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Tax Reform and Human Capital Formation:

Putting Education into the Equation

By J.D. Foster, Ph.D.

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The Road Map to Tax Reform™ Series

Executive Summary

Tax reform should encourage investment in physical capital through expensing, and it should encourage investment in human capital through expensing as well. Tax reform will also remedy other areas of the tax code such as high marginal tax rates and progressive taxation that discourage people from acquiring extra skills and punish them as they deploy their talents and abilities—their human capital.

It is clear that the more and better education somebody has, the greater are his or her prospects for economic success. One study showed that on average, lifetime earnings increase by about 10 percent with every additional year of education.

This return is not only personal, however, for studies show that higher education levels lead to overall economic growth for the nation. In fact, the economic return of educational investment is likely higher on the macro level than on the micro level. Society, democracy and the economy all profit from the education of the people. Complete tax reform should take away the current tax code's many disincentives to human capital formation.

Fundamental tax reform promises improvements in economic performance because it makes the tax system far more neutral and therefore far less distorting of relative prices. The Flat Tax, for instance, allows first-year "expensing" of all purchases of plant and equipment. Proposals for a national retail sales tax would exclude all purchases of plant and equipment from the sales tax base.

If the proper treatment of physical capital formation is expensing, it should follow that the proper treatment of human capital formation is also expensing. That is, all expenditures associated with improving an individual's knowledge, skills, or techniques that could increase their earning power in the future should be immediately deductible from taxable income in any aggregative tax system like the Flat Tax, or excluded from tax in any transactional system like the national retail sales tax.

Even the current tax code contains several provisions for encouraging human capital formation. Though the basic intent behind these tax provisions is on the right track—to encourage human capital formation—they fall far short of a tax code that has no disincentives to education.

Other parts of the Internal Revenue Code, such as high marginal tax rates and progressive taxation, place a roadblock in front of people who want to improve their economic prosperity by acquiring extra skills, making a career change, or just by adapting to advances in technology.

In many ways, especially in the way of simplification, the Flat Tax and the national retail sales tax would be a major improvement over the current tax system. But as regards human capital formation, in their current form they actually would penalize education more than the current system does.

Fortunately, the remedy for this imbalance is simple. The Flat Tax should allow for expensing of educational costs. Likewise, the national retail sales tax should allow for exclusions of educational costs.

The equation of education and economic success has never been so pertinent. Virtually every industry and every occupation is experiencing a rapid infusion of new technologies.

At a time when the importance and the value to society of higher education is clear and increasing, and when these costs are rising rapidly, the punitive tax treatment of education seems highly unwise.

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Tax Reform and Human Capital Formation:
Putting Education into the Equation

By J.D. Foster, Ph.D.

"In today's economy, investments in education and in worker training are at least as important as investments in hard business assets."

— Congressman Charles Rangel
Ranking Member, House Committee on Ways and Means

Introduction

For all the talk of simplification, tax neutrality, economic growth, transparency, and fairness, people who discuss tax reform often forget that the purpose of improving any public policy, be it education reform, Medicare reform, or tax reform, is to improve the lives of people. And in a very important way, fundamental tax reform discussions and proposals have heretofore tended to ignore a crucial and basic economic role of people. Most experts forget that people are productive not just because of our social and economic systems and not just because of the number and quality of the machines they use, but also because of the education and training they bring to the workplace. Tax reform is often so concerned with investment in plant and equipment, what economists call "capital formation," that human capital formation is forgotten.

To date, it can be fairly said that no machine ever created itself or another machine from inspiration to completion. It takes people to imagine what some new machine might achieve, how to develop that machine, how to produce it, how to test it, and ultimately how to employ it. These innovators and creators share much in common, but one characteristic they all share is a certain degree of education. Once the machinery is produced and ready to use, it then takes other people to use it. These people, too, require a degree of education–they embody human capital formation.

The more and better education one has, both formal and informal, the greater are his or her prospects for economic success.

Education also plays a critical role in determining one's economic fortunes. There are, of course, many stories of people with high school educations or less being very successful and amassing great wealth. And the economy is littered with individuals who have earned their doctorates and yet earn little financially. Even so, it is clear that the more and better education one has, both formal and informal, the greater are his or her prospects for economic success.

This is not just a theoretical consideration. It can have important practical consequences for economic growth. A tax system can discourage individuals from advancing their education and thereby reduce the productive capacity of the national workforce. For example, as a general rule education raises an individual's expected lifetime earnings. However, if an individual faces higher tax rates as his or her income rises, then the tax code creates a disincentive to the individual expending the time and resources necessary to attain a higher educational level. High and rising tax rates punish success and thereby create a disincentive to succeed and to take the actions necessary to succeed, whether those actions are working harder, working smarter, or advancing one's education. In other words, if tax rates increase with income, they discourage human capital formation in the same way they discourage work or saving or investment in physical capital.

The tax system can discourage human capital formation in other, less familiar ways that reduce future economic growth and that can have a powerful influence on persistent income inequality. For example,

most families understand the importance of a college education in today's economy. A tax system that discourages education by failing to treat education expenditures properly will raise its effective cost. This, in turn, will reduce the extent of the educational effort, but it is also more apt to discourage families of modest means than it is the more well-to-do. Higher-income families simply have greater ability to disregard the higher after-tax costs of higher education than do families with fewer resources. Of course, this can be offset in part or in whole by federal student loan programs and various grants and scholarships, but a far more rational, more comprehensive system could be implemented just by treating human capital formation properly in the tax code, thereby reducing some of the cost of education.

Virtually every industry and every occupation is experiencing a rapid infusion of new technologies. The new technologies are not restricted to information processing and the Internet; they apply in avionics, design, new materials, new processes for doing basic operations such as baggage handling at an airport, and in better tools used by workers across the board. As the economy evolves, so, too, do its demands for and rewards given to particular levels of education and skills. According to the Bureau of Labor Statistics, between 1994 and 2005 sixty percent of all jobs created in the United States may require a "fairly high skill level."

The tax system should not erect roadblocks to individuals seeking to expand their education or training.

To take full advantage of the rapid expansion and integration of higher technologies, our education system must be up to the task, and our supporting social and governmental systems must be up to the task. In particular, the tax system should not erect roadblocks to individuals seeking to expand their education or training. Unfortunately, our current system gets a gentleman's "C" in this regard, while most tax reform proposals simply fail.

While in many ways obvious, the importance of education needs to be stressed at the outset of any tax reform discussion because it has almost always been omitted in the past. As a consequence, most tax reform proposals have, unintentionally to be sure, treated people worse from a tax perspective than they have treated machines, or, more precisely, they have treated human capital formation more punitively than they treated physical capital formation. Thus, many of the gains in economic growth and prosperity promised by tax reform would go unclaimed and unrealized if fundamental reform were enacted without a proper regard for human capital formation.

Individuals as Embodiments of Human Capital

"Human capital" is the concept that a crucial aspect of individuals in their role as producers of value in the economy is the sum total of their skills, experience, and knowledge. This concept was formalized initially by Theodore W. Schultz and subsequently by Gary Becker. As individuals, we develop our human capital through our life experiences, through specific training, and through education. Without this human capital aspect, economically we are nothing but a collection of bones and muscle and tissue. It is the quality and extent of our human capital that largely determines our ability to contribute to the economy and therefore to earn a higher or lower wage.

Three more years of education could produce almost $10,000 per year, or about 40 percent more in average earnings.

Families have for generations sacrificed so that some or all of their children could go to college. They believed that in this way they could offer their children a better life than they had. Sometimes, of course, this expectation of a better life was simply a belief in the intrinsically higher quality of an educated person's life. Most often, the parents understood that more education created more career opportunities, more opportunities for higher earnings, and generally more financial security. A recent study by the U.S. Census Bureau bears out this faith in education. The study reported median earnings of full-time workers by level of educational attainment in

1998. The data showed that, on average, an individual with a 9th-grade education or less earned $16,808 per year. Individuals with a high school diploma on average earned $26,592. In other words, three more years of education could produce almost $10,000 per year, or about 40 percent more in average earnings.

The effects of education did not stop with a high school diploma. An individual with a bachelor's degree earned $46,285 on average. So just four more years of school could almost double a person's expected income. And it continues: someone with a doctorate earned $63,361 on average, and someone with a professional degree such as a medical doctor or an attorney earned $75,239 on average.

Each additional year of schooling raises lifetime earnings by about 10 percent in the United States.

Higher education levels also give individuals greater mobility across professions as well as greater upward income mobility. It is much easier, for example, for a more educated individual to adjust to changing labor markets by acquiring new skills or applying old knowledge in new ways. For example, a 1996 study showed that the majority of the population out of the workforce or unemployed was relatively uneducated. Education is important when times are good because an individual who can succeed at more things is more likely to be able to move to those activities most in demand. Likewise, when the economy is doing poorly, this higher degree of labor mobility allows an individual to adjust when fortune turns unfavorable.

It is natural in considering these matters to attempt to calculate an expected return on investment in one's education. That is, given the expected costs in terms of tuition, fees, and foregone income, what rate of return is implied by the income differentials for different levels of education? Indeed, economists have attempted to determine such rates of return. For example, for 1949 Becker estimated the returns to white males at 20 percent for high school graduates and 13 percent for college graduates.

In 1974, Jacob Mincer examined the relationship between attending school an additional year and the expected increase in lifetime earnings. A superior aspect of this study was that it focused on incremental increases in the amount of time spent at study rather than upon the degree attained. In his study Mincer considered that the only cost of attending school an additional year is the income foregone, thus he ignores the direct costs of additional schooling such as tuition and fees. This construction was necessitated by data considerations, so that results from this methodology must be considered in the nature of an upper bound estimate. A more recent review of the literature indicates a fairly robust conclusion consistent with Mincer's findings that each additional year of schooling raises lifetime earnings by about 10 percent in the United States.

While these results are helpful in understanding the effects of education on an individual's expected future earnings, there remains the question of whether they extend to the macro level, that is, to the economy as a whole. Heckman and Klenow examined this question and found that the general result does in fact extend from individuals to the nation. Indeed, under one formulation of their model they found that education has an even larger effect at the macro level than at the micro level. In other words, there appears there may be an "externality," that is an extra benefit, to education enjoyed by society that is not captured by the individual. In economic parlance, the social return to education may exceed the private return. We turn now to some notions of what that externality may be.

Education has an even larger effect at the macro level than at the micro level.

As important as human capital formation is to an individual's personal ability to contribute to the economy and to earn a higher wage, the societal consequences of having a more educated population should not be ignored. Education benefits society in a myriad of ways, many of which have important if subtle feedback effects on the operation of the economy and our economic institutions. For example, ignorance and intolerance generally go hand in hand. A higher degree of education may be associated with more

stable families as mothers and fathers properly assess the consequences of those kinds of behavior associated with broken homes. The more educated a people, the more stable its communities may be as personal confidence and awareness encourage a greater respect for human rights and property rights.

Finally, a more educated people is more likely to follow current events and better understand their consequences for their families, their communities, and the nation. One of democracy's greatest legacies is that it gives citizens the right and the ability to attend to their own lives free of undue government interference. But one of the greatest dangers to democracy arises when individuals continually exercise those rights and abilities and ignore the external events shaping their lives and their nation's future. By following current events more thoroughly, an educated people is more likely to understand the events' importance and thus is more likely to be able to guard against complacency. A more educated people, therefore, is more likely to enjoy the enduring blessings of democracy. Democracy, in turn, with its proper respect for both individual rights and property rights is the most natural political system to support a free-market economy.

Tax Reform and Tax Neutrality

Of the many factors that indicate the propriety of a tax system, including transparency, simplicity, ease of administration, and fairness, neutrality is by far the quality that most determines the extent to which the tax system leaves an economy free to realize its maximum growth potential. A tax system is neutral if it leaves undisturbed the relative prices of goods, services, and activities. It is the price of a loaf of bread relative to a half dozen bagels that, along with an individuals' preferences, determines how much of one he will buy and how much of the other. Throughout the economy, relative prices determine how much of one item consumers will buy relative to another. Relative prices, both costs and returns, also determine how much a business will invest in one project versus another. And relative prices in the form of expected, after-tax lifetime wages guide individuals in their choice between working more or enjoying more leisure.

A tax system is neutral if it leaves undisturbed the relative prices of goods, services and activities.

Relative prices are important because they are the signals that indicate how individuals and businesses should allocate their resources. When relative prices are undisturbed by government policies, including tax policy, and are undistorted by market peculiarities such as monopolistic powers of some participants, then these prices guide the allocation of capital and labor resources to the production of those goods and services that will provide the greatest benefit to consumers as they define it. Our current tax system at the federal, state, and local levels distorts relative prices in countless ways, thereby robbing the economy of some of its potential by misdirecting resources. Most of the improvements in economic performance promised by fundamental tax reform derive from making the tax system far more neutral and therefore far less distortive of relative prices.

For example, a consistent focus of tax reform has been the neutral taxation of saving, in part because the current tax system so much violates tax neutrality with respect to saving. Another focus of tax reform has been the treatment of saving's counterpart—investment—especially the tax treatment of physical capital, such as land, structures, and equipment. The process of acquiring and employing these productive assets is often called "capital formation." Capital formation is a primary means of raising labor productivity—essentially the amount of output each worker can produce—and increasing labor productivity is synonymous with higher wages and economic prosperity.

Given its importance to increasing workers' wages, the tax treatment of income produced by plant and equipment is obviously very important. When an individual or a business buys a "real" asset, such as a

new machine, for purposes of producing future income, he or she expects to receive some positive return on that investment. He also, however, has a minimum after-tax return that is required to undertake the investment. This minimum return reflects inflation expectations and the various risks associated with the investment. This minimum return is often called the "normal" return or "normal profit," whereas all income received in excess of this normal return is "economic profit." If a tax system is poorly designed, i.e., is non-neutral with respect to investment, then it will artificially raise the pre-tax returns the investments are required to yield, often called the "cost of capital." A marginally worse tax system is one that also artificially raises the cost of capital for some assets more than for others.

If a tax system is poorly designed, it will artificially raise the pre-tax returns the investments are required to yield.

There are certain truisms in life, such as the old adage that what goes up must come down. A basic truism of tax policy is that the more you tax something, the less you get of it. The more you tax cigarettes, for example, the less people will smoke. The more you tax wages, the less people will work. Similarly, the heavier the tax burden on productive capital, the less businesses will be willing to invest in new plant and equipment. Thankfully, the converse is also true: The less you tax productive capital, the more capital will be employed, which is partly why fundamental tax reform promises better economic performance.

A basic failing of even a properly designed income tax is that, by design, it raises the cost of capital to all purchases of real assets. It does so by taxing not only the economic profit an investment may yield, but also an investment's normal return. The dimension of neutrality emphasized by income tax proponents is that all assets be subject to the same level of taxation on their normal returns. Thus, by design even a properly formulated income tax is intended to yield a lower level of capital formation and a lower level of capital use than is consistent with maximizing wages and economic growth. Income tax proponents justify this lost income by emphasizing the redistributive effects of the tax. Essentially, they are willing for everyone to have less income as long as that income may be more equitably distributed.

Few would argue that the U.S. federal income tax in practice is properly formulated when it comes to the treatment of real investment. While the returns to most assets suffer some level of punitive tax, some assets suffer worse than others and some taxpayers suffer worse than others. A small business, for example, is allowed to deduct up to $24,000 in 2001 capital purchases, so that the income tax is actually neutral with respect to these purchases. In contrast, a corporation may be paying the Alternative Minimum Tax (AMT), which is a parallel tax system to the corporate income tax under which a taxpayer pays the greater of their regular and Alternative Minimum Tax liabilities. The economic value of an AMT corporation's depreciation is typically much less than that of a regular income-tax-paying corporation, whose value of depreciation is, in turn, generally less valuable than the treatment accorded the small business.

Few would argue that the U.S. federal income tax in practice is properly formulated when it comes to the treatment of real investment.

The failings of the income tax when it comes to capital formation are some of the prime motivations for most tax reform proposals and the source of much of the improvement in economic performance that tax reform is expected to produce. Flat Tax proposals, for example, would give all businesses the same, neutral tax treatment currently afforded small businesses: first year expensing. In other words, a business would be allowed to deduct from its taxable income all purchases of plant and equipment in the year the purchase is made. This system, commonly known as "expensing" since it treats capital purchases like any other expense, eliminates any neutrality problems between assets, but more importantly, it also eliminates the income tax's levy on an asset's normal return. Expensing was employed in the USA tax system originally introduced by Senators Nunn (D-GA) and Domenici (R-NM) and more recently introduced by Congressman English (R-PA). Economically, the effect of expensing is to exclude from taxation the normal return on investment, while still subjecting any economic profits the investment may earn to the

full amount of tax. Proposals for a national retail sales tax avoid this problem altogether by excluding all purchases of plant and equipment from the sales tax base.

Neutrality and Human Capital Formation

If the proper treatment of physical capital formation is expensing, it should come as no surprise that the proper treatment of human capital formation is also expensing. That is, all expenditures associated with improving an individual's knowledge, skills, or techniques that could increase their earning power in the future should be immediately deductible from taxable income in any aggregative tax system like the Flat Tax, or excluded from tax in any transactional system like the national retail sales tax.

If education expenses are excluded from the tax base, then the tax system will be neutral with respect to human capital formation and individuals and families will be uninfluenced by the tax system in their decision making with respect to education. On the other hand, if the tax system penalizes education expenditures, then taxpayers will make less appropriate educational choices for themselves and their families. For example, it is easy to imagine how an individual of few resources who dropped out of high school could be deterred from obtaining his or her GED if monies spent for that purpose were subject to tax. The same holds for a family considering college for their children, or for someone in the workplace considering returning to college to finish a degree, or someone considering more advanced training or a refresher course. In each case, if tax is levied on the income used to pay for these educational activities, then it is less likely they will be fully pursued.

If the proper treatment of physical capital formation is expensing, it should come as no surprise that the proper treatment of human capital formation is also expensing.

Tax reform has emphasized tax neutrality because neutrality guides the design of a tax system so that it can permit the economy to achieve its highest efficiency, producing the greatest well-being. Neutrality clearly implies that expenditures on plant and equipment should be immediately deductible or expensed. Neutrality also indicates that education expenditures intended to maintain or increase one's economic value, i.e., future earning power, ought also to be expensed.

Expensing of educational outlays, while a clear general rule, raises at least one difficult issue. In much of education there is a mixture of motivations between current pleasure and future earnings. For example, when a student of electrical engineering opts to take a course in French literature, there is certainly something to be said for the improvement of the individual that may result in terms of his understanding of human nature and his outlook on life. These, in turn, may help the individual to become a better and happier person and therefore a better employee and workmate. Nonetheless, there is the definite possibility that the student was motivated not by any expectation that the study of French literature would enhance his future earnings, but rather by his love of the humanities. A more clear-cut case is that of a retired individual who enrolls in the same class. As a retired individual, it is highly unlikely that he or she was motivated by anything other than the pleasure that he or she finds in the course.

Neutrality also indicates that education expenditures intended to maintain or increase one's economic value ought also to be expensed.

Most education expenses will involve a mixture of consumption and investment, and it will rarely be possible to determine when it is wholly one or the other. If tax reform proceeds and if it properly recognizes the importance of extending tax neutrality to educational outlays, then some rough rules will need to be developed to determine which expenses should be deductible and which should not. One can only hope that in constructing these rules the authors of tax reform recognize there is little real cost to tax revenues, and certainly none to society, by writing them to err on the side of liberality.

Before turning to the performance of current law and the two leading tax reform contenders with respect to their treatment of human capital formation, it is important to emphasize one other dimension of the nexus between tax policy and incentives, or disincentives, for education. Thus far, the discussion has been entirely about the tax base—the determination of what is to be subject to tax. However, tax rates can also play a profound role. When tax rates increase with income, i.e., when the tax system is progressive, the very progressivity of the rates is itself a disincentive to individuals considering earnings-enhancing education.

The very progressivity of the rates is itself a disincentive to individuals considering earnings-enhancing education.

Without question, higher marginal tax rates are a disincentive to work. They also pose a disincentive to strive for higher earnings by working harder or by enhancing one's abilities and skills through education. Consider, for example, a working mother contemplating whether to go to school at night to become a nurse. Such a commitment can involve enormous sacrifices of time, energy, and financial resources. These sacrifices are far less acceptable if the net result is that her higher earnings are subject to a tax rate nearly twice as high as before. Some, of course, will accept the sacrifices and the higher tax rates on their increased earnings. But some will not, and some of these who turn away from the opportunity for a sounder financial future will do so because of the higher tax rates. This sort of barrier erected by steep tax rates is a terrible burden to impose on families willing to work for a better life.

A recent study attempted to quantify the effect of rising tax rates on educational incentives. This paper developed an economic model that included both human capital formation and physical capital formation. This model was then used to study the effects on what the authors called "skill formation" of switching from progressive income taxes to a flat income tax, and then to a flat consumption tax. The study concluded that:

> *A progressive wage tax reduces the incentive to accumulate skills, since human capital promotes earnings growth and moves persons to higher tax brackets. As a result, marginal returns on future earnings are reduced more than marginal costs of schooling.*

A progressive wage tax reduces the incentive to accumulate skills, since human capital promotes earnings growth and moves persons to higher tax brackets.

In other words, a progressive tax system discourages educational pursuits by reducing the returns relative to the costs. The study further concluded that under a flat-rate income tax:

> *College attendance rises dramatically as the higher earnings associated with college graduation are no longer taxed away at higher rates.*

The Current Law Taxation of the Returns to Education

Surprisingly, the federal income tax could easily be given a passing grade, though not by much, for its treatment of human capital formation. For example, most public elementary and secondary education in the United States is paid for by state and local property, income, and sales taxes. Until the 1986 Tax Reform Act, all of these taxes were deductible from an individual's federal taxable income. And even after the 1986 Act, state and local property and income taxes remained deductible. The justification for allowing these deductions was to avoid double taxation, not to avoid imposing a tax on education expenses, but the result is the same. Thus, current law provides the appropriate treatment with respect to education by allowing income and property taxes to be deductible to the extent they fund public schools, and fails in disallowing the deduction for sales taxes.

Cities, counties, and states also undertake large expenditures to maintain and improve their local and statewide systems of colleges and universities. These amounts are also funded out of the general budget

and paid for by income, property, and sales taxes. So, once again, the income tax is properly designed to the extent that these state and local taxes cover education expenses and are deductible from federal taxable income.

The federal income tax's positive qualities with respect to the treatment of costs associated with public elementary and secondary education generally do not extend to private education or to post-secondary education expenses. The federal income tax generally does not allow for any deduction or exclusion for expenses associated with private elementary or secondary school education. Because many private schools are operated by religious organizations, there has long been sensitivity about allowing a deduction for amounts paid to private schools. The logic of this policy is very thin, however, when one considers that an individual can receive a tax deduction for contributing to a charitable organization, but not for paying tuition for one's child to attend a school run by that same institution. Beyond the issue of schools affiliated with religious institutions, there is simply no tax policy rationale for denying parents a deduction for their children's private school education.

There is simply no tax policy rationale for denying parents a deduction for their children's private school education.

The proper tax treatment of income dedicated to a child's education extends well beyond the private school versus public school question. Current law allows for no deduction for expenses a family incurs to give its children extra help. For example, suppose a family needs to pay for special training to overcome a speech impediment, or a reading impairment. Or suppose a family is willing to cover the costs of additional tutoring to help their child catch up or excel in mathematics or in a foreign language. In each case, the proper tax treatment would allow the family a tax deduction for these expenses, and in each case the current tax code is silent.

Matters worsen still for higher education. In general, whether incurred by the student or his or her family, income spent on tuition and related expenses associated with college, graduate training, technical training, or other post-secondary education is fully taxed. At a time when the importance and the value to society of higher education is clear and increasing, and when these costs are rising rapidly, such a punitive tax treatment on education seems highly unwise.

Tax "Incentives" in the Federal Income Tax for Education

In recognition of the heavy tax burden on individuals with expenses relating to human capital formation, over the years Congress has enacted a series of tax provisions, and is considering still more, to relieve some of this burden. However, just as the central failing of the current system in this regard is its failure to adhere to tax neutrality, these education "incentives," which are actually partial reductions in a tax disincentive, are likewise not guided by any notions of tax neutrality. The following are some of the provisions in the tax code that effectively help move current law in the direction of education tax neutrality.

Education Individual Retirement Accounts

A relatively new education incentive is provided under Section 530 of the Internal Revenue Code providing for Education Individual Retirement Accounts (EIRAs). These are certain trusts or custodial accounts created exclusively for the purpose of paying qualified higher education expenses of a named beneficiary. Contributions may not exceed $500 per designated beneficiary and may not be made after the beneficiary reaches age 18. The $500 annual contribution limit for EIRAs is phased out ratably for contributors with modified Adjusted Gross Income between $150,000 and $160,000 for couples filing jointly. Individuals making the contributions must first pay tax on the amounts contributed. However, distributions from an EIRA are excludable from gross income to the extent the distributions do not exceed the qualified higher education expenses of the student during the year the distributions are made.

The EIRA encourages families to save for their children's college education. They also help to move the tax system slightly toward education tax neutrality. The key tax benefit here is that the family can save for future education expenses and the earnings on those savings are tax-free. The benefit is only a slight remediation of the fundamental tax non-neutrality, however, because the principal amount—the contributions to the accounts—is subject to tax. In this way, the federal income tax is not treating the original contributions as saving at all, but as a form of consumption.

Individual Retirement Accounts

There are two types of Individual Retirement Accounts (IRAs) under present law. The traditional IRA allows both deductible and nondeductible contributions. Then there is the more recently created Roth IRA, under which only nondeductible contributions may be made. In both cases, withdrawals from an IRA before the age of 59 ½ are generally subject to a 10 percent additional tax. One exception to the early withdrawal tax surcharge is if the withdrawal is used to pay for educational expenses. The amounts withdrawn from a traditional IRA must still be included in the taxpayer's gross income, however.

At a time when the importance and the value to society of higher education is clear and increasing, such a punitive tax treatment on education seems highly unwise.

State Tuition Programs

Section 529 of the Internal Revenue Code provides tax-exempt status to "qualified state tuition programs." These programs are established and maintained by some states and permit a person to:

(1) purchase tuition tax credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses, or

(2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account.

In practice and in effect, these programs are similar to the Education Individual Retirement Accounts (EIRAs) mentioned above except that they are run by states under state-specified guidelines. As with EIRAs, contributions to a Section 529 account are made in after-tax dollars, while qualified distributions from a state tuition program are generally excluded from tax both to the contributor and to the student/beneficiary.

Employer-Provided Educational Expenses

The federal income tax allows for a variety of employer-provided fringe benefits to be excluded from the employee's taxable income. Some tax-exempt fringe benefits include health insurance, certain life insurance policies, and some parking expenses. Another such fringe benefit is an exclusion under Section 127 of the Internal Revenue Code of up to $5,250 annually of employer-provided educational expenses. The benefit is limited, however. For example, the exclusion does not apply to graduate courses. Also, the exclusion only applies if the employer has a separate written plan, the program must not discriminate in favor of highly compensated employees, and there are other limitations relating to expenses incurred on behalf of the business' owner and his or her immediate family. Even with these limitations, the effect of the employer-provided education expense exclusion is to achieve tax neutrality with respect to education for these expenses.

Individual Education Expenses

Individuals can exclude from income certain qualified education expenses under Section 162 of the Internal Revenue Code. In general, an individual can deduct education expenses under this provision if the education:

(1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or

(2) meets the express requirements of the taxpayer's employer, applicable law, or regulations imposed as a condition of continuing employment.

In addition, as a special provision relating to teachers, if the minimum teaching requirements have already been met, a teacher may deduct the expense of any education required to retain his or her position, even if the education will qualify the teacher to teach a new or different subject, lead to an advanced degree, or lead to a change of duties. Costs of courses to renew a provisional teaching certificate or that lead to a permanent certificate are deductible if necessary to continue teaching.

The Section 162 individual education expense deduction and the Section 127 exclusion are good examples of how the current tax code has moved in the direction of neutrality with respect to human capital formation. Unfortunately, the individual education deduction is inadequate in that it is restricted to those expenses associated with the individual's current occupation. This obviously discriminates against individuals needing to advance their education to shift careers. For example, a draftsman seeking to become a mechanical engineer or a nurse seeking to become a doctor would not be allowed to deduct her education expenses, but if she were to take a continuing education course in drafting or nursing, the expenses would be deductible. Similarly, the Section 127 fringe benefit is deficient in that it expressly excludes graduate courses, even those directly related to the employee's occupation.

> ***The current tax code has moved in the direction of neutrality with respect to human capital formation.***

Student Loan Interest Deduction

Individuals are generally denied a deduction for interest expense, with the notable exception of home mortgage interest expense. A second exception to this rule under Section 221 of the Internal Revenue Code is that certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such expenses, subject to a maximum annual deduction limitation currently set at $2,500. This deduction limitation phases out for individual taxpayers with modified Adjusted Gross Income of between $40,000 and $55,000 and for married filers with incomes between $60,000 and $75,000. The deduction is allowed only with respect to interest paid during the first 60 months in which interest payments are required. There is no deduction if the student is claimed as a dependent on another taxpayer's return for the taxable year.

A qualified education loan generally is defined as any debt incurred to pay to attend a qualified educational institution, including room and board. A qualified educational institution must be either:

(1) a post-secondary institution,

(2) a vocational training school, or

(3) an institution conducting internship or residency programs leading to a degree or certificate from an college, university, hospital, or a health care facility.

As with the previous provisions, the limitations and qualifications associated with this provision prevent it from moving the income tax significantly in the direction of neutrality with respect to human capital formation. In particular, the preclusion of the ability of a family to deduct the costs associated with a

loan taken out so that a child can attend a school is particularly unfortunate. It is also quite unfair and discriminatory in that a common technique for homeowners is to borrow against the equity built up in a home to pay for college and in this way to be able to deduct the costs of the effective student loan through the deduction for mortgage interest. Of course, those who rent rather than own their domiciles are denied this ability.

Tax-Exempt Scholarships

Under the normal principles guiding the federal income tax, scholarships, educational grants, and the like would be treated as current income. Current law, however, provides that amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees be exempt from gross income. While there are other limitations and conditions, it is important to note that this provision of current law is clearly neutral from a tax policy perspective in that it excludes income used for human capital formation.

HOPE Credit

A good example of the federal government seeking to reduce the tax disincentives to education is the recently enacted "HOPE" credit. The HOPE credit allows a nonrefundable income tax credit of up to $1,500 per student per year for qualified tuition and related expenses paid for the first two years of a student's post-secondary education in a degree or certificate program. Qualified expenses must be incurred by the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. HOPE credit availability phases out for married couples filing jointly with modified Adjusted Gross Incomes between $80,000 and $100,000. This credit is specifically designed to help a student or the family of a student to afford education expenses for the first two years of the student's post-secondary education. Once again, there are other qualifications and rules associated with the credit, but what is important is that it moves the tax code in the direction of a more neutral tax policy with respect to education.

> ***The preclusion of the ability of a family member to deduct the costs associated with a loan taken out so that a child can attend a school is particularly unfortunate.***

Lifetime Learning Credit

The Lifetime Learning credit allows qualifying individuals to claim a nonrefundable credit against federal income taxes of up to 20 percent of qualified tuition and related expenses up to $5,000 ($10,000 beginning in 2003). The credit is phased out for taxpayers with modified Adjusted Gross Incomes between $80,000 and $100,000. Unlike the HOPE credit, a taxpayer may claim the Lifetime Learning credit for an unlimited number of years. Also, whereas the HOPE credit limitation is determined on a per student basis, the Lifetime Learning credit is computed on a per family basis. Thus, whether the family has one student or four in college, the maximum amount of credit remains $1,000.

Discharges of Student Loans

When a taxpayer takes out a loan that he or she ultimately is unable to repay, if the debtor forgives the debt, then the debt is said to be discharged. Generally, when a taxpayer has debt that is discharged, the amount of the discharged debt is treated as income and is included in gross income. An exception exists for certain student loans. For qualifying loans that are discharged, the amount of the debt is not included in taxable income, provided the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers.

The exclusion from gross income of discharge of indebtedness for student loans is another slight but clear movement toward a neutral tax system with respect to human capital formation. It is equivalent, economically, to excluding the income that would have been used to pay off the student loan.

Education Savings Bonds

As demonstrated by the Education Individual Retirement Accounts and the support for qualified state tuition programs, Congress is concerned about helping families save for their children's college education. Though the motivation is certainly not explicitly to encourage a neutral tax treatment of human capital formation, the net result is very similar to the extent this concern manifests itself in a reduction in the tax burden on education. Another manifestation of this concern relates to the purchase of U.S. Series EE savings bonds. If such a bond is purchased after 1989, then the interest earned on the bond is excludable from taxable income as long the proceeds from the bond do not exceed qualified higher education expenses paid by the taxpayer during the taxable year. As is usually the case, however, this exemption phases out for taxpayers with incomes above a certain threshold. The phase-out range in this case for families filing jointly is between $83,650 and $113,650 in modified Adjusted Gross Income.

The federal income tax currently contains a great many special provisions to reduce the tax disincentives to education.

Employees of Education Institutions

Under Section 117(d) employees of education institutions who receive a reduction in tuition for either themselves, their spouse, or a dependent child may exclude the value of the reduction from their adjusted gross income. Qualified tuition reductions must be received by an employee of an educational organization for below-graduate-level education at that or a similar institution. A tuition reduction is also allowed a graduate student engaged in teaching or research.

Taken as a group, the federal income tax currently contains a great many special provisions to reduce the tax disincentives to education. As a group they reflect a clear recognition of the importance of education. However, each of them is so slight in effect that it is almost more political window dressing than serious tax policy. Furthermore, because they are so minor in magnitude, they certainly cannot be said to reflect recognition of true tax neutrality with respect to human capital formation.

They certainly cannot be said to reflect recognition of true tax neutrality with respect to human capital formation.

This can be seen more clearly if we consider the many education expenditures that are fully subject to tax. While not exhaustive, this list should indicate the magnitude and scope of the matter. Fully taxed education expenses generally include all tuition, fees, and related expenses:

- Incurred so that a child may attend private elementary or secondary school.
- Incurred so that an individual may prepare for the GED exam.
- Incurred relating to tutoring and special classes necessary to overcome a handicap or learning disability or incurred to otherwise improve the student's education.
- Incurred so that a student may attend a university, college, or technical school.
- Incurred to attend graduate school.
- Incurred as necessary for career advancement or for a change in career.
- That would be deductible, excludible, or qualify for a tax credit under current law but for an income test, a contribution limitation, or qualification limitation.

Education, Neutrality, and Tax Reform

All major proposals for fundamental tax reform can be grouped as being either aggregative or transactional. Aggregative tax systems, like the current income tax, the Flat Tax, and the USA tax, levy tax on aggregates of income received by the taxpayer. Thus, at the individual level the income tax is an

aggregative tax where all of a taxpayer's wages and salary and certain returns to capital are combined. Transactional taxes, in contrast, levy a tax on every transaction of a defined type. Typical transactional taxes include European-style Value Added Taxes, retail sales taxes, and excise taxes. Each type of tax system imposes its own set of problems and opportunities with respect to the taxation of education expenses. The two leading tax reform candidates, though not necessarily the best two candidates, are the Flat Tax and a national retail sales tax. It is worthwhile, therefore, as a further elaboration of the issues raised above to see how these alternative tax systems treat human capital formation.

The Flat Tax

The Flat Tax is in many ways superior to the current federal income tax. For example, it is unquestionably vastly simpler for both the taxpayer and the tax administrator. Compliance and administrative costs associated with the Flat Tax are commensurately much lower than those of the income tax. The Flat Tax is also almost neutral with respect to the decisions to save and invest—physical capital formation—which is the source of most of its potential to spur the economy to higher rates of non-inflationary growth. The one great failing of the Flat Tax, however, is that the base of the Flat Tax tends to leave it more punitive than current law to human capital formation—a weakness that may be only partly remedied by lower tax rates facing some taxpayers.

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The economy combines its resources to produce a stream of income generally called national income. This stream of income can be divided into three distinct components. The first component is the return to labor, essentially all wages, salaries, benefits, and so forth that is paid to individuals for the use of their backs and their brains. The second component is the normal returns to the owners of capital—those who have previously saved. An enormous amount of complex discourse revolves around precisely defining this "normal" flow of returns, specifically whether it includes only the non-risk rate of return or also includes the return to systematic risk. For purposes of this discussion, however, all that is important to know is that such a flow exists and to distinguish it from the third component of the national flow of income, which is the speculative returns to capital, or economic profit, earned on the nation's capital stock. These speculative returns are all those returns to capital in excess of the normal returns. Thus, the stream of income produced by the economy can be characterized as being either labor or capital income, and capital income can be further broken down into normal returns and economic profit.

In ideal form, the federal income tax would impose a single level of tax on all labor, normal returns to capital, and economic profits, irrespective of source or the form of the enterprise generating the income. In practice, of course, some labor income is excluded from tax through a myriad of deductions, exemptions, and credits, and some capital income is excluded as well, while other components of the stream of capital income can be subject to repeated taxation. The Flat Tax, in contrast, imposes a single level of tax on all labor income over a fixed amount, excludes all capital income from the tax base at the individual level, and imposes a single level of tax on economic profits at the business level. The essential differentiating characteristic of the tax base of the Flat Tax vis-à-vis the income tax is that it does not tax "normal" returns to capital either at the individual or business levels.

The Flat Tax completely fails when it comes to human capital formation.

Despite its laudable intent to pursue tax neutrality, the Flat Tax fails completely when it comes to human capital formation. While the Flat Tax properly permits businesses to deduct in full, or expense, the costs associated with their investments in plant and equipment, it permits no deduction or exclusion for individuals' expenditures on education. Thus it imposes an unwarranted tax burden on individuals seeking to increase their future earnings.

One of the selling points of the Flat Tax is its simplicity. Individuals and families, for example, are allowed no deductions or credits other than a single deduction that is specific to the size of the family. This elevation of simplicity as the paramount goal even superceding tax neutrality has caused the Flat Tax to violate tax neutrality in other areas besides human capital formation. For example, because of its emphasis on simplicity, the Flat Tax does not allow a deduction for charitable contributions, even though a neutral tax system would only levy tax on income received and either consumed or saved. Similarly, the Flat Tax fails to allow a deduction for state and local taxes paid, thus violating an intergovernmental dimension of tax neutrality.

As important a goal as is simplicity, it cannot be elevated to the primary consideration if we are to have a tax system that imposes the fewest possible distortions on economic decision making. With an issue as important as education in a modern economy emphasizing expanding knowledge and increasing skills, it should certainly not discriminate against human capital formation and it should not place simplicity over the need to avoid tax biases against education.

The Flat Tax should be modified to treat educational expenses properly.

Correcting this failing in the Flat Tax is relatively simple once simplification is put in perspective. Individuals should be allowed to deduct any and all costs for themselves or members of their family associated with education unless it cannot be shown that the education was intended to allow the student to earn a higher wage than would otherwise be the case. Even if the Flat Tax improperly continues to deny a deduction for state and local taxes paid generally, an exception should be made for those state and local taxes that pay for public education at any level.

In addition, if a child needs special tutoring, these costs ought to be deductible under a Flat Tax. If a child goes to a private school, then all tuition, fees, and directly related expenses ought to be deductible. All costs associated with the pursuit of a bachelor's degree or other certificate or diploma ought to be deductible. At some point in the educational ladder, some distinction will be needed for educational efforts that are clearly consumptive in nature and not intended to increase future earnings of the student, but once this distinction is settled then all costs with all other educational endeavors should be deductible.

The simplicity of the Flat Tax is one of its most popular features, and with good reason given the inane complexities of the federal income tax. Nevertheless, simplification should not be allowed to run roughshod over tax neutrality, or tax reform will forego much of its potential benefits. This is certainly the case with respect to human capital formation. In that the correctives are so easy to achieve, the Flat Tax should be modified to treat educational expenses properly.

National Retail Sales Tax

The national retail sales tax is currently the primary alternative to the Flat Tax among tax reform options. In the abstract, it is a relatively simple tax with which Americans are very familiar as many states impose their own general sales taxes. In most versions of the tax, a specific percentage levy is imposed on every retail sale of a good or service. Because the tax is imposed only at the final sale, it automatically excludes from tax all purchases of goods and services by businesses for the purpose of generating future income. To avoid imposing an undue tax burden on low-income individuals, provisions are made for individuals to file a claim for an annual refund amount depending on their level of income.

Like the Flat Tax, the national sales tax is also highly punitive toward education.

The sales tax, like the Flat Tax, has its strengths and weaknesses. Like the Flat Tax, for example, the common form of a national retail sales tax is neutral with respect to physical capital formation and so it offers the real promise of more rapid growth in jobs and wages. However, like the Flat Tax, the sales tax is also

highly punitive toward education. And, like the Flat Tax, corrections to remedy this failure are fairly straightforward.

Under a sales tax, individual purchases of goods and services are generally subject to tax unless it can be demonstrated that the item purchased will be used to generate future income. Thus, for example, when an individual purchases a car the full amount of sales tax would generally be imposed unless the individual can show the car is necessary for his or her profession and will only be used for that purpose.

A common problem of sales taxes is determining when an item is purchased for consumption and when it is purchased as part of a business enterprise. For some items, of course, the issue is fairly straightforward. Few individuals, for example, buy industrial lasers for their personal consumption. On the other hand, it can be much more difficult to distinguish when an item such as an automobile is purchased only for business purposes. It is certainly nearly impossible as an administrative matter to know that a vehicle claimed to have been purchased for business purposes is never used for personal use. For all the difficulties in this regard, the states that levy broad-based sales taxes have dealt with the issue for years and it is reasonable to expect that the federal government could extrapolate from this experience in the introduction of a national retail sales tax.

While an industrial laser is excluded from taxation under a sales tax, the education necessary to train someone to work that laser is fully taxed.

Generally, sales taxes do not exclude from the tax individual expenses associated with education. Sales tax proposals do not generally exclude tuition, fees, and books at any level of education from the tax base. Thus, while an industrial laser is excluded from taxation under a sales tax, the education necessary to train someone to work that laser is fully taxed. This treatment is clearly non-neutral and distortive, in just the same way as the Flat Tax's treatment.

The non-neutrality of the sales tax extends to a second dimension that needs to be mentioned for completeness. As noted above, sales tax proposals include some form of rebate or allowance system to offset in whole or in part the sales tax paid by low-income individuals and families on their consumption purchases. The amount of rebate they receive can be related to their income for the period and, generally, the rebate is phased out as a family's income rises beyond a certain threshold.

The definition of the family's income is obviously critical to the calculation of the family's rebate. If done properly, the definition would be based on the family's labor income including wages, salary, and fringe benefits, and would exclude any form of capital income. In order to be fully neutral with respect to human capital formation, the definition of income for purposes of calculating the rebate would also need to exclude any family expenditures on education for any family member included in the tax rebate filing.

Conclusion

Sound tax policy, whether improving the current federal income tax or state income taxes, or enacting fundamental tax reform, should always be directed with the overarching goal of improving people's lives. Better tax policy should help markets operate more efficiently. It should help individuals make better decisions about their economic lives today and tomorrow. And it should help businesses make better decisions about how much capital they should employ and how they should finance the purchase of this capital.

High tax rates on labor income are essentially a form of punishment for success.

Much of the focus of tax policy has been about helping individuals make better decisions about their current saving by eliminating the tax biases of current law against saving. Similarly, much of the focus at the business level has been about helping businesses make better and wiser decisions about their investments. Tax policy should place the same emphasis on the decisions individuals make to invest in themselves and their family members.

Taxation involves two distinct though not independent aspects, namely the tax rate and the tax base. Each of these aspects can create a disincentive toward education. High tax rates on labor income, for example, are essentially a form of punishment for success. They discourage the education process by reducing the returns to the education investment. Indeed, it is patently contradictory to encourage education as a national priority and simultaneously support high tax rates on labor income.

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Education can be discouraged by high tax rates on the returns to the education investment, but it can also be discouraged by raising the after-tax cost of that investment. Human capital formation is both a form of saving and a form of investment and should be treated neutrally by the tax system along with setting aside current income for future consumption and along with business capital formation. In the past, both income taxes and the dominant proposals for fundamental tax reform have failed to place the proper emphasis on education and so both have permitted a highly distortive and deleterious bias against education to persist.

It has often been said that the current U.S. tax system is woefully inadequate to the demands of the 20th century. And this is true for many reasons. But most tax reform proposals are equally inadequate to the demands of the 21st century. We can glibly say that people should be treated at least as well as machines. But in an increasingly information-based economy, where technology in product and production methods changes constantly, where "intangible capital" and know-how yield the highest value-added, and where "clicks" may one day be as important as "bricks," tax policy must treat human capital formation at least as well as it treats physical capital formation, and tax reform should strive to treat each of them neutrally.

Editor's Supplement

"Realized" Human Capital: *Managers, Innovators and Entrepreneurs*

If economic growth were only a pedantic progress of mobilizing men, money and materials, most economic systems would be viable. Systematic education of managers would suffice to supply the human ingredients. In fact, all the net new employment in the private sector of the U.S. economy comes from competitors who did not exist two decades earlier, living witness to Joseph Schumpeter's description of capitalism as a process of "creative destruction."

Does federal taxation encourage or discourage this entrepreneurial "creative destruction" process?

At the root of nearly every significant and successful innovation stands a singular individual, or at most a few. While this singular individual may be a professional businessman or multi-degreed scientist, more often than not he or she lacks extraordinary credentials, and may even be a school dropout or job jumper. What is common to all entrepreneurs is the capacity to see not what is but what can be; to muster the courage to risk loss of financial security and self-image for the prospect of personal wealth and self-actualization; and to organize the capability to make it happen. Whatever the ingredients in whatever proportion of formal education versus the "school of hard knocks," innovative experimentation versus inspiration, or experience versus natural aptitudes, entrepreneurial talents are arguably our most valuable national asset.

In order to answer whether federal taxation encourages or discourages the entrepreneurial process, it is necessary to see what are the effects of taxation on the factors which affect commitment to

innovation, and success of the committed venture. These factors are: sufficient personal savings to at least weather the period from inception to commercialization; reasonable terms for securing adequate capital; cash flow necessary to meet the requirements of growth; and prospects for ownership and wealth.

Few families will accept the risk of forming a new venture until they have achieved the goal of a middle class life style and sufficient savings to prevent disruption during startup. Not surprisingly those that will are often immigrants with low lifestyle expectations and less to lose, particularly for entry into service businesses with low cost of entry. Manufacturing enterprises typically require more specific qualifications, larger scope and more initial capital.

Financial planners consider six month's income a precondition for financial security. Before most married families with children can fund that goal comes investment in autos, furnishings, home ownership, 401K retirement plans, and kids education. That requires above median family income, with the consequence of 28 percent income tax on top of 15.3 percent payroll taxes, a composite 43.3 percent marginal tax. An escalating rate schedule on income tax and phaseouts combine to maintain high marginal rates above the $84,900 maximum FICA income, and up to double that for the typical two income family.

High marginal income tax rates thus limit the savings of potential entrepreneurs, with the result that they are more hesitant than otherwise to "take the plunge." It is demonstrable that higher marginal personal income tax rates in Europe have been accompanied by lower rate of new business formation compared to the U.S.

The U.S. could expect a higher rate of new business formation from the lower marginal personal tax rates and higher personal savings that would result from the single rate, consumption-based taxation proposed for fundamental tax reform.

Not long ago it was reported that the average business in the U.S. has a life of 4 years. The cost of venture capital must cover this high risk of failure. Use of a limited liability partnership or subchapter S status can allow write-off of startup losses, but loss of the original capital can only be offset against capital gains, other than the annual pittance allowed under current law. This raises cost of capital to the entrepreneur for federal tax purposes.

The number one incentive for entrepreneurs is ownership of all or at least a major portion of the business created. This requires either substantial capital on the part of the venturer, or the use of other peoples' money. When the venturer has limited or no investable capital, some combination of leverage and "sweat equity" participation in earnings and residual capital, is the usual alternative. However, participation in earnings is taxed as ordinary income, requiring payout of at least a sufficient portion to pay the taxes. Gains on stock options are taxed as ordinary income if the recipient holds 10 percent or more of the outstanding shares, frustrating the goal of more substantial ownership.

A consumption tax would not pose these disincentives to risking loss and betting on "sweat equity."

Ownership often connotes the opportunity to pass on a family business to one's children, particularly a business of a scale that would assure heirs the "good life" and stature in their hometown. Inheritance taxes serve to dissuade such motives for new business creation and continued investment in an enterprise.

A consumption tax would eliminate the inheritance tax, and with it disinclination to build or perpetuate a family business.

One should not underestimate the importance to major established businesses of attracting and retaining senior management with the ability to direct the continuous process of renewal necessary to avoid being a casualty of "creative destruction." When politicians disallow a corporate tax deduction for compensation of an executive in excess of one million dollars, that sends a message that rock stars or movie stars deserve $20 million a performance or sports stars $10 million a year, but a Fortune 500 executive cannot be worth over $1 million dollars.

Tax reform proposes equal treatment before the tax law for everyone, not arbitrary taxation at the mercy or whimsy of the political climate of the moment.

Many economists picture an economy whose composite savings pool is like a bathtub. They claim it makes little difference at which end you pour the water; the effect will be the same uniform level. In reality it makes a huge difference whether the would-be or emerging entrepreneur saves a dollar of taxes, or whether that dollar of taxes is taken by the federal government and deposited in financial intermediaries with slender likelihood the result will be timely financing of entrepreneurs.

The entrepreneurial process is the single most important source of America's economic success. The right kind of tax reform would strongly encourage entrepreneurship and innovation in important ways, while the current code tends to discourage this vital national asset.

—David A. Hartman, Series Editor

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The Road Map to Tax Reform™ is a series of studies published by the Institute for Policy Innovation (IPI) and produced in cooperation with participating organizations. The purpose of this project is not to promote a particular tax reform plan or proposal, but to provide research, analysis and argument in service of fundamental tax reform toward a neutral federal tax system, and to work with all proponents of such reform. The series consists of topical investigations by leading experts, with the goal of creating a corpus of research that makes a truly comprehensive case for a neutral, transparent, and simple tax code.

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