

Center for American Progress



Testimony to the President's Tax Reform Panel

John D. Podesta

President
Center for American Progress

May 11, 2005

Progressive Ideas for a Strong, Just and Free America



Overview

- **The Center for American Progress Tax Reform Plan**
 - **Fair and Responsible Reform**



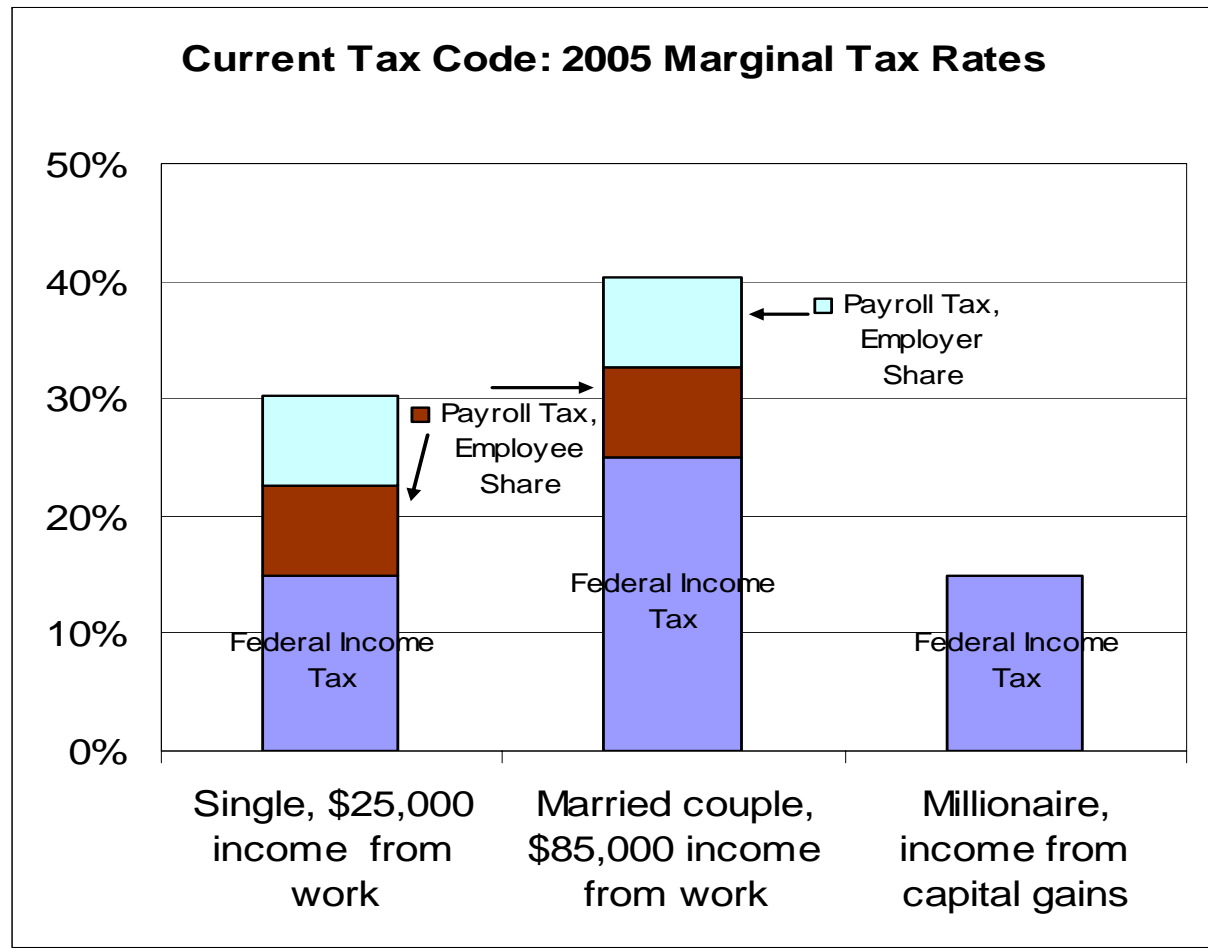
The Center for American Progress Plan: Principles

- Fairness
 - Treat income from wealth and work equally
 - We should rely on progressive forms of taxation
- Simplicity
- Opportunity and Economic Growth



The Current Tax Code: Preferential Treatment for Wealth

- Under the current system, middle-income taxpayers can easily pay twice the tax rate on income from work than millionaires pay on income from wealth.





Fairness

- **Each Source of Income Will be Taxed the Same**
 - in other words, we will tax income from wealth—capital gains and dividends—according to the same rate schedule as ordinary income.
- **We Will Reduce the Dependence on Regressive Payroll Taxes**
 - the Center’s plan will remove the employee side of the Social Security Payroll Tax, and remove the cap on the employer side.
- **We Will Enhance the Take-Home Pay of Lower-Income Taxpayers**
 - by reducing the marriage disincentive of the EITC while expanding eligibility for the child tax credit.
- **We Will Reform the Estate Tax**
 - our plan increases the exemption to \$2.5 million to further ensure that virtually all small business owners, farmers and ranchers could pass on their assets without being subject to the estate tax, while still asking the very wealthy to paid their fair share.



Simplicity

- Reduce the Number of Income Tax Brackets
 - At 15%, 25%, and 39.6%,
 - Brackets set at \$0, \$25,000 and \$120,000 of taxable income, with a \$10,000 standard deduction (all indexed to inflation).

- Our Plan Will Eliminate Corporate and Individual Tax Loopholes
 - that now allow corporations and wealthy individuals to avoid paying their fair share of taxes.

- Eliminate the Alternative Minimum Tax in a responsible manner by undertaking comprehensive reform



Increasing Economic Opportunity and Growth

- **Reduce the Deficit**
 - Increases national savings by raising \$500 billion over 10 years relative to the president's policy.*
- Offer Tens of Millions of Americans **New Opportunities to Save and Create Wealth for Retirement**
 - Replace retirement savings deductibility with 25% refundable matching credit
 - Additional revenue could be used to increase savings incentives for low- and middle-income savers
- **Encourage long-term savings**
 - For those earning less than \$1 million annually, assets held at least 1 year would be able to exempt 10% of their capital gains. The exemption would increase by 10 percentage points annually, and for assets held for more than 5 years, they would receive a 50% exemption.

*Distributional and revenue estimates derived from Urban/Brookings Tax Policy Center's micro-simulation model, see <http://www.americanprogress.org/tax> for more details.



Distributional Implications

The tax plan will:*

- increase the take-home pay of most people earning under \$200,000 a year, and will provide an average tax cut of over \$600 for this group.
- Most of those making more than \$200,000 a year will likely see a tax increase relative to current policy.

Cash Income Class (thousands of 2003 dollars)²	Percent with Tax Cut	Percent with No Change	Average Tax Change (\$)
Less than 10	59.9	29.4	-220
10-20	63.6	19.3	-524
20-30	73.1	6.6	-620
30-40	73.0	3.8	-496
40-50	72.8	2.0	-519
50-75	76.7	0.4	-687
75-100	76.1	0.1	-950
100-200	73.7	0.0	-1,138
200-500	24.1	0.0	12,722
500-1,000	6.8	0.0	64,752
More than 1,000	3.9	0.0	360,646
All	68.4	9.1	793.1

*Distributional and revenue estimates derived from Urban/Brookings Tax Policy Center's micro-simulation model, see <http://www.americanprogress.org/tax> for more details.



Enhancing Retirement Security

- **New savings incentives** for over 30 million Americans by enacting refundable credits for retirement savings**
- Enhance our full **commitment to financing Social Security**
 - Eliminate the cap on the income limit for the employer payroll tax (currently set at \$90,000)
 - Dedicate a portion of general revenues—2.25% of GDP—to the Social Security trust fund
 - Enact safeguards to prevent Congress from reducing this dedicated stream. Any reduction can be made only after a three-fifths majority vote in the Congress
 - The additional revenue raised by our plan would be sufficient to cover these dedicated funds
 - This would cut in half the long-run, 75-year difference between dedicated revenues and outlays**
- **Reduce the deficit** – make sure that revenues are available to meet the challenge of an aging population

**For full details on the implications of the plan, see <http://www.americanprogress.org/tax>.



June 9, 2005

The President's Advisory Panel on Federal Tax Reform
1440 New York Avenue NW, Suite 2100
Washington, DC 20220
comments@taxreformpanel.gov

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 formation. 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).

Comments submitted to the President's Advisory Panel On Federal Tax Reform
Center for American Progress – June 9, 2005

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.”

References

David, Paul A., with John Gabriel Goddard Lopez (2001), “Knowledge, Capabilities and Human Capital Formation in Economic Growth,” New Zealand Treasury Working Paper, no. 13 (June), 2001, 143pp. Available in pdf format at: <http://www.treasury.govt.nz/workingpapers/2001>.

David, Paul A. (2003), “Reforming the Taxation of Human Capital: A Modest Proposal for Promoting Economic Growth,” Economics for an Imperfect World: Essays in Honor of Joseph Stiglitz, eds. R. Arnott, B. Greenwald, R. Kanbur, and B. Nalebuff, MIT Press, Cambridge MA. Available at <http://www-econ.stanford.edu/faculty/workp/swp01007.pdf>.

Jacobs and Bovenberg (2005), “Human Capital and Optimal Positive Taxation of Capital Income,” Tinbergen Institute Discussion Paper No. TI 05-035/3.

Judd, Kenneth (1998), “Taxes, Uncertainty and Human Capital,” *American Economic Review* 88(2), p. 289-92.

Steuerle, C. Eugene (1996), “How Should Government Allocate Subsidies for Human Capital?” *American Economic Review*, vol. 86 (1), pages 353-57.

Trostel, Phillip A. (1993), “The Effects of Taxation on Human Capital,” *Journal of Political Economy*, 101(2), p. 327-50.

Trostel, Phillip A. (1997), “The Incentive Effects of Tax and Education Policies,” *Policy Options*, July/August, p. 54-57.