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).1 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 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.

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 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

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Those on the margin of college entry are disproportion-
ately 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.8

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.6 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 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

4College Board, 2005a. Figures are for the top quintile of family income (above $78,000) and bottom two quintiles (below $31,000).

3Ninety-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.

2Strikingly, 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.

8For 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.

6Dynarski 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.
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.7 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 the previous year’s income to define eligibility for financial aid, the IRS can use the 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.8

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.9 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.

References


