Simplify, Refocus, and Coordinate Tax Incentives for Higher Education

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College Is a Good Investment

- College grads earn more, live healthier lives, and are more likely to vote
- Maintaining a highly skilled workforce is key to economic growth
- Other nations are quickly catching up with and even exceeding the U.S. in the proportion of young people earning a college degree
- Evidence shows that subsidizing college can increase college entry and completion

How does the tax code subsidize college?

- Incentives That Subsidize *Future* Education
  - Coverdell & 529 Education Savings Accounts
- Incentives That Subsidize *Current* Education
  - Hope & Lifetime Learning Credits
  - College tuition deduction
- Incentives That Subsidize *Completed* Education
  - Student-loan interest deduction

Major Tax Incentives for Education

Program	**2005 (billions)**
Coverdell and 529 tax-preferred savings plans	$0.6
Hope and Lifetime Learning tax credits	$5.2
Tuition and fees deduction	$2.8
Student loan interest deduction	$0.8

Coverdell & 529 Savings Accounts

- Roth IRAs for education
- Coverdell is a federal program
  - $2000 annual contribution limit
- 529s are state programs
  - Contributions of up to $12K/year (per parent, per child) are not subject to gift tax
    - Family with two kids can put $48K a year into 529
  - Account size capped, varies by state (S. Dakota: $325K)

Hope & Lifetime Learning Credits

- Hope & LLC
  - Phase out between $87K & $107K (joint)
  - Are not refundable
- Hope
  - Worth up to $1500 (100% of first $1000 in tuition & fees, 50% of next $1000)
- LLC
  - Worth up to $2000 (20% of up to $10,000)

Tuition Deduction

- Phases out between $130K & $160K (joint)
- Deduct up to $4,000 in tuition & fees annually

Student-Loan Interest Deduction

- Phases out between $105K & $135K (joint)
- Deduct up to $2500 in interest annually

The Education Tax Incentives are Regressive

Incentives have greatest value for high-income families

- The credits are non-refundable
  - Family of four needs income > $30,000 to get maximum credit
  - 46% of families with college students don't get the full credit because their tax liability is too low
- The tuition deduction is more valuable in higher tax brackets
  - Deducting $4,000 from taxable income is more valuable in the 28% bracket than in the 15% bracket.
  - Over half of the benefits of this deduction accrue to households with incomes over $100,000.

Incentives have greatest value for high-income families *cont'd*

- The savings incentives are more valuable in higher tax brackets
  - Upper-bracket households save more
  - Shielding asset income is more valuable in the upper brackets
    - Lower brackets: 529 yields after-tax return 25-40 percent above that on a non-advantaged account
    - Highest bracket: 529 yields after-tax return double that on a non-advantaged account

Incentives have greatest value for those attending expensive schools

- The Lifetime Learning Credit has maximum value when tuition & fees exceed $10,000
- 90% of college students attend schools with tuition & fees below $10,000

Incentives have greatest value for those attending expensive schools *cont'd*

- Living expenses do not count toward costs for the credits
  - For those at public colleges, schooling costs are "too low" to qualify for a credit
- Yet living expenses *do* count as a cost for the saving incentives
  - Thereby allowing families with children attending schools like Harvard & Yale to shield substantial assets from taxation

Regressivity reduces the incentive effects of the education tax provisions

- The greatest potential for increases in college education is among low-income students

- Among those who scored in the top 25% on an 8th grade math achievement test
  - Share who never went to college
    - High SES: 1%
    - Low SES: 26%
  - Share who did not complete a BA
    - High SES: 26%
    - Low SES: 71%

- Source: NCES, *Youth Indicators 2005*

The Education Tax Incentives Are Complex

Which Education Tax Incentive Should a Taxpayer Use?

Depends on …

- Income Phase-out
- AMT Status
  - Credits do not survive AMT
  - But tuition deduction does
- Marginal Tax Rate (MTR)
  - Does not affect value of credits
  - Affects value of deduction (value increases with MTR)

Which Education Tax Incentive Should a Taxpayer Use?

Depends on …

- Enrollment Status
  - First two years or higher
  - Half-time or less?
- Number of Students in Household
  - One LLC per *household*
  - One Hope credit per *student*
  - Deduction cap is for *household*
- Type of Schooling Costs
  - Hope, LLC & tuition deduction count tuition & fees
  - 529 & Coverdell count all educational expenses
- Dollar Amount of Schooling Costs
- Interactions with Financial Aid

Complexity reduces the incentive effects of the education tax provisions

- Simple, easily-communicated tuition subsidies have been shown to have a strong impact on college entry & completion
- Little to no evidence that the tax provisions, or complicated need-based aid programs, have any such effect.
- Students cannot respond to a price incentive if they do not know it exists

Complexity reduces the incentive effects of the education tax provisions *cont'd*

- As is the case with traditional, need-based financial aid, complexity blunts the incentive effect of the subsidies
- If we make the education tax provisions more progressive without substantially *simplifying* them, we are unlikely to affect the behavior of
  - First-generation college students
  - Children of non-English speakers
  - Low income high school students

Policy Recommendations

Simplify, Refocus and Coordinate the Tax Benefits for Higher Education

Create a single, refundable credit for tuition, fees, room and board

- A single credit would reduce complexity
  - Families can estimate their credit in advance
- Making the credit refundable would better target the subsidy toward those on the margin of college.
- Counting room and board would
  - Extend the credit to those at public schools
  - Reduce complexity by aligning definitions of costs across the incentives

A simplified credit could have an impact on schooling

- A simple credit can be communicated *easily* and *early*
  - Families would know when their children were young that college was affordable
- Estimates of future education credits could be sent to families
  - Just as estimates of future Social Security benefits are now sent to workers

Ballpark Costs

- Brookings-Urban simulated a roughly similar simplification, estimating costs of:
  - Unify and simplify credits: $1.4b
  - Make credit refundable: $2.1b
- Eliminate tuition deduction: ($1.4 to $2.8b)
- **Cost: $0.7b to $2.1b**
- Sources: Urban-Brookings Tax Policy Center; Joint Committee on Taxation