

# “Are Tax Credits the Proper Tool for Making Higher Education More Affordable?”

Testimony by  
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## **Mr. Chairman and members of the Committee:**

I am Scott Hodge, president of the Tax Foundation. Thank you for the opportunity to speak to you today on the issues surrounding education and taxes.

Founded in 1937, the Tax Foundation is the nation’s oldest organization dedicated to promoting economically sound tax policy at the federal, state, and local levels of government. We are a non-partisan 501(c)(3) organization.

For 75 years, the Tax Foundation’s research has been guided by the immutable principles of economically sound tax policy that were first outlined by Adam Smith – taxes should be neutral to economic decision making, they should be simple, transparent, stable, and they should promote economic growth.

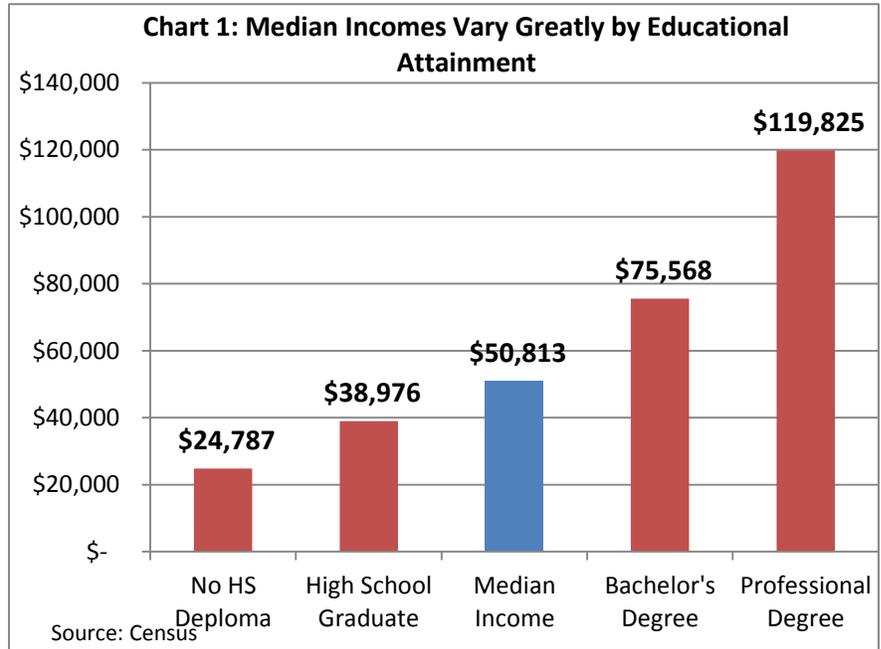
In other words, the ideal tax system should do only one thing – raise a sufficient amount of revenues to fund government activities with the least amount of harm to the economy. By all accounts, the U.S. is far from that ideal. According to the National Taxpayer Advocate, tax complexity is the number one issue facing taxpayers and the IRS today. The main cause of that complexity has been the proliferation of credits, deductions, and preferences built into the tax code.

## **Introduction**

Inequality is on the minds of many these days and it is commonly thought that the Bush-era tax rates are a principle cause. The reality is very different, however. One of the biggest contributors to rising inequality in America today is the growing earnings gulf between workers with college degrees and those without. Indeed, as can be seen in Chart 1, the median income for a worker with a 4-year college degree was \$75,568 in 2010. By contrast, the median income for a worker with only a high school diploma was nearly half as much – \$38,976. There is even greater income disparity between those with high school diplomas and those with advanced degrees.

As Chart #2 clearly shows, America's income gap is really an education gap. At the bottom end of the income scale, about 70 percent of low-income Americans have a high school degree or less, whereas at the other extreme 78 percent of those earning over \$250,000 have a college education or better.

To some, America may be the land of the haves and have-nots, but at the heart of that disparity is that some have a sheepskin while the others don't.

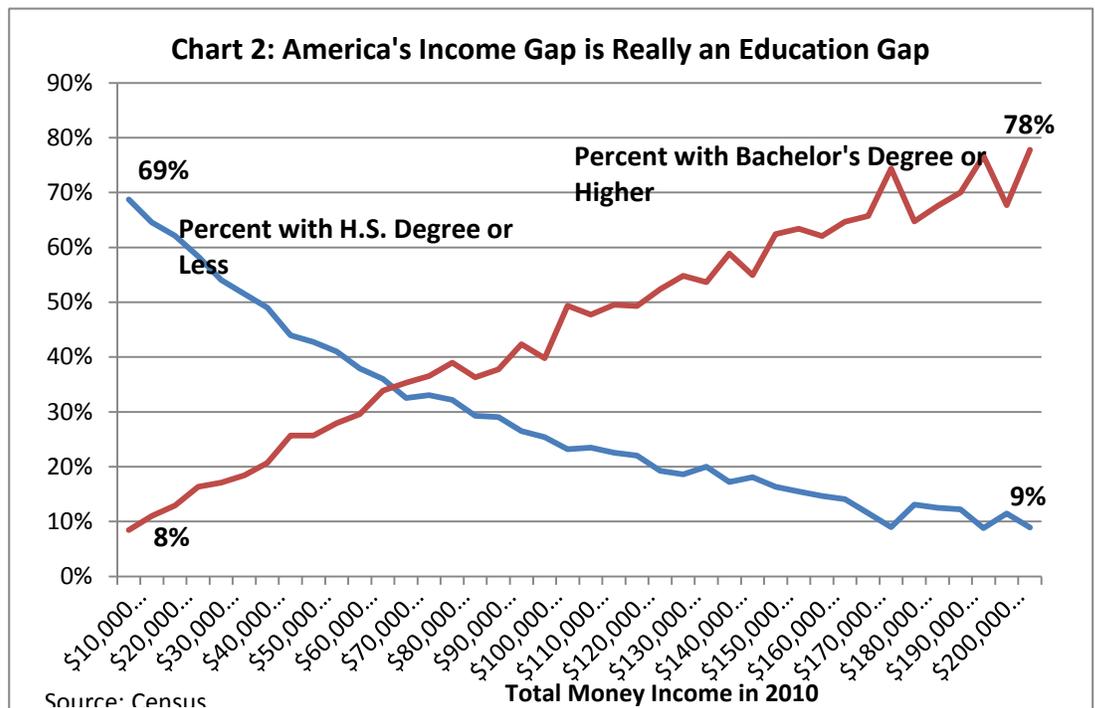


Considering the financial benefits of getting a college degree, higher education policy has shifted in recent years away from traditional loan and direct subsidy programs (such as Pell Grants) toward the use of various tax credits and deductions.

The question is, is the tax code the proper tool to increase access to higher education and make college more affordable?

Generally speaking, the answer is no.

First, these tax credits violate the principles of sound tax policy by greatly increasing the complexity and distortions in the tax code. But there are serious practical reasons we should be wary of using such policies and this will be the focus of my testimony today.



I will discuss four of the more serious unintended consequences of using tax policy to promote higher education:

1. Tax credits and subsidies undermine market forces and can actually cause price inflation for the very thing they are intended to make more affordable. It is clear that higher education is headed down the same path as health care and housing for the same reasons.
2. The extensive use of tax credits has already knocked a record 58 million Americans off the tax rolls – 41 percent of all filers have no income tax liability after taking their credits and deductions. In addition to the lost revenues from having so many people off the tax rolls, and the social cost of having so many Americans with no skin in the game, our research suggests that the 20 year growth in nonpayers is associated with more than \$200 billion in higher transfer spending this year. There is also a strong correlation between the growth in nonpayers and increases in the national debt.
3. Education tax credits and deductions tend to benefit high-income taxpayers much more than low income families. About one-third of the benefits of these credits accrue to families earning over \$100,000.
4. The over-use of tax credits has turned the IRS into an extension of – or substitute for – other government agencies. The IRS is not equipped to be a social welfare agency. As a result, these credits tend to be abused and fraud rates are very high.

It is time to call a truce to using the tax code for social and economic engineering. Instead, the tax code should be overhauled by eliminating all of these provisions while flattening tax rates.

### **Education Going the Way of Health Care and Housing**

It should be no surprise that the sectors suffering the biggest financial crises today – health care, housing, and now higher education – all receive the most government intervention through the tax code and other mechanisms such as subsidized loans.

The effect of these policies is well known. For example, the tax preference for employer-provided health insurance creates a classic third-party payer problem in which patient-consumers are disconnected from the cost of service. The cost of health care is soaring because we have an unlimited demand for health care due to the belief that someone else is paying the bills. The market forces that deliver quality goods at low prices for everything from toasters to automobiles have been disrupted in the health care system because it is tax preferred.

Housing suffers a similar problem because of the plethora of tax and spending subsidies intended to promote home ownership.<sup>1</sup> Economists find that the mortgage interest deduction gets

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<sup>1</sup> While the lion's share of the blame for the current housing crisis properly rests with government-sponsored enterprises Fannie Mae and Freddie Mac, the MID certainly played a role in encouraging some families to purchase homes that they really could not have afforded otherwise. Canada does not have a mortgage interest deduction, yet its rate of homeownership is equal to that in the U.S. Professor Dennis J. Ventry, Jr. of the UC Davis School of Law, calls the Mortgage Interest Deduction (MID) the "accidental deduction," because the authors of the original tax code

capitalized into the price of homes and may amplify price volatility<sup>2</sup>, which then offsets whatever effect it has on promoting home ownership. The actual economic benefits of those capitalized costs tend to flow to the home builders and realtors, who have naturally been the most vocal opponents of eliminating the deduction. One study determined that the mortgage interest deduction is “an ineffective policy to promote homeownership and improve social welfare.”<sup>3</sup>

Subsidized student loans and education credits are similarly fueling higher college costs by disconnecting student-consumers from the true cost of higher education. In turn, the benefits of these programs get capitalized into tuition costs because universities can boost tuitions without suffering the normal market backlash.

In the wake of the housing bubble, the next loan bubble is in student loans. The Consumer Financial Protection Bureau reports that the amount of outstanding student loan debt has topped \$1 trillion. Americans now have more student loan debt than consumer debt. And, unlike housing and consumer debt, people cannot walk away from these loans in bankruptcy or dump them in short sales. The loans are with people forever. While the interest deduction for student loans may give them some relief, the benefits of that deduction accrue largely to upper-middle class households.

The cure for what ails these industries is to be weaned off the tax code, not the granting of more subsidies through increased credits and deductions.

### **Tax Credit Proliferation**

Over the past two decades, lawmakers have increasingly asked the tax code to direct all manner of social and economic objectives, such as encouraging people to buy hybrid vehicles, purchase health insurance, buy a home, replace the home’s windows, adopt children, put them in daycare, take care of grandma, purchase school supplies, go to college, and the list goes on.

In too many respects, the IRS has become an extension of, or rather a substitute for, every other Cabinet agency – from Energy and Education to HHS and HUD. But perhaps the most troubling development in recent years is that the efforts of lawmakers to use the tax code to help low and middle-income taxpayers has knocked millions of taxpayers off the tax rolls and turned the IRS into an extension of the welfare state.

Today, as can be seen in Chart 3, a record number of Americans – 58 million, or 41 percent of all filers – now have no direct connection with the basic cost of government because they pay no income taxes. We have not had such a large share of people off the tax rolls since 1940 when the income tax became a “mass tax.”

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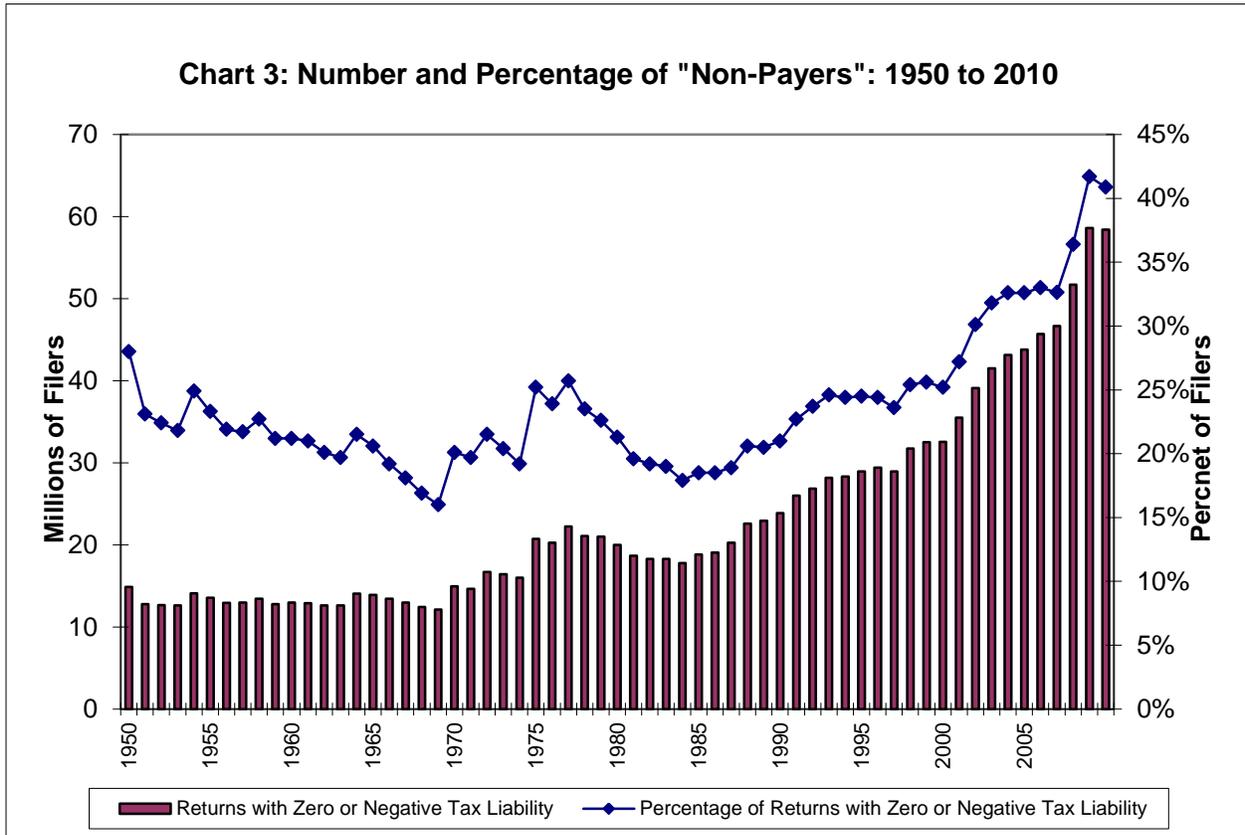
never intended the deduction for personal interest expenses to subsidize home ownership. See: Dennis J. Ventry, Jr., “The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest,” UC Davis Legal Studies Research Paper Series, *Research Paper No. 196*, November 2009.

<sup>2</sup> Dan Andrews, “Real House Prices in OECD Countries: The Role of Demand Shocks and Structural and Policy Factors,” *OECD Economics Department Working Papers*, No. 831, OECD Publishing, 2010.

<sup>3</sup> Christian A. L. Hilber and Tracy M. Turner, “The mortgage interest deduction and its impact on homeownership decisions,” August 2010.

If we add this group to the people who have some income but don't file a tax return, the ranks of American households outside the income tax system rises to nearly 50 percent.<sup>4</sup>

Many of these 58 million tax filers now look to the IRS as a source of income thanks to the more than \$100 billion in refundable tax credits paid out to people who have no income tax liability.



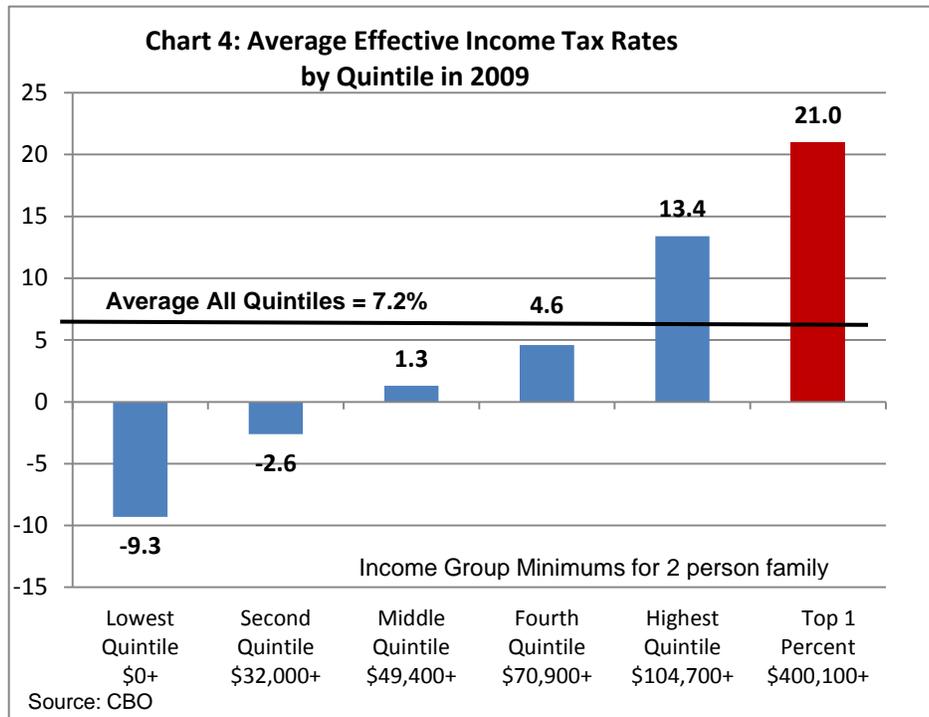
As a result of removing millions of people off the bottom of the tax rolls, we have dramatically reduced the number of people with “skin in the game.” According to the Congressional Budget Office, the bottom two quintiles – representing the bottom 40 percent of taxpayers – now have a negative income tax liability. This means, they don't pay income taxes, they simply get checks back from the IRS.

As we can see in Chart 4, people in the lowest quintile have an average effective income tax rate of -9.3 percent while those in the second quintile have an average effective tax rate of -2.6 percent. More worrisome is the fact that the middle quintile – representing the middle 20 percent of taxpayers – has an overall effective tax rate nearing zero, just 1.3 percent.

<sup>4</sup> Roberton Williams, “Why Nearly Half of Americans Pay No Federal Income Tax,” *Tax Notes*, June 7, 2010, p. 1149.

The means that for all practical purposes, the bottom 60 percent of taxpayers have little or no connection with the basic cost of government. Indeed, to them the IRS is a source of cash benefits because of the growth in refundable tax credits.

Chart 5 details the growing cost of non-refundable and refundable tax credits over the past two decades.<sup>5</sup> In 1990, the combined value of these credits was roughly \$20 billion, after adjusting for inflation. Of that amount, the budgetary cost of basic tax credits was around \$8 billion, while refundable credits totaled \$12 billion.



By 2000, non-refundable tax credits had grown to a budgetary cost of \$46.5 billion, in 2012 dollars. The child credit was, by far, the biggest portion of this at more than \$25 billion, after adjusting for inflation. Some 26 million taxpayers took advantage of the child credit that year. Refundable credits amounted to \$43.4 billion in 2000, nearly all of which was attributed to the EITC.

A decade later, the combined budgetary cost of both the non-refundable and refundable tax credits reached a remarkable \$224 billion in 2010. To put this cost in perspective, it is larger than the budgetary cost for the tax exclusion for employer-provided health insurance, which is the largest tax expenditure in the federal budget. In 2010, the budgetary cost of non-refundable tax credits was \$104 billion. Roughly two-thirds of these costs were comprised of the non-refundable portions of the Making Work Pay Credit and the Child Credit. Another 24 percent of these costs were attributable to the foreign tax credit and to the education credits.

As of 2010, refundable cash payments to nonpayers comprised over half (\$120 billion) of the total cost of tax credits. The largest refundable credits in 2010 were the EITC (\$59 billion), and the refundable portions of the child credit (\$27.5 billion) and the Making Work Pay Credit (\$16 billion).

<sup>5</sup> Internal Revenue Service, Table A. Selected Income and Tax Items for Tax Years, 1990-2009, in Current and Constant 1990 Dollars <http://www.irs.gov/pub/irs-soi/09intba.xls>

## The Growth of Education Credits

In the scope of federal assistance for higher education expenses, tax credits and deductions are relatively new.<sup>6</sup> Prior to the enactment of the Hope Scholarship Credit and the Lifetime Learning Credit in 1997, the government’s primary tools for helping students had been direct assistance (such as the G.I. Bill and Pell Grants) and loan programs. Since 1997, however, lawmakers have increasingly turned to the tax code to help students and families with education costs.

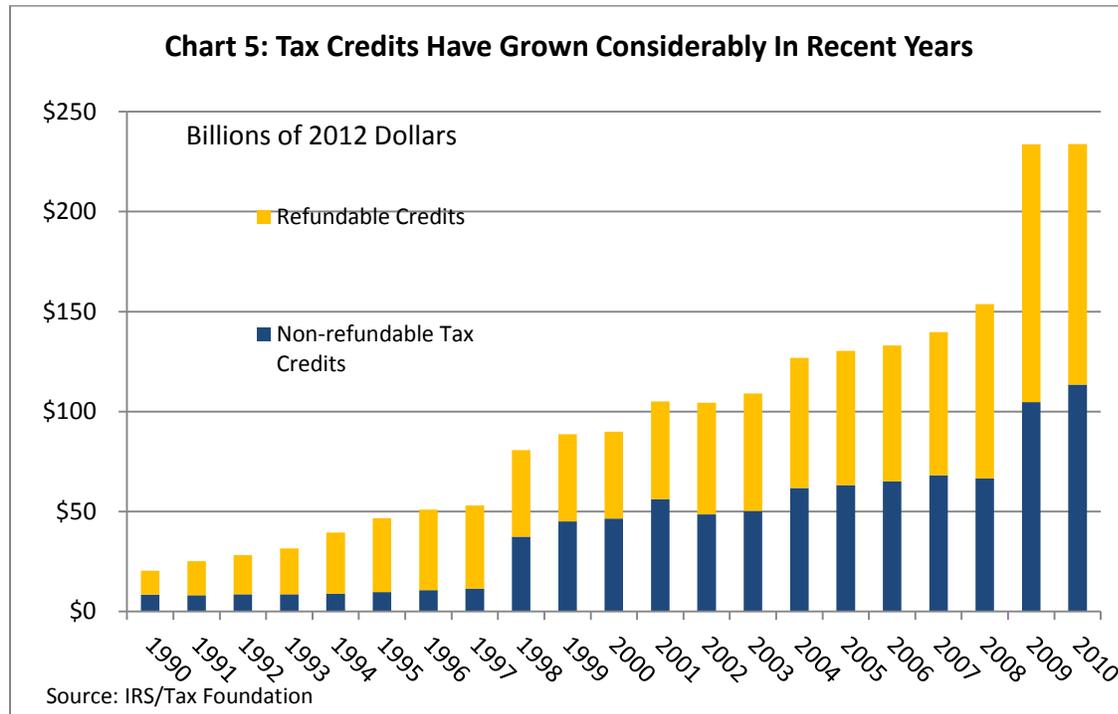
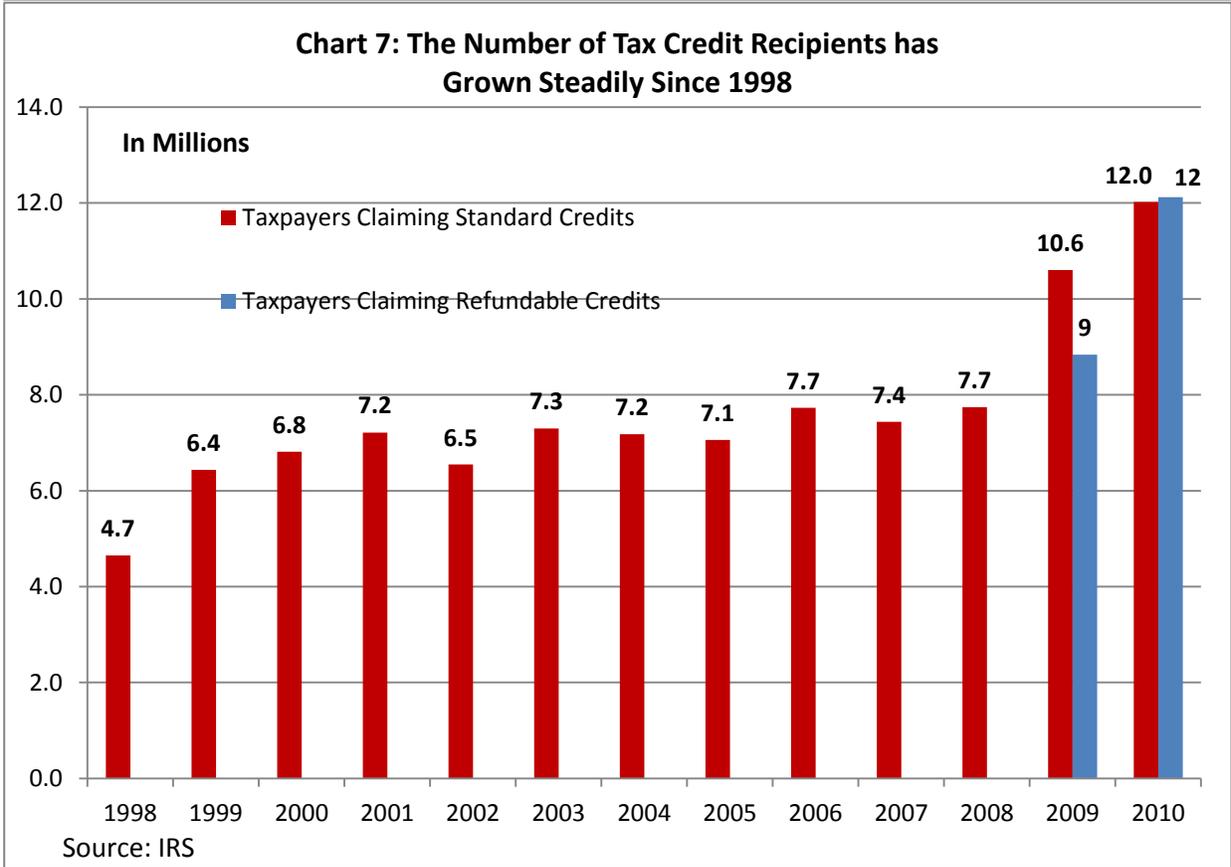
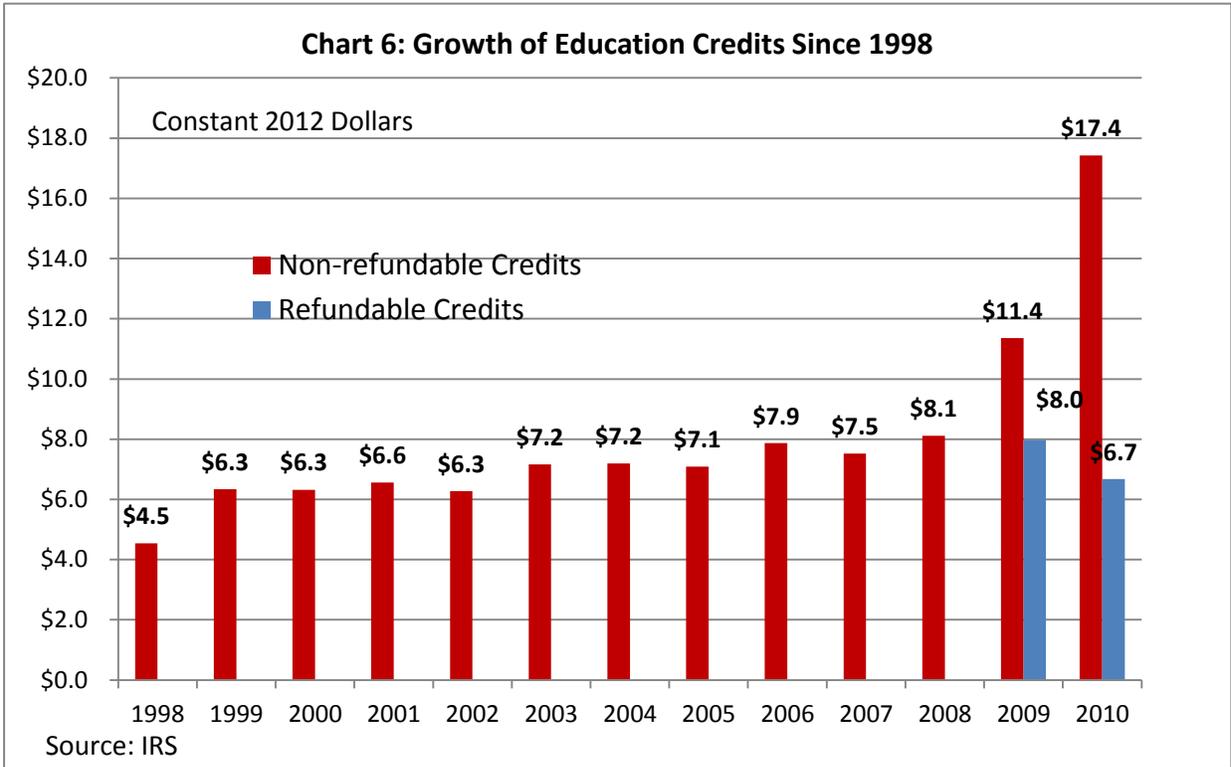


Chart 6 illustrates the gradual growth of the budgetary costs of education tax credits since 1998, while Chart 7 documents the number of tax returns claiming those credits each year since 1998. In 1998, some 4.7 million taxpayers claimed \$4.5 billion in credits, after adjusting for inflation. Within five years, the number of taxpayers claiming these credits had climbed to over 7 million, while the inflation-adjusted costs increased to over \$7 billion. In other words, the average taxpayer claimed roughly \$1,000 in education tax credits.

The cost of these programs held steady until 2009 with the enactment of the American Opportunity Tax Credit (AOTC). The AOTC is more generous than the Hope Credit – it is worth 100 percent of the first \$2,000 of education expenses compared to \$1,200. It also allowed taxpayers with higher incomes can claim the credit – it phases out at \$180,000 for joint filers compared to \$120,000 for the Hope Credit. Lastly, the AOTC was made refundable for those with no income tax liability.

<sup>6</sup> For a short history of federal assistance for higher education costs, see Elaine M. Maag and Katie Fitzpatrick, “Federal Financial Aid for Higher Education: Programs and Prospects,” Urban Institute, January, 2004.



As can be seen in Chart 6, the inflation-adjusted cost of non-refundable education credits jumped from \$8.1 billion in 2008 to \$11.4 billion in 2009 and then to \$17.4 billion in 2010. Moreover, the IRS distributed \$8 billion in refundable American Opportunity credits in 2009 and another \$6.7 billion in 2010.

Meanwhile, as is shown in Chart 7, the number of taxpayers claiming various education credits more than doubled between 2008 and 2010, from 7.7 million to over 16 million. In 2010, some 12 million taxpayers received refundable AOTC credits even though they had no income tax liability.

The table below compares the current value of the non-refundable credits and refundable credits relative to the other large credits in 2010. Education credits are the third-most costly basic tax credit, behind the Making Work Pay Credit and the Child Tax Credit, and the fourth-most costly refundable tax credit.

<b>Largest Tax Credits Claimed by Taxpayers in 2010</b>			
<b>Non-Refundable Portions</b>	<b>In Billions</b>	<b>Refundable Portions</b>	<b>In Billions</b>
Making Work Pay Credit	\$37.30	EITC	\$60.47
Child Tax Credit	\$28.70	Child Credit	\$28.12
Education Credits	\$16.80	Making Work Pay Credit	\$17.40
Foreign Tax Credit	\$13.10	American Opportunity Credit	\$6.43
Residential Energy Credit	\$6.30	First Time Homebuyer	\$1.00
		Adoption Credit	\$1.00

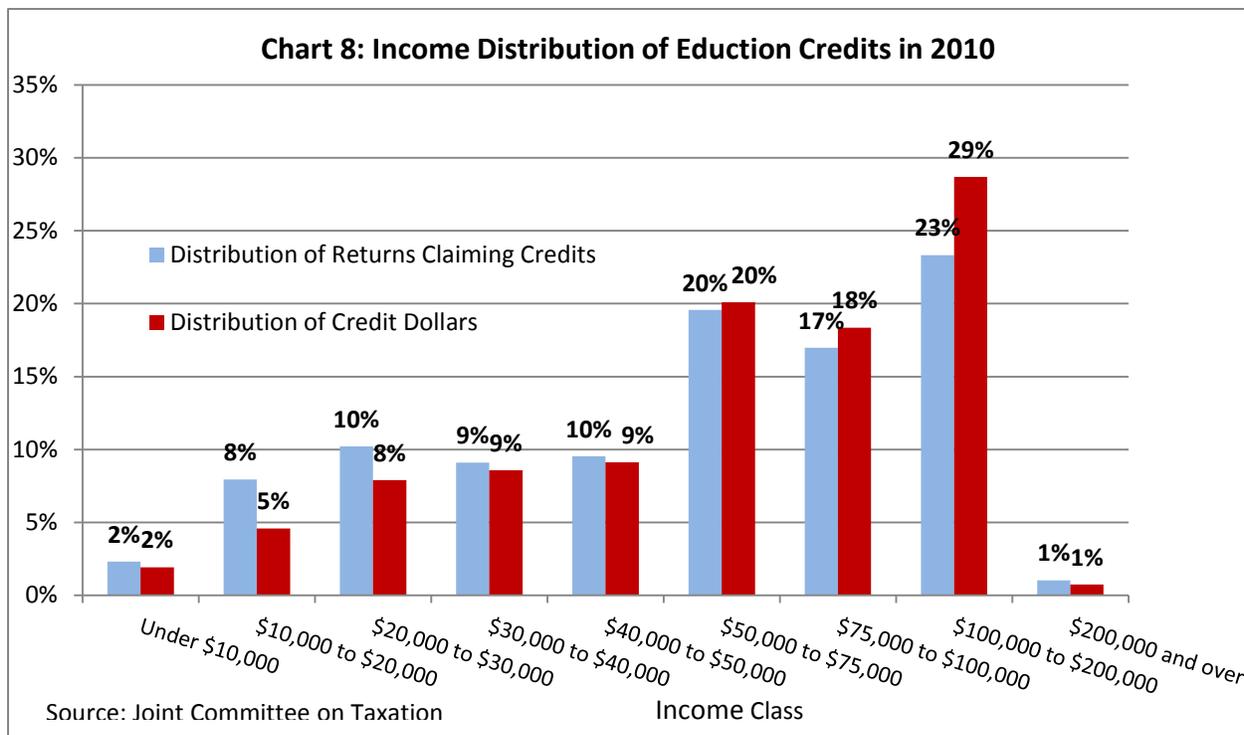
Source: IRS

### **Distributional Issues**

One of the dominant issues in any discussion of tax preferences is who benefits from them. Because the value of a tax deduction depends upon the marginal tax rate faced by the taxpayer, many of the largest and well known tax preferences – such as the mortgage interest deduction, deduction for state-local taxes, and the deduction for student loan interest –tend to benefit upper-income taxpayers because they are the taxpayers who itemize.

Credits are only of value to taxpayers to the extent that they have an income tax liability to which those credits may be applied. As we've seen, this is becoming increasingly difficult because so many taxpayers are off the tax rolls because of the plethora of generous tax credits. The only way to provide more tax benefits to these taxpayers is to simply write them a check in the form of a refundable tax credit.

As Chart 8 illustrates, roughly 30 percent of the current benefits of education tax credits accrue to taxpayers earning over \$100,000 and an additional 18 percent accrues to those earning over \$75,000. By most accounts, these tax preferences are becoming upper-middle class entitlements.



### The IRS is Ill-Equipped to Manage Tax Credits

The cost of tax credits are often larger than their budgetary costs. They increase the cost of compliance for taxpayers and the IRS, and they are susceptible to fraud. As it stands, simply complying with the tax code costs taxpayers an estimate \$163 billion each year. About 62 percent of all taxpayers use tax return preparers, but the percentage climbs to about 73 percent for those claiming the EITC, for example.<sup>7</sup> The complexity of EITC eligibility is a contributing factor to the estimated \$11 billion to \$13 billion in improper overpayments according to the IRS.<sup>8</sup>

Problems with education credits have not reached this level, but there is cause for concern. For instance, the Treasury Inspector General for Tax Administration has found that, “Some taxpayers are claiming the Hope Credit for more years than allowed by law.”<sup>9</sup> The limit is two years but some were found to claim the credit for three and even four years. In one investigation, the IG found that “the amounts of credits inappropriately claimed averaged close to \$1,400 and totaled just over \$232 million.”<sup>10</sup>

Furthermore, the IG reported that:

<sup>7</sup> National Taxpayer Advocate, Report to Congress: Fiscal 2010 Objectives, June 30, 2009, p. xxii.

[http://www.irs.gov/pub/irs-utl/fy2010\\_objectivesreport.pdf](http://www.irs.gov/pub/irs-utl/fy2010_objectivesreport.pdf)

<sup>8</sup> “Improper Payments in the Administration of Refundable Tax Credits,” Testimony of J. Russell George, Treasury Inspector General for Tax Administration, before the Committee on Ways and Means, Subcommittee on Oversight, U.S. House of Representatives, May 25, 2011, p. 3.

<sup>9</sup> “Improvements and Needed in the Administration of Education Credits and Reporting Requirements for Educational Institutions,” Treasury Inspector General for Tax Administration, September 30, 2009, Reference Number: 2009-30-141, p. 2.

<sup>10</sup> Ibid.

“educational institutions are spending millions of dollars and staff hours each year to provide taxpayers and the IRS with copies of Tuition Statements (Form 1098-T). However, the IRS does not use this Form in its compliance programs, or accept the Form as documentation to support claims for education credits.”<sup>11</sup>

More recently, the IG has raised red flags about taxpayers improperly claiming the American Opportunity Tax Credit. Again, reports the IG:

“The IRS requires no documentation to be provided to verify eligibility, including whether an individual claimed as a student even attends a required accredited educational institution. Our review is identifying significant improper payments being made to taxpayers claiming the credit and using ineligible students.”<sup>12</sup>

I would argue that while we should be appalled by such abuse, we should not be surprised by it. As the IG testified, “Although each of these refundable credits provides benefits to individuals, the unintended consequences of these credits is that they are often the targets of unscrupulous individuals who file erroneous claims for those benefits.”<sup>13</sup>

Moreover, enforcing these credits is simply asking the IRS to be more than a tax collection agency. It is asking it to manage a social program – a role far beyond what it is designed to perform.

## **Conclusion**

While we all understand the value and financial benefit of getting a college degree, using the tax code to “make college more affordable” not only violates the principles of sound tax policy, but also produces serious unintended consequences.

These “tax programs” – for lack of a better word – are likely contributing to the rising costs of higher education while helping to knock millions of people off the tax rolls. This, in turn, is disconnecting millions of people from the basic cost of government and transforming the IRS into an extension of the Department of Education and the welfare system.

These are not the kind of consequences that can be cured by a simple reform of tax credits, but by a wholesale reform of the entire tax code.

Thank you very much for the opportunity to discuss these issues with the Committee today. I look forward to any questions that you may have.

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<sup>11</sup> Ibid., p. 1.

<sup>12</sup> Testimony of J. Russell George, Ibid., p. 7.

<sup>13</sup> Ibid., p. 2.