Federal Tax Expenditures For Higher Education

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The tax-exempt higher education sector is huge and growing, as government policies encourage demand and tuition prices continue to rise. There are many higher education tax benefits, on both the supply and demand sides, and estimated tax expenditures for the sector reached $50 billion, or about $2,400 per student, in 2012.

As millions of students begin a new school year at colleges and universities around the country, it is worth pausing for a moment to consider the large size of this mainly tax-exempt sector, its poor price performance, and the significant federal tax expenditures associated with it. Although we will not claim to have proved causal relationships, in the last decade: (1) the sector has grown rapidly and is massive, with $479 billion in revenues in 2011-2012; (2) tuition prices have significantly outstripped general price inflation; and (3) even ignoring direct expenditures and subsidized student loans from the federal government, as well as state and local government support, the value of government funding through various federal tax expenditures has grown rapidly and is substantial. It is reasonable to ask how much of this government spending is unnecessary, misdirected, or even harmful to public policy goals at a time of fiscal constraint.

A. Size of the Higher Education Sector

As shown in Figure 1, student enrollment in colleges and universities has increased rapidly in the postwar years. Some of that expansion may be attributed to the baby boom and general population growth, but there has also been greater motivation to enroll as higher levels of education have become the norm in both the job market and social life. The biggest spurts occurred in the late 1950s through the 1960s, the late 1980s, and the 2000s, likely reflecting demographics, the competing attractions, or lack of them, of the job market and military service, and the costs, net of all sorts of government and private support, of tuition. There are now more than 21 million students enrolled in some form of higher education.

Another measure of size is the total revenue of the sector, broadly defined to include all levels of postsecondary institutions, both public and private, as well as affiliated hospitals, endowments, sports activities, and research. According to data from the National Center for Education Statistics, total revenue in higher education grew from $399 billion in 2005-2006 to $479 billion in 2011-2012, despite fluctuations in investments, grants, appropriations, and gifts, and steadily increasing tuition.

Finally, statistics from the Delta Cost Project indicate the number of both public and private employees in the sector, at all levels, from community colleges to research institutions, including faculty as well as professional, support, and administrative staff. In 2000 there were 2.5 million employees; by 2012 that number had grown to 3.2 million.

These indicators — students, revenue, and employees — consistently show robust growth in the higher education sector in the last decade, despite overall weaknesses during the same period in the economy, personal income, and the labor and financial markets.

B. Tuition Increases

Although only between a quarter and a third of the tax-exempt higher education sector’s revenue comes from tuition (net of scholarships), the posted tuition rate is still a relevant indicator of the cost to the consumer of the service provided by the sector’s institutions — the education of students. Therefore, we will briefly review the recent history of increases in tuition and fees compared with the general increase in consumer prices.

In Figure 2, statistics from the Bureau of Labor Statistics are plotted, comparing the overall level of tuition and fees with the consumer price index from 1978 through 2012. Tuition and fees have increased about eightfold over this period, compared with a threefold increase in general consumer prices. Apparently, there was a particularly large spike in tuition in the early 2000s.

A more detailed view of tuition and general price increases appears in Figure 3. It shows the monthly year-over-year price changes in tuition and fees and general consumer prices, in percentage terms, during the period from January 1979 to February 2013.
The source is again the Bureau of Labor Statistics. The message in the two charts is clearly the same — with the exception of the late 1970s, when general price inflation was fueled by the Federal Reserve, college tuition and fees have risen at a faster pace than general prices. The early 1990s and early 2000s saw particularly high rates of tuition inflation (10
percent in 2004, for example). More recently, consumer price inflation has moderated, at less than 2 percent, but tuition has increased at 4 percent and 5 percent annual rates. In fact, over the last five years (2008-2009 to 2013-2014), tuition and fees increased, in real terms, 14 percent at private nonprofit four-year colleges and 27 percent at public four-year colleges.

There are many possible reasons for this rapid rise in tuition, that is, the base cost of a college education. In any economic model, the increases in relative price and in the number of students and employees can be explained largely by robust demand. A lack of innovation (that is, few productivity enhancements and poor efficiency) on the production side and rent-seeking behavior among tenured faculty, senior administrators, coaches, and athletic directors, as well as a lack of competition among the trendsetting elite institutions, could be factors as well.

C. Federal Tax Expenditures

In this section, we catalogue the numerous tax preferences, benefits, and exemptions that the federal government provides to the higher education sector, on both the producer/supply side (colleges and universities) and the consumer/demand side (for example, parents of college students). We also report the tax expenditures in nominal dollars as estimated by the Joint Committee on Taxation. We add our own rough estimate of the tax expenditures arising from the exemption of the income (revenues less expenditures) of colleges and universities from the corporate income tax.

The most obvious tax benefits and expenditures on the producer side are the exemption for interest on bonds issued by tax-exempt colleges and universities (for example, to build dormitories, parking structures, or hospital buildings) and the exemption for charitable giving to colleges and universities.
According to the JCT, the value of these exemptions has grown from $4.8 billion in 1999 to $9 billion in 2013, as shown above.

Next, we provide a rough estimate of the value of the exemption of the sector from the federal corporate income tax. Although nearly the entire sector is tax exempt, there are some educational organizations, like the University of Phoenix and DeVry University, that are for-profit and taxable. In 2013 the effective tax rate for these and other publicly traded higher education companies averaged 35 percent. Applying this tax rate to the income of the tax-exempt higher education sector, with income defined as revenues (including investment income and gains) less expenditures, we estimate that the exemption from corporate income taxes at the federal level was worth about $4.9 billion in 2011-2012. This is a rough estimate — probably underestimated — because the definitions of income in the for-profit and nonprofit sectors are quite different, and the inclusion of investment income and gains (which were relatively low in 2011-2012) will make the estimated annual tax expenditures volatile.¹

Now we provide a list of the various tax benefits — exemptions and deductions on the consumer/demand side — with brief nontechnical explanations.

1. **Qualified tuition programs.** Investment income on the assets in these programs (also known as section 529 plans), established by states and educational institutions, is exempt from personal income taxes, and distributions to pay expenses for higher education, including tuition and fees and room and board, are not taxed. There are no income restrictions on contributions to these plans, unlike section 401(k) and other retirement plans, and the contribution limits, set by the program sponsors so that a contributor can fully finance the cost of a college education, are quite high.

2. **Coverdell plans.** These are another type of tax-advantaged education savings plan, more limited than section 529 plans in terms of annual contribution caps and income restrictions but broader in terms of investment possibilities.

3. **Tax credits (HOPE, American opportunity, and lifetime learning).** The American opportunity tax

¹According to a 2012 study from the Tellus Institute, the value of the federal income tax exemption for Northeastern University for fiscal 2011 was $33 million. State and local government exemptions were worth $23 million and $39 million, respectively. See Ann Solomon and Joshua Humphreys, “Public Investment in Private Higher Education: Estimating the Value of Nonprofit College and University Tax Exemptions,” (Footnote continued in next column.)

Tellus Institute (Sept. 2012). See also the interesting paper by the Congressional Budget Office focusing on collegiate sports, which makes the case that athletics at Division I-A schools in the NCAA are fairly obviously commercial activities under current law, even if subjecting them to the unrelated business income tax would be technically challenging. CBO, “Tax Preferences for Collegiate Sports,” May 2009.
credit is a credit of up to $2,500 per year per eligible college student (usually a dependent) — 40 percent of which is refundable — for four years, covering tuition and fees paid toward earning an undergraduate degree through at least half-time study. The income limit on claiming the credit is $180,000 for married households. This credit, which was authorized by the 2009 stimulus legislation, replaced and significantly expanded the HOPE credit.

The lifetime learning tax credit is a nonrefundable credit of up to $2,000 per return per year, for any course of postsecondary education, having no time limitation and covering tuition and fees. The income limit is $127,000 for married households. The American opportunity tax credit and the lifetime learning tax credit cannot be claimed simultaneously; the latter is particularly well-suited to graduate or part-time study, and often, the students claim the credit themselves.

4. Deduction for tuition and fees. Taxpayers are allowed to deduct up to $4,000 in tuition expenses as an above-the-line exclusion from income. For married couples, income must be less than $160,000. The deduction cannot be taken if education tax credits or other specified education tax benefits are claimed.

5. Parental personal exclusion. Taxpayers with qualifying children who are students (up to age 24) may be able to claim dependent exemptions and the earned income tax credit.

6. Employer-provided assistance exclusion. Up to $5,250 of education assistance benefits may be excluded from taxable income each year. Any course of study that improves capabilities is eligible.

7. Student loan cancellations and repayment assistance. These are not included in taxable income if the cancellation or repayment is conditioned on work for a specific period and in specified professions, such as healthcare in underserved areas.
8. Scholarships and fellowships. These are excluded from taxable income if granted as aid in the pursuit of study or research, if the individual is a candidate for a degree at an eligible educational institution and no services, such as teaching, are provided by the individual to the institution.

9. Deduction for student loan interest. This is an above-the-line exclusion of up to $2,500. For married couples, income must be less than $155,000.

Other tax benefits for education include the education savings bond program and the education exception to additional tax on early IRA distributions.

Figure 5 shows the tax expenditures on the demand side for higher education, as estimated by the JCT, from 1995 through 2012. By the end of that period, they were more than $35 billion.

All tax expenditures, on both the producer and consumer sides, totaled about $50 billion in 2012.

D. Conclusion

Government support for higher education is rarely questioned, and there seems to be a continual political impetus to expand that aid, despite fiscal constraints. Yet it is fair to ask whether the intended public policy goals — an educated workforce, transmission of past cultural and scientific knowledge, and innovative research — are most efficiently and fairly achieved through the benefits bestowed on this tax-exempt sector, or whether there are better alternatives. A comprehensive answer to that question is beyond the scope of this article. However, consideration of the size of this sector, the prices charged, and the tax expenditures provided, as well as their rapid growth, is a good starting place.