Institute For Policy Innovation IPI

QUICK STUDY

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.*

THE ROADMAP TO TAX REFORM™

Tax Reform and Human Capital Formation:

Putting Education into the Equation

By J.D. Foster, Ph.D.

Introduction

Fundamental tax reform discussions and proposals have heretofore tended to ignore a crucial and basic economic role of people: It takes people to imagine new means of production, to know how to develop those innovations, how to produce them, how to test them, and ultimately how to employ them. Tax reform is often so concerned with investment in plant and equipment, what economists call "capital formation," that human capital formation is forgotten.

High and rising taxes discourage human capital formation in the same way they discourage work or saving or investment in physical capital. A burdensome tax on education can be offset in part by a myriad of complex additions to the federal income tax (how this has been attempted so far is described below), 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.

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. Higher levels of education give people greater mobility across professions as well as greater upward income mobility. What return is there on the national level? According to a study by economists James Klenow and Peter Heckman of the University of Chicago, 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," an extra benefit to education enjoyed by society that is not captured by the individual.

In addition to the economic benefits of human capital formation, the societal consequences of having a more educated population should not be ignored. The more educated a people, the more stable its communities. 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. A more educated people 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. Neutrality occurs when relative prices are undisturbed by government intervention (such as high taxes).

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. 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. Thus, individuals and businesses face a tax disincentive to saving and investment.

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.

Neutrality and Human Capital Formation

Just as tax reform proposals have addressed the need to make taxes neutral to physical capital formation, the proper tax treatment of human capital formation is also neutrality. 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.

The Current Taxation of 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. On the other hand, there remain some gross inequalities in the current tax treatment of education. Some of the efforts enacted to fix the system are described (with their limitations) in the next section.

Tax "Incentives" for Education in the Federal Income Tax

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.

Education Individual Retirement Accounts

Under Section 530 of the Internal Revenue Code, Education Individual Retirement Accounts (EIRAs) are certain trusts or custodial accounts created exclusively for the purpose of paying qualified higher education expenses of a named beneficiary. The benefit is only a slight remediation of the fundamental tax non-neutrality because the principal amount—the contributions to the accounts—is subject to tax.

State Tuition Programs

Section 529 of the Internal Revenue Code provides tax-exempt status to "qualified State tuition programs." 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.

HOPE Credit

The recently enacted 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.

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.

In addition to these programs, there are several other provisions such as exclusions from taxable income of scholarships and interest on certain savings bonds. There are also deductions of student loans, employer-provided education and some forms of individual educational expenses. Taken as a group, the federal income tax currently contains a great many special provisions to reduce the tax disincentives to education.

However, they certainly cannot be said to reflect a recognition of true tax neutrality with respect to human capital formation. Fully taxed education expenses generally include all tuition, fees, and related expenses for the following (among others): private education, preparation for the GED exam, tutoring for special cases, higher education, graduate school, instruction for a career change.

Education, Neutrality, and Tax Reform

In considering how tax can discourage or encourage human capital formation, we now turn to two major tax reform proposals to see how they treat investment in education. As mentioned already, in their current forms they fall far short of neutral taxation with regard to the expenses of education. But the remedy to these shortcomings is simple.

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. In contrast to the non-neutral federal income tax, the Flat Tax 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.

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. Correcting this failing in the Flat Tax is relatively simple once the goal of 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 (including tutoring, private schooling, and higher 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.

Tax 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 primary alternative to the Flat Tax among tax reform options, the national retail sales tax is a specific percentage levy imposed only at the final sale of goods, and it automatically excludes from tax all purchases of goods and services by businesses for the purpose of generating future income. The sales tax, like the Flat Tax, has its strengths and weaknesses. 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.

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. This treatment is clearly non-neutral and distortionary, in just the same way as the Flat Tax's treatment. Making educational expenses excludable from the national retail sales tax base is a simple way to give it full neutrality with respect to human capital formation.

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. In order to be fully neutral with respect to human capital formation, the definition of income for purposes of calculating the rebate should exclude any family expenditures on education for any family member included in the tax rebate filing.

Conclusion

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. 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.

Virtually every industry and every occupation is experiencing a rapid infusion of new technologies. 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." 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.

Editor's Supplement

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

At the root of nearly every significant and successful innovation stands a singular individual, or at most a few, with the courage and ability 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. Such entrepreneurial talents are arguably our most valuable national assets.

The factors that affect commitment to innovation, and success of the committed venture are: sufficient personal savings, reasonable terms for securing adequate capital, cash flow necessary to meet the requirements of growth, and prospects for ownership and wealth.

Financial planners consider six month's income saved a precondition for financial security. But high marginal income tax rates limit the savings of potential entrepreneurs. 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.

Entrepreneurship 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.

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

Inheritance taxes frustrate the continued investment in and passing on of a family business to one's children.

A consumption tax would eliminate the inheritance tax, and with it disincentive to develop and perpetuate a family business.

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.

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

Editor & Publisher . . . . Tom Giovanetti

IPI *Quick Study* is published by the Institute for Policy Innovation (IPI), a non-profit public policy organization.

Direct all inquiries to: **Institute for Policy Innovation**
250 South Stemmons, Suite 215
Lewisville, TX 75067

(972) 874-5139 (Voice)
(972) 874-5144 (FAX)

Email: ipi@ipi.org
Internet Website: www.ipi.org

This study is a summary of IPI Policy Report # 173, *Tax Reform and Human Capital Formation: Putting Education into the Equation,* by J.D. Foster, Ph.D., Senior Advisor (Economics), U.S. Department of the Treasury..

Want More Info?

Copies of the full study are available from our Internet Website (**www.ipi.org**), in HTML and Adobe® Acrobat® format. Point your browser to our website, and follow the dialogs to the Policy Reports section.

Or contact IPI at the address at left, and we'll mail you a full copy.