

The Impact of the FairTax on Education

The FairTax is the most pro education tax reform proposal, and is much more supportive of education than current tax law. In fact, the FairTax makes education about half as expensive to American families, compared to today's current educational costs. The FairTax embodies the principle that investments in people (human capital) and investments in things (physical capital) should be treated comparably. The current tax system, in stark contrast, treats education expenditures very unfavorably.

Current Law

Tuition expense is not tax deductible. Today, to pay \$10,000 in college or other school tuition, a typical middle class American must earn \$15,540---and this number reflects only federal income taxes and the employee payroll tax.¹ The amount one must earn to pay the \$10,000 is really more like \$20,120, once employer and state income taxes are taken into account.²

Although tuition expense is not tax deductible, contributions to certain not-for-profit educational organizations are generally tax deductible as charitable contributions.³ Salaries of teachers and others in education are subject to income and payroll tax.

In the absence of a special rule, when an employer pays the tuition expense of an employee, that expense would be viewed as taxable compensation to the employee. However, section 127 allows up to \$5,250 of such educational assistance to be excluded in certain circumstances.

Generally, interest expense that is not related to a taxpayer's primary residence, business or investments is not tax deductible. However, in 1997 and 1998, the law was modified so that in the year 2000, educational loan interest up to \$2,000 per year was deductible, with a possible \$2,500 deduction in the year 2001 and thereafter. Moreover, the interest deduction is allowed only for the first 60 months and only in certain circumstances. The deduction starts to be phased out for couples with adjusted gross income over \$60,000 and fully phased-out for couples with adjusted gross income over \$75,000. For single persons, it is fully phased out at \$55,000.⁴

Pursuant to section 2503(e), gifts for purposes of paying tuition are not subject to the gift tax. Scholarship recipients are not subject to income tax on the money received provided various

¹ \$15,540 less 7.65 percent in employee Social Security (\$1,189) and Medicare payroll taxes less 28 percent in federal income taxes (\$4,351) leaves \$10,000.

² Economists generally agree that the employer share of payroll taxes is borne by the employee in the form of lower wages. This figure assumes that employees bear the burden of the employer payroll tax and that they are in a seven percent state and local income tax bracket. \$20,120 less \$5,634 in income tax (28 percent), \$3079 in payroll taxes (15.3 percent) and \$1,408 in state and local income taxes (7 percent) leaves \$10,000. Ignoring state taxes, but including all payroll taxes, the required earnings would be \$17,637.

³ Provided that the educational institution has received a favorable determination from the IRS pursuant to section 501(c)(3) and further provided that the limitations on charitable contributions or restrictions on itemized deductions do not apply.

⁴ See I.R.C. section 221.

requirements and restrictions, and that the money is used for tuition, fees, books, equipment and related expenses rather than living expenses.⁵

⁵ I.R.C. section 117.

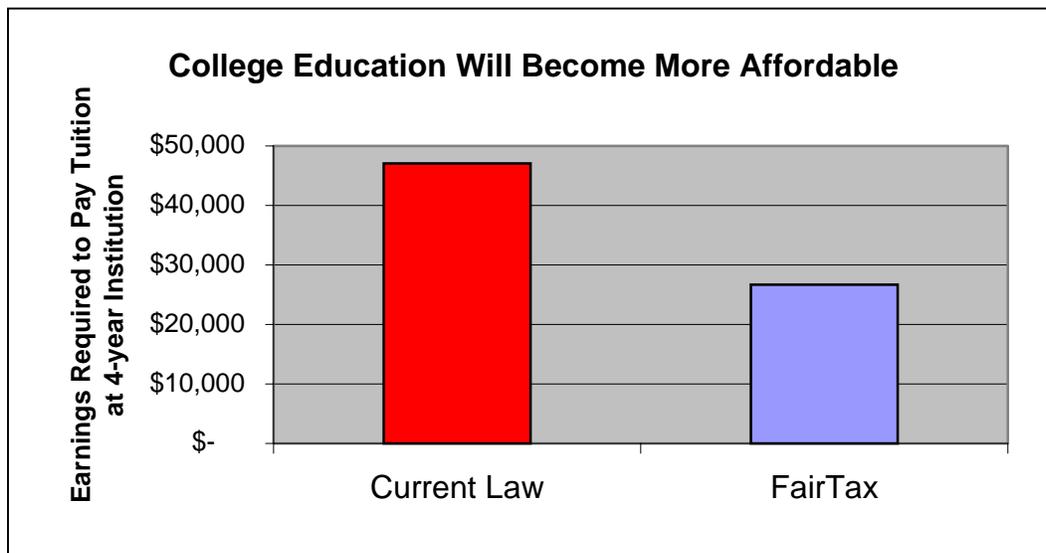
The FairTax

The FairTax does not tax education expenditures.⁶ Education can be paid for with pre-tax dollars. This is the equivalent of making educational expense deductible against both the income tax and payroll taxes today. Thus, under the FairTax, a family will need to earn \$10,000 to pay \$10,000 in tuition, making education much more affordable.⁷ Compared to current educational costs, The FairTax makes education about half as expensive to American families.

The FairTax also fully exempts government schools from tax. There will be no more income or payroll taxes on teachers. Schools will no longer need to withhold taxes from their teacher's checks or pay taxes on their employees. Government education expenditures will be free of tax.

Under the FairTax, saving for education will become much more affordable. Savings would be made from pre-tax dollars and the return to savings would not be taxed until it was spent on consumption goods. Accordingly, it will be much easier and take less time to save for educational needs under the FairTax.

Education is the best means for the vast majority of people to improve their economic position. It is the most reliable means that people have to invest in themselves and improve their earning potential. Yet the tax system today punishes people who invest in education, virtually doubling its cost. Only the FairTax would remove this impediment to upward mobility.



⁶ H.R. 2525 defines education and training to mean “tuition for primary, secondary, or postsecondary level education, and job related training courses.” It excludes “room, board, sports activities, recreational activities, hobbies, games, arts or crafts or cultural activities.”

⁷ If the states kept their income taxes rather than replacing them with a sales tax, then the family would need to earn \$10,753, about half of what they would need to earn today.

Tuition at a 4-year institution of higher learning averaged \$6,672 annually for the 1998-99 academic year.⁸ To pay that bill, a middle class taxpayer would have to earn \$11,767 or \$47,069 over four years under the current tax system. As the chart shows, under the FairTax, that same taxpayer would only have to earn \$26,688 to pay the same tuition bill.

Other Tax Reform Plans

The flat tax would not allow education expenditures to be deducted. Accordingly, it retains the bias against investment in education as compared to other investments.

Under the flat tax, most Americans will have to earn less (\$13,158) than they would today to pay \$10,000 in education expense because the flat tax lowers marginal tax rates substantially.⁹ Thus, education will become more affordable under the flat tax. However, the disparity in the relative tax treatment of education investment as opposed to other investment will actually be exacerbated to some degree, since the flat tax would expense other investments and allow no deduction for educational expenses. Today, other investments are depreciated over many years and subjected to multiple layers of tax in many instances. Accordingly, today both educational investments and other investments are disfavored. The flat tax, in contrast, is neutral toward all investments except investments in education.

The original USA Tax had relatively high marginal tax rates for much of the middle class (40 percent) and did not afford a deduction for educational expenditures.¹⁰ Accordingly, it would have been the least favorable tax reform plan with respect to education. However, a new version of the legislation introduced by Rep. Phil English has much lower marginal tax rates and an education deduction. Accordingly, the English proposal is more favorable toward education than the flat tax. The English proposal, however, would have somewhat higher marginal tax rates for many Americans than the FairTax and would continue to require school systems to deal with income and payroll taxes.

In both the case of the flat tax and the USA Tax, saving for education will become easier. In the case of the flat tax, individuals will need to save from after-tax dollars but the returns from those dollars will be exempt from additional tax. This is similar to the tax treatment of a Roth IRA under current law. In the case of the original USA Tax, savings will be deductible when made and taxed on withdraw.¹¹ This is similar to the tax treatment under a regular IRA under current law except that there is no additional penalty beyond tax upon withdrawal. The Rep. English version of the USA Tax would adopt the Roth IRA treatment of savings.

⁸ Digest of Education Statistics, 1999, Table 317. Average undergraduate tuition and fees and room and board rates paid by full-time-equivalent students in institutions of higher education, by type and control of institution: 1964-65 to 1998-99.

⁹ They would have to earn \$13,158 less \$2237 in flat tax and \$921 in state tax (assuming a 7 percent rate).

¹⁰ Originally promoted in a book and introduced by Sens. Nunn, Domenici and Kerrey.

¹¹ In the case of the bill introduced by Rep. English (H.R. 134, 106th Congress), savings are treated as in Roth IRAs.

Conclusion

Rather than punishing people who are trying to improve themselves through education as the current tax system does, the FairTax is neutral toward education. Education will be much more affordable and upward mobility will be enhanced. The FairTax is significantly more favorable toward education than the flat tax and the original USA Tax. The FairTax is somewhat better than the Phil English version of the USA Tax because the FairTax has somewhat lower marginal tax rates for many Americans and continues to require education systems to deal with income tax and payroll tax compliance.