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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 s*implify* 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

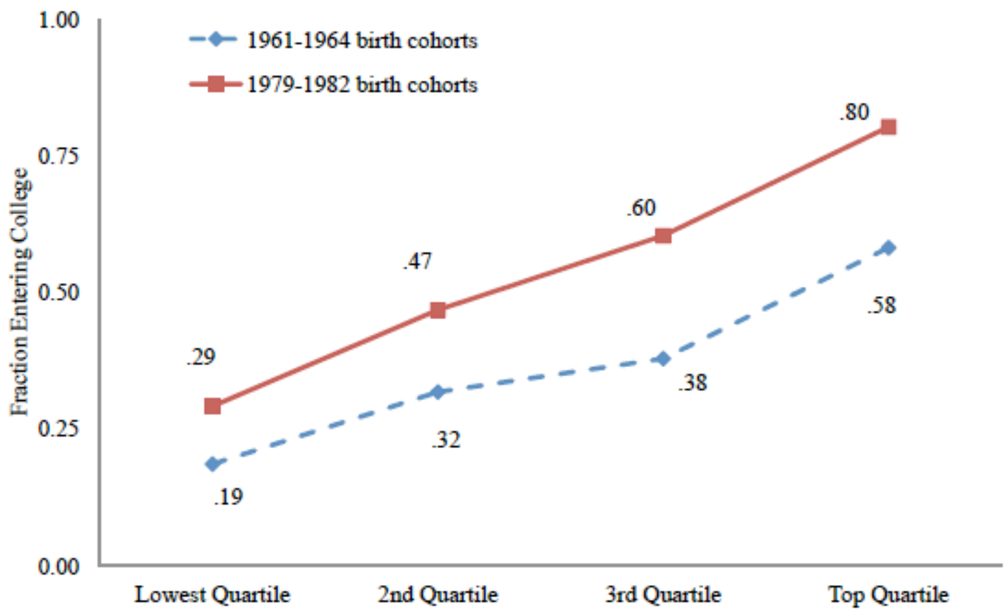
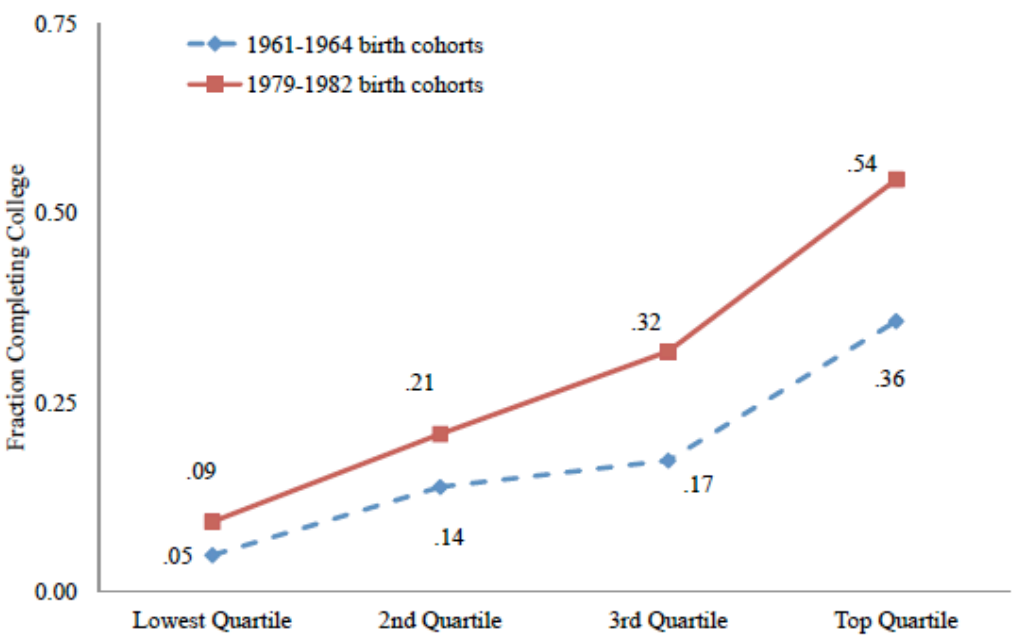


Figure 3: Fraction of Students Completing College, by Income Quartile and Year of Birth



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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.