HIGHER EDUCATION TAX INCENTIVES: WHY CURRENT REFORM IS NECESSARY

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I. INTRODUCTION

During the State of the Union address in January, 2012, President Barack Obama emphasized the need for a comprehensive plan to promote access to higher education for all Americans. This reignited what has been an ongoing discussion regarding the increasing cost of higher education, how to make a college education more accessible, and whether the benefits of obtaining advanced education outweigh those costs. The debate has been fueled by stories of college graduates who cannot find employment and are facing the heavy burdens of their substantial student loan debt. While these unfortunate stories are real, research suggests that in the long-run those who obtain a college education will generally be far better off than those who do not. In most cases, higher education leads to a better quality of life for the individual and economic stability and growth for society.

It is of little surprise to most that the United States government has subsidized, or attempted to subsidize, higher education through various programs. As evidenced by its increasing complexity, the federal income tax code (referred to in this article as the "Code") has become an increasingly popular vehicle for subsidizing certain socially desired behaviors and for funding welfare programs in the United States.[1] Among these tax subsidies are various provisions dealing with higher education. The education tax incentives include credits for higher education expenses, tax-free education savings accounts, the student loan interest deduction, and a higher education expenses deduction, among others. This paper analyzes the U.S. government's use of the Code for enacting policies aimed at encouraging participation in higher education.

The conclusion of this paper is that as currently implemented, education tax incentives do not reach, at least to any significant degree, those who most need the help. Currently, taxpayers with higher incomes receive more tax benefits than those with low incomes. If a subsidy is intended to encourage or enable behavior which would not otherwise occur, higher education

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[1] Eric J. Toder, *Tax Cuts or Spending—Does it Make a Difference?*, 53 Nat'l Tax J. 361, 361 (2000).

subsidies through the tax system are ineffective. The majority of education tax incentives, and other education subsidies, should be aimed at those with the most need and who are most likely to respond positively to them. This group is lower-income individuals. Policies should be designed to make higher education accessible to all persons who desire to participate regardless of their race, gender, or economic background by removing significant financial barriers that prevent greater participation.

Undeniably, there are myriad factors that contribute to whether a person continues his or her education after high school. However, this paper will principally address the economic barriers that prevent low-income individuals from participating in higher education, as these are likely the most significant of the relevant factors. In addition, there are many alternative, more effective means of achieving the purposes of tax incentives that do not involve the tax system and that can directly assist the target groups.

II. WHY SHOULD THE GOVERNMENT SUBSIDIZE HIGHER EDUCATION?

A. *Why Subsidize Higher Education?*

1. Benefits to the Individual

"[M]ost U.S. citizens now accept as an article of faith that going to college pays off by providing access to better jobs, better salaries, and brighter futures."[2] A college degree has always been a worthwhile investment, but in recent years it has become an even better one. In 1994, high school graduates without college degrees earned approximately the same amount in constant dollars as high school graduates in 1949.[3] Since 1995, the nominal income of high school graduates has increased very little. In 1995, the median income for high school graduates with no college education was approximately $31,000.[4] In 2005, for persons in the same group the median income was approximately $38,000.[5] In 2009, the median

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[2] ROBERT ZEMSKY, U.S. DEP'T OF EDUC., THE TRANSITION FROM INITIAL EDUCATION TO WORKING LIFE IN THE UNITED STATES OF AMERICA 8 (1998).

[3] *Id.*

[4] *Current Population Survey, Total Money Income in 1995*, U.S. CENSUS BUREAU (1996) [hereinafter TMI 1995].

[5] *Current Population Survey, Total Money Income in 2005*, U.S. CENSUS BUREAU (2006) [hereinafter TMI 2005].

income for male high school graduates with no college education was approximately $39,476.[6]

In 2005, for those who had obtained a bachelor's degree the median income was $72,000[7] compared to $52,000 in 1995.[8] In 2009, the median income was $71,466 for those who had obtained a bachelor's degree.[9] Over the course of a lifetime, a college graduate will earn approximately one million more dollars than someone without a college degree.[10] Not only do college graduates generally earn more than those without any college education, but they typically have more employment stability. According to the U.S. Bureau of Labor Statistics, all of the job growth in the U.S. over the last two decades has been for workers with at least some college experience.[11] Furthermore, in 2009 the unemployment rate for individuals with a college degree was just above four and a half percent, while the unemployment rate for workers with no college experience was nearly ten percent.[12]

Additionally, the transition into the work force is the smoothest for graduates of four-year degree programs.[13] This is likely due in part to the fact that college graduates enter the workforce with many skills that non-graduates typically acquire only after several job changes.[14] That is, a person's workplace productivity generally increases as education level increases.[15] The difficulty American students, particularly those without college degrees, have had in transitioning to work is not insignificant. In fact, the federal government has passed several pieces of legislation aimed at improving the ability of young Americans to transition to work.[16]

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[6] *Current Population Survey, Total Money Income in 2009*, U.S. CENSUS BUREAU (2010) [hereinafter TMI 2009].
[7] TMI 2005, *supra* note 5.
[8] TMI 1995, *supra* note 4.
[9] TMI 2009, *supra* note 6.
[10] Susan Dynarski, Assoc. Professor of Pub. Policy at Harvard University, Testimony before the Senate Finance Committee 2 (Dec. 5, 2006); COMM'N ON HIGHER EDUC., U.S. DEP'T OF EDUC., DRAFT REPORT 9 (2006).
[11] *Spotlight on Statistics: Back to College*, U.S. BUREAU OF LABOR STATISTICS (Sept. 2010), http://www.bls.gov/spotlight/2010/college/home.htm.
[12] *2010 – Labor Force Statistics*, US BUREAU OF LABOR STATISTICS, http://www.bls.gov/webapps/legacy/cpsatab4.htm.
[13] ZEMSKY, *supra* note 2, at 30.
[14] *Id*.
[15] *Id*. at 3.
[16] *See, e.g.*, The Jobs Training Partnership Act (amended in 1992); The School-to-Work Opportunities Act of 1994.

2. Benefits to Society

Individuals are not the only beneficiaries of higher education. Economists have speculated for more than a century that the social return to education may exceed the private return.[17] Indeed, there is a positive relationship between individual wages and the share of college graduates in a city.[18] According to one study, a rise in the proportion of better-educated workers has a large positive effect on less educated workers.[19] Specifically, a one-percent increase in the labor force share of college graduates increases the wages of high school dropouts and high school graduates by 1.9 percent and 1.6 percent respectively.[20] This may be because "[e]ducated workers manage and perform better—and they increase the output of their less-educated peers."[21]

As noted previously, increasing access to higher education for lower-income individuals will decrease income inequality because as these individuals gain education, their incomes will generally increase.[22] This is significant not only for the individuals whose income increases, but for society as a whole because the absence of income inequality is associated with greater economic growth.[23] Increased economic growth is important because richer countries are healthier, safer places to live.[24] There is also a well-known and "persistent association between education and health."[25] Those with more education are less likely to smoke, "drink a lot," be overweight, or use illegal drugs and are more likely to exercise and obtain preventative care.[26] These characteristics benefit the individuals and society as a whole. Thus, the government has a significant interest in higher education because of the beneficial affect it appears to have on the health of individual citizens.

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[17] Enrico Moretti, *Estimating the Social Return to Higher Education: Evidence from Longitudinal and Repeated Cross-Sectional Data* 1, NAT'L BUREAU OF ECON. RES., Working Paper No. 9108 (2002), *available at* http://www.nber.org/papers/w9108.
[18] *Id.* at 1-2. There is still some question as to whether the relationship is causal. *Id.*
[19] *Id.* at 3.
[20] *Id.*
[21] Daniel S. Hamermesh, Four Questions on the Labor Economics of Higher Education 7 (Nov. 9, 2005) (unpublished paper).
[22] *See supra* notes 3-12 and accompanying text.
[23] Gunther Rehme, *Education, Economic Growth and Personal Income Inequality Across (rich) Countries* 4, LUXEMBOURG INCOME STUDY, Working Paper No. 300 (2002).
[24] V. Kerry Smith, *Social Benefits of Education: Feedback Effects and Environmental Resources*, 1 (Oct. 11, 1995).
[25] David M. Cutler & Adriana Lleras-Muney, *Education and Health: Evaluating Theories and Evidence* 1, NAT'L BUREAU OF ECON. RES., Working Paper No. 12352 (2006), *available at* http://www.nber.org/papers/w12352. There is some evidence that more educated people live longer and experience fewer diseases. *Id.*
[26] *Id.* at 4-5.

3. The Dramatically Increasing Cost of Higher Education

The many benefits of higher education are not the only reason the government is involved in funding access to it. Access to higher education has been made extremely more selective because of dramatic increases in the cost of attending, particularly rising tuition prices.[27] As recently as 1975, the median household income (in constant dollars) was nearly thirty percent more than the cost of four years at a private institution and three times more than the cost of four years at a public institution.[28] By 1994 the cost of attending a private four-year institution was twice the median household income.[29] Between 1975 and 1995, the cost of attending a four-year institution (including tuition, room and board, and fees) increased nearly threefold after adjusting for inflation.[30] Between 1995 and 2005, the average tuition and fees at a four-year public institution increased by fifty-one percent after adjusting for inflation.[31]

Between 1987 and 1993 net tuition (i.e. amount paid by student after financial aid) increased substantially more than inflation.[32] This resulted in low-income students experiencing relatively sharper increases in their net tuition than higher income students.[33] However, the largest cost (for all but the most elite private institutions), and therefore the largest barrier to college attendance, is likely the opportunity cost of attending college. This represents the difference in what a person enrolled in college earns while attending compared to what a similarly situated person not attending college earns during the same period. For example, a 2004 study showed that those attending college earned on average $10,000 less than those not attending.[34] This is especially significant for low-income students who need money to meet their basic needs.

Not surprisingly, low-income students enroll in and complete college degree programs at a drastically lower rate than high-income students.[35] Less

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[27] The fact that many students are required to take remedial courses has increased the costs of higher education. These courses have an annual cost to educational institutions of $1 Billion. Eric. P. Bettinger & Bridget Terry Long, *Addressing the Needs of Under-Prepared Students in Higher Education: Does College Remediation Work?* 2, NAT'L BUREAU OF ECON. RES., Working Paper No. 11325 (2006), *available at* http://www.nber.org/papers/w11325.
[28] ZEMSKY, *supra* note 2, at 9-10.
[29] *Id*. at 10.
[30] *Id*. at 10.
[31] COMM'N ON HIGH. EDUC., *supra* note 10, at 12.
[32] ZEMSKY, *supra* note 2, at 10. Financial aid increased dramatically during this period, but beginning around 1987 did not keep pace with the increasing costs of tuition. *Id.* at 9.
[33] *Id*. at 10.
[34] Hamermesh, *supra* note 21, at 5.
[35] This paper does not address the many other factors that influence decisions regarding college attendance. For a discussion of some of those factors see SANDRA S. RUPPERT, EDUC.

than twenty-five percent of qualified low-income students complete bachelor's degrees while sixty-two percent of high-income students complete bachelor's degrees.[36] One study found that even after controlling for student ability, academic expectations, and parents' education, students from high-income families (incomes over $74,000 in 1997 dollars) are twenty percent more likely to attend a highly selective school (average freshman SAT over 1176) than equally bright middle- and lower-income students.[37] This discrepancy in college participation rates is most significant for minority students. While about one-third of whites between the ages of twenty-six and thirty have obtained a bachelor's degree, only eighteen percent of African Americans have done so, and only twelve percent of Hispanics in the same age group have completed such a degree.[38] The Advisory Committee on Student Financial Assistance estimated that between 2000 and 2010, financial barriers would prevent nearly two million low- and middle-income college-qualified high school students from attending college.[39]

A study of high school seniors in Boston found that while attending college is not the "default" behavior of low-income students, few of them actually decide against going to college.[40] Rather, they miss a deadline, incorrectly fill out a form or do not take the required classes and therefore never enroll in college.[41] This is likely due to low-income students' lack of a support group. Most low-income high school seniors have few family members, if any, who have attended college.[42] Only thirty-four percent of low-income African American youth and thirty-three percent of low-income Hispanics have even attempted college, severely limiting the informal transmission of information about college costs within these populations.[43] On the other hand, the decision to attend college is usually part of "the plan" for higher-income students. As such they have support groups who help them as they prepare to enter college.[44] In light of these facts, financial barriers to higher education will only perpetuate the low participation rate of low-income students. This is true despite the fact that the financial returns to

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COMM'N OF THE STATES, CLOSING THE COLLEGE PARTICIPATION GAP (2003) and Bettinger & Long, *supra* note 27.

[36] COMM'N ON HIGH. EDUC., *supra* note 10, at 6.

[37] Julie-Anne Cronin, *The Economic Effects and Beneficiaries of the Administration's Proposed Higher Education Tax Subsidies*, 50 Nat'l Tax J. 519, 535 (1997).

[38] COMM'N ON HIGH. EDUC., *supra* note 10, at 6.

[39] *Id.* at 13.

[40] Susan M. Dynarski & Judith E. Scott-Clayton, The Cost of Complexity in Federal Student Aid: Lessons from Optimal Tax Theory and Behavioral Economics 17 (Apr. 25, 2006) (unpublished paper).

[41] *Id.*

[42] *Id.* at 13.

[43] *Id.*

[44] *Id.* at 17.

a college education dwarf any reasonable estimate of the costs of applying for aid.[45]

Thus, higher education subsidies can be an opportunity equalizer when provided to low- and middle-income individuals. However, that is not the only reason why at least a significant proportion of education subsidies should be targeted to these groups. Education subsidies that do not target these groups may actually make the public higher education system regressive in nature.[46] This results because public higher education institutions are funded primarily by state tax revenues which are typically only slightly progressive. Low- and middle-income families pay a significant portion of state taxes, but are greatly underrepresented in these public institutions.[47] Therefore, programs that reduce the net costs of attendance for lower-income individuals may increase participation in higher education and make the cost of receiving higher education less regressive.

B. *Effect of Education Subsidies in General*

It is clear that the government has a significant interest in increasing access to higher education. The question becomes how to achieve this goal. Subsidizing higher education appears to create only slight increases in the demand for higher education. According to one recent study of merit-based aid systems, reducing the net tuition cost nearly to zero increases the share of the population receiving a college degree by only three percent.[48] This is likely due to the fact that reducing tuition prices addresses only one portion of the total "cost" of attendance, and does not address what is arguably the biggest cost—the opportunity cost of attendance—for low-income students.[49] Furthermore, merit-based systems generally benefit higher-income students, for whom attending college is already part of the plan.[50] This low elasticity of demand for higher-income students indicates that subsidizing higher education will not generate large increases in enrollment within this group.[51] However, a few simple, easily communicated merit aid programs did have a greater impact on the enrollment of non-white women, who enrolled at a rate seven percent higher than they did prior to the enactment of these aid

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[45] *Id.* at 15.
[46] Hamermesh, *supra* note 21, at 2.
[47] *Id.*
[48] *Id.* at 6.
[49] *Id.* at 5.
[50] *See infra* notes 66-68.
[51] Hamermesh, *supra* note 21, at 6.

programs.[52] This may be reflective of the positive impact that subsidies could have on low-income students.[53]

Merely increasing college enrollment will not achieve the maximum benefit, unless college completion rates also increase. Currently, college completion rates are not keeping up with enrollment rates. Between 1968 and 2000, the percentage of 23-year-olds who had attended college increased by nearly twenty percent.[54] During this same period, the share of 23-year-olds who completed bachelor's degrees increased by only five percent.[55] Thus, while increasing college enrollment is an important goal, it must coincide with an effort to determine why so few students actually complete a degree, a topic that is outside the scope of this paper.[56] This is critical because optimal benefits, both individual and societal, are only achieved when college degrees are obtained. That is, earnings increase significantly with the completion of post-secondary degree programs. The median income for households where the highest education level is some college (but no degree) is approximately $30,000 less than that of households where a bachelor's degree was attained.[57]

C. *How the Complexity of Higher Education Subsidies Affects Students*

There are many choices when deciding how to finance a post-secondary education. In fact, there may be too many choices. Currently, there are at least twenty federal programs that provide direct financial benefits or tax breaks to those seeking a postsecondary education.[58] This complexity, and the problems with these programs, discourage enrollment.[59] Education tax incentives are also very complex.[60] Taxpayers may choose from a number of different provisions,[61] and surprisingly, if the taxpayer does not make the proper decision, she could be worse off than if she had not chosen any of the

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[52] Dynarski & Scott-Clayton, *supra* note 40, at 3.
[53] At least one reason for the more significant increase in minority women rather than men is that minority men are more likely to "drop out of high school, be incarcerated, or join the military, all of which will blunt the effect of any scholarship on this group's schooling decisions." *Id.* at 29. However, because minority women are disproportionately from low-income families, the result may be reflective of what it may be for low-income individuals.
[54] *Id.* at 1.
[55] *Id.*
[56] *See id.* (discussing of this topic in detail).
[57] TMI 2005, *supra* note 5.
[58] COMM'N ON HIGH. EDUC., *supra* note 10, at 7.
[59] *Id.*
[60] Albert J. Davis, *Choice Complexity in Tax Benefits for Higher Education*, 3 Nat'l Tax J. 509 (2002).
[61] *See* I.R.C. §§ 25A, 135, 117, 221, 222, 529, 530.

tax incentives.[62] It is often very difficult for taxpayers to make the best decision among the competing provisions. This difficulty arises at almost every stage of the process—planning for a child's education years in advance, decision making when the choice to attend has been made, and at tax time when tax returns are filled out.[63] Parents (and independent students) must decide whether it is better to save ahead of time or borrow money later. Each decision has its own tax benefits, some of which will be discussed in detail later. For now it is enough to know that the choices exist and they are difficult to make. Tax choice complexity is also affected by federal Pell Grants and other forms of student aid because these other forms of subsidy are affected by tax decisions and *vice versa*.

The complexity in current subsidies for higher education, including tax provisions and federal financial aid, lead to uncertainty about the net costs of attending college.[64] In fact, because of this complexity, the cost of attending college has become extremely individualized, making financial planning difficult.[65] Many high school students overestimate the cost of attending college, a fact that has greater negative impact on low-income students who are typically already pessimistic about being able to afford a college education (a problem not faced by higher-income students).[66] The costs associated with tax benefits "fall heavily on low-income, non-white and non-English speaking youth, [those] whose lagging educational levels are repeatedly cited as justification" for financial assistance programs.[67] Though these costs are relatively small compared to the benefits received from higher education, even minor complexities can have a significant impact upon the effectiveness and efficiency of a policy.[68]

If this is true, why then should the government continue to subsidize higher education, whether through the tax system or otherwise? The answer is simple, yet significant. While lowering the costs of attendance does not have large overall impacts on the rate of enrollment, the impact is especially significant to lower-income families.[69] Any policy that significantly limits the access of poorer families to higher education will potentially exacerbate the already increasing income inequality in the United States.[70] The result

[62] Davis, *supra* note 60, at 509.
[63] *Id.* at 510.
[64] Dynarski & Scott-Clayton, *supra* note 40, at 2.
[65] *Id.* at 2.
[66] *Id.* at 3.
[67] *Id.*
[68] *Id.*
[69] Hamermesh, *supra* note 21,at 7.
[70] *See* Uwe E. Reinhardt, *What Does Economic Growth Mean for Americans?*, N. Y. TIMES (Sept. 2, 2011), *available at* http://economix.blogs.nytimes.com/2011/09/02/what-does-economic-growth-mean-for-americans/?scp=5&sq=income%20inequality&st=cse.

will be that those students coming from higher-income families will likely obtain better jobs and have higher incomes while those lower-income students who did not attend because of financial barriers will have stagnated earnings, less job stability and generally a lower quality of life.

D. *Can Education Policy Be Achieved Through the Tax System?*

One argument (with three parts) as to why tax subsidies will not significantly increase college enrollment is that (i) tuition prices have little effect on middle and high income students, (ii) tax credits will not affect those who do not plan or intend to go to college, and (iii) low-income students cannot take advantage of the available tax credits because they are not refundable.[71] In fact, three years after the Hope and Lifetime credits were established, researchers found no evidence of increased enrollment.[72] One estimate is that fewer than sixty percent of students were eligible for the tax credits.[73] Another estimate is that the credits were available for only forty-five percent of students.[74] Since the purpose of the credits is to increase access to higher education, it is important to remember that approximately thirty-five percent of all U.S. households have no income tax liability in a given year.[75] Thus, the tax incentives will have little to no effect on the enrollment of these individuals, who were the primary target of the provisions.

Increasing tax credits may also cause institutions to decrease financial aid to low- and middle-income students and increase merit based aid, which tends to favor upper middle- and high-income students.[76] Furthermore, one study has found that only one-third of eligible students actually claimed the available tax credits.[77] Another estimate is that about two-thirds of eligible students claimed the credits.[78] However, participation in the tax credits tends

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[71] Leonard E. Burman et al., *The Distributional Consequences of Federal Assistance for Higher Education: The Intersection of Tax and Spending Programs* 14-15 (Discussion Paper, 2005).
[72] *Id.*
[73] *Id.*
[74] Bridget Terry Long, *The Impact of Federal Tax Credits for Higher Education Expenses* 10-11, NAT'L BUREAU OF ECON. RES., Working Paper No. 9553 (2003), *available at* http://www.nber.org/papers/w9553.
[75] LILY L. BATCHELDER ET AL., THE BROOKINGS INSTITUTION, REFORMING TAX INCENTIVES INTO UNIFORM REFUNDABLE TAX CREDITS 2, Policy Brief No. 156 (2006). There is another possible problem with tax credits—they may conflict with the Alternative Minimum Tax. *See* Long, *supra* note 74 at 9.
[76] Burman et al., *supra* note 71, at 15.
[77] *Id.* at 16.
[78] *Id.*

to increase with income, indicating that those most in need do not or cannot participate.[79]

Subsidizing higher education may have the tendency to cause increases in tuition rates. Subsidies provide little, if any, incentives for higher education institutions to improve efficiency and productivity.[80] In fact, it is widely accepted that post-secondary institutions may in fact increase tuition in response to education subsidies.[81] There is evidence that some states have considered raising tuition at community colleges for the explicit purpose of capturing more of the funds from education tax incentives.[82] These increases tend to occur up to the level where the educational institution will receive the most funds from the subsidies.

At the same time, there is a counterbalancing pressure to maintain price levels so as not to dissuade students who are not eligible for aid from enrolling.[83] When the subsidies are broad and available to most students, the counterbalancing pressures are minimal and likely have no effect on the institution or the overall enrollment rate.[84] However, when institutions respond to tax subsidies by increasing tuition to "catch" the most of the subsidy, low-income students are negatively affected and could enroll at a lesser rate[85] because most low-income students are not eligible for the tax credits.[86]

Tax credits also have significant timing drawbacks. Tax credits are received after the higher education expenses have been incurred and in some cases may not be received until some fifteen months later.[87] This could have significant impacts on the effectiveness of the incentives on increasing college enrollment and the timing issues may be partially responsible for the evidence which indicates no significant increase in college attendance due to tax incentives but noticeable increases in response to other programs of direct aid.[88] The timing also creates a disconnect between the incentive and the

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[79] *Id.*
[80] *Id.* at 6.
[81] Susan M. Dynarski, *Building the Stock of College-Educated Labor* 5, 10 n.17, HARV. U. FAC. RES. WORKING PAPERS SERIES, Paper No. RWP05-050 (2005), *available at* http://ssrn.com/abstract=800124.
[82] Burman et al., *supra* note 71, at 14.
[83] *Id.* at 14; Dynarski & Scott-Clayton, *supra* note 40, at 9.
[84] Dynarski & Scott-Clayton, *supra* note 40 at 9; Michael S. McPherson & Morton Owen Shapiro, *Financing Undergraduate Education: Designing National Policies*, 50 NAT'L TAX J. 557, 563 (1997).
[85] Burman et al., *supra* note 71, at 14.
[86] *Id.*
[87] This occurs when tuition is paid in January of taxable year, and the refund is not received until April of the following year.
[88] *See* Dynarski & Scott-Clayton, *supra* note 40, at 3.

activity.[89] A person who receives a tax credit up to fifteen months after paying education expenses is less likely to think of the aid as reimbursement for previous expenses, rather it may likely be viewed as income to spend on something else.[90]

On the other hand, the delayed receipt of the tax incentive may be a beneficial feature of tax credits. Any form of up-front aid might encourage individuals who do not want to attend or that are not well-suited for college to enroll simply because there is no (or little) present cost to the student. If these students do not complete a degree program or otherwise take advantage of the opportunity, the aid could be considered wasted funds.[91] Funds should be given to those who will maximize the benefit. Delaying the payment of funds through the tax system helps ensure that individuals who are more committed to higher education receive the benefit.[92]

III. CURRENT EDUCATION TAX INCENTIVES

The current tax provisions which relate to higher education can be separated into three groups: (i) Those that involve significant planning in order to receive the benefit; (ii) those that provide a benefit while attending college (or shortly thereafter); and (iii) those that benefit the taxpayer after receiving the education. This paper discusses only a few of the tax provisions from the first two groups.[93]

A. *Tax Provisions Which Require Long-Term Planning*

1. Section 529 Qualified [State] Tuition Programs

Given that a college education is so important in today's economy, many people likely save money in advance to cover the high costs associated

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[89] Long, *supra* note 74, at 3.

[90] This, however, is not as much of a problem as other issues because the taxpayer likely refrained from spending on other items in order to finance the education expenses up front. Thus upon receiving the credit, the taxpayer may feel financially secure in purchasing any forgone products or services.

[91] It is difficult to consider funds used to encourage college attendance as "wasted" given the possibility that the student might enjoy college or at least understand the its value and become interested in obtaining a degree. At the minimum, the individual was given the opportunity to do so, whether or not she decided to pursue it any further. As a result, such funds are less efficiently used than they might otherwise be.

[92] However, this argument ignores the fact that many taxpayers who receive the tax credits are not the students themselves; rather they are the students' parents. Thus, while the parents may value higher education, the student who is attending may not be taking full (or any) advantage of the opportunity.

[93] For a discussion of all of the education tax incentives see Davis, *supra* note 60.

with attending college. One of the many vehicles available for college saving is what is referred to as State Sponsored Tuition Programs or 529 savings plans. These accounts receive favorable federal income tax treatment pursuant to Code Section 529, but are developed and implemented by individual states and/or eligible education institutions.

Section 529 was enacted in 1996 in response to *Michigan v. United States*,[94] a 1994 Sixth Circuit Court of Appeals case.[95] In that case, the state of Michigan had developed a pre-paid tuition program in response to the rapidly increasing tuition prices as a means of helping parents "guarantee to their children the opportunity of a Michigan college education."[96] The stated purpose of the program was in part to "help provide the benefits of higher education to the people of [Michigan]."[97] Payments into the trust fund ensured that the beneficiary's full tuition costs at a Michigan public college or university would be paid for the length of time specified in the contract, thus protecting parents and students from future tuition increases.[98] However, if the student decided not to attend a public university in Michigan, the trust would issue a refund according to the formula contained in the contract.[99]

The education trust requested a private letter ruling from the Internal Revenue Service ("IRS") stating that the purchasers and beneficiaries of the pre-paid contracts (i.e. parents and students) would not be considered to have income from such contracts and that the trust itself would be exempt from taxation on the income it earned. The IRS issued a private letter ruling[100] which stated that the parents and beneficiaries would not have income at the time the contract was executed, but that the education trust's income would be subject to tax.[101] Despite the ruling, Michigan entered into some tuition contracts and paid the corresponding income taxes. The education trust then filed a claim for a tax refund. When the IRS did not respond, the education trust, joined by the state, commenced a refund action in court.[102] The claim was denied and an appeal followed. On appeal, the Sixth Circuit held that the education trust was not subject to income tax because it was an "integral part of the State of Michigan" and Congress had not explicitly imposed a tax

[94] 40 F.3d 817 (6th Cir. 1994).
[95] Sen. Rep. No.104-281, at 105 (1996).
[96] *Michigan*, 40 F.3d at 820.
[97] M.C.L.A. § 390.1423, section 3 of the act (1986).
[98] M.C.L.A. § 390.1423, section 3 of the act (1986).
[99] *Michigan*, 40 F.3d at 821.
[100] I.R.S. Priv. Ltr. Rul. 88-25-027 (Mar. 29, 1988).
[101] *Michigan*, 40 F.3d at 821. The ruling did provide that the beneficiary or purchaser of the contract would be subject to tax if the value of any subsequently-received educational services or refund exceeded the amount initially paid. *Id.*
[102] *Michigan*, 40 F.3d at 822.

on investment income of states.[103] Thus, all parties to Michigan's pre-paid tuition program contracts were now exempt from federal income taxation.

In an effort to "clarify the tax treatment of state-sponsored prepaid tuition and educational savings programs" Congress enacted Section 529.[104] In doing so, Congress intended to encourage people to save for post-secondary educational expenses.[105]

Generally, Code Section 529 provides that "[a] qualified tuition program shall be exempt from taxation."[106] These "qualified tuition program[s]" can be one of two types. First, an individual may purchase tuition credits on behalf of a designated beneficiary.[107] These credits entitle the beneficiary to either a waiver of qualified higher education expenses or payment of such expenses.[108] The other option involves making contributions to an account "which is established for the purpose of meeting the qualified higher education expenses of the designated beneficiary of the account."[109] In order to be considered a "qualified tuition program," Code Section 529 requires that contributions be made in cash and that the contributor or beneficiary not direct the investment of the contributions.[110] The enactment of this portion of Section 529 codified the holding of the court in *Michigan*—that state education trusts are not subject to income tax.

Section 529 also codified the private letter ruling involved in that case. Section 529 provides that, subject to some exceptions, distributions or earnings under Section 529 programs are not included in the gross income of beneficiaries or contributors to the extent they are used to pay "qualified higher education expenses of the beneficiary."[111] While contributors do not pay income tax on these accounts, they may incur gift tax liability if the contributions exceed the $13,000 annual exclusion limit under Code Section 2503(b).[112] This general exclusion from income codified, in modified form, the private letter ruling issued to Michigan's education trust.

One important characteristic of Section 529 programs is that unlike other savings provisions, there is no income limitation. This is significant because it benefits individuals of all income levels and does not provide any additional benefit to low-income students. As previously noted, education subsidies have the greatest effect when they remove the financial barriers that

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[103] Id. at 824, 829.
[104] Sen. Rep. No. 104-281 at 106 (1996).
[105] *Id.*
[106] I.R.C. § 529(a) (2006).
[107] § 529(b)(1)(A)(i).
[108] § 529(b)(1)(A)(i).
[109] § 529(b)(1)(A)(ii).
[110] § 529(b)(2).
[111] § 529(c).
[112] § 529(c)(2)(A). *See generally* I.R.C. § 2503 (2006).

prevent many able and qualified low-income students from enrolling in higher education institutions.

2. Section 530 – Coverdell Education Savings Accounts

Code Section 530 was enacted in 1997. The relevant Senate Committee on Finance Report provides that the reasons for enacting the provision are as follows:

> To encourage families and students to save for future education expenses, the Committee believes that tax-exempt status should be granted to certain prepaid tuition programs operated by States or private educational institutions and to certain education investment accounts (referred to as "education IRAs") established by the taxpayers on behalf of future students. The committee further believes that distributions from such programs and accounts should not be subject to federal income tax to the extent that the amounts distributed are used to pay for higher education expenses of an undergraduate or graduate student who is attending a college, university, or certain vocational schools on at least a half-time basis.[113]

Thus, Section 530 was clearly intended to encourage saving for higher education. When originally enacted, Section 530 referred to the tax-free savings accounts as "Education Individual Retirement Accounts,"[114] however, the name was later changed to "Coverdell Education Savings Accounts" ("Coverdell Accounts") in 2001.[115] This change gives a better indication as to the purpose of the accounts given that they have nothing to do with retirement. Coverdell Accounts and distributions from such accounts are exempt from federal income taxation.[116] These accounts are "trust[s] created or organized in the United States exclusively for the purpose of paying the qualified education expenses of an individual who is the designated beneficiary of the trust."[117] In order to qualify, the trust must be designated as a Coverdell Account at the time it is created.[118] All contributions must be made in cash, before the beneficiary reaches age

[113] Sen. Rep. No. 105-33, at 15-16 (1997).
[114] Pub. L. No. 105-34, sec. 213, Aug. 5, 1997, 11 Stat. 788.
[115] Pub. Law No. 107-22, § 1(a)(2)(A), (B), July 26, 2001, 115 Stat. 119.
[116] I.R.C. § 530(a), (d) (2006).
[117] § 530(b)(1).
[118] *Id*.

eighteen, and the total annual contributions cannot exceed $2,000.[119] The trustee of Coverdell Accounts is typically a bank and there are specific requirements as to the type of investments in which the funds can be invested.[120]

Coverdell Accounts differ from Section 529 accounts in a few significant areas. First, the funds are invested at the discretion of the contributor as opposed to the sponsoring state or organization. This also means that the contributor bears the risk of losing investments, whereas with Section 529 accounts the state guarantees that the higher education expenses will be paid for in the future. Second, Coverdell Accounts can be used for higher education or elementary or secondary education. Third, there are income limitations on the contributor(s). If the contributors are joint filers with modified adjusted gross income (MAGI)[121] above $220,000, they cannot take advantage of this provision. Fourth, while distributions used to pay qualified education expenses are not included in gross income, any excess distributions from Coverdell Accounts are included in gross income and also assessed a ten-percent penalty.[122] This is similar to non-qualified distributions from an individual retirement account that are assessed a ten-percent penalty.[123]

Code Sections 529 and 530 both include a provision for how the benefits interact with each other and other education tax provisions. Multiple tax benefits cannot be taken with respect to the same dollars used to pay qualified education expenses. For example, if a student has qualified education expenses of $10,000, she (or her parents, depending on her status) cannot receive a $10,000 tax-free distribution from a Coverdell account and also receive a tax-free distribution from a state sponsored account.[124] Nor can the student receive a $10,000 distribution from a Coverdell or state sponsored account and also claim a tuition credit or deduction.[125] Thus, a taxpayer may only receive one education tax benefit for each qualified education expense.

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[119] § 530(b)(1)(A). When originally enacted the contribution limit was only $500. The limit was increased to $2,000 by the 2001 amendments as part of the Economic Growth and Tax Relief Reconciliation Act.
[120] § 530(b)(1)(B)-(D).
[121] MAGI is calculated as adjusted gross income plus any amounts deducted for foreign income. *Id.* at § 530(c)(2).
[122] § 530(d)(4)(A).
[123] I.R.C. § 72(t). If the penalty was not included in Coverdell Accounts, individuals could simply invest money in these accounts and then withdraw them early without paying the tax penalty.
[124] I.R.C. § 529(c)(3)(B)(vi); § 530(d)(2)(D).
[125] I.R.C. § 529(c)(3)(B)(v); § 530(d)(2)(D).

3. Do These Provisions Achieve Their Stated Purposes?

Both Code Section 529 and Section 530 were enacted for the explicit purpose of encouraging people to save for education expenses. Thus, a reasonable measure of the success would be whether more people do in fact save for education than would if the provisions did not exist. It is difficult, if not impossible, to determine whether more people save for higher education now than before. However, some statistics give indications as to who is using these savings programs. According to one estimate in 2006, the total number of Section 529 accounts in the U.S. was just over nine million. Based on that estimate, the number of Section 529 accounts represents less than one percent of the total number of U.S. children under the age of eighteen. The 2001 Survey of Consumer Finances estimated the number to be three percent. In either case, participation is extremely low.

A likely cause of the low participation rate is found in statistics relating to the characteristics of people who save for college and in particular those who participate in education savings plans. A 2003 survey of households with children found that sixty-four percent of responding households were currently saving for college.[126] Of the responding households with income of $50,000 or less, only forty percent were saving for college, while seventy-two percent of the households with income of $75,000 or more were saving for college.[127] Only half of the households in which the highest education level obtained was a high school diploma or less were saving for college.[128] Three-quarters of households with the highest education level being a bachelor's degree or higher were saving for college.[129] Thus, not surprisingly, those households with higher incomes save for college at a higher rate. The same survey found that sixty-four percent of those who were not saving for college indicated that it was due, at least in part, to lack of resources.[130]

Interestingly, less than ten percent of those households that were saving for college used any of the three available education savings programs.[131] According to two separate surveys, the median income of those households that use either a Section 529 or Coverdell Account is between $91,000 and

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[126] INVESTMENT COMPANY INSTITUTE, PROFILE OF HOUSEHOLDS SAVING FOR COLLEGE 3 (2003).
[127] *Id.*
[128] *Id.*
[129] *Id.*
[130] *Id.* at 4. Fifty-nine percent indicated that they expected the child to receive financial aid. *Id.*
[131] *Id.* at 7. Seven percent were using pre-paid plans, eight percent were using state savings plans, and ten percent were using Coverdell accounts. *Id.*

$100,000.[132] These statistics indicate that the savings incentives have not encouraged a widespread increase in college savings. It is most likely that those taxpayers utilizing the savings programs were already saving for college, or would have done so without such tax favored devices.[133] Given the higher average incomes of families who save in Coverdell Accounts and Section 529 plans, children from these families would likely attend college regardless of these tax preferred savings vehicles.[134]

B. *Tax Provisions Which Provide "Current" Benefits While Attending*

Prior to 1997, taxpayers generally could not deduct higher education expenses from their income and received no other tax benefit for pursuing a college degree. A deduction was only permitted if the education improved or maintained a skill required in the business currently engaged in by the taxpayer or if the education met specific requirements of the employer.[135] These requirements assuredly prevented many workers from taking the necessary steps to improve their employment by gaining more education. The provision likely had a "lock-in" effect. By providing a tax deduction, it encouraged people to increase only their skills as related to their current employment rather than encouraging those who desired to move beyond their current level.

In 1997, as part of the Revenue Reconciliation Act, Congress enacted Code Section 25A which provided for a tax credit for certain higher education expenses.[136] The stated purpose of this section was "[t]o assist low- and middle-income families and students in paying for the costs of post-secondary education . . . ."[137] As will be shown in Part IV of this paper, this provision has not satisfactorily reached its targeted group.

1. Section 25A – Hope Scholarship Credit

The Hope Scholarship Credit ("Hope Credit") is available to students for the first two years of higher education, and may only be claimed for a

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[132] Susan M. Dynarski, Urban-Brookings Tax Policy Center, *High-Income Families Benefit Most from New Education Savings Incentives*, TAX POL'Y ISSUES & OPTIONS 1 (Feb. 2005); INVESTMENT COMPANY INSTITUTE, *supra* note 126 at 7. This is approximately double the median income for all households with children and is even significantly higher than the median income of those saving for retirement. *Id*. at 2.

[133] There are other tax preferred savings vehicles currently available and that were available prior to the enactment of I.R.C. § 529 and § 530. *See* I.R.C. §§ 72, 135.

[134] Burman et al., *supra* note 71, at 16.

[135] I.R.C. § 162.

[136] Pub. L. No. 105-34, sec. 213, Aug. 5, 1997, 11 Stat. 788.

[137] Sen. Rep. No. 105-33, at 9 (1997).

total of two taxable years.[138] Furthermore, the individual must be enrolled at least half-time for a minimum of one academic period during the year and cannot have been convicted of a felony drug offense at any time.[139] An individual who meets these requirements is eligible to receive a tax credit of up to $1,500 for each eligible student.[140] The taxpayer receives one-hundred percent credit for the first $1,000 of qualified tuition and related expenses and fifty percent credit for up to $1,000 of additional qualified expenses.[141] This credit is not refundable, nor is it available to joint filers with MAGI above $110,000.[142] In order for a married couple with one child to receive the maximum benefit from this credit, they must have at least $37,350 of income and no more than $90,000.[143]

2. Section 25A - Lifetime Learning Credit

The Lifetime Learning Credit was enacted in 1997. This credit is calculated per taxpayer—the maximum credit is $2,000 no matter how many eligible students are involved.[144] The credit is calculated as "20% of . . . the qualified tuition and related expenses paid by the taxpayer during the taxable year" up to a total credit of $2,000 ($10,000 in actual qualified expenses).[145] Unlike the Hope Credit, there is no requirement that the student be enrolled at least half-time; however, the qualified expenses must be for courses "to acquire or improve job skills."[146] Like the Hope Credit, the Lifetime Credit begins to phase out when MAGI reaches $90,000 and is not available to joint

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[138] I.R.C. § 25A(b)(2)(A), (C) (2006).
[139] § 25A(b)(2)(B), (E).
[140] § 25A(b).
[141] § 25A(b). For purposes of the Hope and Lifetime Learning Credits, qualified expenses include tuition and fees, but do not include room and board, personal expenses, expenses for non-degree sports related courses, or activity/athletic fees. § 25A(f)(1). The fact that this definition is different than that used in connection with Coverdell and 529 Accounts is not insignificant. *See* Testimony of the Staff of the Joint Committee on Taxation Concerning the Overall State of the Federal Tax System and Recommendations for Simplification 13 (Apr. 26, 2001).
[142] § 25A(a), (d), (h). See *supra* note 121 for calculation of MAGI.
[143] The calculation of minimum income is based on joint filers with one dependent who take the standard deductions. Only at gross income levels of above $37,350 would such taxpayers have a tax liability of at least $1,500, the amount required to receive full benefit from the credit since it is non-refundable. The $90,000 upper limit is the income level at which the credit begins to be reduced. I.R.C. § 25A(d).
[144] § 25A(c)(1).
[145] § 25A(c)(1). Not insignificantly, approximately eighty percent of students attend universities with tuition of less than $10,000. Dynarski, *supra* note 10, at 3. Thus, a taxpayer with only one dependent attending college will be unlikely to receive the maximum benefit.
[146] § 25A(c)(2)(B).

filers with MAGI in excess of $110,000.[147] In order for joint filers with one dependent to receive the maximum benefit from this credit, they must have at least $38,450 but no more than $90,000 income.[148]

IV. Recommendations for Reform

Given the fact that the current higher education tax incentives do not reach the group most in need of the assistance, this section will discuss possible alternatives to the current incentives, whether through the tax system or otherwise. It is very unlikely that education tax incentives will be eliminated or reduced in any significant manner. Therefore, this section begins with the assumption that tax incentives are here to stay. The proposals presented for reforming the tax incentives will only address tax credits, because they are the largest form of tax subsidy for higher education and the only ones that are likely to be used by lower-income taxpayers.[149] This paper does not address the other issues that may be involved in helping low-income students enroll in, and complete, a college degree program.[150]

A. Reform to Education Tax Credits

There are many arguments against using the tax system to subsidize higher education and other social programs. The first is that it creates unnecessary complexity in the Code, which increases compliance costs. Companion to this argument is that tax expenditures decrease the tax system's fairness and efficiency—two of the most basic goals of tax policy.[151] However, when viewing tax expenditures as "[direct] expenditures

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[147] § 25A(d).

[148] *See supra* note 143. Only at gross income levels above $38,450 would such taxpayers have a tax liability of at least $2,000.

[149] The tax-preferred savings devices clearly do not benefit low- or middle-income taxpayers, nor were they intended to do so. *See* Sen. Rep. No. 104-281 at 106 (1996). Another possible alternative to tax credits is the expansion of § 127 Educational Assistance Programs. This would require the involvement of employers to encourage them to pay for education costs of their employees. As of this paper, there is little research, if any, as to the use of such benefits among employers.

[150] These issues may include poor academic performance, lack of support group (i.e. family and friends who have participated in higher education), and others. For a detailed discussion of these topics, see Dynarski & Scott-Clayton, *supra* note 40 and Bettinger & Long, *supra* note 27.

[151] Toder, *supra* note 1 at 362. The fairness is reduced because it allows some to pay less than others with the same level of income. *Id*. It is less efficient because it induces taxpayers to choose tax-preferred behaviors over those that would be more beneficial without the tax incentive. *Id.* In the case of higher education, while in the short term it may be more beneficial for taxpayers to work rather than attend college, it is significantly more beneficial in

in disguise" tax policy principles are inapplicable. This is because all spending programs are designed to benefit a target group based on the individual circumstances of the group members. A second argument is that the tax code is the tax code, not the social welfare or education code.[152] Tax subsidies are not subject to the scrutiny of the spending budget, and therefore are not subjected to the same reauthorization procedures as other programs.[153] Furthermore, as currently enacted, the education tax incentives do not reach the people who need the most assistance. Because of this, the tax incentives are both ineffective and inefficient.

Perhaps the most widely offered suggestion for reforming education tax credits in order to reach more of the target group is to make the education credits refundable.[154] Currently the benefit of these credits goes mainly to those with higher incomes, while low-income families receive relatively few benefits. Only forty-five percent of the families claiming either of the credits had income of $50,000 or less.[155] Families with incomes above $50,000 receive the largest average benefit.[156] Approximately sixty-five percent of the tax credit dollars from the Hope and Lifetime Credits are received by taxpayers with Adjusted Gross Income ("AGI") of $30,000 or more.[157] These tax credits were intended to benefit low- and middle-income families, however many of these families do not have any income tax liability in a given year, and therefore, are unable to benefit from the credits. In fact, approximately thirty-five percent of all U.S. households have zero income tax liability in a given year[158] and these lower-income families are home to nearly half of the children in the U.S.[159] As a result, these credits miss half of U.S. children, and the omitted children are the intended beneficiaries of the programs[160] and represent the group that needs the most assistance.

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the long term for the taxpayer to forgo current employment opportunities and complete a post-secondary degree program.

[152] Sheldon S. Cohen, *The Erwin N. Griswold Lecture*, 14 AM. J. TAX POL'Y 113, 121 (1997).

[153] Long, *supra* note 74 at 7. Tax expenditures are required to be evaluated annually, but it does not appear that these evaluations are carried out in any significant manner, if at all. Thomas L. Hungerford, *Tax Expenditures: Good, Bad, or Ugly?*, TAX NOTES 325 (Oct. 23, 2006). The tax writing committees and Treasury rather than the Department of Education creates the tax expenditures and "often lack the expertise, background, and staff resources to design tax expenditures that meet desired economic and social goals." *Id.* at 328 (internal quotation omitted).

[154] *See, e.g.*, Long, *supra* note 74; BATCHELDER ET AL., *supra* note 75.

[155] Long, *supra* note 148, at 11. This is based on 2001 data. *Id.*

[156] Long, *supra* note 148, at 13.

[157] Burman et al., *supra* note 71, at tbl.11.

[158] BATCHELDER ET AL., *supra* note 75, at 3.

[159] *Id.*

[160] *See supra*, note 137 and accompanying text.

Using a refundable tax credit rather than a non-refundable credit or deduction also eliminates some of the incentive's "upside-down" characteristics. A non-refundable credit provides the most benefit to tax payers who have a certain minimum level of income and thus incur a certain minimum tax liability. Therefore, up to a certain income level, taxpayers with higher incomes receive more of a benefit. A similar result occurs when using a deduction. Assuming an equal deduction amount, a deduction is more valuable to a taxpayer in a high tax bracket than in a low tax bracket.[161] Given the fact that the cost of attendance is a significant factor in college attendance among low-income students but has little impact on high-income students, these two scenarios result in a greater subsidy to those with higher incomes—individuals who are less likely to change their behavior in response to the incentives. Thus, unless the benefits are in the form of refundable tax credits, they are not only "upside-down" they are also ineffective.

A related proposal is that of creating a single, uniform education credit. This could decrease the complexity of the system, lower administrative and compliance costs, and allow for a more efficient subsidy. As noted previously, complexity in education incentives creates disincentives for attendance.[162] These "costs of complexity" fall heaviest on low-income students who have less of a support group to guide them through the choices of aid. Therefore, reducing the complexity of the tax incentives should increase participation in the programs, particularly by low-income taxpayers. This proposition is supported by the finding that "simple, easily communicated financial aid programs have a robust impact on college entry and completion, and complicated programs do not."[163] The Commission on Higher Education found that the complexity of the current financial aid system, including tax benefits, has discouraged some low-income students from applying for college.[164]

Based on the data and research available today, the creation of a uniform credit is the most efficient tax incentive. As previously noted, education tax incentives that benefit low-income individuals have greater social benefits than those that benefit high-income individuals because they reduce income

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[161] The following example illustrates this point. Taxpayer One and Taxpayer Two each have a $3,000 higher education expenses deduction. Taxpayer One is in the ten percent tax bracket and Two is in the thirty percent bracket. Taxpayer One's benefit is only $300—the amount of taxes saved because of the deduction. Taxpayer Two's benefit is $900. Thus, the subsidy is "upside-down" because the taxpayer with the most income receives the most benefit from the deduction.

[162] *Supra* notes 59-70 and accompanying text.

[163] Susan Dynarski, Assoc. Professor of Pub. Policy at Harvard University, Testimony before the Senate Finance Committee 4 (Dec. 5, 2006).

[164] COMM'N ON HIGH. EDUC., *supra* note 10, at 13.

inequality and promote economic growth.[165] Therefore, given the fact that low-income students respond more to price changes in higher education, the Hope and Lifetime Credits should be consolidated into a single refundable credit. By combining the credits into a single credit and making it refundable, this education incentive can reach many more low- and middle-income students and reduce some of the financial barriers that prevent them from attending college.

B. Non-Tax Programs of Financial Aid

While the Code is becoming an increasingly popular method of subsidizing higher education, it is likely not the best method for doing so. There are many non-tax programs that provide financial aid for higher education. These programs vary significantly, but are effective and can be improved and expanded to become even more effective. This paper will address only a few of the available alternatives to tax incentives.

1. Institution-Specific Aid Programs

A handful of higher education institutions have begun to offer a new type of financial aid. For example, in 2005 Arizona State University ("ASU") implemented a program called "ASU Advantage."[166] This program was administered by Arizona State University and provided assistance to low income Arizona residents. In order to receive assistance under the program, students must come from a family with less than $25,000 annual income.[167] At this income level, the program could reach nearly one quarter of Arizona children. Those students who met the income and other requirements received financial aid, none of which had to be repaid, to cover tuition for a year and living expenses.[168] This and other similar programs have the potential to benefit many low-income students who would not otherwise be able to attend college and who are not currently eligible for federal tax credits. Such programs are more likely to be communicated to students within the community and do not have the timing drawbacks associated with tax credits.

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[165] *See supra* notes 17-26.
[166] See *Arizona State University FY08 Congressional Briefing Book* , http://www.asu.edu/president/federal/documents/08BB072707web.pdf (last visited Nov. 16, 2012). Princeton University appears to be the first to implement this type of program in 2001. The University of North Carolina-Chapel Hill was the first public university to offer a similar program in 2003.
[167] The income level was originally set at $18,850 but was raised to $25,000 in 2007. *Id.*
[168] *Id.*

2. State Merit Aid Programs

Another alternative to tax incentives would be to expand the various state merit aid scholarship programs. These programs began in the 1990s with Arkansas and Georgia leading the way.[169] Unlike traditional merit scholarship programs, these new programs are not available to only the elite students "who are unlikely to alter their decision to complete a degree based on whether they receive the scholarship."[170] These programs have a broad enough reach that approximately thirty percent of high school seniors would qualify.[171]

The Georgia HOPE (Helping Outstanding Pupils Educationally) Scholarship Program was established in 1993.[172] In order to participate, entering college freshman must have a minimum 3.0 GPA in high school.[173] Those not meeting these criteria can become eligible for the scholarship by earning at least a 3.0 GPA in the first thirty semester hours of college.[174] This program pays the full tuition cost of attending a Georgia public university, and up to $1,500 per semester at private universities.[175] As originally enacted the program had an income limit of $66,000, but the limit has been eliminated.[176] These types of programs have the ability to benefit many students, particularly low-income students. A study of the Georgia program found that it increased the college enrollment of minority women by seven percent.[177]

3. Expanding the Pell-Grant Aid System

Expanding the Pell-Grant system is another attractive alternative to tax expenditures. This system is more effective for several reasons. First, it is better targeted at low-income students. In fact, in 2002, students (and parents of students) with Adjusted Gross Income of $30,000 or less received more than $10 billion in Pell-Grant aid.[178] This represented more than eighty-nine percent of the total aid provided by this program.[179] Less than thirty-four

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[169] Dynarski & Scott-Clayton, *supra* note 40, at 7.
[170] *Id.*
[171] *Id.*
[172] *Id.* at 9.
[173] *Id.*
[174] *HOPE Scholarship Program at Public Institutions, Regulations – 100*, GA. STUDENT FIN. COMM'N (July 1, 2011), http://www.gsfc.org/Main/publishing/pdf/2012/2013-HOPE-PUBLIC.pdf.
[175] *Id.*
[176] Dynarski & Scott-Clayton, *supra* note 40, at 9.
[177] *See id.* at 7.
[178] Burman et al., *supra* note 71, at tbl.10.
[179] *Id.*

percent of the total aid provided by the tax credits was received by taxpayers with AGI of $30,000 or less.[180] Second, it is also less likely that higher education institutions will raise tuition in response to increased Pell-Grant aid. This is because unlike tax credits, Pell-Grants include non-tuition expenses in the calculation of the total reward.[181] Thus, increasing tuition will not allow education institutions to "catch" as much of the increased aid as they do with tax credits.[182]

In addition, the federal government should partner with states. Part of the reason for increased tuition is the reduction in state funding. Many states are reducing appropriations for higher education.[183] Federal matching of state means-tested aid could encourage states to invest more in higher education, resulting in fewer tuition increases.[184] Rather than increasing the Pell-Grant aid alone, a new hybrid program could be developed. This program would add an additional requirement that in order for students at a particular institution to be eligible for a grant, the institution must demonstrate that it meets a specified percentage of the financial need of full-time, dependent, undergraduate students from families with incomes below a certain level.[185] Such a program would cause institutions to maintain relatively low tuition or ensure that low-income students will not be adversely affected by tuition increases because the institution would be responsible for meeting the increased need.

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[180] *Id.* Undeniably, at least part of the reason for the lower amount of aid being received through the tax system is because of the "anti-double dipping" provisions in the code. Any qualified expenses that are covered by Pell-Grant funds, cannot be used to calculate the education credit. I.R.C. § 25A (2006). However, taxpayers with AGI of $30,000 or less are likely not able to take full advantage of the tax credits, so they receive less aid through those credits.

[181] McPherson & Shapiro, *supra* note 84, at 564.

[182] *See supra* notes 80-86 and accompanying text.

[183] Thomas J. Kane & Peter R. Orzag, THE BROOKINGS INSTITUTION, *Higher Education Spending: The Role of Medicaid and the Business Cycle* 5, Policy Brief No. 124 (2003).

[184] *Id.* at 7. Currently the federal government matches states' contributions to Medicaid. This is likely a partial reason why Medicaid contributions have increased and higher education budgets have decreased. *Id.* President Obama's "Blueprint for Keeping College Affordable and Within Reach for All Americans" also contains provisions that incentivize colleges and universities that are actively working to offer lower tuition and restrain tuition growth. *See FACT SHEET: President Obama's Blueprint for Keeping College Affordable and Within Reach for All Americans*, WHITE HOUSE.GOV (Jan. 27, 2012), http://www.whitehouse.gov/the-press-office/2012/01/27/fact-sheet-president-obama-s-blueprint-keeping-college-affordable-and-wi.

[185] McPherson & Shapiro, *supra* note 84, at 566. The income level could be determined by using the statistics regarding incomes in that state in order to make the program more state-specific.

V. CONCLUSION

The value of higher education to an individual is tremendous. The benefits often include increased income, a better quality of life, an increased sense of fulfillment, and more. However, the benefits are not only received by the individual, they are also received by society as a whole. Increasing the overall level of education of a society contributes to a reduction in income inequality which generally leads to more economic growth. It is no wonder that the federal government has enacted many programs to encourage participation in higher education. No matter what form the subsidies for higher education take, it is clear that they must continue and must be specifically targeted at low-income taxpayers in order to create the largest societal benefit.

There are several federal income tax provisions that address higher education. The largest proportion of the aid from these tax subsidies comes from the Hope and Lifetime Credits. These credits were enacted in order to assist low- and middle-income Americans in paying for college. Unfortunately, the majority of the benefits are not received by those who need the assistance the most. Because the education credits are non-refundable, more than one-third of U.S. households are unable to access them because they have no income tax liability in a given year. In light of this fact, the tax credits should be amended in several respects. First, the credits should be combined into one, simple education credit. This will reduce complexity in the Code. Second, the credits should be refundable. This change will allow low-income taxpayers to benefit from the subsidy despite having little or no income tax liability.

In addition to reforming the tax credits, other existing methods of providing financial aid should be expanded and new alternatives should be implemented. The Pell-Grant system should be expanded. This system currently provides the most benefits for higher education. The program is especially good at targeting low-income individuals and therefore provides the greatest overall benefit. In addition, the federal government can partner with states to create a more stable state funding system. This will incentivize states to provide more funding to higher education, which could limit the frequency and level of tuition increases.