Issue Brief

A Publication of the Institute for Policy Innovation June 11, 1996

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A Primer on Refundable Tuition Tax Credits

President's Proposal Scores an "E"—Expensive!

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TaxAction Analysis

The "silly season" is again upon us. As the Presidential election campaign moves into full swing, the candidates will be tempted to fish for votes with proposals that have little or no policy or economic merit. The tuition tax credit outlined by President Clinton in his commencement address at Princeton University is just the first (but probably not the last) of many such ill-advised ideas.

Postsecondary Tax Credits and Deductions

The President has proposed a $1,500, refundable tax credit for the first two years of postsecondary tuition. The second year of the tax credit would be available only to students who maintain at least a "B" average and have no felony drug convictions. This latest announcement significantly expands the President's March budget proposal for a $10,000 income-tax deduction for families with incomes up to $100,000.[1]

Which option a family would choose would depend upon its income and the student's tuition costs. For example, suppose a student had annual tuition costs of $3,000. The deduction would be worth nothing for a family with no taxable income; $450 to a family in the 15% marginal tax rate bracket; and $840 for a family in the 28% bracket.

At that tuition level, the $1,500 credit would be a better deal for all families. Because the credit is *refundable* (like the Earned Income Credit), a family paying no federal income taxes would receive a $1,500 check from the government. Families paying less than $1,500 in taxes would receive a check for the difference between their tax amount and $1,500. Families paying more in taxes would have their tax bill reduced by $1,500.

In fact, the credit is always a better for deal for families in the 15% bracket, regardless of tuition costs. Only taxpayers in the 28% bracket with annual tuition costs of $5,357 or more would find the deduction more attractive. To these families, the deduction could be worth up to $2,800.

Costs and Financing

The Clinton administration estimates the postsecondary tuition deduction/credit would cost $42.9 billion over six years. The original deduction proposal was put at $35 billion and paid for in the March budget. That leaves an additional $7.9 billion to cover the expanded proposal.

President Clinton would pay for the credit by *raising taxes elsewhere*. He would reinstate and increase (from $6 to $10) the departure fee on international flights, bringing in $2.3 billion. Another $3.5 billion would purportedly come from higher taxes on the export income of multinational corporations. Auctioning parts of the radio spectrum now reserved for new audio services would raise another $2.1 billion.

The Current State of Postsecondary Education

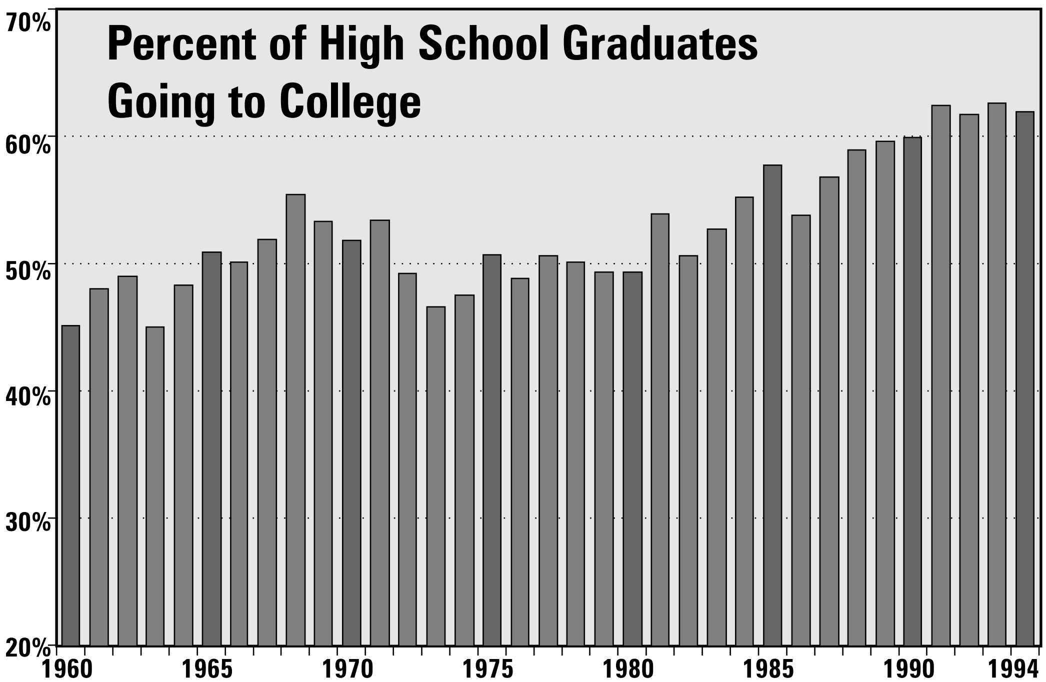
In his Princeton address the President said that "Our goal must be nothing less than to make the 13th and 14th years of education as universal to all Americans as the first 12 are today." *But that is already almost true today*.

Today, 62 percent of high school graduates go on to college. That is up from 45 percent in 1960, an increase of 37 percent.[2] At the end of 1993, 15 million were enrolled in colleges and universities.[3] [See Figure 1.]

Figure 1

Percent of High School Graduates Going to College

Source: American College Testing Program, unpublished tabulations, 1987, derived from statistics collected by the U.S. Bureau of the Census; and U.S. Department of Labor, College Enrollment of 1993 High School Graduates, and unpublished data, June 1995.



Higher education is already heavily subsidized. Tuition paid by students and their families accounts for only one-fourth of the costs of postsecondary education. The remainder comes from government, private gifts, endowments, and proceeds from sales and services.[4] [See Figure 2.]

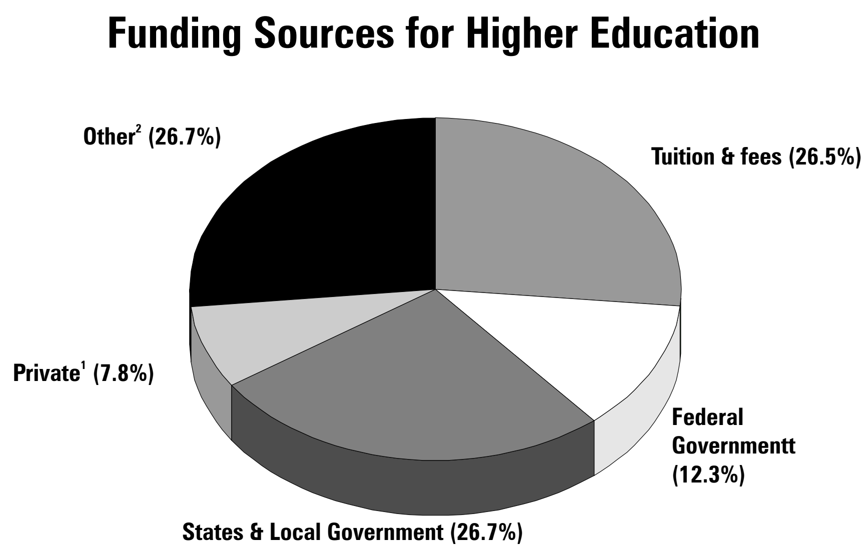
Figure 2

Funding Sources for Higher Education

[1] Includes private gifts, grants, and contracts and endowment income.

[2] Includes sales and services.

Source: U.S. Department of Education, National Center for Education Statistics, "Financial Statistics of Institutions of Higher Education" surveys; and Integrated Postsecondary Education Data System (IPEDS), "Finance" surveys, April 1995.



The federal government plays a significant financing role. The Clinton administration estimates that 5.7 million students will borrow $32 billion through Federal student loan programs in 1997. About a fifth of all college students receive Pell grants, and 90 percent of those recipients come from families with incomes under $30,000. The administration estimates Pell grants will cost $6.4 billion in 1997. Presidential honors scholarships and work-study programs would add another $0.8 billion, bringing the postsecondary education budget request for fiscal year 1997 to $39.7 billion.[5]

Likely Effects of the President's Proposal

Despite the stated goal of encouraging high school graduates to go on for two more years of schooling, the President's proposed tuition tax credit would likely reap few rewards while imposing significant costs.

We estimate that the proposed credit would lower the cost of postsecondary tuition by less than 1.5 percent. When combined with the original $10,000 deduction, tuition costs would be reduced by 10 percent on average.[6] Because tuition accounts for, at best, a third of a student's postsecondary education costs, the proposed tax relief would lower those costs by only 3 percent.[7]

"…the President's proposal would spend $51,500 for every new student drawn to postsecondary education."

If people's behavior with respect to college education follows the pattern of most other goods and services, the 3 percent reduction in price would lead to a 3 percent increase in enrollment. If people are 50 percent more price sensitive to college education than to other goods and services, enrollment would increase by 5 percent. If they are 300 percent more price sensitive, enrollment would still be only 10 percent higher.

The difficulty with using the tax system to encourage more enrollment is that *the new deduction/credit must be given to all those who would go on to college even without the tax relief*. As a result, this use of the tax system delivers very little bang for the buck.

For example, suppose 100 students already will attend college and that the credit/deduction encourages 3 more to go. While the 3 additional students cost $4,500 (3 x $1,500), the government also must spend $150,000 on the 100 students who would have gone to college anyway. In other words, the Treasury spends $33.33 for every $1 that reaches one of the three new students, and the President's proposal would spend $51,500 for every new student drawn to postsecondary education.[8]

The President claims that a student with two years of college will earn an extra $250,000 over his or her lifetime. At first blush, the $3,000 in tax credits would seem like a good deal. However, for each extra student encouraged to go to school, *society would have to pay a $100,000 windfall to the 33 students that would have attended anyway*. Even taking account of the revenue pick up on the extra earnings, the government ends up wasting $60,000 for each new student.[9]

The analysis so far has only looked at the demand side. What about supply constraints? If the new tuition subsidies drive up the price of college, the costs to all students will go up, and fewer new students will enroll. Evidence from 1973 to 1993 suggests that this is what would happen. On average, every extra dollar spent on higher education drives up the real cost per student by 40 cents.[10] As a result, the tuition tax credit would reduce the price of college education by only 6 percent instead of 10 percent. The lower price reduction would drop the expected increase in college enrollment from 3 percent to 1.8 percent and raise the government's cost per new student from $60,000 to $125,000.[11]

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Further, these meager gains would take an exceptionally long time to affect the average education level of the U.S. labor force. It would take 20 years to increase the proportion of workers with some postsecondary education by 0.5 percentage point, and 35 years to raise the proportion by 1 percentage point.

Beyond the scope of this analysis, there are other objections to the President's proposal, including the introduction of pressures to issue higher grades in order to maintain the enrollment of students dependent on the refundable tax credit.

Better Ideas

The $63,000 in tax credits to get one more student two years of postsecondary education could be far better spent. Mechanisms like the Pell Grant *that do not generate windfalls of unnecessary reimbursements* are already in place, and could be expanded with more efficient results than the President's proposal. Even expanding direct student grants would be far cheaper and effective than using the tax system.

Better yet, instead of decreasing the price of college education, suppose we increase its return. Increasing the value of investment in human capital can come about by:

❶ lowering the taxes on labor income and

❷ raising the demand for labor services and, therefore, wage rates.

Lowering marginal tax rates would do both.

Endnotes

1. The Education and Job Training Tax Deduction would provide a deduction of up to $5,000 for tuition and fees directly related to a student's enrollment in degree programs and courses to improve job skills for 1996 through 1998. The deduction, available whether or not the taxpayer itemizes, would rise to $10,000 in 1999. No other conditions are attached to the deduction.
2. American College Testing Program, unpublished tabulations, 1987, derived from statistics collected by the U.S. Bureau of the Census; and U.S. Department of Labor, College Enrollment of 1993 High School Graduates, and unpublished data, June 1995
3. U.S. Department of Education, U.S. National Center for Education Statistics, *1995 Digest of Education Statistics*, Table 165
4. These figures are based on data for 1992-1993 when the total costs for institutions of higher education totalled $171 billion. See U.S. Department of Education, National Center for Education Statistics, "Financial Statistics of Institutions of Higher Education" surveys; and Integrated Postsecondary Education Data System (IPEDS), "Finance" surveys, April 1995.
5. Executive Office of the President, *Budget of the United States Government, Fiscal Year 1997*, Washington, DC: U.S. Government Printing Office, 1996, pp. 76-81
6. In 1993, tuition was estimated at $45 billion while scholarships and grants were $10 billion. Adjusting the 1999 tax credit estimates to reflect 1993 levels implies a 10 percent reduction in tuition costs.
7. This is true when measured by including the costs of room and board or the opportunity cost of lost earnings.
8. $150,000 for the 100 students who would already attend college, plus $4,500 for the three students presumably encouraged to enroll, equals $154,500. Diving this total of $154,500 between the three newly-encouraged enrollees equals $51,500 per enrollee encouraged by the President's plan.
9. The present value of taxes on $250,000 earned over 45 years is $40,000.
10. Between 1973 and 1993, total real expenditures for institutions of higher education rose by nearly 70 percent, while full-time equivalent enrollment increased by 32 percent.
11. While the windfall costs go from $33.33 to $55, the lifetime tax offset remains at $40,000.