

## INTRODUCTION

The Center for American Progress is pleased to host a full-day conference with academic and policy experts from around the country who will highlight options for reforming the tax code. Many experts agree that the tax code is in need of repair. Yet it has been 20 years since the landmark 1986 reform. Given the growing complexity of the tax code, increased revenue pressures, and a changing economy; tax reform will likely be a central issue for 2006 and beyond. This conference will provide a forum for sharing proposals—both quick fixes and broad overhaul—and for open and engaged discussion.

The papers included in this packet are the views of the authors and do not necessarily represent the position of the Center for American Progress.

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# SIMPLIFY, REFOCUS, AND COORDINATE TAX INCENTIVES FOR HIGHER EDUCATION

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## OVERVIEW

Economic research has consistently shown that a college education is well worth the investment, both for individuals and for society. Gaps between earnings for college graduates and those with a high school education or less are large and have grown over time. Over a lifetime, those with a bachelor's degree can expect to earn about one million dollars more than those with only a high school diploma.<sup>2</sup> College graduates are also more likely to vote and more likely to engage in healthy behaviors.<sup>3</sup>

In addition to the private returns to college attendance, there are significant productivity benefits to having a well-educated citizenry and workforce. Information and technology industries require a high level of education and skill. The U.S. has an advantage on this dimension, but other nations are quickly catching up. In 1991, only two countries (Canada and Finland) exceeded the United States in their share of young people with a college degree and only by a couple of percentage points. By 2002, the picture had changed dramatically. Thirteen countries have equaled or exceeded the benchmark achieved by the United States in 1991, and four nations are now ahead of us, with Japan and Korea outstripping us by more than 10 percentage points.<sup>4</sup>

Our nation has long realized the importance of a strong education system. The federal and state governments have used a variety of methods to make college more accessible, including direct support to colleges as well as grants and loans to students. More recently, policymakers have looked to the tax code to promote higher education. In the past 10 years, new tax provisions have been established to ease the financial strains that a college education can place on families, as well as encourage families to save for college.

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<sup>2</sup> College Board, 2004. *Trends in College Pricing 2004*. New York: College Board Publications.

<sup>3</sup> College Board, 2005. *Education Pays 2005*. New York: College Board Publications.

<sup>4</sup> Organization for Economic Cooperation and Development, 2004. *Education at a Glance: OECD Indicators 2004*. Paris: OECD.

Unfortunately, the product is a maze of education tax deductions, credits, and tax-preferred savings plans, which are ultimately regressive in their incidence:

- Multiple education tax provisions, each with their own set of rules, leave the average taxpayer confused about the benefits for which she is eligible. This makes it more likely that the education tax benefits act as *ex-post* transfers than as incentives. Families cannot respond to incentives if they do not understand them.
- The education tax incentives are regressive, with the largest benefits for high-income families and those who send their children to the most expensive institutions.
- The education tax incentives produce perverse consequences when they interact with the entirely separate system for determining financial aid for college.

If we want to maximize the impact on college attendance decisions and ensure that the benefits reach those who need it most, we should simplify the tax incentives for education, eliminate provisions that prevent low-income families from getting the maximum assistance, and work towards integrating federal benefits for higher education across the tax and financial aid systems. Creating a single, refundable credit for tuition, fees, room, and board would go a long way toward achieving these goals.

### **CURRENT TAX INCENTIVES FOR HIGHER EDUCATION**

There are three main mechanisms by which families and students receive tax incentives for higher education. First, there are tax incentives to help families pay for college today. These provisions include the Hope Tax Credit, the Lifetime Learning Tax Credit, and the deduction for college tuition and fees. Parents can also claim children under 25 as dependents if they are enrolled in college. Second, tax-preferred savings plans such as the Coverdell Education Savings Account and the 529 Savings Plans are aimed at encouraging families to save for future college costs by offering higher net-of-tax rates of return; these are essentially Roth IRAs for education. Third, the student loan interest deduction helps individuals pay for college costs incurred in the past.

Table 1 presents the costs to the federal government of these incentives. It is worth noting that the combined value of these provisions (\$10.5 billion) is nearly as large as the \$13.1 billion the federal government spends on the Pell Grant program, traditionally the cornerstone of federal aid for college students.<sup>5</sup>

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<sup>5</sup> The College Board, 2005. *Trends in Student Aid 2005*. New York: College Board Publications.

**Table 1. Cost of major tax incentives for education. (\$ billions)<sup>6</sup>**

Program	2005
Hope & Lifetime Learning Tax Credits	\$5.2
Tuition and Fees Deduction	\$2.8
Coverdell & 529 Tax-Preferred Savings Plans	\$0.6
Parental Exemption for Dependent Students	\$1.1
Student Loan Interest Deduction	\$0.8

All of these incentives aim to reduce the cost of attending college. However, each provision comes with its own set of rules regarding who is eligible, what counts as a qualified college expense, the size of the maximum benefit (or contribution), and the income thresholds at which benefits phase in and phase out. As we discuss next, the combined effect of these regulations is to limit benefits for low-income families.

*The education tax incentives are regressive*

To maximize the impact of the tax incentives on schooling, we should aim the tax incentives at those on the brink of college who just need a little push. The incentives should be structured to reflect the needs of students on the margin of college entry. These marginal college students are not upper-income youth deciding between going to an expensive school like Harvard and skipping college altogether. They are lower-income youth deciding between skipping college or going to a public two- or four-year college, where average tuition and fees are \$2,200 and \$5,500, respectively.<sup>7</sup> However, the specifics underlying the tax provisions are such that these students get few benefits.

- Because the education tax credits are not refundable, a family of four must have income above \$30,000 to get the maximum credit.<sup>8</sup> Nearly half (46 percent) of families with college students do not get the full credit because their income is too low.<sup>9</sup>

<sup>6</sup> Joint Committee on Taxation, 2005. *Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009*, p. 36. Washington: U.S. Government Printing Office. Retrieved March 13, 2006 from <http://www.house.gov/jct/s-1-05.pdf>.

<sup>7</sup> The College Board, 2005. *Trends in College Pricing 2005*. New York: College Board Publications.

<sup>8</sup> If the education tax credit is larger than the family's federal income tax liability, the credit is effectively capped at the amount of income tax liability. Note that these families might still owe other taxes and fees, including the payroll tax, state sales taxes, local property taxes, etc.

<sup>9</sup> Bridget Terry Long, 2004. "Using the Tax Code to Provide College Aid: The Higher Education Tax Credits, 1998-2001." Harvard University manuscript.

- The full benefit of the Lifetime Learning Tax Credit does not kick in until tuition and fees are \$10,000 a year, which is nearly double the cost of the typical public four-year college and four times that of the typical community college. Over 90 percent of college students attend schools with tuition and fees under \$10,000.<sup>10</sup>
- The tuition and fees deduction is more valuable for those in higher tax brackets.<sup>11</sup> Deducting \$1,000 from taxable income is more valuable for someone in the 33 percent bracket than for someone in a lower bracket. Over half of the benefits of this deduction accrue to households with incomes over \$100,000.
- The savings incentives are more valuable for those in higher tax brackets. Families earning \$50,000 or less can earn an after-tax rate of return that is 25 to 40 percent better than the after-tax rate of return on a non-advantaged account, but those earning \$335,000 or more can glean an after-tax rate of return nearly double that of a non-advantaged account. Strikingly, those in the top two tax brackets benefit more from non-educational use of a Coverdell (which triggers a penalty) than those in the bottom bracket gain from its educational use.<sup>12</sup>

### *The education tax incentives are complex and confusing*

Navigating the complexities of tax incentives for higher education practically requires an advanced degree. Tellingly, the publication devoted to explaining these tax benefits (IRS Publication 970) is 82 pages long.

- The credits, deductions, and savings plans have different income limits and phase-outs and can be swept away by the alternative minimum tax.

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<sup>10</sup> 95 percent of full-time students at public four-year institutions pay less than \$9,000, while all two-year public colleges cost less than \$10,000. Even once we include private four-year schools, 67 percent of full-time students at four-year institutions pay less than \$9,000. Weighting these figures by enrollment at each type of institutions (<http://nces.ed.gov/pubs2006/2006155.pdf>) yields the 90 percent figure.

<sup>11</sup> The phase-out range for the tuition and fees deduction begins at \$130,000 for a married couple and \$65,000 for a single individual or head of household. See IRS Publication 970, <http://www.irs.gov/publications/p970/ch06.html#d0e6536>.

<sup>12</sup> Dynarski, 2004. "Who Benefits from the Education Savings Incentives? Income Educational Expectations and the Value of the 529 and Coverdell." *National Tax Journal*, Vol. LVII, No. 2, Part 2, p. 359. This occurs because asset earnings are taxed at the child's tax rate instead of the parents' higher tax rate, and because the penalties for non-qualified usage are flat rather than a proportion of income.

- Each of the tax provisions defines college costs differently. Each provision also has its own definitions of eligible students, eligible institutions, eligible educational expenses, and even what items should be included or excluded in adjusted gross income.<sup>13</sup>
- Every state has its own 529 savings plan(s) — Arizona and Nevada each have six — and there are over 100 plans to choose from. Every plan has its own application, contribution limits, investment options, penalties for non-educational use, administrative fees, loads, expense ratios, and annual fees. And since SEC disclosure rules do not apply, there is no way to easily compare fees across plans.
- Eligibility for tax credits and deduction changes if a student receives financial aid, if a student uses a 529 or Coverdell to pay for college, or if a family falls under the AMT. Eligibility for financial aid changes if a family has money in a 529 or Coverdell, or if they take the tuition and fees deduction. In order to prevent the education tax credits from affecting eligibility for federal financial aid, information about these credits is now collected on a separate line of the already cumbersome application for federal student aid (the FAFSA).

## **REGRESSIVITY AND COMPLEXITY BLUNT THE IMPACT OF EDUCATION TAX INCENTIVES ON COLLEGE DECISIONS**

The consequences of regressivity extend beyond unfairness, and the consequences of complexity extend beyond mere annoyance and frustration. Common sense suggests that there is more room to have an impact on education among lower-income families: Only 49 percent of high school completers from the bottom two-fifths of the income distribution enroll in college immediately after high school, compared to 80 percent of graduates from the top fifth of the income distribution.<sup>14</sup>

Families whose children are on the margin of college entry will have an especially hard time navigating the current thicket of education tax incentives. These are families in which the parents have not gone to college or for whom English is not the first language. Since they are likely to have less experience and less assistance in navigating the tax system, complexity makes the education tax incentives even more regressive in practice than they are by design.

<sup>13</sup> For example, the tuition and fees deduction requires that foreign housing deductions be added back into adjusted gross income, while several of the other benefits do not.

<sup>14</sup> The College Board, 2005. *Education Pays 2005*. New York: College Board Publications, p. 8. Top quintile of family income in 2003 began at approximately \$78,000 while the bottom 40 percent included incomes up to about \$31,000.

Along multiple dimensions, low-income families differ from upper-income families in ways that make complexity particularly costly. Half of low-income high school seniors do not have a parent who ever attended college.<sup>15</sup> Their parents will therefore be unable to informally guide them through the process of applying to and financing college. Thirteen percent of low-income students primarily speak a language other than English at home, double the rate of families with above-median incomes.<sup>16</sup> Low-income families are substantially less likely to have access to the internet at home. In 2003, over two-thirds of children from low-income families had no access to the internet at home, compared to just 12 percent of those in wealthier families.<sup>17</sup>

Research shows that simple, easily communicated aid programs have a robust impact on college entry and completion.<sup>18</sup> In contrast, a recent study by Long (2005) finds that the tax credits for education have had no effect on college enrollments.<sup>19</sup> There is little to no compelling evidence that traditional forms of student aid (which require an application about as lengthy and complicated as a 1040) have any impact on schooling; decades of research on Pell Grants have yielded no robust evidence of their effectiveness.<sup>20</sup>

Complexity is likely the culprit. A prospective student who is able to deduce her aid eligibility, apply to college without knowing what resources will be available to pay for it, complete the financial aid application process, file for an education tax incentive, and then wait up to 15 months to receive a tax benefit, almost by definition reveals herself as not on the margin of college attendance, but firmly inside the margin. If federal assistance mostly reaches those who would have attended college even without it, then our significant federal expenditures are unlikely to have an impact on college enrollment rates.

<sup>15</sup> Source: Authors' calculations using NELS:1988-2000 data, comparing families with income below \$25,000 to those with income above \$50,000.

<sup>16</sup> Ibid.

<sup>17</sup> Source: Authors' computations using published tables from the 2003 Computer and Internet Supplement to the Current Population Survey, <http://www.census.gov/prod/2005pubs/p23-208.pdf>. We compare families with income below \$25,000 to those with income above \$50,000.

<sup>18</sup> The Social Security Survivors' Benefit program, a simple, transparent college subsidy, substantially increased college enrollment rates for the eligible population (Dynarski, 2003). Georgia's HOPE Scholarship program, another simple and transparent program, also increased college enrollment (Dynarski, 2000) and college completion (Dynarski, 2005). Other HOPE-like programs have had a similar effect (Dynarski, 2004a; Kane, 2005).

<sup>19</sup> Long, Bridget Terry, 2005. Chapter in Caroline Hoxby, ed., *College Choices*.

<sup>20</sup> See Hansen, 1983 and Kane, 1995. Sefor and Turner (2002) find an effect of Pell Grants on college enrollment but only for older, "nontraditional" students. An analysis of more recent data by Bettinger (2004) finds suggestive evidence that Pell Grant size affects college completion among those receiving grants, but the results are very sensitive to the particular statistical method used.

## **POLICY RECOMMENDATIONS:**

### **SIMPLIFY, REFOCUS, AND COORDINATE TAX BENEFITS FOR HIGHER EDUCATION**

The tax code can help increase college attendance in the U.S. However, the inefficiencies and complexities in the current code should be corrected. The goals of reform should be to *refocus* the incentives on those who are on the margin of entering or completing college, to *simplify* the incentives so that families can understand and respond to them, and to *coordinate* incentives to maximize their impact. Several concrete steps can be taken to achieve these goals:

*Merge the Hope and Lifetime Learning Credits and the tuition tax deduction into a single, refundable credit with a consistent definition of eligible students, eligible institutions, and eligible expenses.*

We should create a single, refundable tax credit for tuition, fees, room, and board.

- A single credit would significantly reduce complexity, enabling families to estimate their likely credit well in advance. Families who are struggling to pay for college need to be able to count on the credit — it should not be a gamble whose outcome they discover in April.
- Counting room and board as eligible expenses aligns this definition of college costs with the definition applying to 529 and Coverdell accounts. This simplifies and also better targets the credit. It extends the credit to students at public colleges, many of whom do not currently qualify for full benefits because their costs, as statutorily defined, are too low to get the maximum credit.
- Making the credit refundable would ensure that families in lower tax brackets are eligible for the maximum benefits and would thus aim more funds at students truly on the brink of college.

Simplifying the incentives in this way would open up new opportunities for maximizing their impact. Families claiming children as dependents could be sent estimates of the aid their children could get for college, much in the way that the Social Security Administration sends out annual estimates of retirement benefits. The simpler and more streamlined these benefits are, the easier this information

dissemination would be.<sup>21</sup> Early, clear information has the potential to affect behavior of families when their children are still young and forming the academic skills they need to enter and complete college.

The government could further establish a mechanism for getting benefits to students and their families *at the time of enrollment*, before taxes are filed. For example, students could complete a simple form verifying their enrollment status and receive a “Rapid Enrollment Assistance Loan” in the amount of the expected credit, based on the prior year’s tax information. If the student dropped out or otherwise becomes ineligible, the loan could be recollected through the tax system. The “rapid refund loans” provided by tax preparers are believed to significantly increase take-up of the Earned Income Tax Credit; similarly, access to education credits at the time when finances are most strained may provide students on the brink the small push they need to enroll in college.

The cost of these changes could be quite reasonable. A recent analysis from the Urban-Brookings Tax Policy Center (Burman et al., 2005) suggests that a unified, simplified version of the education credits would cost an additional \$1.4 billion. Making the credit refundable would cost an additional \$2.1 billion, for a total increase of approximately \$3.5 billion. Eliminating the tuition and fees deduction would, by itself, save up to \$2.8 billion, thereby offsetting most of the cost of this improved credit.

*Coordinate all federal benefits for higher education through the tax system*

We can even more radically simplify federal benefits for higher education by consolidating all aid for college under the auspices of the IRS. College students and their families now face two parallel, duplicative and unwieldy systems for delivering federal aid for college: the tax system and the aid system. The tax system and aid system collide in an explosion of paperwork, bureaucracy, conflicting rules and unintended consequences. Their intersecting rules also create opportunities for those with the means to game the system. Moving aid determination into the tax system would substantially simplify the aid process for families.<sup>22</sup>

<sup>21</sup> In Georgia, for example, 90 percent of high school freshmen know about the Georgia HOPE Scholarship program and can explain the eligibility rules because they are simple to explain and remember. (Dynarski, 2000)

<sup>21</sup> This approach assumes a maximum credit of \$2,500 (based on eligible expenses of up to \$4,500) and is not restricted to the first two years of college.

<sup>22</sup> The federal aid application (the FAFSA) makes the IRS tax forms look svelte. The IRS 1040EZ is a single page with 37 questions. Form 1040A is two pages, with 83 questions. Form 1040 is also two pages, with 118 questions. The FAFSA is *five* pages, with 128 questions. A handful of these questions — which are already asked by the IRS — determine most of the variation in aid. For example, earnings, marital status, family size, and number of family member in college

## CONCLUSION

A well-educated workforce is key to the economic competitiveness of the United States and the economic security and well-being of its families. But the federal government is not maximizing the impact of its expenditures on higher education. Although the education tax benefits do provide relief for middle- and high-income families who are sending their children to college, they do little to help those who are most likely to have children teetering on the margin of college enrollment. The changes proposed above would simplify, refocus, and coordinate tax incentives for college, maximizing their impact on the nation's human capital.

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explain 80 percent of the variation in Pell Grants (Dynarski and Scott-Clayton, forthcoming).

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