

## Simplify and Focus the Education Tax Incentives

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A college education is a good investment, for both individuals and society. Over a lifetime, a worker with a bachelor's degree earns, on average, a million dollars more than a less-educated worker. College graduates are more likely to vote and live healthy lives. On every measurable dimension, college graduates are healthier, wealthier and economically more secure than those who have completed only high school (College Board, 2004 and 2005a)..

But college remains out of reach for many. Blacks are less than half as likely as non-Hispanic whites to earn a bachelor's degree (13 percent vs. 32 percent). Hispanics are one-quarter as likely as non-Hispanic whites to earn a B.A. (8 percent vs. 32 percent).<sup>1</sup> Some of these differences trace back to performance gaps in elementary school and high school. But even among those who do well on achievement tests, inequalities remain: 74 percent of high-scorers who grew up in upper-income families complete college, compared to only 29 percent of those who grew up in low-income families (U.S. Department of Education, 2005).

How can we close these gaps in college attendance and completion? Colleges and governments spend billions on financial aid, trying to keep college affordable. In the past decade, federal and state tax authorities have stepped in, offering to college students and their families a dizzying array of education tax credits, tuition deductions and tax-advantaged college savings plans. But these billions of dollars are largely flowing to high-income students at expensive schools who would have gone to college anyway.

While the tax code *can* be an effective tool for encouraging college attendance, the current tax incentives fall far short of their potential. To make the tax incentives for education more effective, we should simplify and focus them on low-income families. Creating a single, refundable credit for tuition, fees, room, and board would go a long way toward achieving these goals.

## Overview of the Education Tax Incentives

Table 1 lists the education tax incentives and their revenue implications. The Hope and Lifetime Learning tax credits and the deduction for college tuition and fees help families pay for current college costs. These provisions reduce tax liabilities of households by about \$9 billion a year. Parents can also claim children under 24 as dependents if they are enrolled in college, costing an additional \$1.1 billion in tax revenues. The student loan interest deduction reduces taxes for those with education debt.

The federal Coverdell Education Savings Account and the state 529 savings plans help families pay for college in the future by increasing their after-tax returns on savings. The current costs of these programs are deceptively low (\$0.6 billion). The tax implications of the billions of dollars invested in these accounts will be felt when the principal and earnings are drawn down, tax-free, over the coming decades.

**Table 1: Tax Incentives for Education, 2005**

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

*Source:* Joint Committee on Taxation, 2005.

With a total cost of \$10.5 billion, the education tax incentives approach spending on the Pell Grant (\$13.1 billion), historically the cornerstone of federal aid for college students (College Board, 2005c).

## Designing Effective Education Tax Incentives

The education tax incentives reduce the pinch of rising college costs for many American families. But the tax incentives can *increase schooling* only for those whose college attendance is sensitive to price. A student admitted to Yale, whose family earns \$100,000, is going to college, tax incentive or none. This student is *not* sensitive to price. This is not a value judgment: the family may appreciate a tax credit and make good use of it. But, for this student, the tax incentives do not open the door to college.

For the tax incentives to get more people into college, they need to reach people who are sensitive to price, who would not go to college in the absence of the incentive.

- Who are these potential college students? Disproportionately, they are from low-income families. Just half of low-income youth go to college right after high school, compared to 80 percent of their upper-income classmates.<sup>2</sup> They are disproportionately nonwhite or Hispanic.
- Where might these potential college students go to school? The local community college, where tuition and fees average \$2,200, or a state university, where costs average \$5,500 (College Board, 2005b).

This is who we should keep in mind as we design tax incentives for college: a low-income person attending an inexpensive public college.

### **The Education Tax Incentives Don't Reach the Right Students**

But the education tax incentives do just about nothing for these low-income students at inexpensive public colleges. Perversely, the tax incentives are focused on upper-income students at the most expensive private colleges.

- Because the education tax credits are not refundable, a family of four must have income above \$30,000 to get the maximum credit. Nearly half (46 percent) of families with college students do not get the full credit because their income is too low (Long, 2004b).
- Only students who pay tuition and fees over \$10,000 a year get the full Lifetime Learning Credit. This is nearly double the cost of the typical, public four-year college and four times that of the typical community college. Over 80 percent of college students attend schools with tuition and fees under \$10,000.<sup>3</sup>
- The tuition and fees deduction is most valuable to those in high tax brackets. 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 (Burman, *et al.*, 2005).

- The savings incentives are most valuable to those in high tax brackets. Families earning \$335,000 or more can earn twice as much in a 529 as in a non-advantaged account; the advantages are far smaller in lower brackets.<sup>4</sup>

### **The Education Tax Incentives Are Complex and Confusing**

The regressivity of the tax incentives is not all that hampers their effectiveness. They are too complicated and confusing to affect schooling decisions. Simply put, families can't respond to a price subsidy if they do not know about it.

Again, let's keep our target student firmly in mind. Those on the margin of college entry are disproportionately low-income, nonwhite and Hispanic, with parents who did not graduate college, or perhaps even from high school. For many of these families, English is the second language.

In this context, consider the following thicket of rules, regulations and peculiarities in the education tax incentives. Tellingly, the IRS publication devoted to explaining these tax benefits is 82 pages long (Department of the Treasury, 2005).

- Each tax provision defines college costs differently.
- Each tax provision has its own definition of eligible students and eligible schools.
- Each credit, deduction, and savings plan has a different income limit and phase-out. They even differ in how income is *defined* for the purposes of eligibility.<sup>5</sup>
- Eligibility for tax credits and deduction changes if a student receives financial aid or if a student uses a 529 or Coverdell to pay for college.
- Eligibility for financial aid changes if a family has money in a 529 or Coverdell, or if they take the tuition and fees deduction.
- Some tax benefits are swept away by the alternative minimum tax, others are not.

The consequences of this complexity extend beyond mere annoyance and frustration. Evidence shows that simple, easily communicated financial aid programs have a robust impact on college entry and completion. By contrast, we have little to no compelling evidence that complicated forms of student aid increase schooling.<sup>6</sup> A simple tax incentive is an easily-communicated tax incentive. 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.

### **Simplify and Focus The Education Tax Incentives**

The goals of reform should be to *focus* the incentives on those who are on the margin of attending college and *simplify* the incentives so that families can understand and respond to them.

1) Create a single, refundable tax credit for tuition, fees, room, and board.

- Merge the Hope and Lifetime Learning Credits and the tuition tax deduction into a single, \$2,500 credit. A single credit would significantly reduce complexity, enabling families to estimate their likely credit well in advance.
- Make the credit refundable so families in lower tax brackets are eligible for the maximum benefits.
- Count tuition, fees, room and board as eligible expenses for the purposes of the credit. This matches the definition used for the 529 and Coverdell accounts. It extends the credit to the vast majority of students who attend public colleges but who currently do not qualify for full benefits.

The simpler and more streamlined the tax benefits, the easier they are to communicate to families and students.<sup>7</sup> Just as workers are annually sent projections of their Social Security benefits to help them plan for retirement, families could be sent estimates of their tax benefits to help them plan for college.

2) Deliver the credit at the time of college enrollment.

- Families need the credit when tuition is due, not a year or more later when taxes are filed. The Department of Education delivers grants and loans to students and their colleges at the time of enrollment, demonstrating that this can be done.
- Just as the Department of Education uses previous year's income to define eligibility for financial aid, IRS can use previous year's income to define eligibility for the education tax credit.

We could even more radically simplify federal benefits for college by consolidating *all* aid for college under the auspices of the IRS. College students and their families face two parallel, duplicative and unwieldy bureaucracies that provide 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 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>8</sup>

The cost of these proposals is modest. A recent analysis by the Urban-Brookings Tax Policy Center (Burman *et al.*, 2005) shows that a simple, refundable education tax credit would cost about \$3.5 billion.<sup>9</sup> 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.

## **Conclusion**

A well-educated workforce is key to the economic competitiveness of the United States and the well-being of its families. The federal government could do better with its tax incentives for college. Although the education tax benefits provide relief for middle- and high-income families with children in college, they do little to get more people into college. Simplifying and focusing the tax incentives will allow them to serve their goal: opening the doors of college to those who have the ability but not the means to further their education.

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## Endnotes

<sup>1</sup> Authors' tabulations of completed education of 24- and 25-year-olds from 1998, 1999 and 2000 October Current Population Surveys.

<sup>2</sup> College Board, 2005a. Figures are for the top quintile of family income (above \$78,000) and bottom two quintiles (below \$31,000).

<sup>3</sup> Ninety-five 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 if we include private four-year schools, 67 percent of full-time students at four-year institutions pay less than \$9,000. See College Board, 2005b.

<sup>4</sup> 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. See Dynarski, 2004b.

<sup>5</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>6</sup> Dynarski and Scott-Clayton (forthcoming) review the empirical evidence on the types of aid programs that increase education. Long (2004a) shows that the current tax credits do not increase college attendance.

<sup>7</sup> In Georgia, for example, a simple aid program has increase college attendance and completion (Dynarski, 2000, 2004a, 2005). Ninety percent of high school freshmen can name the program and a majority know its eligibility rules, because they are easy to explain and remember.

<sup>8</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 127 questions. A handful of these questions determine most of the variation in aid. For example, earnings, marital status, family size, and number of family member in college explain 80 percent of the variation in Pell Grants (Dynarski and Scott-Clayton, forthcoming).

<sup>9</sup> This approach assumes a maximum credit of \$2,500 (based on eligible expenses of up to \$4,500) that is not restricted to the first two years of college.