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UPSIDE DOWN

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Upside Down: Higher Education Tax Spending

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Every family should be able to save and invest in their child's education

Income helps families get by; savings and investments help them get ahead. There is no better investment that families can make to break the cycle of poverty than to invest in the talents and aspirations of their children. Higher education is one the surest pathways out of poverty and one of the most effective strategies for securing a foothold in the middle class.[1]

As a nation, we believe in this transformative power of education. Our federal budget reflects this belief, devoting large sums to help millions of Americans afford higher education. This support is especially important to the less than 10% of low-income students who graduate from college by their mid-20s.[2] Federal investments in these students' education are an investment in economic opportunity.

In the last several years, federal tax spending programs (also known as "tax expenditures") have become an increasingly large source of support for higher education. Unfortunately, most of the billions of dollars we now spend on higher education tax benefits fails to support the families who need support the most. Federal reforms are necessary to turn this upside-down tax spending right-side up. This report provides an overview of the size and shape of higher education tax spending, the distribution of these benefits, the tax support for college savings in particular and federal policy recommendations that can expand educational opportunity for all Americans.

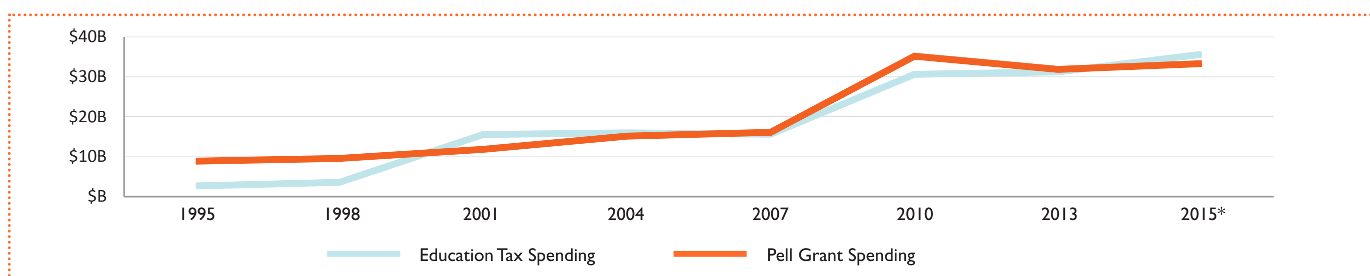
The remainder of the report is organized as follows:

1. Size of higher education tax spending
2. Distribution of tax spending for higher- and lower-income households
3. Tax support for college savings
4. Federal policy recommendations to turn higher education tax spending right-side up

I The tax code spends billions of dollars to support higher education

Tax spending is one of the largest sources of support for higher education. The federal government spent more than $60 billion in the form of non-loan aid to help students pay for higher education in 2013. While spending on Pell Grants for low-income students accounts for a significant percentage of that support, federal tax spending accounts for an even greater share.[3] This is not a new phenomenon. Although most higher education tax spending programs came into existence only in the last twenty years, they have grown quickly. Between 1995 and 2003, Pell Grant spending increased 258% (adjusted for inflation), while higher education tax spending increased more than 1,050%. Given this rapid pace of expansion, it is no surprise that tax spending on higher education has regularly matched or exceeded Pell Grant spending since the early 2000s.

For 20 years, higher education tax spending has regularly matched or exceeded Pell Grant spending



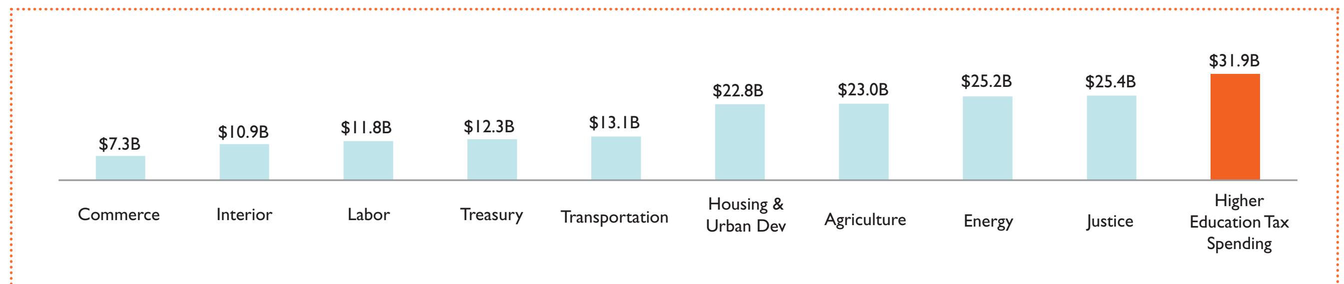
Author's calculations based on Office of Management and Budget (Appendix, Budget of the United States Government) data for fiscal years 1997, 2000, 2003, 2006, 2009, 2012 and 2015. Inflation adjusted to 2013 dollars. Values for 2015 are presidential budget requests, not actual outlays. Tax expenditures include the following: exclusion of scholarship and fellowship income, the HOPE tax credit, the Lifetime Learning Credit, the American Opportunity Tax Credit (including refundable portion), Coverdells, 529s, deduction for student loan interest, deduction for higher education expenses, parental personal exemption for students and exclusion of employer-provided educational assistance.

In 2013, the largest sources of this tax spending were:[4]

- **$16.6 billion – American Opportunity Tax Credit (AOTC)**, a $2,500 partially refundable credit for tuition, fees and books for students at degree-granting postsecondary institutions. The AOTC can be claimed for up to four years of undergraduate education, and families without tax liability can claim as a refund up to $1,000 of the credit each year.
- **$5.2 billion – Parental personal exemption for students**, which allows families to reduce their taxable income by claiming a student aged 19-23 as a dependent. Without this provision, most students over the age of 18 cannot be claimed as dependents by their parents.
- **$2.9 billion – Exclusion of scholarship income,** which allows students who use academic scholarships to pay for qualified expenses—generally tuition, fees and course materials—to reduce their tax liability by excluding those scholarship dollars from their taxable income.
- **$1.8 billion – Lifetime Learning Credit (LLC)**, a $2,000 nonrefundable credit that applies to tuition and fees. Unlike the AOTC, the LLC can be claimed for graduate school expenses (in addition to undergraduate expenses) and can be claimed for an unlimited number of years.
- **$1.75 billion – 529s and Coverdells** allow families to deposit after-tax savings into a restricted savings account that grows tax-free, similar to a Roth IRA. An account's designated beneficiary can use the savings to pay for qualified higher education expenses (and K-12 expenses in the case of Coverdells).
- **$1.7 billion – Deduction for student loan interest**, a $2,500 above-the-line deduction that can be claimed for loans taken out to pay for tuition and fees, course materials, room and board, and other expenses like transportation.
- **$0.7 billion – Exclusion for employer-provided education assistance**, a $5,250 exclusion for education benefits provided to employees by their employers, covering tuition, fees and course materials.
- **$0.6 billion – Deduction for higher education expenses,** a $4,000 above-the-line deduction that can be claimed for tuition and fees. Neither room and board nor course-related materials are eligible expenses for this deduction.

To put this funding in perspective, the amount of tax spending on higher education is larger than the discretionary budgets of nine cabinet-level departments. From another perspective, spending through the tax code for higher education is roughly equal to the primary sources of federal support for special education (IDEA), K-12 (Title 1-A) and Pre-K (Head Start) *combined*.

Billions in Perspective: federal higher education tax spending in 2013 outweighed the discretionary budgets of 9 federal cabinet-level agencies



Author's calculations based on data from the Office of Management and Budget (2014) and Tax Policy Center (2014).

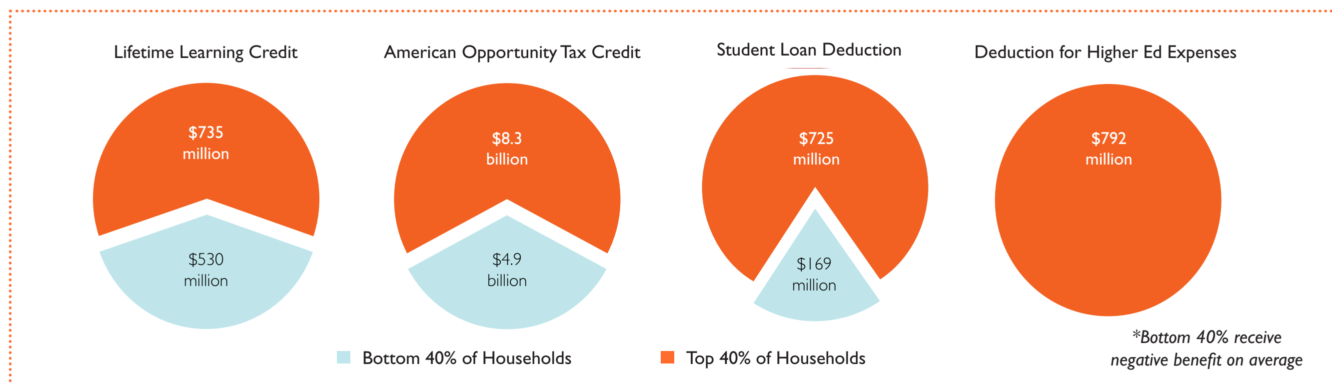
2 Education tax spending focuses support on high-income households

Federal investment in education should aim to expand opportunity regardless of whether the investment is made through direct or tax spending. Aid may come through tax spending, such as the AOTC, or direct spending, such as Pell Grants. But the most important feature of higher education support is not the mechanism through which it is provided, but the effectiveness with which it expands opportunity.

Pell Grants, for instance, clearly target aid to working families and students who need support the most. Among dependent students who received Pell Grants in the 2011-2012 school year, 95% came from families that made less than $60,000 per year.[5] Pell Grants primarily helps working families and individuals afford college, expanding opportunity for students who might otherwise not attain a higher education degree. Tax support may reach further up the income spectrum, but the focus of *all* higher education aid policy should be to expand opportunity in this way.

A simple test of equity and efficiency: do the bottom 40% of households receive as much aid as the top 40%? For a four-person household, the bottom 40% make less than about $70,000 annually on average; the top 40% make more than $100,000.[6] An education aid program that fails the 40/40 test clearly fails to focus support on expanding educational opportunity. The Urban Institute analyzed four of the largest sources of higher education tax spending, the American Opportunity Tax Credit (AOTC), the Lifetime Learning Credit (LLC), deduction for interest on student loans and deduction for higher education expenses.[7] Combined, these four credits cost the federal government $20.4 billion in 2013—accounting for the vast majority of all spending on higher education tax spending. Not one of these tax credits passes the 40/40 test. In fact, for all but the LLC, the top 40% of households receives more than all other households combined.

Upside Down: Higher education tax spending focuses support on high-income households



Author's calculation based on data from Urban Institute (2014).

Poorly targeted tax spending leaves working families behind. For every dollar of aid a top 40% household receives from one of these tax benefits, a bottom 40% household receives less than 52 cents. The largest of these programs, the AOTC, is partially refundable, increasing the benefits it provides to low-income households. But even with this commendable feature, the top 40% of households received $8.3 billion from the program in 2013—more than half of all AOTC spending.

While smaller in size, the most lopsided of these higher education tax spending programs is the deduction for higher education expenses. On average, the bottom 40% of households receives *negative* support from the deduction because it increases tax code complexity. Many families accidentally claim the deduction instead of an alternative higher-value credit (like the AOTC or LLC), thus reducing their overall tax benefit. A 2012 GAO report found that over 200,000 households claimed the deduction for higher education expenses instead of the more valuable LLC in 2009.[8] Because of its structure, the deduction for higher education expenses is essentially a Pell Grant for the wealthy, providing support almost exclusively to those at the very top.

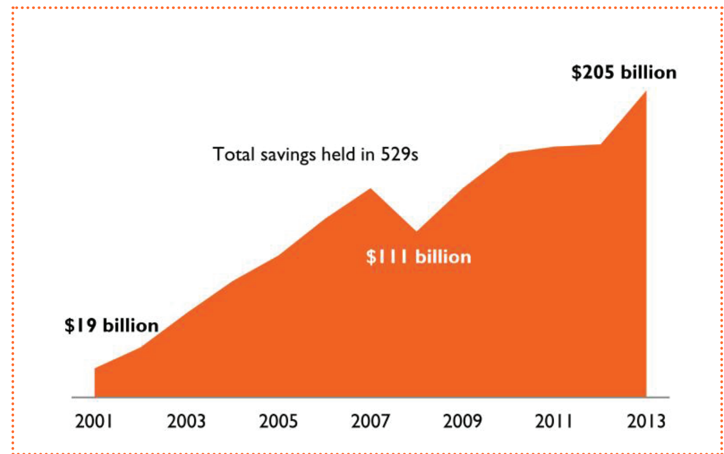
3 Existing tax incentives fail to help most families save for college

Most higher education tax spending is poorly timed for working families. More than 90% of higher education tax spending comes in the form of after-purchase subsidies, meaning households receive the tax benefit months after paying for tuition, buying books or financing some other qualified education expense. This structure of support naturally benefits high-income households who can tap existing savings for educational purchases today while counting on support in the future after they file taxes. This does very little for the 44% of Americans who are liquid asset poor and do not have the financial resources necessary to front these costs.[9]

But there is another way to help families afford college: help them save for college. Families with savings for college can use those savings at the time they incur education expenses. Investments made today grow every year—boosting the ultimate amount of savings and maximizing its impact. Furthermore, evidence suggests that the act of saving for college itself can significantly improve educational outcomes.[10]

Saving for college can have a big effect on college access and completion. Not only do college savings programs solve the timing problem presented by traditional tax-based aid, college savings can also expand educational expectations and increase college success.[11] We know that even small savings can make a big difference. The Assets and Education Initiative at the University of Kansas found that low- and moderate-income children with less than $500 saved for college were three times more likely to enroll and four times more likely to graduate than those without savings.[12]

Savings in 529s have increased 954% in 12 years



Authors calculations based on data from Government Accountability Office (2009), Savings for College (2013) and Savings for College (2014).

529s and Coverdells were created to increase college savings. Created in the mid-1990s, 529s function similarly to Roth IRAs but for education rather than retirement. Deposits are not tax deductible on federal tax returns, but the accounts grow tax-free and qualified withdrawals are not counted as taxable income. Thirty-four states also provide a state tax deduction for 529 contributions.[13] In the most common version of 529s, parents, children or others make deposits into state-administered "Qualified State Tuition Plan" savings accounts. Students can make qualified withdrawals to pay for tuition, fees, books, supplies, and room and board. Withdrawals made for non-qualified expenses are subject to a 10% penalty, and the earnings of those withdrawals are subject to normal income taxation. Fueled by generous tax treatment of these investments, total savings in 529s has exploded from $19 billion in 2001 to more than $200 billion in 2013.[14]

Coverdells are also tax-advantaged savings accounts for higher education, but they function slightly differently than 529s. Coverdells can invest in a more diverse array of assets, including stocks and bonds. And unlike 529 accounts, withdrawals from Coverdells can also be used to pay for K-12 expenses, such as prep school.

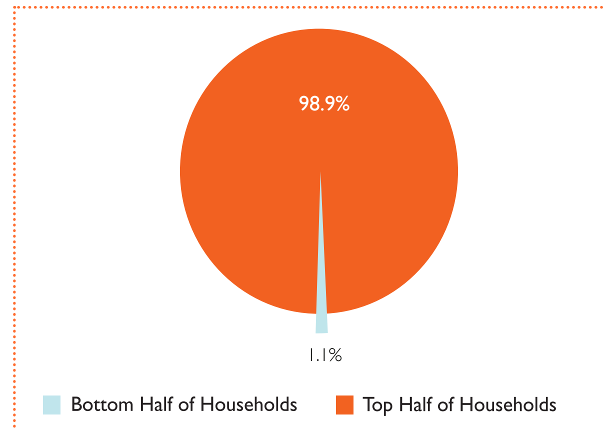
The structure of 529s and Coverdells tilts benefits toward high-income households. Coverdell and 529 tax benefits accrue at the top of the income distribution for two reasons. First, these benefits take the form of deductions and exclusions rather than refundable credits, so higher-income families who have greater tax liability receive greater tax benefit. Second, several features of 529s act as barriers to low- and moderate-income families, including minimum deposits, account fees and public benefits asset limits that actively discourage saving.[15] Several states have reformed 529s in order to close the gap in college savings, but the fact remains that these federally-supported savings accounts are, by and large, structured to widen that gap, helping the wealthy grow their wealth further while doing little for the vast majority of working families.[16]

529s and Coverdells do little to help most working families save for college. Less than 3% of U.S. families use 529s or Coverdells.[17] Those families that do use these programs tend to be high-income, while working families who need the most help to build savings get left behind.[18] In fact, support for college savings is even more focused on high-income families than is the support provided through higher education tax spending programs like the AOTC or LLC.

In Kansas, more than 80% of the 529 state tax spending goes to the top 11% of households, those with more $100,000 in income. In Louisiana, households earning more $100,000 hold more than 70% of the total savings in 529s.[19]

This state-level experience is not an anomaly. A 2009 Treasury report found that the top half of households hold 98.9% of 529 and Coverdell savings. Similarly, the Government Accountability Office analyzed households who use 529s or Coverdells and found that across the country, these households:

Top 50% of earners own nearly all 529 and Coverdell savings



Authors calculations based on data from U.S. Department of Treasury (2009).

- ***Have higher income.*** Families with 529s or Coverdells had about three times the income of those without these accounts.
- ***Have greater wealth.*** Those who saved in 529 or Coverdell accounts had financial assets worth $413,500—more than 25 times the average family's assets.
- ***Receive more in tax benefits.*** Among families that use 529s to pay for higher education, those making less than $100,000 per year received $561 in tax benefits, while those making over $150,000 a year received an average of $3,132 in tax benefits.[20]

4 Federal reforms to turn higher education tax spending right-side up

Congress has acted before to improve higher education tax benefits for working families. Tax spending is not the enemy in the fight to expand educational opportunity, but a potentially potent policy tool. Today, however, this tool exacerbates inequality of opportunity, focusing direct support and savings incentives on high-income households. Congress can change this. Past federal reforms have helped make these programs work better for all working families:

- The 2008 Farm Bill ended the practice of counting 529 savings against asset limits for SNAP (previously known as Food Stamps), ensuring that families that use 529s to save for their children's future do not risk losing support that helps them put food on the table today.
- In 2009, Congress converted the 12-year-old HOPE tax credit into the AOTC. The new AOTC became partially refundable, and so for the first time, those without tax liability could receive some benefit from the credit. Largely as a result of this change, the bottom 20% of households now receives a greater share of AOTC than they do from any other source of higher education tax spending.

Congress needs to do more to turn upside-down tax spending right-side up. The reforms above are small steps, but they are steps in the right direction. Congress should go further down this road. This does not necessarily require new spending, but rather a restructuring of existing spending. The following reforms would make strides in the direction of turning our upside-down higher education tax spending right-side up:

- **Eliminate the deduction for higher education expenses and create a savings account for every child at birth.** The deduction for higher education expenses has three strikes against it. First, it is the most upside-down source of higher education spending, directing almost all support to high-income households. Second, it actively makes most

families worse off by adding complexity to the tax code. Third, it provides support in the form of an after-purchase subsidy, which benefits higher-income households, rather than a forward-looking savings incentive.

Instead of wasting $600 million on a poorly targeted deduction, we could provide a $100 savings account for every one of the four million babies born in the country every year. The $200 million remaining could provide matches to help low- and moderate-income families build savings faster. The recently proposed myRA program, which aims to create a simple, safe and affordable option for retirement savings, could serve as inspiration for development of a new universal Children's Savings Account program.[21] Teachers across the country could use the account as tool for teaching financial education early in life, knowing that every student in their classroom would have access to an account. Given the proven impact of matching a savings product with early financial education, and the big effect that even small college savings can have on future college success, this funding would be well spent.[22]

- **Reform the AOTC to support college savings directly.** Families that use 529 savings to pay for higher education expenses cannot claim the AOTC for those expenses. In other words, a dollar saved today for education may reduce education support in the future. This policy quirk can actively discourage families from saving for college, but simply removing this restriction would mainly benefit the high-income households that are currently most likely to use 529s.

  A better reform would make deposits into 529s—or into the education myRA accounts proposed above—eligible for the AOTC, allowing the credit to function as a college savings match. Similar to proposals that would advance a portion of the Pell Grant in order to support college savings,[23] this proposal would advance a portion of the AOTC. Both strategies would deploy existing federal spending on higher education more effectively.

  The AOTC reform would not expand the credit, nor would it raise the $10,000 lifetime cap per student. Rather, instead of only providing support months after families incur costs, the reformed credit would also support savings years before children go to college. Use of the savings matches provided through the AOTC would only be allowed for higher education expenses, ensuring that this reform does not divert AOTC dollars to non-education purchases. The reform could be done independently or in addition to the reform of the deduction for higher education expenses proposed above.

  Limiting this new AOTC savings credit to $250 per year—roughly $20 per month in savings—would encourage regular saving over the course of the child's life. A family maxing out this credit starting at birth of the child would have nearly $15,000 saved by age 18 (assuming a modest 5% rate of return). This child would have used only $4,500 of her AOTC and so would remain eligible for $5,500 in additional support from the credit. All this is possible without expanding the maximum size of the credit by a dime.

- **Exempt children's savings from public benefit asset limits.** In some states, as little as $1,000 in children's savings can make a family ineligible for TANF benefits**.** The 2008 Farm Bill excluded 529 savings from SNAP asset limits, but other Children's Savings Accounts still count towards SNAP asset limits (which are often as low as $2,000 for a family).[24] Furthermore, both 529 and non-529 Children's Savings Accounts count against asset limits for other public benefits programs. A parent who saves for her child's education should not be punished by being forced off of TANF, SNAP, LIHEAP, SSI or any other income maintenance program.

- **Expand the Saver's Credit to support college savings.** As currently structured, the Saver's Credit only supports retirement savings. The Savings Enhancement for Education in College Act (H.R. 529), introduced by Representative Lynn Jenkins (R-KS) and Representative Ron Kind (D-WI), would expand eligible saving products to include 529s. Additional reforms could make the credit fully refundable and make deposits into all Children's Savings Accounts eligible for the credit, greatly increasing the impact of the Saver's Credit for working families.

Conclusion

Access to higher education is critical for ending the cycle of poverty and expanding economic opportunity. Children who are educated to reach their potential are best able to become self-sufficient contributors to the national economy. These are the moral and economic grounds that justify government investment in higher education.

Yet, while the federal government now spends more than $60 billion every year in non-loan support for higher education, college enrollment and graduation rates of America's low-income students remain disastrously low. We need to rethink how we're supporting higher education.

As this report illustrates, one of the largest sources of support for higher education is federal tax spending, which has regularly matched or exceeded federal spending on Pell Grants since the early 2000s. Unlike Pell Grants, this tax spending disproportionately goes to the households who need help the least—to parents who could already finance the education of children who were already college bound. This is no way to expand opportunity.

A large new federal investment in educational opportunity need not require a large new influx of federal dollars. We are spending billions through the tax code that could be spent more equitably and more efficiently. Instead of paying back wealthy families who settled college expenses months ago, we could ensure that every family has the chance to save and invest in their children's future. We can expand access to the American Dream by expanding educational opportunity—we just need to turn our upside-down tax spending right-side up.

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