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Change Tax Incentives to Encourage Students to Attend College, Senators Are Told

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Washington

The federal government should consolidate and simplify federal-tax incentives for college students and make permanent the tax exemption of education-related withdrawals from 529 college-savings plans, college and industry officials told the Senate Finance Committee on Thursday.

Such actions would improve the United States' global economic competitiveness by encouraging more students to attend college, the officials said. Sen. Charles E. Grassley, an Iowa Republican and the committee's chairman, and Sen. Max S. Baucus of Montana, the committee's top Democrat, both emphasized their concern that American students are falling behind their international peers in college preparation and achievement, particularly in mathematics and science.

Susan Dynarski, an assistant professor of public policy at Harvard University and an expert on higher-education finance, recommended three ways to alter tax incentives to increase the number of people who go to college.

First, she said, the government should tailor popular federal programs to favor students whose families have lower incomes and who are often forced to choose whether to attend college on the basis of cost.

Existing tuition tax breaks, she said, tend to help only families with earnings high enough that they pay income taxes that can be offset by credits. The Hope tax credit, for example, covers 100 percent of college expenses up to $1,000 and 50 percent of the next $1,000, for a maximum of $1,500. The Lifetime Learning tax credit pays 20 percent of tuition costs up to $10,000, for a maximum of $2,000. Both credits are denied to people whose families have incomes of $100,000 or more, but people with low incomes cannot take full advantage of the credits.

Currently, 71 percent of students at four-year institutions pay less than $10,000 a year in tuition, the point where the Lifetime Learning credit reaches its full value, Ms. Dynarski said. Forty-nine percent of people who apply for the Hope and Lifetime Learning credits do not get their full value, she said, because the families' incomes, and thus their tax liabilities, are too low. How much of a credit a person receives depends on how much tax, if any, that person owes.

Second, Ms. Dynarski said, the credits should be combined and simplified. "People can't respond to incentives if they don't understand them," she said. "You need a B.A. to figure it out." She suggested merging the Hope and Lifetime Learning credits and a tax deduction on tuition into one benefit.

"Making it more simple will make it more powerful," she said. She lauded Georgia's HOPE Scholarship program, which pays tuition for high-school students who graduate with a B average. Ninety percent of high-school freshmen in the state know of the program and its eligibility rules, she said. She suggested changing the Lifetime Learning credit to a similar model: $2,000 for any student going to college.

As part of that proposal, Ms. Dynarski also recommended using the same criteria to count expenses as tax-exempt in all the tax breaks offered to students. In particular, she said, room and board should be considered as a deductible expense. Public tuition in many states is too low for students to qualify for the credits, she said, and adding room-and-board costs would help lower-income students qualify for the credits.

Third, Ms. Dynarski said, rules governing the tax incentives should be adjusted so that students who use the breaks would not be penalized for taking other steps to save for college. For instance, the money that families save in 529 accounts, the prepaid tuition plans that are offered in many states, is counted against the families when colleges determine their eligibility for financial aid.

Other experts invited to testify made other recommendations to the senators on how changing federal tax policy could benefit colleges and the country. Peter B. Corr, senior vice president for science and technology at Pfizer Inc., one of the world's largest pharmaceutical companies, said that Congress should renew a tax credit for research and development that expired last month.

The loss of that credit will make it more expensive for companies to finance research and hire the best people at competitive salaries, said Mr. Corr, a former professor at Washington University in St. Louis. While legislation is pending to extend the tax credit through end of 2005, he said, it should be made permanent.

David Forbes, dean of the School of Pharmacy at the University of Montana at Missoula, suggested creating tax incentives for students at professional schools to get training in multiple disciplines to handle the complex math and science being used in today's industry. For example, he said, students could get breaks on earning a Ph.D. as well as a Pharm.D, a costly package of degrees.

All of the witnesses seemed to agree that the suggested changes would help. They also seemed to agree that Congress should make permanent the legislation governing 529 college-savings plans. The legislation that guarantees the plans' tax exemptions for education-related expenses expires on December 31, 2010.

Charles Toth, director of education savings at Merrill Lynch, said the programs had become quite popular over the past two years. As of the first quarter of 2004, there were 4.7 million 529 accounts holding $40-billion. That is up from 2001, when 1.4 million accounts held $8.5-billion.

But many individuals, states, and companies are hesitant to support the college-savings plans, he said, because they do not know if they will be able to withdraw the money tax-free after 2010.

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