

## Moving On Up: How Tuition Tax Breaks Increasingly Favor the Upper-Middle Class

**The Obama administration and Congress have had to make significant cuts to federal student aid funding over the last year to try to shore up funding for the Pell Grant program, the primary source of aid for**

**low-income students.** To maintain the maximum Pell Grant at its current level of \$5,550, lawmakers narrowed eligibility for the grants and made the program less generous by, for example, ending recipients' ability to obtain supplemental grants to attend summer school. They also eliminated a long-standing program that provided matching funds to states to entice them to spend their own resources on need-based financial aid and scaled back the in-school interest subsidy the government provides on student loans for financially needy students.

The Pell Grant program, however, remains in jeopardy. It is facing yet another major funding cliff next year, when the \$17 billion in emergency funding Congress provided last summer to keep the program afloat is set to run out. But while policymakers take aim at the traditional federal student aid programs, they have left another category of college aid untouched: the large and growing amount of money the government provides through the tax code subsidizing higher education for upper-middle income families who are more able to afford sending their children to college without the help.

When the Clinton administration and Congress first introduced the Hope and Lifetime Learning Tax Credit programs in the late 1990s, their aim was to make college more affordable for the middle class. And at first, these tax credits, which are subtracted directly from the amount of federal income tax owed, lived up to their billing: more than 80 percent of the benefits went to families earning less than \$75,000 a year. But in the years since, federal officials have added new tax breaks to the mix that have increasingly steered benefits to families with higher incomes.

Policymakers who have championed these programs say that delivering student aid through the tax code is the easiest way for them to provide relief to students and families who are facing ever-rising college prices. That's because, unlike federal grant and loan programs, the tax benefits are not counted as spending in the federal budget and therefore do not appear to increase the deficit, even though they reduce the amount of revenue the government collects each year. As Jason Delisle, director of the New America Foundation's Federal Education Budget Project, has explained: "Tax benefits don't look like spending and therefore win more support from lawmakers. But from a true budget perspective, tax benefits and grants have the same effect."<sup>1</sup>

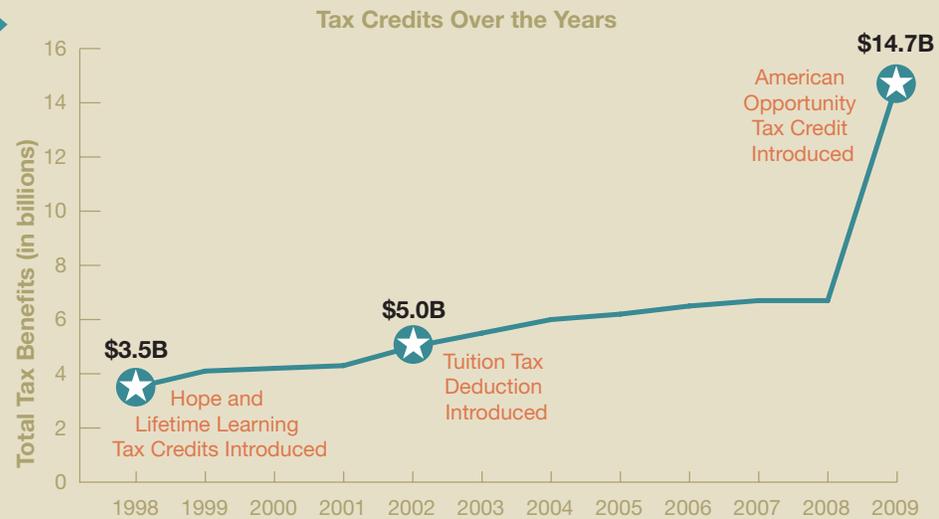
But policymakers also have a more self-serving reason for pushing these tax expenditures: they allow them to provide federal subsidies to upper-middle income tax filers who are most likely to vote. Every Democratic presidential contender since Clinton has offered his own tuition tax break plan because such proposals poll extremely well among this powerful constituency.<sup>2</sup>

Regardless of policymakers' motives, at a time when the budget axe is falling on the Pell Grant program, providing billions of dollars in tax benefits to upper-middle income families who would send their children to college without the help is a luxury that the government can no longer afford.

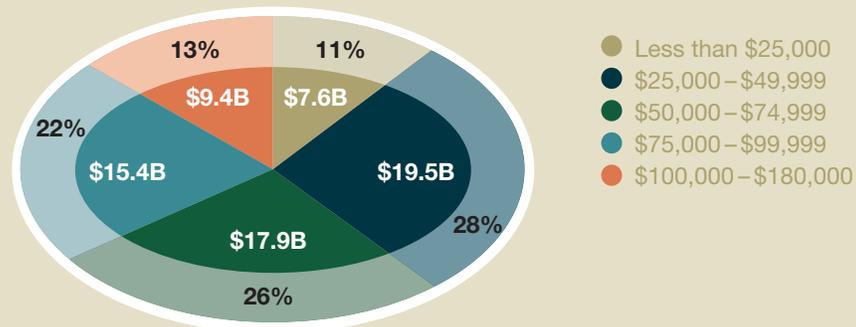
Using Internal Revenue Service data collected by the College Board, we took a close look at the distribution of the tuition tax breaks from 1999 to 2009, the latest year for which the data is available.<sup>3</sup> The following charts show how the tuition tax break programs have evolved over time to provide a greater and greater share of the benefits to higher-income families.

#### CHART 1

Over the years, the government has spent \$70 billion on tuition tax breaks.



#### Overall Total and Share of Benefits Received by Income From 1999 Through 2009



**Total Benefits: \$70 billion**

**Source:** Education Sector analysis of Internal Revenue Service data collected by the College Board

## The Big Picture

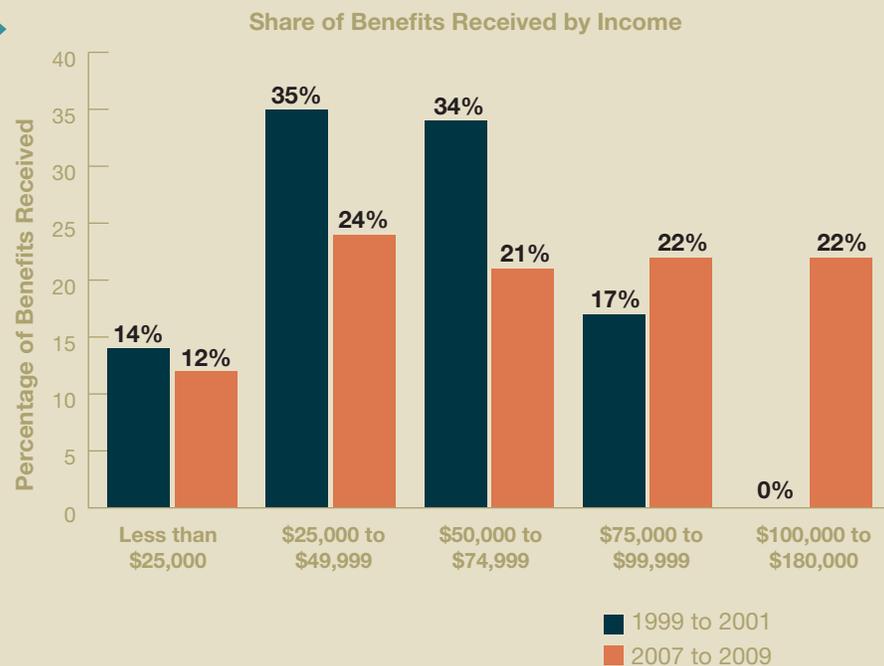
From 1999 to 2009, the government spent \$70 billion on tax breaks aimed at subsidizing higher education for families.<sup>4</sup> As **Chart 1** shows, about 13 percent, or \$9.4 billion, of that total went to families making more than \$100,000 a year. At the same time, only 11 percent went to the neediest families, those making less than \$25,000. Families in the middle—those making between \$25,000 and \$99,999—received the lion's share of the aid, taking in slightly more than three-quarters of the benefits.

Overall, middle-income families made out the best. However, that's only part of the story. Federal higher education tax benefits have become increasingly generous to well-off families over time, under Democratic and Republican leaders alike. In fact, in recent years, with the creation of new and more-generous tax breaks, the amount and share of the tax savings going to the highest income families eligible for these programs has soared.

As **Chart 2** shows, nearly 83 percent of the higher education tax benefits distributed from 1999 to 2001 went to families earning less than \$75,000 per year. No benefits went to those earning more than \$100,000. By contrast, in the last three tax years alone, families making between \$100,000 and \$180,000 received nearly a quarter of the benefits. The share going to middle-income families sharply declined.

CHART 2

Tuition tax breaks have become increasingly generous to well-off families over time.



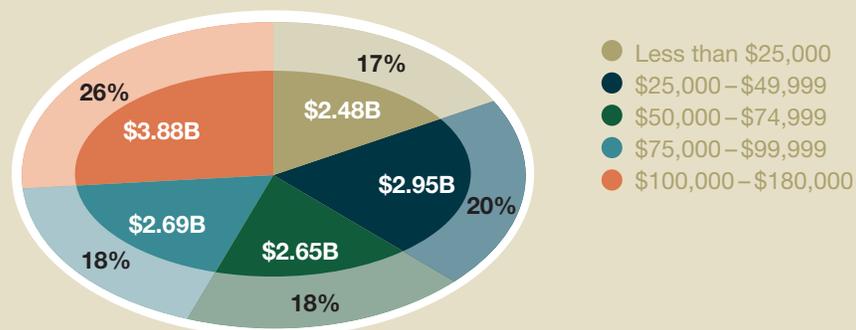
Source: Education Sector analysis of Internal Revenue Service data collected by the College Board

The introduction of the Obama administration's American Opportunity Tax Credit (AOTC) in 2009 has proven to be a bonanza for the highest income group. As **Chart 3** shows, families making between \$100,000 and \$180,000 received the largest amount (\$3.88 billion) and share (26 percent) of the nearly \$15 billion in benefits the government provided that year. Low-income students and families also benefited because the administration and Congress made the tax credits partially refundable (meaning that they are available to those who are too poor to have any tax liability). Middle-income families saw their share of the benefits drop to 56 percent.

### CHART 3

In 2009, tax breaks benefited the highest income group the most.

Total and Share of Benefits Received by Income in 2009



Total Benefits: \$15 billion

Source: Education Sector analysis of Internal Revenue Service data collected by the College Board

All signs suggest that these trends will continue, or even become more acute. The U.S. Joint Committee on Taxation has estimated that the government will spend about \$55 billion on the tuition tax break programs from 2010 through 2014.<sup>5</sup> Families making over \$100,000 should continue to be the primary beneficiaries of these tax breaks through the end of 2012, when the AOTC is set to expire. In addition, President Obama has called on Congress to permanently extend the AOTC. If lawmakers follow through with this proposal, they will provide a huge windfall to higher-income filers in perpetuity.

## How Did We Get Here?

For the first three decades after the introduction of the Higher Education Act in 1965, champions of the federal student aid programs successfully warded off several efforts by lawmakers and the Reagan administration to start providing student aid through the tax code. In fighting these proposals, they argued that the federal government should focus its resources on helping those who would not be able to attend college without the help.

In fact, in the 1960s and the early 1970s, the Democratic-led Congress explicitly rejected proposals to create tuition tax credits. Instead, to open the doors of college to low-income students, they created Pell Grants, which predominantly go to students from families with annual incomes under \$40,000. For less needy students, they launched a government-backed student loan system, aimed primarily at helping middle-income students afford costlier colleges.

But critics of the government's student aid programs were not satisfied. They argued that the system was unfair to middle-income families, who did not qualify for grant aid.

The fight came to a head in the late 1970s when a bipartisan group of lawmakers called for eliminating the federal student aid programs and replacing them with tuition tax breaks. President Jimmy Carter strongly opposed these efforts, arguing that a system of grants for low-income students and loans for middle-income students was more equitable than one that would leave those who needed the government's help the most in the lurch because their families did not earn enough to pay taxes. Congress was divided. Only in the waning hours of the 1978 session did the proponents of the existing system quash the tax plans. With that victory, student aid supporters believed they had finally put the issue to rest.<sup>6</sup>

But the issue resurfaced 15 years later, when, ironically, the first Democratic president since Carter put tuition tax breaks back on the table. Heading into his campaign for a second term, President Bill Clinton wanted to make a big splash by proposing a massive expansion in funding for federal student aid. But, with both ends of Pennsylvania Avenue focused on trying to balance the federal budget, the president and his advisers knew that it would be unrealistic to call for huge spending increases on the traditional student aid programs. So instead, they sought to achieve their goals through the tax code.<sup>7</sup> Through these efforts, the Hope and Lifetime Learning Tax Credits were created.

### ***The Birth of the Tax Credits***

When President Clinton first unveiled his tuition tax break proposals in a speech he delivered at Princeton University's commencement in June 1996, he sold them as a way to "make the 13th and 14th years of education as universal to all Americans as the first 12 are today." Under the plan, students and their families could choose between a \$10,000 tax deduction and a \$1,500 Hope Tax Credit to help them pay for college. The full deduction or credit was to be available only to families that earned less than \$80,000 and to individual taxpayers who earned less than \$50,000. The value of the tax break was to decline progressively for families that earned \$80,000 to \$100,000 and for individuals who earned \$50,000 to \$70,000. Meanwhile, the Hope credit was to be available only for students in their first two years of college.

These proposals caused an outcry from student aid advocates and experts. They particularly objected to the tax deduction proposal because they said it would primarily help the highest income families eligible for the benefit. That's because a tax deduction is subtracted from the amount of a taxpayer's income that is subject to tax. As a result, individuals in higher tax brackets would receive greater savings than those in lower brackets who paid the same tuition. In addition, low-income families who pay little or no income tax wouldn't receive any benefit from it at all.

Clinton eventually bowed to the opposition and abandoned his tuition tax deduction proposal. In its place, the administration proposed—and Congress adopted along with the Hope tax break—a second tax credit aimed at encouraging lifelong learning. The “Lifetime Learning Credit” is available for up to \$2,000 annually for qualified students enrolled in at least one postsecondary education course in a given year.<sup>8</sup> At the same time, administration officials acknowledged that low-income students would derive only minimal benefits from the new programs. “This is a middle-class tax break, first and foremost,” Gene Sperling, President Clinton's economic adviser, told a gathering of college lobbyists in January 1997.<sup>9</sup>

For the first several years after they were created, the tax credits lived up to their promise as a middle-class benefit. As Chart 2 shows, from the tax years 1999 through 2001, 83 percent of the benefits went to students and families making less than \$75,000. Nearly half went to filers earning less than \$50,000. Because of the income limits, families making \$100,000 or more were not eligible for these benefits.

### ***The Return of the Tuition Tax Deduction***

The demise of the tuition tax deduction proposal was short-lived. Urged on by private college lobbyists and leaders and lawmakers from Northeastern states where these institutions are heavily represented, Congress included the “Higher Education Tax Deduction” in President Bush's tax cut legislation in 2001.<sup>10</sup>

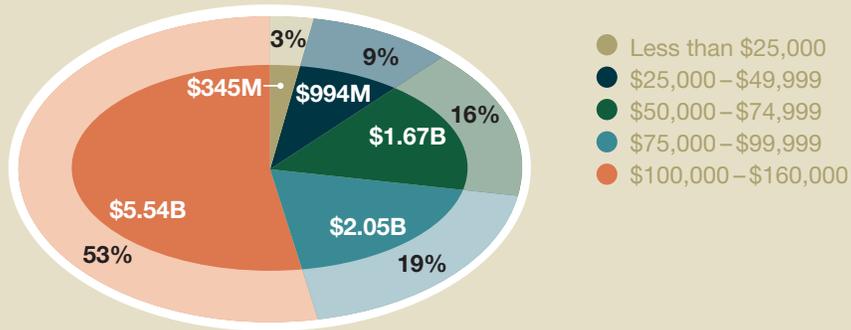
Under the new program, students and their families became eligible to subtract from their taxable income up to \$4,000 in tuition and fees. Congress made the deduction, which expired at the end of 2011, available to individuals earning up to \$80,000 a year and families making as much as \$160,000 annually.

Student aid experts who opposed this new tax break warned that the largest benefits from tax deductions would go to individuals and families in the highest tax brackets. **Chart 4** shows that those concerns were warranted. As Chart 4 indicates, more than half of all the savings through the tax deduction went to families making \$100,000 or more, and nearly three-quarters to those earning \$75,000 and above. Meanwhile, only 12 percent went to individuals and families making less than \$50,000.

CHART 4

New tax deduction pays off for the upper-middle class.

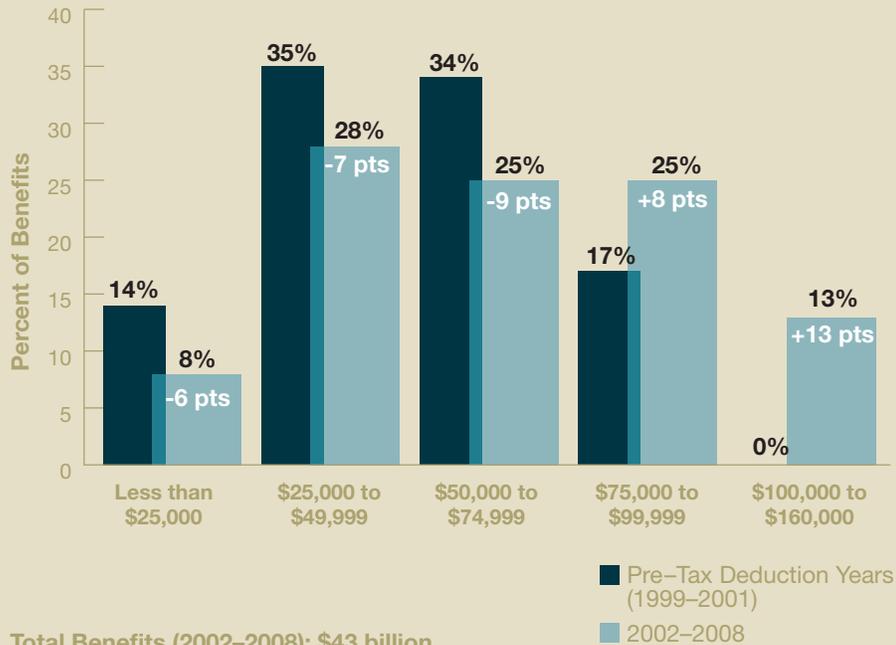
Higher Education Tax Deduction From 2002 Through 2009



Total Benefits: \$11 billion

Source: Education Sector analysis of Internal Revenue Service data collected by the College Board

Share of Benefits Received by Income Before and After Tax Deduction



Total Benefits (2002–2008): \$43 billion

Total Benefits (Pre-Tax Deduction Years): \$13 billion

Source: Education Sector analysis of Internal Revenue Service data collected by the College Board

The availability of the higher education tax deduction shifted the overall tuition tax break benefits up the income scale. While nearly 50 percent of tax breaks had gone to students and families making less than \$50,000 before the deduction was introduced, as Chart 4 shows, these individuals and families received only a little more than a third of the benefits from 2002 through 2008. And where previously families making over \$75,000 had only a slight advantage over recipients earning less than \$25,000, they now were nearly five times as likely to receive the benefits.

### An 'Opportunity' to Expand Hope

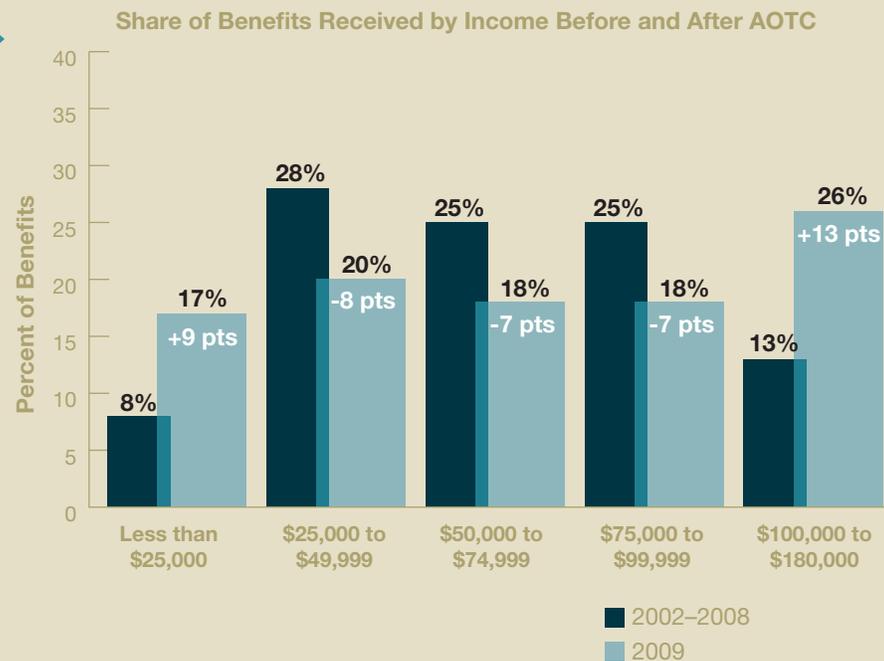
In the years since President Clinton championed the Hope and Lifetime Learning Tax Credits, every successive Democratic presidential candidate has pushed his own tuition tax cut plan on the campaign trail—each more generous than the last.

Barack Obama was no exception. On the stump in 2008, Obama proposed to consolidate all of the existing tuition tax breaks into a single \$4,000 American Opportunity Tax Credit (AOTC) that would be fully refundable and available to any student, regardless of income, who performed at least 100 hours of community service.<sup>11</sup>

After President Obama took office, however, political and budgetary realities set in. The administration succeeded in getting the AOTC in the federal budget stimulus legislation Congress approved in February 2009, but in a much altered form. Lawmakers agreed to temporarily replace the Hope Tax Credit with a new \$2,500 credit, but left the other tuition tax breaks in place and removed the community service requirement. To keep the cost of the AOTC down, Congress made the credit only partially refundable—allowing students and families without tax liability to claim up to \$1,000 as a tax refund.

While Congress and the administration did not make the tax credits universally available, they did significantly move eligibility for tuition tax credits up the income scale. The AOTC is available to individuals earning up to \$90,000 a year, and

**CHART 5**  
**American Opportunity Tax Credit shifts benefits even further up income scale.**



**Total Benefits (2009): \$14.7 billion**

**Total Benefits (2002–2008): \$43 billion**

**Source:** Education Sector analysis of Internal Revenue Service data collected by the College Board

families with annual incomes up to \$180,000 (compared to the Hope and Lifetime Learning credits, which are now available to individuals making up to about \$60,000 a year and families with incomes of nearly \$120,000 annually). These caps exceed even those of the higher education tax deduction.<sup>12</sup>

By increasing the maximum credit, making it partially refundable, and boosting the income eligibility limits, policymakers essentially put the Hope Tax Credit on steroids—causing explosive growth in the federal subsidies individuals and families receive through the tax code. In 2009, students and their parents claimed \$14.7 billion in tuition tax benefits, more than double the amount they had received in 2008.<sup>13</sup>

With this huge infusion of funding, all income groups benefited in terms of the amount of savings they received. However, higher-income families made out the best.

By making the AOTC a partially refundable credit, President Obama and Democratic lawmakers managed to significantly increase the share of benefits going to low-income students and families. As **Chart 5** shows, the proportion of tax breaks going to filers earning less than \$25,000 more than doubled from the period after the tuition tax deduction was introduced (Chart 4).

But by far, the biggest winners were families with incomes of \$100,000 or more, who in 2009 received the largest share of the savings from the tax breaks. And despite the expansion of funding for low-income students and families, filers making more than \$75,000 were two-and-half times more likely than those earning less than \$25,000 to receive the benefits.

Notably, while policymakers continue to tout the tuition tax breaks as a middle-class benefit, the introduction of the AOTC led to significant reductions in the share of the overall benefits going to families making between \$25,000 and \$75,000.

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## No More Tuition Tax Breaks

President Obama has made making the AOTC permanent a centerpiece of his higher education agenda for his re-election campaign. In his recent State of the Union address, Obama said his proposal would save “millions of middle-class families thousands of dollars.” What he didn’t say was that this proposal would also provide a major windfall for families up the income scale who presumably were already planning to send their children to college without the help.

At a time when Congress is struggling to fund the Pell Grant program and financially needy students who pursue a higher education are facing mountains and mountains of debt, policymakers need to refocus the government’s resources on

## Tuition Tax Breaks

*The federal government began offering student aid through the tax code in the late 1990s. The tuition tax break programs that students and their families can choose among have evolved in the years since. The following is a brief description of these programs:*

**Hope Tax Credit:** In 1997, Congress created the Hope Tax Credit, which is a nonrefundable \$1,800 tax credit that was available until 2009 to help students cover their tuition and fees in their first two years of college. Initially, the tax credit was worth \$1,500 and available to individuals earning up to \$40,000 per year, and to joint filers making up to \$80,000 annually. Individuals earning between \$40,000 and \$50,000 and joint filers making between \$80,000 and \$100,000 annually were qualified for partial credits. Both the amount of the credit and the income limits were indexed for inflation. In 2009, Congress temporarily replaced the Hope credit with the American Opportunity Tax Credit. (See below.)

**Lifetime Learning Tax Credit:** In addition to Hope, Congress in 1997 created the Lifetime Learning Tax Credit, which is a \$2,000 nonrefundable tax break that is available to students who take at least one postsecondary education course. Lawmakers put the same inflation-adjusted income limits on the Lifetime Learning credit as on Hope. Currently, individuals earning up to \$51,000 and joint filers making up to \$102,000 are eligible for the full credit, while individuals making between \$51,000 and \$61,000 and joint filers earning between \$102,000 and \$122,000 can receive a partial credit.

**Higher Education Tax Deduction:** In 2001, Congress created the Higher Education Tax Deduction, which allowed students and their families to subtract from their taxable income up to \$4,000 in tuition and fees. Congress made the deduction, which expired at the end of 2011, available to individuals earning up to \$80,000 a year and joint filers making as much as \$160,000 annually. It's unclear whether Congress will try to revive it.

**The American Opportunity Tax Credit:** Created as part of the federal stimulus legislation in 2009, the AOTC is a \$2,500 annual income tax credit available to help students cover tuition, fees, and course material expenses for their first four years in college. The full credit is available to individuals earning up to \$80,000 a year and joint filers making as much as \$160,000 annually. Individuals earning between \$80,000 and \$90,000 and joint filers making between \$160,000 and \$180,000 are qualified to receive a partial credit. The AOTC is partially refundable; meaning that low-income students and families who do not have any tax liabilities can receive a payment of up to \$1,000 a year. President Obama has called on lawmakers to permanently extend the program, which is set to expire at the end of 2012. If Congress doesn't follow through, the AOTC will revert back to the Hope Tax Credit.

its core mission of eliminating the financial barriers that prevent low-income and working-class students from enrolling in and completing college.

Instead of making further cuts to Pell eligibility, reducing grant amounts, or eliminating interest subsidies for student loans, Congress should allow the AOTC to expire at the end of this year, eliminate all of the other tuition tax breaks, and use the savings to ensure that the Pell Grant program remains on a sustainable path.

If lawmakers insist on maintaining the tax breaks, they should at least scale them back so that they are helping only those who truly need the assistance—low-income students and lower-middle income individuals and families that just miss the cut off for federal need-based financial aid.

Either way, policymakers will have to be courageous enough to make difficult decisions that will undoubtedly not poll well with likely voters.

## Notes

1. Jason Delisle, “Extending the American Opportunity Tax Credit Shouldn’t Be a Slam Dunk,” *Higher Ed Watch*, November 3, 2010.
2. Richard Kahlenberg, “Billions to Non-Needy Students,” *The Chronicle of Higher Education’s* “Innovations” blog, December 1, 2011.
3. For this report, we analyzed data from the College Board’s annual “Trends in Student Aid” reports from 1999 through 2011. The College Board gathers data on the tax credit programs from the Internal Revenue Service’s official estimates of the volume of Hope, Lifetime Learning, and American Opportunity credits for tax years 1999 and later. According to the College Board, “For nonrefundable credits, only those claimed on taxable returns are included. Tax Deductions are based on IRS Statistics of Income, with associated savings estimated by the College Board based on the marginal tax rates applied to the taxable income of the taxpayers in each income bracket claiming the deduction on taxable returns. Calendar year amounts are split between the two associated academic years.”
4. This total does not include \$3.5 billion that the government spent on the Hope and Lifetime Learning Tax Credits in 1998 because the College Board did not collect and analyze this data during the programs’ first year.
5. “Federal Higher Education Tax Breaks to Cost \$95.3 Billion by 2014,” *The Chronicle of Higher Education’s* Ticker, August 31, 2011.
6. Stephen Burd, “Some Educators Say Democrats Have Deserted Low-Income Students,” *The Chronicle of Higher Education*, October 18, 1996.
7. Douglas Lederman, “The Politicking and Policy Making Behind a \$40 Billion Windfall,” *The Chronicle of Higher Education*, November 28, 1997.
8. Initially, the maximum Lifetime Learning Credit that could be claimed was worth \$1,000. That amount doubled in 2003.
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10. Peter DeMarco, “Schumer: Give Tax Break on College Tuition Costs,” *New York Daily News*, March 19, 2001.

11. Obama '08: "Helping All Americans Serve Their Country." Available at [http://obama.3cdn.net/3b3158f85f69a39217\\_hydpmvzbb.pdf](http://obama.3cdn.net/3b3158f85f69a39217_hydpmvzbb.pdf)
12. Mark P. Keightley, "An Overview of Tax Benefits for Higher Education Expenses," Congressional Research Service, February 11, 2011.
13. College Board, "Trends in Student Aid 2011," p.21.

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