates low (while raising sufficient revenue) within a progressive regime. By providing capital income with a tax preference,[1] we are necessarily shifting the tax burden onto income from work and hence the return to skill accumulation.

According to a recent analysis by Stanford economist Paul A. David (2003):

> ***A bias against human capital formation expenditures presently exists in many national tax codes, which tend to favor investments in tangible capital formation and intangible business expenditures*** *for R&D and in-house production of computer software. Differentials in the tax treatment of different classes of assets are "inefficient" in the static welfare-analytic sense, and the inefficiencies become magnified where the various assets are strong complements in production, or in consumption. Due to the complementarities between human capital formation and the accumulation of other classes of productive assets, and the role of human capital in generating technological and organizational innovations, this particular aspect of "non-neutrality" in the workings of the tax system may well have significant perverse consequences for economic growth.*
>
> *The progressive taxation of personal income, moreover, tends to exacerbate the distortions in the allocation of investment that arise from the failure of most modern tax regimes to treat human and non-human capital formation in a neutral fashion.* ***Because it proves more feasible under most tax regimes to shelter personal property income streams from the effects of rising marginal tax rates than is the case for wage and salary income, educational and training investments that yield incremental earned income are particularly punished****. (Emphasis added)*

Listed below are some additional sources on the economics of human capital formation and labor taxation.

[1] In the context of taxation of human capital vs. physical capital, see Judd (1998) or Steuerle (1996).

Thank you again for the opportunity to present our tax reform plan to the panel.

Sincerely,

John Podesta
Center for American Progress
President

John Irons
Center for American Progress
Director of Tax and Budget Policy

Economic Research

The literature on the impact of various government policies—including tax policy—on human capital formation is substantial. For a general overview, see Trostel (1997) or David (2003). For a review and extended bibliography on human capital see David and Lopez (2001), especially pages 98-103 for the impact of tax policy.

To name a couple of specific examples, Trostel (1993) shows that higher wage taxes can impact human capital formation when there are costs to education that are not reduced by taxation, such as tuition. More recently, Jacobs and Bovenberg (2005) present a model of optimal taxation in which capital and labor are both taxed at positive rates, and conclude: "The positive tax on capital income serves to alleviate the distortions of the labor tax on human capital accumulation.… Numerical calculations suggest that the optimal marginal tax rate on capital income is close to the tax rate on labor income."

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