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Human capital investment and globalization in extortionary states

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Abstract

This paper considers education investment and public education policy in closed and open economies with an extortionary government. The extortionary government in a closed economy chooses an education policy in order to overcome a hold-up problem of time-consistent taxation similar to benevolent governments. The two types of government differ in their education policies if highly productive labor is mobile. Extortionary governments' incentives for a policy that stimulates higher private education efforts vanish; instead they have incentives to prevent individuals from mobility-increasing education investment. Tax competition therefore reduces hold-up problems of time-consistent extortionary taxation, but introduces other distortions that reduce workers' utility.

Keywords: Migration; Education; Globalization; Commitment; Time consistent income taxation

JEL classification: H21; H23

1. Introduction

The transaction costs of migration are declining in Europe. Migration obstacles within the EU, for instance, have been abolished in several steps, with the biggest

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step made in 1992 when the common market that granted free mobility for factors was introduced. The resulting increase in mobility is discussed and documented in, for example, Wildasin (2000). In addition, the further EU enlargement that opens up the labor markets between the current members of the EU and the countries currently applying for membership, as well as other global trends, will further increase labor mobility in the first decade of the new century. In this paper we consider the impact of increased mobility for education policy and the taxation of returns from human capital investment.

The starting point of this paper is the well-established insight that optimal education policy and taxation of human capital income are closely related. Human capital investment suffers from a severe hold-up problem. The optimal time consistent tax on the returns from human capital investment is high at the time when education investment decisions are already made. This high tax is anticipated by individuals at the stage when they make their investment choices, and this reduces their incentives to invest.[1] Boadway et al. (1996) analyze this problem and show that mandatory education or, similarly, subsidized provision of public education is a natural solution to this problem.[2] Hence, public provision of education is a second-best policy. It is chosen as a remedy for the detrimental welfare effects of time consistent human capital income taxation in a closed economy.[3] While Boadway et al. (1996) consider benevolent governments, it is clear that benevolent governments as well as kleptocrat or Leviathan governments face the same hold-up problem when it comes to the taxation of human capital returns; hence, their analysis carries over qualitatively to the Leviathan case.

Increased international mobility of skilled labor changes the set of constraints under which national policies are chosen. Taking the private investment problem and time consistent taxation as an isolated problem, it has been emphasized in the

[1] Kydland and Prescott (1980) were among the first to analyse time consistent taxation of investment returns and the hold-up problem it generates in the context of capital income taxation.

[2] Indeed, this instrument is widely used in many OECD countries. Public investment in schooling and higher education is considerable. The mean of public expenditure on educational institutions among OECD countries was 5.3 percent of GDP in 1998 (OECD, 2001a, p. 100) and this amount exceeds private expenditure on educational institutions by several hundred percent. While public subsidies to education as a second-best tool may be important for all levels of education, there are important additional aspects justifying public intervention, particularly for primary and secondary education. Total expenditure on tertiary education are also considerable, averaging 1.59 percent of GDP in the OECD countries in 1998, and the average share of public financing exceeds 80 percent if subsidies to households are included (OECD, 2001a, p. 81 and 94). Given the fact that human capital is, for most parts, a private good, this may be surprising. In addition, human capital returns are highly taxed. Maximum personal income tax rates of central government within the OECD averaged 54.2 percent in 1986, and ranged from 33 percent (New Zealand) to 66 percent (Belgium), with an OECD average of 50.2 percent in 1998 (OECD, 1989, 2001b).

[3] Gradstein (1998) has made a similar point regarding the role of public provision of education; Kanniainen and Poutvaara (2000) have explored how complementarities in production make subsidization of education desirable.