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before the

Committee on Finance

United States Senate

on

The Role of Higher Education Financing
in Strengthening U.S. Competitiveness
in a Global Economy.

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Chairman Grassley, Senator Baucus, Members of the Committee,I am pleased to have the opportunity to testify before you today on the tax incentives for higher education.

I have studied the impact of college costs on college attendance for ten years. I am interested in the topic for the same reason you are: because I believe that a well-educated workforce is key to the economic competitiveness of the United States and the economic security and well-being of its families.

Growing up, I had it drummed into me that college was the key to economic security. My father was a high school dropout, but my mother went to night school well into her fifties, trying to earn her degree. She knew that education was the key to success in life. Even though she never was able to finish that BA, she made sure that all of her daughters got through college.

College attendance is good not just for me and my sisters, but good for America. Scarcity of any good, including labor, drives up its price. A shortage of college-educated workers drives up their wages, increasing inequality in the US and pushing employers to find cheaper, skilled labor overseas. By making college affordable for more people we can open good jobs to more Americans and keep America competitive.

Today I will talk about how the tax incentives for higher education can help us achieve these goals. As structured, they provide tax relief for middle- and high-income families who are currently sending their children to college - a worthy goal. But as structured, the tax incentives do *not* encourage *more* people to go to college. In my testimony, I will suggest how the tax incentives can be modified so that they do encourage more people to attend college.

Background on Tax Incentives for Higher Education

During the 1990s, the federal and State governments introduced a number of tax policies intended to increase college-going. The tax incentives work in two ways:

(1) Help families save for college

- 529 Savings Plans
- Coverdell Education Savings Account

(2) Help families pay for college today

- Hope tax credit
- Lifetime Learning Credit
- Tuition Tax Deduction

The tax incentives were introduced in the context of rapidly escalating college tuition prices. As shown in Exhibit 1, tuition and fees at four-year, private colleges rose from an average of $9,200 in 1982 to nearly $20,000 in 2003 – and those are inflation adjusted dollars.[1]

Tax Incentives Are Most Valuable for Those at the Most Expensive Colleges

Perhaps with an eye to these eye-popping tuitions, the tax credits and deductions were designed to give the greatest help to students at expensive private colleges. For example, the full benefit of the Lifetime Learning Credit does not kick in until tuition and fees are $10,000 a year (Exhibit 2).

$10,000 a year does not sound very high. After all, Harvard's tuition and fees are over $27,000. But the truth is that 71 percent of students at four-year colleges attend schools with tuition and fees under $10,000. The typical student attends a public university, where annual tuition and fees average $4,700; only four percent of students at public universities pay tuition and fees over $8,000. Or she attends a community college, where average costs are less than $2,000.[2]

Why does it matter that the typical student, at the typical college, cannot qualify for the maximum tax credit? Because it is a typical person – *not* the potential Harvard student – that we are trying to get into a college.

How Do We Modify The Tax Incentives To Get More People into College?

There are three key ways to alter the tax incentives so that they increase college-going.

- *Focus* the incentives on those on the brink of college
- *Simplify* the incentives so that families understand and respond to them
- *Coordinate* the incentives with financial aid to avoid harming families who get aid

[1] Prices are in constant 2003 dollars. The College Board, *Trends in College Pricing 2003*.

[2] The College Board, *op cit*.

I. Focus the incentives on those on the brink of college.

To get more people into college, we need to aim our tax incentives at those on the brink of college, who need a little push. These potential college students are not teetering between skipping college and going to an expensive school like Harvard. They are teetering between skipping college and going to Iowa Central Community College, where tuition and fees are $2,700.[3]

It is this student – trying to decide whether college is the right path, her family nervous about the costs – that we need to help if we want to increase the skills of our workforce. Making the local community college or public university cheaper may just convince her to go to college.[4] Making Harvard cheaper will not.

II. Simplify the incentives so that families understand and respond to them.

Simplicity is not a word that we usually associate with the Internal Revenue Code. But to the extent that we can simplify the tax incentives for education, we will make them more effective. Families cannot respond to an incentive if they do not know about it or do not understand it.

Clear, simple aid programs have the greatest impact on college attendance. For example, Georgia's HOPE scholarship waives college tuition and fees for high school students who achieve a B average in high school. Simple, easy to understand: get a B, go to college for free. 90% of Georgia's high school freshmen know of this aid program and can explain the eligibility rules.[5] We can strive for similar simplicity with the tax incentives. For example, college students could be guaranteed a tax credit of $2,000, the current maximum of the Lifetime Learning Credit and the cost of the typical community college. Very simple: go to college, get a credit of $2,000. At the end of this testimony, I suggest modifications to the incentives that take them in this direction.

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[3] Research shows that the tax credits have not affected college attendance rates, and this is attributed to the inability of low-income families to access the credit. Bridget Terry Long, "The Impact of Federal Tax Credits for Higher Education Expenses," in Caroline Hoxby, ed., *College Choices* (University of Chicago Press, forthcoming)

[4] Extensive research shows that reducing college costs increases college attendance. For a review of this literature, see Susan Dynarski, "Behavioral and Distributional Implications of Aid for College," *American Economic Review* (May, 2002).

[5] For an analysis of the impact of Georgia's HOPE program on college attendance see Susan Dynarski, "Hope for Whom: Financial Aid for the Middle Class and Its Impact on College Attendance," *National Tax Journal* (September, 2000). For an examination of similar programs in other states, including how their program design affects their impact on college attendance, see Susan Dynarski, "The New Merit Aid," in Caroline Hoxby, ed., *College Choices* (University of Chicago Press, forthcoming).

III. Coordinate the incentives with financial aid to avoid harming families who get aid.

The tax incentives for education do not exist in a vacuum. They are layered onto an existing system of financial aid for college students. The tax incentives and financial aid are run by different agencies and overseen by different committees. Without careful coordination between these two sets of policies, families can get hit hard.

The federal aid system's treatment of the Coverdell is a case in point. The aid formula considers assets and asset income to be resources for college, and so aid is lower for families with higher assets and higher income. Until recently, Coverdells were treated particularly harshly.

As of last fall, a family with $1,000 in a Coverdell could lose $1,200 in aid over four years of college. The family was *worse off* because it saved in a program intended to encourage college attendance.[6]

The Department of Education just changed these rules this winter, after the Coverdell had been in existence for *seven years*. There are still problems to be corrected: for example, a family that has saved in a 529 prepaid plan has its financial aid reduced one dollar for each dollar distributed by the plan. Again, this family is worse off than if it had not saved at all.

[6] For discussion of the interactions of the Coverdell with financial aid see Susan Dynarski, "Tax Policy and Education Policy: Collision or Coordination? A Case Study of the 529 and Coverdell Saving Incentives," James Poterba, ed., *Tax Policy and The Economy* (2004).

Four Recommendations to
Focus, Simplify and Coordinate
The Tax Incentives for Education

1) *Merge the Hope and Lifetime Learning Credits and the tuition tax deduction into a single, refundable credit.*
   - This simplifies the tax incentives and extends them to students on the brink of going to college.
   - Having three different tuition tax incentives is confusing; families don't understand which they qualify for.
   - 49% of those who file for Hope and LLC do not receive the full credit because their tax liability is too low.[7]
   - Tax liability is not known until filing, so families are uncertain in September about how large a credit they will receive in April. Families who are struggling to pay for college need to be able to count on the credit – it can't be a gamble whose outcome they discover in April.

2) *Define qualified expenses the same for all the tax incentives.*
   - Each incentive defines qualified expenses differently. This is confusing to families trying to figure out the costs of college and how to pay.
   - Room and board are qualified expenses for the savings plans but not the credits.
   - Many students who want to attend a public college do not qualify for the credits because their tuition and fees are too low. Adding room and board to the credit-eligible expenses would aim more funds at students at the brink of college.

3) *Alter the treatment of non-qualified use of the Coverdell to prevent its abuse.*
   - Those who use the Coverdell for non-qualified purposes should not benefit from doing so.
   - Currently, high income families get more benefit from non-qualified use than low-income families get from qualified use.[8]
   - This is because non-qualified withdrawals from the Coverdell are taxed at the child's rate. This is a boon to high income families, because the child's tax rate is

[7] Bridget Long, "Using the Tax Code to Provide College Aid: The Higher Education Tax Credits, 1998-2001," Harvard University manuscript, 2004.

[8] By investing in a Coverdell and using the funds for college, a low-income family gains 19 percent over investing in a standard mutual account. By investing in a Coverdell and *not* using the funds for education, a high-income family gains 21 percent over investing in a standard account. Source: Susan Dynarski, "Who Benefits from the Education Saving Incentives? Income, Educational Expectations and the Value of the 529 and Coverdell," *National Tax Journal* (June, 2004).

so much lower than the parent’s (Exhibit 3).

- Solution: tax withdrawals at the parent’s rate. Half the states follow this approach in taxing non-qualified withdrawals from the 529. See Exhibit 4 for the incentives this would create.

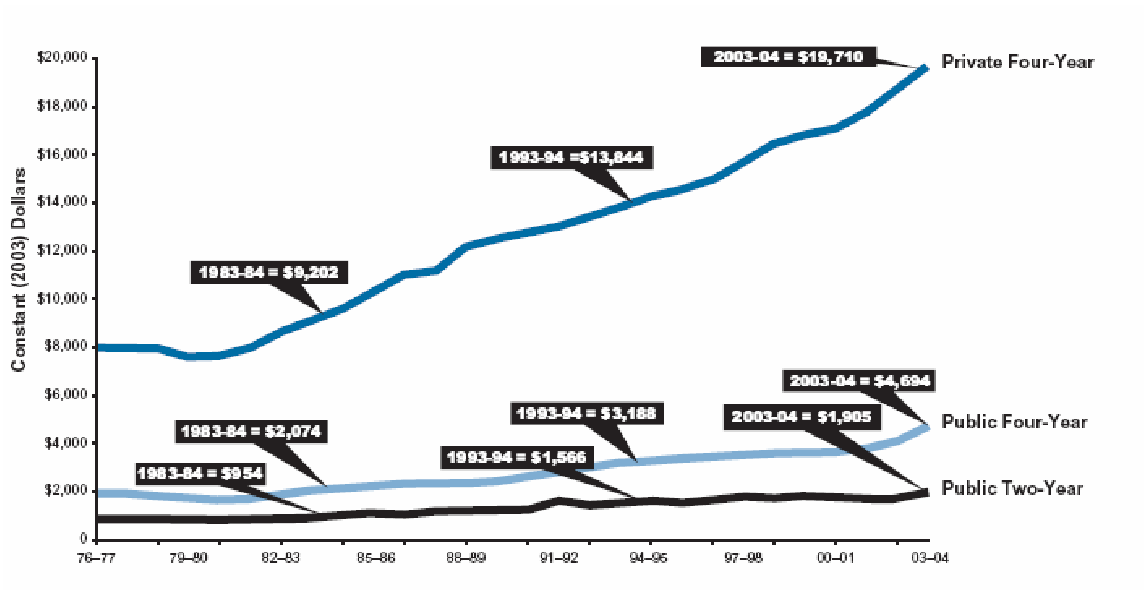
4) *Maintain or increase the current Coverdell contribution limit*

- The $500 limit on the Coverdell severely limited its appeal as a vehicle for college saving.

- If the $2,000 limit cannot be maintained the Coverdell should simply be scrapped, as it adds to the complexity of the tax incentives without providing sufficient value to induce students into college.

- Consider substantially raising the contribution limit on the Coverdell and setting a joint contribution limit with the 529 plans. The Coverdells are simple, have the same rules nationwide, and generally have low fees. Families choose the financial products they wish to place in a Coverdell, and any mutual funds they invest in are subject to the usual SEC rules on disclosure. In all of these characteristics, the Coverdell compares favorably with the 529 savings plans.

Exhibit 1:
Average Tuition and Fee Charges, 1976-77 to 2003-04



Source: *Trends in College Pricing 2003*, College Board (2004).
Tuitions are in 2003 dollars and enrollment weighted.

Exhibit 2
Examples of Tax Savings
Hope Credit, Lifetime Learning Credit, & Higher Education Tax Deduction

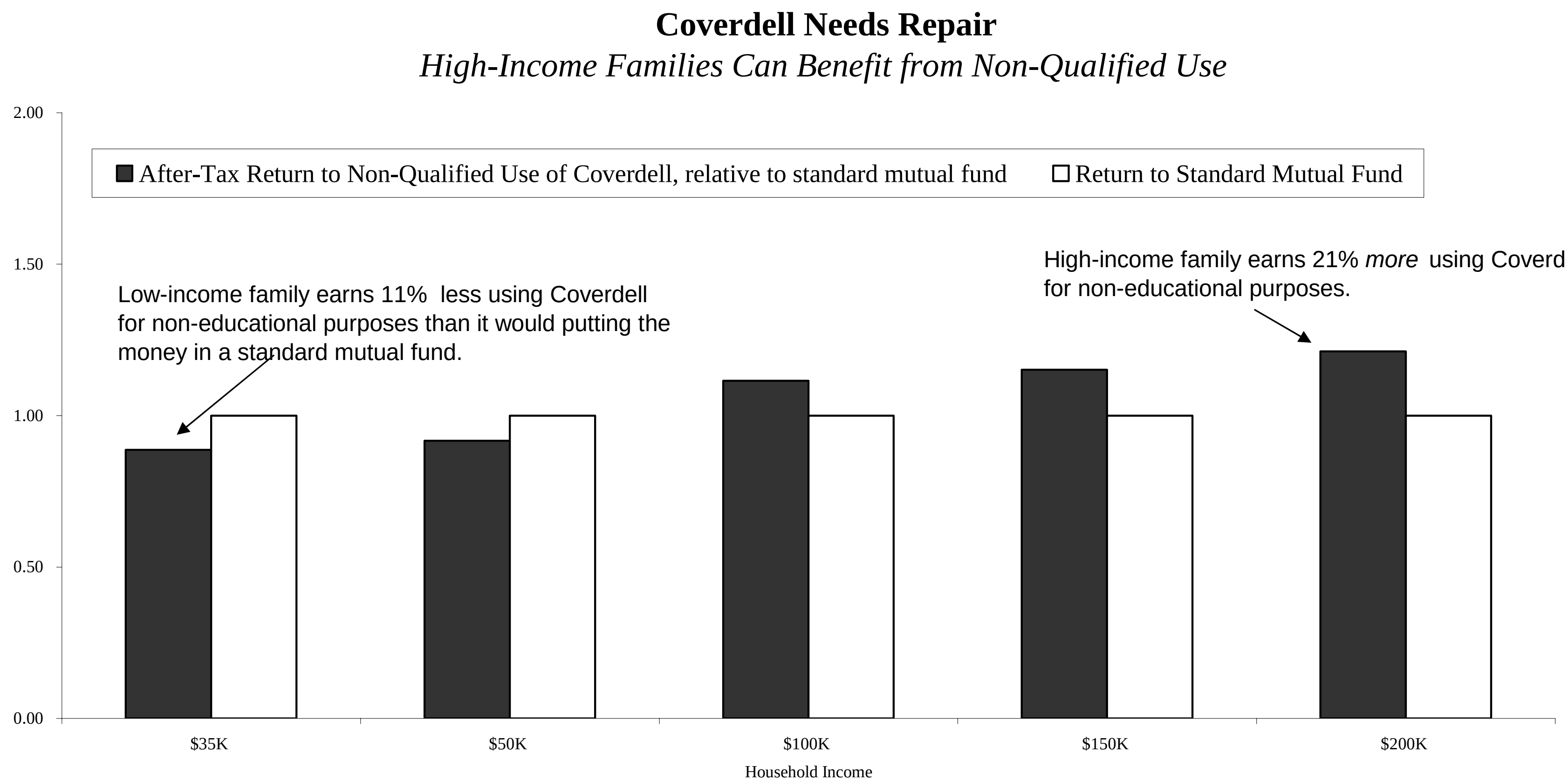
Tuition and fees	Value of tax benefit per return			
	Hope Scholarship Credit	Lifetime Learning Credit	Higher education deduction	
			15% marginal tax rate[a]	25% marginal tax rate[b]
$350	$350	$70	$53	$88
700	700	140	105	175
1,700[c]	1,350	340	255	425
2,000	1,500	400	300	500
3,000	1,500	600	450	750
4,100[d]	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: U.S. Congressional Research Service.

[a] Represents married-couple family filing jointly with one child enrolled full-time in the freshman year of college at an eligible institution of higher education with an AGI of $56,000, which is below the Hope and Lifetime Learning credits' income phase-out range.
[b] Represents married-couple family filing jointly with one child enrolled full-time in the freshman year of college at an eligible institution of higher education with an AGI of $82,000, which is below the Hope and Lifetime Learning credits' income phase-out range.
[c] Average tuition and fees at 2-year public postsecondary institution in 2002-2003, according to The College Board, *Trends in College Pricing 2002*.
[d] Average tuition and fees at 4-year public postsecondary institution in 2002-2003, according to The College Board, *Trends in College Pricing 2002*.
[e] Average tuition and fees at 4-year private postsecondary institution in 2002-2003, according to The College Board, *Trends in College Pricing 2002*.

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

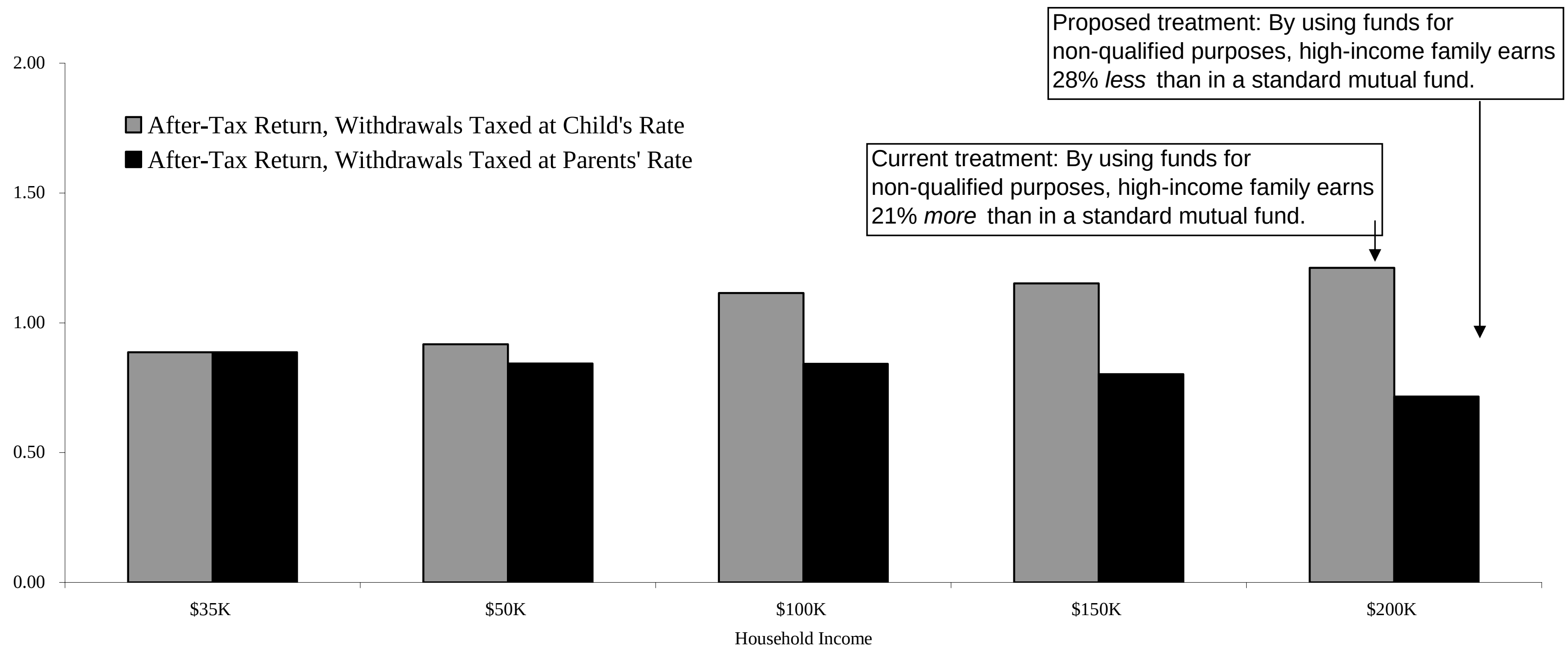
Exhibit 3:



Source: Susan Dynarski, "Who Benefits from the Education Saving Incentives? Income, Educational Expectations and the Value of the 529 and Coverdell," *National Tax Journal* (June, 2004).

Exhibit 4:

Taxing Non-Qualified Withdrawals at the Parent's Tax Rate Would Discourage Abuse of the Coverdell



Source: Susan Dynarski, "Who Benefits from the Education Saving Incentives? Income, Educational Expectations and the Value of the 529 and Coverdell," *National Tax Journal* (June, 2004).