

Tax Incentives for Education

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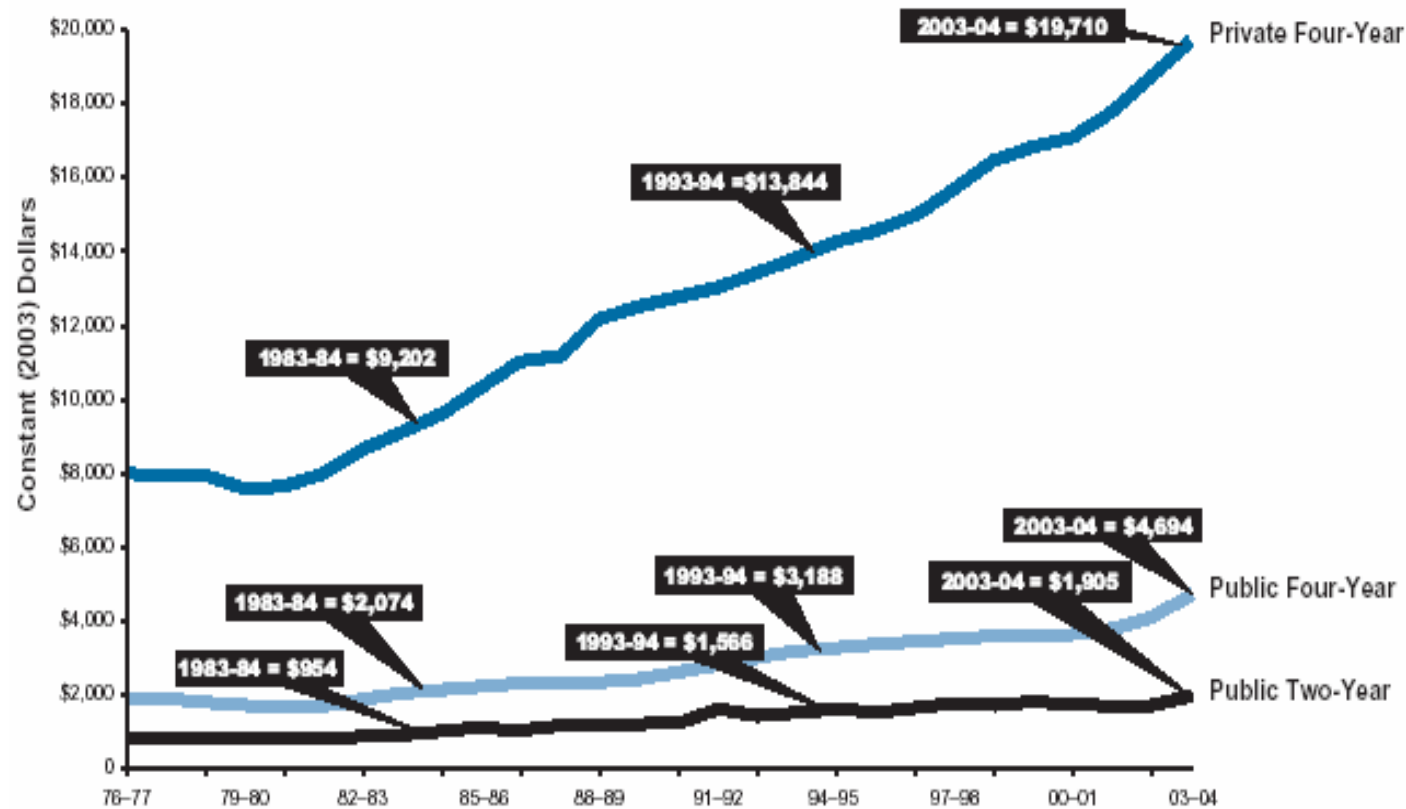
Testimony before the President's Advisory Panel on
Federal Tax Reform
March 16, 2005

Overview

- Background on college costs
- Tax expenditures for education
- Education savings accounts
 - Complexity
 - Distribution of benefits
- Tuition tax credits and deductions and exemptions
 - Complexity
 - Distribution of benefits
- Concluding Thoughts

College Costs Trends:

*Very High for the Few at Private Schools,
Moderate for the Many at Public Schools*



Source: *Trends in College Pricing 2003*, College Board (2004). Enrollment-weighted averages of tuition and required fees are in 2003 dollars.

Tax Expenditures for Education

(with estimates from the Joint Committee on Taxation in billions of dollars)

Tax Expenditures Aimed at Reducing:

- Future Education Costs
 - Coverdell & 529 savings accounts (\$0.5 in 2005; \$1.1 in 2009)
- Current Education Costs
 - Hope & Lifetime Learning credits (\$5.7 in 2005; \$5.7 in 2009)
 - Personal exemption for student dependents age 18-23 (\$2.6 in 2005; \$1.4 in 2009)
 - Tuition deduction (\$1.7 in 2005; sunsets after 2005)
 - Exemption from taxation of employer benefits for education (\$0.6 in 2005; \$0.7 in 2009)
- Completed Education Costs
 - Student loan interest deduction (\$0.8 in 2005; \$0.8 in 2009)

Future Education Costs: Coverdell & 529

- Think of these savings accounts as Roth IRAs for education
 - 529 for college
 - EGTRRA 2001 eliminated federal taxes on 529 withdrawals
 - This provision sunsets in 2010
 - Tax liabilities of 529 backloaded - realized when funds drawn down when child goes to college
 - Very rapid recent growth in 529s
 - Coverdell for K-college

College Saving Complexity: Multiple Tax-Advantaged Options

- Education Savings Accounts (ESAs)
 - 529
 - Coverdell
- Retirement Vehicles
 - Roth IRA
 - Traditional IRA
 - 401k
- Other
 - Uniform Transfer to Minors Act (account in child's name)
 - Savings Bonds
 - Home Equity

Complexity in College Savings: More than One Hundred 529 Plans to Choose From

- Arizona and Nevada each sponsors *six* 529s
- Every plan has its own...
 - Application
 - Contribution limits
 - Investment options
 - Costs
 - Asset-based administrative fees, loads, expense ratios, annual fees
 - SEC disclosure rules *do not* apply → no way to easily compare costs across plans
 - Penalties for non-educational use

Variation in After-Tax Returns Creates Complex Choices

After-tax return to saving for college depends upon whether you save in

- Standard mutual fund
- Traditional IRA
- UTMA
- 529
- Coverdell

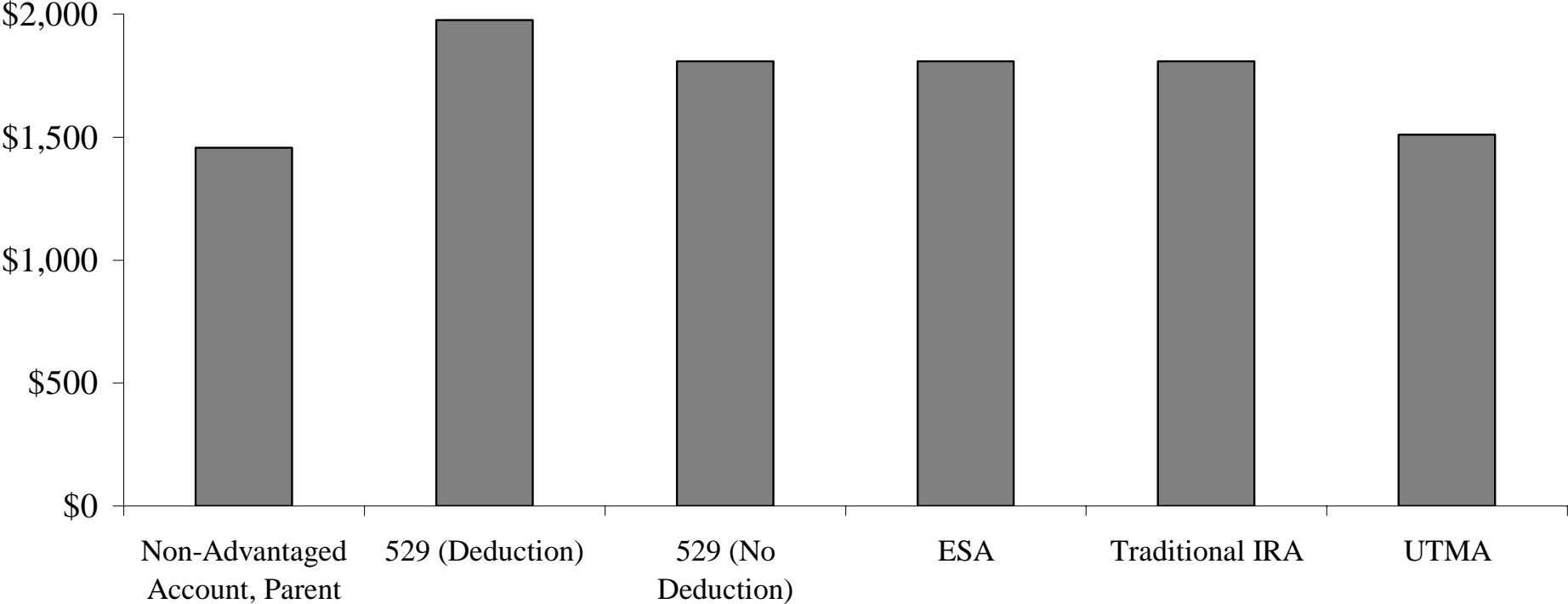
Assumptions in Calculating After-Tax Returns

- Married couple, two kids, one earner
- Pretax deposit of \$1,000 made when child is born
- After-tax earnings reinvested
- Funds drawn down over four years of college

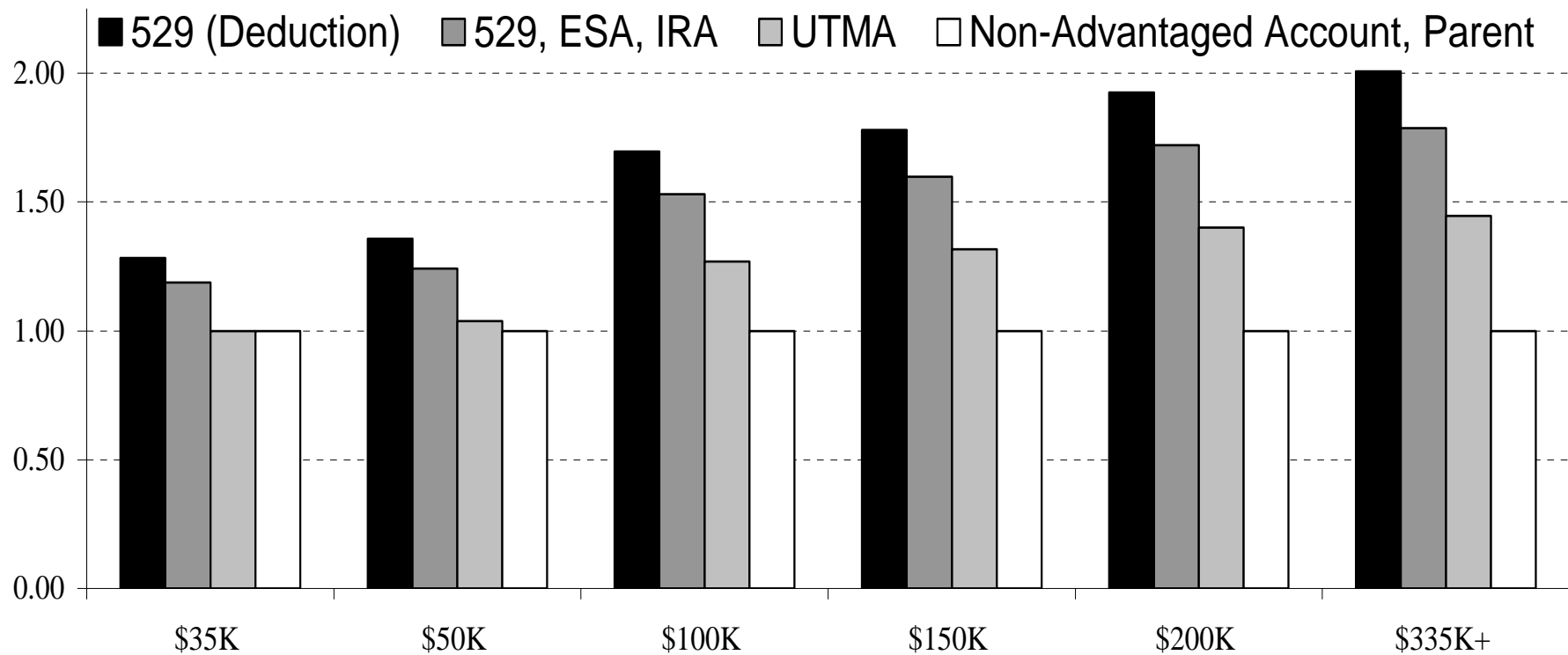
Portfolio Assumptions

- Stock returns 9%
 - 2% dividends
 - 7% LT capital gains, unrealized until withdrawal
- Bond returns 4%
- Aggressiveness of portfolio decreases as child ages

After-Tax Returns Vary Considerably
Across College Savings Options
Example: Household Income=\$50,000

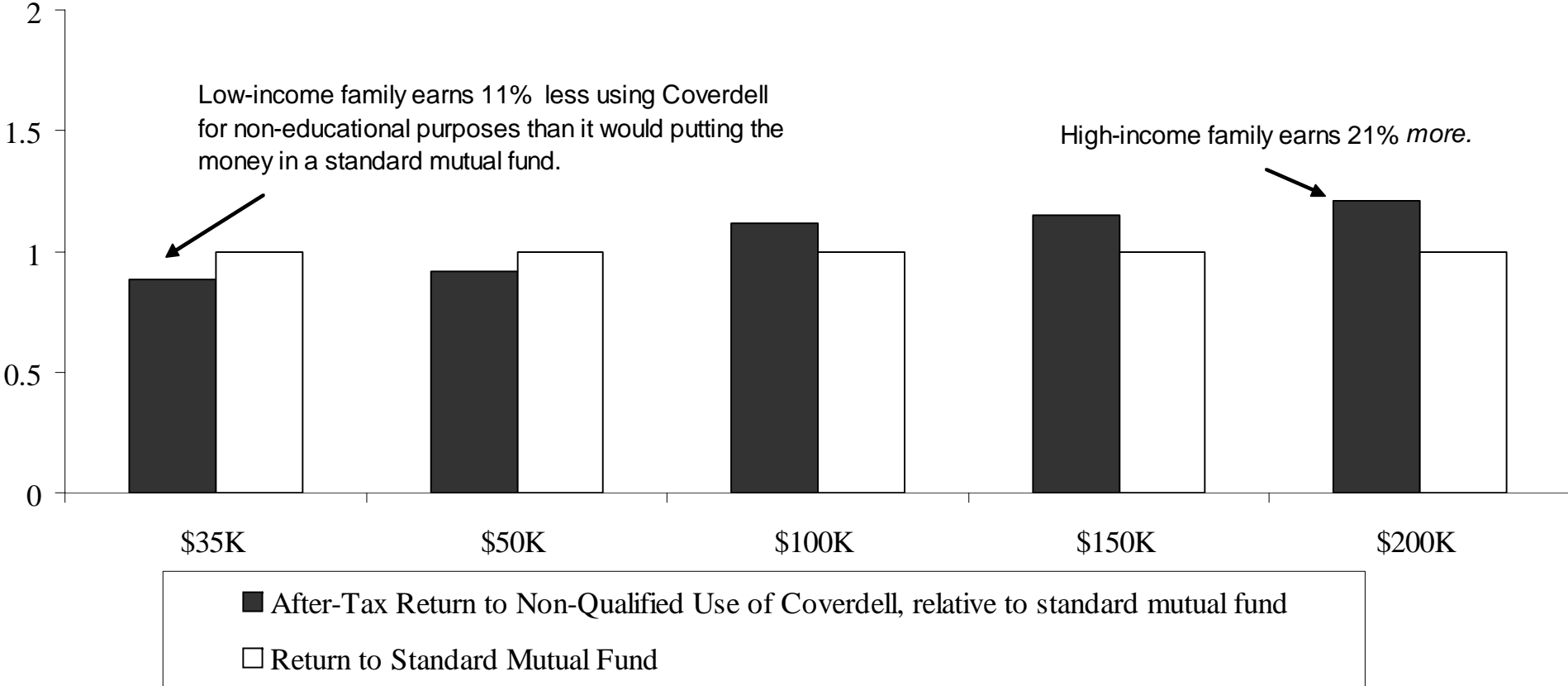


Value of Savings Incentives Depends on Your Tax Bracket, Rising Sharply with Income



Return shown is relative to non-advantaged account

Penalties Make Coverdell Risky for Low-Income Families



Characteristics of Education Savings Account Investors

Sample: 2001 Survey of Consumer Finances,
Households with children less than 17 years of age

	All Households	Education Savers (529 or ESA)	Retirement Savers (IRA or Keogh)
Household has 529 or ESA	3%	100%	5%
Household has IRA or Keogh	38%	70%	100%
Median Income	\$50,000	\$91,000	\$75,000
Median Net Worth	\$61,830	\$281,200	\$227,600
Mean Balance in IRA accounts	\$20,132	\$89,400	\$56,523
Parent has a bachelor's degree	37%	91%	59%
Number of observations	1,533	46	588

Tax Benefits for Current Education Costs

- Hope Tuition Tax Credit
- Lifetime Learning Credit (LLC)
- Tuition Tax Deduction
 - Sunsets in 2005

Household Choice of Tuition Tax Benefits:

Depends on ...

- Income Phase-out Range
 - Credits: \$42 - 52K (single)/ \$85 -105K (married)
 - Deduction: \$65 - 80K (single) /\$130 -160K (married)
- AMT
 - Credits do not survive AMT
 - But deduction does
- Marginal Tax Rate (MTR)
 - Does not affect value of credits
 - Affects value of deduction (value increases with MTR)

Household Choice of Tuition Tax Benefits:

Depends on ...

- Enrollment Status
 - Hope covers first two years of college, LLC covers all levels
 - Must be at least half-time in school for Hope, not for LLC
- Number of Students in Household
 - One LLC allowed per *household*
 - One Hope credit allowed per *student* in the household
 - Deduction cap is for *household*
- Schooling Costs
 - Hope covers 100% of first \$1,000, 50% of second \$1,000
 - LLC covers 20% of first \$10,000
 - Deduction is for up to \$4,000

Value of Tuition Tax Benefits: 2003

Tuition and fees	Value of tax benefit per return			
	Hope Scholarship Credit	Lifetime Learning Credit	Higher education deduction	
			15% marginal tax rate ^a	25% marginal tax rate ^b
\$350	\$350	\$70	\$53	\$88
700	700	140	105	175
1,700 ^c	1,350	340	255	425
2,000	1,500	400	300	500
3,000	1,500	600	450	750
4,100 ^d	1,500	820	450	750
7,500	1,500	1,500	450	750
10,000	1,500	2,000	450	750
18,300 ^e	1,500	2,000	450	750

Source: Congressional Research Service, *Higher Education Tax Credits and Deduction: An Overview of the Benefits and Their Relationship to Traditional Student Aid*.

Take-up of Education Credits Concentrated Among Middle & Upper Tax Brackets

	Under \$15K	\$15K to \$30K	\$30K to \$50K	\$50K to \$100K	\$100K to \$200K
Income group's total credits (in billions)	\$0.21	\$1.36	\$1.78	\$2.55	\$0.00
Income group as % of credit claimants	9%	26%	28%	36%	0%
Income group as % of all returns	29%	23%	19%	21%	7%
Income group share of total credit \$	4%	23%	30%	43%	0%

Where are Tax Credits Spent?

Most of Credits Spent at Expensive Private Colleges

- Full benefit of LLC does not kick in until tuition and fees are \$10,000 a year
- Typical student attends a public university, where
 - Tuition and fees average \$4,700
 - Just 4% of students pay over \$8,000.
- At community colleges, average costs are less than \$2,000

(Amounts are for 2003-2004 and expressed in 2003 dollars)

Source: *Trends in College Pricing 2003*, College Board, 2004)

Who Benefits from the Tax Incentives for Education?

- Savings Plans
 - Value highest for higher-income families
 - Risky for lower-income families due to penalties
 - Early takeup concentrated among higher-income households
- Tax Credits
 - Greatest benefit to those at most expensive private schools
 - Takeup highest in middle and upper brackets

Effect of Incentives on Behavior

- Tax credits do not increase college-going (Long, 2004)
 - Too complicated
 - Not available to lower brackets, where there is more room for response
- Savings plans
 - No strong evidence they increase savings
 - Too early to tell if they increase college-going

Concluding Thoughts:

Costs of tax complexity

- Some taxpayers spend time researching complicated rules (or pay others to advise them) then alter their behavior to maximize credits/deductions and asset returns
 - waste of social resources
- Other taxpayers do not understand the complicated rules & pay higher taxes than those who do
 - horizontal inequities
- Simplifying the code can have a positive impact on both efficiency and equity