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Tax Expenditures for Education

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TAX EXPENDITURES FOR EDUCATION

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The federal government devotes substantial resources to primary, secondary and postsecondary education through direct spending programs and tax incentives. This support helps individuals acquire the knowledge and skills required to realize good jobs and achieve secure economic outcomes. This paper analyzes tax expenditures for education by describing current tax provisions, evaluating current tax programs and by reviewing tax reform options. The reforms outlined here simplify the tax code for millions of families, while retaining important incentives for investments in education. In addition, the reforms will improve coordination between direct spending programs and the tax system, further reducing burdens on students and families who are working towards their education goals.

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I. INTRODUCTION

The federal government devotes substantial resources to primary, secondary and postsecondary education through direct spending programs and tax incentives. This support helps individuals acquire the knowledge and skills required to realize good jobs and achieve secure economic outcomes. This support also helps the overall success of the U.S. economy. A skilled and educated workforce allows the U.S. to remain competitive and to prosper in an increasingly competitive global economy.

From an economic perspective, government support for education is justified if there are failures in the education market that prevent students from choosing the socially optimal level of education. The socially optimal level of education is an amount of schooling at which one more dollar spent on education yields one dollar of benefits. The benefits include private benefits that accrue to the student and their family as well as the social benefits that accrue to others. Individuals receive large private benefits from education in the form of higher wages, greater job satisfaction, greater likelihood of employment and even better health.[2] Despite these benefits, individuals are likely to choose a level of education that is less than the socially optimal level.

One reason for choosing too little education relative to the socially optimal level is that individuals are unlikely to account for the social benefits from education. These social benefits are positive spillover effects that accrue to people other than the students or the students' families, and so are unlikely to offer the student a strong motive for acquiring more education. Positive spillovers from education include increased economic growth that benefits less educated workers, lower crime rates, greater civic participation, better political decisions as a result of a literate electorate, and higher rates of volunteerism.[3] The positive spillovers from education are likely to be largest for primary and secondary education, with smaller spillovers from postsecondary education.

A second reason that individuals may select a level of education that is lower than the socially optimal level is inadequate access to affordable credit. Credit constraints may prevent low-income individuals from achieving their desired level of education, even if their lifetime benefits from education

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[2] Card, David. 1999. "The Causal Effect of Education on Earnings," Handbook of Labor Economics, Vol. 3, p. 1801-1863. College Board. 2011. "Education Pays: Trends in Higher Education." (http://trends.collegeboard.org/education-pays). Currie, Janet and Enrico Moretti, 2003. "Mother's Education and the Intergenerational Transmission of Human Capital: Evidence from College Openings," *The Quarterly Journal of Economics*, Vol. 118, p.1495-1532.

[3] Katz, Lawrence and Claudia Goldin. 2010. The Race between Education and Technology. Moretti, Enrico. 2004. "Workers' Education, Spillovers, and Productivity: Evidence from Plant-Level Production Functions," *The American Economic Review,* Vol. 94, p.656-690. Lochner, Lance. 2004. "Education, Work, and Crime: A Human Capital Approach," *International Economic Review*, Vol. 45, p. 811-843. Milligan, Kevin, Moretti, Enrico and Phillip Oreopoulos. 2004. "Does Education Improve Citizenship? Evidence from the United States and the United Kingdom," Journal *of Public Economics*, Vol. 88, p. 1667-1695. College Board, 2011. "Education Pays: Trends in Higher Education."

exceed their costs of schooling.[4] An inability to borrow on affordable terms is likely to have the largest effect for postsecondary education because states and localities provide free primary and secondary education. Direct federal spending programs, such as Pell grants, subsidized student loans and higher education tax credits, alleviate credit constraints by lowering the cost of attending college.

Informational barriers and complexity may also prevent students from selecting the socially optimal level of education. These factors are likely to impact the level of postsecondary education because of incomplete information on student aid and complexity in the student aid application process. These frictions may cause some students to forgo federal student aid and thus select a level of education less than the socially optimal level. Research suggests that providing youths information on the costs of college and reducing transactions costs for financial aid application increases college enrollment.[5]

II. DESCRIPTION OF CURRENT TAX PROGRAMS

Tax benefits for postsecondary education take the form of credits, deductions and income exclusions. As these benefits lower tax revenue compared to a comprehensive income tax system that taxes all income and activities in the same way, they are considered tax expenditures.[6] The term tax expenditure is used to describe these tax benefits because they, or their effects, are similar to direct spending programs.

Tax expenditures are an imperfect way to provide subsidies. They tend to hide the subsidy from public view and complicate the operation of the tax system. These problems do not arise when providing a comparable subsidy through a direct spending program. Tax expenditures effectively require the IRS to monitor and administer economic and social programs, which may make it difficult for the IRS to fulfill its core mission of collecting tax revenue. This is especially true during periods, like the present, when the IRS budget is limited.

Yet, tax expenditures are often politically popular because they can be a substitute for direct spending programs with the additional benefit of providing a tax cut. In addition, using the tax system can offer some advantages compared to direct spending programs. Nearly all families file tax returns, so

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[4] Economic research is mixed on the extent to which credit constraints currently prevent low-resource individuals from attending postsecondary institutions. However, even studies that suggest credit constraints are currently non-binding note that credit constraints would likely prevent postsecondary attendance in the absence of existing federal student aid programs.

[5] See Bettinger, Eric, Terry Long, Bridget T, Oreopoulos, Phillip and Lisa Sanbonmatsu. 2012. "The Role of Application Assistance and Information in College Decisions: Results from the H&R Block FAFSA Experiment," *The Quarterly Journal of Economics*, Vol. 127, p. 1205-1242.

[6] Deductions or exclusions for expenses related to the earning of income are not tax expenditures. For example, the itemized deduction for work-related education expenses in excess of two percent of adjusted gross income is directly related to earning income, and is not included in this discussion of tax expenditures. However, most education tax provisions are not directly related to earning income.

that the burden of claiming a tax benefit may be reduced compared to a direct spending program that has an additional application.[7] Another benefit of using the tax system for subsidies is that income information is readily available so that it may be easier to restrict program access to the income-eligible population. In part because tax based programs allow for anonymity, there may be less stigma attached to taking tax benefits compared to taking direct spending benefits, resulting in higher take up.

Whatever the relative merits, many major government programs are run through the tax system, including a variety of subsidies for education. This is true even though the federal government already devotes substantial resources to education through direct spending programs. Total direct federal spending for all levels of education was over $298 billion in 2015.[8]

Tax expenditures for education can be divided into the following categories.

1. Tax benefits for current postsecondary education expenses (see Table 2A for further details).

a. Credits and Tuition Deduction.

Tax incentives for higher education include two credits and a tuition deduction. Taxpayers may claim at most one education credit or the tuition deduction per student per year. The credits and deduction are subject to income limits that are intended to target the tax reductions to lower and middle income families. Only education spending net of other tax-free education assistance, such as grants, scholarships or distributions from education savings accounts, qualifies for these tax benefits.

For many families, the American Opportunity Tax Credit (AOTC) offers the largest tax benefit among these programs. The AOTC is available for up to four tax years for students enrolled at least half-time who pursue a degree or credential. The AOTC has a maximum value of $2,500 per student per year (up to $10,000 in tax relief over four years).[9] Up to 40 percent of the otherwise allowable credit is refundable, meaning that taxpayers who do not have any income tax liability, including many low-income students, may still benefit from the credit. The AOTC replaced the similar, but less generous, Hope Tax Credit (HTC).[10]

[7] For example, many families fail to apply for federal student aid administered through the Department of Education. According to data from the Department of Education (National Postsecondary Student Aid Study, 2012) about 70 percent of enrolled undergraduate students applied for federal student aid for the 2011-12 school year.
[8] National Center for Education Statistics, Digest of Education Statistics, 2015. Table 401.10. This total includes on-budget support, off-budget support and nonfederal funds generated by federal legislation.
[9] The $2,500 maximum amount is not indexed for inflation.
[10] The Protecting Americans from Tax Hikes Act of 2015 made the AOTC permanent.

Instead of the AOTC, taxpayers may choose one of two other tax benefits for current education expenses. One option is the Lifetime Learning Tax Credit (LLTC), which is available for an unlimited number of years of education and is available to students enrolled in a post-secondary degree program or for coursework to acquire or improve job skills. The LLTC offers up to a $2,000 non-refundable tax credit per tax return. Another option available to taxpayers (through tax year 2016) in place of the tax credits is the tuition and fees deduction. Taxpayers need not itemize to claim this deduction of up to $4,000 of education spending (because it is an "above the line deduction"). Like the LLTC, the deduction is available for an unlimited number of years and applies to coursework towards a post-secondary degree or for coursework to improve job skills. Neither the tuition deduction nor the LLTC is refundable, and thus they do not provide benefits to taxpayers who do not have income tax liability.

To claim the AOTC, the LLTC, or the deduction, taxpayers must generally receive a Form 1098-T from the institution of higher learning that reports the amount of qualifying education expenses paid. In addition, taxpayers must report the employer identification number (EIN) of the institution of higher learning on the tax form when claiming certain credits (Form 8863 for the AOTC or LLTC). These reporting requirements were modified or added by legislation in 2015 to increase program compliance and to help reduce taxpayer confusion.

b. Extension of child-related benefits.

The tax code also extends child-related tax benefits to families with students. Full-time students ages 19-23 qualify for the dependent exemption. For dependent children who do not attend full time, eligibility for the dependent exemption ends at age 18. Low-income working families may also be able to claim an eligible full-time student ages 19-23 for the Earned Income Tax Credit. Eligibility for the EITC ends at age 18 for children who do not attend school full-time.[11]

c. Exclusions from income.

Current law allows taxpayers to exclude scholarships, grants, tuition reductions, and up to $5,250 of employer-provided educational assistance from income. Tuition reductions provided to employees of

[11] For more information about the benefits for qualifying children, see Ackerman, Cooper, Costello and Tong (2016) "Tax Support for Families with Children: Key Tax Benefits, their Impact on Marginal and Average Tax Rates and an Approach to Simplification 2017 Law" https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/WP-112.pdf

institutions of higher education and their spouses are also excludable from income. In addition, direct payments of tuition by a donor on behalf of a student are not subject to gift tax.

2. Tax benefits for education savings (Table 2B provides further details).

The tax code incentivizes education savings in several ways. Earnings in qualified tuition savings accounts (so called "529 plans" allowed by Internal Revenue Code section 529 and "education IRAs" allowed by section 530) are not taxed when they are used for qualified education expenses. Generally, 529 plans can be used for undergraduate and graduate expenses,[12] while 530 education accounts may be used for these expenses as well as certain expenses at the K-12 level. For both 529 plans and 530 accounts, distributions of earnings that are not used for qualifying expenses are generally subject to income tax and a 10 percent penalty.[13] Most 529 plans are administered by states and maximum allowed account balances are high. In recent years, 529 plan maximums ranged from $225,000 to $370,000. Contributions to 530 accounts are capped at $2,000 per year per beneficiary across plans and can only be made by joint filing households with less than $220,000 of AGI (or $110,000 for persons from non-joint-filing families).[14].

Besides education savings accounts, the tax code provides additional incentives for education savings. Taxpayers may take early distributions from IRA accounts without penalty if the distributions are used for education expenses.[15] Interest on savings bonds that are used for education expenses is not taxable.

3. Tax benefits for prior education expenses (see Table 2C for details).

Beyond providing tax relief for current and future education expenses, the tax code also provides tax benefits for prior education expenses. Taxpayers who meet income limits may deduct up to $2,500 of qualified student loan interest paid. In addition, the discharge of certain forms of student debt is excluded from income subject to tax.

[12] There are two types of 529 plans: pre-paid tuition plans and college savings plans. Pre-paid tuition plans allow college savers to purchase units or credits at participating colleges and universities for future tuition and, in some cases, room and board. College savings plans permit a college saver (the "account holder") to establish an account for a student (the "beneficiary") for the purpose of paying the beneficiary's eligible college expenses.

[13] If the student receives a scholarship then generally 10% penalty does not apply.

[14] The income restriction is based on modified adjusted gross income, which for most families is equal to AGI. See IRS Publication 970 for details on modified adjusted gross income.

[15] In general, early distributions from IRA accounts are subject to a 10% penalty.

4. Benefits for education institutions (Table 2D provides further details).

The tax code provides important benefits for public and non-profit education institutions. Charitable contributions by individuals may be deducted from income (by taxpayers who itemize their deductions) and contributions received by these institutions are not taxable. Public and non-profit education institutions may benefit from tax-preferred financing. Bonds that qualify for tax-free interest include private activity bonds, student loan bonds and school construction bonds. The tax code also provides tax credits for investors who hold zone academy bonds. These bonds are typically used to finance operation of primary and secondary schools in low-income areas.

Teachers at the K-12 level may deduct $250 (or $500 for a joint return with two teachers) for unreimbursed expenses for professional development expenses, for books, supplies, computer equipment, or other material used in the classroom.[16] While teachers claim the deduction, schools (and students) may benefit from the subsidy for classroom materials.

III. EVALUATION OF CURRENT TAX PROGRAMS

A. Criteria for Effective Education Tax Benefits

Policymakers should consider several criteria when evaluating education tax benefits. First, does the benefit work towards a clearly defined and justified policy goal? Second, is the benefit best delivered through the tax system? Third, is the tax benefit easy for taxpayers to use? Fourth, how does the benefit impact the progressivity of the tax code?

B. Evaluation of Current Education Tax Programs

1. Tax benefits for current postsecondary education expenses.

In tax year 2014 over 14 million families benefited from education tax credits and/or the tuition deduction. Research suggests that the introduction of education tax credits and the tuition deduction increased college enrollment, meeting an important policy goal.[17] Targeting of the tax benefits towards lower-income and middle-income families is one reason that education tax credits may increase college attendance, though the tax benefits also lower the cost of attendance for many families who would have

[16] Beginning in 2016 the $250 maximum amount is indexed to inflation.
[17] See Turner, Nicholas. 2011."The Effect of Tax-Based Aid on College Enrollment," *National Tax Journal,* Vol. 64, p. 839-861.).

sent their children to college absent the tax benefits. [18] Making these tax benefits more generous and expanding eligibility to higher income families may not have the same impact on enrollment.[19]

Although tax subsidies for education are widely used, they are complex. Complexity in program rules and complex interactions across programs may limit the effectiveness of these tax benefits.[20] As a result, many taxpayers do not select the single tax benefit that offers them the largest reduction in taxes when they are eligible for multiple programs and many taxpayers fail to claim a tax benefit when they are eligible.[21] Interactions with direct spending programs, including Pell grants, add additional complexity for many students and their families and results in some families failing to claim the full value of their total education benefit.[22]

For many families, the ability to claim a personal exemption for full-time students ages 19-23 is unlikely to impact education decisions because this benefit is relatively small for lower-income families which are more likely to have children on the margin of college attendance. In contrast, the ability to claim a dependent student for the Earned Income Tax Credit offers a relatively larger benefit for lower-income families and may increase college enrollment and persistence for lower-income youths.[23] Allowing families with dependent college students to qualify for the Earned Income Tax Credit also makes the tax code more progressive, which may be a desirable policy outcome.

By excluding employer provided education assistance, the tax code treats education expenses differently across students. An employee who realizes this benefit may receive up to $5,250 per year of tax-free education. In contrast, an employee who does not receive this benefit may have to cover

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[18] The effectiveness of the tax credits and the tuition deduction may be offset by the strategic response of institutions of higher learning. There is evidence that some colleges and universities act to capture the financial benefits of the tax credits and the tuition deduction by reducing their own financial aid for students who receive education tax benefits (Turner, Nicholas. 2012. "Who Benefits from Student Aid? The Economic Incidence of Tax-based Federal Student Aid," *Economics of Education Review,* Vol. 31, p. 463-481.).

[19] See Bulman, George and Hoxby, Caroline. 2015. "The Returns to the Federal Tax Credits for Higher Education," in Tax Policy and the Economy, Volume 29. Ed. (Brown) and Bulman, George and Hoxby, Caroline. 2015. "The Effects of the Tax Deduction for Postsecondary Tuition: Implications for Structuring Tax-Based Aid," National Bureau of Economic Research Working Paper No. 21554)

[20] Individuals are more responsive to clear incentives than to more complicated incentives (Chetty, Raj, Looney, Adam and Kory Kroft. 2009. "Salience and Taxation: Theory and Evidence," *The American Economic Review,* Vol. 99, p. 1145-1177. 2009), yet existing tax incentives are complicated, e.g., students may be eligible for multiple tax credits and the tuition deduction.

[21] Turner, Nicholas. "Why Don't Taxpayers Maximize their Tax-Based Student Aid? Salience and Inertia in Program Selection," *The B.E. Journal of Economic Analysis & Policy,* 11.1.

[22] See the "Report to Congress on Coordinating the American Opportunity Tax Credit and the Federal Pell Grant," U.S. Department of the Treasury, May 2014 for details. Available here: https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Coordinating-AOTC-2014.pdf

[23] Manoli, Day and Nicholas Turner. 2014. "Cash on Hand & College Enrollment: Evidence from Population Tax Data and Policy Nonlinearities," National Bureau of Economic Research Working Paper Number 19836.

education expenses with after tax dollars, though they may claim the LLTC. Tax efficiency and fairness suggests that the tax system should treat these two cases similarly. However, allowing a limited exclusion for employer-provided education for any purpose eliminates the need for employers to distinguish between expenses that are for the benefit of the employer and those that benefit primarily the employee, when the expenses are below $5,250. Thus, it simplifies administration of the tax code as well as potentially encouraging education spending.

2. Tax benefits for prior education expenses.

As a result of the graduated income tax rates, the deduction for student loan interest paid offers a relatively larger benefit to higher-income families than it does to lower-income families. As a result, this deduction may not be consistent with distributional objectives. Allowing taxpayers to deduct interest paid on student loans is unlikely to encourage additional schooling because it offers only modest tax relief.[24] The absence of the student loan interest deduction between 1986 and 1997 had little demonstrable effect on enrollment, persistence, degree-attainment or student loan default. In addition, the deduction comes after schooling has been completed and so may be less salient an incentive compared to benefits offered during the years of enrollment. The deduction of student loan interest also offers redundant incentives. Taxpayers with student loans already benefit from generous federal student loan programs that offer relatively low interest rates and favorable repayment options. For example, loan repayment options such as Income Based Repayment or Graduated Repayment plans may more effectively reduce the financial stress of loan repayment compared to the student loan interest deduction because most of the burden of monthly payments represents principal repayment, not interest expense.

3. Tax benefits for education savings.

Families that benefit most from education savings accounts (529 plans and 530 accounts) are relatively high-income, which has two important implications.[25] One, high income families are likely to send their children to college absent these programs, so that education savings accounts will not have a meaningful effect on college attendance. Two, these tax incentives make the tax code less progressive.

[24] In 2011, roughly 10 million families claimed the student loan interest deduction, with an average deduction of nearly $950.
[25] Analyzing data from the Survey of Consumer Finances, the U.S. Government Accounting Office found that families with college savings plans are more likely to have parents with college degrees and have greater financial assets, compared to families without college savings plans ("Higher Education: A Small Percentage of Families Save in 529 Plans. A report to the Chairman, Committee on Finance, U.S. Senate. U.S. GAO 13-64).

High income families are more likely to receive greater benefits from these tax-advantaged savings programs for several reasons. First, the financial benefit of tax-free growth in 529 plans and 530 accounts increase with the marginal tax rate, which increases with income.[26] Second, college financial aid systems reduce need-based student aid for families with financial assets, including 529 plans and 530 accounts. This reduction in aid generally does not harm higher-income students because they don't receive need-based aid. However, the reduction hurts many lower-income families who could potentially receive larger grant awards absent their college savings.[27] A third reason that wealthier families are able to benefit from these savings plans more than other families is that the contribution limits aimed to cap their benefits are ineffective. In the case of 530 accounts, wealthier families can avoid the income limitation by having lower-income family members, such as retired grandparents, make contributions. In the case of 529 plans, total contribution limits are quite high and can be avoided by opening accounts in multiple states.[28]

IV. TAX REFORM OPTIONS

Education tax incentives are commonly cited as an area in need of reform. Below is one tax reform option that maintains a limited set of tax incentives for education with reduced complexity and better coordination with direct spending programs that works towards important policy goals such as increasing college enrollment and preserving the progressivity of the tax code. Many features of this tax reform option were included in the Administration's FY2017 Budget.

[26] High income families may also benefit from taking non-qualified distributions from 530 accounts. Non-qualified distributions are assigned to the beneficiary and are taxed at a relatively lower rate compared to the rate for the parent/guardian, even when adding the penalty for non-qualified use. Some research finds that this non-qualified use of education savings accounts for high-income families may actually exceed the qualified benefit for low-income families (Dynarski, Susan. 2004. "Who Benefits from the Education Savings Incentives? Income, Educational Expectations and the Value of the 529 and Coverdell," *National Tax Journal,* Vol. 57, p. 359-383.).

[27] While each educational institution may treat assets held in a 529 plan differently, investing in a 529 plan will generally reduce a student's eligibility to participate in need-based financial aid. Beginning July 1, 2006, assets held in pre-paid tuition plans and college savings plans are treated similarly for federal financial aid purposes. Both are treated as parental assets in the calculation of the expected family contribution toward college costs (source: http://www.sec.gov/investor/pubs/intro529.htm)

[28] A beneficiary can have plans in up to 44 states, which effectively removes any contribution limit (U.S. Treasury, 2009 "An Analysis of Section 529 College Savings and Prepaid Tuition Plans.")

A. Simplify Tax Benefits for Current Education Expenses

1. Replace existing tax credits with an expanded American Opportunity Tax Credit.

For current education expenses, taxpayers may claim one of two tax credits or they may claim the tuition deduction. Selecting across these programs requires taxpayers to navigate a complex set of options. This complexity is exacerbated by interactions between tax incentives and direct spending programs such as Pell grants, as discussed below. Streamlining the existing set of options for current education expenses, while retaining a meaningful tax benefit, will simplify the tax code and help education tax benefits meet their intended policy goals.

This option simplifies tax benefits for current expenses by replacing the existing set of programs, including the AOTC, the LLTC and the tuition deduction, with an expanded AOTC. The expanded AOTC will have a lifetime cap of $12,500 and will be available for up to five tax years. The expanded AOTC indexes the maximum credit amounts for inflation so that the benefit does not erode in real terms. For degree-seeking students enrolled at least half-time the existing formula for benefits applies, including income limits and the partially refundable portion. Degree-seeking students enrolled less-than half-time and non-degree seeking students could claim the expanded AOTC, but would qualify for a credit that is one-half as large as they would receive if they were degree-seeking enrolled at least half-time. Retaining the AOTC will provide an important form of federal student aid for all potential students from income eligible families that file tax returns, including those who fail to apply for student aid from direct spending programs.

Streamlining and expanding education tax breaks for current expenses provides several benefits. First, the expanded credit may increase degree attainment and decrease time to degree by increasing the tax benefit per year, while limiting the total number of years it is available. The expanded AOTC provides a larger benefit for four school years (four school years generally span five tax years), compared to current law. At the same time, the proposal repeals the LLTC, which is available in any year of education over a taxpayer's lifetime. Second the expanded AOTC offers a partially refundable credit to low-income less-than half-time students and for non-degree seeking students. Under current law these students could not claim the AOTC, but would qualify for a non-refundable LLTC if they have tax liability.

Not all students benefit from this reform. Under current law, the LLTC is available to graduate students and to students in their fifth year of education or later.[29] The proposal repeals the LLTC and graduate students generally do not qualify for the expanded AOTC. This change may be desirable because private returns to graduate school are relatively higher while social returns are relatively lower compared to undergraduate education. In addition, the LLTC is unlikely to alter the decision to attain graduate degrees so that the program largely subsidizes individuals who would have attended graduate school even in the absence of the credit. This change may also be appropriate for students enrolled in undergraduate education beyond the fourth school year, especially for the many non-degree seeking students who enroll in classes primarily for enjoyment.

Recent legislation enacted changes to information reporting that schools must provide to students about their enrollment and also added a requirement for taxpayers when claiming education tax credits. These changes are aimed at increasing program integrity. A simple change to the definition of expenses that qualify for the expanded AOTC could further increase program integrity. Specifically, under the proposal outlined here, eligible course and related expenses are capped at $500/year for full-time students and $250/year for all other students.[30] This option, which was not included in the Administration's FY2017 Budget proposal, may help improve program integrity by limiting the amount of non-verified expenses that qualify for the AOTC. The downside to limiting expenses is that some students with otherwise low-levels of tuition but higher costs for books and expenses will realize a smaller credit under this option.

2. Simplify interactions of AOTC and Pell grants by making Pell grants non-taxable.

Pell grants offer substantial education support for low income families.[31] In the 2015-2016 school year, the maximum Pell grant was $5,775. This amount is enough to cover all of tuition and fees at many postsecondary institutions, especially public two-year institutions. Low-income families who are the targeted beneficiaries of Pell grants may also benefit from the refundable portion of the AOTC.

Many families who benefit from Pell grants may realize less than their maximum level of total education support because of complex interactions with the tax code. Allowing Pell grants to be non-

[29] If students complete their undergraduate education in less than four years, they may claim the AOTC for graduate education for the remaining years.

[30] The National Association of College Stores estimates that students spend roughly $650 per year on required course materials, and that this amount has decreased in recent years.
http://www.nacs.org/advocacynewsmedia/pressreleases/studentspendingontextbookscontinuestodecline.aspx

[31] For the 2013-14 School year, , nearly 9 million students received Pell grants and total Pell grant funds were $31.5 billion.
http://www2.ed.gov/finaid/prof/resources/data/pell-2013-14/pell-eoy-2013-14.html

taxable regardless of use would simplify this interaction. Under current law, Pell grants are not taxable if they are used for tuition and fees, but Pell grants are taxable when used for other expenses including room and board. This complication is increased by interactions with the AOTC. Only education spending net of other tax preferences such as grants, scholarships and education savings distributions, qualifies for the AOTC. If families allocate their tuition and fee expenses to Pell grants, the grants are not taxable, but the family might no longer be eligible for an AOTC because they have no remaining qualified expenses. Some of these families would realize a larger level of total education support from the federal government if they allocated a portion of their expenses to the AOTC, and then applied Pell grants to the remaining expenses and room and board, even though it means including part or all of the Pell grant in taxable income. Making Pell grants nontaxable for all uses would make the interaction with the tax code simpler for families and help insure that the benefits from this need-based program are not offset by the tax system.

3. Repeal exclusion of employer provided education assistance.

This option removes current law's unequal tax treatment of employer-provided education and out-of-pocket education expenses. It is unlikely that repealing the employer provided tax benefit will have a substantive impact on postsecondary enrollment. Many individuals who benefit from employer provided education have already completed most of their formal schooling. In addition, these benefits are not likely to be realized by individuals who would otherwise be financially unable to enroll. By retaining the itemized deduction for work-related education expenses, the tax code provides some relief to taxpayers with large expenses incurred in the generation of income.

B. Limit Tax Benefits for Prior Education Expenses and Simplify the Discharge of Student Loan Debt

1. Repeal the deduction for student loan interest for new students and exclude the discharge of student loan debt from gross income.

The deduction for student loan interest does not seem to have a large impact on education attainment. This suggests that most of its benefit is simply a windfall to qualifying taxpayers. Many families with student loan debt already benefit from federal loan programs that provide relatively low interest rates. Individuals who struggle with student debt can avail themselves of other benefits of federal student loans including income-based loan repayment plans and student loan deferments that may be more effective than the interest deduction in reducing the burden of student loan debt.

Repealing the deduction for new students allows taxpayers who currently claim the deduction to continue to receive a tax benefit.

For students in dire financial stress, the Department of Education may discharge federal student loan debt for a variety of reasons including for disability, for cases when the school closes during attendance and for cases when the school has been found to have made misrepresentations to students. In general, the amount of debt discharged is included in taxable income (because it represents an increase in net worth, and so is income.) However, borrowers who receive a discharge of student loan debt generally have low incomes and few if any assets. For these taxpayers paying the tax on discharged amounts may be difficult (and in many cases the amounts would still be excluded under an exception for insolvency). Requiring borrowers to justify their eligibility for the exclusion of the discharged amounts is inefficient for both taxpayers and the IRS and partially offsets the financial benefit of discharge.

V. CONCLUSION

Reforming tax incentives for higher education will help insure that support is targeted to the areas where it can have the largest impact. The reforms outlined here simplify the tax code for millions of families, while retaining important incentives for investments in education. The reform option streamlines overlapping programs while expanding the American Opportunity Tax Credit. The reforms will help maintain program integrity so that support is channeled to targeted groups. In addition, the reforms will improve coordination between direct spending programs and the tax system, further reducing burdens on students and families who are working towards their education goals.

Table 1: Cost of Education Tax Benefits (Current Law Tax Expenditure Estimates)												
(millions of dollars)	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2017-2026
Programs for Current Education Expenses												
Tax Credits and deductions for postsecondary expenses*	20,160	20,150	20,020	20,220	20,380	20,440	20,480	20,520	20,530	20,490	20,390	203,620
Dependent Exemption	4,220	4,210	4,310	4,470	4,600	4,720	4,830	4,940	5,030	5,100	5,180	47,390
Exclusion of Scholarship Income	3,290	3,410	3,500	3,560	3,690	3,820	3,960	4,100	4,240	4,400	4,550	39,230
Exclusion of Employer Provided Educational Assistance	850	900	950	990	1,040	1,090	1,140	1,200	1,260	1,320	1,380	11,270
Programs for Education Savings												
529 Saving Plans	1,740	1,920	2,110	2,300	2,490	2,700	2,910	3,140	3,390	3,650	3,930	28,540
530 Saving Plans	30	40	40	40	40	40	40	50	50	50	50	440
Exclusion of Interest on Savings Bonds used for Education	30	30	30	30	30	40	40	40	40	50	50	380
Programs for Prior Education Expenses												
Student Loan Interest Deduction	1,950	1,970	2,010	2,050	2,130	2,150	2,200	2,270	2,290	2,330	2,410	21,810
Discharge of Student Loan Debt	90	100	100	100	110	110	110	110	120	120	120	1,100
Other Programs												
Deduction for Teacher Expenses	210	210	210	210	220	220	260	270	270	270	270	2,410
Exclusion of Interest on Student Loan Bonds	440	460	480	500	560	620	680	730	760	790	820	6,400
Deductibility of Charitable Contributions	5,110	5,480	5,890	6,330	6,730	7,100	7,490	7,860	8,250	8,630	9,000	72,760
Exclusion of Interest on Bonds for Private Non-profit Education Facilities	2,260	2,380	2,490	2,600	2,870	3,230	3,490	3,730	3,920	4,080	4,220	33,010
Qualified School Construction Bonds*	1,330	1,380	1,380	1,380	1,380	1,380	1,380	1,380	1,380	1,380	1,380	13,800
Credit for Zone Academy Bonds*	220	230	240	230	210	190	170	150	140	120	110	1,790

Notes: These estimates assume that all other aspects of the tax code are held fixed.
*These estimates include budget outlay portion.
Source: Office of Tax Analysis, unofficial tax expenditure estimates.

Table 2A: Tax Benefits for Current Education Expenses, 2016					
Program	**Benefit**	**Qualifying Expenses**	**Qualifying Education**	**Qualifying Income Range**	**Expiration Date**
American Opportunity Tax Credit (AOTC)	Maximum credit of $2,500 per student, equal to 100% of first $2,000 of spending plus 25% of next $2,000 of spending. Up to $1,000 (40 percent) of the credit may be refundable.	Tuition, required fees, course related books, supplies and equipment.	Undergraduate and graduate. May be claimed for up to four tax years for students enrolled at least half-time who purse a degree or credential.	Benefits phase out for non-joint returns between $80,000-$90,000 and for joint returns between $160,000 - $180,000.	None.
Lifetime Learning Tax Credit (LLTC)	Maximum (nonrefundable) credit of $2,000 per return equal to 20% of the first $10,000 of Education spending.	Tuition and required fees.	Undergraduate and graduate. May be claimed for any number of years for all postsecondary enrollment.	Benefits phase out for non-joint returns between $55,000-$65,000 and for joint returns between $111,000 - $131,000.	None.
Tuition Deduction	Maximum deduction of $4,000 per return or $2,000 per return depending on income.	Tuition and required fees.	Undergraduate and graduate. May be claimed for any number of years for all postsecondary enrollment.	Maximum deduction of $4,000 for joint (non-joint) returns with income not more than $130,000 ($65,000). Maximum deduction of $2,000 for joint (non-joint) returns with income more than $130,000 ($65,000) and not more than $160,000 ($80,000).	2016
Dependendent Exemption for Enrolled Students	Youths ages 19-23 may be claimed as dependents and qualify for children for the Earned Income Tax Credit if they are full-time students.	NA	Undergraduate and graduate. Students must be enrolled fulltime for at least five months, live with the taxpayer claiming the student as a dependent for at least half of the year.	NA	None.
Exclusion of Scholarships, Grants and Tuition Reductions	Amounts received may not be taxable.	Tuition, fees, and course-related expenses including books, supplies and equipment.	K-12, undergraduate and graduate.	NA	None.
Employer Provided Educational Assistance	Up to $5,250 of employer benefit is not taxed.	Tuition, fees, and course-related expenses including books, supplies and equipment.	Undergraduate and graduate. Courses do not have to be work-related.	NA	None.
Gift tax exclusion for Education expenses	Up to $14,000 of gifts for tuition expenses is not taxable.	The gift tax does not apply to amounts paid to education institutions for tuition.	Education at qualifying education institutions.	NA	None.

Table 2B: Tax Benefits for Education Savings, 2016					
Program	**Benefit**	**Qualifying Expenses**	**Qualifying Education**	**Qualifying Income Range**	**Expiration Date**
Qualified Tuition Plans (529s)	Earnings in accounts are not subject to tax. Contributions may be receive benefit at state level. Accounts are not necessarily the property of the designated beneficairy.	Tuition and fees, books, supplies and equipment. Room and board for students enrolled at least half-time. Expenses for special needs.	Undergraduate and graduate.	None.	None.
Coverdell ESA (530s)	Earnings in accounts are not subject to tax. Up to $2,000 may be contributed each year. Accounts become the property of the benficiary (usually the intended student) at age 18 and distributions must be taken by age 30.	Tuition and fees, books, supplies and equipment. Room and board and special needs expenses for students enrolled at least half-time in postsecondary institution. Tutoring, room and board, uniforms, transportation and computer access for K-12 students.	K-12, undergraduate and graduate.	Individuals contributing to 530 plans must meet an AGI threshold. Maximum contribution limit phases out for non-joint returns between $95,000-$110,000 and for joint returns between $190,000 - $220,000.	None.
IRA Distributions	Distributions used for qualifying education expenses are not subject to the additional 10% tax.	Tuition and fees, books, supplies and equipment. Room and board for students enrolled at least half-time. Expenses for special needs.	Undergraduate and graduate.	None.	None.
Education Savings Bond Program	Interest on savings bonds is not taxed. Applies to EE bonds issued after 1989 or series I bonds.	Tuition and fees, payments to 529 or 530 savings plan.	Undergraduate and graduate.	Program phases out for non-joint returns between $77,550-$92,550 and for joint returns between $116,300 - $146,300.	None.

Table 2C: Tax Benefits for Proir Education Expenses, 2016					
Program	**Benefit**	**Qualifying Expenses**	**Qualifying Education**	**Qualifying Income Range**	**Expiration Date**
Student Loan Interest Deduction	Deduction of up to $2,500 of student loan interest paid.	Loans used to pay for tuition, fees, books, supplies, equipment, room and board, transportation or other necessary expenses.	Undergraduate and graduate. Student must have been enrolled at least half-time.	Program phases out for non-joint returns between $65,000-$80,000 and for joint returns between $130,000 - $160,000.	None.
Discharge of Student Debt	Discharge of certain student loans is excluded from income subject to tax.	Loans used to pay for tuition, fees, books, supplies, equipment, room and board, transportation or other necessary expenses. Only loans made by the federal government, a state government, certain tax-exempt public benefit corporations or an educational institution.	Undergraduate and graduate.	None.	None.

Table 2D: Tax Benefits for Education Institutions, 2016					
Program	**Benefit**	**Qualifying Expenses**	**Qualifying Education**	**Qualifying Income Range**	**Expiration Date**
Deductibility of charitable contributions	Taxpayers may deduct charitable contributions to non-profit education institutions. Qualifying education institutions do not pay tax on the contributions.		Education institutions must meet the definition of charitable education institution defined in IRC 501(c)3. For education institutions, "charitable" includes the advancement of education or science and "educational" relates to the instruction or training of individuals.	None, but taxpayers must itemize in order to deduct the contribution from their income.	None.
Tax-exempt financing for education institutions	Interest on bonds issued by state and local government is excluded from income.	Qualifying bonds include private activity bonds, 501 (c) 3 bonds, student loan bonds and school construction bonds.		NA	None.
Credit for holders of zone academy bonds.	Tax-credit bonds provide tax credits to investors to replace a prescribed portion of the interest cost.	Bonds issued by a state or local government where 100 percent of the proceeds are used at "zone academies" and where at least 10 percent of the bond proceeds are contributed by private entities.	Zone academies include public schools below the college level that operates in a special academic program with businesses and is located in an empowerment zone, or in an area where at least 35 percent of students receive free and reduced price lunch.	NA	None.