PRINCIPLES FOR REFORM: HIGHER EDUCATION & COLLEGE SAVINGS TAX EXPENDITURES

About the Tax Alliance for Economic Mobility

The Tax Alliance for Economic Mobility, co-led by CFED and PolicyLink, convenes racial justice advocates, asset-building advocates, tax reform experts, and researchers to identify near- and longer-term policy priorities to expand savings and investment opportunities for lower-income households through reform of the U.S. tax code. The Alliance includes a coalition of national organizations that have agreed on shared principles and are working to educate and engage their networks about why equitable, inclusive, and progressive tax reform is crucial to building the long-term security of families, communities, and the national economy.

This document reviews the role of higher education in promoting economic mobility, examines tax expenditures for higher education and college savings, and proposes a set of principles for reform.

Reform Principles Snapshot

1. Provide support to students who can most benefit.
2. Expand access to and support for college savings for lower-income students.
3. Provide support to students when they need it.
4. Simplify existing programs and increase take-up.
5. Incorporate automatic enrollment and eligibility programmatic features.
6. Eliminate programmatic features that disadvantage lower-income students.

The principles outlined in this document were developed by the Higher Education & Children's Savings Working Group and may not reflect the views of individual members of the Tax Alliance for Economic Mobility.

Introduction: Higher Education and Economic Mobility

Higher education is critical for economic mobility. A college degree can be a ticket out of poverty, and few investments have a greater rate of return than an associate's, professional, or bachelor's degree.[i] Supporting early college savings by low-income families is a very promising pathway to expanding access to college. A recent experimental study of automatic and progressive college savings documents a number of impacts on outlooks and behaviors that matter for child development and educational attainment.[ii]

But the benefits of higher education have not been equally shared, and this inequity has grown in recent years along with college costs and college debt. Nationwide, whites are about 50% more likely than people of color to have a 4-year college degree. In some states, whites are more than twice as likely to have a postsecondary degree.[iii]

Tax-based aid, including subsidized children's savings accounts, have the potential to play an important role in supplementing a strong Pell Grant program to create a system of supports to significantly expand access to college. Unfortunately, the way most tax-based aid is now structured falls short of this goal."

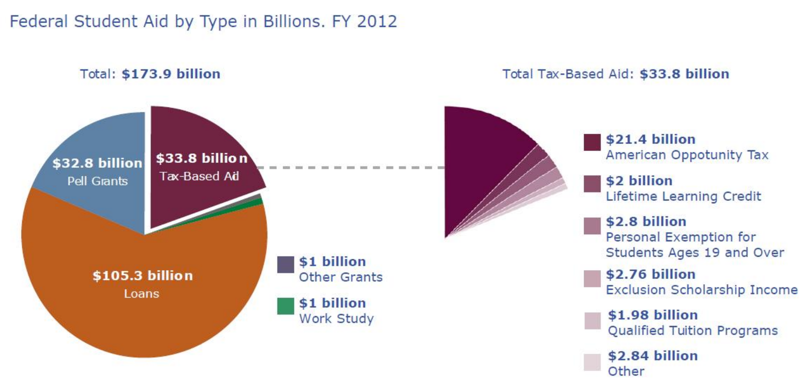
Evidence shows that other types of college aid—such as Pell Grants—disproportionately help low-income students and students of color. Recently, analyses have shown that a robust children's savings policy could significantly close the growing racial wealth divide.[iv] But the existing programs for both college savings and other forms of tax-based student aid fail to provide support to those students who could most benefit.

The remainder of this document reviews the current state of tax-based aid and makes recommendations for reform. We begin with a review of tax-based aid as a whole, comparing its size and distribution to the more equitable Pell Grant program. We then consider a particular type of tax-based aid, tax-subsidized college savings accounts, examining how these tax subsidies fail to expand economic mobility. We conclude with principles for reform of tax-based aid generally and tax-subsidized college savings accounts specifically.

The Shortfalls of Tax-Based Student Aid

The federal government provides financial support to students seeking higher education through two main strategies: subsidized loans and direct subsidies, which can be cash grants or tax-based aid. Pell Grants for low-income students are one of the main types of direct subsidies for higher education; however, they are not the largest. More than half of spending on direct subsidies comes in the form of tax-based aid, such as the American Opportunity Tax Credit (AOTC) and Tuition and Fees Deduction. In fact, for the last two decades, tax-based aid has roughly matched or outweighed federal spending on Pell Grants.[v]

Types of Federal Student Aid: Loans, Pell Grants, and Tax-Based Aid



Source: CLASP analysis of President's FY2014 Budget. Note that "Qualified Tuition Programs," also known as 529s, are the largest federally-subsidized college savings accounts.

Both Pell grants and tax-based subsidies aim to help students afford higher education. However, there is one striking difference: which students benefit. Pell Grant eligibility is limited to households with annual income under $50,000, and most Pell Grant benefits go to households with annual income under $20,000. In contrast, the majority of tax-based benefits go to households with income above $50,000. An analysis of four of the largest of these programs found that more of their value went to upper-income households in the top 40% than households in the bottom 40%. Even the AOTC, which is partially refundable and therefore more available to lower-income households, delivers more of its value in dollar terms to households in the top 40% than the bottom 40%. Furthermore, while there is evidence of the impact of Pell Grants on college access and success, emerging research has found that tax-based aid has "little or no causal effect on college-going."[vi]

Currently, tax-based aid is poorly targeted to expand educational opportunity. Researchers and advocates have identified three reasons why tax-based aid fails to have positive impact[vii]. In short, existing tax-based aid programs are:

1. **Poorly targeted**. These programs tend to focus benefits on higher income households, and in some cases systematically exclude lower-income students. For instance, some tax-based aid limits support for ex-offenders and students who need more than four years to graduate.
2. **Poorly timed**. Benefits for most tax-based programs are only available after education expenses are incurred, which is often too late for credit-constrained, lower-income students.
3. **Complex and not well-known.** With multiple overlapping tax-based programs, thousands of students every year make use of the wrong tax program, receiving less benefit than they are entitled to.[viii] Many students don't even know the programs exist and fail to claim any benefit at all.

The Shortfalls of Tax-Subsidized College Savings Accounts

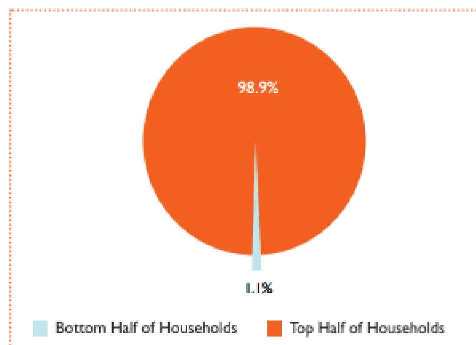
One particularly inequitable type of tax-based aid comes in the form of tax-subsidized college savings accounts, also known as 529s and Coverdells. Savings in these accounts grow tax free, and withdrawals can be used to pay for higher education expenses. A college savings account in the hands of a low-income student can be a powerful tool for expanding educational opportunity, as evidenced by universal, progressive programs in states such as Maine, Nevada, and California.[ix] While some of these programs make use of 529s to support lower-income students, nearly 99% of all savings in these accounts is owned by above-median income households nationwide. Evidence from state 529 plans shows that the beneficiaries tend to have higher income and greater wealth, and larger benefits go to those with the higher income.[x]

Researchers and advocates have identified several key features of an effective children's savings policy.[xi] Such a policy should:

- Provide simple, low-cost accounts automatically to all children.
- Ensure lower-income households receive additional support to develop savings.
- Ensure accounts can be used over the child's lifetime for asset-building purposes.
- Couple accounts with financial education.

While existing tax subsidies for college savings fall short, thoughtful reforms could achieve these each of these goals.

Top 50% of earners own nearly all 529 and Coverdell savings



Source: CFED analysis of data from U.S. Department of the Treasury, *"An Analysis of Section 529 College Savings and Prepaid Tuition Plans,"* 2009.

Principles for Reforming Tax-Based Aid

While tax-based aid is only one of several tools for expanding college success, these programs are significant in size and scope. Unfortunately, as currently structured, both tax-based aid overall and tax-subsidized college savings accounts specifically are inequitable and ineffective programs that fail to expand educational opportunity. Reforming these programs can be a complement to proposals around Pell Grants and more comprehensive plans to reduce college debt.

Tax-based aid should be viewed in the context of the overall system. Costs and benefits of specific tax-based programs should be weighed against each other and against other types of direct subsidies that expand access to higher education and increase graduation rates. Researchers and advocates have proposed various options for improving tax-based programs, including combining tax-based aid into a simpler, more equitable credit;

improving the timing of tax-based aid; providing subsidized savings accounts automatically at birth; and ensuring incentives to save for college are more equitably distributed.

In short, there are several paths forward that would lead to a much more effective and equitable system of tax-based aid. As policymakers evaluate reform options, they should focus on improvements that will expand educational opportunity. To accomplish this goal, reforms to tax-based aid should:

- **Provide support to lower-income students who can most benefit.** Reforms should ensure that low- and moderate-income households receive a majority of support from tax-based aid programs, including college savings programs.
- **Expand access to and support for college savings for lower-income students.** Reforms should expand the number of households with college savings accounts, with a focus on account ownership and savings support for low-income households and households of color.
- **Provide support to students when they need it.** Reforms should ensure that students are not required to wait to receive support until months after they've incurred higher education expenses.
- **Simplify existing programs and increase take-up.** Reforms should consolidate existing tax-based aid programs into a more robust and equitable AOTC, while investing in outreach to increase take-up among low-income Americans and households of color.
- **Incorporate automatic enrollment and eligibility programmatic features.** Reforms should adopt opt-out systems for students and savers in order to maximize participation among lower-income populations.
- **Eliminate programmatic features that disadvantage lower-income students.** Reforms should end discrimination against ex-offenders and eliminate the four-year cap on the AOTC.

These principles for reform of tax-based aid can lead to more equitable programs that will expand educational opportunity throughout the country. As such, the Tax Alliance for Economic Mobility strongly encourages policymakers to ensure that any reforms of tax-based aid programs are in line with these principles.

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[i] Michael Greenstone et al., *"Thirteen Economic Facts about Social Mobility and the Role of Education"*, June 2013.
[ii] Beverly, S. G., Clancy, M. M., & Sherraden, M. (2016, June). The early positive impacts of Child Development Accounts (CSD Research Brief 15-08). St. Louis, MO: Washington University, Center for Social Development
[iii] CFED, *"Assets & Opportunity Scorecard: Four-Year Degree by Race"*, 2016.
[iv] Annie E. Casey Foundation, "*Investing in Tomorrow: Helping Families Build Savings and Assets"*, 2016.
[v] CFED, "*Upside Down: Higher Education Tax Spending",* May 2014.
[vi] George Bulman & Caroline Hoxby, *"The Returns to the Federal Tax Credits for Higher Education"*, January 2015.
[vii] See Reimagining Aid Design and Delivery (RADD) Consortium for Higher Education Tax Reform, "*Higher Education Tax Reform: A Shared Agenda for Increasing College Affordability, Access, and Success*", November 2013.
[viii] U.S. Government Accountability Office, *"Improved Tax Information Could Help Families Pay for College"*, May 2012.
[ix] Maine's *Harold Alfond Challenge*, Nevada's *College Kickstart*, and San Francisco's *Kindergarten to College* program each provide children with seeded CSAs automatically, either at birth or upon beginning kindergarten.
[x] CFED, *"529 Reform: Promote a Culture of Savings & Educational Opportunity"*, May 2015.
[xi] See Michael Sherraden & Julia Stevens, "*Lessons from SEED, a National Demonstration of Child Development Accounts*", Center for Social Development, September 2010.