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Expand But Simplify? Education Credits Under Emanuel-Camp-Bayh

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New bills in Congress would expand federal subsidies to higher education in a way that would likely help students little financially but would straighten out the current maze of federal subsidies.

Representatives Rahm Emanuel (D-IL) and Dave Camp (R-MI) and Senator Evan Bayh (D-IN) have proposed H.R. 2458 and S. 1501 to expand and streamline the federal tax credits for college tuition. Much of the expansion would go to those at the bottom and at the top of the income scale, and a useful lifetime cap would be set on the credits: no more than 6 years' worth or $12,000.

Currently, the federal tax code offers three potential tax subsidies to a taxpaying student or the taxpaying parents of a dependent student, and like the entire college assistance process, they are terribly complex. What's worse, because colleges themselves cleverly capture much of the benefits of this financial assistance, the tax subsidies often fail to save students and their parents the large amounts of money they purport to save, even after the students and parents jump through all the hoops on their tax returns and discover they qualify.

There is a strong argument for deciding the current tax credits are simply not worth the foregone revenue and should be left out of the tax code altogether. In this *Fiscal Fact*, we examine the benefits and drawbacks to Emanuel-Camp-Bayh. Would this bill improve the current situation? We find that it has both good and bad elements.

Bill Would Simplify Education Tax Credits

The tax code already has two definitions of income: adjusted gross income (AGI) and taxable income. Alas, when the current education tax credits were written into law, someone decided that neither of those suffices, so the taxpayer who wants an education subsidy must calculate what's called MAGI, modified adjusted gross income. After doing that, he can claim one, and only one, of three different federal tax subsidies: (1) an above-the-line tax deduction, (2) the Hope Learning Credit, or (3) the Lifetime Learning Credit. Each calculation varies according to income (MAGI) and dependency status. Essentially, to get the best deal, the taxpayer must calculate his tax bill under three scenarios to see which provides the most relief.

Most federal credits have a "phase-out range," which means that people who earn above some amount gradually start to lose the tax relief, usually in $50 or $100 increments for each additional

$1,000 of income. Eventually, the relief is gone. For two of the three current education tax preferences, the Lifetime Learning and Hope credits, the beginning of the phase-out range is $47,000 in 2007. At the upper end of the phase-out range, currently $57,000, the credit reaches zero. (Amounts double for couples.) This is a comparatively rapid phase-out, which economists invariably decry because it results in a high effective tax rate during the phase-out range. For example, if a taxpayer in the 25-percent tax bracket is also losing $100 for each additional $1,000 he earns (a 10-percent rate), then he's essentially paying a 35-percent marginal tax rate.

As for the third education tax preference in current law, the above-the-line deduction, the way the tax code currently takes it away is even worse economically. It doesn't use a gradual phase-out at all. Instead the deduction just drops in value by 50 percent when the taxpayer's income hits $65,000, then stays steady until his income hits $80,000, and then vanishes ($130,000 and $160,000 for couples). This fall-off-the-cliff method of taking away a tax benefit is a known cause of tax evasion and economic harm.

These are the areas where the Emanuel-Camp-Bayh bill would do the most good. It proposes to convert all of the tax subsidies for higher education into one unified credit that has a gradual phase-out range. Students and their parents would have a much easier time figuring out if they qualify for relief.

Another reasonable provision strikes at the "over-usage" controversy. We've all heard of career students. Currently, they can take the Lifetime Learning Credit for as many years as they keep enrolling, even for a stretched out period of graduate school. This type of student clearly deserves no government subsidy, and the Emanuel-Camp-Bayh bill makes sure these students don't receive subsidies by limiting the unified credit to four years of undergraduate and two years of graduate school. Even within those eligible years, it caps the lifetime amount of the credit at $12,000 per student.

Clearly it's an offense to reasonable public policy for the federal government to pay a law school student or MBA student $2,000 a year when that person already has an undergraduate degree and is likely to spend most of his life in the nation's highest income group.

Bill Would Expand Education Credit "Spending"

Emanuel-Camp-Bayh would expand education credits in three ways: by raising the annual credit limit, by making the credit refundable for low-income taxpayers, and by giving the credit to higher-income people.

A Higher Annual Amount

Currently, $2,000 per year is the maximum education tax savings anyone can receive. Emanuel-Camp-Bayh would push this limit up to $3,000 per year. Of course, it can't be that simple: the new unified credit would permit the taxpayer to credit 50 percent of the first $3,000 of expenses and then 30 percent of the next $5,000, so a taxpayer can't get the full $3,000 unless he's paying at least $8,000.

Pushing the credit up to a maximum of $3,000 could have the perverse effect of raising tuition. How could that happen? Colleges have detailed financial information on students, which they can easily use to engage in price discrimination. In other words, colleges can simply raise their tuition to the amount their students can afford plus the amount the government gives them, and then offer financial aid to reduce the effective price for some students based upon the detailed financial information provided. Understood this way, then, higher credits would mostly just push tuition up, which raises the list price of tuition, which creates political pressure for higher credits. It's like a dog chasing its tail. Unfortunately, the main beneficiaries of education credits appear to be faculty and administrators, which is why Ohio University economist Richard Vedder called the creation of the initial education credits in 1997 the "Faculty Salary Enhancement Act."

A Refundable Credit
The second expansion would make part of the credit "refundable." Under current law, if a student or paying parent claims so many other deductions and credits that he reduces his federal tax bill to zero—that is, he gets back every dollar withheld from paychecks during the year—he can't benefit from the education provisions. There's no income tax left to give relief from. Under Emanuel-Camp-Bayh, such a person would receive a check for 50 percent of the amount credited.

Because refundable credits are no different from direct government spending (legally they are the same) and the goal of government spending is to merely subsidize some activity, when Congress sets out to subsidize an activity such as higher education, the subsidy should not depend upon taxpayers' tax and income profiles, unless good evidence suggests it should. Therefore, since this tax credit has the same economic effect as a spending program anyway, consistency would likely call for the tax credit to be 100 percent refundable. Congress is merely using the tax code as an instrument for spending.

However, rather than using the tax code at all, Congress could simply expand Pell Grants, which many of these lower-income taxpayers are likely to be claiming anyway. This would spare them the complexity of dealing with two separate systems—Pell Grants and refundable education tax credits. There are benefits and costs to doing each through the tax code rather than through a spending program. (For more on the benefits and costs of using the tax code for this, look for a forthcoming *Tax Foundation Special Report* on the role of government in education financing.)

A Higher Phase-Out Range
Emanuel-Camp-Bayh would grant the full credit to single taxpayers making less than $50,000 or couples making less than $100,000. Above those amounts, the tax relief would phase out, reaching zero for singles making $85,000 and couples making $170,000.

Why would Emanuel-Camp-Bayh propose an income ceiling for credit eligibility as high as $170,000? Many politicians have been erroneously referring to such earners as "middle-class," which is an absurdity. The IRS puts them in the top five percent of the nation's earners. However, parents and students are not the principal beneficiaries of government tax subsidies, anyway. Raising the income limits for qualifying does the same thing that increasing the annual credit amount does: transfer more taxpayer money into college coffers, leaving little benefit for the students and parents.

Bill Has Potential Abuses
One of the best provisions of current law is the limited list of educational expenses that a student can count for Hope and Lifetime Learning Credits: tuition and fees only. Not housing, not books or equipment, not transportation. Unfortunately, Emanuel-Camp-Bayh would change this.

Of course, housing, books and transportation are big-ticket items, and some students and parents have difficulty affording them. That's undoubtedly why Emanuel-Camp-Bayh would add them, but these provisions would be far too easy to abuse. A laptop computer would undoubtedly qualify as an educational expense, no matter how expensive it is or whether it's more often used to view pornography and play games. How about an expensive piece of software or a TI-89 calculator? Or movie tickets for a film class? If such things are permitted, as Emanuel-Camp-Bayh intends, the IRS might have to force students to keep receipts for every supply purchased. Such a policy would defeat much of the bill's move towards simplicity, and it would be a nightmare for the IRS.

The current rule allowing only tuition and fees isn't perfect. Some schools incorporate textbook costs into tuition, giving their students more to deduct—an advantage over students and schools that charge separately for books. However, this discrepancy is minor, especially compared to the avalanche of credit abuse that would occur if all manner of educational spending is permitted.

The bill should abandon the total-expense approach and perhaps attack only the textbook problem or perhaps the transportation issue as well. Congress could direct the IRS to determine the average amount of expenses per dollar of tuition credit or per hour of course study, and use that to publish a table of how much students are allowed to deduct for books. This would mirror the IRS's approach to the deduction for state and local sales taxes. The main benefit is the lack of paperwork for students, as well as the prevention of abuse relating to questionable classroom supply purchases. A similar system could apply to transportation expenses.

Conclusion

The Emanuel-Camp-Bayh bill has elements of both good and bad tax policy. Unfortunately, it expands higher education subsidies through the tax code. Such policies largely fail to help parents and students because colleges themselves capture much of the economic benefits through price discrimination.

On the other hand, Emanuel-Camp-Bayh does simplify the current complicated process, and all tax simplification is welcome. This accomplishment may be completely undone by the bill's expansion beyond tuition and fees. If other supposedly education-related expenses are counted towards the credit, Congress will be making April 15th a paperwork nightmare for students, parents and the IRS.

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