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EDUCATION TAX INCENTIVES AND TAX REFORM

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BEFORE THE

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CONTENTS

OPENING STATEMENTS

WITNESSES

ALPHABETICAL LISTING AND APPENDIX MATERIAL

COMMUNICATIONS

EDUCATION TAX INCENTIVES AND TAX REFORM

WEDNESDAY, JULY 25, 2012

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:10 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Bingaman, Wyden, Hatch, Grassley, Snowe, and Thune.

Also present: Democratic Staff: Russ Sullivan, Staff Director; Tiffany Smith, Tax Counsel; and Lily Batchelder, Chief Tax Counsel. Republican Staff: Chris Campbell, Staff Director; Jim Lyons, Tax Counsel; and Chris Hanna, Senior Tax Policy Advisor.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

Benjamin Franklin once said, "An investment in knowledge always pays the best interest."

For more than a century, America has invested in education, and this investment has paid ample dividends. For older generations, up to age 64, the United States ranks second in the world in college graduation rates. But for younger generations, the United States is slipping. For those ages 24 to 35, the United States has fallen to 16th in the world. And in today's global economy, an education is even more important than ever.

In these tough economic times, as job markets get even more competitive, this is even more apparent. And yet, American families face skyrocketing college costs. In the last 2 decades, the price of higher education has grown at 19 percent a year, 4 times faster than inflation. College costs are growing at twice the pace of medical care.

These rising costs hit low-income families especially hard. A low-income family has to spend the equivalent of 72 percent of its income to send a child to college. Compare that to 14 percent for a higher-income family.

This debt burden often deters young people from going to college at all and has harmful ripple effects throughout our economy. Differences exist even for students with similar high test scores. Students from high-income backgrounds were about 32 percent more likely than those with the same test scores but from low-income backgrounds to enroll in college.

That means some of our best and brightest students never have the opportunity to develop their talents. This leads to fewer scientific breakthroughs, fewer innovative companies, and a weaker overall economy.

Since 1954, Congress has provided tax cuts for families with children pursuing a college education. These provisions help families cover past, present, and future expenses. The student loan interest deduction provides students a tax deduction for interest paid on a student loan.

The tax code also encourages families to save for future education expenses by providing tax-free savings vehicles. Five-twenty-nine programs and Coverdell accounts allow families to save for college without paying taxes on the earnings. Distributions from these accounts can be used to pay education expenses.

The tax system provides the most tax benefits for current expenses. Under our current tax system, there are helpful provisions that exclude certain financial assistance from income. For example, scholarships and fellowships that cover qualifying education expenses are excluded from income of the student. The tax code also contains credits and deductions to help students pay for current expenses.

The code cannot solve our educational challenges on its own, but it plays an important role. In 2009, taxpayers claimed almost $30 billion in education tax cuts, making college more affordable. This equates to about 22 percent of the assistance received through Federal grants and loan assistance.

That same year, 2009, we expanded these education tax benefits by passing the American Opportunity Tax Credit. As a result, 4.8 million more lower-income students and families had access to college subsidies.

These expansions are critical to ensuring that American families can afford college. This is particularly true in my home State of Montana. Montana has a higher proportion of lower-income students than other States. As a result, many Montanans only benefit from tax benefits that are partially refundable, like the American Opportunity Tax Credit. In 2010, Montanans claimed nearly $105 million in education tax credits and deductions to help offset the cost of college.

But the multitude of education tax benefits can result in complexity and confusion for American families. Under current law, there are eight separate tax expenditures—that is, deductions and credits and so forth—eight separate tax expenditures related to higher education, and these benefits use five different definitions of "eligible expenses."

The chart to my right, behind me, gives an example of the complexity and the questions asked of taxpayers when they are trying to calculate what provisions qualify. And I might say, at this point, this is IRS Publication 970. It is entitled *Tax Benefits for Education for Use in Preparing 2011 Returns*. This is just with respect to tax provisions. I do not think anybody—very few people read it.

Taxpayers must calculate their taxes using each tax cut to determine which one works best. It is a little bit like the AMT—you have to figure which one works best here.

Behind me on this chart is an actual IRS questionnaire—I just referred to it—that families need to fill out to determine if they are eligible for an education tax credit. This is just one page from an 87-page IRS guide for obtaining education tax credits.

Based on the complexity of this guide, one would think the IRS expected all of America's future students to want to major in accounting. The Government Accountability Office will tell us today how this complexity affects families. They have found that many families often pick the wrong benefit and leave money on the table.

Kelly McInerney is a CPA in Fairfield, MT. Kelly is the mother of four college-aged kids and knows firsthand how complicated these tax benefits can be. Kelly says many families she works with do not realize that they can claim credits for tuition paid for with student loans. As a result, they get less help than they are eligible for. This can make the difference between being able to send a kid to college or not.

We obviously need to make the system simpler for families. We should improve these benefits for the students. Through tax reform, we need to look at how we can achieve the greatest bang for our buck. Our system has to work a lot better to make sure we do not lose our competitive edge. Let us listen to Ben Franklin's advice that investment in knowledge will pay the best interest.*

[The prepared statement of Chairman Baucus appears in the appendix.]

Senator Hatch?

OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM UTAH

Senator HATCH. Thank you, Mr. Chairman.

The focus of today's hearing is narrow, but it is a very important one: the role of education incentives in our tax code. Traditionally, the Federal Government has supported millions of individuals seeking higher education through grants and loans. Over the last 15 years, however, Federal support for higher education has increasingly relied on incentives in the tax code. These education tax incentives can generally be classified into one of three categories.

The first category includes tax incentives for current expenditures for higher education. These incentives include the Hope, American Opportunity, and Lifetime Learning credits; a deduction for higher education expenses; and the exclusion for scholarships and fellowships.

The second category includes tax incentives for student loans. These incentives include the deduction for interest paid on student loans and the exclusion from income for certain student loans that have been forgiven.

The third category includes tax incentives for savings for college. These incentives include qualified tuition plans, generally referred to as 529 plans; Coverdell plans; education savings bonds; and IRA withdrawals to pay for college expenses without penalty.

Generally, two reasons have been given for the various education tax incentives. First, college education costs are increasing and are

*For more information, *see also,* "Background and Present Law Relating to Tax Benefits for Education," Joint Committee on Taxation staff report, July 23, 2012 (JCX–62–12), *https://www.jct.gov/publications.html?func=startdown&id=4474.*

a barrier to entry for those who cannot afford the costs. Second, college education is a good investment that produces external benefits, sometimes referred to as positive externalities.

According to the National Center for Education Statistics, the cost of college education for the 2009–2010 academic year—annual prices for undergraduate tuition, room, and board—were estimated to be $12,804 at public institutions and $32,184 at private institutions.

Between 1999–2000 and 2009–2010, costs for undergraduate tuition, room, and board at public institutions rose 37 percent, and costs at private institutions rose 25 percent, after adjustment for inflation.

The high cost of a college education does create a barrier to entry. However, some portion of the barrier is alleviated by the U.S. Department of Education's direct loan programs, such as Stafford loans, Federal Perkins loans, Federal Work Study, Federal Supplemental Educational Opportunity Grants, and the Federal grant programs, such as Pell Grants, for lower-income students.

In fact, according to the John William Pope Center for Higher Education Policy, of the 16.4 million undergraduate students enrolled in college in the United States in 2010, approximately 58 percent, or 9.6 million students, received Pell Grants.

As to the external benefits of a college education, some benefits from higher education may benefit not just the individual student in the form of higher wages, but also, society as a whole. Since these external benefits may not be considered by individual students when considering higher education, individuals may invest less in higher education than is optimal for society. Providing educational tax incentives may induce potential students to enroll in higher education, increasing investments in education and thereby creating external benefits.

A frank conversation about these incentives must also consider whether Congress is encouraging a higher-education bubble. Are these incentives encouraging students to take on more debt and degrees than is warranted by the economic and professional gain these students are likely to realize from their educational achievements?

In evaluating the education tax incentives, we use the same three factors that are used in evaluating all tax incentives—equity, efficiency, and simplicity. Some crucial questions in evaluating education tax incentives are whether Federal subsidization of higher education is good policy and whether a tax subsidy would be provided more efficiently by direct spending.

In 1987, then Secretary of Education William Bennett stated that, in the long run, Federal financial aid programs lead to higher tuition as colleges capture some of the Federal aid to students. Some studies have shown some evidence of the Bennett hypothesis. I would be interested to hear from our witnesses if they believe the Bennett hypothesis applies to Federal student aid in the form of education incentives in the tax code. In other words, do colleges and universities capture the financial benefits of education tax incentives at the expense of eligible students and families? One recent economic paper indicates that this is the case.

As to simplicity, one noted tax scholar, Michael Graetz, has said, "The education tax incentives represent the greatest increase in Federal funding for higher education since the GI Bill. But no one can tell you what they are, how they work, or how they interact. Planning to pay for college around these tax breaks is essentially impossible for middle-income families."

I think there is a lot of agreement that the education tax incentives are very complex and, at a minimum, should be consolidated and reformed.

Now, we have a very distinguished panel with us today, and I look forward to hearing what they have to say.

I want to congratulate you, Mr. Chairman, for this hearing and looking at this matter.

[The prepared statement of Senator Hatch appears in the appendix.]

The CHAIRMAN. Thank you, Senator.

I would like to introduce the panel. The first witness is Dr. Waded Cruzado. Dr. Cruzado is the president of Montana State University in Bozeman, MT. Welcome, Doctor.

Next, Ms. Munson. Ms. Lynne Munson is president and executive director of Common Core.

The third witness is Dr. Susan Dynarski. Dr. Dynarski is a professor of public policy and education at the University of Michigan.

Our fourth witness is Mr. Scott Hodge. Mr. Hodge is the president of the Tax Foundation.

And the last witness is Mr. Jim White. Mr. White is the Director of Tax Issues at the Government Accountability Office.

Thank you all for coming. I would ask each of you to speak about 5 minutes and submit your statement for the record.

Dr. Cruzado, welcome. Good to have you here. Why don't you go ahead?

STATEMENT OF DR. WADED CRUZADO, PRESIDENT, MONTANA STATE UNIVERSITY, BOZEMAN, MT

Dr. CRUZADO. Thank you very much. Good morning, Mr. Chairman and Ranking Member Hatch and members of the committee. I am Waded Cruzado, president of Montana State University.

Thank you for the opportunity to appear before you to discuss tax policy as it relates to higher education, a topic that affects millions of students and their families.

Montana State University is one of more than 100 land grant universities created by the Morrill Act of 1862, a brave piece of legislation that opened the doors of higher education to the sons and daughters of the working families of America.

The Morrill Act, proposed by a former chairman of this committee, I should add, was approved by Congress in the midst of the Civil War. This month, we celebrated the courage of those elected officials who, 150 years ago, envisioned a better and brighter future by focusing on education as the key to social mobility and the strengthening of American democracy.

More than 48,000 students attend the Montana State University system, with almost half of them enrolled in the four campuses of MSU. Even in this day, many of our students are the first in their family to attend college. Unfortunately, we see that it is becoming

increasingly difficult for students and their families to pay for their education. At MSU, faculty, students, staff, and alumni are committed to improving the situation by working together to maximize efficiency in administration without sacrificing access or excellence in academics.

I want to propose how, by reforming the tax code, you too can make a difference. Federal financial aid and tax credits related to higher education are crucial to students and their families as they confront serious challenges. According to the Department of Education, between 2006 and 2011, the percentage of first-time full-time undergraduates receiving financial aid increased from 75 to 85 percent at all 4-year colleges. There is evidence students are assuming more costs and borrowing more.

According to a recent Sallie Mae report, parents reduced their spending on college, both in terms of current income and savings. The report also notes that scholarship awards were down. To compensate, students assume more costs on their own and borrow more.

For a student from a low-income family or with a limited family contribution, a package of aid is usually required to finance a college education. But complex paperwork accompanies applications for Federal financial aid. Furthermore, how students stack aid may affect the amount they ultimately qualify for or, in some sad, but not all together infrequent choice of fate, make a student ineligible outright.

A first-time student in his or her family must understand the tax code and master the 1098–T form and another form known as a FAFSA, which stands for Free—not simple—Application for Federal Student Aid.

Based on national data, we know that thousands of Montana State students and their families are utilizing at least some of the tax deductions and exemptions available. But we also know that not all of them take full advantage of the tax code provisions. Even tax accountants find the tax credits and deductions for higher education confusing.

For students confronting such a steep learning curve, especially for the first time, this complexity translates into insurmountable obstacles, and many of them simply will give up. To describe the situation at MSU, a school with one of the lowest student loan default rates in the Nation, let me start with two data points—FAFSA applications and Pell Grant awards.

The number of FAFSA forms received by MSU has grown 43 percent in just the last 3 years, and that tremendous growth rate shows no signs of slowing down. The number of students receiving Pell Grants has jumped by 66 percent in the same period. Currently, a third of our entire undergraduate student body is deemed by Federal standards to have the greatest financial need.

This aid is particularly important for our Native American, adult, and Hispanic students, with about 67 percent of these groups receiving Pell Grants. That is twice the utilization of the student body as a whole.

Another disturbing trend is the amount of debt students have when they graduate. Up until 2007, the average amount of debt MSU students graduated with remained relatively flat at $17,000.

Once we entered the recession, that debt grew by almost 36 percent, so that now, 66 percent of our graduates are living with an average debt of about $26,000.

Anecdotally, I am meeting more parents who are sending their children to college while they are still trying to pay off their own college debts. Recent data from the New York Federal Reserve indicates this is a real national trend.

And I know about a family who, confronting a difficult financial situation, had to sit at the kitchen table to decide which of their twins was sent off to college and which would stay behind, knowingly impacting their lives forever.

American families deserve better than this. And here are some recommendations. One, commit to protect Federal financial aid. There is no way a large portion of our students could afford to attend college without it. There is a compelling national interest in providing assistance for students to attend college. Studies suggest that the U.S. is projected to produce 3 million fewer college graduates than needed in the next decade. This will happen while other nations are making significant investments in higher education as a strategic element of their economic development and advantage.

Two, simplify the tax code as it relates to higher education expenses. The tax code can play a vital role in assisting students and their families with the cost of higher education, but its complexity discourages many from even considering its use. Simplifying it and following up with an intrusive, almost fanatical communications campaign would alert students and their families to take advantage of these provisions.

Third, clarify and coordinate the various Federal aid programs so that students and their families fully understand their options and utilize the available resources. The current collection of Federal aid programs, while well-meaning, is difficult to understand and navigate. You will not be surprised to learn that this derives from the split jurisdiction between the Department of Education and the Department of the Treasury, and the individuality of the programs themselves.

And finally, number four, continue support for deductions for college savings plans. Such deductions offer an important incentive for students and families to plan ahead, save for college, and, importantly, help students avoid indebtedness.

In closing, I would like to emphasize that, just like it was 150 years ago, a college degree results in benefits to the individual and to the Nation as a whole. The Morrill Act had it right. Providing the opportunity for our Nation's citizens to attend and succeed in college is crucial to the future economic prosperity of our Nation and the strength of our democracy.

Thanks for your leadership.

[The prepared statement of Dr. Cruzado appears in the appendix.]

The CHAIRMAN. Thank you very much, Doctor.

Ms. Munson?

STATEMENT OF LYNNE MUNSON, PRESIDENT AND EXECUTIVE DIRECTOR, COMMON CORE, WASHINGTON, DC

Ms. MUNSON. Chairman Baucus, Ranking Member Hatch, thank you for inviting me back to testify on the issue of college affordability.

For the record, I want to point out that I am actually not here in my capacity as president of Common Core, which is a nonprofit that I run that looks out for the quality of K–12 public education. Rather, I am here as a former Deputy Chairman of the National Endowment for the Humanities, as an independent scholar who has researched and published on college affordability since 2007, and as a mother of two precocious toddlers whose college education is going to cost $1 million if current trends continue.

When you asked me here 5 years ago, I shared some tuition cost analyses that many found surprising. I took the prices of milk and of gas in 1980, and I told you how much those goods would cost at that time—this was in 2007—if their prices had gone up as rapidly as had in-State tuition at 4-year public institutions.

I have now updated those prices. Back in 2007, the tuition-adjusted price of a gallon of gasoline was $9.15. Today, it stands at $13, just 5 years later. The tuition-adjusted price of milk is up from $15 for a gallon 5 years ago to $22 today.

For decades, we have been accommodating the problem of runaway tuition instead of holding schools accountable for the price that they put on American education. As former committee staffer Dean Zerbe has written, "Colleges and universities have been raising tuition faster than a monkey can shell nuts. And of course, Washington's response has been to throw a lot more peanuts their way."

The most popular accommodation is to increase the number and size of Federal student loans and grants, but, as Senator Hatch asked about, Bill Bennett's hypothesis has indeed held true. This only incentivizes colleges to deliver students bigger bills. And please, do not for a moment entertain the illusion that education tax credits end up in the bank accounts of families. Every subsidy simply ups the footing upon which tuition continues to grow.

Let us remember that higher education's take on the public purse is not limited to these subsidies. There are the billions in research dollars the government provides and the fact that schools pay no taxes on bonds, donations, real estate, sports revenues, and on their endowments.

Further, remember that our colleges and universities are sitting on more wealth than had been amassed by any nonprofit institution in the history of our Nation, including private foundations. Now, I should not say they are sitting on these billions, because they are actually very busy investing them in some of the most complicated and illiquid, long-term, experimental investments that man has ever created. My point is that the focus is on amassing this wealth, not on spending it.

Today, 143 colleges and universities have endowments larger than $500 million; 74 have endowments over $1 billion. One-third of those schools with $1 billion-plus endowments are public institutions, including the Universities of Michigan, Texas, Oklahoma, Nebraska, Minnesota, and Florida.

Keeping in mind this wealth and these subsidies and the tax freedom our colleges and universities enjoy, tuition accountability is long overdue. Here are a couple of ideas to get the ball rolling. First, require colleges and universities to do what private foundations must: spend a certain percentage of the value of their endowments every year. Foundations must spend 5 percent, which is an old number that likely needs to be revised upwards. Even a very conservative minimum payout requirement would let loose more than $1 billion, which could be spent on decreasing the cost of college.

Second, make colleges and universities publicly disclose the amount and purpose of every endowment expenditure, as private foundations must do in annual reports. You want higher education endowment spending to bring down tuition, not to fuel more opulent fundraisers or more climbing walls in the gymnasium.

When this committee focused its attention on the issue of college affordability 5 years ago, there were some very good effects. Unfortunately, they were short-lived. A few schools instituted "no loan" policies, allowing students from low-income families to attend college without taking out any loans. But most of these programs, including at Williams and Dartmouth Colleges, were cancelled just 2 years after they were created. No one who had enrolled under the program even had a chance to graduate.

Some schools also increased scholarship and grant expenditures 5 years ago. But according to Sallie Mae, college and university grants and scholarships fell 15 percent during the last academic year. That is more than $1,000 per student.

Also, in 2008, the IRS sent 400 colleges and universities questionnaires to inform work on a new schedule to the 990 on endowments. The schedule never appeared.

I suggest, Chairman Baucus and Ranking Member Hatch, that you write to the IRS and ask them what happened.

Our colleges and universities have been given every opportunity for decades to do the right thing with regard to controlling the cost of college. They have not done it, and there is abundant proof that they will never deliver American families a fair and honest tuition bill unless our Nation's political leaders join the public and insist on it.

Thank you very much.

[The prepared statement of Ms. Munson appears in the appendix.]

The CHAIRMAN. Thank you very much. I appreciate that.

Senator HATCH. Mr. Chairman, before you go to the next witness, I am going to have to go to the floor. So I want to apologize to all of you. This has been extremely interesting to me, and I will read the transcripts, and we will see what we can do. Forgive me for that.

The CHAIRMAN. Thank you, Senator.

Dr. Dynarski, you are next.

STATEMENT OF DR. SUSAN DYNARSKI, PROFESSOR OF PUBLIC POLICY AND EDUCATION, UNIVERSITY OF MICHIGAN, ANN ARBOR, MI

Dr. DYNARSKI. Chairman Baucus, Senator Hatch, members of the committee, I am honored to testify before you today.

The goal of student aid and the education tax incentives is to open the doors of college to those who have the ability, but not the means to attend.

Through some simple reforms, the government can serve this goal more effectively and efficiently. The current education tax benefits do little to get more people into college. We should simplify and focus the tax incentives and coordinate them with the student aid programs.

A college education is one of the best investments a young person can make. Even with record-high tuition prices, a bachelor's degree pays for itself several times over. Everyone has been hammered by the recession, but college graduates have been buffered from the worst of it. Those without a degree are twice as likely to be unemployed and earn much, much less.

As college has grown more valuable, it has grown more unequal. Only 9 percent of children born in the poorest quarter of families earn a BA. The figure is 54 percent, 6 times larger, for those with the highest incomes. This gap is much larger than it was 20 years ago.

Education has long been a vehicle for opportunity in our country, a path to prosperity for every class. Growing education gaps between the children of the rich and the poor threaten this vision of economic mobility. We are in danger of devolving into a rigid caste society in which the children of the poor are destined to low levels of education and menial jobs.

There is a role for post-secondary policy in shrinking these disturbing gaps. These gaps can be eliminated only with improvements at every level of education. Inequality builds along the entire educational pipeline. Half the gap between the rich and poor and college attendance is explained by the gap in high school graduation.

The Pell Grants and the American Opportunity Tax Credit are the flagships of the student aid and tax incentive programs. The Pell is squarely focused on low-income students. Just 15 percent of Pell recipients have household incomes above $40,000 a year, and just 3 percent of them have $60,000. The AOTC, by contrast, is less focused, extending to families with incomes as high as $180,000 a year.

The AOTC, while not as well-targeted as the Pell, does a better job getting money to poor families than did its predecessor of Hope Credit. This is because the AOTC is partly refundable and covers some non-tuition costs.

Both of these programs have doubled in size in the past few years. We now have two full-scale systems of aid for college in this country, one run by the Department of Education and one run by the Department of the Treasury. This is double the trouble, because both of these well-meaning bureaucracies generate complexity, paperwork, and administrative headaches that burden families, colleges, and taxpayers.

Complexity in these programs is undermining their effectiveness. How? It is very simple. Families cannot respond to a price subsidy if they do not know about it. Information about both the Pell Grant and the tax incentives is hidden behind a thicket of paperwork. Students do not find out about how much help they can get until a few months before college entry. This is simply too late to affect the decision to prepare for, apply to, and attend college.

Here are some concrete suggestions for focusing, simplifying, and coordinating the tax credits and aid to make them more effective.

First, deliver the tax credits at the time of college enrollment. Families need the credit when the tuition bill arrives, not months or years later. The refundable portion of the AOTC could be delivered to students through the aid system along with the Pell.

Second, create a single simple application for aid and for the tax credits. Families currently have to wade through two long duplicative forms, the 1040 and the FAFSA. The FAFSA alone has 100 questions. Research shows that most of these questions could be eliminated and still target aid in the same way as we do now.

The data already collected on the 1040, in fact, could be used to define financial aid eligibility. We have moved a step towards this goal by allowing some aid applicants to automatically transfer their IRS data into their FAFSA application.

A single simple application would reduce fraud and error and save citizens millions of hours spent filling out duplicative forms. Best of all, it would boost college enrollment. A recent experiment showed that college attendance rose significantly when low-income families were allowed to use a vastly simplified aid application process.

You asked that I address whether aid for college students drives up college prices. The best economic evidence indicates no, at least for the 91 percent of students who attend public and nonprofit institutions. We do have evidence that prices at the for-profit schools do increase when the Pell does. While these schools teach only 9 percent of students, they account for 24 percent of Pell expenditures.

I stress that this problem is limited to the for-profit sector, and any remedies should, therefore, be focused on this sector.

The Federal Government can do better with its aid and tax incentives for college. Simplifying, focusing, and coordinating the tax and aid programs will allow them to serve their goal: opening the doors of college to those who have the ability, but not the means to further their education.

Thank you.

[The prepared statement of Dr. Dynarski appears in the appendix.]

The CHAIRMAN. Thank you very much, Dr. Dynarski.

Mr. Hodge?

STATEMENT OF SCOTT HODGE, PRESIDENT, TAX FOUNDATION, WASHINGTON, DC

Mr. HODGE. Thank you, Mr. Chairman and members of the committee. I appreciate the opportunity to talk about this important issue.

As you all know, inequality is in the news these days, and it is commonly thought that tax policies, in particular low tax rates, are the principal cause of inequality. But the reality is very different.

One of the biggest contributors to inequality in America is the growing earnings gulf between workers with college degrees and those without. Indeed, median income for a worker with a college degree is $76,000 a year, while the median income for a worker with a high school diploma is about half as much. And there is even greater income disparity between those with a high school diploma and those with advanced degrees.

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 end of the extreme, 80 percent of those earning over $250,000 a year have a college education or better.

And there has been a clear shift in recent years in education policy away from traditional loan programs and direct subsidy programs toward the use of various tax credits and deductions. So really, the question here before the Finance Committee today is, is the tax code the proper tool to increase access to higher education and make education more affordable? And generally speaking, the answer should be "no." At the highest level, these education credits and deductions 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 very wary of using such policies. The first is that tax credits and subsidies undermine the market forces that deliver quality goods at low prices for everything from toasters to automobiles. 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. This intervention is actually causing the price inflation for the very things that they are intended to make more affordable.

Subsidized student loans and education credits are helping to fuel higher education costs by disconnecting student consumers from the true cost of higher education, and, in turn, the benefits of these programs get capitalized into the price of tuition because universities can boost tuition costs without suffering the normal backlash that you see in the marketplace.

Another reason to avoid using the tax code in this way is that the extensive use of tax credits has already knocked 58 million Americans off the tax rolls. Today, some 41 percent of all tax filers have no income tax liability because of the generosity of credits and deductions in the tax code. And many of these people, about half of them, actually receive refundable tax credits because of the expansion of these types of programs. We have not had such a large share of Americans off the tax rolls since 1940, when the income tax system became a mass tax.

In addition to the lost revenues from having so may Americans 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 the non-payers is associated with more than $215 billion in higher transfer spending this year. And there is also a very

strong statistical correlation between the growth in non-payers and increases in the national debt. And as we heard, on the distributional level, education credits and deductions tend to benefit high-income families, not low-income families. They are simply becoming middle-class entitlements.

But lastly, the overuse of tax credits has turned the IRS into an extension of and, in some cases, a substitute for other government agencies, and the IRS is simply not equipped to be a social welfare agency. And as a result, these credits tend to be abused, and fraud rates are very high.

Treasury's Inspector General has raised many red flags about taxpayers improperly claiming the Hope Credit and billions of dollars in improper payments of the American Opportunity Tax Credits. And we should not be surprised by these kinds of abuses. In fact, we are simply asking the IRS to do more than just be a tax collection agency.

And let me just conclude, Mr. Chairman, that, 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 unintended consequences. And these education tax programs, for lack of a better term, are likely contributing to the rising cost of higher education, while helping to knock millions of people off the tax rolls. And this, in turn, is disconnecting millions of people from the basic costs 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 address you today, and I appreciate any questions that you may have.

[The prepared statement of Mr. Hodge appears in the appendix.]

The CHAIRMAN. Well, you gave us a lot to think about. Thank you, Mr. Hodge. We appreciate that.

Mr. White?

STATEMENT OF JAMES WHITE, DIRECTOR, TAX ISSUES, GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, DC

Mr. WHITE. Chairman Baucus, Ranking Member Hatch, and members of the committee, on behalf of my colleague, George Scott, and myself, I am pleased to be here to discuss Federal assistance for higher education provided through a variety of tax and spending programs.

By way of background, figure 1 on page 2 of my statement shows large title IV grants, loans, and work-study programs run by the Department of Education. It also shows the large tax deductions, credits, and exemptions administered by IRS.

Several things are noteworthy about the programs in figure 1: first, the number of students and families getting assistance. In 2009, almost 13 million students received title IV aid; 18 million tax filers claimed one of the higher education tax benefits.

Second, the cost of the programs. In 2010, the Department of Education provided $38 billion in grants and billions more in inter-

est subsidies on student loans. For the tax programs, the foregone revenue was an estimated $25 billion.

Third, the programs provide assistance through a student's entire life. Before a student attends college, the qualified tuition and Coverdell savings programs allow for tax-free buildup in savings accounts. While in college, a variety of grant, loan, and work-study tax credit and deduction programs help pay tuition and other expenses. After college, interest on student loans may be tax deductible.

Now, I want to summarize the results of our analysis regarding the distribution of these benefits across families, the extent to which eligible families are using the benefits, and what is known about the effects of these programs on college attendance.

The various programs tend to benefit different types of families. Title IV grants tend to benefit families below the national median income of about $52,000. Loan and work-study programs benefit a broader income range, as do most of the tax credits. The tuition and fees deduction and parental exemption for students generally went to families with incomes above the median.

When we looked at whether families are claiming benefits for which they are eligible, we found they were not always doing so. We had data to analyze tax filers who were eligible for either the Lifetime Learning Credit or the tuition and fees deduction. They could claim one or the other, but not both. We estimated that 1.5 million tax filers, 14 percent of those eligible, failed to claim either one, giving up an average of almost $500 in benefits. Furthermore, we found another quarter of a million filers who made the wrong choice. They claimed one benefit, but would have gained an average of $300 by claiming the other one instead.

Why did so many taxpayers make wrong choices? The answer, at least in part, may be due to the complexity of the provisions. For example, the IRS lists 12 separate higher education assistance provisions in its guidance. What constitutes academic eligibility can be difficult to figure out for students who do not follow the traditional path of 4 years of college. Some of the provisions are similar, making it hard to figure out which one is best. For example, there are four different tax breaks for educational savings, each with different requirements and benefits to the taxpayer. What counts as a qualified expense varies across the provisions.

Although educational institutions must send the form 1098–T to taxpayers about their qualifying educational expenses, the different program rules mean that what is reported on the form may not match what taxpayers are allowed to claim on a tax return.

In addition, the number of education-related tax provisions has led to so-called "anti-double-dipping rules." While important protections, these rules add yet more complexity for families trying to figure out their best option.

IRS and the Department of Education have taken steps to inform students and their families about tax benefits, but further actions, such as more research on the characteristics of non-claimants, could help develop a coordinated and comprehensive strategy. An example of this is the new financial aid shopping sheet just developed by the Department of Education and others. We have not evaluated this sheet, which is voluntary, but it appears to provide

information that could help students plan for college costs. However, I would also note that it does not mention any tax benefits.

My final point is that we do not know as much as we should about the effectiveness of the many tens of billions of dollars we invest annually in higher education assistance. Has Federal spending increased college attendance? Has it improved graduation rates? Some good research has been done on these questions, but it is incomplete.

Education's efforts to sponsor and conduct research are an important step, but we still lack evaluative information on the effects of Federal assistance. Tax information that might be useful for research is not readily available to most researchers. Evaluative research can help policymakers build on successful programs and make changes to less effective programs. This is especially important in today's tight budget environment.

Mr. Chairman, this concludes my statement. I would be happy to answer any questions.

[The prepared statement of Mr. White appears in the appendix.]

The CHAIRMAN. Thank you very much, Mr. White. I appreciate that.

Dr. Cruzado, I would like to ask you your thoughts on the remarks of a couple panelists that a lot of these increases, whether it is direct aid, Pell Grants, for example, or increases in tax benefits, are just absorbed by the institution, and the benefits are not passed on to the students. I think Ms. Munson makes the point that colleges and universities in America are getting bigger. There is no requirement that they pay out any percent of their endowment. Tuition rates have gone up pretty rapidly. Costs are going up, and so forth.

You are the only president here of a university. So why don't you tell us what you think about all of that?

Dr. CRUZADO. At Montana State University, we pay special attention, and we really make it almost a philosophy that dollars will follow students and their needs.

But start with the realization that running a university nowadays is a far more complex business than what it was 20 years ago. Twenty years ago, we did not have the complexities of information technology nor the requirements of compliance, not accreditation requirements, but the whole host of student services that our students need and deserve, particularly mentoring and counseling for those with additional learning disabilities whom we encounter.

Having said that, though, as I said in my testimony, we at Montana State University are paying close attention to reducing the cost of administration. I started that 2½ years ago when I reduced the number of vice presidents from eight to five, and that established a tone.

We are now taking a look at all our administrative efforts and trying to reduce the cost of payroll and human resources and finance and accounting so that those dollars can be freed up and redirected back to the students.

And finally, we are encouraging our students to finish their degree as soon as possible. That is the best way in which we can reduce cost at the university.

One of the best examples has to do with some courses that students need to take over and over again. How can we make sure that, without diluting course content, we give students the tools to be successful so that they only need to take those courses once and accelerate the time to graduation, which results in a gain for families, for the students, and for the institution as well?

The CHAIRMAN. A legitimate question could be asked of, why are college expenses rising at such a rapid rate, much more rapidly than health care costs? I assume my statistic of 19 percent annual is not too far off the mark. But whether it is a little bit off or not, still, college costs are going up at a very rapid rate.

Why is that? What is the cause of all that?

Dr. CRUZADO. That is a fair question, Mr. Chairman and members of the committee. And again, at Montana State University, what we have observed is just that the cost of operations has increased rapidly.

For example, information technology, as you know, is a huge investment in colleges and universities, and it is a necessary one. We need to provide for students and the faculty members the information technology that they need, and those are additional costs that were not with us 20 years ago.

As I mentioned also, the cost of student services has skyrocketed in colleges and universities. For example, we are observing a great need for additional counseling services in all our colleges and universities. Student disabilities, learning disabilities, put an additional burden on colleges and universities, and we want to make sure that students have the resources that they need in order to be successful in the classroom.

New, additional compliance efforts that have added—for example, institutional data that we need to provide for some Federal agencies—those are costs that were not with us 20 years ago and have resulted in additional tuition expenses.

Having said that, though, I need to say, in the State of Montana, we were able to keep tuition flat for almost a decade. We have not increased tuition since 2007, and we only did that last year, but only after the State further reduced the State appropriation that will support students.

So it is a combination, also, of the erosion of the State support that has affected almost every State. Let me just give you this example. When you and I went to school, and almost until 20 years ago, the State would subsidize our studies by almost 80 percent. Today, that is a complete reversal. The State provides between 20 and 30 percent of the cost of education and asks students and their families to shoulder the remaining 80 percent.

That is the biggest cost, and that is why tuition has increased so rapidly in America.

The CHAIRMAN. My time is up, but very briefly, would that apply to private schools as well?

Dr. CRUZADO. I am sorry?

The CHAIRMAN. That would not apply to private schools. Why has private school tuition gone up so rapidly? Maybe they have State aid.

Dr. CRUZADO. Well, Mr. Chairman, I cannot speak for private institutions. They have additional resources and a different set of pri-

orities than public institutions. I can speak for public institutions who are not part of some of the goals of private universities.

The CHAIRMAN. Thank you very much. I appreciate that.

Dr. CRUZADO. Thank you.

The CHAIRMAN. Senator Bingaman, you are next.

Senator BINGAMAN. All right. Thank you very much. Thank you all for being here.

Let me ask Mr. White to comment on some of the recommendations that Dr. Dynarski has made in her comments. She recommended that we merge the AOTC and the Lifetime Learning Credit into a single credit. Is that something that makes sense?

Mr. WHITE. Senator, we have developed a framework for thinking about questions like that. And one issue is thinking about the purpose of the provisions. And you have some provisions, such as the grant programs, the tax credits, and some of the deductions, that have a very similar purpose of providing a lump of money to students or families to pay for current education costs.

So that raises the question of whether we need so many different programs. Part of the answer to that question depends on whether the differences in these programs allow you to target different groups differently, more effectively, than you would otherwise.

But I think it is a combination of thinking about the purpose of the program and whether you can do something different. If you cannot do something different with it, that does suggest some consolidation.

Consolidating would allow you to save on administrative costs and provide the same amount of aid to families and students.

Senator BINGAMAN. I am going to take that as a qualified "yes."

Mr. WHITE. It is a qualified "yes."

Senator BINGAMAN. Let me ask about—she also suggests we deliver the credit at the time of college enrollment rather than wait, having people wait to file tax returns and all of that. Does that make sense, from your perspective?

Mr. WHITE. That is one of the disadvantages of providing assistance through the tax code, that the money does not come in to families or students until the following year when they file their tax return.

Senator BINGAMAN. So you think going ahead and providing that credit at the time of college enrollment makes good sense?

Mr. WHITE. Well, if you try to provide the credit up front, that creates more challenges for IRS, because then you are providing the money to taxpayers before they file the tax return. So it is harder—you are not determining eligibility then.

There might be alternative ways to provide the money up front, not through a tax credit, but through an up-front grant.

Senator BINGAMAN. Right. And is that what you are recommending, Dr. Dynarski?

Dr. DYNARSKI. Yes, it is. An additional option is to use income data from an earlier year to establish eligibility for the tax credit. So, we could simply use a previous year's income to indicate somebody's need and use that to determine their eligibility for a tax credit, which could then be delivered to the institutions through the same mechanism that the Department of Education uses to deliver the Pell Grants.

Senator BINGAMAN. Let me ask any of the witnesses, but maybe, Mr. White, you would particularly know the answer to this.

Has there been a proposal developed, an actual legislative proposal, to accomplish some of this simplification of these education-related tax provisions, or is this something that we just have hearings about?

Has anybody put a piece of legislation on the table and said, "Here is a way to do it"? Has the tax advocate done that, for example, or anybody else in the administration or in the Congress, as far as you are aware?

Mr. WHITE. I am not sure the extent to which actual legislation has been drafted to do this.

Senator BINGAMAN. Do any of the rest of you know about that?

Dr. DYNARSKI. There is legislation that has been crafted to simplify the aid programs in such a way that potentially we could establish eligibility for both the aid programs and the tax incentives using the same information.

Essentially, if you were able to whittle down the aid application to include the same questions that are used to determine eligibility for the tax incentives, we could have a unified application.

Senator BINGAMAN. Mr. Hodge, your basic point was that the tax code is not the right vehicle to be assisting people with the costs—covering the costs of their education. Is that an accurate statement?

Mr. HODGE. That is accurate, yes.

Senator BINGAMAN. You are not advocating that the Federal Government back off of supporting people in covering the costs of their education, you are just saying it should not be done in the tax code; is that right?

Mr. HODGE. That is correct. I would rather see that assistance on the spending side of the budget rather than on the tax side. Perhaps even, rather than having duplicate programs, we could simply fold in any of the moneys dedicated to tax programs into, say, Pell Grants and what have you.

Rather than having the IRS run this program, it should be run exactly where it is, at the Department of Education.

Senator BINGAMAN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Next, Senator Wyden?

Senator WYDEN. Thank you very much, Mr. Chairman. I know it has been a hectic morning trying to get in and out. I thank you for doing it.

I would like to ask you all about the nature of Federal education policy and whether, particularly in the context of tax reform, there is an opportunity to make a break.

What we historically have done in terms of Federal education policy is to focus on access to education. That is the magical word: access. And so we make available grants and loans and, through the tax code, interest subsidies and things of that nature. But it is all designed to make sure that people have access to education.

I continue to think that that is hugely important, and I want to keep that focus. I think what I would like to ask you, Ms. Munson, and you, Dr. Dynarski, is whether there ought to be an effort to build on top of that focus on access a new emphasis on value—on

value of various kinds of education offerings and whether we ought to start looking at that, as well, as part of the tax debate.

Mr. Hodge knows that Senator Coats and I have the first bipartisan tax reform bill in a quarter-century. So we have provisions that relate to the tax code, trying, again, to reform it and look to the future.

But apropos of this question of value, for you, Ms. Munson, and you, Dr. Dynarski, Senator Rubio and I—he is the Republican Senator from Florida—have introduced a bill called the Student Right to Know Before You Go Act. And this legislation would, for the first time, make it possible in one place to get information about graduation rates and debt levels and a lot of the essential information that students and parents need. But it would also make it possible for a student, for the first time, to get a sense of how much they would earn if they got a degree in a particular field from a particular school.

So my question is, what are your thoughts on that, again, recognizing that I do not want to tamper at all with this historic focus on access? I have supported Pell Grants and Stafford Loans and all of the efforts that have provided assistance to students.

The question is, can we go further and put a new focus on value as part of the tax reform debate? I also love the fact I was getting some nods there from our wonderful witness from Montana.

So maybe we will start with you three and get your reaction, if time allows.

Mr. Hodge, as you know, we always enjoy working with you, and your input would be welcomed.

Doctor?

Dr. DYNARSKI. More information is better. Families need good information if they are going to make smart choices about which institution to send their kids to. Prices vary wildly across schools, both sticker prices and prices net of scholarships. Success rates, graduation rates vary wildly across schools that are quite similar in the same missions.

So I think it would be a great step forward to have uniform information about graduation rates, about prices, and about employment rates and earnings of graduates from institutions. The State of Florida has been doing this on its own using its own data systems, but seeing a more uniform set of information across the country would be a great step.

We have been moving in this direction a bit with the gainful employment rules, which require that we gather this information for schools and programs that are focused on career preparation. These standards are pretty weak ones, and they do not apply across the board. So getting that information published for all schools, I think, would be a wonderful step forward.

Senator WYDEN. Great. Ms. Munson?

Ms. MUNSON. I appreciate your dedication to the important agenda of maintaining access, and, as I said, I have two young toddlers. I look forward to——

Senator WYDEN. Me too.

Ms. MUNSON. You do too.

Senator WYDEN. Another one on the way.

Ms. MUNSON. Congratulations.

Senator WYDEN. Pictures available on my iPhone later. [Laughter.]

Ms. MUNSON. I think though, when we think about tax policy, in particular with regard to education, we are often torn between our desire to help in the current day provide access now, but trying to do it in a way that maybe is not contributing to a larger problem of feeding this tuition machine.

I think that part of the equation, the second part, is where our focus needs to be, and that is why I talk a lot about tuition honesty and full disclosure. I agree entirely with Professor Dynarski that more information is always better.

One piece of valuable information: we have talked about graduation rates, but you realize that it actually, on average, takes students 6.2 years now to graduate from so-called 4-year public institutions of education. Only 27 percent of entrants to 4-year public institutions these days are actually graduating within 4 years.

This is, obviously, contributing to the debt problem, to the tax burden, to the bankruptcies, and all of this.

Senator WYDEN. Dr. Cruzado?

Dr. CRUZADO. I could not agree more. I would welcome an opportunity to build on the layer of value. At Montana State University, perhaps because of our culture of being very prudent and very conservative in how we approach finances, we would be more than happy to show parents and families what are the programs that will result in higher wages or in additional opportunities for our students.

And I think that, with the proper instruments, we can show the taxpayers exactly where is the money that they are investing in our university.

Senator WYDEN. I thank you. It is striking, Dr. Cruzado, your answer is very similar to what the president of Oregon State University, Ed Ray, said when I asked him about this. He said, "We have an important story to tell. We like what you are talking about, Ron, with Senator Rubio, because we think disclosing this information at a school like ours"—and, obviously, a school like Montana State—"if anything, allows you to showcase the important work that you are doing."

So I am going to put you and Ed Ray from Oregon State down now as people whom we are going to call on.

I think the other point I would mention—I know my time is up, and Chairman Baucus has been very gracious to give me the time. One of the things that has come up in discussion about this, Mr. Hodge, because you and I have talked a lot about markets over the years, and, as you know, I am a Democrat who believes strongly in trying to find a role for marketplace forces. Part of what I think this legislation can do, the Student Right to Know Before You Go Act, is, if you have a school over here and they are charging a lot more than the school over there, and the school over here is not producing as impressive a record in terms of graduation and employment prospects and the like, the school over here is going to say to themselves, apropos of Dr. Cruzado's comments, this is going to be out in the real world. This is going to be on line. It is going to be part of a market that families look at for purposes of education. And the school over here had better say to themselves, "We

better clean up our act in terms of graduation rates, prospects for careers," or the school over here is going to have problems.

So I am going to want to talk to you some more about it, because I think what you and I have talked about in the past—and you have been very helpful to us in the discussions with respect to tax reform—always comes back to, can you, under the tax code, find new ways to unleash marketplace forces and do it fairly so that there is opportunity for everybody, not just the people born on third base, but opportunity for everybody. And I am going to want to follow up with you.

Thanks for the extra time, Mr. Chairman.

The CHAIRMAN. You bet, Senator. You are very welcome.

Senator Grassley?

Senator GRASSLEY. I would prefer to make a statement instead of asking questions, and I am going to refer to a Turner endowment study, a Ginsberg article, and a CBO report. And I would ask unanimous consent that those be put in the record.

The CHAIRMAN. Without objection.

[The publications referred to appear in the appendix beginning on p. 51]

Senator GRASSLEY. As we consider how tax incentives help students and families pay for college, we should consider whether and how these incentives also increase cost. This is something that Chairman Baucus referred to in his last question.

We have a 2010 study by Nicholas Turner, University of California-San Diego, suggesting that schools are reducing financial aid awards by the amount of tax benefits a student or family may receive.

In addition, a 2011 article in *Washington Monthly* by Benjamin Ginsberg exposes the explosion in spending on administrators and support staff who are not directly involved in instruction or research. Such spending includes hefty increases in executive compensation and benefits.

Aside from getting a handle on the rising costs and tax incentives for students and families, it is also important to consider the tax benefits that tax-exempt colleges and universities receive. Just like tax-exempt hospitals, tax-exempt colleges and universities are exempt from income taxes. They also have the ability to raise capital through tax-deductible charitable contributions and the issuance of tax-exempt bonds.

The Joint Committee on Taxation, in a document prepared for today's hearing, indicates that the most expensive Federal tax expenditure for education is the charitable deduction, at more than $32 billion. The tax exemption for bonds is third most expensive at $18 billion.

The charitable deduction for sure fuels the growth of multi-billion-dollar college and university endowment funds. According to the most recent annual endowment study, endowments with more than $1 billion in assets had a 1-year rate of return of more than 20 percent and a 10-year rate of almost 7 percent.

So, even though they had a couple of rough years, like 2007 and 2008, they are also still doing well. Yet, despite their success and skyrocketing tuition, their payout rate hovers around 5 percent.

Part of their success results from their investment strategies. The same endowment study tells us that these endowments with more than $1 billion are 60 percent invested in what is termed "alternative strategies." Such investments include private equity; international private equity; mergers; acquisition funds; hedge funds; derivatives; and energy and natural resources, including oil, gas, timber, and commodities.

Aside from their lack of spending on students, it is unclear whether such investments may also be contributing to the erosion of the tax base by sheltering otherwise taxable commercial activity in tax-exempt entities. Commodity speculation is another issue that I have been working on that concerns both me and Senator Wyden of this committee. When it comes to tax-exempt bonds, it seems that the ease of borrowing is causing a race to spend without considering whether such spending adds to student learning.

In a May 1, 2012 CNBC report, the dean of admissions of Pomona College suggests a $53-million investment in student housing is very important because students are not making choices based on whether they are going to get a good education. The same report highlights other California colleges offering perks such as dorm rooms with oceanfront views and cafeterias with gourmet food.

In addition, an April 30, 2010 Congressional Budget Office study suggests that colleges and universities may benefit from indirect tax arbitrage by using tax-exempt bonds to fund buildings and equipment while hoarding money to invest in assets such as I just mentioned that provide a higher rate of return.

So I get to the bottom line. The incentives for students and families are not the only ones that should be reviewed in the context of tax reform. All education-related tax expenditures should be examined to ensure that students and families, in addition to taxpayers, are getting the most bang for their buck.

Thank you.

The CHAIRMAN. Thank you, Senator.

I would just like to focus a little bit on what works here. I also tend to think—this is from my perspective—there is still not a sufficient sense of urgency about what needs to be done to address America's education needs.

Let me start this way. A few years ago, I took several Montana business people to Asia, China, India, and other countries. Near the end of the trip, we were in Bangalore, India, one of General Electric's major research facilities. They have a big one there in Bangalore. It is called the Jack Welch Research Facility.

We went through it, spent half a day there, all the "gee whiz" stuff. And at the end of the day, I walked up to the manager, Dr. Guillermo Willie is his name. He is not Indian. He is half German and Portuguese. But most everybody else working there are all Indians. They are from Bangalore.

And I said to him, "Why are you located here in Bangalore? Why is your facility here?" He said, without batting an eyelash, without skipping a beat, "Greatest talent pool." So I asked, "What country has the next greatest talent pool?" "China," he said. "Where are we?" I asked. "What about our talent pool?" "Well, you're kind of down there pretty far." I asked, "What do we have to do to get up there?" Again, without skipping a beat, this is just his view, he

looked straight at me and said, "Two things. One, health care. Second is education." He said, "You've got to educate your people better, and, second, your health care system tends to discriminate against—makes it more difficult for your companies to compete compared with other companies in other countries."

Now, I am not going to say this fellow had all the answers, but I do think he had a kernel of truth in what he was talking about, both, including education. And I believe strongly, because we see all the data, how competitive this world is becoming, that we have to focus a lot more on how we get better bang for our buck in education.

It is all levels. It is elementary, it is K–12, it is community colleges, it is votech schools, it is higher ed, and so forth.

But the hearing today is focused a little more on higher ed. Community colleges and other similar forms of education would qualify here. But I am just trying to get a sense here of, what do we do to cut through all this stuff?

So what works? Let us just take, for the sake of discussion right now, only the tax provisions. And there are a lot of them, and they are complex, and they are very difficult for people to understand.

So I would just like you, whoever wants to take a crack at this, to tell us which ones work the best, which ones do we pare back and perhaps even eliminate. We have 529 plans, Coverdells, the American Opportunity Tax Credit, a couple others.

What works for students, and what really does not work that much, just candidly? And, if you want to change some of these, tell us how they should be changed. It sort of begs the question, though. Should there be any tax provisions?

Mr. Hodge is basically saying, no, we do not need any. Let this all be handled on the spending side, Pell Grants, et cetera. Well, there are some people who do not qualify for a Pell. And education costs are different in different parts of the country. It is a pretty big country we have here.

So let us just say, first, which tax provisions work? How should they be modified? And should we even think about tax provisions or just forget them and say, "Department of Ed, it's up to you. You take care of students. The Finance Committee, we are just going to wash our hands of it, from a tax perspective."

Who wants to tell us what works?

Dr. DYNARSKI. I would say that if the tax credits could be made refundable, delivered up front, if they are targeted, made simpler to understand, then families are going to find them indistinguishable from a grant. If we cannot get to that goal, then they are not useful.

The CHAIRMAN. You say refundable and up-front.

Dr. DYNARSKI. Delivered up front when people pay a tuition.

The CHAIRMAN. Advanced refundability.

Dr. DYNARSKI. Indeed. So, if people need the money to go to school, they need it when they need to pay the tuition bill. They do not need it 18 months later. If we could achieve those goals with the tax provisions, then as far as the families are concerned, they are going to be a grant. So, if we can make the tax credits look like a grant, great. If we cannot get to that goal, then we are probably

better off just running things through the traditional systems and with one program in particular.

No matter how we are delivering them, whether it is through the tax system, through the Ed system, I think we need a unified system so that we have a single application for families, so they can understand clearly what their eligibility is, and so we—so you, as policymakers, can understand clearly who is getting how much money.

The CHAIRMAN. What is the importance of incentives to save, like 529 plans? We have several options—incentives for saving. Second is assistance while you are in college. Third is paying off loans. Maybe it is a combination. What do you think?

Dr. DYNARSKI. The low-income families that we are trying to get into college, whose attendance rates are low, they are not using the 529 and the Coverdell.

The CHAIRMAN. Sorry. Say again.

Dr. DYNARSKI. They are not using the 529 and Coverdell.

The CHAIRMAN. Who is not? I am sorry.

Dr. DYNARSKI. Low-income families. So the people who save the most and who benefit most from the savings protections are going to be upper-income families. They are the ones who save more.

So I would say we do not have any evidence at all that the savings incentives increase college attendance.

The CHAIRMAN. Who else? Ms. Munson?

Ms. MUNSON. I think you are chasing a runaway train. I think that tuition—unless you can find a way to disconnect the relationship between tuition increase and providing more subsidies, you are going to be in the business of just continually providing more subsidies.

The CHAIRMAN. All right. Now, give me one or two ways you would do that.

Ms. MUNSON. I am not sure. One idea would be to make universities and colleges get some skin in the game and worry about themselves being taxed, for example, if they are not spending from their endowment.

The only way you can start getting to some evaluative information about the use of endowments and their potential to truly bring down the cost of college is to shine really some very bright sunshine on them.

The CHAIRMAN. You gave us two proposals.

Dr. Cruzado, what do you think of those two ideas that Ms. Munson has? Number one, you have to spend a certain percent of your endowment. Number two, you have to disclose your expenditures, as, apparently, private foundations do, and I am not that knowledgeable about private foundations.

Dr. CRUZADO. I am always in favor of more transparency rather than less. So in that sense, I would not be opposed.

I have been thinking about whether there can be some type of provision where we say, the tax code benefits will be available for a fixed number of years, because whatever incentive we put out there, we will incentivize a particular type of behavior.

And what we really want to do is to reduce that. The best way is to make sure that students get in school, get in school full-time, if possible, and graduate as soon as possible.

The CHAIRMAN. On the requirement about a certain percent of endowment being paid, what is your thought about that?

Dr. CRUZADO. Well, again, let us talk about which percentage, and I think that we would be open to have a conversation. For example, at Montana State University, the endowment of the ASMSU Foundation is about $125 million, of which only 79 percent is permanently restricted.

Yet, every year—last year, for example, our students received more than $2.5 million in scholarships. Those are dollars that would not have been there had it not been for those donors and benefactors who decided to invest in Montana State students.

The CHAIRMAN. Dr. Dynarski, you gave me an answer to my question of what works.

Does anybody else have an idea of what works? We are going to put runaway train aside for a moment. What works?

Mr. HODGE. I think, Senator, that we need to get the government as much out of this as possible, because we do not have an efficient marketplace in higher education.

This is the only market that I know of in which the seller of a good has complete financial information about the buyer. If I go into a store to buy a pair of shoes, the seller has no idea of what my income is or what my assets are. If I go to buy an airline ticket, the seller has no idea what my assets are or what my income is.

And yet, in this marketplace, the seller of the good has complete information about my finances and can cherry-pick and design a financial package or a price that I can pay based on all of that.

That is not an efficient market. That is a backwards market.

The CHAIRMAN. That is going to occur, also, with respect to spending only; the seller is going to have more information.

Mr. HODGE. The problem here is that we have all of these dollars which are forcing up cost. This is exactly the kind of bubble that was created in the housing market, where all of that cheap lending caused a bubble in the housing market.

This is exactly what we are seeing in health care, where such things as the exclusion for employer-provided health insurance creates a third-party payer problem in which the actual consumer of the good has no real market power, because the seller of the good, the doctors and hospitals, are dealing with the insurers and the employers.

And the more that we can try to make this a functioning market, that is the only way to get these costs under control and put the consumers back in the driver's seat. Right now, they are not. They are simply victims or pawns in this whole system.

The CHAIRMAN. How do we get there from here?

Mr. White, go ahead. What works?

Mr. WHITE. Mr. Chairman, the fact that you have to ask that question is part of the problem here.

The CHAIRMAN. Yes.

Mr. WHITE. We do not know the answer. There is a debate among the panelists here about the effect of Federal assistance on tuition. Well, the flipside of that is the effect of Federal assistance on the quantity of students attending college. Price and quantity are just flipsides of the same thing in a market.

And we do not know the effect on price, nor do we understand very well the effect on students' access to education, the extent to which these programs affect that.

So what is needed here is some—part of what is needed to get you to the answer to the questions you are asking about is some better research by the Department of Education about the effects of these different programs on students' access to education, their persistence, the extent to which they follow through and graduate, what the ultimate outcome is from the billions of dollars that are being spent on these programs right now.

The CHAIRMAN. You have somewhat answered the question. But what are some of the questions you want to have answered?

Mr. WHITE. What is the increase—what is the effect of all of the tens of billions of dollars that are being spent, at the margin, on the number of students attending college and finishing college?

The CHAIRMAN. Does the Department have that data?

Mr. WHITE. Right now, the answer to that question is not very well understood. Part of the job of the Department ought to be to figure out what data is needed to answer that question and work with, for example, the IRS to obtain the data to answer that question.

The CHAIRMAN. I did not realize Senator Thune was here. I am sorry, John.

Senator THUNE. Thank you, Mr. Chairman. I just kind of blend in down here.

I am interested in that data as well. If there is a way—I think that would be really important information to have in order to make informed judgments about what works and what does not work and what is cost-effective.

I think we all understand the critical role that education plays in our modern society and how important it is that we continue to expand the opportunity for more Americans. I think the tax code can and has played a role in that.

I think the question is if the tax system is the appropriate place from which to expand access to education, and if these subsidies are really truly benefitting students or are they just structured primarily to benefit the educational institutions. It seems, to me at least, given the critical importance of education, that these are questions that really need to be explored, certainly, as part of fundamental tax reform, if we ever get there.

I am interested in asking the question the chairman was asking maybe a slightly different way. But, between these various incentives that exist in the tax code today to help Americans afford higher education, you have provisions to help Americans save for college, provisions to help Americans deal with the debt associated with a college education, and some incentives to help Americans afford higher education.

I am interested in drilling down a little bit more on the question of which of these categories of tax benefits are most cost-effective to the Federal Government. And again, that gets maybe back to the previous question that really needs more of an analysis of the data to come to that conclusion.

But, if we could only choose one of these incentives, which is the one that you think would be the one that we would want to put

our resources and our effort behind, and why? I just throw that question open.

Mr. White?

Mr. WHITE. I will start. And I think part of the problem here is that we are spending tens of billions of dollars on these programs and we do not know the answer to the question you are asking.

Some of these programs do serve different purposes. Some are effectively grants. The credits and deductions are providing money right now to pay for current expenses. Other programs are assisting with paying off loans, which is a different sort of assistance. But we do not know what the effect of these different kinds of programs is. We do not adequately understand—there is some research that has been done, but it is limited. We do not understand how effective those programs are at things that we want to accomplish, such as increasing college attendance by students who would not otherwise have gone to college.

Senator THUNE. Mr. Chairman, is that something that we could ask the GAO to do?

The CHAIRMAN. We can ask them to do whatever we want. [Laughter.]

Senator THUNE. Good.

Dr. DYNARSKI. I would like to point out, actually, that the Department of Education is right now fielding two experiments that will answer some of these questions. They are about to start some experiments that would look at the effect of the Pell Grant, as well as the education savings incentives.

So at least we are moving in the direction of getting answers to some of these questions.

Senator THUNE. Let me ask Mr. Hodge. There are a number of us on this committee, I think, who have been surprised to learn that roughly half of all Americans do not pay Federal income tax at all, because they do not have an income tax liability.

What are your thoughts and your opinion as to what extent the tax benefits in the code for education contribute to that?

Mr. HODGE. Well, it has not been the driving force. Obviously, the child credit, the Earned Income Tax Credit, Making Work Pay, all these others are the bigger factors, but this is certainly a factor. And certainly, the American Opportunity Tax Credit has been a big part of that.

I was troubled to read the Inspector General report which found as much as $3.2 billion in erroneous payments under the American Opportunity Tax Credit in the last year. So these programs are ripe for fraud, in addition to the fact that they are knocking people off the tax rolls.

But to answer your previous question, I would say the only provisions that we are talking about here that are consistent with fundamental tax reform are the savings provisions, the 529 plans and the IRAs, because, even under fundamental tax reform, we would want to encourage savings.

I would not try to pigeonhole savings into various buckets that we choose, such as health insurance or housing or so forth, but to encourage savings for whatever a family's needs may be, but certainly, education would be a big part of that.

And so all of these other credits do violate the basic principles of fundamental tax reform and the basic principles of tax policy. But on the other hand, the savings provisions are fully consistent with that and are things that we would want to encourage.

It is better to encourage people to save for college rather than to mortgage their future with all of these loans, which too many Americans now—I think the outstanding loan debt in America is now over $1 trillion, which is greater than all of the consumer debt that is out there.

We are facing the same kind of bubble in student loans that we have seen in housing, and that is a very troubling turn of events.

Dr. DYNARSKI. I would just like to add to that that I agree it is important to encourage savings, but I think we should be clear about that savings policy and not call it education policy. We basically do not have any evidence that these programs increase college-going.

The people who take up the 529 plan, the Coverdell, are very high-income families. Their children go to college at rates well north of 90 percent. And providing tax savings incentives for them is not going to increase education levels.

Senator THUNE. Final question, and I guess maybe this was addressed earlier. But did we sort of establish, in response to some of the questions that were raised earlier, that some of these subsidies for education are contributing to the higher cost of college education? Was that a sort of agreed-upon point?

Dr. DYNARSKI. No.

The CHAIRMAN. It was discussed.

Senator THUNE. Good. Well, I will go back and read the transcript and figure out who agreed and who disagreed.

But anyway, this is—if we get to fundamental tax reform—obviously something that will be hopefully included, an element of that, and, hopefully, by then we will have some of the information that will give greater clarity at least to what works, what does not work, what is a good return for the taxpayer. And so I look forward to that.

Thank you, Mr. Chairman. Thank you all.

The CHAIRMAN. Thank you, Senator.

Don't financial aid directors have some sense of what works and what does not work? Surely, we need some data, but we can be chasing data until the cows come home, and I am guessing that some financial aid directors have some sense—they are going through the applications—what works and what does not work and so forth.

Dr. DYNARSKI. We actually do have evidence that simple, well-designed, easy-to-communicate aid programs increase college attendance quite a bit. This evidence comes from State programs that have those characteristics.

We also have evidence that simplifying the Federal programs would have a large impact on college-going. There was a recent experiment run by economists at the National Bureau of Economic Research where they randomly assigned families to get a vastly simplified aid application process, and it boosted college enrollment rates substantially.

So we have very strong evidence that if we were able to streamline and simplify the process for applying for aid, we would get a large boost to college attendance right away.

The CHAIRMAN. Given the number of potential grants and the number of potential tax provisions, is it possible to design a simple form, or do we just have so many different alternatives here that it is pretty hard to design one?

Dr. DYNARSKI. It can be complicated on the back end, but simple on the front end for the student who is applying. So, if we want to have aid coming from lots of different funding streams, that is fine. But as long as the student who is applying sees a transparent and simple answer to how much does college cost and how much does the government help me, then that can have a real impact.

The CHAIRMAN. I think we are going to have both spending and tax provisions. That is just reality here. So it seems to me we have to simplify and streamline both the law and, second, the forms. And I am trying to figure out how we make that happen.

You have two departments here. You have IRS and you have the Department of Education, and it is a problem.

But while I am thinking about that, you raised your hand, Mr. White.

Mr. WHITE. Well, we have been discussing the merits of grants versus tax programs. One of the advantages of tax programs that gets at your point is that IRS has information off of tax returns suitable for making decisions about means-tested programs. If you are going to target people based on income, IRS has that information off of tax returns. So that information is already there.

The CHAIRMAN. That is a good point.

Mr. Hodge?

Mr. HODGE. Senator, I should point out that 73 percent of people who get the Earned Income Tax Credit have to pay a professional preparer in order to get that credit. So even something like that, which is well-intended to try to assist low-income working Americans, people are then stuck with this highly complicated tax credit in which they have to pay someone else in order to fill out the form.

The CHAIRMAN. That may be, but I would guess that the benefit outweighs the cost. I do not know.

Mr. WHITE. Well, it also has led to a lot of unscrupulous preparers. And so the fraud rates are between 23 and 28 percent of EITC.

The CHAIRMAN. Are you suggesting we repeal the EITC?

Mr. WHITE. We have to consider whether or not—we have two programs. We have TANF and we have EITC. They are awfully similar. And which ones are most effective?

The CHAIRMAN. No, they are not. They are very different. They are very different. One is work-related, the other is not. They are very different.

Anyway, final thoughts. Has anybody said anything that needs to be addressed? Did somebody say something so outrageous that it has to be addressed?

Ms. MUNSON. I simply think that you are not going to get to the honest truth about why tuition is going up so much unless colleges and universities are forced to have some skin in the game with re-

gard to controlling those tuition costs and being honest with the public about how they are using their resources.

I do not think that you are ever going to catch up with the runaway train unless universities really are forced to put themselves on the tracks. So just looking at the student side of the equation or, as Mr. Hodge would say, the buyer part of the equation, and providing all the information from the buyer and none from the seller, is never going to get us anywhere.

The CHAIRMAN. Yes. Dr. Cruzado?

Dr. CRUZADO. Yes. Mr. Chairman, I could not agree more in terms of the need for transparency, but also with the need for building a platform of urgency here and in the end asking ourselves, so what type of a Nation do we want to build; what type of a Nation do we aspire to continue being or to be in the future? And the answer to that is in higher education.

I need to say that many universities are doing the right thing, and perhaps sufficient credit has not been given, perhaps because the information is not there. But for example, at Montana State University, I discovered that our graduation rate, our 6-year graduation rate, was 42 percent, and I thought that was unacceptable. And we started to do some work, and 2 years later it is 52 percent, a 10-percent increase in just 2 years. Still, a lot needs to be done.

One of the findings that I have made is that—why is it that it is taking so long for students to complete their degrees? And there are some exceptions in which students are head of household and have other obligations. The reality is, students across the Nation are taking far less credits than what we used to take when we went to college. Perhaps we enrolled in 15 or 18 credits.

At Montana State University, we have a provision that we call the flat spot. That is, students will pay exactly the same tuition whether they enroll in 12 credits or 15 credits, up to 18 credits. And what did I find? That 50 percent of our students are enrolled in 14 credits or less.

So starting this year, we are doing things differently. We are starting financial literacy sessions with students and their families, and we are urging the new class of freshman to enroll in more credits. We call it Freshman 15. It is a new take at augmenting their academic workload.

And in order to make it visual, at a meeting with the parents of all the freshman, I show them a voucher, and I say, "How many of you would like to have a voucher for $800 if you are an in-State student or for $2,400 if you are an out-of-State student?" And of course, all of the hands go up.

And I say, "Well, that is the equivalent of a 3-credit course over 12 credits if you were to enroll now. If you were to enroll in up to 18 credits, that is twice as much." And I finish up by telling them to not leave money on the table.

So there are sound opportunities that colleges and universities are already improving and implementing today in order to make sure that families and students get to their objectives but, collectively, we build that Nation that we want to build.

The CHAIRMAN. Thank you. That is a very good point to end on, a platform of urgency.

Thanks, everybody, very, very much for attending. I know you have come great distances at great expense to come here, and we thank you very much for the hearing.

[Whereupon, at 11:52 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Hearing Statement of Senator Max Baucus (D-Mont.)
Regarding Access to Education and Tax Reform

Benjamin Franklin once said, "An investment in knowledge always pays the best interest."

For more than a century, America has invested in education. This investment has paid ample dividends.

For older generations up to age 64, the United States ranks second in the world in college graduation rates. But for younger generations, the U.S. is slipping. For those ages 25-34, the U.S. has fallen to 16th in the world. And in today's global economy, an education is more important than ever.

In these tough economic times, as job markets get more competitive – this is even more apparent. Yet American families face skyrocketing college costs. Over the past two decades, the price of higher education has grown four times faster than inflation. College costs are growing at twice the pace of medical care.

These rising costs hit low-income families especially hard. A low income family has to spend the equivalent of 72 percent of its income to send their child to college. Compare that to 14 percent for a higher income family.

This debt burden often deters young people from going to college at all. That has harmful ripple effects throughout our economy.

Differences exist even for students with similar high test scores. Students from high income backgrounds were about 32 percent more likely than those with the same test scores but from low income backgrounds to enroll in college.

That means some of our best and brightest students never have the opportunity to develop their talents. This leads to fewer scientific breakthroughs, fewer innovative companies, and a weaker overall economy than we could have.

Since 1954, Congress has provided tax cuts for families with children pursuing a college education. These provisions help families cover past, present and future expenses. The student loan interest deduction provides students a tax deduction for interest paid on a student loan.

The tax code also encourages families to save for future education expenses by providing tax-free savings vehicles. 529 programs and Coverdell accounts allow families to save for college without paying taxes on the earnings. Distributions from these accounts can be used to pay education expenses.

The tax system provides the most tax benefits for current expenses. Under the current tax system, there are provisions that exclude certain financial assistance from income. For example, scholarships and fellowships that cover qualifying education expenses are excluded from the income of the student. The tax code also contains credits and deductions to help students pay for current expenses.

The tax code cannot solve our educational challenges on its own. But it plays an important role. In 2009, taxpayers claimed almost $30 billion in education tax cuts, making college education more affordable. This equates to about 22 percent of the assistance received through Federal grants and loan assistance.

That same year, we expanded these education tax benefits by passing the American Opportunity Tax Credit. As a result, 4.8 million more lower-income students and families had access to college subsidies. These expansions are critical to ensuring American families can afford college. This is particularly true in my home state of Montana.

Montana has a higher proportion of low-income students than other states. As a result, many Montanans only benefit from tax benefits that are partially refundable, like the American Opportunity Tax Credit. In 2010, Montanans claimed nearly $105 million in education tax credits and deductions to help offset the cost of college.

But the multitude of education tax benefits can result in complexity and confusion for American families. Under current law, there are eight separate tax expenditures related to higher education. And these benefits use five different definitions of "eligible expenses." Taxpayers must calculate their taxes using each tax cut to determine which one works best.

Behind me on this chart is an actual IRS questionnaire that families need to fill out to determine if they are eligible for an education tax credit. This is just one page from an 87 page IRS guide for obtaining education tax credits. Based on the complexity of this guide, one would think the IRS expected all of America's future students to want to major in accounting.

The Government Accountability Office will tell us today how this complexity affects families. They have found that many families often pick the wrong benefit and leave money on the table.

Kelly McInerney is a CPA in Fairfield, Montana. Kelly is a mother of four college-age kids and knows firsthand how complicated these tax benefits can be. Kelly says many families she works with do not realize they can claim tax credits for tuition paid for with student loans. As a result, they get less help than they are eligible for. This can make the difference between being able to send their kids to college or not.

We need to make the system simpler for families. And we should improve these benefits for students. Through tax reform, we need to look at how we can achieve the greatest bang for our buck. Our entire system should work to help, not hinder, the pursuit of an education.

America is losing its competitive edge, but it is not too late. So let us heed the warnings. Let us listen to Benjamin Franklin's advice that investing in knowledge will pay the best interest. Let us find ways to continue to close the education gaps. Let us ensure this next generation – our children and our grandchildren – have a fair shot at making their futures brighter.

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Testimony of Dr. Waded Cruzado before the Senate Finance Committee, July 25, 2012

Mr. Chairman and Members of the Committee, I am Waded Cruzado, President of Montana State University. Thank you for the opportunity to appear before the committee today to discuss federal financial aid and tax policy as it relates to higher education, a topic that affects millions of students and their families.

Montana State University is one of more than 100 land-grant colleges and universities created by the Morrill Act of 1862, a brave piece of legislation that promised the average American an opportunity at a higher education that would help him or her prosper and become a more engaged member of our society.

The Morrill Act was signed by President Abraham Lincoln in the midst of this nation's greatest trial, the Civil War. This year is the act's 150th anniversary. In those years, more than 20 million Americans have earned degrees and given America one of the most highly educated workforces in the world, helping to ensure our prosperity and the strength of our democracy.

More than 14,000 students attend Montana State University's flagship campus in Bozeman. Many of our students are the first in their family to attend college. These students pursue a wide range of studies from agriculture and natural resources, to arts and humanities, to education, to engineering and the sciences.

Our most cherished asset and strength are the students who choose to attend MSU. Unfortunately, we see that it is becoming increasingly difficult for students and their families to pay for college. In my remarks today, I want to emphasize two points:

1) Students are taking on far more debt.
2) The tax code can play a vital role in assisting students and their families with the cost of higher education.

Current challenges/Scope of problem:

Federal financial aid and tax codes related to higher education are vital to students and their families:

- In 2009, 12.8 million students received Title IV aid and approximately 18 million tax filers claimed a higher education tax benefit for current expenses, according to the GAO report, "Improved Tax Information Could Help Families Pay for College."
- Between 2006-7 and 2010-11, the percentage of first-time, full-time undergraduates receiving financial aid increased from 75% to 85% at all four-year colleges, according to the Department of Education report, "Condition of Education, 2012," released in May.
- Based on national data, we can assume that thousands of Montana State students and their families are utilizing at least some of the tax deductions and exemptions available.

There is evidence students are assuming more cost and borrowing more:

- Parents reduced their spending on college, both in terms of current income (4%) and savings (22%), according to the recent Sallie Mae and Ipsos report, "How America Pays for College 2012."
- This is a change from two years ago when parents reached "deeply" into their pocketbooks. The report surmises that such a level of commitment was unsustainable.

- The report also notes that scholarship awards were down and attributes this to the economy, constraints on endowments and tighter budgets.
- To compensate, students assumed more costs on their own and borrowed more.

Financial aid for higher education comes in packages:

- Students and their families rely on several types of aid, including: federal grants, federal loans, work-study, and some type of institutional aid.
- The best known form of federal aid is the Pell Grant, which is based on need. Federal loans are widely available and must be repaid, but offer interest rates dramatically lower than the private market.
- Additionally, there are federal "campus-based" aid programs, as well as state programs, private and institutional awards.
- For a student from a low-income family or family with a limited family contribution, a package of aid is usually required to finance a college education.

Complex – if not bewildering – paperwork accompanies applications for federal financial aid:

- A first-time student – and his or her parents – must master a form known as FAFSA, which can be intimidating, as well as the tax code and the 1098T form.
- Some students or their parents will have to understand something of the tax code even when they have no tax liability if they want to access a program such as the American Opportunity Credit (AOC) which has a "refundability" provision.
- Even tax accountants find the tax credits and deductions for higher education confusing.
- The situation is further complicated by the fact that these different programs were passed at various times, are somewhat "stove piped" in their implementation and operation, and carry assorted terms and conditions.
- For example, some may cover tuition and fees, while others may allow for housing or other expenses. Furthermore, how a student "stacks" aid may affect the amount they ultimately qualify for.
- For a student confronting all the options, especially for the first time, the situation can be challenging, if not bewildering.

Montana students taking on more debt, more reliant on federal aid:

To describe the situation at Montana State University, let me start with two data points: FAFSA applications and Pell Grant awards. FAFSA stands for Free Application for Federal Student Aid and is the key form students and their families use to access federal student aid. The number of FAFSA forms received by MSU has grown 43 percent in just three years (from 2008-2009 to 2011-2012) and that tremendous growth rate shows no signs of slowing down.

When students and their families use the FAFSA form, those students with the greatest financial need qualify for Pell Grants. As such, Pell Grants are a good indicator of the financial stress students and their families face. The number of students receiving Pell Grants has jumped 65.6 percent in just three years (from 2008-09 to 2011-2012). Currently, 33 percent of all our undergrads are receiving Pell Grants, which means 33 percent of our entire undergrad student body was deemed to have the greatest

financial need under the FAFSA form. These grants are particularly important for our Native American, non-traditional (25+ and older) and Hispanic students, with 66 to 67 percent of these groups receiving Pell Grants – that's twice the utilization of the student body as a whole.

Another trend corresponding to the recession is the amount of debt students have when they graduate. From 1999-2007 the average amount of debt Montana State University students graduated with remained relatively flat at between $17,000 and $18,000.

Once we entered the recession, that debt grew dramatically – by 35.7 percent – so that now 66 percent of our graduates are leaving with an average debt of $25,682.

Anecdotally, I am meeting more parents who are sending their children to college while still trying to pay off their own college debts. Recent data from the New York Federal Reserve indicates this is a real, national trend.

Overall, a dramatic decline in the finances of students and their families has forced them to borrow more.

Recommendations:

Continue, or increase, federal financial aid:
There is no way a large portion of our students could afford to attend college without federal financial aid. Additionally, there is a compelling national interest in providing assistance for students to attend college: Studies suggest that the U.S. is projected to produce 3 million fewer college graduates than needed in the next decade.

Simplify the tax code as it relates to higher education expenses:
The tax code can play a vital role in assisting students and their families with the cost of higher education, but its complexity discourages many from using it to full advantage. Even tax accountants find it difficult to navigate all the rules. For example, the tax code currently assists students across a broad range of incomes – from the "refundability" component of the American Opportunity Credit (AOC); through the Lifetime Learning Credit; deductions for tuition and fees; exclusion of scholarships, grants and tuition reductions from income; exclusion of employer-provided educational assistance; and student loan interest deductions.

Clarify and coordinate the various federal aid programs so that students and their parents fully understand their options and utilize the available resources to their best advantage:
The current collection of federal aid programs – while well-meaning – is difficult to understand and navigate. This derives from the split jurisdiction between the Department of Education and Department of Treasury and the individuality of the programs themselves.

Continue support for deductions for college savings plans:
Such deductions offer an important incentive for students and families to plan ahead and save for college. Saving for college gives students and families more financial flexibility and helps them avoid indebtedness.

Closing:

In closing, I would like to emphasize – again – that students and their families are struggling more than ever with the cost of education and that the tax code can play an important role in assisting them. The number one obstacle to students and their families taking full advantage of federal financial aid and tax benefits is the complexity in understanding and applying for these programs and tax advantages.

Thank you for your work on the tax code as it applies to higher education. Please know I am committed to assisting you in any way I can. Providing the opportunity for our nation's citizens to attend and succeed in college is important to the future economic prosperity of our nation and the strength of our democracy.

Testimony of Dr. Susan Dynarski

Professor, University of Michigan
Gerald R. Ford School of Public Policy,
School of Education &
Department of Economics

Faculty Research Associate, National Bureau of Economic Research
Research Associate, Center for Analysis of Postsecondary Education and Employment

before the

Committee on Finance

United States Senate

July 25, 2012

Chairman Baucus, Senator Hatch, Members of the Committee, I am honored to testify before you today.

Summary

The goal of federal aid and the education tax incentives is to open the doors of college to those who have the ability but not the means to attend. Through some simple reforms, the government can serve this goal more effectively and efficiently. The current education tax benefits provide relief for middle- and high-income families with children in college but do little to get more people into college.[1] We should simplify and focus the tax incentives, and coordinate them with Title IV programs.

College is a Smart Investment

A college education is one of the best investments a young person can make. Even with record-high tuition prices, a bachelor's degree pays for itself several times over, in the form of higher income, lower unemployment, better health and enhanced civic engagement.[2] Within ten years of college graduation, the typical BA will already have recouped the cost of her investment.[3] It's true that during the current economic downturn college graduates have suffered – but much less so than those without a degree, who are twice as likely to be unemployed and who earn substantially less.

Growing Gaps in Educational Attainment

As a college education has grown more valuable, it has also grown more unequally distributed. Children born in the poorest quarter of the income distribution are unlikely to earn a BA – just 9% manage to do so. In the richest quarter of the income distribution, 54% of children go on to earn a BA. Troublingly, this gap has increased substantially over the past twenty years.[4]

This gap in educational attainment is enormous, and translates into a yawning gap in economic opportunity. Disparities of this magnitude in the educational outcomes of rich and poor children bode ill for our democratic society. Education has long been a vehicle for opportunity in our country, a path to prosperity for every class. Growing gaps between rich and poor in educational attainment threaten this vision of economic mobility. We are in danger of devolving into a rigid, caste society, in which the children of the poor are destined to low education and menial work.

What Role for Federal Postsecondary Policy?

I give you these statistics to focus our thinking about postsecondary policy. Getting more low-income kids into and through college is, in my judgment, the defining goal of federal student aid. We may also have other goals, such as easing the pinch of college costs for upper-income families who would send their kids to college even in the absence of federal assistance. In families in the top quarter of the income distribution, eighty percent of children go on to college.[5] Handing money to these families will make their lives more comfortable, and perhaps reduce their borrowing, but it is unlikely to boost their educational attainment.

It is important to understand the limits of postsecondary policy. Gaps in educational attainment and achievement start early. Inequality builds along the entire educational pipeline.[6] Half the gap between the rich and poor in college attendance can be explained by the lower rate of high school graduation among poor children. Postsecondary aid and tax policy can play an important role in shrinking gaps in educational attainment, but these gaps will only be eliminated with improvements at every level of education.[7]

Student Aid and the Education Tax Incentives Have Grown Rapidly

The past few years have seen substantial growth in both traditional student aid (the Title IV programs) and education tax incentives.

- Pell spending doubled from $18.3 billion in 2008 to $36.5 billion in 2010.[8] Part of this growth was driven by the recession, which decreased family incomes (thereby increasing Pell eligibility of current students) and weakened the labor market (thereby driving people into college). However, most of the rise in spending is explained by changes in the Pell formula that made the program more generous.[9]

- With the introduction of the American Opportunity Tax Credit in 2009, the value of the education tax credits doubled, from $9 billion in 2008 to $18 billion in 2009.[10] Most of this increase went to high-income families who were not eligible for the Hope Credit.

These two programs – the AOTC and the Pell – are the largest of a broad array of federal programs that aim to reduce the cost of college.

- The Department of Education (ED) administers the Pell Grant as well as Direct Loans and a number of smaller programs that totaled $145 billion in 2010. Loans are by far the largest program in the Title IV portfolio.

- The IRS administers the American Opportunity Tax Credit and the Lifetime Learning Credit plus a variety of smaller programs (e.g., deductibility of student loan interest, exclusion of earnings from 529 and Coverdell plans) for a total of $28.6 billion in education-related tax expenditures.[11] Besides the tax credits, the dependent exemption for students between 18 and 23 is the largest tax expenditure for education.

Pell is Better Targeted Than The American Opportunity Tax Credit

The Pell Grant is squarely focused on low-income students. The incomes of those receiving the tax credits are comparatively high.

- Only 15% of Pell recipients have household incomes above $40,000, and just 3% above $60,000.[12]

- 27% of AOTC recipients have incomes over $75,000 while 16% have incomes over $100,000.[13]

The lowest-income families get the largest Pell grants. The opposite is true of the AOTC.

- The 58% of Pell recipients with incomes under $20,000 account for 62% of Pell expenditures, while the 26% of recipients with income over $30,000 account for only 20% of spending.[14]

- The 28% of AOTC recipients with income under $20,000 account for only 15% of spending, while the 17% of AOTC recipients with incomes over $100,000 account for 22% of AOTC expenditures.[15]

While the AOTC is not as well targeted as the Pell, it does deliver more money to low-income families than its predecessor, the Hope Credit. This is because, unlike the Hope Credit, the AOTC is partially refundable and covers some non-tuition costs. On the other hand, the income ceiling is much higher on the AOTC than Hope ($180,000 vs. $120,000 for a married couple) and families in this newly eligible group send their children to college at very high rates. As a result, the AOTC flows to many more high-income families than did the Hope Credit.

Complexity in Student Aid and Tax Incentives Undermines Effectiveness

Families can't respond to a price subsidy if they do not understand it. Two parallel bureaucracies and application processes now lie between families and the funds that can help them pay for college.

- The education tax incentives are far too complicated to do their job. The IRS publication devoted to explaining them is 87 pages long. The consequences of this complexity extend beyond mere annoyance and frustration. Many families do not choose the credit that benefits them the most, in part because they are confused about which expenses are eligible for which tax benefit.[16]

- A recent experiment showed that complexity in the aid process discourages many students from attending college. College attendance rose 7 percentage points among those allowed to use a vastly simplified process for applying for aid.[17]

Simplify, Focus and Coordinate Title IV and the Education Tax Incentives

The goals of reform should be to *focus* the incentives on those who are on the margin of attending college, to *simplify* the incentives so that families can understand and respond to them and to *coordinate* the programs.

1) Create a single, refundable benefit for tuition, fees, room, and board.

- Merge the AOTC and Lifetime Learning Credits into a *single credit*. A single credit would significantly reduce complexity, enabling families to estimate their likely credit well in advance.
- Make the credit fully *refundable* so families in lower tax brackets are eligible for the maximum benefits.

2) Deliver the credit at the time of college enrollment.

- Families need the credit when tuition is due, not a year or more later when taxes are filed. If delivered at the time of enrollment the tax credit will pay for college, as Congress intended.
- IRS can use previous year's income to define eligibility for the education tax credit, so that eligibility is known early.

3) Coordinate eligibility, application and administration for the tax credits and Title IV programs.

- A unified program can be easily communicated to families. Families can't respond to an incentive they do not know about.
- A unified program cuts back on duplicative paperwork for families. Complexity in the application process undermines program effectiveness.[18]
- A unified program eliminates perverse and confusing interactions between the tax code and Title IV. Example: Title IV provides a Pell Grant, IRS reduces its value by taxing it, IRS then provides an education tax credit.[19]
- A unified program can be a well-targeted program. Social Security is an example of a program with universal eligibility that still targets assistance to the most needy.[20]
- A unified program cuts down on administrative costs for colleges. Colleges currently have to report on student spending and attendance to both IRS and ED.
- A unified program cuts down on administrative costs for government. The Treasury Inspector General has proposed that IRS substantially expand its oversight of the education tax credits in order to reduce errors and fraud. The infrastructure for such oversight already exists in ED. Duplicative bureaucracies will be costly for taxpayers.[21]

How Can We Get from Here to There? Some Examples

There are several paths to this more effective system of tax credits and aid. Each of the following would, separately or in combination, move us closer to these goals.

Reform 1: Simplify the aid formula and create a single application
The best approach would be to determine eligibility for the aid and tax credit programs with a single, simple application. While the aid application contains over 100 questions, just a handful of data items (e.g., income) affect aid eligibility.[22] By eliminating the superfluous questions (including those about assets) we would allow eligibility for aid and tax credits to be determined in a single application. This would reduce opportunities for fraud and error, as well as save citizens millions of hours now spent filling out duplicative forms.[23]

Reform 2: Deliver the AOTC through the Aid System
The refundable portion of the AOTC could be delivered to students through the aid system, along with the Pell. This would allow students to receive the AOTC when they need it to pay for college, instead of months later. This early delivery would allow the AOTC to affect college decisions, not just reward students who have decided to go to college.

Reform 3: Provide Estimates of AOTC Eligibility to Aid Applicants
The tax credits can affect college attendance only if students know about them before they go to college. When students apply for aid, they learn about their Pell eligibility. ED could inform students about AOTC eligibility at the same time.

Does Aid for College Drive Up Prices?

You requested that I discuss whether aid for college students (in the form of Title IV or tax credits) drives up college prices. The best evidence indicates "No" – at least for the public and non-profit institutions attended by 91% of college students. We do have evidence, however, that prices at for-profit schools increase when the Pell does.[24] While these schools teach only 9% of students, they account for 24% of Pell expenditures.

I stress that the problem is limited to the for-profit sector. Any remedies should therefore be focused on this sector. There are other problems in this sector, which tripled in size from 1999 to 2009. Students at for-profit schools drop out, borrow and default at unusually high rates. We are slowly moving in the right direction by tightening federal oversight of the sector in the form of the new gainful employment standards. These standards are painfully weak, and will have to be strengthened considerably if they are to root out the bad apples in this sector.[25] Failure to do so will result in an upward spiral in Pell costs, loan debt and loan defaults.

Conclusion

The federal government could do better with its aid and tax incentives for college. Although the education tax benefits provide relief for middle- and high-income families with children in college, they do little to get more people into college. Simplifying and focusing the tax incentives, and coordinating them with the Title IV programs, will allow them to serve their goal: opening the doors of college to those who have the ability but not the means to further their education.

Figures: Growing Gaps in College Attendance and BA Completion

These figures are from Bailey & Dynarski (2011)

Calculations are based on data from the National Longitudinal Surveys of Youth, 1979 & 1997.

Figure 2: Fraction of Students Entering College, by Income Quartile and Birth Year

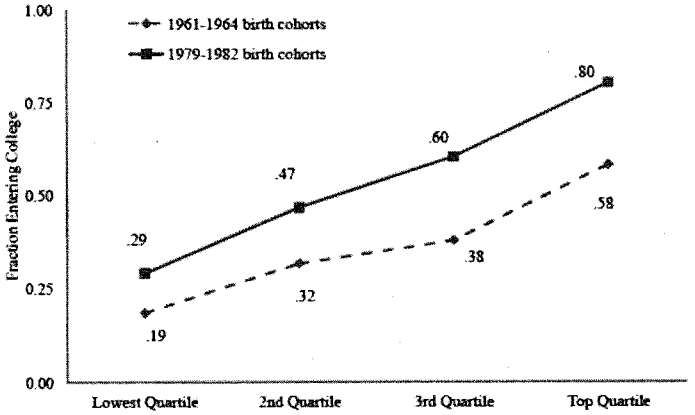
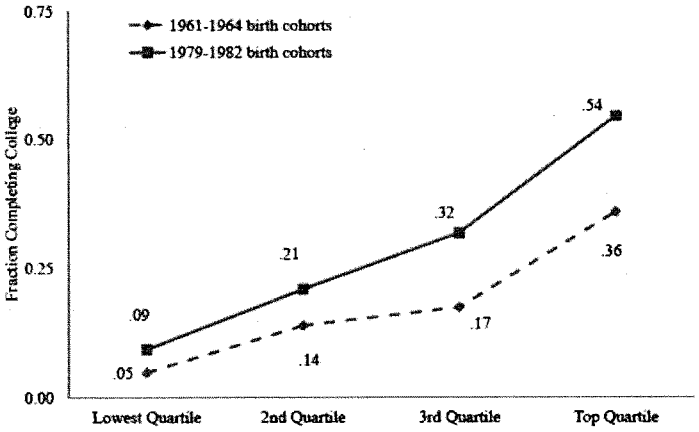


Figure 3: Fraction of Students Completing College, by Income Quartile and Year of Birth



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Endnotes

[1] The best evidence on the effect of the tax credits suggests that they increase college attendance of young people by zero (Long, 2004) to 2.2 percentage points (Turner, 2011). Well-designed aid programs have been shown to have substantially larger effects (Deming and Dynarski, 2010).

[2] See evidence summarized in College Board (2010). College is not a sure bet (no bet is!), and returns vary considerably. For an academically prepared student, however, the odds are quite good that college will more than pay for itself.

[3] Barrow and Rouse (2005).

[4] Bailey and Dynarski (2011), based on National Longitudinal Surveys of Youth. The quartiles are of households with children in 1979 and 1997. For the later cohort, the bottom quartile has a maximum household income of $25,500 (average $14,000), while the top quartile has a minimum income of $85,500 (average $140,000). The gap in BA completion was 31 percentage points twenty years ago, as compared to 45 percentage points today.

[5] Figure on college attendance is from Bailey and Dynarski (2011).

[6] Duncan and Murnane (2011).

[7] Deming and Dynarski (2010) review the evidence on the effect of student aid on educational attainment.

[8] Ackerman, Cronin, Turner and Bershadker (2011).

[9] Dynarski and Wiederspan (2012).

[10] Crandall-Hollick (2012b).

[11] Ackerman, Cronin, Turner and Bershadker (2011).

[12] Table 2 in 2010-2011 Federal Pell Grant End-of-Year Report.

[13] Figures are for 2009 year and are from Ackerman, Cronin, Turner and Bershadker (2011).

[14] U.S. Department of Education (2012). Figures are for 2010-11 academic year.

[15] Figures are for 2009 year and are from Ackerman, Cronin, Turner and Bershadker (2011).

[16] Government Accountability Office (2012).

[17] Bettinger, Long and Oreopoulos (forthcoming).

[18] Bettinger, Long and Oreopoulos (forthcoming).

[19] See Ackerman, Cronin, Turner and Bershadker (2011) for more examples. Dynarski (2004) shows similar perverse interactions between Title IV aid and the tax incentives for education saving.

[20] See Skocpol (1991) for a discussion of the political viability of targeted, universal, anti-poverty programs. Dynarski and Scott-Clayton (2006, 2007, 2008) discuss targeted universalism in the context of federal student aid.

[21] U.S. Department of Treasury (2011).

[22] See Dynarski and Scott-Clayton (2006, 2007, 2008), as well as Rethinking Student Aid Study Group (2008).

[23] In a recent conference presentation, economists from Treasury and ED put forth thoughtful options to combine, coordinate and simplify the AOTC and the Pell. See Ackerman, Cronin, Turner and Bershadker (2011).

[24] Cellini and Goldin (2012).

[25] This sector is highly heterogeneous and the "bad apples" are almost certainly a minority. The gainful employment rules are intended to identify these bad apples and remove them from the Title IV programs.

SUBMITTED BY SENATOR GRASSLEY

WHO BENEFITS FROM STUDENT AID?

THE ECONOMIC INCIDENCE OF TAX-BASED FEDERAL STUDENT AID

Nicholas Turner[a,*,1]
[a] Department of Economics, University of California, San Diego, La Jolla CA 92037

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Abstract: Federal benefit programs are designed to aid targeted populations. Behavioral responses to these programs may alter the incidence of their benefits, a possibility that receives less attention in the literature compared to tax incidence. I demonstrate the importance of benefit incidence analysis by showing that the intended cost reductions of tax-based federal student aid are substantially offset by institutional price increases for a sample of 4-year colleges and universities. Contrary to the goal of policymakers, I find that tax-based aid crowds out institutional aid roughly dollar-for-dollar. Unfortunately, it is not clear how institutions utilize these captured resources, so that the ultimate incidence of the programs is uncertain.

JEL Codes: I22, I28, H22

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* Corresponding author. Telephone: (202)-622-1721. Email: Nicholas.Turner@do.treas.gov.
[1] This work was completed as part of my doctoral thesis while at the University of California, San Diego. My present affiliation is the Office of Tax Analysis, United States Treasury, Washington D.C. 20220.

1. Introduction

Behavioral responses to government programs may undermine their intended effects, and as a result, alter their designed welfare implications. For this reason, tax incidence, which examines where the burdens of taxation ultimately fall, receives much attention in the literature (Fullerton and Metcalf 2002; Gruber 1997; Kubik 2004). The study of benefit incidence of government programs is less common. For example, until recently the assumption that the Earned Income Tax Credit benefits recipients had never been tested. Leigh (2010) and Rothstein (2010) address this omission, and find substantial erosion of benefits for nominal recipients via reduced wages in the labor market. These results suggest that the efficacy of benefit programs depends crucially on the extent of offsetting price changes. This paper adds to the benefits incidence literature by quantifying the institutional price response to tax-based federal student aid.

Funding for federal student aid, over $660 billion between 1998 and 2006,[2] is based on the assumption that students and families claiming the programs are the economic beneficiaries. The existing literature finds that student aid increases enrollment (Dynarski 2000, 2003; Ellwood and Kane 2000; Heller 1997; Leslie and Brinkman 1987; Turner 2009), but how effectively these programs do so depends on the degree to which there are offsetting price changes. Yet, the literature examining the institutional price response to student aid is limited and generally focuses on tuition effects at the school level. The use of tuition increases to appropriate the benefits of federal student aid is referred to as the Bennett Hypothesis, named after former Education Secretary William Bennett.[3] Long (2006, 2008) and Ikenberry (1997) discuss the

[2] Expenditures are in 2006 dollars and include grants, student loans and tax-based aid (Baum and Steele 2007).
[3] Bennett (1987) made his original argument in the context of federal loan programs. Following Singell and Stone (2007) and Hoxby (1998), I use a broad interpretation of the Bennett Hypothesis that includes the appropriation of any external student aid program using tuition increases.

existing work on the Bennett Hypothesis and note that there is weak empirical evidence supporting its validity.[4]

One possible explanation for these inconclusive findings is that instead of increasing tuition, schools may appropriate the benefits of federal student aid by strategically reducing institutional grant aid. I refer to this possibility as the price-discrimination Bennett Hypothesis. Unlike tuition increases that affect all students, the reduction of institutional aid allows schools to realize financial gains from increases in federal student aid while ensuring that no student is made worse off. The strategic use of institutional aid also avoids the highly visible and unpopular process of increasing tuition.[5] Both policymakers and financial aid administrators are aware of the possibility that institutional aid will be replaced by tax-based aid. Former Education Secretary Richard Riley sent a letter to presidents of colleges and universities declaring that the goal of tax-based aid is to, "...provide additional help for families to pay for college and not simply substitute for existing sources of financial assistance" (Riley 1998). In response, some financial aid administrators pledged that students would receive the full benefits of tax-based aid (Burd 1998). However, others argued for the need to incorporate tax-based aid awards in the calculation of institutional aid. One such director noted, "...families that receive

[4] Long (2004) finds limited support for the Bennett Hypothesis in response to two tax-based aid programs. Contrary to the Bennett Hypothesis, Long (2003) and Scafidi, Rubenstein, Schwartz and Henry (2007) report price decreases in the context of the Georgia Hope Scholarship. McPherson and Shapiro (1991) and Singell and Stone (2007) report conflicting patterns of changes in tuition across public and private schools in response to federal grant programs. Singell and Stone (2007) and Rizzo and Ehrenberg (2003) report opposite findings on the effect of out-of-state tuition at public schools.

[5] This is an especially complicated process for public schools. Only 16 states give schools the authority to raise tuition, while the legislature, a state agency or a system board sets tuition in the remaining states (Mumper and Freeman 2005). McPherson and Shapiro (1998) note that there is substantial pressure to limit tuition increases at private schools, and in earlier work (1991), suggest that the goal of maintaining an economically diverse applicant pool moderates tuition increases.

$1,500 from the federal government are better off than those that don't. And I don't think that I can ignore that" (Burd 1998).[6]

Despite the awareness that institutions may decrease aid, rather than increase tuition, in response to increases in external aid, Long (2003) and McPherson and Shapiro (1991) are the only papers that explicitly raise this possibility. They document student aid incidence at the school level and reach different conclusions on whether external aid is a substitute for institutional aid.[7] Yet, the use of school-level data prevents Long (2003) and McPherson and Shapiro (1991) from determining *which* students are impacted by the institutional response. The flexibility of student-level data allows me to add to this work by addressing several related questions. First, do colleges and universities selectively lower institutional grant aid *for students that benefit from tax-based aid*? Second, how do students who experience these aid declines cope? Due to a likely time delay in benefit receipt of tax-based aid, a reduction in institutional aid may cause students to borrow more in order to offset their short-term unmet need.

To estimate student-level effects, I exploit policy-induced variation in all three tax-based aid programs, the Hope Tax Credit, the Lifetime Learning Tax Credit and the Tuition Deduction, using data from the National Center on Education Statistics. The analysis sample includes students enrolled at 190 4-year schools during the 1995-96, 1999-2000 and 2003-04 school years.[8] Enrollment at the schools in the sample represents roughly 40 percent of students enrolled in 4-year colleges and universities, although schools in the sample are relatively more selective and have larger enrollments than comparable 4-year schools nationally. I estimate the intention

[6] $1,500 is the maximum value of the Hope Tax Credit, and was the maximum tax-based aid award when the statement was made in 1998.
[7] Long (2003) reports that merit-based aid substitutes for institutional aid at private colleges in Georgia in the 1990s, whereas McPherson and Shapiro (1991) find that federal grant aid complements institutional aid for private schools in an earlier period for a nationally representative sample.
[8] The number of schools is rounded to the nearest 10 to comply with the Department of Education Institute of Education Sciences confidentiality statutes.

to treat effect of tax-based aid using instrumental variables to address the endogeneity of education spending and school fixed-effects to control for unobserved heterogeneity in student aid practices across institutions.

Contrary to the goal of policymakers, who sought to increase postsecondary access for eligible students by lowering the cost of enrollment, I find that the institutional price response substantially counteracts the intended cost savings of tax-based aid. Students appear to increase loans in response to the reduction of institutional aid, suggesting that tax-based aid falls short of an important federal aid goal to reduce student indebtedness (Burgdorf and Kostka 2006). These results imply that students eligible for tax-based aid may not be the economic beneficiaries of the programs. To determine the ultimate incidence of tax-based aid, I consider two ways in which institutions might utilize the captured resources. One, that institutions redirect aid towards students who are ineligible for tax-based aid, or two, that institutions channel the resources into other expenditures, such as capital improvements or faculty/staff salaries. Unfortunately, these results are largely uninformative so that the incidence of tax-based aid is uncertain (see Appendix A). However, I offer an important first step in establishing the incidence of tax-based aid by demonstrating that eligible students and their families are not directly benefitting from tax-based aid in the manner envisioned by policymakers. Similar unintended behaviors are found to offset the intention of policies in other contexts, including public health insurance (Cutler and Gruber 1996) and intergovernmental grants (Baicker and Gordon 2006; Gordon 2004; Hines and Thaler 1995).

The remainder of this paper proceeds as follows. Section 2 provides information on the tax-based aid. In Section 3, I discuss the institutional price response to federal student aid. Section 4 discusses the empirical specifications and results. Section 5 concludes.

2. Tax-Based Federal Student Aid

Tax-based aid programs provide a convenient natural experiment for examining the impact of federal aid on college pricing. Program implementation and changes in program generosity create discrete changes in aid for eligible students over time. In 1997, the Taxpayers' Relief Act introduced the Hope Tax Credit and the Lifetime Learning Tax Credit. In 2001, The Economic Growth and Tax Relief Reconciliation Act added a third program, the Tuition Deduction. Between 1998 and 2006 these three tax-based aid programs cost over $41 billion and were claimed by more than 54 million students and their families (Baum and Steele 2007).

While there are three tax-based aid programs, only one program may be claimed per student per year. The value of each program depends in part on educational spending. The Hope Tax Credit is equal to 100 percent of the first $1,000 and 50 percent of the next $1,000 of qualified expenses and may only be used during the first two years of undergraduate education (Internal Revenue Service [IRS] 1998). The Lifetime Learning Tax Credit covers 20 percent of qualified expenses for all years of postsecondary study for most students. Between 1998 and 2002, the qualified spending limit was $5,000, and in 2003, it increased to $10,000 (IRS 1998, 2003). The Tuition Deduction allows tax filers to deduct 100 percent of the first $3,000 of qualified education expenses,[9] and has a broader eligibility range compared to the Hope Tax Credit and Lifetime Learning Tax Credit (IRS 2002). Maag and Rohaly (2007) report that program take up is 63-74 percent, comparable to take up rates for Unemployment Insurance,

[9] The maximum deduction increased to $4,000 and the adjusted gross income eligibility range expanded in 2004. Because I use data from the 2003-04 school year, I calculate the Tuition Deduction based on the 2003 program rules, which were in place for the first half of that school year. This is done because the data do not include payment date and only expenses paid after January 1, 2004 are affected by the program changes.

Head Start and the Earned Income Tax Credit (Currie 2006).[10] Table 1 describes the programs in greater detail.

In contrast to federal grant aid, such as Pell Grants and Federal Supplemental Education Opportunity Grants that target relatively low-income students and families, tax-based aid targets middle and upper-middle class families. Figure 1 highlights several key features of the tax-based aid programs that result in middle-class targeting, showing how the maximum value of tax-based aid varies by adjusted gross income for a hypothetical joint-filing family of four. Below $20,000 of income, a family of four claiming only the standard deduction and personal exemptions will have no tax liability. Families in this income range will be unable to capitalize on tax-based aid because the Hope Tax Credit and the Lifetime Learning Tax Credit are nonrefundable and the Tuition Deduction cannot reduce taxable income below zero. As income increases beyond $20,000, tax-based aid phases in according to the marginal tax rate until tax liability is no longer binding. At higher-income levels, the value of the Hope Tax Credit and the Lifetime Learning Tax Credit are reduced due to the phase-out range, which begins around $80,000 for joint returns. The value of the Tuition Deduction is a function of the marginal tax rate. As shown in Figure 1, the Tuition Deduction increases with income due to the progressive tax rate schedule. Figure 1 also shows how the value of tax-based aid changes over time. The top panel reflects the introduction of the Hope and Lifetime Learning Tax Credits. The introduction of the Tuition Deduction and the increased generosity of the Lifetime Learning Tax Credit are visible in the lower panel of Figure 1.

[10] Long (2004) provides evidence that many parents/guardians were unaware of tax-based aid using data from the National Household Education Survey. She also reports that take-up was less than expected in the first years of the programs using National Postsecondary Student Aid Study data. However, the National Postsecondary Student Aid Study may not accurately capture program take up. More than one-third of respondents in the 1999-2000 survey replied "don't know" or "not reached/missing" when asked about tax-based aid use.

The timing of award receipt also sets tax-based aid apart from traditional forms of student aid. Benefits from tax-based aid are likely realized when tax returns are received, generally after educational expenses are paid. For example, a family that pays education costs in September and receives their tax return in April faces an eight-month delay.[11] As a result, if schools substitute tax-based aid for their own sources of aid, students will face a temporary increase in unmet financial need.

3. Institutional Pricing Behavior

While most authors agree that the standard profit maximization model does not fit colleges and universities (Clotfelter 1999; Winston 1999) there is not a consensus in the literature on the objective function for institutions of higher learning.[12] Despite this uncertainty, it is possible to infer the general institutional price response to tax-based aid. Suppose that schools have an optimal input allocation in equilibrium that includes student enrollment.[13] Other inputs are likely to include items such as research support, student services, faculty and staff salaries and physical capital. The introduction of tax-based aid distorts the equilibrium allocation by increasing education demand among eligible students. In response, colleges and universities will act to capture the financial gains from tax-based aid and redistribute it optimally across inputs.

Competitive pressures of the market determine the extent to which colleges and universities may capture the financial benefits of tax-based aid. If there is perfect competition then schools will not be able to reduce grant aid. To the extent that institutions exert some

[11] Tax filers could smooth the impact of the credit by adjusting their withholdings in earlier periods. However, this requires a high level of sophistication, and it is likely that most returns realize the benefits as a lump sum after education costs are paid.
[12] James (1978, 1990) and Long (2003) argue that prestige maximization incorporates many of the important goals of colleges and universities.
[13] Several authors suggest that enrollment is a key input in the objective function (Hoxby 2000; James 1990; McPherson and Shapiro 1991; Rothschild and White 1995).

degree of market power they will be able to realize financial gains by lowering grant aid for students that benefit from tax-based aid. There are several potential sources of market power for colleges and universities.[14] First, colleges and universities may be considered differentiated products. Second, unlike profit maximizing firms, schools select the purchasers of their product (Clotfelter 1999; Rothschild and White 1995; Winston 1999). This aspect allows some schools to maintain excess enrollment demand in equilibrium. Third, information asymmetry may give pricing power to schools. Entering students do not observe the counterfactual level of aid that would have been offered in the absence of the institutional response. Therefore, colleges and universities have the ability to increase the net-price that they receive in a manner that may avoid backlash from parents and students. While some continuing students do have a history of aid that may serve as a basis for comparison with their current aid offer, institutions may still exercise pricing power over continuing students due to the costs associated with transferring schools. Transferring students are likely to incur financial costs in addition to academic costs, as credit hours may not be entirely transferable.

In practice, financial aid administrators can determine eligibility and award size for tax-based aid from the Free Application for Federal Student Aid (FAFSA). Given this information, administrators can substitute tax-based aid for other sources of aid. Such a response should not be driven by a mechanical relationship between the receipt of tax-based aid and an increase the expected family contribution. The FAFSA explicitly collects information on tax-based aid in order to prevent these programs from being clawed-back via the expected family contribution

[14] The Department of Justice alleged anticompetitive behavior among private colleges in the late 1980s and early 1990s (Jaschik 1991; Netz 1999). While Hoxby (2000) shows evidence that schools named in the antitrust case were not colluding to increase tuition or to decrease the total amount of grant aid awarded, she does find evidence that the distribution of institutional grant aid across students changed within these schools following the lawsuit.

calculation.[15] McPherson and Shapiro (1998) speculate that institutional aid may be reduced dollar-for-dollar in response to tax-based aid. In contrast, it is unlikely that tax-based aid will have a large impact on Pell Grants and federal campus-based aid, due to limited overlap in eligibility with these programs. Maag and Rohaly (2007) estimate that tax returns with income of at least $40,000 receive about 65-70 percent of the total expenditures for the tax credit programs while Mercer (2005) notes that 90 percent of families claiming Pell Grants have income less than $40,000.

Ultimately, determining the scope of the institutional price response to tax-based aid is an empirical question. Figure 2 provides some suggestive evidence that financial aid administrators at 4-year colleges and universities responded to tax-based aid by lowering institutional grant aid for eligible students. This figure shows changes in tax-based aid and changes in institutional grant aid by income between the 1999-2000 and 1995-96 school years (top panel) and the 2003-04 and 1999-2000 school years (bottom panel). A decrease in grant aid for students realizing an increase in tax-based aid is consistent with the price-discrimination Bennett Hypothesis, although the changes in aid are unconditional on school or student characteristics and are relatively noisy.

4. Empirical Strategy and Results

4.1. Analysis Sample

To explore the institutional price response to tax-based aid, I use data from the National Postsecondary Aid Study (NPSAS) published by the National Center for Education Statistics. These data provide student-level information on financial aid, student and parent characteristics, and institutional detail. Using samples from the 1995-96, 1999-2000 and 2003-04 school years, I include 190 4-year schools with roughly 74,280 undergraduate students aged 18-24 in the

[15] See Worksheet B in the 1999-2000 FAFSA or Worksheet C in the 2003-04 FAFSA.

primary analysis sample.[16] To construct this sample I limit the data in two ways. First, I drop students with invalid grade level responses.[17] The value of tax-based aid depends on grade level (the Hope Tax Credit is available only during the first two years of college), so including observations with missing grade level information adds measurement error. I also limit the sample to the 190 schools that appear in each of the NPSAS files, ensuring that the sample of schools is balanced over time.[18] As a robustness check, I also analyze an unbalanced panel of 350 4-year schools that appear in the 1995-96 school year and at least one of the later school years (1999-2000, 2003-04).[19]

The NPSAS does not include information on the value of tax-based aid, or reliable information on program use. To address this shortcoming of the data, I estimate the value of the tax-based aid in the following way. First, I use IRS rules (1998, 2002, 2003) to define the formulas for the Hope Tax Credit, the Lifetime Learning Tax Credit and the Tuition Deduction, which depend on education spending, adjusted gross income and taxes owed. The NPSAS contains data on family income and education spending, defined as tuition minus student aid. In calculating taxes owed, I assume that only the standard deduction and personal exemptions are claimed. Using these values of income, education spending, and taxes owed, I apply the tax-based aid formulas to estimate the value of each of the three programs for a given student.

[16] Both the number of schools and the sample size are rounded to the nearest 10 to comply with the Statistical Standards Program of the U.S. Department of Education Institute of Education Sciences restricted use data protocol.
[17] Invalid grade level responses include both observations with missing information and those that skipped the survey question. Roughly 5 percent of students have invalid grade level responses.
[18] In the 1995-96 NPSAS sample there are roughly 440 4-year schools.
[19] The number of schools is rounded to the nearest 10 to comply with the Department of Education Institute of Education Sciences confidentiality statutes.

Students can claim at most one program per year, so for students that are eligible for multiple programs, I assign the program with the largest value.[20]

Figure 3 shows the average value of the eligible tax-based aid award by adjusted gross income for the 1999-2000 and 2003-04 school years. Cross-sectional variation in the subsidy arises from differences in qualified education spending, differences in adjusted gross income, differences in tax filing status and from program rules that define eligibility. These sources of variation are evident across the panels in Figure 3. For example, the decrease in value around $40,000 corresponds to the phase out range for non-joint returns whereas the decrease in value around $80,000 corresponds to the phase out for joint returns. Time-series variation comes from the enactment of the tax-credit programs in 1998, and from the increase in the value of the Lifetime Learning Tax Credit and introduction of the Tuition Deduction between the 1999-2000 and 2003-04 school years.

For public (private) schools in the sample, average tax-based aid eligibility is $586 ($634) compared to $480 nationally in the 1999-2000 school year and $682 ($869) compared to $540 nationally in the 2003-04 school year.[21] Omitting 2-year schools from the sample is likely to result in larger tax-based aid relative to the national average.[22] Table 2 shows the mean values of various measures of student aid, including tax-based aid, and student demographic variables by institution type for each of the three school years. (All dollar amounts in Table 2 are in 2003 dollars.) The value of tax-based aid is comparable across public and private school students in the sample because the maximum qualified spending of the tax-based aid programs is relatively

[20] Analyzing individual tax return data from the IRS, Turner (2010) finds that not all taxpayers select the single tax-based aid program that offers the largest value. However, the dollar amount of the loss incurred from these selections is small, so the effect on the estimated value of tax-based in this work should be minimal.
[21] National average for tax-based aid from Trends in Student Aid 2004, The College Board, Table 7.
[22] The price response by 2-year schools is likely to be different than that of 4-year schools, as 2-year schools generally offer less aid and therefore have less scope for the price-discrimination Bennett Hypothesis. Unfortunately, I am unable to consider 2-year schools separately due to sample size considerations. Omitting 2-year institutions removes an important component of the national postsecondary education market.

low, so that additional education spending by private school students does not increase the value of the tax-based aid award.

Enrollment at schools in the analysis sample represents roughly 40 percent of national 4-year college enrollment during the analysis period. Table 3 shows both aggregate national enrollment and total enrollment for schools in the analysis sample. Broken down by school type, enrollment at 4-year public schools in the sample is roughly 45 percent of 4-year public enrollment nationally and enrollment at 4-year private schools in the sample is about 25 percent of national 4-year private enrollment. However, schools in the sample are on average larger than comparable schools nationally. In the 2003-04 school year, median enrollment in the sample at public (private) institutions is about 24,000 (12,500) compared to roughly 10,000 (2,000) nationally.[23] The sample of schools is also relatively more selective than comparable 4-year schools nationally. In the sample, the share of public (private) schools that are most or very selective is 27 (60), moderately selective 65 (36), and minimally selective and open admissions is 8 (4). Nationally, these shares for public (private) schools were 14 (38), 59 (41) and 27 (21) in the 2003-04 school year.[24] Baum and Steele (2007) show that more selective schools offer more institutional aid, suggesting greater scope for the price-discrimination Bennett Hypothesis. As a result, the institutional response for the sample of schools considered here is likely to represent an upper bound of the price-discrimination Bennett Hypothesis.

4.2. Measuring the Price-Discrimination Bennett Hypothesis

[23] I measure average school size using enrollment and number of institutions from Tables 168 and 243 from the Digest of Education Statistics 2005, National Center for Education Statistics.
[24] National selectivity from the 2003-04 NPSAS and includes 4-year not-for-profit schools.

The price-discrimination Bennett Hypothesis predicts that institutions reduce institutional aid to capture the financial benefits of tax-based aid. To explore this possibility, I exploit policy-induced variation in the value of tax-based aid using Equation (1):

$$(1) \qquad InstitutionalAid_{ijt} = \beta_1 TBA_{it}\left(S_{ijt}, I_{it}, \tau_{it}\right) + \beta_2 X_{ijt} + \alpha_j + \varepsilon_{ijt}$$

where *i, j, t* index individuals, schools and years respectively. The key independent variable is tax-based (*TBA*), which is a function of education spending (*S*), adjusted gross income (*I*) and taxes (τ) as described in Section 4.1. β_1 measures the impact of eligibility for one dollar of tax-based aid on institutional aid. An estimate of -1 for β_1 implies dollar-for-dollar aid substitution, while $\beta_1 < 0$ is consistent with the price-discrimination Bennett Hypothesis.

A primary concern with ordinary least squares (OLS) estimation of Equation (1) is the possibility that tax-based aid and institutional aid are jointly determined, because tax-based aid is a function of education spending. Holding all else equal, if spending is below the programs' limits, an increase in education costs, such as a reduction in institutional aid, will increase the value of tax-based aid. Figure 4 highlights this program feature, showing the values of the three tax-based aid programs as functions of qualified education spending. To address this source of bias, I instrument for tax-based aid using two separate approaches. In each case, I generate an instrument by calculating the value of the tax-based aid using a plausibly exogenous value of education spending in order to isolate policy-induced variation in tax-based aid eligibility.[25]

In the first approach, I instrument using the value of tax-based aid calculated at the programs' spending limits. As shown in Figure 4, the value of tax-based aid is constant for

[25] Wooldridge (2002) refers to this as a generated instrument, and shows that estimates using generated instruments are consistent and reach valid inferences. This approach is similar to Dahl and Lochner (2008) who replace an endogenous input in the Earned Income Tax Credit schedule to isolate policy-induced variation. It is also similar to Hoxby and Kuziemko (2004) who use pre-period school district characteristics in the contemporaneous school aid formula to isolate policy-induced variation from a school finance equalization in Texas and refer to their approach as simulated instrumental variables following Currie and Gruber (1996).

qualified spending that exceeds these limits, so that this instrument is unaffected by an institutional response that increases spending. Equation (2) gives the first-stage equation:

$$(2) \qquad TBA_{it}\left(S_{ijt}, I_{it}, \tau_{it}\right) = \gamma_1 TBA_{it}\left(S_{\max t}, I_{it}, \tau_{it}\right) + \gamma_2 X_{ijt} + \alpha_j + \varepsilon_{ijt}$$

where $S_{\max t}$ is the maximum spending limit in year t.

As a second approach, I use an instrument that includes variation in education spending by student characteristics for each school. This instrument relies on a plausibly exogenous level of spending that is based on the determinants of spending in the 1995-96 school year. A key assumption of this approach is that spending in 1995-96 is unaffected by the endogenous response expected after the enactment of tax-based aid. To construct this instrument, I first estimate spending in the 1995-96 school year as a function of student income and demographic characteristics for each school j, using Equation (3).

$$(3) \qquad S_i = \lambda_{j1} black_i + \lambda_{j2} hispanic_i + \lambda_{j3} income_i + \lambda_{j4} age_i + \lambda_{j5} female_i + \lambda_{j6} dependent_i + \varepsilon_i$$

Next, I use the parameter estimates from Equation (3) to predict qualified spending for students in later periods at the same school (in real terms).[26] From this simulation, I calculate the instrument as the value of tax-based aid that a given student would have received if the pattern of qualified spending were held constant from the 1995-96 school year. Equation (4) gives the first stage equation.

$$(4) \qquad TBA_{it}\left(S_{ijt}, I_{it}, \tau_{it}\right) = \gamma_1 TBA_{it}\left(\hat{S}_{ijt}, I_{it}, \tau_{it}\right) + \gamma_2 X_{ijt} + \alpha_j + \varepsilon_{ijt}$$

$TBA_{it}\left(\hat{S}_{ijt}, I_{it}, \tau_{it}\right)$ is the subsidy based on simulated qualified spending $\hat{S}_{ijt}$ defined by Equation (3). This instrument contains variation at the individual-year level that results from program

[26] I use the CPI-U to adjust dollar amounts to 2003 dollars. I also used both the Higher Education Cost Adjustment published by the State Higher Education Executive Officers Association and the Higher Education Price Index reported in Lingenfelter, L'Orange, Winter, and Wright (2004) to adjust qualified spending, and the results were similar.

rules and differences in income, and also includes variation in spending both across schools and within schools based on income-demographic groups.

A key assumption of the estimation strategy is that the tax-based aid variable is not simply identified from an underlying relationship between institutional aid and income. To guard against this possibility, I flexibly control for income in X_{ijt} using a cubic spline function with five knots. Figure 5 shows the relationship between institutional aid and income in the 1995-96 school year using a similar spline function. For public schools, Figure 5 suggests that the preexisting relationship between institutional aid and income is substantively different than the relationship between tax-based aid and income shown in Figure 3. For private schools, where the underlying relationship between income and institutional aid is non-linear, this implication is less clear. However, for both public and private schools, the estimated effect of tax-based aid is identified, in part, from the differences in functional forms shown in Figures 3 and 5. To test the robustness of the estimates, I consider different income controls, including alternate spline function specifications and higher-order polynomial functions of income. I also control for the key determinants used in calculating tax liability, including the amount of taxes owed, family composition, number of family members and dependency status.

As control variables, I include sources of aid that the financial aid administrator is likely to treat as given when making institutional aid decisions. These include Pell Grants, federal campus-based aid and state aid. I also include school-year averages of these variables to address the possibility that changes in these programs for other students at a given school affect the institutional response to tax-based aid. Another assumption of the identification strategy is that these other sources of aid are relatively constant during the analysis period. Average changes in Pell Grants, campus-based aid and state aid for eligible students are small compared to the

average change in tax-based aid, suggesting that this assumption holds.[27] As a robustness check of the baseline results, I remove students who may have experienced changes in state aid based on the timing of state level policy changes. I discuss these results in Section 4.5.

To address time effects, I include indicator variables for the 1999-2000 and 2003-04 school years, and I allow for different time trends based on institutional selectivity by interacting year indicator variables with variables for selectivity. I also include controls for student, parent and institutional characteristics that may affect the receipt and value of institutional aid such as student race, age, gender, parent/guardian education and Census division of residence. To control for unobserved heterogeneity in student aid practices across schools, I include school fixed effects. I also cluster the standard errors at the school level, to allow for arbitrary correlation in the error terms between observations, both across different students and across different school years, at a given school.[28]

4.3. Baseline Results for the Price-Discrimination Bennett Hypothesis

The estimates imply that colleges and universities substantially offset the intended cost reduction of tax-based aid by reducing institutional grant aid. Panel A of Table 4 presents the baseline results. Columns (1)-(3) show the OLS, maximum spending IV and simulated spending IV results for public schools, while these results for private schools appear in Columns (4)-(6). For public schools, I cannot rule out nearly complete crowd out of institutional aid. The OLS estimate of the effect of an additional $1.00 of tax-based aid implies a reduction of $0.83 in institutional grant aid, while the maximum spending and simulated spending IV results suggest a

[27] For example, between the 1995-96 and 1999-2000 school years the average changes for eligible students were: Pell Grants ($46), campus-based aid (-$81), state aid ($14), tax-based aid ($754).
[28] Kezdi (2004) shows that cluster robust standard errors allow for accurate inference when the number of clusters exceeds 50.

reduction of $0.89 and $0.82. The reduction of institutional grant aid is also substantial at private schools, and I cannot reject an effect equal to that found for public schools. For private institutions, the OLS estimate implies a $1.20 reduction in grant aid per $1.00 of tax-based aid while the IV results suggest a reduction of $0.91 using the maximum spending IV and $0.69 using the simulated spending IV.

The instruments perform well among both public and private school students in Panel A of Table 4. The strength of the instruments is a result of the limited scope for endogeneity, occurring only when actual spending is less than the programs' limits (see Figure 4).[29] To the extent that education spending is endogenous, OLS will overestimate the impact of tax-based aid because education spending and institutional grant aid are negatively related and education spending and tax-based aid are positively related over the endogenous range of spending. Removing this source of bias will decrease the absolute value of the OLS estimates. For private schools, the OLS results are larger in magnitude compared to the IV estimates consistent with this interpretation, although the OLS estimate is not significantly different from the IV results. The results for public schools do not fit this pattern, as the OLS estimate is not larger than the IV estimates. However, I cannot reject a cluster robust test of endogeneity (at the 1 percent level) for either public schools or private schools in Panel A.[30] Therefore, I rely on the IV estimates to address the endogeneity of education spending.

The effect of tax-based aid in Panel A is the average of the institutional response for students eligible for tax-based aid and for ineligible students. However, the institutional

[29] For example, using the maximum spending IV the first-stage regression holds as an identity for students with qualified spending at or above the programs' limits. Roughly 60 percent of public school students and 80 percent of private school students have spending in this range.

[30] I test for endogeneity by calculating the C statistic, defined as the difference in two Sargan statistics. In the case of one endogenous regressor and the null hypothesis of exogeneity, this statistic is distributed chi-square (1). Hayashi (2000) shows that this statistic is equivalent to the Hausman test under conditional homoskedasticity.

response is likely to vary across these student types. The price-discrimination Bennett Hypothesis predicts that colleges and universities will reduce institutional aid to offset the benefits of tax-based aid for eligible students. One possible use for the captured institutional aid is to redirect it towards ineligible students. In this case, the results in Panel A represent the average of institutional aid decreases for eligible students and institutional aid increases for ineligible students. To the extent that this type of aid redistribution occurs, Panel A may overstate the institutional response.[31] To explore this possibility, I limit the sample to eligible students by removing students who would never be eligible for tax-based aid based on the 2003-04 program rules in Panel B of Table 4. In Panel B, I cannot reject a dollar-for-dollar reduction in institutional grant aid for both public and private schools using either of the two instruments. Compared to Panel A, the estimated effects in Panel B are larger, which suggests that colleges and universities do not substantively redirect the captured aid towards ineligible students. In Appendix A, I explore further the possibility that institutions redirect the captured aid to students ineligible for tax-based aid, or towards other institutional expenditures. Unfortunately, these results are inconclusive.

4.4. Further Results

In the baseline results, institutional grant aid includes both non need-based and need-based institutional grants. As Table 5 shows, institutions reduce both of these components in response to tax-based aid.[32] Non need-based aid includes merit-based aid as well as other grant aid

[31] If schools redistribute the captured aid towards ineligible students then the estimated effect of tax-based aid will be more negative on the entire sample compared to the sample of eligible students. To the extent that substantive redistribution occurs, including ineligible students will increase the intercept and will result in a more negative relationship between institutional grant aid and tax-based aid. (Eligible students outnumber ineligible students by roughly 5:1 so that redistributing a large share of the captured aid implies a large increase for ineligible students.)
[32] A small number of observations do not distinguish between need-based and non need-based aid and are not included in Panels A or B of Table 5.

awarded for circumstances not related to financial need. Due to data limitations, I cannot separately consider merit-based aid.[33] The larger reduction in non need-based aid, relative to need-based aid, may be the result of greater discretion financial aid administrators have in awarding non need-based grant aid. The reduction in need-based aid may reflect the belief by financial aid administrators that tax-based aid increases student ability to pay (McPherson and Shapiro 1998). However, differences in non need-based and need-based aid should be interpreted with caution. The definition of what constitutes need-based aid varies across schools (Baum and Lapovsky 2006) and may even change over time for a given school.

Students appear to finance the institutional aid reduction, in part, through increased student loans.[34] These results appear in Panel C of Table 5. Increased borrowing may result from the short-term increase in unmet need in the period after paying education costs but before receipt of tax-based aid. Total loan amounts may also increase if program take up is less than complete, as the results here represent the intention-to-treat effect of tax-based aid. Total loan amounts, including federal Stafford loans and private loans, are estimated to increase $0.42-$0.46 per $1.00 of tax-based aid at public schools using the IV estimates. At private schools, the IV estimates imply an increase of $0.37-$0.43. Although not reported in Table 5, a breakdown of loan types suggests the majority of increased borrowing is from subsidized Stafford loans, the most favorable loan option.[35]

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[33] Merit-based aid is not included as a separate category for the 1995-96 school year in the NPSAS.

[34] These loan effects may be counteracted if continuing students use their tax-based aid to finance education in subsequent years and therefore reduce their borrowing. To test this possibility, I estimated the effect of tax-based aid on total loans for first-year students and students in their second year and beyond separately. Equal borrowing effects across years could not be ruled out. Instead of reducing loans in subsequent years, students and families may use their tax-based aid to finance consumption or pay back loans from previous years. Just under one-third of respondents in the Survey of Consumers report that they will "mostly save" their tax refunds from 2008 and 2001 (Shapiro and Slemrod 2003, 2009).

[35] In the case of dependent students, institutional aid reductions and increases in student loan amounts suggest an intra-family transfer. The institutional grant in the student's name is replaced with tax-based aid for the parent and a loan in the student's name.

4.5. Robustness Checks of Price-Discrimination Bennett Hypothesis Results

In Table 6, I demonstrate the robustness of the baseline results in Table 4 in several ways. (To simplify the discussion, I report only the IV results in Table 6, although as in Tables 4 and 5 the corresponding OLS results are similar in magnitude.) First, I address the possibility that changes in state level policies bias the results. Second, I show that the results are not sensitive to the omission of student and family controls. Third, I show that the substantive reduction in institutional grant aid persists using an unbalanced panel of schools. The results in Table 4 are also robust to alternate income controls, including cubic and linear splines with up to 7 knots (the baseline specification uses a cubic spline with 5 knots), and to higher-order polynomial functions of income (not shown). I also find little evidence that there is substantial heterogeneity in the institutional response based on grade level, by institutional selectivity, or by student quality. These results appear in Appendix B.

During the analysis period, several states enacted changes to race-based admission and aid policies. Additionally, several states initiated merit-based aid programs during this period. Concurrent changes in state-level policies could bias the estimated effect of tax-based aid if schools respond to changes in state-based aid programs.[36] Although not reported, I find little evidence that institutional aid responded to changes in state aid in the analysis sample. One reason for this finding may be the difficulty in determining which students experience increases in state aid. Changes to state-based programs could still bias the effect of tax-based aid by altering the composition of enrolled students. To further explore these possible sources of bias, I estimate the effect of tax-based aid after removing states that enacted substantive policy changes.

[36] The average increase in state aid for eligible students is $110 in states enacting merit-based aid compared to $8 for students in the remaining states between the 1999-2000 and 1995-96 school years.

Panel A of Table 6 reports the results after removing three states (CA, MI, TX)[37] that experienced major changes to race-based policies. The results obtained on this limited sample are similar to those reported in Table 4, and suggest that large-scale changes to race-based admissions and aid policies in three populous states do not affect the baseline results. Using sample splits based on minority status and also on gender, I also find that the effect of tax-based aid on institutional aid is similar across these groups of students (not shown). In Panel B of Table 6, I remove 10 states (FL, KY, LA, MD, MI, NV, NM, SC, TN, WV) that enacted merit-based aid programs during the analysis period.[38] The similarity of the results from this limited sample, compared to the baseline results, imply that the introduction of merit-based aid in these states does not impact the baseline results.

If tax-based aid affects the sample of enrolled students, then the estimated effect of tax-based aid may also reflect compositional changes. To the extent that students sort into schools based on the lowest net price (into schools that offset their tax-based aid the least), the bias from a changing composition of enrolled students works against finding a substantive effect. Alternatively, if students select different schools than they would have absent tax-based aid and if these schools are less likely to offer less institutional aid, then the bias is towards negative one. I do not find evidence that tax-based aid affects the composition of enrolled students using a school-year level analysis that estimates the effect of tax-based aid on the share of eligible students (not shown). To further explore the possibility that a changing composition of enrolled students impacts the estimated effect of tax-based aid, I estimate Equation (1) after omitting the

[37] In 1996 the Fifth Circuit Court of Appeals handed down the *Hopwood v. University of Texas* decision and California passed Proposition 209. Also in 1996, a lawsuit was filed in Michigan challenging race-based admissions. In 2003, after several lower court rulings and appeals in this lawsuit, *Grutter v. Bollinger,* the Supreme Court ruled that race could be used as a "plus factor" in the admission decision, but it can't be the only factor schools consider, and schools can't have a quota system for race.

[38] See Dynarski (2004) Table 2.1. I also tried removing an additional three states that enacted merit-based aid programs in an earlier period (AR, GA, MS) and the results were similar to those in Panel B.

following controls: student demographic variables (race, age gender, dependency status); parent characteristics (education level, marital status); and family size. If the effect of these control variables is changing over time due to compositional effects of tax-based aid, then omitting them from the analysis may lead to a different estimated effect of tax-based aid. The similarity of the results without the control variables in Panel C of Table 6, compared to the baseline results, suggests that the impact of the observable control variables is not changing over time in a way that is correlated with tax-based aid. This may be interpreted as evidence that compositional effects do not substantively impact the baseline results.

I also find a substantial reduction in institutional grant aid using an unbalanced panel of 4-year schools as shown in Panel D of Table 6. The unbalanced panel includes institutions that appear in the NPSAS in the 1995-96 school year and at least one of the later school years (1999-2000, 2003-04).[39] Enrollment in these schools represents a considerable share of national 4-year enrollment: 57 percent in the 1995-96 school year, 53 percent in the 1999-2000 school year and 48 percent in the 2003-04 school year. In Panel D, the impact of tax-based aid is identified from either the introduction of the programs (schools that appear in 1995-96 and 1999-200 only), the total change in the programs (schools that appear in 1995-96 and 2003-04 only), or from the introduction and expansion of tax-based aid (schools that appear in all three school years). In contrast, for each school in the balanced panel, the institutional response is identified from both the introduction and expansion of tax-based aid.

IV. Conclusion

I demonstrate the importance of benefit incidence analysis by showing that the intended cost reductions of tax-based federal student aid are substantially counteracted by reductions in

[39] The number of public (private) schools in the unbalanced panel (rounded to the nearest 10) is 200 (150) for 1995-96, 170 (110) for 1999-2000 and 140 (100) for 2003-04.

institutional grant aid for a sample of 4-year colleges and universities. I find that students at these schools cope with this reduction of institutional support by increasing student loan amounts. Together, these findings imply that students eligible for tax-based aid are not directly benefitting from the programs in the sense of realizing a lower cost of postsecondary attendance. Rather, they may be evidence that institutions and the student loan industry realize financial gains from tax-based aid at the expense of eligible students. Given that schools in the primary analysis sample represent about 25 percent of all students enrolled at degree-granting postsecondary institutions, the results here imply that a substantial share of total tax-based aid expenditures do not reduce costs for students and their families. In aggregate, more than 37 million students claimed one of the programs during the analysis period for a total tax expenditure of $29 billion (Baum and Steele 2007).

The results here suggest several areas for future work. First, it is unclear how institutions utilize the captured resources. The two possibilities considered here, that schools redirect the captured aid towards students ineligible for tax-based aid, or into other institutional expenditures are inconclusive. Clarifying this aspect of the institutional response is a necessary step for determining the ultimate incidence of tax-based aid. Eligible students may partially benefit from tax-based aid if institutions devote the captured resources to increasing education quality, providing student services, or other expenditures valued by students.

Second, the results here do not characterize the response of all postsecondary institutions. While enrollment at schools in the sample represents roughly 40 percent of national 4-year enrollment, schools in the sample have larger enrollments and are more selective than 4-year schools nationally. The sample also excludes students enrolled at 2-year institutions. Less selective 4-year schools and 2-year schools generally offer less institutional aid compared to

more selective 4-year schools, so that the effects found here are likely to be an upper bound of the institutional price response. Understanding the pricing behavior of the remaining school types is an important avenue for future research.

Third, the results suggest that institutions may also offset the intended cost reduction of other direct student aid programs targeting middle-income students and families, such as the recently enacted American Opportunity Tax Credit. Yet, it is not clear if the crowd out of institutional aid similarly undermines traditional student aid programs targeting lower-income students. To the extent that the reduction of institutional grant aid holds for other forms of student aid, previous studies may have underestimated the price sensitivity of postsecondary enrollment by presuming greater than achieved cost reductions. More generally, the results underscore the need for consideration of benefit incidence in the context of other government benefit programs.

Appendix

A1. Institutional Aid Redistribution

A1.1 Measuring Institutional Aid Redistribution

An increase in institutional aid for ineligible students may be evidence that schools redistribute institutional aid. I consider this possibility by estimating how much of the total institutional aid withheld from eligible students is redistributed to ineligible students using Equation (A1).

$$\text{(A1)} \quad InstitutionalAid_{ijt} = \pi_1 \left(\frac{\sum_{i \in j}^{Enrollment_j} TBA_{it}\left(S_{ijt}, I_{it}, \tau_{it}\right)}{IneligibleEnrollment_{jt}} \right) + \pi_2 X_{ijt} + \alpha_j + \varepsilon_{ijt}$$

X_{ijt} contains similar controls as in Equation (1). The key independent variable is $\left(\frac{\sum_{i \in j}^{Enrollment_j} TBA_{it}\left(S_{ijt}, I_{it}, \tau_{it}\right)}{IneligibleEnrollment_{jt}} \right)$, the total value of tax-based aid, per ineligible student, received at school j in year t. It represents the total amount of institutional aid available for redistribution if schools reduce institutional aid dollar-for-dollar with tax-based aid. The parameter π_1 measures the share of this total that is redistributed. A positive estimate for π_1 in Equation (A1) combined with a negative estimate of β_1 in Equation (1) is consistent with the redistribution of institutional aid away from eligible students towards ineligible students. Complete redistribution is implied by $\pi_1 = 1$ and $\beta_1 = -1$.

Total tax-based aid per ineligible student may be endogenous in Equation (A1) for several reasons. First, similar to the case of eligible students, qualified spending may be endogenous. School-wide changes in institutional aid could affect both the tax-based aid of

eligible students, through qualified spending, and the institutional aid of ineligible students. Second, enrollment may be affected by institutional aid redistribution, so that the number of ineligible students and the total value of tax-based aid at a given school may both be endogenous. To address these concerns, I exploit the timing of tax-based aid implementation to generate plausibly exogenous instruments. In place of contemporaneous values of spending and enrollment, I use values from the 1995-96 school year. This approach isolates the policy-induced variation in the tax-based aid function while holding fixed the composition of students from the 1995-96 school year. Spending and enrollment in this year should be free from the endogenous responses expected in later periods. Paralleling the approach used in the text, I also estimate the total value of tax-based aid based on maximum spending. Equation (A2) gives the first-stage regression using the IV based on actual spending in the 1995-96 school year:

$$\text{(A2)} \qquad \left(\frac{\sum_{i \in j}^{Enrollment_{jt}} TBA_{it}\left(S_{ijt}, I_{it}, \tau_{it}\right)}{IneligibleEnrollment_{jt}} \right) = \gamma_1 \left(\frac{\sum_{i \in j}^{Enrollment_{j96}} TBA_{it}\left(S_{ij96}, I_{i96}, \tau_{i96}\right)}{IneligibleEnrollment_{j96}} \right) + \gamma_2 X_{ijt} + \alpha_j + \eta_{ijt}$$

where $\left(\frac{\sum_{i \in j}^{Enrollment_{j96}} TBA_{it}\left(S_{ij96}, I_{i96}, \tau_{i96}\right)}{IneligibleEnrollment_{j96}} \right)$ is the total value of the tax-based aid received at school j in year t based on the enrollment characteristics in the 1995-96 school year.

I also explored the possibility that schools translate large total tax-based aid receipt into increased expenditures in other categories. Unfortunately, the NPSAS has little information on other types of expenditures and changes in accounting practices during the analysis period make expenditures from other sources difficult to compare across years (Budack 2000; IPEDS Data Center; Wellman, Desrochers and Lenihan 2008). For categories that may be comparable, I

linked the NPSAS data to expenditure data from the Integrated Postsecondary Education Data System (IPEDS) from the National Council of Education Statistics at the school-year level to estimate if schools translate large total tax-based aid receipt into increases in other expenditures. These estimates are imprecise, and combined with the data quality concerns, offer little insight into this possibility.

A1.2. Institutional Aid Redistribution Results

The redistributive results for ineligible students are largely inconclusive because the approach suffers from weak instruments. As shown in Panel A of Table A1, neither of the instruments perform well in the first stage. (F-tests on the restriction that the instrument is zero in the first stage range from 2.01 to 6.52.) The weakness of the instrument may be the result of the limited sources of variation in total tax-based aid at the school-year level after including both school fixed effects and flexible time controls. In Panel B, I replace the time controls (year indicator variables and interactions of year indicators with indicator variables for institutional selectivity) with a squared time trend. When this step is taken, the instrument performs better in the first stage, although it is still weak for private schools. (Making this replacement has no effect on the baseline results reported in Table 4.) At public schools, the estimates in Panel B suggest at most a modest amount of redistribution. A necessary condition for complete redistribution, $\pi_1 = 1$, is unlikely in this case. However, as these results are not robust to the flexible time controls in Panel A, the redistributive consequences are unclear even for public schools. Results using a sample of only low-income ineligible students or only high-income ineligible students are also inconclusive.

B1. Heterogeneity in the Price-Discrimination Bennett Hypothesis by Grade Level, Institutional Selectivity and Student Ability

Both entering and continuing students experience nearly complete crowd out of institutional grant aid. Table B1 reports the results for first year students and students in years two through five separately. For both public and private schools, the estimated reduction in grant aid is larger for first year students compared to continuing students. Entering students have no history of institutional aid offers, and therefore do not observe an aid offer that may represent their counterfactual level of aid. This information asymmetry may provide schools with increased pricing power for entering students relative to continuing students, some of whom have a history of institutional aid offers. However, the differences across first year students in Panel A and continuing students in Panel B are not substantively large, nor are they statistically significant, so that this implication is unclear. One explanation for the similar effects across grade levels is the transaction costs associated with transferring schools. As a result of these costs, both academic and financial, schools may also exert pricing power over continuing students.

The reduction of institutional grant aid holds for both more selective and less selective institutions. Panel A of Table B2 shows the results based on institutional selectivity.[40] The point estimates suggest that the reduction in institutional aid is larger at more selective institutions, compared to less selective ones. This pattern may reflect the market structure for selective schools. If more selective institutions have fewer direct competitors and/or larger excess demand for enrollment, compared to less selective institutions, then the price response should be relatively larger at more selective institutions. Due to sample size considerations, I combine

[40] Institutional selectivity is defined by NPSAS categories. Most selective includes "most" and "very" selective, while less selective includes "moderately" and "minimally" selective as well as "open admissions." There are very few "open admissions" schools and the results are the same if these schools are removed.

public and private schools when considering institutional selectivity.[41] However, because relatively more private schools are in the most selective category, the comparison across institutional selectivity may also be partially attributable to the differences in public and private school types.

The reduction of institutional grant aid holds for both high and low ability students. Using SAT scores to determine student ability, I define above (below) average students as those with combined math and verbal SAT scores that are above (below) the average scores at their school in a given school year.[42] Unfortunately, in the NPSAS many student records do not include valid SAT scores. Roughly 55 percent of students in the analysis sample have valid scores, and I am forced to condition the sample to these students in order to explore student ability implications.[43] As shown in Panel B of Table B2, I cannot reject the possibility that tax-based aid is substantively offset for both high ability and low ability students. While the point estimates imply a larger effect for higher ability students, the differences across high and low ability students are not significant.

[41] Kezdi (2004) shows that cluster robust standard errors allow for accurate inference when the number of clusters exceeds 50. Given the distribution of selectivity across school types, I am forced to combine public and private schools to create school quality groups that meet this requirement.

[42] I also tried different cuts of the data, using the 75th and 25th percentiles to define three student quality groups. The results from this analysis are similar to the results reported in the text.

[43] Using a specification similar to Equation (1) but with an indicator variable for valid SAT scores as the dependent variable, I find no evidence of a substantive or significant relationship between having valid SAT scores and tax-based aid, suggesting that tax-based aid does not affect SAT reporting. Missing SAT scores appears to be distributed evenly across grade level and public and private school types.

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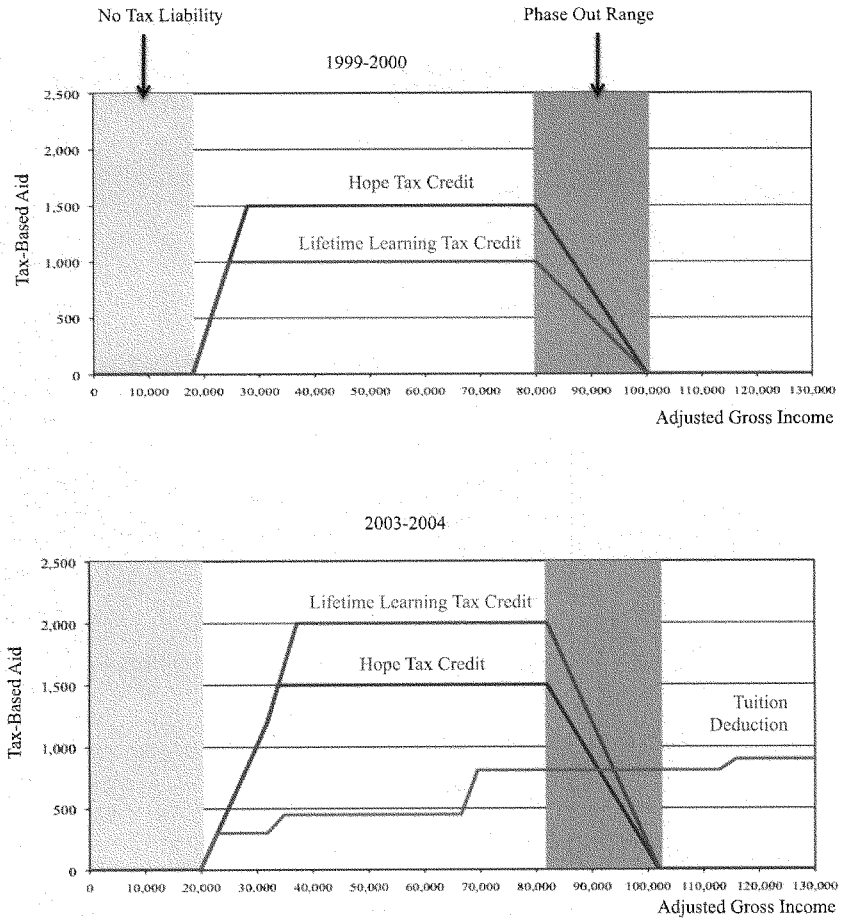
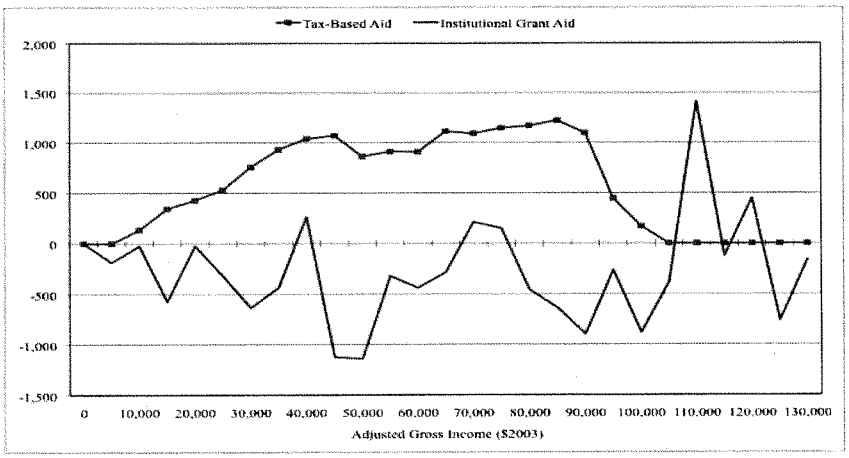


Figure 1

Maximum Tax-Based Aid for Joint-Filing Married Family of Four with one College Student

Notes: Tax liability is estimated using only the standard deduction and personal exemptions.
See Section 2 for a description of tax-based aid.

Changes 1999-2000 and 1995-96 School Years



Changes 2003-04 and 1999-2000 School Years

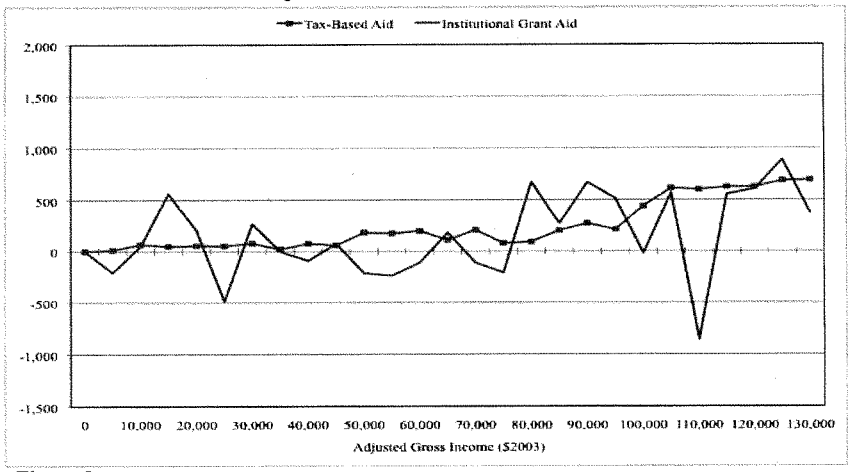


Figure 2

Changes in Tax-Based Aid and Institutional Grant Aid by Adjusted Gross Income

Notes: The value of tax-based aid is calculated from program rules (IRS 970) and income and education spending data from the NPSAS. Institutional aid is from the NPSAS data. See Section 4.1 for details.

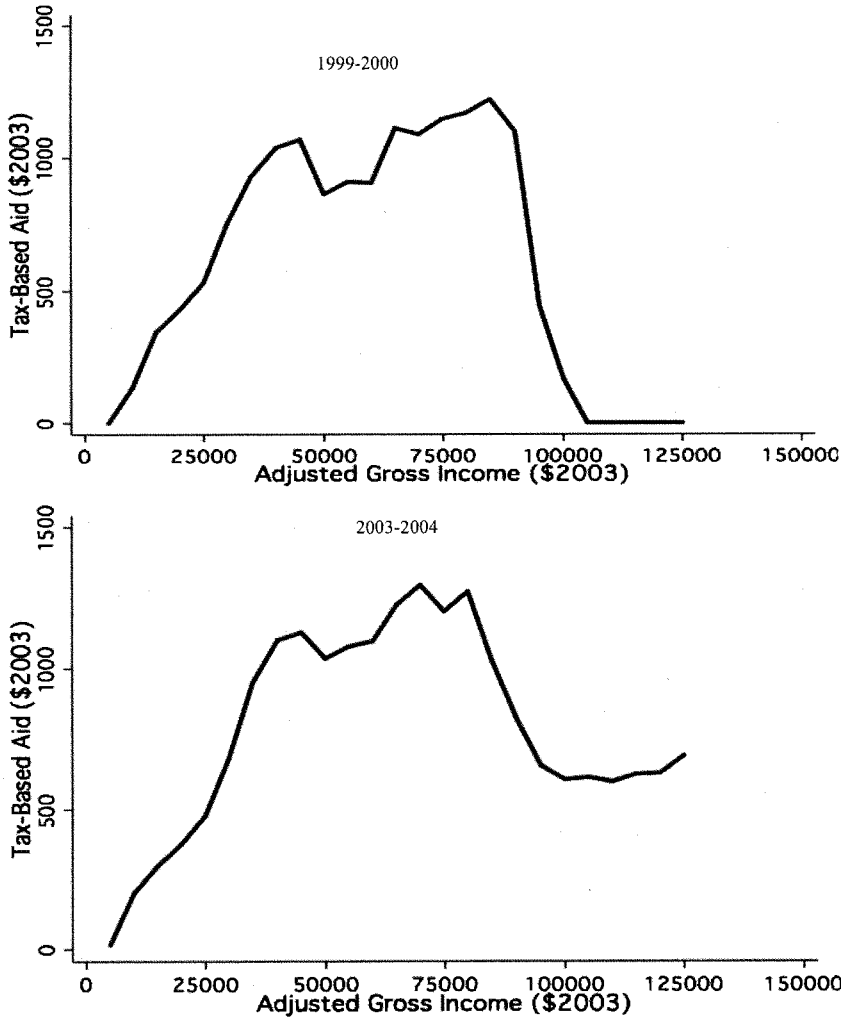


Figure 3

Average Tax-Based Aid Eligibility by Adjusted Gross Income

Notes: The value of tax-based aid is calculated from program rules (IRS 970) and income and education spending data from the NPSAS. See Section 4.1 for details.

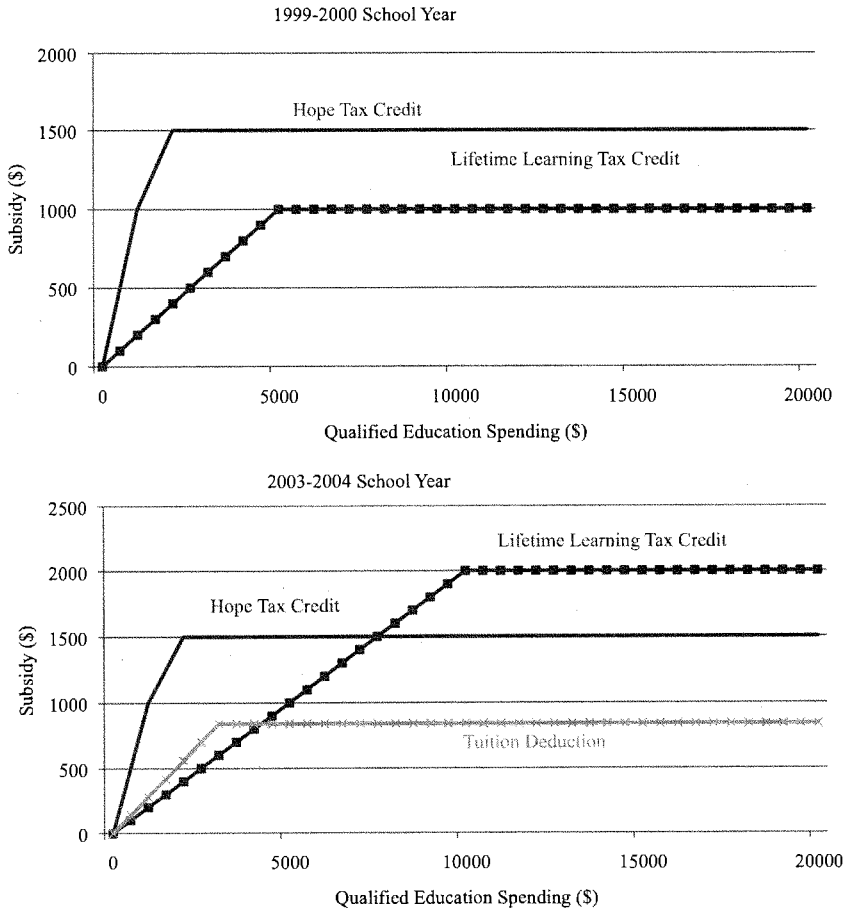


Figure 4

Value of Tax-Based Aid by Education Spending

The value of the programs also depend on taxes owed. The values shown here assume a tax liability as least as large as the subsidy. The value of the Tuition Deduction also depends on the marginal tax rate. The value shown uses a 28-percent marginal rate.

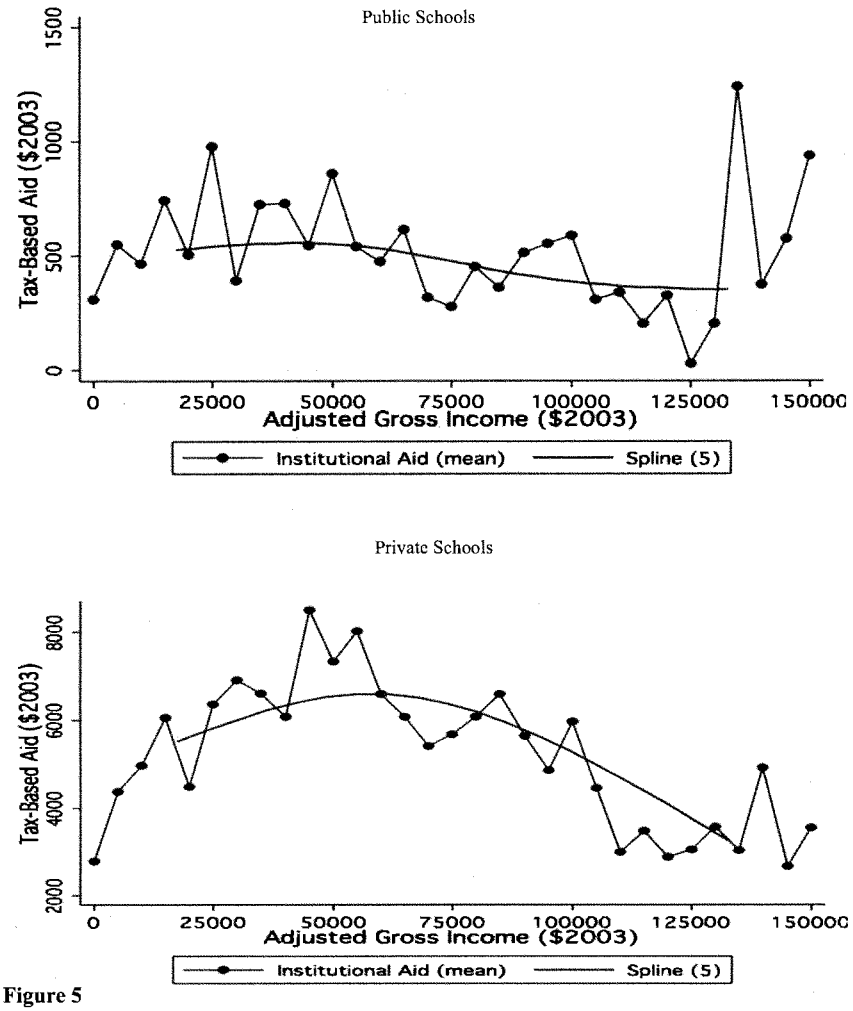


Figure 5

Institutional Aid by Income Group, 1995-96

Notes: These figures show average institutional aid, and the fitted values using a cubic spline function with five knots. This is the same spline function used in Equation (1) that estimates institutional aid effects at the student level. Income groups are based on $5,000 increments with the top group including all observations with income $150,000 or more.

Table 1

Tax-Based Aid Program Details, 1998-2003

	Hope Tax Credit	Lifetime Learning Tax Credit	Tution and Fees Deduction
Expenses Covered	Tuition and required fees at an educational instituion eligible for Department of Education student aid programs. Expenses covered do not include medical expenses, room and board, transportation, insurance and are net of scholarships, Pell Grants or any other tax free funds used to pay education expenses.		
Adjusted Gross Income Eligibility	1998-2001: Full credits for single (joint) returns less than $40,000 ($80,000). Credits linearly phased out for single (joint) returns until $50,000 ($100,000). 2002: Limits changed to $41,000 ($82,000) and $51,000 ($102,000) for single (joint) returns. 2003: Limits changed to $83,000 and $103,000 for joint returns.		Single filers with less than $65,000. Married couples must file a joint return less than $130,000.
Amount	100 percent of first $1,000 plus 50 percent of the next $1,000 of qualified education spending. Max credit $1,500 per student.	1998-2002: 20 percent of first $5,000. Max credit $1,000 per return. 2003: 20 percent of first $10,000. Max credit $2,000 per return.	100 percent of first $3,000 of qualified education spending per return. Value to student/family depends on marginal tax rate.
Recipient Eligibility	Only available for two tax years for students in the first two years of postsecondary education. Must be enrolled at least half-time, pursuing a degree or credential and student cannot have a felony drug conviction.	Undergraduate, graduate, vocational education and job skills programs. Available for an indefinite number of years. Lack of a felony drug conviction does not apply.	
Start Date	January 1, 1998	July 1, 1998	Janury 1, 2002

Source: IRS Publication 970 "Tax Benefits for Education" Various Years.

Table 2

Means of Student Aid and Demographic Data by School Year and Institutional Control

School Year	*1995-1996*		*1999-2000*		*2003-2004*	
School Type	Public	Private	Public	Private	Public	Private
Tuition and Student Aid						
Tuition	3,752	16,588	3,998	17,553	5,115	20,174
Institutional Aid	550	5,667	643	6,287	807	6,242
Tax-Based Aid*	0	0	586	634	682	869
Federal Grant Aid	1,291	2,171	1,208	2,310	1,884	3,246
Federal Campus-Based Aid	435	1,518	315	1,262	468	1,325
State Aid	409	855	480	845	640	911
Student and Family Characteristics						
Family Income	50,892	61,723	57,395	68,108	63,297	75,791
Dependent Student	84.33	90.58	79.61	87.16	85.72	92.31
Age	20.40	20.06	21.46	21.01	20.69	20.16
Black	11.49	9.68	10.94	12.86	11.81	9.58
Hispanic	6.58	9.29	7.75	9.35	7.29	10.37
Female	54.68	53.26	59.12	59.13	56.42	57.46
Student Married	4.45	3.45	4.30	3.47	2.11	1.18
Median School Enrollment	23,746	12,707	22,082	11,529	23,755	12,403
Number of Schools	120	70	120	70	120	70

Data from the National Postsecondary Student Aid Study (NPSAS) 1995-96, 1999-2000 and 2003-04.

*Tax-Based Aid is calculated as the value of the eligible award. By definition it is equal to zero for the 1995-96 school year. See Section 4.1 for details.

The number of schools is rounded to the nearest 10 to comply with the Department of Education confidentiality statutes.

All dollar amounts are in 2003 dollars.

Table 3

National Enrollment and Enrollment in Analysis Sample

School Year	*1995-1996*	*1999-2000*	*2003-2004*
National Enrollment			
4-year Public	5,806,036	5,969,950	6,649,441
4-year Private	2,998,157	3,228,575	3,767,806
Total 4-year	8,804,193	9,198,525	10,417,247
2-year Public	5,314,463	5,339,449	6,209,257
2-year Private	248,864	253,250	284,977
Total 2-year & 4-year	14,367,520	14,791,224	16,911,481
Enrollment in Institutions in the Analysis Sample			
4-year Public	2,571,280	2,704,230	3,146,390
4-year Private	784,610	793,810	929,390
Total 4-year	3,355,890	3,498,040	4,075,780
Ratio of Sample Enrollment to National Enrollment			
Sample/National 4-year	38	38	39
Public Sample/National 4-year Public	44	45	47
Private Sample/National 4-year Private	26	25	25
Total Sample/Total National 2-year & 4-year	23	24	24

National enrollment from the Digest of Education Statistics: 2009, Table 190, National Center for Education Statistics and includes students enrolled at institutions granting at least an associate's degree and whose students are eligible for Title IV federal aid. Sample enrollment calculated from the annual enrollment for the schools included in the primary analysis sample from the National Postsecondary Student Aid Study and is rounded to the nearest 10 to comply with the U.S. Department of Education confidentiality statutes.

Table 4

Estimated Tax-Based Aid Effect on Institutional Grant Aid

School Type	(1) Public	(2) Public	(3) Public	(4) Private	(5) Private	(6) Private
Estimator	OLS	Maximum Spending IV	Simulated Spending IV	OLS	Maximum Spending IV	Simulated Spending IV
			Panel A: Entire Sample of Students			
Tax-Based Aid	-0.828	-0.894	-0.819	-1.203	-0.905	-0.685
	[0.075]	[0.083]	[0.089]	[0.228]	[0.235]	[0.278]
R^2	0.081	0.081	0.081	0.188	0.187	0.186
Sample Size	51,800	51,800	51,800	22,480	22,480	22,480
Number of Schools	120	120	120	70	70	70
First Stage Results						
F (instrument)		8,343	2,003		7,847	1,985
Partial R^2		0.80	0.58		0.91	0.77
C-statistic		9.23	4.35		16.33	10.84
			Panel B: Eligible Student Sample			
Tax-Based Aid	-1.035	-1.158	-1.081	-1.846	-1.449	-1.202
	[0.091]	[0.103]	[0.112]	[0.311]	[0.317]	[0.371]
R^2	0.109	0.108	0.109	0.189	0.188	0.187
Sample Size	41,210	41,210	41,210	17,350	17,350	17,350
Number of Schools	120	120	120	70	70	70
First Stage Results						
F (instrument)		6,403	1,188		6,155	886
Partial R^2		0.75	0.52		0.87	0.69
C-statistic		16.99	1.25		16.34	9.09

Sample sizes and the number of schools are rounded to the nearest 10 to comply with the Department of Education confidentiality statutes.
Panel A includes the entire sample of students. Panel B limits the sample to students who would be eligible for tax-based aid based on 2003-04 program rules.
The estimates use tax-based aid based on maximum spending or on simulated spending as the instrument. See Section 4.2 for details.
The F-test is for the restriction that the excluded instrument is zero.
The C-statistic is distributed chi-squared (1) under the null hypothesis that all regressors are exogenous.
Control variables include school fixed effects, student characteristics (race, age, gender, dependency status), family income (cubic spline), parent/guardian controls (education and marital status), family controls (size, home Census Division), time (year indicator variables and interactions of year indicators with indicators for institutional selectivity).
Controls are also included for other forms of aid (Pell Grants, federal campus-based aid, state aid) at both the student level and as the school-year average values.
Standard errors, clustered at the school level, are reported in brackets.

Table 5

Estimated Tax-Based Aid Effect on Non Need-Based and Need-Based Institutional Grant Aid and Student Loan Amounts

School Type	(1) Public	(2) Public	(3) Public	(4) Private	(5) Private	(6) Private
Estimator	OLS	Maximum Spending IV	Simulated Spending IV	OLS	Maximum Spending IV	Simulated Spending IV
			Panel A: Non Need-Based Institutional Grant Aid			
Tax-Based Aid	-0.510	-0.551	-0.553	-0.690	-0.512	-0.469
	[0.059]	[0.066]	[0.068]	[0.177]	[0.182]	[0.184]
R^2	0.055	0.055	0.055	0.069	0.069	0.069
Sample Size	51,600	51,600	51,600	22,240	22,240	22,240
Number of Schools	120	120	120	70	70	70
First Stage Results						
F (instrument)		8,321	1,997		7,847	2,017
Partial R^2		0.80	0.58		0.91	0.77
C-statistic		7.90	4.50		11.32	12.09
			Panel B: Need-Based Institutional Grant Aid			
Tax-Based Aid	-0.264	-0.286	-0.233	-0.456	-0.339	-0.322
	[0.045]	[0.050]	[0.049]	[0.180]	[0.195]	[0.202]
R^2	0.073	0.073	0.073	0.203	0.202	0.202
Sample Size	51,600	51,600	51,600	22,240	22,240	22,240
Number of Schools	120	120	120	70	70	70
First Stage Results						
F (instrument)		8,321	1,997		7,846	2,017
Partial R^2		0.80	0.58		0.91	0.77
C-statistic		3.95	3.94		5.45	6.71
			Panel C: Student Loan Amounts			
Tax-Based Aid	0.556	0.416	0.464	0.515	0.365	0.426
	[0.079]	[0.086]	[0.114]	[0.127]	[0.123]	[0.142]
R^2	0.147	0.147	0.147	0.112	0.112	0.112
Sample Size	51,800	51,800	51,800	22,480	22,480	22,480
Number of Schools	120	120	120	70	70	70
First Stage Results						
F (instrument)		7,756	1,863		7,934	2,050
Partial R^2		0.79	0.57		0.91	0.77
C-statistic		12.07	2.88		11.64	4.66

Sample sizes and the number of schools are rounded to the nearest 10 to comply with the Department of Education confidentiality statutes.

The estimates use tax-based aid based on maximum spending or on simulated spending as the instrument. See Section 4.2 for details.

The F-test is for the restriction that the excluded instrument is zero.

The C-statistic is distributed chi-squared (1) under the null hypothesis that all regressors are exogenous.

Control variables include school fixed effects, student characteristics (race, age, gender, dependency status), family income (cubic spline), parent/guardian controls (education and marital status), family controls (size, home Census Division), time (year indicator variablesand interactions of year indicators with indicators for institutional selectivity).

Controls are also included for other forms of aid (Pell Grants, federal campus-based aid, state aid) at both the student level and as the school-year average value. Standard errors, clustered at the school level, are reported in brackets.

Table 6

Robustness Checks of Tax-Based Aid Effect on Institutional Grant Aid

	(1)	(2)	(3)	(4)
School Type	Public	Public	Private	Private
Instrument	Maximum Spending	Simulated Spending	Maximum Spending	Simulated Spending
Panel A: Remove States with Changing Race-Based Aid/Admission Policies				
Tax-Based Aid	-0.859	-0.828	-0.909	-0.768
	[0.095]	[0.100]	[0.260]	[0.288]
R^2	0.081	0.082	0.186	0.185
Sample Size	43,370	43,370	19,060	19,060
Number of Schools	110	110	70	70
F (instrument)	6,537	1,969	8,249	2,033
Panel B: Remove States Introducing Merit-Based Aid				
Tax-Based Aid	-0.924	-0.832	-0.866	-0.646
	[0.095]	[0.103]	[0.229]	[0.275]
R^2	0.089	0.089	0.188	0.187
Sample Size	43,030	43,030	19,130	19,130
Number of Schools	120	120	70	70
F (instrument)	7,864	1,630	6,131	1,883
Panel C: Remove Parent/Family Controls				
Tax-Based Aid	-0.869	-0.811	-1.022	-0.846
	[0.081]	[0.086]	[0.243]	[0.293]
R^2	0.063	0.063	0.155	0.154
Sample Size	51,780	51,780	22,480	22,480
Number of Schools	120	120	70	70
F (instrument)	8,471	2,380	9,367	2,053
Panel D: Unbalanced Panel of Schools				
Tax-Based Aid	-0.801	-0.728	-0.766	-0.510
	[0.071]	[0.073]	[0.203]	[0.248]
R^2	0.081	0.081	0.172	0.132
Sample Size	71,860	71,860	37,960	37,960
Number of Schools	200	200	150	150
F (instrument)	8,526	3,002	7,070	3,230

Sample sizes and the number of schools are rounded to the nearest 10 to comply with the Department of Education confidentiality statutes.

Panel A removes students from three states (CA, MI and TX).

Panel B removes students from 10 states (FL, KY, LA, MD, MI, NV, NM, SC, TN, WV).

Panel C removes student demographic varaibles and parent/family controls from the primary (balanced panel) sample.

Panel D uses an unbalanced panel of schools that appear in the 1995-96 school year and one of the later (1999-2000, 2003-04) school years.

The F-test is for the restriction that the excluded instrument is zero.

Control variables include school fixed effects, student characteristics (race, age, gender, dependency status), family income (cubic spline), parent/guardian controls (education and marital status), family controls (size, home Census Division), time (year indicator variables and interactions of year indicators with indicators for institutional selectivity). Controls are also included for other forms of aid (Pell Grants, federal campus-based aid, state aid) at both the student level and as the school-year average value.

Standard errors, clustered at the school level, are reported in brackets.

Table A1

Institutional Aid Redistribution for Ineligible Students

	(1)	(2)	(3)	(4)
School Type	Public	Public	Private	Private
Instrument	Maximum Spending	Simulated Spending	Maximum Spending	Simulated Spending
	Panel A: Flexible Time Controls			
Total Tax-Based Aid	0.147	0.141	1.963	1.751
per Ineligible Student	[0.119]	[0.102]	[1.608]	[1.329]
R^2	0.038	0.033	0.217	0.211
F (instrument)	3.85	6.52	2.03	2.01
Sample Size	10,590	10,590	5,130	5,130
Number of Schools	120	120	70	70
	Panel B: Time Trend Controls			
Total Tax-Based Aid	0.066	0.056	0.737	0.647
per Ineligible Student	[0.067]	[0.044]	[0.415]	[0.348]
R^2	0.031	0.033	0.115	0.137
F (instrument)	11.29	24.61	5.88	5.05
Sample Size	10,590	10,590	5,130	5,130
Number of Schools	120	120	70	70

Sample sizes and the number of schools are rounded to the nearest 10 to comply with the Department of Education confidentiality statutes.
The sample is limited to students who would be ineligible for tax-based aid based on 2003-04 program rules.
Panel A includes year indicator variables and interactions of year indicators with indicator variables for institutional selectivity.
Panel B uses a squared time trend.
The instrument uses enrollment from the 1995-96 school year and spending from either the 1995-96 school year (simulated spending), or from program limits (maximum spending). See Appendix for details. The F-test is for the restriction that the excluded instrument is zero.
Control variables include school fixed effects, student characteristics (race, age, gender, dependency status), family income (cubic spline), parent/guardian controls (education and marital status), family controls (size, home Census Division), time (year indicator variables and interactions of year indicators with indicators for institutional selectivity).
Controls are also included for other forms of aid (Pell Grants, federal campus-based aid, state aid) at both the student level and as the school-year average value.
Standard errors, clustered at the school level, are reported in brackets.

Table B1

Estimated Tax-Based Aid Effect on Institutional Grant Aid by Grade Level

School Type	(1) Public	(2) Public	(3) Public	(4) Private	(5) Private	(6) Private
Estimator	OLS	Maximum Spending IV	Simulated Spending IV	OLS	Maximum Spending IV	Simulated Spending IV
			Panel A: Entering Students (1st year)			
Tax-Based Aid	-0.935	-0.976	-0.934	-1.597	-1.039	-1.018
	[0.129]	[0.139]	[0.159]	[0.254]	[0.288]	[0.321]
R^2	0.092	0.092	0.092	0.188	0.187	0.186
Sample Size	11,180	11,180	11,180	5,440	5,440	5,440
Number of Schools	120	120	120	70	70	70
First Stage Results						
F (instrument)		4,890	1,750		3,514	755
Partial R^2		0.81	0.63		0.90	0.74
C-statistic		12.49	9.77		16.97	6.82
			Panel B: Continuing Students (2nd-5th years)			
Tax-Based Aid	-0.798	-0.866	-0.789	-1.147	-0.918	-0.594
	[0.076]	[0.083]	[0.089]	[0.271]	[0.277]	[0.316]
R^2	0.083	0.083	0.083	0.191	0.191	0.191
Sample Size	40,620	40,620	40,620	17,040	17,040	17,040
Number of Schools	120	120	120	70	70	70
First Stage Results						
F (instrument)		7,108	1,628		7,708	2,329
Partial R^2		0.79	0.56		0.91	0.78
C-statistic		7.29	3.88		9.18	11.92

Sample sizes and the number of schools are rounded to the nearest 10 to comply with the Department of Education confidentiality statutes.
Panel A includes only 1st year (entering) students. Panel B includes students enrolled in 2nd-5th years (continuing students).
The estimates use tax-based aid based on maximum spending or on simulated spending as the instrument. See Section 4.2 for details.
The F-test is for the restriction that the excluded instrument is zero.
The C-statistic is distributed chi-squared (1) under the null hypothesis that all regressors are exogenous.
Control variables include school fixed effects, student characteristics (race, age, gender, dependency status), family income (cubic spline), parent/guardian controls (education and marital status), family controls (size, home Census Division), time (year indicator variables and interactions of year indicators with indicators for institutional selectivity).
Controls are also included for other forms of aid (Pell Grants, federal campus-based aid, state aid) at both the student level and as the school-year average values.
Standard errors, clustered at the school level, are reported in brackets.

Table B2

Estimated Tax-Based Aid Effect on Institutional Grant Aid by Institutional Selectivity and Student Ability

	(1)	(2)	(3)	(4)	(5)	(6)
School Type	Public & Private	Public & Private	Public & Private	Public & Private	Public & Private	Public & Private
Estimator	OLS	Maximum Spending IV	Simulated Spending IV	OLS	Maximum Spending IV	Simulated Spending IV
	Panel A: Effects by Institutional Selectivity					
	More Selective	More Selective	More Selective	Less Selective	Less Selective	Less Selective
Tax-Based Aid	-1.205	-1.149	-0.825	-0.591	-0.613	-0.464
	[0.170]	[0.173]	[0.216]	[0.094]	[0.104]	[0.129]
R^2	0.164	0.164		0.060	0.060	
Sample Size	27,040	27,040	27,040	47,240	47,240	47,240
Number of Schools	70	70	70	120	120	120
First Stage Results						
F (instrument)		2,730	2,499		6,785	1,782
Partial R^2		0.87	0.72		0.80	0.60
C-statistic		2.26	8.05		3.44	5.53
	Panel B: Effects by Student Ability					
	Above Average	Above Average	Above Average	Below Average	Below Average	Below Average
Tax-Based Aid	-1.064	-1.108	-0.871	-0.809	-0.809	-0.550
	[0.165]	[0.166]	[0.200]	[0.139]	[0.140]	[0.174]
R^2	0.060	0.060		0.107	0.107	
Sample Size	20,710	20,710	20,710	20,340	20,340	20,340
Number of Schools	180	180	180	180	180	180
First Stage Results						
F (instrument)		5,980	2,246		4,535	1,632
Partial R^2		0/86	0.72		0.84	0.65
C-statistic		1.16	6.56		0.66	4.39

Sample sizes and the number of schools are rounded to the nearest 10 to comply with the Department of Education confidentiality statutes.

In Panel A, institutional selectivity is defined by NPSAS categories. In Panel B, student quality is determined by SAT scores. See Appendix B1 for details.

The F-test is for the restriction that the excluded instrument is zero. Standard errors, clustered at the school level, are reported in brackets.

The C-statistic is distributed chi-squared (1) under the null hypothesis that all regressors are exogenous.

Control variables include school fixed effects, student characteristics (race, age, gender, dependency status), family income (cubic spline), parent/guardian controls (education and marital status), family controls (size, home Census Division), time (year indicator variables and interactions of year indicators with indicators for public institutions, and other forms of aid (Pell Grants, federal campus-based aid, state aid) at both the student level and as the school-year average value.

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Administrators Ate My Tuition

Want to get college costs in line? Start by cutting the overgrown management ranks.

By Benjamin Ginsberg

No statistic about higher education commands more attention—and anxiety—among members of the public than the rising price of admission. Since 1980, inflation-adjusted tuition at public universities has tripled; at private universities it has more than doubled. Compared to all other goods and services in the American economy, including medical care, only "cigarettes and other tobacco products" have seen prices rise faster than the cost of going to college. And for all that, parents who sign away ever-larger tuition checks can be forgiven for doubting whether universities are spending those additional funds in ways that make their kids' educations better—to say nothing of three times better.

Between 1975 and 2005, total spending by American higher educational institutions, stated in constant dollars, tripled, to more than $325 billion per year. Over the same period, the faculty-to-student ratio has remained fairly constant, at approximately fifteen or sixteen students per instructor. One thing that has changed, dramatically, is the administrator-per-student ratio. In 1975, colleges employed one administrator for every eighty-four students and one professional staffer—admissions officers, information technology specialists, and the like—for every fifty students. By 2005, the administrator-to-student ratio had dropped to one administrator for every sixty-eight students while the ratio of professional staffers had dropped to one for every twenty-one students.

Apparently, as colleges and universities have had more money to spend, they have not chosen to spend it on expanding their instructional resources—that is, on paying faculty. They have chosen, instead, to enhance their administrative and staff resources. A comprehensive study published by the Delta Cost Project in 2010 reported that between 1998 and 2008, America's private colleges increased spending on instruction by 22 percent while increasing spending on administration and staff support by 36 percent. Parents who wonder why college tuition is so high and why it increases so much each year may be less than pleased to learn that their sons and daughters will have an opportunity to interact with more administrators and staffers—but not more professors. Well, you can't have everything.

Of course, universities have always employed administrators. When I was a graduate student in the 1960s and a young professor in the 1970s, however, top administrators were generally drawn from the faculty, and even midlevel managerial tasks were directed by faculty members. These moonlighting academics typically occupied administrative slots on a part-time or temporary basis and planned in due course to return to full-time teaching and research. Whatever their individual faults and gifts, faculty administrators seldom had to be reminded that the purpose of a

university was the promotion of education and research, and their own short-term managerial endeavors tended not to distract them from their long-term academic commitments.

Alas, today's full-time professional administrators tend to view management as an end in and of itself. Most have no faculty experience, and even those who have spent time in a classroom or laboratory often hope to make administration their life's work and have no plan to return to teaching. For many of these career managers, promoting teaching and research is less important than expanding their own administrative domains. Under their supervision, the means have become the end.

Every year, hosts of administrators and staffers are added to college and university payrolls, even as schools claim to be battling budget crises that are forcing them to reduce the size of their full-time faculties. As a result, universities are now filled with armies of functionaries—vice presidents, associate vice presidents, assistant vice presidents, provosts, associate provosts, vice provosts, assistant provosts, deans, deanlets, and deanlings, all of whom command staffers and assistants—who, more and more, direct the operations of every school. If there is any hope of getting higher education costs in line, and improving its quality—and I think there is, though the hour is late—it begins with taking a pair of shears to the overgrown administrative bureaucracy.

Forty years ago, America's colleges employed more professors than administrators. The efforts of 446,830 professors were supported by 268,952 administrators and staffers. Over the past four decades, though, the number of full-time professors or "full-time equivalents"—that is, slots filled by two or more part-time faculty members whose combined hours equal those of a full-timer—increased slightly more than 50 percent. That percentage is comparable to the growth in student enrollments during the same time period. But the number of administrators and administrative staffers employed by those schools increased by an astonishing 85 percent and 240 percent, respectively.

Today, administrators and staffers safely outnumber full-time faculty members on campus. In 2005, colleges and universities employed more than 675,000 full-time faculty members or full-time equivalents. In the same year, America's colleges and universities employed more than 190,000 individuals classified by the federal government as "executive, administrative and managerial employees." Another 566,405 college and university employees were classified as "other professional." This category includes IT specialists, counselors, auditors, accountants, admissions officers, development officers, alumni relations officials, human resources staffers, editors and writers for school publications, attorneys, and a slew of others. These "other professionals" are not administrators, but they work for the administration and serve as its arms, legs, eyes, ears, and mouthpieces.

Before they employed an army of professional staffers, administrators were forced to rely on the cooperation of the faculty to carry out tasks ranging from admissions to planning. An administration that lost the confidence of the faculty might find itself unable to function. Today, ranks of staffers form a bulwark of administrative power in the contemporary university. These administrative staffers do not work for or, in many cases, even share information with the faculty. They help make the administration, in the language of political science, "relatively autonomous," marginalizing the faculty.

While some administrative posts continue to be held by senior professors on a part-time basis, their ranks are gradually dwindling as their jobs are taken over by full-time managers. College administrations frequently tout the fiscal advantages of using part-time, "adjunct" faculty to teach courses. They fail, however, to apply the same logic to their own ranks. Over the past thirty years, the percentage of faculty members who are hired on a part-time basis has increased so dramatically that today almost half of the nation's professors work only part-time. And yet the percentage of administrators who are part-time employees has fallen during the same time period.

Administrators are not only well staffed, they are also well paid. Vice presidents at the University of Maryland, for example, earn well over $200,000, and deans earn nearly as much. Both groups saw their salaries increase as much as 50 percent between 1998 and 2003, a period of financial retrenchment and sharp tuition increases at the university. The University of Maryland at College Park—which employs six vice presidents, six associate vice presidents, five assistant vice presidents, six assistants to the president, and six assistants to the vice presidents—has long been noted for its bloated and extortionate bureaucracy, but it actually does not seem to be much of an exception. Administrative salaries are on the rise everywhere in the nation. By 2007, the median salary paid to the president of a doctoral degree-granting institution was $325,000. Eighty-one presidents earned more than $500,000, and twelve earned over $1 million. Presidents, at least, might perform important services for their schools. Somewhat more difficult to explain is the fact that by 2010 even some of the ubiquitous and largely interchangeable deanlets and deanlings earned six-figure salaries.

If you have any remaining doubt about where colleges and universities have been spending their increasing tuition and other revenues, consider this: between 1947 and 1995 (the last year for which the relevant data was published), administrative costs increased from barely 9 percent to nearly 15 percent of college and university budgets. More recent data, though not strictly comparable, follows a similar pattern. During this same time period, stated in constant dollars, overall university spending increased 148 percent. Instructional spending increased only 128 percent, 20 points less than the overall rate of spending increase. Administrative spending, though, increased by a whopping 235 percent.

Three main explanations are often adduced for the sharp growth in the number of university administrators over the past thirty years. One is that there have been new sorts of demands for administrative services that require more managers per student or faculty member than was true in the past. Universities today have an elaborate IT infrastructure, enhanced student services, a more extensive fund-raising and lobbying apparatus, and so on, than was common thirty years ago. Of course, it might also be said that during this same time period, whole new fields of teaching and research opened in such areas as computer science, genetics, chemical biology, and physics. Other new research and teaching fields opened because of ongoing changes in the world economy and international order. And yet, faculty growth between 1975 and 2005 simply kept pace with growth in enrollments and substantially lagged behind administrative and staff growth. When push came to shove, colleges chose to invest in management rather than in teaching and research.

A second common explanation given for the expansion of administration in recent years is the growing need to respond to mandates and record-keeping demands from federal and state governments as well as numerous licensure and accreditation bodies. It is certainly true that large numbers of administrators spend a good deal of time preparing reports and collecting data for these and other agencies. But as burdensome as this paperwork blizzard might be, it is not clear that it explains the growth in administrative personnel that we have observed. Often, affirmative action reporting is cited as the most time consuming of the various governmental mandates. As the economist Barbara Bergmann has pointed out, however, across the nation only a handful of administrators and staffers are employed in this endeavor.

More generally, we would expect that if administrative growth were mainly a response to external mandates, growth should be greater at state schools, which are more exposed to government obligations, than at private institutions, which are freer to manage their own affairs in their own way. Yet, when we examine the data, precisely the opposite seems to be the case. Between 1975 and 2005, the number of administrators and managers employed by public institutions increased by 66 percent. During the same time period, the number of administrators employed by private colleges and universities grew by 135 percent. These numbers seem inconsistent with the idea that external mandates have been the forces driving administrative growth at America's institutions of higher education.

A third explanation has to do with the conduct of the faculty. Many faculty members, it is often said, regard administrative activities as obnoxious chores and are content to allow these to be undertaken by others. While there is some truth to this, it is certainly not the whole story. Often enough, I have observed that professors who are willing to perform administrative tasks lose interest when they find that the committees, councils, and assemblies through which the faculty nominally acts have lost much if not all their power to administrators.

If growth-driven demand, governmental mandates, and faculty preferences are not sufficient explanations for administrative expansion, an alternative explanation might be found in the nature of university bureaucracies themselves. In particular, administrative growth may be seen primarily as a result of efforts by administrators to aggrandize their own roles in academic life. Students of bureaucracy have frequently observed that administrators have a strong incentive to maximize the power and prestige of whatever office they hold by working to increase its staff and budget. To justify such increases, they often seek to capture functions currently performed by others or invent new functions for themselves that might or might not further the organization's main mission.

Such behavior is common on today's campuses. At one school, an inventive group of administrators created the "Committee on Traditions," whose mission seemed to be the identification and restoration of forgotten university traditions or, failing that, the creation of new traditions. Another group of deans constituted themselves as the "War Zones Task Force." This group recruited staffers, held many meetings, and prepared a number of reports whose upshot seemed to be that students should be discouraged from traveling to war zones, unless, of course, their home was in a war zone. But perhaps the expansion of university bureaucracies is best illustrated by an ad placed by a Colorado school, which sought a "Coordinator of College

Liaisons." Depending on how you read it, this is either a ridiculous example of bureaucratic layering or an intrusion into an area of student life that hardly requires administrative assistance.

The number of administrators and staffers on university campuses has increased so rapidly in recent years that often there is not enough work to keep all of them busy. To fill their time, administrators engage in a number of make-work activities. This includes endless rounds of meetings, mostly with other administrators, often consisting of reports from and plans for other meetings. For example, at a recent "president's staff meeting" at an Ohio community college, eleven of the eighteen agenda items discussed by administrators involved plans for future meetings or discussions of other recently held meetings. At a gathering of the "Process Management Steering Committee" of a Midwestern community college, virtually the entire meeting was devoted to planning subsequent meetings by process management teams, including the "search committee training team," the "faculty advising and mentoring team," and the "culture team," which was said to be meeting with "renewed energy." The culture team was apparently also close to making a recommendation on the composition of a "Culture Committee." Since culture is a notoriously abstruse issue, this committee may need to meet for years, if not decades, to unravel its complexities.

When they face particularly challenging problems, academic administrators sometimes find that ordinary meetings in campus offices do not allow them the freedom from distraction they require. To allow them to focus fully and without interruption, administrators sometimes find it necessary to schedule off-campus administrative retreats where they can work without fear that the day-to-day concerns of the campus will disturb their deliberations. Sometimes these retreats include athletic and role-playing activities that are supposed to help improve the staff's spirit of camaraderie and ability to function as a team. For example, at a 2007 professional development retreat, Michigan Tech staffers broke into teams and spent several hours building furniture from pieces of cardboard and duct tape. Many staff retreats also include presentations by professional speakers who appear to specialize in psychobabble. Topics at recent retreats included "Do You Want to Succeed?" "Reflective Resensitizing," and "Waking Up the Inner World." In all likelihood, the administrators and staffers privileged to attend these important talks spent the next several weeks reporting on them at meetings with colleagues who had been deprived of the opportunity to learn firsthand how to make certain that their inner worlds remained on alert.

Administrative budgets frequently include travel funds, on the theory that conference participation will hone administrators' skills and provide them with new information and ideas that will ultimately serve their school's interests. We can be absolutely certain that this would be the only reason administrators would even consider dragging themselves to Maui during the winter for a series of workshops sponsored by the North American Association of Summer Sessions. Given the expense and hardship usually occasioned by travel to Hawaii, it is entirely appropriate for colleges to foot this sort of bill.

Another ubiquitous make-work exercise is the formation of a "strategic plan." Until recent years, colleges engaged in little formal planning. Today, however, virtually every college and university in the nation has an elaborate strategic plan. This is typically a lengthy document—some are 100 pages long or more—that purports to articulate the school's mission, its leadership's vision of the future, and the various steps that are needed to achieve the school's

goals. The typical plan takes six months to two years to write and requires countless hours of work from senior administrators and their staffs.

A plan that was really designed to guide an organization's efforts to achieve future objectives, as it might be promulgated by a corporation or a military agency, would typically present concrete objectives, a timetable for their realization, an outline of the tactics that will be employed, a precise assignment of staff responsibilities, and a budget. Some university plans approach this model. Most, however, are simply expanded "vision statements" that are often forgotten soon after they are promulgated. My university has presented two systemwide strategic plans and one arts and sciences strategic plan in the last fifteen years. No one can remember much about any of these plans, but another one is currently in the works. The plan is not a blueprint for the future. It is, instead, a management tool for the present. The ubiquity of planning at America's colleges and universities is another reflection and reinforcement of the ongoing growth of administrative power.

There is, to be sure, one realm in which administrators as a class have proven extraordinarily adept. This is the general domain of fund-raising. Even during the depths of the recession in 2009, schools were able to raise money. On the one hand, the donors who give selflessly to their schools deserve to be commended for their beneficence. At the same time, it should still be noted that, as is so often the case in the not-for-profit world, university administrators appropriate much of this money to support—what else?—more administration.

The stress on fund-raising has enabled more than a few university presidents to acquire luxurious offices, lavish residences, and an assortment of perks in addition to princely salaries. Some enjoy the services of a chauffeur when they commute to work and a household staff when they entertain or even relax at home. These and many other perquisites are usually defended by administrators as needed to carry out their social duties and, particularly, to impress their schools' wealthy benefactors. Yet no study has ever proved that presidents who arrive at fundraising events in chauffeur-driven limousines are more likely to succeed in their capital campaign goals or in any other endeavor than their counterparts who drive their own cars or come by taxi or, for that matter, by subway. I have personally known university presidents who were outstanding fund-raisers but, nevertheless, lived frugally and always traveled as cheaply as possible. Among college officials, though, the spendthrifts seem to outnumber the penny pinchers.

College presidents are usually the guiltiest parties, since they are in the best position to authorize expenditures, and many are more than happy to use school funds to burnish their own images. One recent case in point is that of Benjamin Ladner, the former president of American University in Washington, D.C. Soon after arriving on the campus in 1994, Ladner and his wife, who dubbed herself AU's "first lady," declared that the president's official residence was inadequate and had the university build an expensive new house, which included a waterfall and pond behind the patio, a few blocks from the campus. They outfitted the house with expensive furnishings, china, and stemware. At university expense, the Ladners employed a chauffeur, a cook, a social secretary, and numerous other personal staff members. They hosted gala events to which they invited prominent Washington figures. They traveled abroad frequently, generally charging their first-class tickets to the university.

Matters came to a head in March 2005, when an anonymous whistleblower wrote to the board of trustees accusing the Ladners of "severe expense account violations." An extensive audit subsequently revealed hundreds of thousands of dollars in questionable spending, some personal but most associated with President Ladner's frenetic image-polishing efforts. Over the previous several years, the Ladners had charged the university for $6,000 in club dues, $54,000 in drivers' costs, $220,000 in chefs' services, $44,000 for alcohol, and $100,000 in services from their social secretary.

After months of bruising battles within the AU board, Ladner's contract was terminated—though he and the first lady received a generous severance package. While Ladner mingled with the rich and famous at the school's expense, faculty members had to settle for miserly annual salary increases and students saw their tuitions rise markedly every year.

The expansion of college and university administration has not been coupled with the development of adequate mechanisms of oversight and supervision, particularly for senior managers. University boards, which technically oversee the administrations, are generally not well prepared for the task. One recent study found that 40 percent of university trustees said they were not prepared for the job and 42 percent indicated that they spent less than five hours a month on board business. Many trustees serve because of loyalty to their school and say they have "faith" in its administration. They do not go out of their way to look for problems, and administrators are generally able to satisfy trustees with the rosy pictures of college life presented at weekend board meetings.

Moreover, university boards do not have the same legal responsibilities borne by corporate boards. Most federal regulations establishing management standards for private-sector firms, such as the 2002 Sarbanes-Oxley Act, do not apply to nonprofit entities, and state regulation of university administration is spotty. At the same time, while schools have developed many internal rules and standards applying to the conduct of faculty members and students, few if any have established standards governing administrative conduct or established oversight mechanisms. For the most part, senior administrators police themselves.

The result of this lack of supervision is that a number of college and university administrators have, in recent years, succumbed to the temptation to engage in corrupt practices. In 2008, for example, the director of Tufts University's Office of Student Activities, Josephine Nealley, was indicted on three counts of larceny for embezzling more than $300,000 in student activities funds. She allegedly transferred the money to her personal bank accounts and used it for purchases and trips. While acting on an anonymous tip regarding Nealley's activities, university auditors uncovered a second, apparently unrelated case of embezzlement. Raymond Rodriguez, a budget officer, allegedly stole more than $600,000 from the university, which he spent on trips and luxury goods. Rodriguez was indicted on two counts of larceny for his alleged thefts. Both Nealley and Rodriguez entered guilty pleas and were sentenced to prison terms.

In a similar vein, the president of the University of Tennessee was forced to resign when an audit revealed that he had spent hundreds of thousands of dollars in university funds on personal trips, entertainment, and purchases. The president's travel at university expense allegedly included

trips to Birmingham, Alabama, where he was said to have a "personal involvement" with the president of another school.

Often, frauds go unnoticed for years because the perpetrators are the accountants and financial officers responsible for fiscal oversight. When fraudulent conduct is discovered, university officials often prefer to allow the perpetrators to resign or retire quietly rather than risk a public brouhaha that might upset donors and lead to questions about the quality of the school's leadership. Many professors can point to cases at their own school when crooked administrators were allowed to leave quietly, sometimes even without being compelled to make restitution for their offenses.

When fraud is exposed and restitution demanded, the sums can be considerable. In January 2008, Roy Johnson, chancellor of Alabama's community college system, pled guilty to bribery and was required to forfeit the $18 million he admitted receiving in direct and indirect benefits from companies doing business with the colleges he oversaw. As the U.S. attorney who prosecuted the case observed, "Taxpayers must wonder how many more Alabama students could have been educated had money not been wasted on fraud."

The priorities of the hyper-administrative university emerge most clearly during times of economic crisis, when managers are forced to make choices among spending options. Thanks to the sharp economic downturn that followed America's 2008 financial crisis, almost every institution, even Harvard, America's wealthiest school, has been compelled to make substantial cuts in its expenditures. What cuts did university administrations choose to make during these hard times?

A tiny number of schools took the opportunity to confront years of administrative and staff bloat and moved to cut costs by shedding unneeded administrators and their brigades of staffers. The most notable example is the University of Chicago's Pritzker School of Medicine, which in February 2009 addressed a $100 million budget deficit by eliminating fifteen "leadership positions," along with 450 staff jobs, among other cuts. The dean also emphasized that faculty would not be affected by the planned budget cuts. Chicago's message was clear: administrators and staffers were less important than teaching, research, and—since this involved a medical school—patient care; if the budget had to be cut, it would be done by thinning the school's administrative ranks, not by reducing its core efforts.

Unfortunately, few if any other colleges and universities copied the Chicago model. Facing budgetary problems, many schools eliminated academic programs and announced across-the-board salary and hiring freezes, which meant that vacant staff and faculty positions, including the positions of many adjunct professors, would remain unfilled until the severity of the crisis eased.

Perverse administrative priorities were even more in evidence at a number of schools that actually raised administrative salaries or opted to spend more money on administrative services while cutting expenditures on teaching and research in the face of budget deficits. For example, in January 2009, facing $19 million in budget cuts and a hiring freeze, Florida Atlantic University awarded raises of 10 percent or more to top administrators, including the school's president. In a similar vein, in February 2009, the president of the University of Vermont

defended the bonuses paid to the school's twenty-one top administrators against the backdrop of layoffs, job freezes, and program cuts at the university. The university president, Daniel Fogel, asserted that administrative bonuses were based on the principles of "extra pay for extra duties" and "pay for performance." The president rejected a faculty member's assertion that paying bonuses to administrators when the school faced an enormous budget deficit seemed similar to the sort of greed recently manifested by the corporate executives who paid themselves bonuses with government bailout money. Fogel said he shared the outrage of those upset at corporate greed, but maintained there was a "world of difference" between the UVM administrative bonuses and bonuses paid to corporate executives. He did not specify what that world might be.

In the meantime the president of Washington State University, Elson Floyd, accepted a $125,000 pay raise, bringing his 2009 salary to $725,000 per year, soon after announcing that financial circumstances required the school to freeze hiring. At another university that had just announced a large budget deficit and mandated salary and hiring freezes, the outgoing president was feted by the board of trustees at a gala 350-person dinner, to which trustees, senior administrators, alumni, donors, and other notables—but no students or faculty—were invited. The dinner, which might as well have been held on the promenade deck of the *Titanic*, featured musical performances, videos, and a lounge area with hundreds of Chinese newspapers and a tea set to recognize the president's many trips to China. (No wonder university spending was frozen.) Later, this same university placed restrictions on the use of copy paper by graduate students. Maybe the Chinese newspapers should have been recycled.

On any given campus, the only institution with the actual power to halt the onward march of the all-administrative university is the board of trustees or regents—which, as we've seen, tend to be unprepared or disinclined to make waves. But they need to do so if their institutions are to be saved from sinking into the expanding swamp of administrative mediocrity.

To begin with, trustees interested in trimming administrative fat should compare their own school's ratio of managers and staffers per hundred students to the national mean, which is currently an already inflated nine for private schools and eight for public colleges. If the national mean is nine administrators per hundred students at private colleges, why does Vanderbilt need sixty-four? Why does Rochester need forty and Johns Hopkins thirty-one? Management-minded administrators claim to believe in benchmarking, so they should not object to being benchmarked in this way.

The right kind of media coverage would embolden boards to ask the right questions. In particular, the various publications that rate and rank colleges—*U.S. News* is the most influential—should take account of administrative bloat in their ratings. After all, a high administrator-to-student ratio means that the school is diverting funds from academic programs to support an overgrown bureaucracy. I am certain that if Vanderbilt or Duke or Hopkins or Rochester or Emory or any of the other most administratively top-heavy schools lost a few notches in the *U.S. News* rankings because of their particularly egregious administrative bloat, their boards would be forced to act.

But given the general fattening of administrative ranks in recent years, even schools with average administrator-to-student ratios could stand to see major cuts in their administrative staffs and

budgets. This could help not only to fill budget holes but, more importantly, to begin a healthy shift in the balance of bureaucratic power within universities. A 10-percent cut in the staff and management ranks would save millions of dollars but would have no effect whatsoever on the operations of most campuses. The deanlets would never be missed; their absence from campus would go unnoticed. A 20-percent or larger cut would begin to be noticed and would have the beneficial effect of substantially reducing administrative power and the ongoing diversion of scarce funds into unproductive channels.

With fewer deanlets to command, senior administrators would be compelled to turn once again to the faculty for administrative support. Such a change would result in better programs and less unchecked power for presidents and provosts. Faculty who work part-time or for part of their careers as administrators tend to ask questions, use judgment, and interfere with arbitrary presidential and provostial decision making. Senior full-time administrators might resent the interference, but the university would benefit from the result. Moreover, with fewer administrators to pay and send to conferences and retreats, more resources might be available for educational programs and student support, the actual items for which parents, donors, and funding agencies think they are paying.

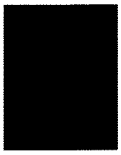
Benjamin Ginsberg is a professor of political science at Johns Hopkins University. This article is adapted with permission from The Fall of the Faculty: The Rise of the All-Administrative University and Why It Matters, *by Benjamin Ginsberg, published by Oxford University Press, 2011.*

A
CBO
STUDY

Tax Arbitrage by Colleges and Universities

April 2010

The Congress of the United States ■ Congressional Budget Office



Preface

Because colleges and universities serve a public purpose—advancing higher education and promoting myriad forms of research—they enjoy a variety of tax preferences. In addition to being exempt from paying federal income taxes, institutions of higher learning can accept tax-deductible charitable contributions and use tax-exempt debt to finance capital expenditures. It is the latter preference that the Congressional Budget Office (CBO) focuses on in this study, which was prepared at the request of the Ranking Member of the Senate Finance Committee. The law explicitly prohibits the use of tax-exempt-bond proceeds for the purchase of investment assets, a practice known as tax arbitrage; however, issuers of tax-exempt bonds may use the proceeds for the purchase of operating assets while they simultaneously hold investment assets that provide a higher rate of return. To the extent that colleges and universities earn an untaxed return on investments that exceeds the interest they pay on tax-exempt debt, they are benefiting from a form of indirect tax arbitrage.

Using data from information returns filed with the Internal Revenue Service by institutions of higher learning and by issuers of tax-exempt debt, CBO created several measures of tax arbitrage under a broader definition of the term that includes indirect tax arbitrage. Over time, if legislators were to expand the definition of tax arbitrage, nonprofit institutions would most likely respond by reducing their issues of tax-exempt debt. That response, in turn, could decrease the cost to the federal government of granting such tax preferences. In accordance with CBO's mandate to provide objective, nonpartisan analysis, the paper makes no recommendations.

Kristy Piccinini of CBO's Tax Analysis Division wrote the study, under the supervision of Frank Sammartino and G. Thomas Woodward (formerly of CBO). Nabeel Alsalam, Robert Dennis, Mark Hadley, and Deborah Lucas provided helpful comments. In addition, Thomas Pollack of the National Center for Charitable Statistics provided assistance with the data, and William Gentry of Williams College, Thomas Holtmann of the Joint Committee on Taxation, Kim Reuben of the Urban Institute, and Dennis Zimmerman of the American Tax Policy Center commented on earlier drafts. (The assistance of external reviewers implies no responsibility for the final product, which rests solely with CBO).

Loretta Lettner edited the study, and Kate Kelly proofread it. Maureen Costantino designed the cover, and Jeanine Rees prepared the report for publication. Lenny Skutnik printed the initial copies, Linda Schimmel coordinated the print distribution, and Simone Thomas prepared the electronic version for CBO's Web site (www.cbo.gov).

Douglas W. Elmendorf
Director

April 2010

Contents

Tables

Figures

Box

Tax Arbitrage by Colleges and Universities

Summary and Introduction

Colleges and universities enjoy a variety of federal tax preferences that are designed to support a broader public purpose—the advancement of higher education and research. Not only are institutions of higher learning exempt from paying federal income taxes, they also are eligible to receive tax-deductible charitable contributions and allowed to use tax-exempt debt to finance capital expenditures.

This Congressional Budget Office (CBO) study focuses on one of those tax advantages, the ability of colleges and universities to borrow funds by issuing tax-exempt debt. According to the staff of the Joint Committee on Taxation (JCT), the cost of allowing institutions of higher learning to borrow using such debt—measured in terms of the revenues that could have been collected if those institutions had borrowed using taxable debt—will be about $5.5 billion in 2010. The use of proceeds from lower-cost tax-exempt bonds to directly finance the purchase of higher-yield securities—a practice known as tax arbitrage—is prohibited by law. Nevertheless, the law as currently implemented allows many colleges and universities to use tax-exempt debt to finance investments in operating assets (buildings and equipment) while, at the same time, they hold investment assets that earn a higher return. (Investment assets are publicly traded and privately held securities, as well as land or buildings held for investment purposes.) To the extent thar colleges and universities can earn untaxed returns on investments that are higher than the interest they pay on tax-exempt debt, they are benefiting from a form of "indirect" tax arbitrage.

Rules in the Internal Revenue Code (IRC) and regulations established by the Department of the Treasury limit tax arbitrage by restricting the yield on any investments held by the bond issuer that are deemed to be directly related to the tax-exempt bond issue (for example, an asset pledged as collateral).[1] Other investment assets are not yield-restricted even though they contribute indirectly to securing the bonds and are considered by rating agencies when rating the tax-exempt debt. A broader definition of tax arbitrage would include most or all investment assets held by an institution borrowing with tax-exempt debt.

Using data from information returns filed with the Internal Revenue Service (IRS) by institutions of higher learning and by issuers of tax-exempt debt, CBO developed measures of tax arbitrage as practiced by colleges and universities under a broader definition of the term that encompasses both direct and indirect tax arbitrage. Under one such definition, nearly all of the tax-exempt bonds that 251 institutions issued in 2003 would be classified as earning profits from tax arbitrage. If some investment assets were set aside in a reserve, which would be excluded from the arbitrage measure under an alternative expanded definition, the amount of debt earning returns from arbitrage would be lower; even so, about 75 percent of bonds issued in 2003 would still be classified as earning arbitrage profits under that expanded definition. By either measure, the amount of debt issued by colleges and universities that earns arbitrage profit would be considerably larger than that issued by nonprofit hospitals (which was the subject of a previous CBO study on broadening the definition of tax arbitrage).[2] Over time, if legislators were to expand the definition of tax arbitrage and thereby eliminate some of the benefits of tax-exempt financing,

1. Internal Revenue Code, 26 U.S.C. 148(b)(3)(A). The terms "debt" and "bond" are used interchangeably to refer to debt with maturities in excess of a year. The dollar figures for such debt cited in this analysis also include any leasing arrangements that are tax-exempt.

2. Congressional Budget Office, *Nonprofit Hospitals and Tax Arbitrage*, letter to the Honorable William M. Thomas (December 6, 2006).

nonprofit institutions would probably respond by reducing the issuance of tax-exempt debt. That response, in turn, would decrease the cost to the federal government of the tax preference.

Tax Preferences for Higher Education

Institutions of higher learning, both public and private, benefit from several types of preferential tax treatment. Like other nonprofit organizations defined in section 501(c)(3) of the IRC, nonprofit private schools are exempt from the federal income tax, eligible to receive charitable contributions that donors may deduct from their taxable income, and allowed to use tax-exempt debt to finance capital expenditures.[3] As state or local government entities, public colleges and universities receive broadly similar tax preferences: they are exempt from federal income taxation, eligible for donations that are tax-deductible, and may have access to tax-exempt debt. Although there are no estimates of the cost to the federal government of exempting contributions made specifically to colleges and universities, the deduction of charitable contributions to educational institutions at all levels is expected to cost about $6.6 billion in forgone tax revenues in 2010; charitable contributions to colleges and universities account for about 70 percent of all contributions to educational institutions.[4] JCT estimates that allowing institutions of higher learning to borrow using tax-exempt debt will cost the federal government—in the form of forgone tax revenues—about $5.5 billion in 2010.[5]

As is the case with other nonprofit organizations, colleges and universities receive preferential tax treatment because they are viewed as serving a public purpose. Institutions of higher learning perform two activities that are typically considered to serve the needs of society: providing education and conducting research. Education is associated with a wide range of favorable outcomes. Investment in human capital through education confers considerable private benefits on an individual, in the form of higher income and better health.[6] Education probably also yields benefits for the community as a whole, including a more productive workforce, which leads to faster economic growth, as well as lower crime, a more informed electorate, and increased social mobility.[7] How much education an individual prefers to invest in depends solely on the private benefit he or she might expect from that investment; in the absence of government intervention, that decision will yield fewer public benefits than is socially desirable.[8]

Some colleges and universities also perform research that may have large spillover effects that benefit the rest of the economy.[9] Although businesses make substantial investments in research and development, private investors cannot retain all of the benefits from that spending because the knowledge produced by such research can be used by others. As is the case with individuals who must decide how much to invest in their own education, the private sector chooses the amount of research and development it is willing to fund on the basis of private, rather than social, benefit.

3. Section 501(c)(3) of the Internal Revenue Code defines a qualified nonprofit as any entity "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition…or for the prevention of cruelty to children or animals." A nonprofit may not engage in political activity, and none of its earnings may benefit any private shareholder or individual.

4. Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2008–2012,* JCS-2-08 (October 31, 2008), p. 53.

5. Estimates of tax expenditures are not intended to capture all of the ways in which taxpayers might respond to a change in law. In particular, the estimate discussed here assumes that if investors did not hold tax-exempt bonds, they would hold taxable bonds instead. In one study, researchers examined some of the other ways in which investors might change their portfolios in response to limits on tax-exempt bonds. That study found that because taxable bonds are one of the most heavily taxed types of asset, investors would probably seek alternatives that are less heavily taxed and, therefore, the revenue loss to the federal government would probably be smaller than the tax-expenditure cost discussed here. See James Poterba and Arturo Verdugo, *Portfolio Substitution and the Revenue Cost of Exempting State and Local Government Interest Payments from Federal Income Tax,* Working Paper No. 14439 (Cambridge, Mass.: National Bureau of Economic Research, October 2008), available at www.nber.org/papers/w14439.

6. See David Card, "The Causal Effect of Education on Earnings," in Orley Ashenfelter and David Card, eds., *Handbook of Labor Economics,* vol. 3 (Amsterdam: Elsevier Press, 1999), pp. 1801–1863. Researchers in another study discuss the evidence for a positive relationship between education and health outcomes, paying particular attention to the mechanisms through which education may lead to better health. See David M. Cutler and Adriana Lleras Muney, "Education and Health: Evaluating Theories and Evidence," in Robert F. Schoeni and others, eds., *Making Americans Healthier: Social and Economic Policy as Health Policy* (New York: Russell Sage Foundation, January 2008).

Granting favorable tax treatment to postsecondary educational institutions is just one way in which policymakers may be able to increase investment in human capital and research. Other ways that the federal government currently subsidizes educational institutions include direct grants to states and localities for elementary and secondary education, tax preferences for private institutions that provide elementary and secondary education, direct grants to schools for research, and subsidies and loan programs for individuals pursuing undergraduate and graduate degrees.

Tax-Exempt Bonds and Tax Arbitrage

State and local governments use tax-exempt bonds to finance their own capital projects and to provide the means for other entities, including nonprofit and state-supported colleges and universities, to use tax-exempt debt. The tax code contains provisions that are designed to prevent that tax preference from becoming an unlimited subsidy for all types of spending and to restrict its use to financing capital investment in operating assets (such as the construction or renovation of buildings and the purchase or repair of equipment). Tax arbitrage—the use of proceeds from lower-cost tax-exempt bonds to finance the purchase of higher-yield securities—is specifically prohibited both by the IRC and by Treasury regulations.[10] However, in most situations, the law does not prevent tax-exempt borrowers from engaging in what is essentially indirect tax arbitrage.

Indirect tax arbitrage occurs when a borrower with tax-exempt status earns interest on invesrment assets not directly financed with bond proceeds that exceeds the interest cost incurred from contemporaneous tax-exempt borrowing. A borrower could sell those assets to finance the capital expenditure instead of borrowing with tax-exempt debt. Holding those assets while borrowing on a tax-exempt basis is, in effect, equivalent to using tax-exempt proceeds to invest in those higher-yielding securities.

The Use of Tax-Exempt Bonds

About $290 billion in tax-exempt bonds was issued in 2007, the most recent year for which aggregate data are available—up from about $100 billion in 1990 (see Figure 1). About 70 percent of those were governmental bonds, which are typically issued by state and local governments for public projects such as the construction of highways or public schools. The payment of interest on those obligations is generally funded through tax revenues.

The remaining tax-exempt bonds were "qnalified private-activity bonds"—tax-exempt bonds issued by state and local governments on behalf of certain private entities or for designated activities.[11] Eligible activities include financing student loans or mortgages for owner-occnpied

7. See Enrico Moretti, "Estimating the Social Return to Higher Education: Evidence from Longitudinal and Repeated Cross-Sectional Data," *Journal of Econometrics*, vol. 121, no. 1–2 (July–August 2004), pp. 175–212. In his analysis, Moretti found that college education creates positive spillovers in productivity and wages. See also Eric Hanushek and Ludger Woessmann, *Do Better Schools Lead to More Growth? Cognitive Skills, Economic Outcomes, and Causation*, Working Paper No. 14633 (Cambridge, Mass.: National Bureau of Economic Research, January 2009). In their analysis, the authors found empirical evidence of a causal relationship between educational attainment and growth rates across countries. Other research has found that educational attainment is associated with a decreased likelihood of incarceration or arrest. See Lance Lochner and Enrico Moretti, "The Effect of Education on Crime: Evidence from Prison Inmates, Arrests, and Self-Reports," *American Economic Review*, vol. 94, no. 1 (March 2004), pp. 155–189. Still other research suggests a positive correlation between educational attainment and the likelihood of electoral participation. See Kevin Milligan, Enrico Moretti, and Philip Oreopoulos, "Does Education Improve Citizenship? Evidence from the United States and the United Kingdom," *Journal of Public Economics*, vol. 88, no. 9-10 (August 2004), pp. 1667–1695. For a discussion of the relationship between postsecondary education and social mobility, see Robert Haveman and Timothy Smeeding, "The Role of Higher Education in Social Mobility," *Future of Children: Opportunity in America*, vol. 16, no. 2 (Fall 2006), pp. 125–150.

8. Individuals who face financial constraints may invest in less education than is either privately or socially desirable. Federal student loan programs are one way to reduce the impact of such constraints. See Congressional Budget Office, *Costs and Policy Options for Federal Student Loan Programs* (March 2010).

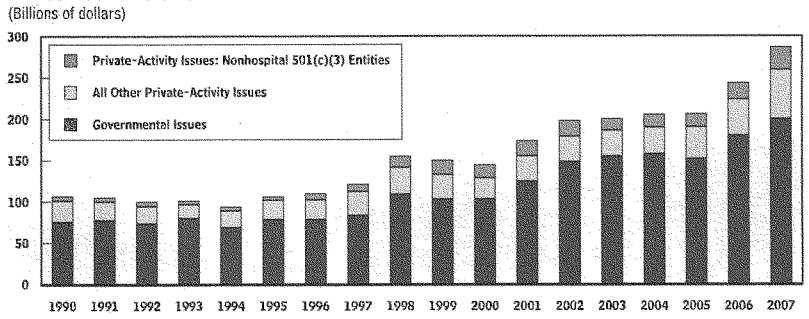
9. For a more detailed discussion of federal subsidies for research and development, see Congressional Budget Office, *Federal Support for Research and Development* (June 2007).

10. Internal Revenue Code, 26 U.S.C. 148; Treas. Reg., 26 C.F.R. 1.148-0.

11. Such bonds can be issued on behalf of a private entity if more than 10 percent of the proceeds is used for any private business purpose and if more than 10 percent of the payment of principal or interest is secured by an interest in property used for a private business purpose or is derived from payments for property used for a private business purpose. Private-activity bonds are taxable unless they are issued for a qualified purpose or entity.

Figure 1.

The Value of New Issues of Tax-Exempt Bonds, 1990 to 2007



Source: Congressional Budget Office.

Notes: Private-activity bonds are issued on behalf of private entities by state and local governments. Unless they are issued for specific tax-exempt activities or entities, interest paid on such bonds is taxable. Activities that are eligible for tax-exempt status include the financing of student loans or mortgages for owner-occupied housing. Entities that qualify for tax-exempt status include nonprofit hospitals, schools, and other qualified 501(c)(3) organizations. Aside from nonprofit hospitals, the Internal Revenue Service does not separate out data on bond issues for any other type of 501(c)(3) organization.

The category "all other private-activity issues" consists primarily of bonds issued on behalf of hospitals, mortgage bonds, and residential rental bonds.

Governmental bonds are typically issued by state and local governments for public projects such as the construction of schools or highways.

housing; eligible entities include nonprofit hospitals, nonprofit schools, and other qualified 501(c)(3) organizations. The interest on tax-exempt private-activity bonds is typically paid with revenue generated by the project that was financed with the bond proceeds rather than by state and local taxpayers. The volume of most eligible types of tax-exempt private-activity bonds that can be issued in a given year by a given state is limited by the Internal Revenue Code, as amended in 1986, but those caps do not apply to bonds issued on behalf of qualified 501(c)(3) organizations. The only cap that applied to tax-exempt bonds issued on behalf of qualified 501(c)(3) organizations—previously $150 million for the benefit of any single organization—was lifted in 1997.

New issues of tax-exempt private-activity bonds totaled $87 billion in 2007. Of that amount, about $27 billion was issued on behalf of qualified nonhospital 501(c)(3) organizations and $17 billion was issued on behalf of qualified 501(c)(3) hospitals. The IRS does not separate out data on bond issues for any other type of 501(c)(3) organization. Of the remaining tax-exempt private-activity bonds, qualified mortgage bonds and qualified residential rental bonds were the largest categories by volume; $14 billion of the former and $7 billion of the latter were issued that year.

To estimate the amount of new bonds issued specifically for colleges and universities, CBO analyzed all information returns submitted to the IRS for bonds issued on behalf of 501(c)(3) organizations in 2003.[12] That year, bonds issued on behalf of institutions of higher learning accounted for just under $6 billion of the $14 billion in new issues for nonhospital 501(c)(3) organizations. Including hospitals, total issues for all 501(c)(3) organizations were about $24 billion that year, while all tax-exempt private-activity issues totaled $46 billion.

12. Although data from more recent years are now available, the most current data available when CBO undertook this analysis were for 2003.

Table 1.

Uses of Proceeds from Tax-Exempt Bonds Issued on Behalf of Colleges and Universities, 2003

	Number of Issues	Percentage of Issues
Construction and/or Expansion of Buildings		
Academic buildings	42	40
Residence halls	34	32
Student centers	8	8
Athletic facilities	11	11
Equipment	10	10
Maintenance/Safety	45	43
Total	**105**	**n.a.**

Source: Congressional Budget Office based on data provided by issuing authorities in nine states.

Notes: The number of issues in the various categories adds to more than 105 and the percentage of issues in each category adds to more than 100 percent because many projects span multiple categories.

n.a. = not applicable.

Since those data were collected, the market for tax-exempt bonds issued by institutions of higher learning and the value of the assets that those institutions hold have been greatly affected by the financial crisis that began in 2007. Interest rates for tax-exempt debt rose sharply during that period, and issues by colleges and universities have probably declined since the crisis began. However, there are signs that the pressures created by the financial crisis are beginning to ease. In particular, the difference between interest rates on tax-exempt debt and those on short-term Treasury bonds—a standard measure of the risk premium that investors require in order to hold the bonds—has fallen. The liquidity problems that some borrowers face may decrease the use of certain types of short-term debt, but that decrease seems unlikely to have a permanent effect on the availability of credit for long-term capital needs. Because of widespread declines in asset prices, educational endowments have fallen in value considerably from their peak, but they retain some of the benefit from previous years of growth. This analysis is intended to capture the effect of broadening the definition of tax arbitrage in the long term rather than the effects of the recent disruptions in financial markets.

CBO also collected data on projects that were financed by tax-exempt bonds issued on behalf of institutions of higher learning from issuing authorities in nine states in 2003, covering $2.3 billion in issues (about 40 percent of all issues in that year). The most common use of proceeds from tax-exempt bonds issued on behalf of colleges and universities in 2003 was for maintenance projects, such as improved heating and cooling systems, and safety enhancements, such as sprinkler systems. About 43 percent of all bond issues involved such projects. (Proceeds from a single issue may be used for projects in multiple categories; see Table 1.) About the same number of bond issues (40 percent) involved the construction and/or expansion of academic buildings; the next most common use (nearly 30 percent) was for the construction and/or expansion of residence halls. The use of bond proceeds for athletic facilities, student centers, or the purchase of equipment was considerably less common.

Advantages and Disadvantages of Tax-Exempt Bonds

Compared with other ways the federal government could choose to subsidize colleges and universities, tax-exempt bonds have both advantages and disadvantages. Because nonprofit institutions of higher learning are exempt from the income tax, any further subsidy through the tax code must be indirect, which leads to one disadvantage. The tax-exempt-bond subsidy is routed through investors, who are willing to accept a rate of return on a tax-exempt bond that is lower than the return on a taxable bond by the amount they would have to pay in taxes on income from the taxable bond. As long as the supply of tax-exempt bonds exceeds the demand from taxpayers in the highest income tax bracket, the market interest rate on such bonds needs to fall below the rate on taxable bonds only by enough to induce taxpayers in a lower tax bracket to also hold the bonds; that rate is higher than what would be necessary to attract investors in the highest tax bracket. Therefore, investors in the highest bracket receive the interest tax-free at their higher marginal tax rate, retaining some of the value of the subsidy rather than passing it on to the issuer of the bonds.

Another disadvantage is that, in contrast with federal spending programs, tax expenditures—including forgone revenues on tax-exempt bonds—are not explicitly

identified in the budget.[13] Also, unlike discretionary spending programs, they are not governed by the annual appropriation process. Thus, the federal government does directly control the issuance of tax-exempt bonds, which is determined by state and local issuers in accordance with federal rules on the total volume and type of issue. Though state and local governments may be better equipped to identify beneficial capital investments by their local institutions, delegating decisionmaking power away from the federal government increases the probability that bond issues will be evaluated on the basis of their benefit to the locality, rather than to the federal taxpayers who finance the subsidy.

One advantage to using tax-exempt bonds as the means for offering a subsidy is that they provide a standard framework through which educational institutions can access capital markets. Access to the tax-exempt-bond market may increase the availability of bond financing for some educational institutions, although the schools most likely to be affected by the expanded definition of arbitrage discussed in this study have investment-grade credit ratings and therefore probably would be able to obtain funding in the taxable-bond market.

The use of tax-exempt bonds also affects the allocation of resources. The lower cost of financing for projects funded by tax-exempt bonds diverts resources toward those projects and away from other activities. Whether that is an advantage or a disadvantage depends in part on whether the subsidized investment would have been undertaken even in the absence of the subsidy. On the one hand, if colleges and universities use tax-exempt financing for projects that they would complete even without the subsidy, resources are just reallocated from taxpayers to the schools with no additional social benefit. On the other hand, if the subsidy finances capital projects that would not otherwise have been undertaken and that create a social benefit in addition to the benefit to the institution, it could improve the nation's overall welfare.

13. The Administration provides estimates of tax expenditures in the *Analytical Perspectives* volume of the budget. See Office of Management and Budget, *Analytical Perspectives, Budget of the U.S. Government, Fiscal Year 2011*, Chapter 16. The Joint Committee on Taxation also reports annually on tax expenditures. See Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2009–2013*, JCS-1-10 (January 11, 2010).

Direct and Indirect Tax Arbitrage

Because the purchasers of tax-exempt bonds do not pay income tax on the interest those bonds earn, they are willing to accept a lower rate of interest than they would otherwise earn on taxable bonds of comparable risk and maturity. That yield differential presents an opportunity for some issuers of tax-exempt debt to engage in tax arbitrage—borrowing with tax-exempt debt and investing the proceeds in higher-yielding taxable assets. Those who meet the criteria for borrowing using tax-exempt bonds—whether qualified 501(c)(3) organizations or state and local government entities—have an added incentive because they do not pay tax on their net income, regardless of whether it is from an operating surplus (the excess of revenue over cost) or from investment income. The higher return on those taxable assets not only finances the lower interest cost of the tax-exempt debt but also provides untaxed earnings to be used for other purposes.

To restrict such activity, the tax code specifies that "arbitrage bonds" are not tax-exempt. Section 148 of the IRC defines an arbitrage bond as "any bond whose proceeds are reasonably expected to be used directly or indirectly to acquire higher-yielding investment assets or to replace funds which were used directly or indirectly to acquire higher-yielding securities."[14] The tax code has provisions that prevent the direct diversion of bond proceeds away from investment in physical capital to the earning of investment income. In general, those provisions allow earnings from tax arbitrage only for temporary periods before the proceeds are needed to fund the project for which they were designated or for specific types of investments such as reserve funds. (Such funds typically contain a portion of the proceeds from a bond issue that is set aside to pay debt service in case the expected sources of funds for that purpose are not available). Outside of those limited exceptions, however, any earnings from tax arbitrage must be rebated to the Treasury.

The Treasury regulates arbitrage using a "replacement proceeds rule" that requires the yield to be restricted on any investment assets or other amounts that have a connection (nexus) to a tax-exempt-bond issue that is sufficiently direct for one to conclude that, in the absence of proceeds from tax-exempt borrowing, the assets or

14. Internal Revenue Code, 26 U.S.C. 148(a).

amounts would have been used to finance the project.[15] For example, if a school uses securities as collateral for its debt-service obligation on a tax-exempt bond, the securities are treated as replacement proceeds subject to yield restriction. The Treasury restricts the yield on investment assets in one of two ways. Under one method, the borrower may be required to return to the federal government any excess yields earned on an amount of assets that is equal to the value of the tax-exempt bonds issued.[16] (Excess yields are defined as earnings that exceed the interest paid on the bond.) Under a second method, the borrower may be required to sell an amount of assets that is equal in value to the bonds issued and to invest that money in a specially designed Treasury debt instrument that earns a discounted return to offset the federal government's implicit contribution to the return on the tax-exempt bonds.

Those provisions do not eliminate all opportunities for tax arbitrage, however. Because financial statements typically do not report the use of particular assets as collateral, the replacement proceeds rule is difficult to enforce. In addition, if assets are not specifically pledged to pay the debt service on a tax-exempt bond or if the assets have no other direct connection to the bonds, the arbitrage restrictions do not apply. However, it is widely recognized that assets and their earnings can be used to pay the interest on debt or to cover other expenses to free up funds for interest payments, regardless of whether they are directly pledged to do so.[17] Such use of higher-yielding assets to finance tax-exempt debt constitutes indirect tax arbitrage.

The limited scope of the tax code's restrictions on arbitrage is not unique to colleges and universities. It applies equally to other nonprofit institutions, such as nonprofit hospitals, which have sizable financial assets. For all such institutions, the current tax arbitrage rules ensure that a bond issue is associated with the acquisition of new capital, and they reduce its cost. Nonetheless, a change in the rules that broadened the definition of tax arbitrage would identify bonds earning arbitrage profits on the basis of the total assets that were implicitly available as collateral rather than requiring a direct relationship between proceeds from tax-exempt bonds and investment assets explicitly pledged as collateral. That expanded definition, which would encompass indirect tax arbitrage, would decrease the value of the federal subsidy that is currently available to institutions of higher learning through tax-exempt-bond issues and reduce the net cost of the tax exemption to the federal government.

Approaches to Measuring the Extent of Indirect Tax Arbitrage

Determining the degree to which colleges and universities benefit from the practice of indirect tax arbitrage requires data on the volume of new and outstanding issues of tax-exempt bonds and on the value of investment assets held by those institutions of higher learning. CBO collected data on assets and liabilities from IRS information returns (specifically, Forms 990 and 8038), adjusting the data to account both for the misreporting of tax-exempt liabilities and for the presence of assets held by other organizations for the use of colleges and universities (see Box 1). To estimate the extent to which indirect tax arbitrage occurs, CBO compared an institution's outstanding bond issues (bonds that have not been completely retired) or new bond issues with the value of its existing investment assets. If an institution held assets that were greater in value than its holdings of either outstanding or new bond issues, those bond issues were classified as earning returns from tax arbitrage. Presumably, the school chose to use tax-exempt debt to finance capital projects rather than selling investment assets because it could earn a rate of return on those assets that was higher than the interest it was obligated to pay on the bonds. If the dollar value of investment assets was less than that of outstanding or new bond issues, only the portion of capital spending that could have been financed with the assets was considered to be earning arbitrage profit. CBO also calculated estimates of tax arbitrage allowing some investment assets to be set aside in a reserve that would be exempt from the broader definition of arbitrage.

Investment Assets and Tax-Exempt Debt

Colleges and universities in aggregate hold investment assets that are significantly higher in value than the stock of outstanding tax-exempt bonds, although the distribution of both is highly skewed. That relationship holds both for amounts reported on IRS Form 990 returns and

15. Treas. Reg., 26 C.F.R. 1.148-1(c).

16. Such payments must be made every five years during the life of the issue, with the first payment made no later than five years after the issue date of a bond. If the computation in later years shows no arbitrage profit because the yield on restricted assets has declined, previous payments are refunded to the issuer.

17. It is also standard practice for rating agencies to base credit ratings for a particular debt issue on all available assets, not just on those directly pledged to that debt issue.

Box 1.

Estimating the Extent of Indirect Arbitrage Practiced by Colleges and Universities

As nonprofit entities, institutions of higher learning must file Form 990 information returns with the Internal Revenue Service (IRS) on an annual basis that provide data from their balance sheets on revenues, expenses, liabilities, and assets. The Congressional Budget Office (CBO) used information from a sample of these returns, which are available from the IRS, to calculate the investment assets and outstanding stock of tax-exempt debt—weighted to be representative of all schools that filed Form 990 returns in 2003. CBO also used Form 990 returns from the IRS sample, supplemented by additional Form 990 returns from the National Center for Charitable Statistics (NCCS) at the Urban Institute, to calculate the investment assets and outstanding stock of tax-exempt bonds for each institution that issued new tax-exempt debt in 2003. To identify the latter group, CBO used information from Form 8038 information returns, which all issuers of tax-exempt debt are required to file annually. Those returns were then used to estimate the volume of tax-exempt borrowing by institutions of higher learning in 2003.

CBO found that Form 8038 returns were filed for 324 bond issues made on behalf of colleges and universities. Of those, 38 were classified as "refunding" bonds that refinanced debt already issued in previous years. Proceeds from the remaining 286 bond issues, which amounted to about $6 billion, were distributed to 274 institutions (some bonds were issued on behalf of more than one organization). Of those 274 institutions, CBO was able to identify and match 251 with information culled from Form 990 returns (obtained either from the IRS sample or from the NCCS). Those 251 institutions received $5.7 billion, or 94 percent, of all proceeds from tax-exempt bonds issued on behalf of higher education in 2003.

One difficulty with measuring tax-exempt debt is that, when filing Form 990 returns, institutions often misallocate balance-sheet information on tax-exempt liabilities. In an earlier study of tax-exempt bonds issued on behalf of nonprofit hospitals, CBO found that the majority of tax-exempt bond liabilities were misreported as "mortgages and other notes payable" on Form 990 returns.[1] Issuers of tax-exempt bonds for educational institutions confirmed that such misreporting is present in returns for colleges and universities as well. In many cases, schools consider the proceeds of an issue as a loan from the issuing authority rather than as a tax-exempt liability. CBO therefore adjusted the stock of tax-exempt bonds reported on Form 990 returns to account for that misreporting using the factors estimated in CBO's earlier study of hospitals.[2]

In some cases, the value of investment assets reported on Form 990 returns for institutions listed as the recipient of bond proceeds underestimated the true value of investment assets available to the institution. For public universities, particularly those with large endowments, the majority of investment assets are held not by the university, but by a foundation dedicated to the support of the institution and separately incorporated as a public charity. That separation allows state-supported institutions to exercise greater control over their endowment assets. Of the group of 251 borrowers, CBO was able to identify 27 institutions that held assets in other 501(c)(3) organizations. CBO adjusted their stock of investment assets and tax-exempt liabilities to reflect the assets and liabilities of those related organizations.

1. See Congressional Budget Office, Nonprofit Hospitals and Tax Exempt Bonds (a letter to the Honorable William M. Thomas, December 8, 2004). In its analysis, CBO found that for those institutions reporting no tax-exempt liabilities, 90.6 percent of their reported mortgage liabilities were tax-exempt liabilities. When an institution reported both tax-exempt liabilities and mortgages on average, 86 percent of mortgage liability was actually tax-exempt bond liability.

2. When an institution reported no tax-exempt liabilities, CBO reclassified all mortgage liabilities as tax-exempt liabilities. When an institution reported both tax-exempt liabilities and mortgages, CBO reclassified 86 percent of mortgage liability as tax-exempt bond liability. Such adjustments results are presented in the appendix.

Table 2.

Selected Assets and Liabilities Held by Colleges and Universities, 2003

(Millions of dollars)

	All Institutions		Institutions that Borrowed in 2003	
	Total	Median	Total	Median
Net Investment Assets (Unadjusted)	262,151	4	151,053	37
Net Investment Assets (Adjusted)	a	a	152,324	39
Outstanding Tax-Exempt Debt (Reported)	44,326	0	16,901	10
Mortgage Debt (Reported)	17,524	1	5,935	3
Outstanding Tax-Exempt Debt (Adjusted)	60,442	2	22,199	22
Memorandum:				
New Bond Issues	n.a.	n.a.	5,703	10
Number of Institutions	913	n.a.	251	n.a.

Source: Congressional Budget Office based on data from information returns (Forms 8038 and 990) filed with the Internal Revenue Service.

Notes: Investment assets include publicly and privately held securities as well as land and buildings held for investment purposes, net of accumulated depreciation.

Tax-exempt debt is frequently misreported as "mortgages and other notes payable." If no tax-exempt debt is reported, the adjusted stock of tax-exempt debt includes all mortgages reported by the institution. If both tax-exempt debt and mortgages are reported, the adjusted stock of tax-exempt debt includes 84 percent of mortgages reported.

The value of investment assets reported on a school's Form 990 return does not include any assets in related organizations dedicated to the support of the institution and separately incorporated as a public charity. Of the group of 251 borrowers, CBO was able to identify 27 institutions that held assets in other 501(c)(3) organizations and adjusted their stock of investment assets and tax-exempt liabilities to reflect the assets and liabilities of those related organizations.

n.a. = not applicable.

a. CBO identified related organizations just for new borrowers in 2003.

for those amounts adjusted to correct for misreporting (see Box 1). Colleges and universities reported about $260 billion in total investment assets and about $45 billion in liabilities for tax-exempt bonds in 2003 (see Table 2). After adjusting for misreporting, CBO estimated that the outstanding stock of tax-exempt debt was about $60 billion. The median amount of investment assets reported on Form 990 returns for 2003 was about $4 million (that is, half of the institutions had more than $4 million in assets and half had less), and the median amount of tax-exempt debt was zero. With adjustments for misreporting, the median stock of tax-exempt debt increased to about $2 million.

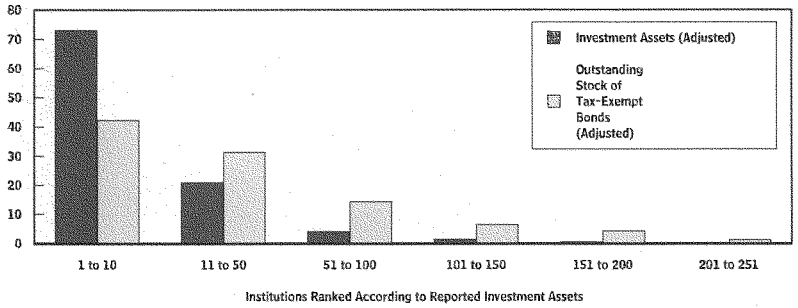
The subset of schools that borrowed using tax-exempt debt in 2003 also had total investment assets that far exceeded tax-exempt liabilities. Those schools' total investment assets, at about $150 billion, were nine times larger than the total reported stock of outstanding tax-exempt bonds and seven times larger than the total adjusted stock of outstanding tax-exempt bonds. The median school that borrowed in 2003 had an estimated $39 million in investment assets. The median stock of tax-exempt liabilities was about $22 million for schools that borrowed in 2003, about 40 percent less than the median amount of investment assets.

Within the group of 2003 borrowers, the distributions of investment assets and tax-exempt bonds were highly skewed (see Figure 2). The top 10 schools that borrowed in 2003, ranked by investment assets, made up about 4 percent of the sample but held almost 75 percent of the total amount of investment assets held by the entire group. The top 50 schools that borrowed in 2003, ranked by investment assets, made up about 20 percent of the sample but held about 95 percent of total investment assets. The group of institutions with the largest share of investment assets had also issued a substantial share of the tax-exempt bonds, but the distribution of the bond issuances was less skewed. The top 10 schools that borrowed

Figure 2.

The Distribution of Investment Assets and Outstanding Tax-Exempt Bonds Held by 251 Colleges and Universities in 2003

(Percent)



Source: Congressional Budget Office.

Notes: In an earlier study of tax-exempt-bond issues made on behalf of nonprofit hospitals, CBO found that the majority of tax-exempt-bond liabilities were misreported as "mortgages and other notes payable" on Form 990 returns (see Congressional Budget Office, *Nonprofit Hospitals and Tax Arbitrage*, letter to the Honorable William M. Thomas, December 6, 2006). Issuers of tax-exempt bonds for educational institutions confirmed that such misreporting is present in returns for colleges and universities as well. CBO therefore adjusted the stock of tax-exempt bonds reported on Form 990 returns to account for that misreporting using the factors estimated in the earlier study.

Some public schools hold assets in separate 501(c)(3) foundations dedicated to the support of the institution. CBO adjusted the amount of investment assets held by 27 institutions to reflect such assets held by foundations.

in 2003 accounted for about 40 percent of the outstanding value of such bonds, and the top 50 accounted for almost 75 percent of the outstanding value.

The majority of outstanding tax-exempt bonds were held by schools with substantial investment assets, which would probably allow them to borrow even if tax-exempt borrowing was not an option. This suggests that, as currently implemented, the subsidy is not used primarily to ease access to financial markets for schools that would otherwise have difficulty undertaking capital projects.

Possible Approaches to Expanding the Definition of Tax Arbitrage

Any specification of the investment assets that would be covered under an expanded definition of tax arbitrage should account for the legitimate role that such assets play in the operation of colleges and universities. Those institutions accumulate investment assets for a variety of reasons: to earn income to fulfill the purposes that qualify them for tax-exempt status; to protect against uncertainty; to obtain a stronger credit rating; to enhance their reputation; and to honor gift restrictions. Some of those reasons suggest that certain investment assets should not be counted when measuring earnings from tax arbitrage.

The need to maintain an operating reserve is one rationale for allowing an institution to hold some investment assets while issuing tax-exempt bonds. One possible reason for accumulating substantial operating reserves is to maintain spending levels as income from endowments and other sources of revenue fluctuate; but, in practice, most schools follow self-imposed spending rules that limit such "smoothing" and mandate spending reductions when income falls. Another possible reason is that rating agencies offer higher credit ratings as the ratio of expendable financial resources (which include operating reserves) to yearly expenses increases, and those higher

ratings lead to lower costs for borrowing.[18] A comparison of investment assets and annual expenses shows that, by rating agencies' standards, many schools that borrowed in 2003 appear to have substantial operating reserves. For instance, the median ratio of investment assets to annual expenses was 1 for schools that bortowed in 2003; that is, investment assets were equal to about a year's worth of expenses. (That ratio ranged from a high of 89.5 to zero.)

Some investment assets held by colleges and universities are subject to restrictions by the donor. Because educational institutions cannot use such assets for purposes other than those specified by the donor, it could be argued that those assets should not be included when measuring earnings from tax arbitrage. It might be possible, however, to implement a broader measure of tax arbitrage without forcing schools to violate most of those restrictions. For instance, if a donor restricted a gift to an academic institution's endowment—that is, specified that the gift be used to generate future earnings rather than to help pay for current operating expenses—the requirement, under a broader measure of arbitrage, that earnings on the gift be rebated if they exceeded the interest paid on a tax-exempt bond would not necessarily violate the donor's restriction. The gift itself would not be used to purchase the asset financed by the bonds; only the earnings on the gift would be affected.[19] In cases where the donor directed that a gift (but not the earnings on that gift) be used for a specific purpose, similar reasoning would apply. Even in cases where the donor directed that both the gift and its earnings be used for a specific purpose, many restricted purposes—research, certain types of academic support, athletics—would be consistent with using earnings on that gift to finance the construction of academic and athleric buildings, laboratory facilities, and libraries.[20]

Another consideration is that exempting restricted gifts from an expanded definition of tax arbitrage would strengthen the incentive for schools to pursue restricted gifts. Colleges and universities frequently cite restrictions on gifts as one reason they require federal subsidies for other types of spending that are less preferred by donors or to justify their tax-exempt endowments' freedom from fedetally mandated spending requirements such as those that apply to charitable foundations. Currently, schools must weigh the support that additional restricted gifts lend to those arguments against the fact that unrestricted gifts allow the institution more flexibility in setting budgetary priorities and eliminate the possibility of later disagreement between donor and institution regarding the use of a gift.[21] Explicitly exempting restricted gifts from the calculation of tax arbitrage under an expanded definition would increase the attractiveness of restrictions to schools, but encouraging such restrictions could reduce the social benefit of charitable giving—for instance, individual donors may impose restrictions on gifts that diminish the public benefits that a school provides.[22]

To reflect schools' legitimate need for investment assets, CBO calculated measures of tax arbitrage that would allow some investment assets to be set aside in a reserve that, by definition, could not earn returns from tax arbitrage. In calculating those measures, the value of investment assets considered in the arbitrage calculation was reduced by an amount equaling one year's operating expenses—the median amount of investment assets held by schools issuing debt in 2003. CBO did not separately adjust the arbitrage estimates for investment assets subject to restricted uses; reliable data on the type and strength of

18. According to Moody's Investors Service, the median ratio of unrestricted net resources to expenses was 0.9 in 2006. See *Private College and University Medians 2007* (New York: Moody's Investors Service, May 2007).

19. According to a survey conducted by the National Association of College and University Business Officers, about 60 percent of the assets in college and university endowments in 2003 were restricted to income-generating purposes.

20. Although no data exist that detail the exact purposes of accumulated restricted endowment assets, the Council on Aid to Education collects information on the restricted purposes of current gifts to school endowments. In 2008, the most common restriction for endowment gifts was for student financial aid, accounting for 34 percent of restricted giving. Athletics and academic departments each accounted for about 20 percent of restricted gifts to endowments.

21. Disagreements about such restrictions have increasingly resulted in costly legal battles between schools and donors. (See John Hechinger, "New Unrest on Campus as Donors Rebel," *Wall Street Journal*, April 23, 2009). In the most prominent example of such a dispute, a donor's heirs filed a lawsuit against Princeton University's Woodrow Wilson School of Public and International Affairs, alleging that the school was not using a large donation dating to 1961 in accordance with the donor's intent. Princeton paid a settlement of $100 million to end the ligation, which had stretched on for six years.

22. See Burton A. Weisbrod, Jeffrey P. Ballou, and Evelyn D. Asch, *Mission and Money: Understanding the University* (New York: Cambridge University Press, September 2008), p. 121.

restrictions that apply to existing endowments are not available.[23]

Measuring the Volume of Arbitrage Bonds Under a Broader Definition of the Term

CBO used two main measures to determine how much of the value of outstanding bonds issued by colleges and universities and their new tax-exempt borrowing could be considered to earn returns from tax arbitrage under a broader definition of the term. Each approach compared an institution's investment assets with a measure of its tax-exempt-bond liability. With the "historical" measure, CBO considered only the outstanding stock (in 2003) of previously issued bonds. According to that backward-looking measure, if the value of a college's or university's investment assets exceeded the value of the institution's outstanding stock of tax-exempt bonds, all the bonds were classified as earning returns from tax arbitrage. If the value of the stock of tax-exempt bonds exceeded the value of the investment assets, the volume of bonds equal to the value of the investment assets was classified as earning arbitrage profit.

The second, more forward-looking, measure of tax arbitrage considered the position of colleges and universities in the years immediately following an expansion of the definition of arbitrage. That "first-year" measure compared an institution's new issues of tax-exempt bonds in 2003 with its stock of investment assets that year. Under the first-year measure, if the value of investment assets exceeded the value of the new bond issues, all of the bonds were classified as earning arbitrage profit. If the value of the new issues of bonds exceeded the value of the institution's investment assets, the amount of the new issues that was equal in value to the investment assets was considered to be earning profit from tax arbitrage. In the first few years after the implementation of such a policy, a relatively large share of new issues would probably be considered arbitrage bonds because the amount of investment assets newly available for yield restriction would be large compared with new issues in any single year. Analogous to an estimate of tax expenditures, the first-year measure is not meant to capture all of the ways in which issuers might respond to a change in the definition of tax arbitrage. It does, however, capture the immediate effect of broadening that definition.[24]

Estimated Volume of Arbitrage Bonds Under a Broader Definition of the Term

A substantial portion of rhe tax-exempt debt issued by colleges and universities is outstanding at the same time those institutions hold higher-yielding investment assets. Such debt would earn profit from tax arbitrage under an expanded definition of the term that considered all investment assets, not just those directly telated to the tax-exempt debt. CBO's analysis indicates the following:

- If no reserve was allowed, close to 100 percent of the outstanding tax-exempt debt would be classified as earning full or partial returns from arbitrage under the broader definition. If schools were allowed to exempt investment assets equal to one year's operating expenses as a reserve, 72 percent of the currently outstanding debt would be earning full or partial returns from arbitrage.
- Considering only new issues, the share of debt with full or partial arbitrage profit would be about 99 percent if no assets were set aside in a reserve and about 75 percent if a reserve equal to one year's expenses was allowed.

23. Of the 251 schools that borrowed in 2003, 238 provided information on temporary and permanent restrictions on their total net assets. About 55 percent of all net assets were under permanent restriction and 24 percent were under temporary restriction. No information is available on the nature of the restrictions.

24. CBO also calculated a related measure of arbitrage bonds, not reported in the tables, based on both outstanding bonds and new issues. If schools continued to use tax-exempt debt to finance capital projects and accumulate investment assets as they have in the past, their new bond issues would tend to exhaust the assets subject to yield restriction, lowering the share of new issues that would be earning arbitrage profits in later years. If that was the case, the current balance between the stock of investment assets and the outstanding stock of tax-exempt bonds would remain the relationship between the two. Under that assumption, another way to estimate the amount of 2003 issues that would be considered arbitrage bonds would be to measure the new bond issues against the investment assets that remained after the outstanding stock of previously issued bonds was applied to those assets. By that measure, if the value of a new bond issue was less than the difference between investment assets and the outstanding stock of tax-exempt debt, the issue was classified as earning tax arbitrage. If a new issue was greater than the residual investment assets, the amount of the issue equal to residual investment assets was classified as earning returns from arbitrage. By this definition, the proportion of debt that would be earning tax arbitrage was lower than that under the first year measure, by about 10 percentage points.

Table 3.

Tax-Exempt Debt Classified as Earning Profits from Arbitrage in 2003 Under a Broader Definition of the Term

(Percent)

	No Assets Set Aside as a Reserve		Assets Set Aside as a Reserve	
	Historical Measure[a]	First-Year Measure[b]	Historical Measure[a]	First-Year Measure[b]
Debt Classified as Earning Arbitrage Profits Under a Broader Definition	100	99	72	75
Full Arbitrage	90	84	60	56
Partial Arbitrage[c]	10	14	12	19
Debt Not Classified as Earning Arbitrage Profits Under a Broader Definition	*	1	28	25
Memorandum:				
Total Tax-Exempt Debt (Millions of dollars)	22,199	5,703	22,199	5,703

Source: Congressional Budget Office based on information returns (Forms 8038 and 990) filed with the Internal Revenue Service by institutions that borrowed in 2003.

Note: * = less than 0.1 percent.

a. The total volume of tax-exempt bonds issued as a percentage of net investment assets (adjusted for misreporting).

b. Estimated volume of tax-exempt bonds in the first year under a broader definition of tax arbitrage (approximated by the volume in 2003) as a percentage of net investment assets (adjusted for misreporting).

c. Issues held contemporaneously with investment assets lower in value than the total issue.

Most of the debt that would be classified as earning returns from arbitrage is held by the schools that have the largest stocks of investment assets. Compared with CBO's previous estimates of the volume of arbitrage bonds held by nonprofit hospitals, institutions of higher learning hold considerably more debt that would be classified as earning returns from arbitrage under a broader definition.

Estimated Amount of Arbitrage Debt

The historical measure applies the broader definition of arbitrage to already outstanding tax-exempt debt. Although the measure does not directly address the effect of a policy change—because such a change would affect only future issues—it provides a useful starting point for comparing the outstanding stock of tax-exempt debt with investment assets. Using data corrected both for misclassified tax-exempt debt and for underestimates of investment assets owned by institutions that hold assets in foundations, CBO found that in 2003 close to 100 percent of the $22 billion in previously issued tax-exempt debt would be classified as earning returns from arbitrage under the broader definition (see Table 3).[25] In other words, almost all of the outstanding debt was issued by schools that also held higher-yielding investment assets. Furthermore, the majority of the debt that would be classified as arbitrage debt was fully arbitraged—that is, almost all of it was issued by schools that held investment assets greater in value than their outstanding stock of bonds. In the first years after an expansion of the definition of arbitrage, a high proportion of new issues would be subject to yield restriction because accumulated investment assets are large relative to any single year's issues. In 2003, about 99 percent of new bond issues would have been considered to be earning profit from tax arbitrage under a broader definition.

25. The appendix presents alternative calculations of bond holdings that would earn profits from tax arbitrage under a broader definition using no adjustments for misreporting tax-exempt-bond liability or for assets held by supporting organizations.

Table 4.

Colleges and Universities Conducting Tax Arbitrage in 2003 Under a Broader Definition of the Term

(Percent)

	No Assets Set Aside as a Reserve		Assets Set Aside as a Reserve	
	Historical Measure[a]	First-Year Measure[b]	Historical Measure[a]	First-Year Measure[b]
Institutions Conducting Arbitrage Under a Broader Definition	89	98	44	52
Full arbitrage	66	82	31	37
Partial arbitrage[c]	23	16	14	15
Institutions Not Conducting Arbitrage Under a Broader Definition	11	2	56	48
Memorandum:				
Total Institutions	251	251	251	251

Source: Congressional Budget Office based on information returns (Forms 8038 and 990) filed with the Internal Revenue Service by institutions that borrowed in 2003.

a. Total volume of tax-exempt bonds issued as a percentage of net investment assets (adjusted for misreporting).

b. Estimated volume of tax-exempt bonds in the first year under a broader definition of tax arbitrage (approximated by the volume in 2003) as a percentage of net investment assets (adjusted for misreporting).

c. Issues held contemporaneously with investment assets lower in value than the total issue.

The amount of debt that earns returns from arbitrage falls when some assets are set aside as an exempt reserve. Using the historical measure (which compares the outstanding stock of tax-exempt bonds to investment assets not set aside for a reserve), the amount of debt earning arbitrage profits in 2003 fell ro about $16 billion, or about 72 percent of the stock of outstanding tax-exempt debt. For issues in 2003, about 75 percent of new tax-exempt-bond issues would be classified as earning returns from tax arbitrage under a broader definition that allowed an exempt reserve equal to one year's expenses.[26]

The Distribution of Arbitrage Debt

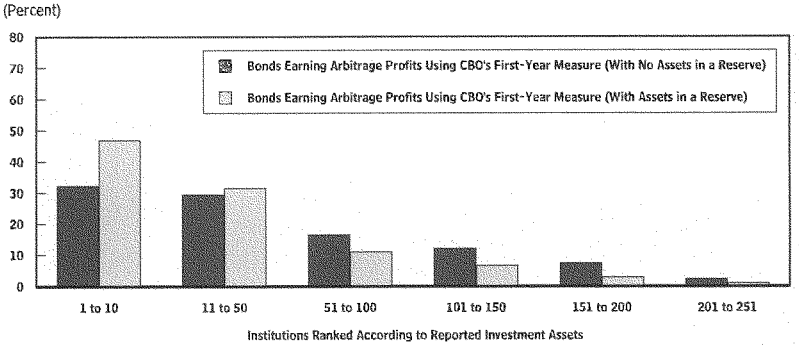
The percentage of institutions engaging in the practice of tax arbitrage is generally lower than the percentage of debt that generates arbitrage profits because the 50 institutions with the most investment assets account for a large share of that debt. If the expanded definition of arbitrage was applied to the already outstanding stock of tax-exempt debt, about 90 percent of institutions would be characterized as profiting from the practice of tax arbitrage (see Table 4). According to the first-year measure, nearly all of the institutions issuing new debt in 2003 would be classified as earning arbitrage profits if a broader definition had been in effect that year.

Even if the broader definition of arbitrage allowed colleges and universities to set aside substantial investment assets in a reserve, the majority of tax-exempt debt held by those institutions would be classified as earning returns from tax arbitrage, regardless of the measure used. Because the distribution of arbitrage earnings is not uniform, however, if a reserve was allowed, only about half of the tax-exempt colleges and universities that borrowed in 2003 would be viewed as conducting arbitrage at all, under either measure. Under the historical measure, the number of institutions conducting arbitrage would fall

26. By that measure, the total amount of debt that would be classified as earning returns from arbitrage under a broader definition is about the same if the exempt reserve is calculated as 70 percent of investment assets rather than as one year of operating expenses. However, the distribution of arbitrage debt among the schools would differ. Defining the exempt reserve on the basis of assets rather than expenses lowers the amount of arbitrage debt for schools with assets that are large in relation to expenses and increases it for schools with assets that are small in relation to expenses. In other words, defining an exempt reserve on the basis of assets favors schools that have better access to taxable borrowing.

Figure 3.

The Distribution of Tax-Exempt Debt Held by 251 Colleges and Universities in 2003 That Would Be Classified as Earning Profits from Arbitrage Under a Broader Definition of the Term



Source: Congressional Budget Office.

Notes: CBO used two main measures to determine how much of the outstanding stock of bonds held by colleges and universities and their new tax-exempt borrowing could be classified as earning profits from tax arbitrage under a broader definition of the term. With the "historical" measure, CBO considered only the historical (outstanding) stock of previously issued bonds. The second, more forward-looking measure considered the position of colleges and universities in the years immediately following an expansion of the definition of arbitrage.

Allowing some assets to escape the broader definition of arbitrage lowers the share of debt considered to be earning arbitrage profits by schools with lower amounts of investment assets.

from 223 to 111, or to about 44 percent of all 2003 borrowers, if some assets were set aside in an exempt reserve. Using the first-year measure, based on the volume of new issues, 52 percent of institutions would have been classified as engaging in arbitrage with new issues in 2003 after accounting for an exempt reserve.

Broadening the definition of tax arbitrage would affect institutions with large holdings of investment assets more than institutions with fewer holdings. The majority of bonds that would be classified as earning arbitrage profit using the first-year measure were issued by the institutions with the largest investment assets. The 50 borrowers with the largest investment asset balances (which comprised about 20 percent of all schools that issued new tax-exempt debt in 2003) accounted for just over 60 percent of the bonds earning tax arbitrage (see Figure 3). If assets equal in value to one year's operating expenses were set aside, about 80 percent of the bonds earning returns from arbitrage would be on behalf of the 50 borrowers with the largest holdings of investment assets.

Comparison with Arbitrage Debt for Nonprofit Hospitals

In a previous study, CBO used similar methods to estimate the percentage of nonprofit hospitals and their debt that would be classified as earning returns from tax arbitrage under an expanded definition.[27] By every measure, a much larger percentage of schools than nonprofit hospitals would be conducting arbitrage under an expanded definition, and a larger share of debt issued by colleges and universities than debt issued by nonprofit hospitals would be classified as earning arbitrage profits.

Using data adjusted for misreporting, CBO found that about 60 percent of the outstanding stock of tax-exempt

27. Congressional Budget Office, *Nonprofit Hospitals and Tax Arbitrage*.

bonds issued by nonprofit hospitals in 2002 had been issued by hospitals that contemporaneously held higher-yielding investment assets. Using the first-year measure, 64 percent of bonds issued by nonprofit hospitals in that year would be classified as earning arbitrage profits under a broader definition. For colleges and universities, those figures were close to 100 percent.

Because different criteria are used to rate hospital bonds and those issued on behalf of colleges and universities, CBO used a different method in its previous study to calculate the amount of assets that might reasonably be set aside as a reserve.[28] According to those estimates, if an exempt reserve had been allowed under an expanded definition of tax arbitrage in 2002, about 33 percent of the outstanding stock of bonds issued by nonprofit hospitals would be earning arbitrage profits in that year. Under the first-year measure, and assuming that an exempt reserve for hospitals would be allowed, CBO determined that 32 percent of new issues of tax-exempt bonds would be classified as earning arbitrage profits under a broader definition. The corresponding figures for colleges and universities were over 70 percent.

Institutional Response to an Expanded Definition of Tax Arbitrage

Schools could adjust to a broadened definition of arbitrage in several different ways. They could issue fewer bonds and reduce their capital spending. They could sell or reduce their stock of investment assets in order to finance capital spending, rather than issuing tax-exempt debt and rebating the yield on investment assets to the federal government. They could also replace borrowing that would result in yield restriction with taxable debt. In all cases, the net cost of the tax preference to the federal government would be reduced.

Another possibility is that decreasing the attractiveness of tax-exempt private-activity bonds might encourage institutions of higher learning to pursue tax-exempt financing through other channels. For example, when the Tax Reform Act of 1986 limited the use of private-activity bonds for the financing of sports stadiums, agreements between local governments and sports teams led to the issuance of bonds specifically designed for stadium financing but legally considered general revenue bonds because they were backed by revenue from general sources. In those cases, the requirement that debt service be paid from revenues not generated by the stadium essentially ensured that local governments would offer teams very favorable lease terms and that the tax burden of such facilities would be shared by all local taxpayers rather than the users of the facility, who most benefited from it.[29]

Local governments could allow both public and private universities to circumvent expanded tax arbitrage rules for private-activity bonds in a similar fashion. Although colleges and universities do not enjoy the monopoly power of major sports teams, many institutions of higher learning are large landowners and employers at the local level, giving them substantial negotiating power with local governments. Local governments could also designate public schools as separate units of government for the purpose of issuing bonds, allowing those schools to issue general revenue bonds on their own. Although careful regulation could in theory circumvent that problem, it is likely that at least some issuance of tax-exempt private-activity bonds would simply shift to the issuance of tax-exempt revenue bonds, limiting the revenue gain to the federal government.

Broadening the rule would reduce the tax preference for schools with large asset portfolios to a greater degree than it would for schools with fewer resources. Because the new rule would be more likely to apply to the few schools with very large portfolios, those schools would effectively face an increase in interest costs relative to schools with smaller portfolios. However, those schools with significant investment assets already tend to have investment-grade credit ratings, suggesting that limiting their ability to issue tax-exempt debt would probably not prevent them from accessing financial markets. Whether diverting the tax-exempt-bond subsidy away from schools with larger endowments would be a more efficient use of scarce resources would depend on the marginal social benefit of subsidies to such schools. If the marginal social benefit of the subsidy decreased as endowments rose, a reduction in the subsidy to schools with large endowments could improve the allocation of the nation's resources. If the marginal social benefit of the subsidy increased as endowments rose, a reduction in the subsidy to schools with large endowments would worsen resource allocation.

28. The reserve was set equal to 100 days of operating expenses; the median hospital in the sample had 117 days of cash on hand.

29. Dennis Zimmerman, "Subsidizing Stadiums: Who Benefits, Who Pays," in Roger G. Noll and Andrew S. Zimbalist, eds., *Sports, Jobs, and Taxes: the Economic Impact of Sports Teams and Stadiums*, (Washington, DC: Brookings Institution Press, 1997), pp. 119–145.

Appendix: Alternative Calculations of Tax Arbitrage as Practiced by Colleges and Universities

In the main text of this report, the Congressional Budget Office (CBO) calculated the extent of tax arbitrage that colleges and universities would be practicing under an expanded definition of the term. To do so, CBO adjusted the outstanding stock of tax-exempt bonds held by those institutions to reflect the fact that they often misreported such debt as mortgages and expanded their measured investment assets to include assets held by related organizations. In this appendix, CBO presents estimates based on the same data—taken directly from information returns (specifically, Form 990 returns) filed with the Internal Revenue Service (IRS)—but without making such adjustments.

According to unadjusted data from Form 990 returns, which nonprofit entities are required to submit to the IRS on an annual basis, the percentage of previously issued outstanding debt that would be classified as earning returns from arbitrage under a broader definition would be similar to the percentage produced using adjusted data. (In determining those percentages, CBO used the historical stock of previously issued bonds, which it terms the "historical" measure). However, 148 institutions—slightly less than 60 percent of the 251 schools that borrowed in 2003—had investment assets with a value that exceeded the reported stock of tax-exempt liabilities, a considerably smaller percentage than was the case when adjusted data were used. Most of the additional stock of debt added by the adjustment was for institutions that reported no tax-exempt debt at all on Form 990 returns; but the additional stock of bonds attributable to the adjustment would be small relative to the total stock of bonds.

Estimates that were produced using what CBO terms the "first-year" measure—which considers the position of colleges and universities in the years immediately following an expansion of the definition of arbitrage—do not include information on the outstanding stock of tax-exempt bonds, so they are affected only by the adjustment to investment assets. Using that measure and unadjusted data, CBO determined that the share of debt earning returns from arbitrage would be slightly lower, by about 1 percentage point, than when adjusted data were used. Using that measure and unadjusted data, the number of institutions conducting arbitrage would be slightly lower as well, by about 2 percentage points. Again, both the adjusted and unadjusted data show that a majority of the new issues of tax-exempt bonds for institutions of higher learning would be classified as earning arbitrage profits after an expansion of the definition of tax arbitrage.

STATEMENT OF HON. ORRIN G. HATCH, RANKING MEMBER
U.S. SENATE COMMITTEE ON FINANCE HEARING OF JULY 25, 2012
EDUCATION TAX INCENTIVES AND TAX REFORM

WASHINGTON – U.S. Senator Orrin Hatch (R-Utah), Ranking Member of the Senate Finance Committee, today released the following opening statement at a committee hearing examining the role of education incentives in the U.S. tax code:

The focus of today's hearing is a narrow, but very important, one – the role of education incentives in our tax code. Traditionally, the federal government has supported millions of individuals seeking higher education through grants and loans. Over the last 15 years, however, federal support for higher education has increasingly relied on incentives in the tax code.

These education tax incentives can generally be classified into one of three categories. The first category includes tax incentives for current expenditures for higher education. These incentives include the Hope, American Opportunity and Lifetime Learning Credits; a deduction for higher education expenses; and the exclusion for scholarships and fellowships. The second category includes tax incentives for student loans. These incentives include the deduction for interest paid on student loans and the exclusion from income for certain student loans that have been forgiven. The third category includes tax incentives for savings for college. These incentives include qualified tuition plans, generally referred to as 529 plans; Coverdell plans; education savings bonds; and IRA withdrawals to pay for college expenses without penalty.

Generally, two reasons have been given for the various education tax incentives. First, college education costs are increasing and are a barrier to entry for those who cannot afford the costs. Second, college education is a good investment that produces external benefits sometimes referred to as positive externalities.

According to the National Center for Education Statistics, the cost of college education for the 2009-10 academic year -- annual prices for undergraduate tuition, room and board -- were estimated to be $12,804 at public institutions and $32,184 at private institutions. Between 1999-2000 and 2009-10, costs for undergraduate tuition, room and board at public institutions rose 37 percent, and costs at private institutions rose 25 percent, after adjustment for inflation.

The high cost of a college education does create a barrier to entry. However, some portion of the barrier is alleviated by the U.S. Department of Education's Direct Loan Program (such as Stafford Loans), Federal Perkins Loans, Federal Work Study, Federal Supplemental Educational Opportunity Grants and the Federal Grant Program (such as Pell Grants) for lower income students. In fact, according to the John William Pope Center for Higher Education Policy, of the 16.4 million undergraduate students enrolled in college in the United States in 2010, approximately 58 percent or 9.6 million students received Pell Grants.

As to the external benefits of a college education -- some benefits from higher education may benefit not just the individual student in the form of higher wages, but also society as a whole. Since these external benefits may not be considered by individual students when considering higher education, individuals may invest less in higher education than is optimal for society. Providing educational tax incentives may induce potential students to enroll in higher education, increasing investment in education, and thereby creating external benefits.

A frank conversation about these incentives must also consider whether Congress is encouraging a higher education bubble. Are these incentives encouraging students to take on more debt and degrees than is warranted by the economic and professional gain these students are likely to realize from their educational achievements?

In evaluating the education tax incentives, we use the same three factors that are used in evaluating all tax incentives: equity, efficiency and simplicity. Some critical questions in evaluating education tax incentives are whether federal subsidization of higher education is good policy and whether a tax subsidy would be provided more efficiently by direct spending.

In 1987, then Secretary of Education William Bennett stated that in the long run, Federal financial aid programs lead to higher tuition as colleges capture some of the Federal aid to students. Some studies have shown some evidence of the *Bennett hypothesis*. I would be interested to hear from our witnesses if they believe the Bennett hypothesis applies to Federal student aid in the form of education incentives in the tax code. In other words, do colleges and universities capture the financial benefits of education tax incentives at the expense of eligible students and families? One recent economic paper indicates that is the case.

As to simplicity, one noted tax scholar, Michael Graetz, has written, "The education tax incentives represent the greatest increase in federal funding for higher education since the GI Bill. But no one can tell you what they are, how they work, or how they interact. Planning to pay for college around these tax breaks is essentially impossible for middle-income families." I think there is a lot of agreement that the education tax incentives are very complex and, at a minimum, should be consolidated and reformed.

We have a very distinguished panel with us today. I look forward to hearing what they have to say.

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"Are Tax Credits the Proper Tool for Making Higher Education More Affordable?"

Testimony by
Scott A. Hodge
President, Tax Foundation

Hearing Before the U.S. Senate Committee on Finance

July 25, 2012

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.

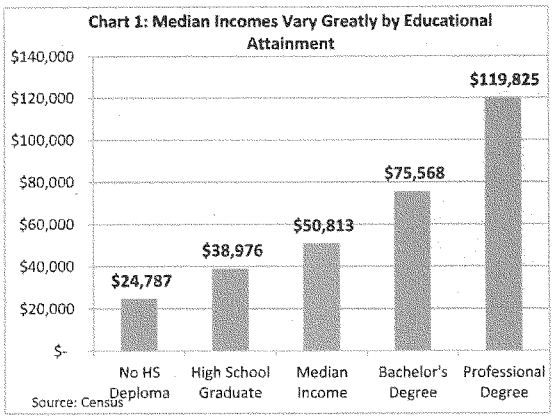
In other words, the ideal tax system should do only one thing – raise a sufficient amount of revenues to fund government activities with the least amount of harm to the economy. By all accounts, the U.S. is far from that ideal. According to the National Taxpayer Advocate, tax complexity is the number 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.

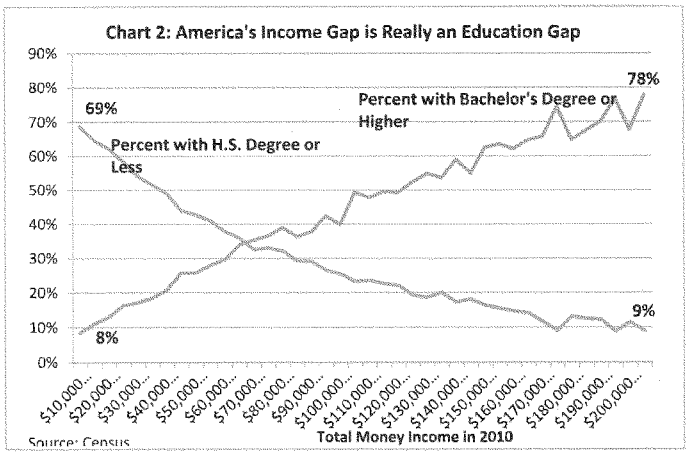


Considering the financial benefits of getting a college degree, higher education policy has shifted in recent years away from traditional loan and direct subsidy programs (such as Pell Grants) toward the use of various tax credits and deductions.

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.[1] Economists find that the mortgage interest deduction gets

[1] 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[2], 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."[3]

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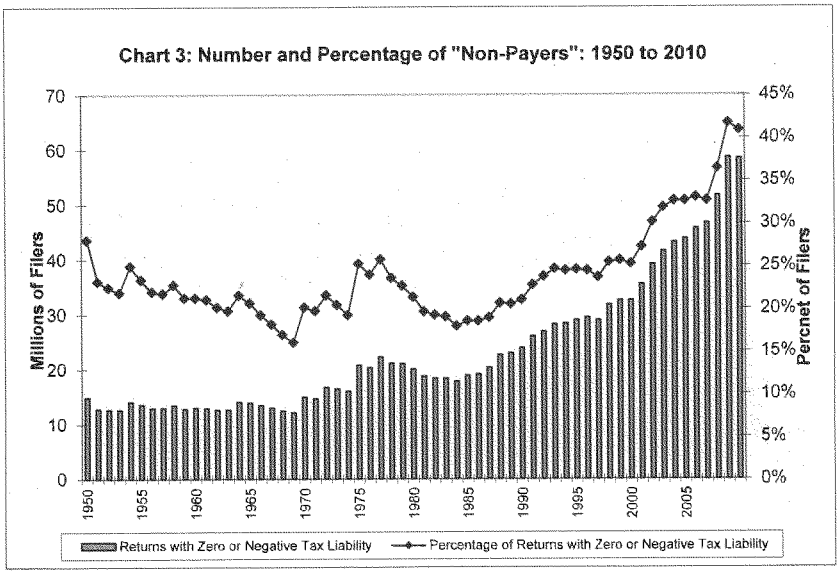
never intended the deduction for personal interest expenses to subsidize home ownership. See: Dennis J. Ventry, Jr., "The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest," UC Davis Legal Studies Research Paper Series, *Research Paper No. 196*, November 2009.

[2] 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.

[3] 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.[4]

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.

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[4] 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.

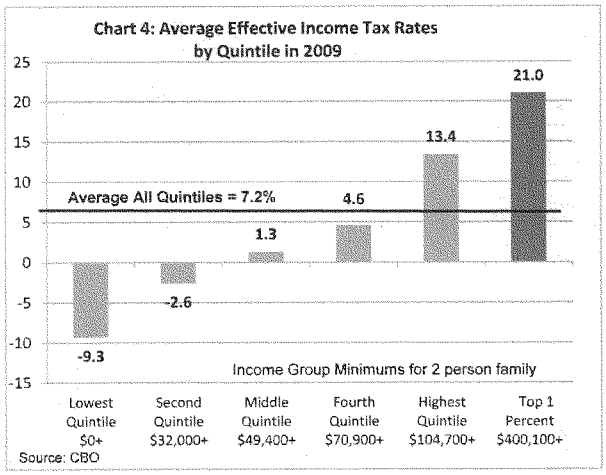

Chart 5 details the growing cost of non-refundable and refundable tax credits over the past two decades.[5] In 1990, the combined value of these credits was roughly $20 billion, after adjusting for inflation. Of that amount, the budgetary cost of basic tax credits was around $8 billion, while refundable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

[5] 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.[6] 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.

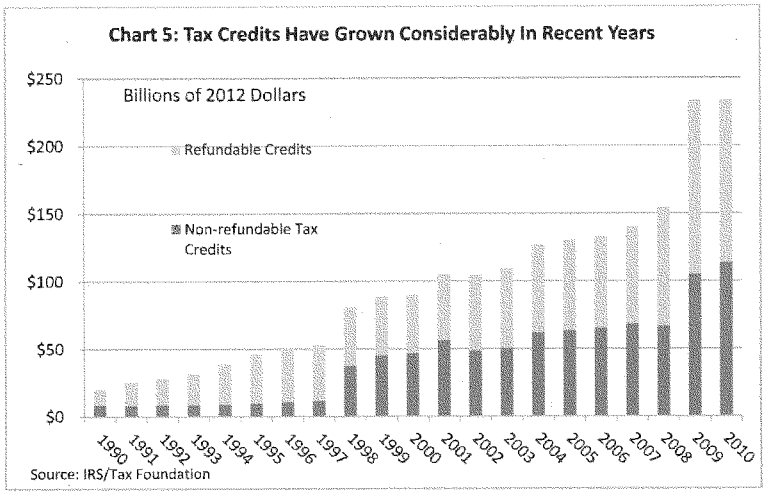

Chart 6 illustrates the gradual growth of the budgetary costs of education tax credits since 1998, while Chart 7 documents the number of tax returns claiming those credits each year since 1998. In 1998, some 4.7 million taxpayers claimed $4.5 billion in credits, after adjusting for inflation. Within 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.

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[6] 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.

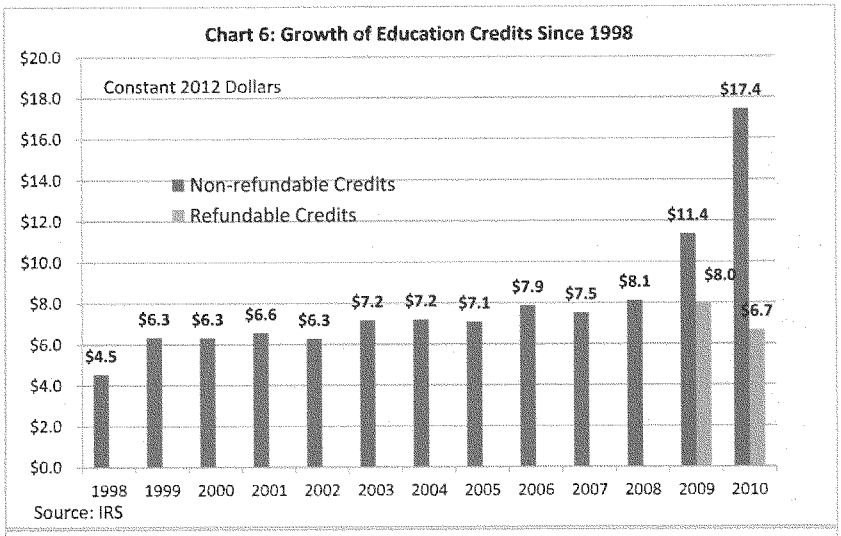


Chart 6: Growth of Education Credits Since 1998
Constant 2012 Dollars
Non-refundable Credits
Refundable Credits
$20.0
$18.0
$16.0
$14.0
$12.0
$10.0
$8.0
$6.0
$4.0
$2.0
$0.0
$4.5
$6.3
$6.3
$6.6
$6.3
$7.2
$7.2
$7.1
$7.9
$7.5
$8.1
$11.4
$8.0
$17.4
$6.7
1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010
Source: IRS

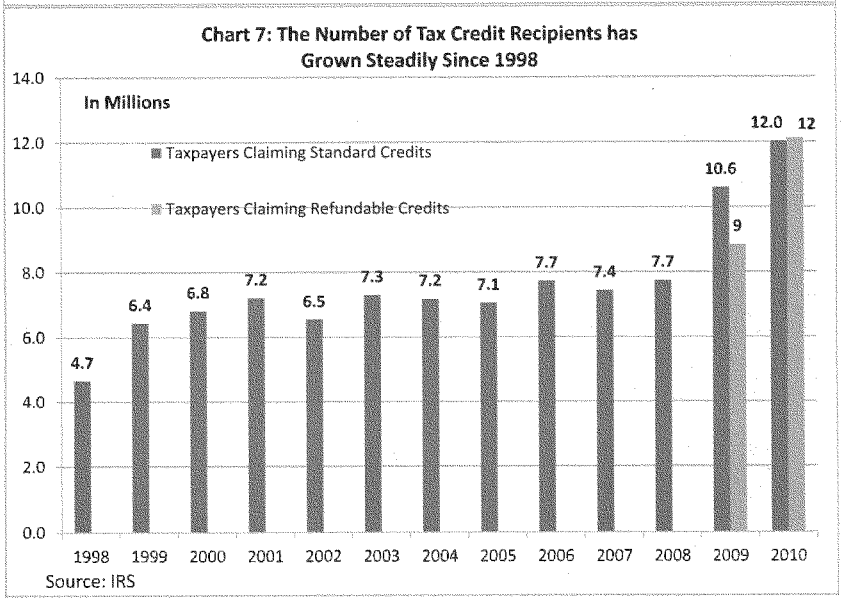


Chart 7: The Number of Tax Credit Recipients has Grown Steadily Since 1998
In Millions
Taxpayers Claiming Standard Credits
Taxpayers Claiming Refundable Credits
14.0
12.0
10.0
8.0
6.0
4.0
2.0
0.0
4.7
6.4
6.8
7.2
6.5
7.3
7.2
7.1
7.7
7.4
7.7
10.6
9
12.0
12
1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010
Source: IRS

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.

Largest Tax Credits Claimed by Taxpayers in 2010

Non-Refundable Portions	In Billions	Refundable Portions	In Billions
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

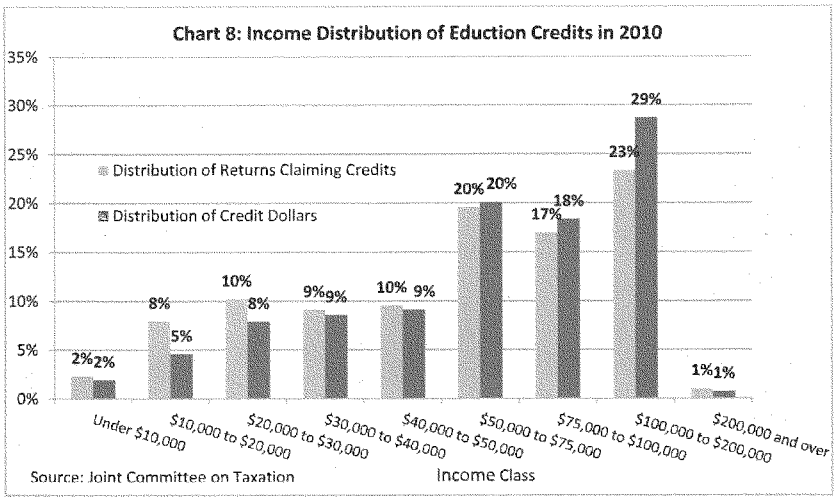
Source: IRS

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.[7] The complexity of EITC eligibility is a contributing factor to the estimated $11 billion to $13 billion in improper overpayments according to the IRS.[8]

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."[9] 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."[10]

Furthermore, the IG reported that:

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[7] National Taxpayer Advocate, Report to Congress: Fiscal 2010 Objectives, June 30, 2009, p. xxii. http://www.irs.gov/pub/irs-utl/fy2010_objectivesreport.pdf

[8] "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.

[9] "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.

[10] 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."[11]

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."[12]

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."[13]

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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[11] Ibid., p. 1.
[12] Testimony of J. Russell George, Ibid., p. 7.
[13] Ibid., p. 2.

TESTIMONY of

LYNNE MUNSON

Before the

COMMITTEE ON FINANCE

of the

UNITED STATES SENATE

July 25, 2012

Chairman Baucus, Ranking Member Hatch, committee members, thank you inviting me back to testify on the issue of runaway tuition and what might be done about it.

When you asked me to come here five years ago to describe how unaffordable college had become, I shared some analyses that many found surprising. I took the prices of milk and of gas in 1980 and told you how much those goods would cost in 2007 if their prices had gone up as rapidly as had in-state tuition at public, four-year universities. I've now updated those prices to the current day.

Whereas, back in 2007, the "tuition-adjusted" price of gasoline was $9.15 a gallon – today it stands at $13. The price of milk? Up from $15 in 2007 to $22 per gallon today.[1] I do these pocketbook analyses to help put the rapid rate of tuition increase in to graspable terms.

Everyone wants to do something about college costs, but no one, including the President, has a plan. We've satisfied ourselves for decades by accommodating the problem rather than holding schools accountable for what they charge. As Dean Zerbe, a former staffer on the committee, has written: "Colleges and universities have been raising tuition faster than a monkey can

[1] This analysis is based on data contained in the College Board's research series, "Trends in College Pricing."

shell nuts (and of course Washington's response has been to throw a lot of peanuts their way)."[2]

Of course, the most popular accommodation is to increase the number and size of federal student loans and grants. But Bill Bennett's hypothesis has held true—this only incentivizes colleges to deliver students bigger bills. The same is the case with education tax credits. Do not for a moment entertain the illusion that these credits end up in the bank accounts of families. Tuition cost will keep pace with, if not exceed, any subsidy you create.

We have also accommodated tuition excess by establishing ways for parents to sock away significant portions of their income, tax-free, for their child's education before they are even born. These are dollars that would undoubtedly be better spent meeting other family needs in these challenging times rather than being set aside, decades early, to pay a future college bill of fear-inspiring proportions.

I don't need to tell you that these methods have failed. What's worse: They have created the dangerous impression that we are addressing a problem that worsens rapidly every single day.

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[2] http://blogs.forbes.com/deanzerbe/

We need to stop accommodating. We need to stop searching for an endless number of ways to pay the tuition bill and, instead, begin holding colleges and universities accountable for the price tag they put on American education.

Let's remember that higher education's take on the public purse cannot be exaggerated. In addition to the billions in research dollars and the massive subsidies that flow from federal and state loans and grants, there are tax-free bonds, tax-free charitable donations, tax-free endowments, tax-free real estate holdings—worth at least $10 billion annually.

Let's also remember that our colleges and universities are sitting on more wealth than has been amassed by any other group of non-profit institutions in the history of our nation—including private foundations.[3] Now, I shouldn't say they are "sitting" on these billions, because they are actually very busy investing them in some of the most complex and illiquid long-term experimental investments that man has ever created. Their focus is on amassing these funds, not on spending them.

Currently, 143 schools have endowments larger than $500 million. Seventy-four colleges and universities have endowments over $1 billion. About 25% of our

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[3] According to the Foundation Center's "Top 100 U.S. Foundations by Asset Size" rankings, there are 65 private foundations in the United States with wealth exceeding $1 billion. See http://foundationcenter.org/findfunders/topfunders/top100assets.html.

nation's wealthiest universities are public institutions including the University of Michigan, Texas, Oklahoma, Nebraska, Virginia, Minnesota, and Florida. Numerous liberal arts schools, that support no graduate programs or big medical research facilities, and enroll just a few thousand students, are among the wealthiest. They include Grinnell College in Iowa and Swarthmore College in Pennsylvania.[4]

Keeping in mind this abundant wealth, and the litany of accommodations and tax benefits higher education enjoys, I suggest tuition accountability is long overdue. Here are three ideas that will get the ball rolling:

- One is to require colleges and universities to do what private foundations must: Spend a certain percentage of the value of their endowments each year. Foundations are required to spend 5%, which is an old number that likely needs to be revised upwards. Requiring schools to spend more would let loose tens of millions which could be spent on decreasing the cost of college. Let me emphasize that this will not be a burden to schools with smaller endowments — as they

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[4] 2011 NACUBO-Commonfund Study of Endowments, http://www.nacubo.org/Research/NACUBO-Commonfund_Study_of_Endowments/Public_NCSE_Tables_.html. See Table: "U.S. and Canadian Institutions Listed by Fiscal Year 2011 Endowment Market Value and Percentage Change in Endowment Market Value from FY 2010 to FY 2011"

already spend their endowments more aggressively than do the wealthier institutions.[5]

- Second, and again this mirrors what already is required of foundations, make colleges and universities publicly disclose the amount and purpose of each and every endowment expenditure. If you require schools to spend more, you do not want it to go for more opulent fundraisers at the university president's house or more climbing walls at the gym. Let's get the sunshine we need to encourage colleges and universities to spend their funds on bringing the cost of education down.

- And, lastly: Let's make the university president, administrators, and professors pay tax on the free college education their children receive.[6] This is a gratuitously unfair and excessive freebie that reeks of privilege, corrupts admissions processes, and undermines the very notion of fairness. At very least, it should be taxed.

These three moves would not solve the problem of runaway tuition. But they would demonstrate that policymakers are willing to begin setting the kind of tax policy, and demanding the sunshine, required to begin holding schools accountable.

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[5] See NACUBO/Commonfund Study of Endowments.

[6] https://www.jct.gov/publications.html?func=startdown&id=1524

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When this committee focused its attention on the issue of college affordability five years ago, there were some good effects. Unfortunately, they were short-lived.

A few of schools instituted "no loan" policies—promising, in most cases, to allow students whose parents earned less than $75,000 per year to attend college without taking out loans. Most of those programs, including at Williams and Dartmouth colleges, were cancelled two years after they were created.[7] No one who'd enrolled under the program even had time to graduate.

Some schools also increased scholarship and grant expenditures five years ago. But, according to a study Sallie Mae just released, college and university grants and scholarships fell 15% during the last academic year.[8] That's more than $1000 per student.

Also, in 2008 an IRS questionnaire was sent out to 400 colleges and universities to inform work on a new schedule to the 990 requiring disclosure of information about education endowments. But the schedule never appeared. I suggest, Chairman Baucus

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[7] http://www.insidehighered.com/news/2010/02/09/dartmouth

[8] Wall Street Journal, July 16, 2012. http://online.wsj.com/article/SB10001424052702303612804577528770015146982.html

and Ranking Member Hatch, you write to the IRS and ask what happened.

Affordability is an illusion the higher education establishment adopts when public or government relations demand it. In order to have lasting impact on the problem of runaway tuition, your attention to it must be enduring.

Our colleges and universities have been given every opportunity, for decades, to do the right thing with regard to controlling the cost of college. They've not done it and there is abundant proof that they will never deliver American families a fair and honest tuition bill unless our nation's political leaders join the public and insist on it.

United States Government Accountability Office

GAO

Testimony
Before the Committee on Finance,
U.S. Senate

For Release on Delivery
Expected at 10:00 a.m. EDT
Wednesday, July 25, 2012

HIGHER EDUCATION

Improved Tax Information Could Help Pay for College

Statement of James R. White
Director, Strategic Issues

George A. Scott
Director, Education, Workforce, and Income Security Issues

GAO-12-863T

Chairman Baucus, Ranking Member Hatch, and Members of the Committee:

We are pleased to be here to discuss federal assistance for higher education. The federal government provides billions of dollars in assistance each year to help millions of students and families meet the costs of higher education. This assistance is provided through federal student aid programs authorized under Title IV of the Higher Education Act of 1965, as amended, (Title IV) and through tax expenditures—reductions in federal tax liabilities that result from provisions in the tax code such as tax credits, deductions, exemptions, and tax-preferred savings programs. Providing federal financial assistance in these varied ways presents students and their families with multiple tools to help them pay higher education expenses. However, it may be difficult for families to understand and apply for higher education assistance.

This statement summarizes our recently issued report that addressed how tax information could help families pay for college.[1] In response to your request, our report: (1) described the size and distribution of federal grants, loans, and tax expenditures available to assist students and families with higher education expenses; (2) assessed the extent to which tax filers select higher education provisions that maximize their tax benefit; (3) summarized what is known about the effect of grants, loans, and tax expenditures on student attendance, choice, persistence,[2] and completion; and (4) described factors that contribute to the effectiveness and efficiency of federal higher education student assistance programs. To address these issues, we analyzed data from the Department of Education (Education), Internal Revenue Service (IRS), and the Board of Governors of the Federal Reserve, and conducted a literature review for original empirical research.[3] We also developed a framework for evaluating federal assistance and validated it with recognized experts of

[1]GAO, *Higher Education: Improved Tax Information Could Help Families Pay for College*, GAO-12-560 (Washington, D.C.: May 18, 2012).

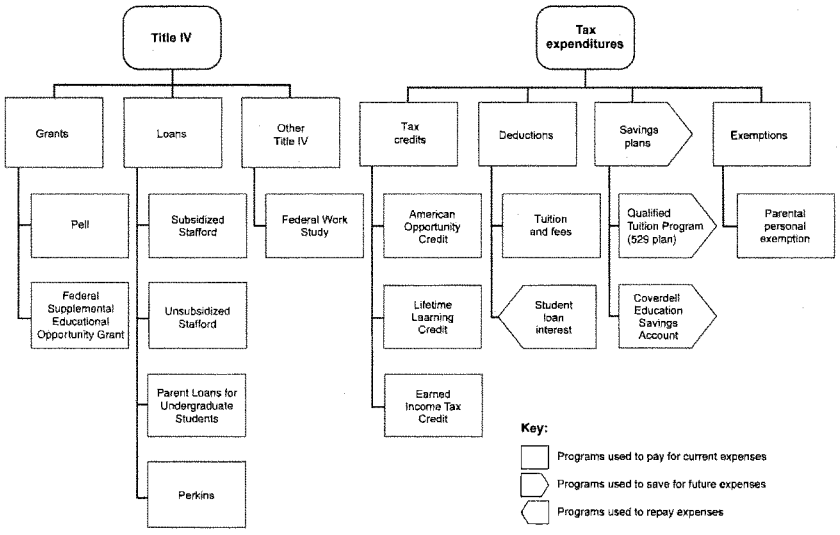
[2]Persistence is the likelihood that students will continue their education.

[3]We conducted this performance audit from June 2011 to May 2012 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

higher education finance. Detailed information on our findings as well as our scope and methodology is available in the report.

We found that multiple Title IV programs and tax expenditures provided substantial aid to populations across income levels. Figure 1 summarizes the Title IV programs and tax expenditures we reviewed.[4]

Figure 1: Title IV Programs and Tax Expenditures Available to Save, Pay, or Repay Higher Education Expenses



Source: GAO.

[4]Details on each program can be found in GAO-12-560.

In 2009, 12.8 million students received Title IV aid, and approximately 18 million tax filers claimed a higher education tax benefit for current expenses.[5] The number of students receiving Title IV aid increased from 10.4 million to 12.8 million, or 23 percent, from 2006 to 2009. The number of tax filers benefiting from an education tax expenditure was larger, and increased from 14.4 million to 18 million, or 25 percent, from 2006 to 2009. Recent increases in both Title IV aid and tax expenditures from 2008 to 2009 may be because of enrollment increases and legislative actions, among other factors. Title IV grants tend to benefit students and families with incomes below the national median (about $52,000 from 2006 to 2010), while loans and work-study serve these students as well as students at family incomes above the median. Most tax benefits from the tuition and fees deduction and the parental exemption for dependent students went to families with incomes above $60,000, whereas the majority of benefits from the other higher education tax expenditures in our review—such as the American Opportunity Credit—went to families with lower incomes.

In our analysis of 2009 IRS data for selected returns with information on education expenses, we found that tax filers do not always choose tax expenditures that maximize their potential tax benefits.[6] We found about 14 percent of filers (1.5 million of almost 11 million eligible returns) failed to claim a credit or deduction for which they appear eligible. On average, these filers lost a tax benefit of $466. We estimate that the total amount of tax benefits filers did not claim was approximately $726 million in 2009. We found no cases where filers' combined state and federal tax liability would have been higher if they had claimed one of those benefits on their federal return. Taxpayers might not maximize their tax benefits because they are unaware of their eligibility for the provisions or confused about their use. IRS and Education have taken steps to provide information on these provisions, but the number of filers failing to claim a higher

[5]The total number of Title IV and tax recipients should not be added together, as in some cases students and families may be eligible for benefits from both types of programs. The most current year for which data are available for both tax and Title IV programs is 2009.

[6]Our analysis is limited to tax filers who appeared eligible for the lifetime learning credit (LLC) or the tuition and fees deduction in 2009, had a Form 1098-T Tuition Statement with information on the student's education expenses, and had a tax liability after claiming other tax benefits. After eliminating returns where eligibility was not clear, we included only 29 percent of returns in our analysis of filers with a 1098-T but selecting neither the LLC nor the tuition deduction in 2009. Estimates have 95 percent confidence intervals that are within 10 percent of the estimate itself. Details on our methodology and its limitations can be found in GAO-12-560.

education tax provision suggests more could be done. For example, IRS stated that it coordinated with tax preparation software providers to provide links to relevant higher education forms, while Education's Federal Student Aid website provides a link to IRS's *Publication 970, Tax Benefits for Education.* Developing a coordinated, comprehensive strategy to better inform eligible students could improve take-up of these tax provisions.

We also found that despite Education's research efforts, evaluative research on the effects of federal assistance for higher education on student outcomes—such as the likelihood students will complete their education—remains limited, as shown in table 1. Researchers have examined the effects of federal assistance on a limited basis, such as only for certain states or groups of students, but these studies provide an incomplete view of the effects of federal assistance. Education's efforts to sponsor and undertake research represent an important step, but research available at present still lacks evaluative information on the effects of federal grants, loans, and work-study. Continuing gaps in research on the effectiveness of federal assistance may be due, in part, to data and methodological challenges that have proved difficult to overcome. Recent changes in Title IV aid and tax expenditures—such as the introduction of the American Opportunity Credit in 2009—may provide opportunities for evaluative research, but Education officials told us they have not conducted such research due in part to the level of resources Education officials told us they devote to such research. In an environment of constrained budgets, evaluative research can help inform policy decisions.

Table 1: Research We Reviewed on the Effects of Federal Assistance Is Limited and Cannot Be Generalized

Federal assistance for higher education	Attendance	Choice	Persistence	Completion
Grants[a]	✓	✓	✓	
Student loans	✓		✓	✓
Work-study			✓	✓
Tax expenditures				
Tuition and Fees Deduction	✓			✓
Student Loan Interest Deduction				
Parental exemption for students age 19 to 23				
American Opportunity Credit				
Hope Credit	✓			
Lifetime Learning Credit	✓			✓
Earned Income Tax Credit for students age 19 to 23				
Coverdell Education Savings Account				
529 Qualified Tuition Program				

Source: GAO analysis.

Note: We did not find research that could be generalized. A check mark indicates that one or more Title IV aid or tax provisions in the category has been studied for certain states, types of school, or groups of students.

[a]Research conducted into the effects of Pell Grants but not Federal Supplemental Educational Opportunity Grants.

Finally, we identified factors that contribute to effective and efficient higher education assistance programs to help policymakers allocate limited resources among multiple programs.[7] These factors can be used as a policy tool for considering improvements to current programs, consolidating programs, eliminating programs, or designing features of new programs. They can be used as a framework for assessing whether a higher education program:[8]

- achieves program goals and produces demonstrable results,
- provides appropriate incentives for targeted populations,
- facilitates beneficiaries' use of the program,

[7]We consulted subject-matter experts and our prior work as we identified these factors. See GAO-12-560 for details on the framework and our methodology.

[8]Programs include federal assistance through Title IV grants, loans, and work-study, and tax expenditures directed at future, current, and past education expenses.

- interacts effectively with other programs,
- minimizes costs and risks, and
- establishes monitoring and evaluation mechanisms.

Based on our work, we recommended the Commissioner of Internal Revenue and the Secretary of Education work together to:

- identify characteristics of tax filers who are not claiming a higher education tax expenditure when they appear to be eligible for one and possible reasons for this, and
- use this information to identify strategies to improve information provided to eligible students and families.

We also recommended that the Secretary of Education take advantage of opportunities presented by recent and anticipated substantive program changes to sponsor and conduct evaluative research into the effectiveness of Title IV programs and higher education tax expenditures at improving student outcomes.

Education and IRS agreed with our recommendations. Education noted that while it does not have access to tax data, it will work with IRS to assist in taxpayer outreach. A complete discussion of agency comments and our evaluation are provided in the report.

Chairman Baucus, Ranking Member Hatch, and Members of the Committee, this completes our prepared statement. We would be happy to respond to any questions you and Members of the Committee may have at this time.

GAO Contact and Staff Acknowledgments

For further information regarding this testimony, please contact James R. White, Director, Strategic Issues, at (202) 512-9110 or whitej@gao.gov, or George A. Scott at (202) 512-7215 or scottg@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement.

Individuals making key contributions to this statement and the related report include David Lewis and Tranchau (Kris) Nguyen, Assistant Directors; Shannon Finnegan, Analyst-In-Charge; Patrick Dudley; John Mingus; Amy Moran Lowe; Tom Moscovitch; Erika Navarro; and Mark Ramage. JoAnna Berry, Jessica Botsford, Amy Bowser, Andrew Ching, Susannah Compton, Michele Fejfar, Lois Hanshaw, Donna Miller, Edward Nannenhorn, Mimi Nguyen, and Melanie Papasian provided technical support.

COMMUNICATIONS

Office of the President

Testimony for the Record
Submitted to the
United States Senate Committee on Finance
Hearing on Education Tax Incentives and Tax Reform
July 25, 2012

August 9, 2012

On behalf of the higher education associations listed below, which represent approximately 4,300 two- and four-year public and private non-profit colleges and universities, I am submitting this written testimony for the record of the July 25, 2012 Hearing on Education Tax Incentives and Tax Reform. We appreciate the opportunity to submit our views to the committee on several tax provisions which are important to college students and their families as well as on the issue of college costs which was also discussed during the hearing.

I. Higher Education Tax Provisions:

We strongly support the American Opportunity Tax Credit (AOTC), the above-the-line deduction for qualified tuition and related expenses (tuition deduction), the Employer-provided Educational Assistance (Sec. 127) benefits, the expanded Student Loan Interest Deduction (SLID), and the expanded Coverdell Education Savings Accounts (ESAs). It is essential that these tax provisions be extended this year to help make higher education accessible to millions of Americans and to ensure our nation will have the educated citizenry the future requires.

Set to expire at the end of 2012, the AOTC significantly enhances and broadens the permanent Hope Scholarship Credit by increasing the credit from $1,800 to $2,500, expanding eligible expenses, making it available for four rather than only two years of college, increasing the income phase-out thresholds, and making the credit partially refundable. Since its enactment, there has been a significant increase in the use of the AOTC across income levels, particularly for middle class students and their families. According to a recent U.S. Government Accountability Office study, in 2009, more than 9 million tax filers claimed the AOTC, receiving $16 billion in tax benefits. Almost 65 percent of these benefits went to middle-income families with incomes above $40,000.

In addition, Sec. 127 will expire in its entirety this year. Originally enacted in 1978, Sec. 127 allows employers to offer up to $5,250 in tuition assistance to employees annually. These funds offer tax benefits to both employers and student employees. According to the most recent available Department of Education data, the nearly 1 million American workers who used this tuition assistance in the 2007-08 academic year had average annual employment earnings of $42,711.

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This provision has been an important means of building and adding to the competencies of the work force, and is a critical tool to help our nation accelerate its economic engine. The top majors among recipients of tax-free tuition include science, technology, engineering and mathematics. More than 35 percent of degrees pursued by employees using education assistance are master's degrees. It is essential that Sec. 127 be extended as soon as possible to provide certainty to employers and student employees as they make plans for the coming year and beyond.

Also scheduled to expire this year are improvements originally made to SLID and Coverdell ESAs in the Economic Growth and Tax Relief Reconciliation Act of 2001. If not extended, SLID will be drastically limited by reduced income thresholds and a five-year limit and Coverdell ESAs will revert to allowing only $500 in tax-free annual contributions (currently $2,000). During this challenging economic time which has led to reduced home equity values for many families, it is particularly important to maintain mechanisms, such as the enhanced Coverdell ESAs, to incentivize college savings.

The tuition deduction allows students or parents to deduct up to $4,000 in eligible higher education expenses from their taxable income. Like the AOTC, the tuition deduction enhances access to higher education by helping to reduce the cost of attending college. The tuition deduction is particularly beneficial to graduate students who are ineligible for the AOTC.

It is broadly acknowledged, however, that the current set of higher education tax credits and the tuition deduction are overly complicated and difficult for taxpayers to correctly use.[1] These provisions include the AOTC, the Hope Scholarship Credit, the Lifetime Learning Tax Credit, and the tuition deduction, which are intended to enhance access to postsecondary education. We have long supported legislative efforts to consolidate and simplify these tax incentives in order to maximize their impact and enhance access to higher education. We strongly support reform of the current tax credits and tuition deduction to create a simpler, consolidated higher education tax credit that provides assistance towards a baccalaureate degree, post-baccalaureate education and lifelong learning. We would welcome the opportunity to work with the committee on such an effort during overall tax reform.

It is for this reason that we strongly support legislation introduced in this Congress by Sen. Charles E. Schumer (D-NY), the "American Opportunity Tax Credit Permanence and Consolidation Act of 2012" (S. 3267), which will make a number of important reforms to the AOTC and Lifetime Learning Credit benefiting families across income categories. The bill significantly improves the current AOTC and Lifetime Learning Credit by consolidating them into one simplified, permanent AOTC that will provide up to $3,000 per year in tax relief. In addition, the act incorporates the expanded eligible expenses of the current AOTC, increases income phase-out thresholds and replaces current limits on the number of years a student can utilize the AOTC with a $15,000 lifetime cap. Moreover, in steps that will particularly benefit low- and moderate-income students, the act maintains

[1] See GAO Report to the Committee on Finance, U.S. Senate, *Higher Education – Improved Tax Information Could Help Families Pay for College* (May 2012); GAO Testimony before Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, *Multiple Higher Education Tax Incentives Create Opportunities for Taxpayers to Make Costly Mistakes* (May 1, 2008).

the 40 percent partial refundability of the current AOTC and better coordinates the interaction of the credit with the Pell Grant, making postsecondary education more affordable.

II. College Costs:

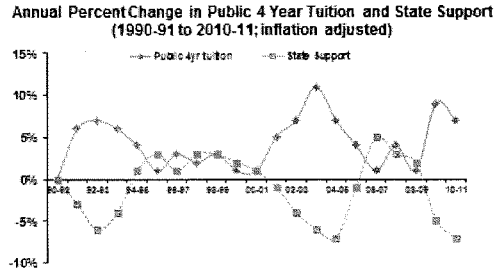
The condition of our economy has elevated the cost of attendance and avenues of access to higher education to sources of genuine anxiety for many American families. While these concerns are understandable, there are also a number of misperceptions about the true cost of attendance that have fueled this dynamic:

- According to the College Board in 2001, two-thirds of full-time students attended four year institutions with a published tuition price less than $15,000. In addition, 45 percent of all undergraduates attended community colleges, where the average published tuition for a full-time student is $2,963.
- Analysis of data reveals that the net price of attendance—the actual cost after incorporating financial aid or tuition discounts, as opposed to the "sticker" price—remains within reach of many students and families, particularly at community colleges. According to the College Board in 2011, students at public four-year schools were paying a net price of $2,490 per year on average.
- Over the five years from 2006–07 to 2011–12, after taking into account grants and education tax benefits, the estimated average net tuition (adjusted for inflation) decreased at community colleges and private, nonprofit four-year colleges by $840 and $550, respectively. The average net tuition increased by just $170 at public four-year campuses after inflation, compared with the $1,800 increase in published tuition.
- The total amount of institutionally provided student financial aid has more than doubled over the last 10 years, increasing faster than the rate of increase in tuition. Indeed, the investment by colleges and universities in student aid has increased over the last decade from $20.5 billion to $38.1 billion in 2011.

Among multiple reasons for rising college costs, there are four particularly strong drivers:

- **State Appropriations**

For public institutions, which enroll 80 percent of all students, the single largest factor in driving up college costs is declining state support. In the last 20 years, states have systematically reduced spending on higher education, resulting in increased tuition at public institutions to offset the reduced state revenue. Indeed, there is a direct and inverse relationship between the level of state appropriations and the level of tuition increases, as illustrated in the chart below. For example, at many institutions, a 1 percent decrease in state appropriations may result in a 3-5 percent increase in tuition.



In 2010, state and local support for general higher education operations fell to a 25-year low in inflation-adjusted terms, while full time equivalent enrollment increased by 61 percent. Over the decade from 1998–99 to 2008–09, state appropriations as a share of institutional revenues per student dropped from 49 percent to 34 percent at public research institutions, 56 percent to 43 percent at state colleges and 64 percent to 57 percent at community colleges. As a result of declining state support, the share of total institutional revenue from tuition rose from 25 percent to 32 percent at public research institutions, 33 percent to 43 percent at state colleges and 22 percent to 27 percent at community colleges. The increases were insufficient to offset declining state support. Between 2007–08 and 2010–11, state appropriations for higher education per student declined by 18 percent in real terms, the largest three-year decline in 30 years.

Private colleges and universities face a different set of circumstances. Few independent institutions receive significant amounts of state support for their operating budgets. Some states provide financial aid that helps students attend these institutions. When state financial aid is reduced as a result of budget cuts, colleges must use even more of their own funds to fill the gap.

- **Technology and Knowledge Creation**

With the rapidly changing nature of information technology, the technological expectations and requirements of students, faculty and staff are rising. Beyond initial costs for IT infrastructure, a significant investment of institutional resources goes to the creating and upgrading of technology-enhanced instruction and research media, student services and faculty and staff training. Today's college students expect institutions to provide information and technological services that allow them to access instructional resources and campus services anywhere and anytime. This is evidenced by the rising use of wireless classrooms, lecture capture and podcasting, mobile apps and e-portfolios, for example. No one wants colleges and universities to be equipped with scientific and technological resources from 2000 as they try to meet the needs of students in 2012 and beyond.

Moreover, knowledge in most scientific disciplines doubles every seven to 10 years. Whole new fields of science—such as nanotechnology—have emerged from obscure specialties to essential fields of study that can be found at most institutions. Over the past three decades, the annual volume of paper and electronic subscriptions at academic libraries grew sharply from less than 4,700 to more than 25,000.

- **Government Regulation**

The persistent growth of federal, state and local regulation creates costs for colleges and universities that institutions cannot control but must consider every year in their budgets as they determine tuition. While some of this regulation may be necessary, a substantial share is burdensome, duplicative and contrary to campus mission. Given the range of their activities, colleges and universities are among the most heavily regulated entities in America. In addition to being regulated by state and local governments, higher education is the only industry regulated by every federal agency. According to Sen. Lamar Alexander (R-TN), in 2005, there were more than 7,000 federal regulations governing colleges and universities.

Regulations impose a heavy toll on colleges and universities in the form of additional staff, increased staff development and training, additional paperwork, creation of computer systems and software to support record-keeping requirements, and higher legal fees. These regulations, in turn, increase operating costs.

- **Work Force**

Higher education is among the most labor- and skill-intensive sectors of the economy, with college graduates comprising almost 70 percent of its employees. Higher education institutions typically spend 60 percent or more of their budgets on human resource costs. In recent years, institutions had sharp increases in benefit expenses that now comprise nearly 25 percent of total human resource costs. Colleges and universities compete with the private sector to hire outstanding individuals—such as engineers, biologists, chemists, doctors and lawyers—for faculty positions.

Efforts to increase productivity or reduce academic personnel costs by increasing class sizes or hiring fewer full-time faculty can have a direct, detrimental impact on academic quality and are very unpopular with students and faculty. Further, student demands for increased non-instructional academic support services (e.g. counseling, health services and campus security) also drive up human resource costs.

III. Federal Financial Aid and Efforts to Control College Costs

During the hearing, some of the witnesses raised the so-called Bennett hypothesis, which claims that increases in federal student aid drive increases in tuition. A landmark federal study on college costs conducted by the Department of Education in 1998 found that increases in federal

financial aid had absolutely no impact on tuition at any type of institution, public or non-profit private.[2] More recent extensive analysis of the issue by economists Robert Archibald and David Feldman not only found no relationship between Pell Grants and increases in tuition at public universities but a reverse effect at private institutions: Increases in the Pell Grant generally *reduced* private sector tuitions.[3] The bottom line is there is no empirical data that suggests federal aid significantly drives up college prices.

Colleges and universities have taken a wide range of steps to contain and cut costs as well as help students pay for education. On the cost containment side, these steps have included: layoffs, pay or hiring freezes; improving administrative efficiency; reducing course offerings, enrollments, or full-time faculty; eliminating academic departments; and imposing budget cutbacks and reallocating resources to pay for other institutional needs. On the affordability side, these steps have included: increasing institutional financial aid, imposing tuition freezes, adopting fixed-tuition guarantees, initiating accelerated degree completion, instituting curriculum innovation, and reducing textbook costs.

IV. Conclusion:

We strongly support extensions of the American Opportunity Tax Credit, the above-the-line deduction for qualified tuition and related expenses, the Employer-provided Educational Assistance benefits, the expanded Student Loan Interest Deduction, and the expanded Coverdell Education Savings Accounts. These tax provisions enhance access to higher education by providing needed support to students or their families, and all of them should be extended this year. We also, however, support efforts to simplify and consolidate several of the higher education tax credits and deductions to make them easier to use and therefore more effective. We thank the committee for the opportunity to submit this statement for the hearing record and for considering our views.

Sincerely,

Molly C. Broad

Molly Corbett Broad
President

MCB/ldw

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[2] Wellman, Jane V. 2008. *Cost, Prices, and Affordability: A Background Paper for the Secretary's Commission on the Future of Higher Education.*

[3] Archibald, Robert B., and David H. Feldman. 2011. *Why Does College Cost So Much?* New York, NY: Oxford University Press.

On behalf of:
American Association of Community Colleges
American Association of State Colleges and Universities
American Council on Education
Association of American Universities
Association of Community College Trustees
Association of Jesuit Colleges and Universities
Association of Public and Land-grant Universities
Council of Graduate Schools
National Association of College and University Business Officers
National Association of Independent Colleges and Universities
National Association of Student Financial Aid Administrators

American Institute of Certified Public Accountants
Written Testimony for the Record
Senate Finance Committee Hearing on Education Tax Incentives and Tax Reform
July 25, 2012

The American Institute of Certified Public Accountants (AICPA) has long been an advocate for sound tax policy that promotes simplification and fairness of the tax law, as well as ease in compliance with and administration of that law. We appreciate the importance and the role that education tax incentives play for families seeking to pay for higher education costs. Thank you for the opportunity to submit our statement on behalf of the members of the AICPA for the hearing record.

Present Law

Included in the Internal Revenue Code are education incentives that may be divided into two general categories: (1) those that are intended to help taxpayers meet current higher education expenses and (2) those that encourage taxpayers to save for future higher education expenses.

The first category includes provisions that may be divided into three main subcategories: (1) exclusions from taxable income such as scholarships (section 117) and employer-provided educat4 ion assistance (section 127); (2) deductions including the student loan interest deduction (section 221) and the tuition and fees deduction (section 222). and (3) credits including the Hope Credit (for tax years 2009 through 2012, referred to as the American Opportunity Tax Credit) and Lifetime Learning Credit (section 25A). Changes to some of these provisions have already occurred while other provisions will see changes on January 1, 2013 unless Congress takes action to extend the current provisions.

The second category, intended to fund future education, includes educational savings bonds (section 135), qualified tuition programs or QTPs (section 529), and Coverdell Education Savings Accounts or ESAs (section 530).

The various provisions contain numerous and differing eligibility rules summarized in the accompanying table.

Background and Analysis

Tax incentives are meant to encourage certain types of economic behavior, but taxpayers will only respond if they are aware of and understand those incentives. Few, if any, taxpayers are both aware of all the education tax incentives and familiar with their details. Fewer still, can perform the analysis to determine which incentive is most advantageous to them.

The Internal Revenue Code (IRC) contains at least 14 complex incentives to encourage saving for and spending on education.[1] Requirements, eligibility rules, definitions, and income phase-

[1] The 14 education tax incentives are (1) non-itemized tuition deduction; (2) non-itemized college loan interest; (3) itemized deduction for work related education; (4) HOPE (American Opportunity Tax) Credit; (5) Lifetime Learning Credit; (6) tax-free treatment of student loans canceled; (7) tax-free student loan repayment assistance; (8)

outs vary from incentive to incentive. For example, eligibility for one of the two education credits depends on numerous factors including the academic year in which the child is in school, the timing of tuition payments, the nature and timing of other eligible expenditures, and the adjusted gross income ("AGI") level of the parents (or possibly the student). Further, in a given year a parent may be entitled to different credits for different children, while in subsequent years credits may be available for one child but not another.

Another complication is that some of the provisions, such as section 222, *qualified tuition and related expenses*, are temporary provisions that are sometimes renewed retroactively, making it difficult for taxpayers to plan for optimal usage of the education provisions. Section 222, qualified tuition and related expenses expired on December 3, 2011 unless Congress acts to extend the provision.

Further complicating the statutory scheme, the Code precludes use of the Lifetime or Hope (American Opportunity Tax) Credit if the child also receives tax benefits from a Coverdell Education Savings Account. Although the child can elect out of such benefits, this decision also entails additional analysis. The IRS publication to explain the income tax rules on education incentives (Publication 970) is 87 pages long.

For many taxpayers, analysis and application of the intended incentives are too cumbersome to deal with compared with the benefits received. The U.S. Government Accountability Office ("GAO") estimated that for tax year that for 2009 returns, about 14% of eligible taxpayers failed to claim education incentives resulting in an average lost tax benefit of $466.[2] Further, according to GAO research, although the number of taxpayers using the educational tax credits is growing quickly, the complexity of the tax provisions prevents hundreds of thousands of taxpayers from claiming tax benefits to which they are entitled or which would be most advantageous to them.[3] Finally, there is evidence that the regressive nature of the provisions prevents low-income taxpayers from getting the tax benefit that Congress envisioned.[4]

Furthermore, there is evidence from government studies that erroneous application of the Hope Credit contributes significantly to the "Tax Gap." A 2009 U.S. Treasury Inspector General for Tax Administration ("TIGTA") report identified approximately 203,000 taxpayers who claimed the Hope Credit for the same student for the three consecutive years ending in Tax Year (TY)

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tax exemption for scholarships used for tuition, fees, and books; (9) Coverdell Education Savings Accounts; (10) penalty-free withdrawal from IRAs to pay for education; 11) interest exclusion for savings bonds used to finance college education; (12) Section 529 qualified tuition plans; (13) tax-free education benefits provided by employer plans: and (14) additional dependent exemption for students age 19–23. There is also one disincentive for saving outside these programs: income from savings of fulltime students age 19–23 can be taxed at their parents' marginal tax rate.

[2] U.S. Government Accountability Office, Testimony Before the Subcommittee on Select Revenue Measures, Committee on Ways and Means, House of Representatives, *Higher Education – Multiple Higher Education Tax Incentives Create Opportunities for Taxpayers to Make Costly Mistakes*, May 1, 2008, GAO-08-717T. A May 2012 report from GAO indicated that for 2009 returns, about 14% of eligible taxpayers failed to claim education incentives resulting in an average lost tax benefit of $466. GAO, *Higher Education: Improved Tax Information Could Help Families Pay for College*, GAO-12-560, May 2012.

[3] *Ibid.*

[4] *Ibid.*

2006 (TYs 2004, 2005, and 2006).[5] The TIGTA report explained that the amounts of the credits inappropriately claimed in TY 2006 averaged close to $1,500 and totaled just over $300 million.[6] Further, over 58,000 of these taxpayers claimed the credit for the same student for four consecutive tax years (TYs 2004 through 2007).[7] The amounts of the credits inappropriately claimed for a fourth year totaled almost $80 million.[8] In a separate report, more than 169,000 taxpayers were identified who claimed the Hope Credit for the same student for the three consecutive tax years ending in TY 2007 (TYs 2005, 2006, and 2007).[9] The amounts of the credits inappropriately claimed averaged close to $1,400 and totaled just over $232 million.[10]

In terms of tax policy, the numerous tax incentives to assist with college expenses are not the only way the federal government provides assistance to college students and their families. Through the Department of Education, the federal government assists low-income individuals through various scholarship and grant programs. We encourage Congress to consider all of these programs together to determine if the desired goals are being met in an effective and efficient manner. The current tax provisions do not always meet the goal of helping low to middle-income families with college expenses. Consideration should be given to where assistance can best be provided through the tax law (such as incentives to save for future college expenses) versus grant and scholarship programs while the student is in college (where assistance is needed at the start of the school year rather than when the tax return is filed). Consideration should also be given to identifying the targeted income group that the federal government should be providing financial assistance to for higher education expenses. When assessing whether this goal is met, aid distributed through scholarships, grants or tax provisions should be considered.

AICPA Proposals

1. Replace tax incentives (i.e., Hope Credit, American Opportunity Tax Credit, Lifetime Learning Credit and the tuition and fees deduction) intended to help taxpayers meet current higher education expenses with one new or revised credit. Combining features of these into one credit would simplify the tax benefits and remove duplicative provisions relating to higher education expenses.

    a. The credit should be on a "per student" rather than a "per taxpayer" basis, offering a potentially larger tax benefit per family.

    b. The credit should be available for any year of postsecondary education, including graduate-level and professional degree courses.

    c. The credit should only be available to students meeting the definition of "student" under section 25A(b)(3).

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[5] Treasury Inspector General for Tax Administration (2009). *Improvements Are Needed in the Administration of Education Credits and Reporting Requirements for Educational Institutions*; September 30, 2009, Ref. No. 2009-30-141.
[6] *Ibid.*
[7] *Ibid.*
[8] *Ibid.*
[9] *Ibid.*
[10] *Ibid.*

d. The credit should have a lifetime limit rather than an annual limit.

e. The tax return reporting requirement should continue including the SSN of the student associated with the expenses claimed with respect to the credit taken for the tax year. Accordingly, amounts claimed over time could be tracked by the student's SSN. These changes may result in improved compliance and enforcement.

f. The credit should be 100% refundable and phased-out for high income taxpayers. The phase-out limitations should be consistent with any other education-related incentive.

g. The credit should be claimed on the parents' return as long as the child is a qualifying dependent of the parent.

2. Create a uniform definition of qualified higher education expenses" (QHEE) for all education-related tax provisions. Specifically, QHEE should include tuition, books, fees, supplies and equipment. Also, the terms "special needs services" and "special needs beneficiary" should be clearly defined.

3. Coordinate the phase-out amounts for the student loan interest deduction and the educational savings bonds and Coverdell Education Savings Accounts exclusions with the new or revised tax credit intended to help taxpayers meet current higher education expenses. All education-related tax provisions should have the same AGI limitations. The concern for excessively high marginal rates resulting from coordinating phase-out provisions should be alleviated by substituting one credit for the several benefits that exist today. In addition, any remaining concerns could be addressed by widening the phase-out range which would still permit coordination that could simplify matters for taxpayers and improve their understanding of eligibility. A single definition of modified AGI should be used for the phase-out determination of any education provision.

Summary of Select Education Tax Incentives				
Code §	**Provision**	**Summary**	**Qualified Education Expenses Defined As**	**AGI Phase-Out**
Exclusions				
117	**Exclusion for scholarships**	Excludes scholarship from income to the extent it covers qualified education expenses for degree-seeking undergraduate student	Tuition, books, supplies, equipment; but not room and board	None
127	**Exclusion for employer-provided education**	*For tax years beginning before 2013* Employee excludes from income up to $5,250 of employer-provided qualified education expenses under educational assistance program	Tuition and fees for undergraduate and graduate courses; books, supplies, equipment; but not room and board Does not have to be for work-related courses.	None
Deductions				

221	**Student loan interest deduction**	For AGI deduction of $2,500 for interest paid on qualifying student loan	Tuition, fees, books, supplies, equipment, room and board, transportation, other necessary expenses	S: $60,000 - $75,000 MAGI MFJ: $125,000 - $155,000 MAGI MFS: No deduction After 12/31/12 the thresholds and phase outs return to levels of : S: $40,000- $55,000 MAGI MFJ: $60,000- $75,000 Indexed for inflation.
222	**Qualified tuition and fees deduction** Expired 12/31/11	For AGI deduction of up to $4,000	Tuition, fees; but not room and board Student-activity fees and expenses for course-related books, supplies, and equipment are included in QHEE only if the fees and expenses must be paid to the institution as a condition of enrollment. Cannot include room & board.	S, HOH: If AGI is not more than $65,000, may deduct $4,000; if between $65,000 and $80,000, may deduct $2,000 MFJ: If AGI is not more than $130,000, may deduct $4,000; if between $130,000 and $160,000, may deduct $2,000 MFS: No deduction

Code §	Provision	Summary	Qualified Education Expenses Defined As	AGI Phase-Out
25A	**Hope credit** **(For tax years 2009 through 2012, the**	Credit of up to $2,500 *per eligible student*: 100% of first $2,000; plus 25% of next $2,000.	Tuition, fees, and course materials including books, during first four years of post-secondary education;	S: $80,000 - $90,000 MFJ: $160,000 - $180,000 MFS: No credit

	American Opportunity Tax Credit as described in 25A(i))	Must be enrolled at least half-time 40 percent of modified credit is refundable (but not for child subject to section 1(g) Kiddie tax) If parent pays the expenses, must be able to claim exemption for student on tax return No felony drug conviction New regulations explain who gets credit in special circumstances	but not room and board. Courses must be associated with degree program or recognized education credential Athletic fees, insurance, activity fees are not eligible unless required as a condition of enrollment and paid directly to the institution	
25A	**Lifetime Learning credit**	Credit of up to $2,000 *per return*: 20% on up to $10,000. The credit is not per child but per taxpayer. A non-refundable elective credit If parent pays the expenses, must be able to claim exemption for student on tax return New Regulations explain who gets credit in special circumstances	Tuition and fees including for graduate courses/continuing education; but not room and board Available for all post-secondary education not necessarily associated with degree	S: $52,000 - $62,000 MFJ: $104,000 - $124,000 MFS: No credit

Code §	Provision	Summary	Qualified Education Expenses Defined As	AGI Phase-Out
135	**Educational Savings Bonds**	Allows for partial or total exclusion of interest income on redemption of qualified U.S. savings bonds used for qualifying purposes	Tuition and fees but not for courses involving sports, games, or hobbies that are not part of degree or certificate granting program; not room and board	S: $72,860-$87,850 for 2012; MFJ: $109,250-$139,250 for 2012, MFS: No exclusion
529	**Qualified Tuition Plans**	For College Savings Plan, account owner contributes cash to a plan	Tuition and fees, books, computers, technology and other expenses for	None

Comments for the Record
United States Senate
Committee on Finance
Education Incentives and Tax Reform
Wednesday, July 25, 2012, 10:00 AM
215 Dirksen Senate Office Building

By Michael Bindner
Center for Fiscal Equity
4 Canterbury Square, Suite 302
Alexandria, VA 22304

Chairman Baucus and Minority Leader Hatch, thank you for the opportunity to address this topic. As always, our comments will be in the context of our four part proposal for tax reform, which is as follows:

- A Value Added Tax (VAT) to fund domestic military spending and domestic discretionary spending with a rate between 10% and 13%, which makes sure very American pays something.
- Personal income surtaxes on joint and widowed filers with net annual incomes of $100,000 and single filers earning $50,000 per year.
- Employee contributions to Old Age and Survivors Insurance (OASI) with a lower income cap, which allows for lower payment levels to wealthier retirees without making bend points more progressive.
- A VAT-like Net Business Receipts Tax (NBRT), which is essentially a subtraction VAT with additional tax expenditures for family support, health care and the private delivery of governmental services, to fund entitlement spending and replace income tax filing for most people (including people who file without paying), the corporate income tax, business tax filing through individual income taxes and the employer contribution to OASI, all payroll taxes for hospital insurance, disability insurance, unemployment insurance and survivors under age 60.

To a large extent, our comments will mirror those of two weeks ago on how tax reform affects the ability of young people to realize the American Dream, since it is largely through education that this occurs.

Our proposal shifts education tax incentives from individuals to employers and from the personal income tax to a VAT-like Net Business Receipts Tax that every employer of a certain size pays, with some firms who now employee consultants adding them as statute employees. The NBRT would both fund public collegiate and vocational education and allow offsets for providing tuition assistance to employees for pursuing education after grade 14 (until that point, education would be free).

We propose that tuition assistance take two forms – the creditable portion which need not be paid back and a loan portion that would be paid back with a service requirement, with the federal government offering student loans only when the employment situation does not work out or the degree is not completed. Involving employers more closely after grade 14 allows for the negotiation of volume discounts – which is a hallmark of the success of such programs as the H-1B Technical Skills Training Grant and the more recent community college initiative. Such employers might also provide housing or pay housing and living expenses through some kind of stipend.

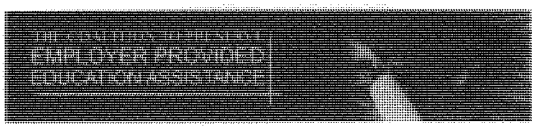
Our proposals go beyond incentives for higher education to other tax incentives to help people obtain adult education, either through employers or through an employer-based tax payment or charitable contribution in lieu of taxes.

Some young people have learning deficits. We propose that instead of placing them in job training right away, we first pay them to achieve literacy at the tenth grade level, with either vocational or college prep/community college after that. In all such cases, students who have families or are living outside the home should be paid a minimum wage for their study time, with the wage funded either by an employee-sponsor or directly by the taxpayer through the training provider, with the funding coming from the NBRT. This training can be arranged either by local government, a local public or private school system or by employers directly as an offset to the NBRT levy. This would replace Temporary Aid to Needy Families. Program providers would also receive a subsidy for providing insurance to participants through the policy under which their employees are covered, replacing Medicaid for needy families.

The other problem that young families face is low wages. While there are certainly tax credits that make having children more affordable, they are not adequate to meet expenses. We propose increasing the Child Tax Credit to $6000 per year (federal share) and making it refundable. This would consolidate assistance now provided by the current CTC, the Earned Income Tax Credit, the exemption for children, the Supplemental Nutrition Assistance Program, the Mortgage Interest Deduction, and the Property Tax Deduction.

Note again that this proposal will likely result in a higher birthrate, as well as lower wages for non-parents or for parents whose children have moved away. As such, this provision will also decrease the use of both abortion and contraception. If support for it is not considered an essential vote for scoring the by National Right to Life Committee, then that scoring is hopelessly partisan, as this particular proposal will prevent more abortions than any criminal sanction ever would (the Guttmacher Institute estimates that 72% of abortions are for economic reasons, including the financial well-being of teen parents).

Thank you for the opportunity to address the committee. We are, of course, available for direct testimony or to answer questions by members and staff.



The United States Senate

Committee on Finance

Education Tax Incentives and Tax Reform Hearing

Wednesday, July 25, 2012

Statement for the Record

The Coalition to Preserve Employer Provided Education Assistance

1800 Duke Street

Alexandria, Virginia 22314

(703) 535-6061

The Coalition to Preserve Employer Provided Education Assistance is a broad-based group of organizations, companies and associations dedicated to ensuring the tax protection of employees who wish to take advantage of an employer's tuition assistance program. Coalition leadership is comprised of the National Association of Independent Colleges and Universities, Society for Human Resource Management, American Council on Education, National Association of Independent Schools, University of Michigan, Harvard University, College and University Professional Association for Human Resources, National Association of Manufacturers, American Federation of Teachers, United Auto Workers and the National Association of College and University Business Officers.

Providing tax-free educational assistance is an important tool employers use to attract the best available employees and build a skilled workforce. Additionally, this benefit enables employees to continue their education, advance within their positions and obtain new knowledge to ensure their competitiveness in the workplace.

As you may know, Section 127 of the Internal Revenue Code allows an employee to exclude from income up to $5,250 per year in assistance provided by their employer for any type of educational course at the associate, undergraduate and graduate level. Employers are not required to provide assistance under Section 127 to their employees. However, if an employer chooses to do so, the benefit must be offered to all employees on a nondiscriminatory basis that does not favor highly compensated employees. Congress has extended Section 127 nine times since it was created in 1978, most recently in 2010. Section 127 will expire at the end of this year unless Congress acts to renew it or make it permanent.

Section 127 of the IRC was enacted first as part of the Revenue Act of 1978. Prior to 1978, only educational assistance provided by an employer to an employee that related to the individual's job was excluded from an employee's gross taxable income. The "job-related" test contained in Internal Revenue Regulation 1.162-5 was confusing and resulted in both the Internal Revenue Service and the courts making arbitrary decisions as to what types of employer-provided educational assistance successfully met the test of job relatedness. Additionally, most entry-level employees were unable to claim an exemption for an educational expense because their job descriptions and responsibilities were not broad enough to meet the test. In effect, only highly skilled individuals were able to use job-related educational assistance.

The 1978 effort to enact legislation to cover employer-provided educational assistance was led by Representatives Guy Vander Jagt (R-MI) and Frank Guarini (D-NJ) and received wide bipartisan support. The sponsors of the legislation believed that enactment of the provision would help to meet three goals: (1) clarify the tax treatment of employer-provided non-job-related educational assistance and job-related educational assistance; (2) reduce the inequity among taxpayers; and (3) provide less-educated and skilled employees with opportunities for upward mobility and advancement through employer-provided educational assistance. Since the 1978 enactment, supporters of Section 127 inside and outside of Congress believe the provision continues to meet the goals expressed by the original supporters of the legislation.

Over the past few years, there have been several failed attempts to make Section 127 benefits permanent. Instead, the provision is continually extended, most recently in the "Tax Relief,

Unemployment Insurance Reauthorization, and Job Creation Act of 2010." The approach of extending the tax treatment of this provision on a temporary basis causes confusion for both employers and their employees who are trying to take advantage of the benefit. Individual recipients of Section 127 benefits -- as well as employers -- encounter the tax implication of this uncertainty every year as they wonder whether Congress once again will temporarily extend Section 127 or make it permanent. Consequently, many employees who would like to continue their education through Section 127 benefits curtail or terminate their education. When Section 127 expires, employers still may offer educational assistance but must include the dollar value of the benefit in the individual's compensation, which makes it subject to federal and state income tax withholding as well as Social Security and Medicare Hospital Insurance taxes. As a result of the inclusion of the benefits in their compensation, many employees must terminate their continuing educational pursuits because of tax liability.

Attempts to extend or make permanent any tax reductions will be difficult in the current political environment due to concerns about the rising federal deficit. Providing tax-free educational assistance is an important tool for employers. Section 127 helps to build and maintain an increasingly skilled workforce, and positions the United States to remain competitive in the global economy. Almost 20 percent of Section 127 recipients are pursuing science, technology, engineering and mathematics (STEM) degrees. More than 35 percent of all degrees pursued by Section 127 beneficiaries are master's degrees and, according to the National Postsecondary Student Aid study of the most recent data, use of Section 127 benefits has doubled since 1994. Today, more than 1 million employees use Section 127 benefits.

Employers use Section 127 as a tool to attract and retain their employees. It also allows employers to prepare their workforces to be responsive to an ever-changing, evolving workplace. By utilizing Section 127, employers are able to train their employees in a variety of disciplines which provides job security and versatility for their workers. Likewise, it enables employees to advance their education, increase their earning potential and, ultimately to contribute to a competitive, adaptive U.S. workforce.

Employers have demonstrated their commitment to providing education assistance to their employees. According to the Society for Human Resource Management (SHRM), 61% offer undergraduate assistance to their employees, up from 58% in 2011. In a joint report by the National Association of Independent Colleges and Universities and SHRM, using data from the National Postsecondary Student Aid Study (NPSAS:08), individuals who took advantage of the benefit were evenly distributed across ages, with the exception of employees who were 44 or old – who took advantage of the benefit at a higher rate. The same survey also informed us that employers' contributions to education assistance were generally over $2,500.

As demonstrated over the past 34 years, Section 127 has met and exceeded Congressional intent. By reducing administrative inequities arising from what is considered "job-related" education, eliminating the confusion created by overlapping provisions in the tax code, and finally by giving employees the opportunity to advance themselves within their careers, this provision has provided millions with a unique opportunity and benefit.

With the current economy in a recession, a benefit such as Section 127 provides the workforce with the opportunity for advancement and development within their careers. Likewise, employers can utilize Section 127 to increase employee recruitment, loyalty, and retention, increasing their global competitiveness and strengthening the skill sets of their workforce. Section 127 is a critical provision that develops and enhances the U.S. workforce and economy and cannot be overlooked. Section 127 is an efficient and cost-effective provision that deserves to be made a permanent part of the tax code.

Statement for the Record
College Savings Foundation
2111Wilson Blvd. Suite 700
Arlington, VA 22201
before the
Committee on Finance
The United States Senate
July 25, 2012

Education Tax Incentives and Tax Reform

Chairman Baucus, Ranking Member Hatch, and Members of the Committee:

The College Savings Foundation ("CSF") appreciates the opportunity to provide comments for the record regarding the important role of Federal education savings incentives in helping Americans meet their higher education costs. CSF is a not-for-profit organization with the mission of helping American families achieve their education savings goals. CSF members include States, program managers, investment managers, and organizations providing services to 529 plans, including legal, accounting, and general consulting firms. The primary focus of CSF is building public awareness of, and providing public policy support for, 529 college savings plans.

A post-secondary education is often critical to helping Americans reach their full personal and professional potential, and research shows that college degrees produce greater financial success. Simply put, higher education leads to higher earnings.[1] Financing a child's college education can be the chief economic goal of an entire extended family, but the costs of a college education can be daunting. Too often, families take on the cost of college through "pay-as-you-go" financing and "pay-after-you-go" loans. Section 529 college savings plans offer a third option -- an opportunity to save in advance. By saving before a child reaches college age, families can help ensure that adequate funds will be there to allow their children to attend college. Moreover, research shows that students with college savings are more likely to attend college than students without any college savings.[2]

Section 529 college savings plans have been a very successful tool in helping families save for college. Generally, under the Federal income tax rules, individuals can make after-tax

[1] Sandy Baum et al., *Education Pays 2010: The Benefits of Higher Education for Individuals and Society*, CollegeBoard Advocacy & Policy Center *available at* http://trends.collegeboard.org/education_pays.

[2] William Elliott & Sondra Beverly, *The Role of Savings and Wealth in Reducing "Wilt" Between Expectations and College Attendance*, 17 JOURNAL OF CHILDREN & POVERTY 165 (2011), *available at* http://csd.wustl.edu/Publications/Documents/WP10-01.pdf.

contributions into 529 plans, have the earnings grow tax-free, and receive tax-favored distributions for amounts used for qualified higher education expenses.

American families are sending a message that 529s are a successful savings vehicle as demonstrated in CSF's most recent quarterly data report. Representing nearly 70 percent of the 529 marketplace, the CSF data was analyzed by the Financial Research Corporation (FRC). The findings are encouraging -- even in these difficult economic times, people are saving and using 529s. During the first quarter of 2012, CSF members reported $3.4 billion in new contributions -- or new money being invested in 529 college savings plans -- representing a 7.2 percent increase from $3.1 billion in the fourth quarter of 2011. Overall, 529 college savings plan assets climbed to $158.3 billion in the first quarter of 2012, reflecting a 9.6 percent increase from $144.4 billion in the fourth quarter of 2011. The growing utilization of these plans demonstrates that they are an important means to assist families in addressing the escalating costs of educating their children.

With the growing popularity of 529 plans, there must be a continued commitment to encourage savings by all families -- including those of modest income. Section 529 plans in every State have a clear focus or mandate to (1) educate all families on the importance of higher education and ways to finance those goals, (2) encourage and assist low- and moderate-income families to aspire to higher education for all family members, and (3) provide programs that are available to a broad segment of the population, including low- and moderate-income families and individuals, to help them prepare and save for college.

Some of the many ways in which State 529 plans help to make college more accessible and affordable for all families include: (1) low minimum balance requirements for 529 accounts, (2) low monthly contribution minimums, (3) access to mutual fund options that otherwise would require contributions in the thousands of dollars, (4) low fee options through direct-sold programs with no sales commissions or loads, (5) a range of conservative and/or nearly-guaranteed investment and savings options (including FDIC-insured bank accounts, Guaranteed Investment Contracts ("GICs"), money market funds, and Treasury inflation-protected options), and (6) State benefits, including in many States income tax credits or deductions and creditor protection for 529 accounts.

Several State 529 plans provide scholarship and matching grant programs targeted at various populations, including low- and moderate-income families. A number of 529 plans also are involved in financial aid programs such as providing assistance to State partners in conjunction with the federal GEAR UP ("Gaining Early Awareness and Readiness for Undergraduate Programs"). GEAR UP uses Federal and State funds to create scholarship accounts for low-income children for post-secondary education.

Many of the scholarship and matching grant programs are still relatively new and developing, and while it takes time to truly assess the full effectiveness of these efforts, the commitment of 529 plans to make a difference and help low- and moderate-income families is certain. Everyone involved with 529 plans understands the tremendous potential of these programs to help children, parents, young adults, and others believe that a college education is possible and financially achievable.

Another significant component of all 529 plans is a variety of outreach programs created and administered by the States -- alone or in conjunction with public and private partners. All of these efforts are targeted to that broad segment of the population 529 plans attempt to reach -- including low- and moderate-income families. A small sampling of typical activities of 529 plans include the following: (1) outreach in public schools, K-12, including work with school administrators, parents, and parent-teacher organizations, (2) public service radio and television segments, (3) inserts regarding 529 plans with DMV notices, with birth certificates, with State income tax mailings, and in conjunction with other public-sector communications, (4) collaborations and partnerships with State councils on higher education, colleges and universities, financial aid offices, and educational foundations counseling at-risk students about higher educational opportunities and financing options, (5) partnerships with employers, both public and private, to provide seminars on saving for college, (6) financial literacy outreach and seminars, (7) creative use of websites to provide financial literacy information, college savings calculators, financial aid information, and other pertinent information, and (8) outreach at State and county fairs, children's expos, sporting events, and other kinds of fairs and festivals.

CSF appreciates the interest of the Finance Committee in exploring the use of the tax code to encourage savings for education. While section 529 college savings plans have already helped millions of American families be better prepared for the expense of educating their children and less dependent on crushing debt, CSF continues to examine ways to make 529 plans even more effective. CSF has endorsed several federal legislative proposals that would enhance the ability of families to better use 529 college savings plans to help meet their education savings goals. These include:

- Allowing the Saver's Credit for contributions to 529 plans. This proposal would provide incentives for low- and moderate-income taxpayers to save for higher education by making 529 contributions eligible for up to a $1,000 tax credit. The Saver's Credit currently is available only for contributions to retirement savings programs such as IRAs and 401(k)s.
- Clarifying that computers are a qualified higher education expense. Computers are a necessary educational tool, and there should be no question that college students should be able to use 529 funds for their purchase.
- Allowing increased flexibility in making investment changes. Permitting States to modify their 529 plans to allow more than one change in a 529 plan's investments per calendar year would provide 529 plan owners the flexibility to better protect the principal

in their plans during times of extreme market volatility. Additionally, the sense that 529 plan investments are "locked in" could even discourage some families from beginning to save for college.

There is no greater investment this country can make than in educating its citizens. Throughout America's history, education has been the gateway to financial prosperity. Today, in the face of a challenging economy, affordable higher education is more important than ever, and section 529 college savings plans are a critical piece in a family's overall college financing strategy. Every dollar saved in advance significantly reduces the cost of college, and every dollar saved is one less that a family must borrow. The College Savings Foundation looks forward to working with the Finance Committee to help ensure that these important college savings vehicles remain viable and available to all American families.

Statement
Submitted for the Record
by
The College Savings Plans Network
for the Hearing Held July 25, 2012 by the Senate Committee on Finance
Entitled "Education Tax Incentives and Tax Reform"

August 8, 2012

Mr. Chairman, Ranking Member and Members of the Committee:

The College Savings Plans Network (CSPN), an affiliate of the National Association of State Treasurers, appreciates this opportunity to submit for the record our comments to supplement the testimony provided to the Senate Committee on Finance (the Committee) at its hearing on July 25, 2012 on *Education Tax Incentives and Tax Reform.* CSPN represents state entities and officials which create and administer Section 529 college savings plans (529 Plans) with the goal of helping make higher education more accessible and affordable for all families and individuals. At the end of 2011, 529 Plans had more than 10.7 million accounts and over $164 billion in assets invested by Americans across the country to help prepare to meet the challenge of funding current and future higher education costs.

In 2009, the U. S. Department of the Treasury (Treasury) researched and wrote a report in response to a request from the White House Task Force on Middle Class Working Families on "Financing the Dream: Securing College Affordability for the Middle Class." That report, *An Analysis of Section 529 College Savings and Prepaid Tuition Plans,* issued on September 9, 2009 (the Report), found that "Section 529 plans are an attractive and convenient means of saving for college." The Report also noted it could be argued that "the most effective way to help low income families with college expenses is through direct student aid, and that Section 529 plans are therefore naturally targeted to higher income families." The Report then focused on recommendations to make Section 529 Plans more accessible, effective and reliable for the middle class. We note that, as in most instances in which participation in 529 Plans is discussed, that term "higher income families" is not defined but used more to differentiate from participation by low income families.

We take the time at the beginning of these comments to highlight the findings of the Report because so much attention in discussions about the effectiveness of 529 Plans centers on who benefits from participation in 529 Plans. CSPN believes that 529 Plans encourage and assist a broad cross-section of people from all levels of household income to plan and save for post-secondary education, with the greatest benefit recognized by that large segment of the population in the so-called "middle class" or with moderate incomes. In short, 529 Plans are available to assist those who are not likely to qualify for large amounts of need-based aid (except loan packages) but who also are not able to pay for the ever rising cost of higher education out of current income or resources. The vast majority of parents and students today need a long term plan to cover the cost of higher education and 529 Plans provide incentives to save for those post-secondary goals.

Families and individuals with low or low-moderate income households, however, are certainly not ignored or forgotten by 529 Plans. Quite to the contrary, as described in greater detail below and in the Appendix to this comment, 529 Plans and the states that sponsor them, are dedicated to outreach and education to all families of all socio-economic levels about the importance of higher education, about the importance of financial literacy generally, and about the need to plan and save to meet those higher education goals.

The vast majority of 529 Plans provide very low cost, low initial contribution options in their plans, to encourage everyone to save. For many plans, the initial required contribution is as low as $15 to $25, with no monthly minimums or service charges. What distinguishes 529 Plans is the variety of options provided to families and individuals saving for higher education. Depending on the individual's income and ability to contribute, their risk tolerance and their college savings time horizon, the best investment or savings options will vary. 529 Plans offer investment options that suit nearly every family by providing a range of affordable, quality investment options for those desiring to save for higher education and providing complete and accurate information and education about those options to allow individuals to choose the 529 plan(s) and investment option(s) best suited to their individual needs, savings time horizon and risk tolerance. An example of this is seen in the large number of low-cost, index fund options, the number of low-cost FDIC-insured bank CD and savings account options and the other low-risk investment options such as stable value funds and money market funds.

The July 25 hearing in the Senate Committee on Finance and other previous hearings on education have well documented the growing challenges to families and individuals seeking to pay for higher education. In the context of tax reform, as Congress considers how to structure tax incentives for education in the most appropriate ways, maintaining and enhancing savings incentives for education should be a significant policy pursuit. One dollar of tax expenditure put toward encouraging savings for education when a child is very young has the potential to return perhaps three times that amount when the child is attending college, through the power of compounded growth. That multiplier effect of education savings in 529 Plans is a powerful policy basis on which to build in tax reform. Funds saved for higher education that are invested in certain investment options offered by 529 Plans are one of the only ways families have the potential to keep pace with the high rate of growth for higher education. That unique aspect of 529 Plans is an important policy factor to consider in the context of how to best structure education incentives in tax reform.

Families have recognized the power of saving for college using 529 Plans as well. Even during the challenges to the economy in recent years and the volatility of investment markets, 529 Plans have experienced significant growth. College savings plans started several decades ago as state-sponsored prepaid tuition programs created to assist families with the then-rising cost of higher education. With the passage of Section 529 in 1996, the opportunities in 529 Plans expanded, as Congress recognized the desirability of encouraging saving generally and of providing tax incentives to encourage families to tackle early the challenges of paying for higher education. The advent of savings programs allowed more states to offer 529 Plans and to broaden the reach of their programs. And families have accepted the challenge and committed to planning and saving. In just ten years – and even with the impact of the recession in 2008 and 2009 – investments in 529 Plans have grown from $8.3 billion in 2001 to over $164 billion at the end of 2011. And this growth has come slowly and steadily, by and large, from modest contributions by millions of people. The average value of a 529 account has grown in recent years but remains at a modest $15,349. This figure includes all open 529 accounts, and so reflects both new accounts that are just beginning the process of accumulating savings as well as those accounts which are currently being used to pay for higher education costs. But the relatively low average balance also reflects that the primary owners of 529 accounts are those families in middle America who are willing to sacrifice every month, or as often as they can, to save for their future dreams. The most recent data compiled by CSPN shows that approximately 39% of 529 accounts receive monthly electronic contributions or payroll deduction. The average amount of that monthly contribution is $148.

529 Plan administrators understand the link between their programs and the aspirations of millions of Americans, and they recognize the importance of just getting started by opening a college savings account. A recent study indicates that students with even nominal amounts of savings dedicated to their college education results in a greatly increased likelihood that students will complete high school, attend college, and obtain a degree. The study concluded that "family income, household net worth, and

parent savings for youth are not significant predictors of college attendance for youth who expect to graduate from college," but instead found that "whether or not youth have accounts and whether or not they have savings set aside for school are important predictors" in college attendance.[i] It would appear that the message that college is accessible and possible has tremendous resonance with parents and students. Even with recent discussions about whether college is still worth the cost, there is little disagreement that a college education – or some post-secondary training – is an important factor in future success and employment. The challenge is in how to make that a reality for everyone at a time when costs are rising and, to some, a college education may seem out of reach. State-sponsored 529 Plans are at the forefront of trying to find solutions to that problem.

Just a small sampling of the outreach programs, scholarship programs and matching grant programs conducted by 529 Plans across the country provides insight into the steps being taken by 529 Plans to assist low and moderate income families. 529 Plans meet with individuals and families at employer benefits fairs, State Fairs, Kids' Expos, science museums and zoos – anywhere significant numbers of families gather – to talk about the importance of higher education and the benefits of 529 programs. In addition, 529 Plans across the country work closely with their institutions of higher education to search for ways to make college more accessible and affordable to all citizens. Twenty-three 529 Plans offer one or more matching grant programs, in which the 529 Plan will match 529 account contributions by individuals meeting certain criteria (generally some moderate income threshold) up to a designated amount. Another fourteen 529 Plans provide a variety of scholarship programs, also aimed at low and moderate income families, to encourage college attainment. Many 529 Plans are involved in financial literacy programs in their states, working either alone or with national organizations like the Federal Reserve Banks, YMCA, Junior Achievement and their Departments of Education to provide the important personal finance and economics education needed to be successful. These programs are aimed at both parents and students, in recognition that planning and preparing for higher education is a joint effort and that parents and students need to understand why post-secondary education is important and strategies for reaching those goals. Finally, a number of 529 Plans administer or partner with their states' GEAR UP (Gaining Early Awareness and Readiness for Undergraduate) program, a federally created program providing federal funding and state matching funds to assist low-income students. This program will be instrumental in evaluating the effectiveness of dedicated college savings on college attainment in coming years as part of a study initiated by the U.S. Department of Education and 529 Plans will be participating in that study. All of these efforts have the goal of increasing awareness of and participation in 529 Plans across a broad segment of the population. Specific examples from around the country of 529 Plan outreach efforts, scholarship and grant programs and other educational programs are included in the attached Appendix.

529 programs across the country provide every American with access to a wide range of affordable, quality, professionally managed investment options offered by some of the best, most highly regarded institutional asset managers in the country. In addition, the plans offer access to these quality investments at a minimum contribution that is substantially lower than the minimum required to invest in many of these same investments outside of a 529 plan. The opportunity to invest in 529 Plans is not only a valuable service to our citizens but it is an important part of enhancing the lives of our participants by assisting in making their higher education dreams a reality. 529 Plans already have made a positive impact on the lives of millions of Americans currently participating in 529 programs, and they have the potential to do so much more. Every program in the country is committed to continually improving programs and outreach efforts and financial literacy initiatives and programs aimed at low and moderate income families. In addition, 529 Plans also encourage efforts to streamline and simplify the education tax incentives, including those provided by Section 529, and look forward to working with Congress in the coming months on ways to accomplish that goal. State-sponsored 529 Plans have accomplished a great deal in a relatively short period of time to assist families in meeting their higher education goals and we realize that much remains to be done. With increased awareness of 529 Plans and their advantages,

along with the education efforts of 529 Plans in financial literacy and about the importance of higher education, 529 Plans look forward to remaining an important part of the solution to increase college attainment by Americans in the coming years.

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[i] Elliott, W. and Beverly, S. (2011). The role of savings and wealth in reducing "wilt" between expectations and college attendance. *Journal of Children & Poverty*, 17(2), 165-185.

APPENDIX

Examples of 529 Plan Outreach and Education Programs by State

ALABAMA

Will be launching a statewide scholarship program in Fall 2012 for students based on need.

ARIZONA

The Arizona 529 Plan engages in the following outreach activities: (i) built a partnership with Valley of the Sun and the Tucson YMCAs to distribute college savings planners throughout the month of October; (ii) promoted its 529 Plan through a coloring contest in *Bear Essential New* with the contest distributed to over 400 elementary and middle schools statewide and the $250 first place scholarship sponsored by the College Savings Bank; (iii) promoted its 529 plan in Arizona College and Career Guide publication and website; (iv) held a promotion on Arizona College Goal Sunday website; (v) created a college savings planner describing the Plan and its benefits; (vi) promotes the 529 plan on the Arizona Department of Education website, which receives 340,000 visits every 2 weeks; (vii) offers promotional brochures in Spanish; and (viii) incorporated information on the Arizona 529 Plan into the "Rapid Guide to Financial Aid" publication, which is distributed to state-wide college access programs and Title I schools.

CONNECTICUT

The Connecticut Higher Education Trust ("CHET") is committed to making the program more accessible to low and moderate income families by providing low fees and low minimum initial and continuing contributions, as well as making sure that the program manager aggressively markets CHET in these communities. CHET also engages in the following outreach and educational efforts: (i) gives away school supplies each summer to underserved children as part of its annual Book Bag Donation to help families get ready for the new school year by providing notebooks, pencils, markers, a string bag and other materials, to get kids off to a good school-year start and in 2011 CHET partnered with the Department of Children and Families (DCF) to distribute 1,529 book bags to the various DCF locations across the state; (ii) runs an annual drawing and essay competition, "Dream Big!" where children grades K-5 tell what they want to be, or how they want to change the world after college, the competition is open to all students, with an emphasis on creating awareness and driving participation among Connecticut's underserved school districts and larger cities and towns, the competition awards a $300 contribution to a CHET account, for 96 students equally dispersed across all Eight CT Counties, and the competition culminates with an awards ceremony at Rentschler Field in East Hartford, CT, where the winners receive a certificate and get their pictures taken for their local paper; (iii) 'adopted' an after-school program in Waterbury, providing a $5,000 donation to allow the organization to hire a grant writer to apply for sustaining funds to support their program and CHET has donated a year's subscription to TestPrepFun.com, an online learning tool to help kids develop skills that will help them succeed on the Connecticut Mastery Test (CMT); (iv) sponsors three minor baseball leagues – the Connecticut Tigers, the Bridgeport Bluefish and the New Britain Rockcats and provides game tickets to various local non-profit organizations whose main focus is to provide services to low-to moderate-income families; (v) runs a parent workshop series with Arte, Inc., as part of the SLATE program (Socialization & Learning Adventures through Exposure) and the SLATE program providing underserved inner city students with skills and opportunities to help them succeed in school and life with the parental component provides workshops such as personal finance and college savings and planning for parents and guardians; (vi) started a new program in 2012, the School Supply Program, to provide "Friday Folders," Kindergarten orientation kits and other school supplies to every elementary school across Connecticut to help defray the cost of school supplies for teachers and families; (vii) has a Hispanic Consultant in place to ensure that CHET is effectively reaching the Latino community and has translated all of the educational

materials, enrollment book, Disclosure Booklet and account forms into Spanish so that Spanish-speaking individuals can read, understand and interact with CHET in the language they prefer; and (viii) has a full-time bi-lingual Field Consultant on staff to reach out to the Hispanic community, give presentations and workshops in both English and Spanish, and to meet one-on-one with Spanish speaking individuals regarding CHET.

INDIANA

Indiana Education Savings Authority ("IESA") engages in the following outreach activities: (i) partners with the Community Action of Greater Indianapolis "Money Management" Financial Literacy camps and through this partnership, both students and parents learn financial skills and the importance of saving, including saving for college; (ii) promotes its "Little By Little" program, teaching families that saving, even a little at a time, adds up by visiting various kindergarten and elementary school events and distributing its "Little By Little" storybook teaching children about the importance of savings, through various languages and storylines; (iii) promotes the "Save, Share, Spend" lesson, by distributing CollegeChoice branded banks that have three sections, for saving, sharing, and spending; (iv) visited college preparation fairs around the state, including reaching out to financial aid and guidance counselors, supplying them with our "Career Chaser" and our "College Prep Book" both are financial literacy and savings tools that help middle school and high school students begin preparing for their future education, while learning that saving and preparing now is important; (v) partners with LearnMore Indiana, a division of its Commission on Higher Education, and a number of their campaigns with a focus on planning, preparing and paying for college; (vi) partners with the Money Smart Week Indiana program designed to educate consumers about money management and generate awareness of financial education available on a wide range of topics such as saving, investing, and using credit wisely; (vii) makes it simple for employers to offer the program to employees, as an added benefit, free of charge to the employer and affordable for employees to participate; and (viii) sponsors, partners, and appears at numbers of community, civic and family friendly events throughout the entire state ranging from community center events, state and county fairs, and family focused community events to a partnership with the Boy and Girl Scouts, promoting financial literacy through a badge earning program.

LOUISIANA

Louisiana's START Saving Program has partnered with the GEAR UP Program, which works with a group of low to moderate income students, to create "Rewards for Success". This program provides an opportunity for students to earn scholarship money that in turn is deposited into a START Savings account for them. An overview of the program can be found at: http://lagearup.com /standard-initiatives-2/rewards-for-success/. Statistics regarding the scholarship disbursements are found at: http://louisianagearup.files. wordpress.com/2012/07/rfs-slide.pdf.

MAINE

The Finance Authority of Maine (FAME), administrator of the NextGen College Investing Plan® (NextGen) has engaged in the following outreach activities: (i) if either the account owner or the account beneficiary is a Maine resident, then the NextGen account is considered a "Maine Account" and may be eligible for matching or automated funding grants to help open and fund accounts; (ii) FAME continues to administer the Harold Alfond College Challenge Grant, which provides a one-time $500 grant for all Maine resident babies to open a NextGen account by the baby's first birthday with FAME hosts enrollment sessions throughout the state to educate and assist families with opening a NextGen account; (iii) the Maine Department of Labor, in partnership with FAME and others, established the Maine LiLA Program (Lifelong Learning Accounts) to help Maine workers upgrade their skills and education while meeting the demands of businesses for a skilled workforce (the Maine LiLA Program also provides free

advising services to employees to assist in education and career planning and employers match contributions to NextGen accounts to help their employees finance lifelong learning); and (iv) NextGen also provides a unique vehicle to first generation, low income students from Maine to save for college called The SAVER Program, launched July 1, 2006 in collaboration with the University of Maine at Presque Isle – TRiO Upward Bound (TRiO Upward Bound students open a NextGen account and contribute a portion of the TRiO Upward Bound stipend to their NextGen account).

MARYLAND

The following are Maryland's 529 Low and Moderate Income Initiatives for fiscal 2012: (i) attendance at BTS Nights and distribution of BTS flyers across the State including areas that have a larger population of low and moderate income families; (ii) attendance at Parent Information Nights across the State; (iii) employer payroll deduction programs with the State and County employees; (iv) attendance at African American Heritage Festival in Baltimore City, Prince George's County Fair, Charles County Fair, College Education is Within Reach – A College Fair in Spanish at University of Maryland, Financial Empower Day, Columbia International Day, Baltimore County African American Cultural Festival, Greenbelt Labor Day Festival, Enoch Pratt Children's Book Celebration, International Festival, Elijah Cummings How to Pay for College Seminar, Nativity Miguel College Fair for Baltimore City (Nativity Miguel middle schools students are in an underserved community in the inner-city), Money Power Day in Baltimore City, MD Annual Black Caucus Foundation Annual Weekend, Annual Church Compliance Conference vendor, and seven Church college fairs in Baltimore City and PG County; (v) partners with Six Flags America in Bowie, Baltimore Ravens, Maryland Cash Campaign (by distributing brochures at Cash Academy events and tax preparation events across the State), Libraries (by sponsoring summer reading programs in 8 counties across the State), the AFRO American Newspaper Character Education Essay Contest, Prince George's County Schools (by distributing a special technical flyer across student services), African American Heritage Museum (by sponsoring the Black History Month lecture series), Minor League baseball teams (by sponsoring Summer Reading Programs), and Maryland Science Center (by giving out free tickets to families with children 8 and under on a College Savings Plans of Maryland Day); and (vi) distribution of literature to PG County Children's Services, Human Services Coalition (large group of PG County group of non-profits), Libraries, Hospitals, Goodwill Industries (for distribution to new hires), and YMCA of Central MD (for distribution to all new hires and employees).

MASSACHUSETTS

The Massachusetts Educational Financing Authority ("MEFA") has produced a video which in part features low and moderate income families who have started saving for college. The video is available at: http://www.youtube.com/watch?v=_RYa5Y7pWjs&_feature=player_embedded. The following are MEFA Savings Outreach to Low- and Moderate Income Families: (i) partner on research project with Harvard University and Stanford University (The Early College Planning Initiative ECPI) examining the effects of a program that attempts to increase awareness about college savings options, simplify the process of opening an account, encourage take-up saving by contributing to the initial balance, and encourage continued savings through automatic monthly contributions (to date, 262 families have participated and 30 U.Fund accounts have been opened); (ii) works with Compass Working Capital, a nonprofit organization that helps working, low-income families save toward a first-time home, a college education, or a small business to provide education about college savings to families (to date, 148 college savings accounts have been opened with 100 of those accounts opened at workshops and 48 opened through IDA programs); (iii) assisted FUEL (Families United in Educational Leadership), an organization providing knowledge, resources, connections, and financial incentives that empower parents to propel their children into higher education, with putting together program to offer 529 plan savings option and presentations reaching families and opening college savings accounts; (iv) in partnership with Upward Bound, an organization serving high school students from low-income families and high school students from families in which neither parent holds a bachelor's degree, presented on Early College Planning and

Saving for College to parents of students in middle and high schools; (v) with assistance from ACCESS and Boston Interfaith organization staff, presented and supported workshops on savings in Spanish, Portuguese, and Haitian Creole; (vi) held workshops with graduates of the One Family Scholar program, an organization with a mission to end homeless in Massachusetts through education, to educate them about how to open college savings accounts for their own children; (vii) presented on "saving for college" and "paying for college" as well as staffed a table at The Money Conference, a free one-day event presented by The Office of Massachusetts State Treasury and the Massachusetts Financial Literacy Trust Fund, in conjunction with local cities and community partners to help households build their financial knowledge and improve their financial behavior through quality financial education; (viii) participates in post-deployment events with the National Guard and Reserve to talk with families about saving and paying for college; (ix) presented to groups of young students about planning for college in partnership with the Girl Scouts of Central and Western MA, an organization dedicated to helping girls develop qualities that will serve them all their lives, like leadership, strong values, social conscience, and conviction about their own potential and self-worth; (x) presented to students and parents at College Readiness Workshop in partnership with Southeast Asian Coalition (SEAC), an organization with the mission of helping Southeast Asians in Central MA successfully integrate into the mainstream society while maintaining their unique cultural identity; and (xi) holding seminars and webinars regularly that are open to the public.

NEVADA

The Nevada Plan engages in the following outreach and educational efforts: (i) hosted 2 Nevada Women Money Conferences in May of 2012 and included granting 200 low to moderate income women access to the conference free of charge; (ii) raised awareness and participation in the Silver State Matching Grant program, a program providing low to moderate income NV families with up to $300 per year, per child towards their SSgAUpromise529 account (127 families applied for this program in 2012, vs. the 88 families who applied in 2011); (iii) coordinated a "Financial Fitness for Life" pilot in 10 High Schools in the State of Nevada, with over 1000 students participating with a portion of the participating schools with low to moderate income families and included lessons on the importance of saving for college through a "Millionaire Facts or Fiction" game among other key lessons aimed at increasing financial literacy amongst youth and the importance of obtaining a college degree; (iv) worked with USAA 529 Program Managers to expand the existing USAA Matching Grant Distinguished Valor program to include all active Nevada Military families making less than $75,000/year; (v) worked with Putnam 529 for America Program Managers to develop a merit based matching grant program to provide matching grant money up to $1000 annually, with a $3500 lifetime maximum for beneficiaries of Putnam 529 accounts who meet merit based eligibility criteria; and (vi) conducted a '529 Day' contest with all Nevada Elementary Schools with five $529 account prizes awarded to families in May to jump start their college savings accounts.

RHODE ISLAND

The Rhode Island Plan engages in the following outreach and educational efforts: (i) Matching Grant Program with funds deposited in CollegeBoundfund® matching contribution accounts established for the benefit of income-qualifying students and their families (this program is geared toward low- and middle-income families); (ii) CollegeBoundfund Baby Program for beneficiaries of CollegeBoundfund accounts established before the child's first birthday or within one year of the child's adoption (eligible beneficiaries are awarded a $100 grant into their CollegeBoundfund account); (iii) each year under the Academic Promise Scholarship Program, RIHEAA provides grants of up to $2,500 per academic year and $10,000 for four years ($12,500 for qualifying 5 year programs) to a cohort of 100 per year (400+ over four years) of the highest achieving and neediest Rhode Island students; and (iv) WaytoGoRI.org is a college and career exploration and planning website available free of charge to all Rhode Islanders and helps students identify and build upon their aspirations, guiding them through high school planning, college planning and onto their career.

UTAH

The Utah Educational Savings Plan ("UESP") actively campaigns across Utah to promote saving for college. While UESP encourages families of all economic levels to plan and prepare for higher education expenses, many local UESP outreach efforts specifically target families with low-to-moderate incomes. To accomplish this, UESP makes the following initiatives and partners with the following community organizations that support UESP's mission: (i) backpack brochures are distributed annually to Utah's elementary schools, 42 percent of which are Title I elementary schools (reaches approximately 125,000); (ii) Fast Forward Matching Program for economically challenged Utah residents matches up to $400 annually per beneficiary (brochures are distributed through Title I schools; Utah Food Bank Services; Big Brothers Big Sisters; Junior Achievement; United Way of Salt Lake; the Utah Department of Workforce Services; and Women, Infants, and Children (WIC) offices); (iii) mails information about UESP, in conjunction with the Utah Department of Vital Statistics, to every Utah parent with a four-to-six-week-old newborn (information reaches more than 15,500 mothers under the age of 25[1]); (iv) sponsor of the Road to Success program, encouraging children from kindergarten to sixth grade to read 20 minutes a day with a parent by entering a child into a drawing to win a $50 UESP college savings certificate when he achieves specific milestones (currently, 260 of Utah's 556 elementary schools are enrolled in the program, including 46,800 students in Title I schools); (v) created and sponsors the Transition to Adult Living (TAL) Scholarship designed for qualified youth who are transitioning out of foster care and are ready to begin their post-secondary education with recipients selected based on financial need, potential for academic success, and their desire to complete a post-secondary program of study (a study[2] performed by DHS reported that only 33.8 percent of youth who left foster care between 2000 and 2006 attended post-secondary education and training programs within three years of leaving care); (vi) partnership with the Utah chapter of the American Heart Association with their program to help the Hispanic population learn about improving their quality of life, including maintaining good health and achieving a higher education; (vii) partnership with Boys & Girls Club an organization focused on serving boys and girls between ages 6–18 through initiatives that promote such topics as gender inclusion, family involvement, education achievement, career exploration, leadership development, and community service; (viii) supporting Head Start, a comprehensive child development program that provides educational, nutritional, medical, and social services to children and families living in poverty, by donating college savings certificates for fundraising activities and giving presentations about UESP Head Start's Family Advocates group; (ix) partnering with the Junior League of Salt Lake City, a charitable organization of women committed to promoting volunteerism, developing the potential of women, and improving communities through the effective action, education, and leadership of volunteers, by promoting the UESP Fast Forward Matching Program to low-income women, children, and families through the league; (x) partnering with the United Way of Salt Lake, an organization supporting a community-wide safety net to meet critical needs and working toward long-term solutions in the areas of education, income, and health, by providing information about UESP for its newsletters and links to uesp.org appear on its website; (xi) partners with Utah Community Action Partnership (UCAP), an organization advocating for, supporting, and training agencies funded by Utah's Community Service Block Grant, utilizing their collective strength to eradicate poverty, by promoting the importance of a higher education in eliminating poverty; (xii) partnering with the Utah Council on Financial and Economic Education, an organization with a mission to educate Utah residents and their children about the importance of financial literacy, by helping drive the mission of this council; (xiii) partnership with Utah Individual Development Account Network (UIDAN) with UIDAN providing a designated match ($3 for every $1 deposited) toward purchasing an approved asset (Individual Development Accounts (IDAs) are matched savings accounts that help low-income families break the cycle of poverty).

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[1] *Utah's Vital Statistics: Births and Deaths, 2010*, Office of Vital Records and Statistics, health.utah.gov/vitalrecords/pub_vs/ia10/10bx_10122011.pdf2010.
[2] *Assessing Outcomes of Youth Transitioning from Foster Care*, State of Utah, Department of Human Services, 2010.

VIRGINIA

The Virginia College Savings Plan (Virginia 529) engages in the following outreach and educational efforts: (i) SOAR Virginia® is an early commitment scholarship program created by Virginia 529 to inspire and assist high school students from low to moderate income households to reach their post-secondary education goals and to participate, eligible students, commencing with mostly 10th graders, pledge to meet program requirements with participating students receiving a range of assistance and accumulate scholarship support of up to $2,000 to apply toward their post-secondary education expenses (participating SOAR Scholars must qualify for the National School Lunch Program as certified by the participating high school) (ii) commitment to enhancing financial literacy initiatives throughout Virginia led Virginia 529 to a statewide partnership with Junior Achievement, which provides financial literacy curricula to K-12 students across Virginia (earlier this year Virginia 529 awarded a $1,000 college savings account to the winner of the Junior Achievement "Dream Job" contes)t; (iii) partnership with the Virginia Department of Education and the Virginia Bankers Association Education Foundation to develop a year-long web-based curriculum on Economics and Personal Finance to meet statutory Standards of Learning requirements and provided to all Virginia high schools without cost (56 school divisions will be offering the Economics and Personal Finance courses during the 2012-2013 school year, the course is also available online through Virtual Virginia and will initially be taught by 29 teachers throughout the state); (iv) partnership with Partnership for the Future (PFF), which affords one high school student an opportunity to experience a real life work environment during the summer and Virginia 529 conducts annual presentations to prospective PFF members about setting up college savings accounts and how benefits can best be utilized. (the selected student will be eligible to receive wages for their work, and will also receive up to $2,000 towards a VEST college savings account, to be used for future college costs with 99% of the 500+ PFF students who have participated in the program have matriculated at post-secondary educational programs); (v) partnership with the Virginia College Access Network (VCAN) to help enhance and support access to post high-school educational opportunities for students (annually, Virginia 529 presents information to 250+ members of the organization, which is then distributed across the state) (vi) partnership with the Virginia Council on Economic Education to sponsor the annual Color the Economic Concepts contest, which engages teachers and students in grades K-8 to illustrate their knowledge of economic concepts in a creative and fun way (winning posters are distributed across the state, with winning entries receiving a $100 VEST College Savings Account); (vii) each year on May 29th, Virginia 529 partners with 10+ hospitals across the state to award $529 college savings accounts to 529 day babies – those born closest to 5:29 pm at participating hospitals (additionally, this year Virginia 529 awarded ten $529 college savings accounts to others throughout the state to promote general college savings awareness); (viii) in an effort to enhance reading and writing curriculums across the Commonwealth, Virginia 529 partners with WCVE (Richmond PBS affiliate) to sponsor the annual PBS Kids GO! Writers Contest, which recognizes students in grades K-3 for original, creative stories, which are written and illustrated by the student; (ix) partnership with the Virginia Parent Teacher Association (VPTA) to increase awareness of college savings opportunities throughout the year (Virginia 529 annually makes 20+ presentations to parents and leadership groups, reaching over 5,000 families throughout the state); (x) partnership with the Science Museum of Virginia and NASA Education Specialists to develop and coordinate the Virginia 529 Kids Zone at Richmond International Raceway. Children and adults who visit Richmond's two annual NASCAR races are able to learn about the influence of science and aerodynamics on the sport of auto racing. Our premier partnership with the Science Museum extends into the museum, with our support helping to fund exhibits while underwriting educational opportunities for students; and (xi) sponsorship of Big Brothers Big Sisters Duck Race, Council of Independent Colleges of Virginia, Hampton Roads 200+ Men Scholars Academic Achievement Breakfast, Organization of Virginia Homeschoolers, Radio One's Teacher of the Week, Virginia High School League, WTVR-6 Battle of the Brains Contest.

Statement on behalf of the National Association of Home Builders

1201 15th St NW

Washington, DC 20005

Committee on Finance

Hearing on

Boosting Opportunities and Growth Through Tax Reform: Helping More Young People Achieve The American Dream

July 10, 2012

The National Association of Home Builders (NAHB) appreciates the opportunity to submit this statement on "Boosting Opportunities and Growth Through Tax Reform: Helping More Young People Achieve The American Dream."

The National Association of Home Builders is a Washington-based trade association representing more than 140,000 members involved in home building, remodeling, multifamily construction, property management, subcontracting, design, housing finance, building product manufacturing and other aspects of residential and light commercial construction. NAHB is affiliated with 800 state and local home builders associations around the country. NAHB's builder members will construct about 80 percent of the new housing units projected for this year.

Importance of Focusing on Lifecycle Impacts in Addition to Income Distribution Impacts

NAHB believes that relying solely on income distribution tables—which is the traditional measure for evaluating the distributional impact of tax changes—when making policy decisions provides only a narrow glimpse into the effects of tax reform. Changes in tax policy can also have significantly different impacts on taxpayers based on their age, which can dramatically alter economic opportunities over a taxpayer's lifetime. NAHB first raised this issue to the committee in the testimony of Dr. Robert Dietz on October 6, 2011, at a hearing focusing on the incentives for homeownership. NAHB is pleased that the committee is holding this hearing on the impact of tax reform on young people.

Homeownership is one of the primary means for young people to invest in their future. The tax code contains several provisions that facilitate homeownership by younger buyers. The importance of this deduction to younger buyers can be seen by looking at the United Kingdom. In the 1980s and 1990s, the U.K. phased out its mortgage interest deduction. Some opponents of the mortgage interest deduction cite the U.K. when calling for eliminating the deduction in the

U.S. However, the changes in the U.K. have had a dramatic impact on younger homebuyers. From 1984 to just recently, the average age of a first time homebuyer in the UK rose from 31 to 38. This is a significant delay that will have dramatic demographic impacts.

NAHB believes that any policy change that makes it harder to buy a home, or delays the purchase of the home until an older age, will have significant long-term impacts on household wealth accumulation and the makeup of the middle class as a whole. Delayed investment in homeownership may translate into lower assets at retirement or a later retirement. Despite recent price declines, equity in a home constitutes a substantial proportion of a typical American family's wealth. According to the 2007 Federal Reserve Survey of Consumer Finances, the median net worth of a homeowner is $234,600; for renters, it was $5,100.

It is also worth noting in this vein that the largest homeownership declines as a result of the Great Recession have occurred among younger homeowners. This has two causes. One, fewer households are being formed as younger individuals double up or, as a second reason, such individuals choose to live with their parents or other family. NAHB estimates that 2.1 million households have not formed for these reasons, and thereby constitute "pent-up housing demand." The Census Bureau has found similar estimates.[1]

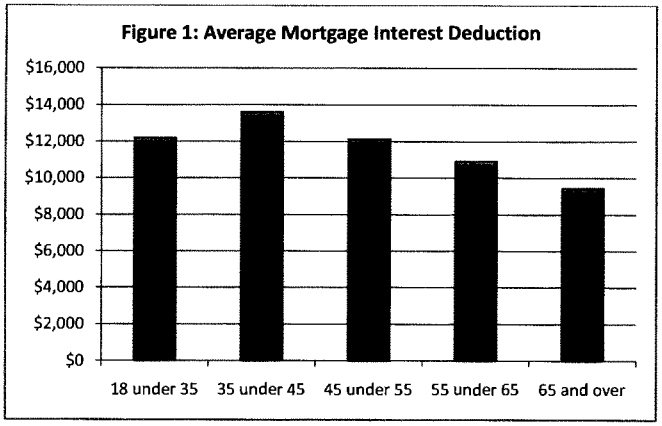
Given that the MID offers large benefits, as a share of household income, for younger homeowners, the loss of this benefit will only make homeownership less-accessible to those younger households who have been devastated by the ongoing housing crisis. Weakening the mortgage interest deduction, particularly in high cost areas (which are high cost because housing demand is high, typically because jobs are in supply), means shutting out younger, aspiring middle class Americans from homeownership, which could have far reaching social and economic outcomes. As an example, CDC fertility rate data indicate that as a result of the Great Recession, the number of births in the United States is declining, and this decline is particularly being recorded among those future middle class Americans.

Housing Tax Incentives Are Targeted To Young Americans

NAHB's research has also shown a direct correlation between the age of the homeowner and their resulting benefit from the housing tax incentives. Unlike other itemized deductions, the total benefits of housing-related deductions, such as the mortgage interest deduction, generally *decline* with age. After all, it is younger households who typically have new mortgages, less amount of equity, and growing families.

[1] http://blogs.census.gov/censusblog/2011/09/households-doubling-up.html

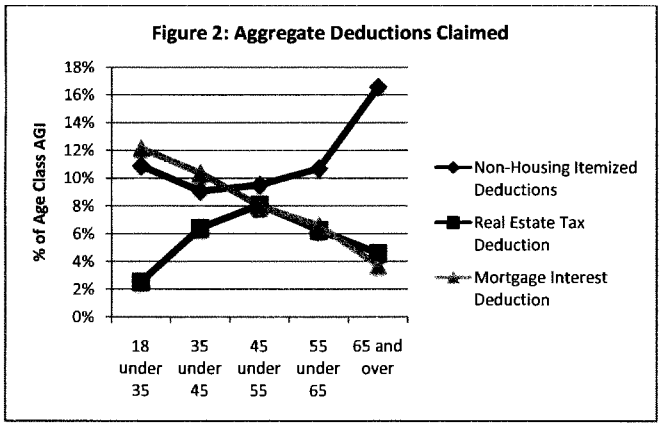
Using IRS data, NAHB examined the age characteristics of taxpayers claiming the mortgage interest deduction. Figure 1 plots the average mortgage interest deduction[2] by age cohort.



This is consistent with the deduction for mortgage interest peaking soon after the taxpayer moves from renting to homeowning and then declines as homeowners pay down their existing mortgage debt.

Figure 2 shows this data as shares of AGI. The data reveal that the mortgage interest and the real estate tax deductions fall as a share of taxpayer income for older taxpayers, while the share increases for non-housing itemized deductions.

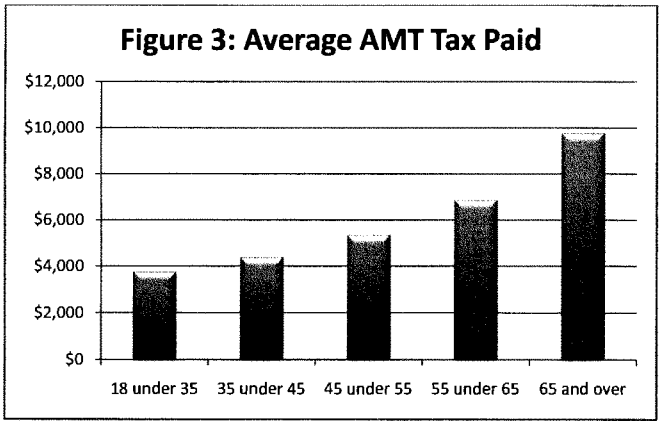
[2] This includes the deduction for home equity loans and real estate tax deductions. See Housing Tax Incentives: Age Distribution Analysis, by Robert Dietz, May, 2, 2010.
http://www.nahb.org/fileUpload_details.aspx?contentID=149284&fromGSA=1



As a share of household income, the largest benefit goes to those aged 18 to 35. Together, this data highlights the fact that the mortgage interest deduction strongly benefits younger households who tend to be recent homebuyers with less home equity.

As an example of how a change in tax policy could impact younger Americans in an unintended but negative fashion, President Bush's 2005 tax reform panel recommended limiting the real estate and mortgage interest deduction to pay for, among other items, a reduction in the AMT.

As Figure 3 shows, the average AMT tax paid increases significantly with age.



While the tax reform panel's suggestion may not have shown as a major change in an income distribution analysis, Figure 3 and the results outlined above indicate that such a proposal would reduce a tax benefit that is of relative importance to younger households in order to increase a tax benefit for older households. Generational impacts like this are often not discussed by tax policy analysts in lieu of traditional income distributional analysis, but the long-term effects are potentially significant. This is why NAHB believes that part of designing a fair tax system involves looking at the effects on both income distribution and across age groups.

Lifecyle Targeting

The current tax code contains a number of tax incentives that target taxpayers at certain points in their life, and as a result can be unfairly characterized as a "loophole" benefiting only a narrow group of taxpayers. Such arguments fail to account for the lifecycle effect of some tax provisions, especially those that target younger workers.

As an analogy, consider the following non-housing example. The 2005 IRS SOI data reveal that only 8 million taxpayers benefited from the tax code's interest deduction for student loans. This represents approximately 6 percent of all taxpayers. Nonetheless, the student loan interest deduction is, like the mortgage interest deduction, a tax preference claimed at a particular time in an individual's life, and does not represent a tax preference that benefits only a narrow set of taxpayers, despite its low number of claimants in a single year.

Opponents of the mortgage interest deduction note, for example, that only a quarter of tax filers itemize, leading some to conclude that only a small percentage of homeowners claim the MID. This is false.

The most important determinant of taxpayer itemization is homeownership. The Joint Committee on Taxation (JCT) estimates reveal that 34.6 million taxpayers claimed the MID for tax year 2009. While this number represents 22% of all tax returns, it is in fact 46% of all taxable returns and nearly 70% of itemizing returns. The more relevant numbers, however, are the shares of homeowners. There are 75 million homeowners in the U.S., so approximately half *in a given year* claim the MID. However, approximately 25 million of that 75 million own their homes free and clear of a mortgage (but likely benefited from the MID in the past). This means of the homeowners with a mortgage, 70% claim the MID.

Of those who do not, most are older homeowners in the later years of the mortgage when they are paying relatively more principal and relatively less interest. For these homeowners, the standard deduction is a better option.

Using Bureau of Economic Analysis data, NAHB estimates that over the last decade, 86% of mortgage interest paid has been claimed as a deduction on Schedule A. Taxpayers benefit from the homeownership tax deductions at specific times during their lives, and as the data above illustrated, this benefit is claimed predominately by younger taxpayers. And cumulatively, these

numbers illustrate that over the tenure of homeownership, almost all homeowners will claim the MID for years at time, particularly as first-time homebuyers paying large amounts of interest and relatively little principal.

Home Equity Deduction and Higher Education

Present tax law also permits homeowners to deduct interest allocable to up to $100,000 of home equity loan debt. Such loans are defined as mortgages taken against a home that are not used for purchase, construction or improvement purposes. This distinction carries over in the rules for the Alternative Minimum Tax. In general, deductions for mortgage interest may be claimed against AMT taxable income. However, there is an exception for home equity loans not used for home improvement purposes.

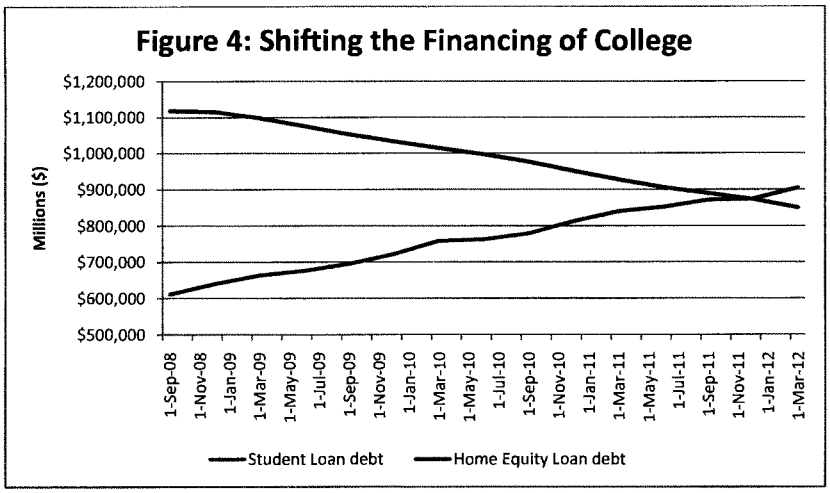
According to the 2009 American Housing Survey, half of all home equity loans are used for remodeling purposes. Remodeling is, of course, another form of housing investment which creates jobs and improves the nation's housing stock, particularly with respect to energy efficiency. Disallowing a deduction for interest for home remodeling provides a disincentive for homeowners to improve the nation's existing housing stock and hurts job creation in the remodeling industry.

There is no data that indicates what the remaining half of home equity loans are used for, but anecdotal evidence suggests that those purposes include college expenses, health emergencies and some consumption purposes.

There has been a lot of attention paid to the rising amount of student loan debt. Some of this commentary goes as far as saying that recent data indicate a bubble exists for student loans, one that will burst with negative consequences for housing and other parts of the economy.

It is true that outstanding student loan debt has risen. But the data suggest that, in part, this rise in explicit student loan debt is in fact a shift of the source of higher education financing—one related to housing itself. Namely, with the onset of the housing crisis, there was a decline in the availability of home equity loans, often used to finance higher education of children by homeowning parents or to finance other large expenditures, thus freeing resources for college expenses. Consequently, students are more likely to take out student loans on their own behalf.[3]

[3] For more details, see: http://eyeonhousing.wordpress.com/2012/06/21/student-loans-and-housing/



The data thus do not necessarily reveal a sharp increase in borrowing for college education, but rather a ***shifting in the form of borrowing***. And this is yet another consequence of the harm inflicted on the middle class as home prices fell, leading to a nearly 40% decline in median household net worth according to the 2010 Survey of Consumer Finances.

This issue is once again a reminder of the importance of housing wealth for the middle class. When that wealth declines, or otherwise becomes inaccessible (as is the case with home equity loans), it causes significant changes for the economy as a whole. The rise in student loan debt is a good example, where it seems to be the case the decline in home equity loans has resulted in some changes for how higher education is financed.

The Pew Charitable Trusts sponsored similar research indicating the critical relationship between housing market health, family wealth, and educational access.[4] The study found: "the model shows that low- and middle-income students whose families experienced increases in housing wealth just before reaching college age were more likely to attend college, more likely to attend higher-quality universities, and more likely to graduate."

This relationship between housing and education is a reminder that debt used for investment purposes – including buying a home (residential capital), obtaining an education (human capital), and starting a business (business capital) – is economically justified and should not be penalized. Debt for these purposes is how young people enter and remain in the middle class. This is a

[4] http://www.pewstates.org/research/reports/housing-wealth-and-higher-education-85899380316. Housing Wealth and Higher Education. December 1, 2011.

useful reminder given ongoing tax reform debates about the justifications of deductions for interest payments.

Conclusion

Since most homeowners benefit from the mortgage interest deduction, and most of that benefit flows to younger, middle class families, making homeownership less accessible is likely to diminish the financial success of future generations. And as owning a home is a significant means for savings for most homeowners, the capitals gains exclusion protects that investment. Without the mortgage interest deduction, NAHB believes that disparity in economic income would increase, opportunities for younger Americans to move up the economic ladder would diminish, and the middle class would continue to shrink.

NAHB supports the goal of many in Congress to reform the tax code. NAHB believes that lower rates, simplification, and a fair system will spur economic growth and increase competitiveness. And that's good for housing, because housing not only equals jobs, but jobs means more demand for housing. To foster that virtuous cycle for economic growth, we believe strongly that you must look upon the homeownership tax incentives with caution.

NAHB also renews its call to the committee, when considering tax reform, to request that the Joint Committee on Taxation look beyond the typical income distribution analysis. Specifically, NAHB believes that any tax reform proposal also examine the generational or age-cohort consequences. As the committee moves forward on tax reform, NAHB wants to be a constructive partner and help this committee with this important issue.

NATIONAL EDUCATION ASSOCIATION
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Executive Director

July 24, 2012

Committee on Finance
United States Senate
Washington, DC 20510

Dear Senator:

The National Education Association, representing more than three million educators across the country, would like to provide you with the following comments in advance of this week's hearing in the Senate Finance Committee on "Education Tax Incentives and Tax Reform." NEA calls on the Finance Committee to:

- Extend the educator tax deduction
- Provide tax incentives for new building, refurbishing, and technology upgrades in post-secondary and K-12 education, including by extending the Qualified Zone Academy Bond program
- Expand access to and affordability of higher education through expanded tax credits.

NEA strongly supports an **extension of the educator tax deduction**. This critical deduction, which expired at the end of the 2011 tax year, helps recognize the financial sacrifices made by teachers and education support professionals.

Educators often reach into their own pockets to purchase classroom supplies because they want to make sure students have what they need to succeed. Studies show that educators are spending more of their own funds each year to supply their classrooms and purchase essential items. According to NEA's most recent survey, 97 percent of educators surveyed indicated that they had spent some of their own money to meet the needs of their students -- an average of $477 a year to purchase classroom supplies such as books, pencils, paper, and art supplies.[1]

According to a 2010 report by Office Max, seven in ten teachers report their schools are not able to provide them with all the necessary tools to effectively teach their students, and 79 percent of educators say their classrooms are in need of more items that they currently lack such as essential classroom supplies, paper products, and arts and crafts supplies. The majority (82%) of teachers think it is their responsibility to ensure students have the best learning experience possible – no matter the price tag – spending their own money on supplies for their students each year. Everyday classroom supplies such as pencils and pens (78%), prizes and incentives (72%), and arts and crafts supplies (72%) top the list of purchases teachers make using their own cash. [2]

[1] National Education Association, *Status of the American Public School Teacher 2005–2006*, March 2010.
[2] OfficeMax Teacher Survey, May 2010, http://multivu.prnewswire.com/mnr/officemax/43900/

Many educators are finding the need to buy supplies for their students has increased in these difficult economic times, as funding cuts lead to shortages in essential materials and more students come to school without basic learning tools. A large majority of educators also spend canan average of $15 a month out of their own pockets to feed students. (*Status of the American Public School Teacher 2005–2006,* March 2010.)[3]

The need for these expenditures is not surprising. According to First Focus:

- 2.7 million more children lived with an unemployed parent during a typical month in 2011, compared to 2007 (an increase of 71%), bringing the 2011 total to 6.5 million children;
- 3 million (47% of those living with an unemployed parent) lived, during a typical 2011 month, with a parent unemployed six months or longer;
- 8 million more additional children relied upon SNAP for food in 2011, compared to 2007, bringing the total number of children receiving SNAP to 21 million (one in four);
- 16 million children (more than one in five) currently live in poverty[4]
- One in three working families today find that employment does not guarantee a decent living standard. Forty percent of all children – 30 million kids – grow up in such households.[5]

The educator tax deduction is a bipartisan recognition of educators' financial sacrifices as well as of the needs of students who lack even the basic necessities for success in school. Extending it will make a real difference for many educators, who often must sacrifice other personal needs in order to pay for classroom supplies and instructional materials.

NEA also supports **providing tax deductions for new building, refurbishing, and technology upgrades**. To this end, we support:

- **Extending the Qualified Zone Academy Bond (QZAB) Program**
  On average, the buildings that house our public schools are more than 40 years old.[6] The American Society of Civil Engineers gives the condition of our schools a grade of "D" and attributes the failure to upgrade them to "problems in the financial sector and declining revenues for states and local governments."[7] According to Fix America's Schools Today (FAST!), a project of the Economic Policy Institute and the 21st Century School Fund schools need an estimated $500 billion in repairs and upgrades.

  The QZAB program has proven to be an efficient and cost-effective way to help disadvantaged communities address pressing renovation and repair needs. QZABs assist school districts in rural and urban communities by providing a financing mechanism to renovate buildings and invest in equipment and technology. Investors receive a federal tax credit equal to the amount of interest payable on the bonds, thereby relieving local taxpayers and municipalities of the interest burden. A school that is awarded a QZAB may use the funds to renovate and repair buildings; invest in equipment and up-to-date technology; develop challenging curricula; or train quality teachers.

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[3] Ibid.
[4] *The Recession's Ongoing Impact on America's Children: Indicators of Children's Economic Well-Being Through 2011*, Julia Isaacs, Brookings Institution, December 2011.
[5] *Living on the Edge: America's Low-Earning Families,* Sophia Parker, The Resolution Foundation, September 2011.
[6] *National Center for Education Statistics*
[7] *Report Card for America's Infrostructure, 2009*

- **Providing Tax Incentives for Higher Education Infrastructure Investments**
  Investments in higher education infrastructure will save and create jobs in the construction and supporting industries and will help ensure postsecondary students access to the state-of-the-art learning environments so critical for the 21st Century.

NEA believes that anyone who is qualified and interested in post-secondary education should have the opportunity, regardless of ability to pay. To that end, NEA supports:

- **Expanding Existing Tax Credit Programs to Augment Access and Affordability**
  Having more college educated workers in the American workforce is crucial to growing our economy. In order to compete in the 21st century global economy, we need to give all Americans the opportunity to pursue a college degree.

  Tax credits like the American Opportunity Tax Credit (AOTC) are critical to increasing access to and affordability of higher education, particularly for lower income students. The AOTC, created as part of the American Recovery and Reinvestment Act, provides a $2500 per year tax credit for working families and students attending college. The tax credit is partially refundable, meaning it can help lower income students afford a college education that might otherwise be out of reach. The AOTC covers many of the expenses associated with sending a child to college, including textbooks and computers. Making this tax credit permanent would mean students could get up to $10,000 for four years of college.

- **Expanding Loan Forgiveness Programs for Educators**
  NEA supports expanding loan forgiveness programs for students who enter public service careers. Spiraling college costs have made it increasingly difficult for many students to afford postsecondary education. And, far too many of today's students rely on loans in order to attend college. The resulting debt burden often limits career choices and prevents many talented students from pursuing careers in public service, including as teachers.

We thank you for the opportunity to provide these comments.

Sincerely,

Kim Anderson
Director, Center for Advocacy

Mary Kusler
Director of Government Relations

REBUILD AMERICA'S SCHOOLS
A National Coalition

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1440 N Street, NW
Suite 1016
Washington, DC 20005

PHONE 202-462-5911
FAX 202-986-4569
E-MAIL
RebuildAmericasSchools@comcast.net

National Parent Teacher Association □ Council of The Great City Schools □ National Education Association
American Federation of Teachers □ American Association of School Administrators □ National School Boards Association
National Association of Elementary School Principals □ National Association of Secondary School Principals
NAACP □ National Association of Federally Impacted Schools □ American Institute of Architects
Organizations Concerned About Rural Education □ National Rural Education Association
Californians for School Facilities

Statement for the Record
U.S. Senate Committee on Finance
Hearing on
Education Tax Incentives and Tax Reform
July 25, 2012

Chairman Baucus and Members of the Finance Committee:

Rebuild America's Schools, a national coalition, is writing to express our support for the extension of the **Qualified Zone Academy Bond** (QZAB) as well as the Qualified School Construction Bond programs. QZABs enacted in the Taxpayer Relief Act of 1997 and extended with bipartisan support in subsequent Congresses allow schools districts to modernize school facilities and to improve curriculum. QZABs are a cost effective program being used by school districts in every state to renovate, repair and modernize school buildings and classrooms. School districts in Montana, Utah, West Virginia, Michigan, Arizona, Texas and every state from Maine to Florida to Alaska and Hawaii have used QZABs to modernize classrooms and schools. The federal tax credits provided to finance QZABs are a small federal investment improving America's school facilities where students can better succeed. Rebuild America Schools also supports the extension of the Qualified School Construction Bond program which has benefited local school districts in forty-nine states.

QZABs and QSCBs are helping school districts provide modern, more energy efficient schools improving the learning environment for students and enhancing the workplace for students, teachers and staff. Equally important, local jobs are generated as modern schools advance student achievement in urban, rural and suburban communities in every state.

Rebuild America's Schools asks that the Qualified Zone Academy Bonds and Qualified School Construction Bonds supporting school modernization and job creation be included among tax extension provisions considered by the Finance Committee this year.

Rebuild America's Schools appreciates the Finance Committee's consideration of these comments.

Robert P. Canavan, Chair

United States Senate
Committee on Finance
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Submission for the Record
Lidia Carneiro
Manager, Employee Scholar Program
United Technologies Corporation
4 Farm Springs Road
Farmington, CT 06034

I am writing to provide input on the critical topic of education tax incentives and tax reform from the perspective of an employer that provides education benefits for its workforce.

United Technologies Corporation (UTC) is an American company with headquarters in Hartford, Connecticut. We provide high-technology products and services to the global aerospace and building systems industries. Our diverse product offerings include heating, air-conditioning and refrigeration solutions; aerospace systems; elevators and escalators; jet engines; helicopters; and fire and security systems.

At UTC, we recognize that a highly educated workforce is critical to our future success. In today's globalized environment, employers cannot promise lifelong employment to every worker. We can, however, provide employees with meaningful opportunities to expand their skills.

UTC demonstrates its commitment to this principle by providing our workforce with an employee education program that is second to none. Through our Employee Scholar Program, UTC covers our employees' expenses for tuition, fees, and books at approved educational institutions for undergraduate, graduate, and professional degree programs regardless of whether they are related to the employee's current job. We make payments directly to schools to minimize out-of-pocket costs. We even provide paid time off for studying.

Since the creation of our Employee Scholar Program, UTC employees have earned over 33,000 degrees. This year, UTC is celebrating a

milestone of investing over $1 billion in this program. To put that level of investment into perspective, $1 billion would cover the entire cost of tuition for every first-year student in all schools in the Big East or Atlantic Coast Conferences.

The benefits received under our Employee Scholar Program can have tax consequences for our employees. In recent years, the tax policies that govern these situations have subjected participants to significant uncertainty. Moreover, the tax laws relating to employer-provided education benefits have not been updated in many years and are ripe for modernization.

To maximize the efficacy of tax policies that promote lifelong learning, Congress should ensure that the tax consequences to employees receiving education benefits from their employers are clear and certain. Tax exemptions for employee scholars, such as those provided under Section 127 of the Internal Revenue Code, should cover both undergraduate and graduate degrees. They should also be indexed for inflation and allow individuals to pursue education in subjects outside their current jobs.

The experience of our employee scholars reminds us regularly why education tax exemptions should be enacted permanently rather than on a temporary basis. Degrees take time to earn. To pursue such long-term goals, students must plan their overall commitment of resources very carefully. This is particularly true for adult students with multiple responsibilities, jobs, and families. Year-to-year uncertainty significantly harms employee scholars, who are to be commended for taking responsibility for their own futures by pursuing further education with self-discipline and sacrifice.

UTC considers itself to be in partnership with leaders in higher education and the government in supporting the transformative power of lifelong learning. As a company, we also support comprehensive tax reform to provide greater certainty, lower rates, and a competitive territorial system. We urge the Congress, as it envisions the tax policies that will shape America's long term economic future, to carefully consider the consequences to employee scholars when it addresses both extensions of current policy and longer term reforms.

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