

Universal Access to College Through Tax Reform

by Paul Weinstein Jr.

Since taking office, President Bush has relentlessly pursued massive tax cuts as an all-purpose remedy for America's economic ills. While doing little to spur growth, however, these policies blatantly favor the most privileged Americans. Unless reversed, this fiscally reckless tax-cutting spree threatens to starve government of what it needs to meet basic responsibilities, such as homeland security and educating our children.

What America needs today is not a new tax giveaway, but tax reform aimed at accomplishing vital national purposes. These include helping working families defray the costs of raising children, paying for college, and saving for retirement. Genuine tax reform also means radically simplifying a code so complex it is tilted in favor of those who can afford accountants and lawyers.

For example, the Progressive Policy Institute (PPI) last year proposed replacing a welter of pension-related tax subsidies with a single, tax-favored retirement account called the Universal Pension. This proposal would not only simplify the tax code, but also use the savings from reform to provide Americans with greater opportunity to save for retirement and grow assets, and create more generous retirement-saving incentives for all Americans.

Another area ripe for overhaul is college tax incentives. During the last 30 years, the federal government has increasingly turned to the tax code to expand access to college. Because incomes rise with education, these incentives serve an important purpose.

Yet while tax incentives have expanded access to college, they've lagged behind skyrocketing

college costs. For example, while tuition and fees jumped 10 percent just in the last year, the maximum HOPE Scholarship has not increased since it was created in 1997. And, as Washington has layered one new tax break upon another, the entire system of indirect college subsidies has become confusing and even contradictory.

This report proposes a radical simplification of education tax breaks. It would fold most of them into just two credits intended for two specific purposes: 1) to help *students pay* for tuition at college, graduate school, or training programs; and 2) to help *families save* for their children's higher education expenses. Specifically, this proposal will do the following:

- ▶ Significantly boost college assistance to cover half the cost of tuition and fees at public colleges and universities;
- ▶ Consolidate six confusing tax breaks for higher education into two new incentives, one to help families save and the other to help students pay the cost of higher education and/or training;
 - Create a single, refundable Education Tax Credit (ETC) worth \$1,500 per year to help students pay for college, graduate school, and training; and
 - Create a College Savings Account (CSA) in which all families can save for their children's college education.

- ▶ Provide every newborn with \$1,000 toward college tuition; and
- ▶ Require all students who wish to take advantage of the ETC to meet a minimum service requirement.

College Tuition Costs Continue to Skyrocket

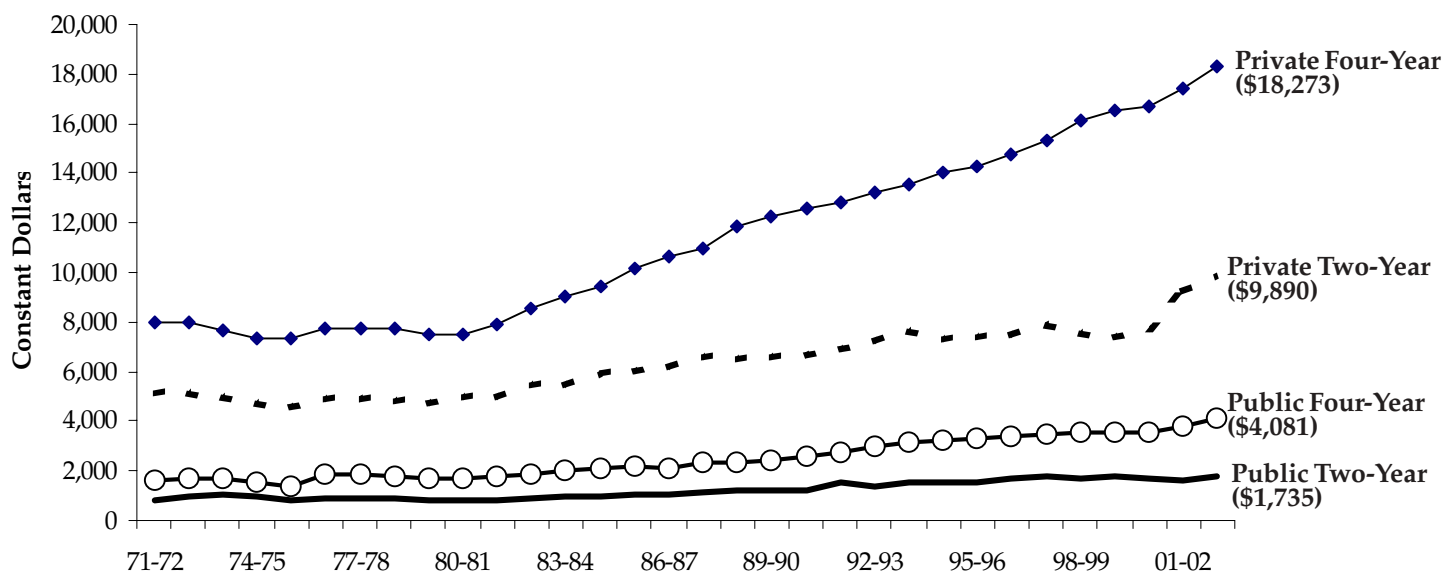
Recent government estimates say parents will spend \$250,000 to raise a child to the age of 18—so a new baby may be the most costly investment they will ever make.

Moreover, that figure doesn't include college. Today, a four-year college education—tuition, rent, food, books, and other expenses—can cost \$16,000 to \$150,000,

depending on the school. Eighteen years from now, it is estimated that those costs will rise to \$50,000 at a public university and more than \$250,000 at a private school.¹

According to the College Board, during the 10-year period ending in 2000-2001, average public four-year college tuition and fees increased 40 percent and private four-year college tuition increased 33 percent after adjusting for inflation. In fact, this past year alone, public colleges and universities raised tuition almost 10 percent, while tuition at private institutions went up almost 6 percent. As Table 1 shows, the average tuition at a private four-year institution is now \$18,273, while tuition at four-year state schools has climbed to \$4,081 per year.²

Table 1
Average Tuition and Fee Charges (Enrollment Weighted), in Constant (2002) Dollars, 1971-1972 to 2002-2003



Source: The College Board, 2002.

Student Aid is Not Enough to Meet Higher Tuition Costs

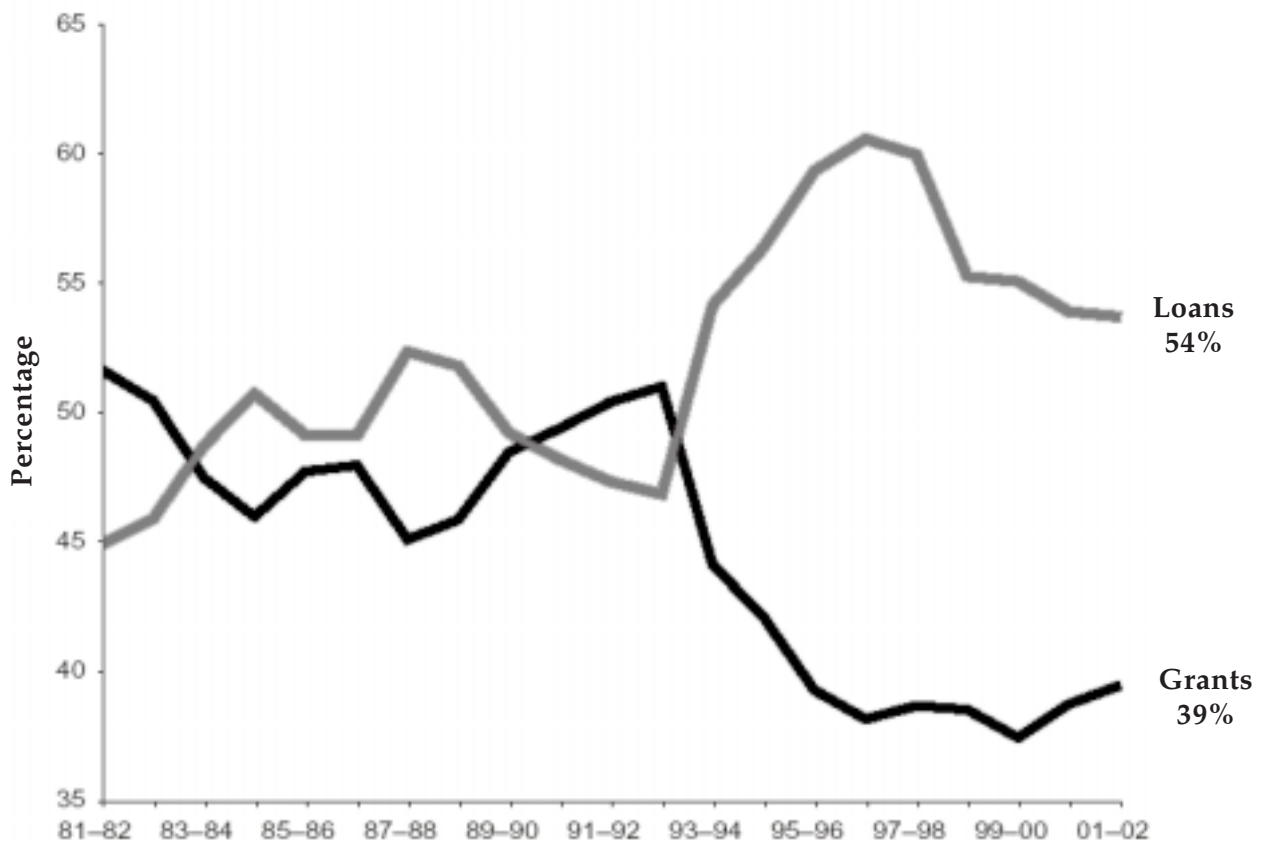
Unfortunately, tuition rates have risen so fast they have outpaced grants, loans, state appropriations, and other subsidies to schools, as well as aid to students and their families. According to one report, a stunning 71 percent of Americans believe that “a four-year college education is not affordable.” Sixty-five percent of Americans list the cost of a college education as a top concern.³

While inflation-adjusted tuition was essentially flat in the 1970s, average tuition at both public and private four-year institutions increased by about 60 percent in real terms during the 1980s. Median income for families most likely to have children in college (parents

aged 45-54) rose much more slowly over this time period, while student aid per full-time equivalent (FTE) student grew hardly at all, after accounting for inflation. The resulting gaps narrowed somewhat during the decade of 1991-2001. Although income rose by a meager 8 percent in constant dollars, aid per full-time student nearly doubled in real terms, and tuition growth slowed to about 38 percent after inflation. Most of the aid increase, however, was in loan aid, which grew over 120 percent per FTE student over the decade, compared to real growth of just over 50 percent in grant aid per FTE student. As Table 2 shows, this trend became exacerbated in the mid 1990s.

Median family income tells only part of the story, because incomes grew less equal during the 1980s and 1990s. The share of family income

Table 2
Grants vs. Loans, Percent Share of Total Aid, 1981-1982 to 2001-2002



Source: The College Board, 2002.

required to pay college costs increased for all except the wealthiest, but has gone up most for those with low incomes. Furthermore, the amount of debt for the typical college student has grown as the use of college loans has increased. Today, the average college graduate carries \$18,000 of debt. That amount is likely to only get heavier in the coming years.

Aggravating the situation further, state support for public universities has declined in recent years. Between 1980-1981 and 1995-1996, the portion of revenues at public colleges and universities coming through state appropriations declined from 45 percent to 36 percent. Tuition and fees increased to constitute 19 percent of revenues, compared to only 13 percent in 1980-81. While tuition and fees account for a much larger percentage of the revenues of private colleges and universities, declines in state and federal funding as a percentage of total expenditures have shifted a greater share of the costs to students and families.

Why are public and private institutions having difficulties helping students pay for rising tuition? Well, many are currently reeling from economic blows on several fronts. The plunging stock market and worsening economic outlook have cut returns from endowments, and donations to colleges are down. Institutions are carrying an even greater debt than before. Just three years ago, the median debt held at a public university or college was \$87 million. By last year it was greater than \$140 million.⁴

In response, Congress has significantly increased aid for postsecondary education and more students are receiving federal support than ever before. The federal government provides the lion's share of direct aid to students. Approximately 70 percent of the \$90 billion in student aid provided during 2001-2002 was generated by federal appropriations, loan guarantees, or tax credits. This includes Pell Grants, which are at an historic high, increasing 33 percent since 1998, and the College Work Study program, which helps needy students earn while they learn, has increased to \$1.2 billion per year. The states, on the other hand, provide the bulk of their subsidies in the form of operating support for institutions of higher education. Overall, the federal government contributes

about 12 percent of revenues for colleges and universities, while state governments contribute twice that amount.

Despite increasing congressional appropriations, federal student aid has not kept pace with the rising cost of college tuition. In the 1970s, the maximum Pell Grant covered 84 percent of the average fixed cost of attending a four-year public university; in 2001-2002, it covered only 42 percent.

Clearly, more support for student aid in the form of grants and loans is needed. Of the 70 percent of student aid provided by the federal government, only 5.6 percent is in the form of tax credits, and need-based loans and grants will continue to be the primary piece of the student aid picture, particularly for low-income students. However, simplifying federal education tax credits and making them more progressive can complement improvements in student aid to help these programs better achieve their goals.

A Complex Set of Tax Incentives

Over the years, policymakers have increasingly used the tax code to provide additional ways to help families and students meet rising tuition costs (see Table 3). During the Clinton administration, several important measures were enacted to make attending college more universally acceptable. The two most important were the HOPE Scholarship and the Lifetime Learning tax credit, which in 1999 were claimed by an estimated 10 million American families struggling to pay for college. The HOPE Scholarship is designed to help make the first two years of college more financially available by providing a tax credit of up to \$1,500 for tuition and fees for the first two years of college. The Lifetime Learning tax credit provides a 20 percent tax credit (capped at \$1,000 per year) on the first \$10,000 of tuition and fees for students beyond the first two years of college, for graduate school, or certified training programs.

There are eight college tuition tax breaks available to families and students. Despite their numbers, these incentives do not provide even enough assistance to cover half the average cost of tuition at public universities. Tuition increases

Table 3

Benefit	Annual limit	Expenses that qualify	Conditions	Max. income
HOPE Credit				
Tax credit	Up to \$1,500 per student for first 2 undergraduate years	Tuition and fees	Must be enrolled at least part-time in a degree program.	\$51,000; joint returns: \$100,000
Lifetime Learning Credit				
Tax credit	Up to \$1,000 per family after second year of college	Tuition and fees	Courses to acquire or improve job skills	\$51,000; joint returns: \$100,000
Coverdale Education IRA				
Earnings are not taxed	\$2,000 contribution per child under 18	Tuition and fees, books, supplies, room and board	Contributions not deductible; cannot contribute to qualified state tuition program or claim an education credit. Must withdraw assets at age 30	\$110,000; joint returns: \$220,000
Interest paid on student loans				
Deduction from income	\$2,500	Tuition and fees, books, supplies, room and board, transportation	Applies to the first 60 months' interest. Must be enrolled at least part time in a degree program	\$65,000; joint returns: \$130,000
Qualified state tuition programs				
Tax on earnings is deferred	None	Tuition and fees, books, supplies, room and board	Earnings are taxed to beneficiary when withdrawn	None
U.S. Savings Bonds				
Interest is not taxed	Amount of qualifying expenses	Tuition, fees, payments to education IRAs and state tuition plans	Applies only to qualified series EE bonds issued after 1989 or series I bonds	\$72,600; joint returns: \$116,400
Employers' Educational Assistance Program				
Employer benefits are excludable from income	\$5,250	Tuition and fees, books, supplies, room and board	Cannot also claim an education credit; for undergraduate work only	None
Education as a miscellaneous itemized deduction				
Higher Education Expense Deduction	Up to \$3,000	Tuition, fees, books	Taxpayers cannot claim this deduction and the HOPE or Lifetime Learning Credit for the same student	\$65,000; joint returns: \$130,000

Source: Internal Revenue Service.

continue to outpace federal and state assistance. The cost of tuition has increased by more than \$4,000 at the average private university and over \$1,000 at the average public university in the last 10 years. At the same time, the level of tax relief provided by the HOPE and Lifetime credits has not changed since their creation in 1997.

Furthermore, some of these tax incentives work at cross purposes with other forms of college aid. For example, low-income students who receive Pell Grants often must deduct those grants from the amount they can receive from the HOPE Scholarship, thus reducing the total aid they can receive. And parents cannot take the higher education deduction if they have claimed the HOPE Scholarship or Lifetime Learning Credit. Thus, some parents who want to help their child with college often shell out the money at the beginning of the school year, only to find out on April 15 that they cannot claim all or part of the deduction.

Parents could hire an accountant to figure this out, but most people would rather just give the money to their kids. After all, a \$1,000 Lifetime Learning Credit minus accounting fees isn't that much at the end of the day.

Another problem for families is the complexity of the rules. Students and parents may not fully understand the benefits and downsides to the variety of tax incentives offered. It takes the Internal Revenue Service (IRS) 58 pages in Publication 970 to explain all the different tax benefits for higher education. And if that is not enough information, there are additional publications on the HOPE and Lifetime credits and work-related educational expenses.⁵

In addition, each of the tax incentives also comes with an array of different income "phase-outs" to keep high-income taxpayers from claiming education tax write-offs. For instance, the HOPE tax credit phases out for couples with adjusted gross income of \$82,000 and disappears at \$102,000. For single filers, the phase-out range is \$41,000 to \$51,000. The higher education expense deduction, on the other hand, phases out at \$130,000 for couples and \$65,000 for singles. In fact, there are seven different phase-out ranges for the eight different

higher education tax credits. While these varying phase-out ranges were necessitated by budget constraints in the 1990s, one byproduct is that it is much more complicated for parents and students to calculate what they are qualified for and how much they need to save for higher education expenses.

Universal Access to College

There is a better way. A tax system which is simple, easy to understand, and expands access to college to every American. This proposal would replace six of the eight existing higher education tax breaks with two simple incentives: First, we would combine the HOPE Scholarship, the Lifetime Learning Credit, and the higher education deduction into a new refundable Education Tax Credit (ETC) which would provide up to \$1,500 for every student who gets into college. Second, we would replace three different college savings tax incentives with a College Savings Account (CSA) that would allow everyone to participate in any state or private plan and would stake every newborn with a \$1,000 down payment toward their tuition.

Together, these reforms and new incentives will provide students with enough money to pay for about half of the average cost of tuition and fees at public colleges and universities over a four-year period at today's rates. And, if family members are able to put away \$200 each year into a CSA, the interest earned over 18 years would provide the additional money needed to pay for the total average cost of tuition and fees at all public institutions.

Table 4 illustrates these figures further.

Education Tax Credit (ETC)

The ETC would replace three existing tax breaks that help students pay for college: the HOPE Scholarship, the Lifelong Learning Credit, and the deduction for higher education expenses. The primary advantage of the ETC over the existing system of college tax incentives is that it is more generous in several ways. First, the ETC would provide enough money to pay just less than half of the cost of tuition at a public university or college for four years. Second,

Table 4

Education Tax Credit (ETC)	\$1,500 per year
College Savings Account (CSA)	
One-Time Federal Government Contribution	\$1,000
Number of Years Earning Interest	18
Expected Annual Rate of Return	7%
Result	\$3,512
Amount Available for Four-Year College at Per-Year Basis	\$878
CSA (with family match)	
Annual Family Contribution	\$200
Number of Years Earning Interest	18
Expected Annual Rate of Return	7%
Result	\$10,784
Amount Available for Four-Year College at Per-Year Basis	\$2,696
Combined Total Available at Start of College (ETC, CSA with family match)	\$20,296
Combined Total Available at Per-Year Basis (ETC, CSA with family match)	\$5,074

because the credit is refundable, millions of low-income students will now be eligible to receive assistance. Third, since the ETC is a credit rather than a deduction, everyone who qualifies will get the full value of the credit.

The ETC is an improvement over the existing

system in several other ways as well. Because it is a single credit with one set of rules, taxpayers will find it more accessible and easier to use. Moreover, the streamlined rules will cut down on red tape and confusion that can lead to tax penalties. Finally, because the same rules apply to everyone, it will increase fairness and prevent people from “gaming” the system.

Under the ETC, any student attending college will receive a refundable credit up to \$1,500 (per year) if attending more than half-time for the first four years of college. In addition, any individual could receive up to \$3,000 to attend graduate school or to upgrade job skills at a degree-granting provider as a full-time or part-time student. A lifetime cap of \$3,000 would be allocated on a per-student basis, with an annual limit of up to \$1,500 per year. However, there would be no limit on the number of students per family who would be eligible for the credit, unlike current law.

Furthermore, in contrast to the HOPE and Lifetime Learning Credit, the ETC would not have income phase-outs and would be refundable. The combined effect would be to make the ETC available at the full \$1,500 to any college student for all four years of college. This is a major upgrade over the HOPE and Lifetime Learning credits, since they only provide a small number of students with the maximum benefit of \$1,500 in the first two years of college and \$1,000 over the last two years.

This proposal would also remove the requirement that Pell Grants and other need-based government aid be subtracted from a family’s eligible college expenses, allowing those families to qualify for the total amount of ETC. Under current law, the value of need-based aid, such as a Pell Grant, received by the child of a lower-income family may reduce or even eliminate the family’s eligibility for a tax credit based on tuition expenses. However, a recent study by the congressionally created Advisory Committee on Student Financial Assistance showed that even after receiving need-based aid, students from low-income families have as much as \$3,800 a year in “unmet need,” or college expenses that are not covered by assistance and which the family may be unable

to afford. Because of the financial barriers, even the most highly qualified students from low-income families attend college at a rate that is 20 percent lower than equally qualified students from the wealthiest families. If we make college aid benefit-neutral, we can make student aid programs more effective by encouraging low- and moderate-income families to save for college. Thus, large numbers of students from low-income families who might otherwise not attend college, will now be able to obtain a bachelor's degree.

College Savings Account

Under current law, parents who want to save for their children's college tuition can start a 529 account, open a Coverdell Education IRA (Coverdell), or purchase an Education Savings Bond. Unfortunately, each of these have a different set of rules and contribution limits. In addition, not everyone can participate in these programs, either because of income limits or a lack of disposable income. For example:

- ▶ States and private higher education institutions may establish and maintain 529 programs that allow individuals to either pre-pay or contribute to an account to cover a child's higher education expenses. While these contributions are not tax deductible, the amount used by the student for higher education is generally not taxed as long as it is not more than the amount of accepted higher education expenses.
- ▶ Contributions to Coverdells are also not deductible, but amounts deposited in the account grow tax-free until withdrawn. Generally, parents and certain other family members can contribute up to \$2,000 per year on behalf of a child's education. Like traditional IRAs, the choice of investment is left to the individual and is only limited by the investment options offered by the financial firm where the Coverdell is held.
- ▶ Education Savings Bonds also grow tax-free, and can be used by students for tuition and other education-related expenses. However, investment choice is limited to the rate and maturity offered by the bond.

The CSA would combine the best features of existing 529 accounts, Coverdells, and Education Savings Bonds. Unlike existing education savings accounts, the CSA account would be open to all Americans. Under this proposal, parents, grandparents, guardians, and potential beneficiaries could set up a CSA not only with states and public universities, but also with private universities and qualified financial firms. This would provide parents greater investment choices. Of course, those who prefer not to worry about investment choices could stick with a state institution plan.

Like Coverdells, contributions would not be tax-free, but the students would not be taxed on distributions used for higher education expenses. And while savings not used for education expenses would be subject to penalties, individuals could protect their accounts from taxation by rolling dollars not spent on college and graduate education into an IRA or into the CSA of another family member.

Similar to current 529 plans, contributions to a CSA would be no more than the amount necessary to pay for a student's higher education expenses, and the accounts would be limited to one per child. And unlike Coverdells, there would be no income restrictions for those who want to contribute.

Of course, many families find it difficult to save for their child's education. Given all the competing needs, families often lack the disposable income to put even a few dollars aside each month toward future college tuition. To ensure that any student who has the opportunity to go to college will have some money saved for tuition, the U.S. government would "stake" each newborn child with a \$1,000 contribution when a CSA is opened on their behalf. The \$1,000 contribution would grow tax-free and could be used by students for college, community college, or graduate school, even if no contributions are made on behalf of the child. However, if the \$1,000 stake is not used for school or rolled into an IRA, the funds would be returned to the U.S. Treasury and the American taxpayer.

Giving Something Back

Covering half the cost of college tuition will eliminate the sticker shock that scares off so

many students and instead encourage them to study and prepare for college. In addition, by reducing the amount of loans students have to take out, we will empower them to focus on school, rather than on a job to cover their future debt.

But if we're going to make this deal with students, we should ask something from them in return. One of the most far-sighted and successful federal initiatives of all, the original G.I. Bill of Rights, embodied a tacit compact: In return for service in World War II, Korea, and Vietnam, the country offered veterans education, housing, and employment benefits. Based on the same principle of linking public benefits to public service, students who want to take advantage of the ETC will have to take responsibility for their community and country by giving back 40 hours of service a year.

Students could fulfill this requirement by volunteering every couple of weekends to build homes for low-income families, tutor children to read after school, or clean up polluted rivers and parkland. Instead of thousands of students spending spring break on the beach, we could unleash a week of volunteerism in which students would spread across the country providing a helping hand to communities in need.

At a time when it is so sorely needed, this straightforward requirement will rekindle the ethic of civic obligation in America.

What it Costs

The cost of providing universal access to college is not free, but the price is far more reasonable than the \$674 billion tax cut currently proposed by the Bush administration. The total cost would amount to roughly \$71.9 billion over five years, with the ETC's share reaching \$50.5 billion and the CSA costing \$21.1 billion. In light of the Bush budget deficit, we need to be fiscally responsible and provide offsets for the ETC and the CSA. Fortunately, more than one-half of the cost of creating the ETC and the CSA can be paid for by consolidating six existing college savings incentives, leaving a net cost of \$31.8 billion over five years or \$6.4 billion per year. For information on the education tax incentives to be consolidated, see Table 5.

Table 5

Higher Education Tax Incentives ^c	Five-Year Cost
HOPE Scholarship	\$10.8 billion
Lifetime Learning Credit	\$10.8 billion
Higher Education Deduction	\$14 billion*
Education Savings Bonds	\$0.1 billion
Coverdell/ Education IRAs	\$3.0 billion
Exclusion of Earnings of Qualified Tuition Plans	\$1.4 billion
Total	\$40.1 billion

* Assumes Congress will extend deduction beyond expiration date of 2006.

Source: Joint Tax Committee.

In order to make this proposal consistent with the principles of tax reform, the additional shortfall could be made up by eliminating a number of tax loopholes and shelters. According to the Center for Tax Justice (CTJ), more than \$170 billion of taxpayer money is to be paid in corporate welfare each year. For example, the corporate tax rate for the largest companies is 35 percent of profits in federal income taxes. This should raise at least \$308 billion per year. But actual corporate-tax payments in 2002 were only approximately \$136 billion. In other words, for the first time since the early 1980s, corporate-tax loopholes

will actually cost the U.S. Treasury more than the amount companies pay in income taxes.⁶

Even before the Bush tax cut went into effect last year, corporate-tax welfare had been expanding rapidly. Congressional indifference to offshore corporate tax shelters and an array of other tax breaks have allowed many companies to earn billions in profits, yet pay little or nothing in federal income taxes. By simply closing corporate loopholes, we would have more than enough money to pay for expanded access to college as well as to lower the Bush budget deficits.

Conclusion

Providing access to higher education for any American who can get accepted to college is a vitally important issue for our country. A well-educated population will strengthen our economic security, raise the standard of living among Americans, and increase our productivity. By streamlining our tax code and creating new incentives to help families save for college, we reduce the financial burden on students and allow them to focus on what counts: their education.

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Endnotes

¹ "Trends in College Pricing, 2002," The College Board, <http://www.collegeboard.com/press/cost02/html/CBTrendsPricing02.pdf>.

² Schemo, Diana Jean, "Public College Tuitions Rise 10% Amid Financing Cuts," The New York Times, 2002.

³ "Trends in Student Aid, 2002," The College Board, <http://www.collegeboard.com/press/cost02/html/CBTrendsAid02.pdf>.

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⁵ <http://www.irs.gov/pub/irs-pdf/p970.pdf>.

⁶ McIntyre, Robert, "The Taxonomist: Your Federal Tax Dollars at Work," Center for Tax Justice, May 20, 2002.

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