The Consortium for Higher Education Tax Reform Report

New America Foundation's Education Policy Program;
Center for Postsecondary and Economic Success at CLASP;
Education Trust;
Young Invincibles

Table of Contents

FOREWORD

This White Paper presents the work of the Consortium for Higher Education Tax Reform, a partnership funded by the Bill & Melinda Gates Foundation as part of the second phase of its Reimagining Aid Design and Delivery (RADD) initiative. Consortium partners are the Center for Postsecondary and Economic Success at CLASP, the Education Trust, New America Foundation's Education Policy Program, and Young Invincibles.

The Consortium has spent the last year identifying strengths and weaknesses in federal higher education tax policy and providing recommendations for redesign and reform. This White Paper and the associated issue briefs reflect the culmination of those efforts. Included are:

(1) *Higher Education Tax Reform: A Shared Agenda for Increasing College Affordability, Access, and Success*, a set of consensus policy recommendations that the consortium released in November.

(2) Four issue briefs written by each of the consortium's members. These briefs address in greater depth four specific aspects of the policy recommendations in the *Shared Agenda*. Each represents the views of the organization that wrote it; the Consortium members have provided feedback to one another, but the briefs are not intended to reflect consensus viewpoints (in contrast to the *Shared Agenda*).

The briefs are as follows:

Building an AOTC Movement: Strengthening Outreach for a Reformed American Opportunity Tax Credit (from the New America Foundation's Education Policy Program) addresses the current lack of awareness about the American Opportunity Tax Credit (AOTC) among financially needy students and their parents, as well as the general lack of support to help students and families understand and utilize the credit. The brief proposes a vigorous outreach campaign modeled on the success observed with the Earned Income Tax Credit and identifies the roles various higher education and tax actors should play.

Help When It's Needed: Advancing the AOTC (from the Center for Postsecondary and Economic Success at CLASP) addresses the current time lag between when students pay college tuition and fees and when they receive the AOTC to help finance those costs (often several months and sometimes over a year later). The issue brief proposes developing new tools and processes that would permit students and their families to receive the AOTC during each academic period, making it a more integrated and effective component of financial aid.

Tough Love: Bottom Line Quality Standards for Colleges (from the Education Trust) looks at the range of federal support provided to institutions of higher education and advocates tying receipt of that support, including tax-related benefits, to minimal performance by colleges on matters of low-income student access, educational service, and post-enrollment success. The brief proposes specific benchmarks for institutional eligibility and outlines a process for how standards would be implemented to encourage institutional improvement.

Tax-Exempt Borrowing at Postsecondary Institutions: How Reforming Tax-Exempt Bonds Can Improve Student Outcomes and Save the Government Money (from Young Invincibles) focuses on the complex world of tax-exempt borrowing, one of the forms of federal aid for higher education targeted for reform in the *Shared Agenda*. The brief supports helping adequately performing higher education institutions reduce their capital borrowing costs but proposes doing so through direct pay tax-credit bonds to reduce unnecessary federal subsidies.

Although these four issue briefs are not presented as the consensus recommendations of the Consortium, the groups generally agree on the major aspects of each paper. There is, however, a difference of opinion on the breadth of application of the institutional performance standards presented in the Education Trust brief. The Education Trust believes conditioning higher education tax benefit eligibility on minimum institution performance standards helps students by strongly leveraging the federal purse against schools that fail to meet minimum success benchmarks, because these poorly performing colleges more likely than not would leave students in a worse economic position than had they attended elsewhere; enrolling students exhaust their federal aid eligibility, incur heavy student loan debt, and overwhelmingly receive no degree at all or a degree with little economic value. All members of the Consortium agree that the tax benefits conferred directly to higher education institutions and their affiliated foundations (such as tax-exempt borrowing and deductibility of donations) should be conditioned on minimum institutional performance. But separate from Education Trust, other partners hold the view that all qualified *students* should have equal access to tax-based financial aid; students and their families should not be held responsible for institutional behavior over which they have no control.

Progress on the Shared Agenda

The Consortium is pleased that many of its recommendations are already becoming integrated into policy conversations about tax reform and higher education budgets.

President Obama's Fiscal Year 2015 budget proposal, for example, would make the AOTC permanent and make Pell Grants tax-free. The Student and Family Tax Simplification Act (H.R.3393), introduced in fall 2013 by Representatives Diane Black (R-

Tenn.) and Danny Davis (D-Ill.), also includes several items similar to those advocated in the *Shared Agenda*. These include repealing some higher education tax credits and deductions, making the AOTC permanent with expanded refundability, targeting the AOTC to families most in need, and ending the taxation of Pell Grants. Although the Consortium applauds the bill as a good first step to promote simplicity and affordability and is pleased that the provisions became part of the draft tax reform bill introduced by House Ways and Means Committee Chairman Dave Camp (R-Mich.) in February 2014, it is important to emphasize that any savings from simplifying and targeting tax benefits must be reinvested in students and not be diverted to overall deficit reduction.

The Obama Administration's guidance regarding the taxability of Pell Grants clarifies that another aspect of the Shared Agenda—flexible coordination of the AOTC and Pell awards—is already possible under current law. The Treasury Greenbook notes that students may choose to apply Pell Grants to costs of attendance (such as room and board) that do not qualify for the AOTC and receive the credit's maximum value. The Consortium looks forward to more widespread recognition of this flexibility among financial aid offices. However, because Pell Grants must still be reported as taxable income if those grant dollars are not applied to tuition and related costs, the Consortium's proposal for fully excluding Pell Grants from taxation remains essential to reduce the complexity of aid coordination and maximize the benefits accruing to lower-income student households.

The four organizations of the Consortium for Higher Education Tax Reform look forward to continued progress in making tax-based federal student aid more fair and effective in promoting college affordability, access, and completion.

Higher Education Tax Reform

A Shared Agenda for Increasing College Affordability, Access, and Success

The Reimagining Aid Design and Delivery (RADD)
Consortium for Higher Education Tax Reform
November 2013

CLASP
policy solutions that work for low-income people

YOUNGINVINCIBLES

NEW AMERICA FOUNDATION

The Education Trust

Table of Contents

About the Consortium

The **Consortium for Higher Education Tax Reform** is a partnership of four organizations concerned with college affordability, access, and completion for low- and modest-income individuals: the Center for Postsecondary and Economic Success at CLASP, Young Invincibles, the New America Foundation's Education Policy Program, and The Education Trust. Over the next year, this consortium will address a variety of issues related to reform of federal higher education tax policy. The Consortium is funded by the Bill & Melinda Gates Foundation as part of its Reimagining Aid Design and Delivery initiative.

This publication represents our shared agreement on initial proposals for reforming higher education tax benefits. It builds on previous work under Reimagining Aid Design and Delivery grants, as well as other research and analysis. Our Shared Agenda is a work-in-progress. Several of the ideas included in the reform agenda will be more fully developed over the coming months and new ideas may be added.

Consortium Partners

The Center for Postsecondary and Economic Success at CLASP advances policies and investments designed to increase the number of low-income adults and youth who earn marketable postsecondary and industry credentials, opening doors to good jobs, career advancement, and economic mobility. CLASP develops and advocates for policies at the federal, state, and local levels that strengthen families and create pathways to education and work. (www.clasp.org)

Young Invincibles is a national organization committed to amplifying the voices of young Americans, ages 18 to 34, and expanding economic opportunity for our generation. Young Invincibles ensures that young Americans are represented in today's most pressing societal debates through cutting-edge policy research and analysis, and innovative campaigns designed to educate, inform and mobilize our generation to change the status quo. (www.younginvincibles.org)

The New America Foundation's Education Policy Program is a nonprofit, nonpartisan public policy institute. It develops ideas that advance equity, access, and excellence in education, from early childhood through elementary and secondary schools, college, and the workforce. (www.education.newamerica.net)

The Education Trust is a national nonprofit that promotes high academic achievement for all students at all levels, pre-K through college. Its goal is to close the gaps in educational opportunity and academic achievement that consign far too many young people—especially those from low-income families or who are black, Latino, or American Indian—to lives on the margins of the American mainstream. (www.edtrust.org)

Higher Education Tax Reform:

A Shared Agenda for Increasing College Affordability, Access, and Success

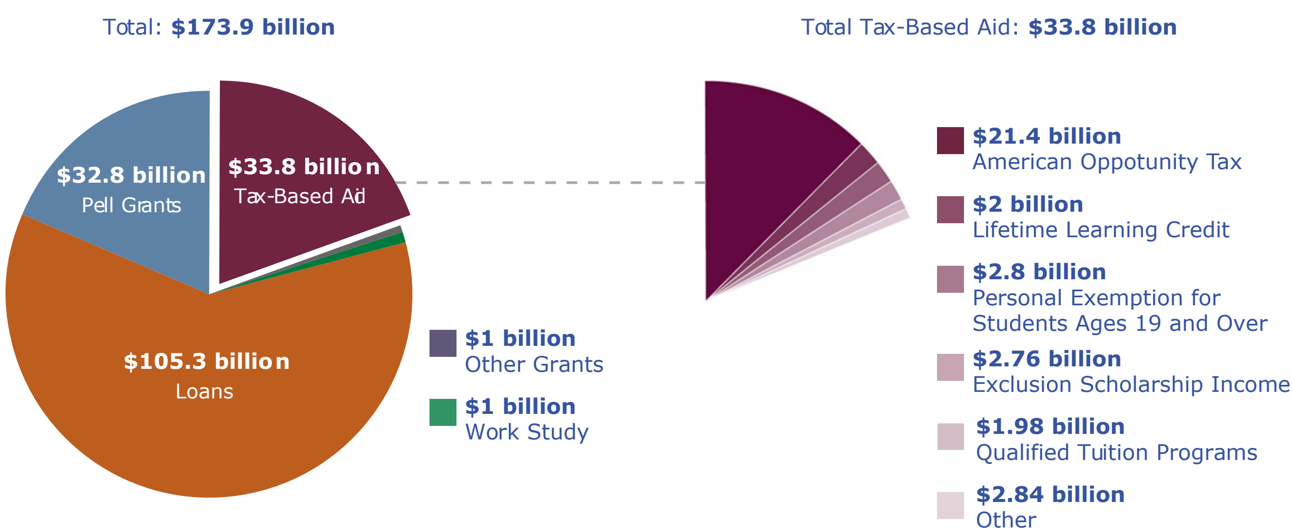
If asked, what would you say is the largest form of federal student aid, excluding loans?

If you guessed Pell Grants, you'd be wrong; it's student aid delivered through the tax system. Since its inception in the late nineties, tax-based student aid has more than quadrupled and now represents more than half of all non-loan federal aid. In 2012, the federal government spent nearly $34 billion on tax-based student aid—a billion more than it spent on Pell Grants (Figure 1).[i] Despite this rapid growth, policymakers haven't scrutinized this aid to determine whether it improves college affordability, access, and success.

Given rising college costs and tight federal budgets, Congress should take action to maximize the impact of federal higher education spending. That means ensuring tax-based student aid goes to low- and modest-income students striving to reach the middle class rather than higher-income individuals who are already very likely to attend college. Reforms should also make it easier for families to understand and claim tax-based student aid and ensure aid is delivered when college bills are due. Further, institutions of higher education that do not meet minimum thresholds for advancing college access and completion goals should not receive federal tax subsidies. Finally, we should reinvest any potential savings from our reforms into students. Every dollar should be used to improve college access, affordability, and success, including through funding for the Pell Grant program.

Figure 1. Tax-Based Aid Now the Largest Source of Federal Student Aid, Excluding Loans

Federal Student Aid by Type in Billions. FY 2012



Source: CLASP, based on estimates from the President's FY14 Budget and the Department of Education's FY14 Budget Summary and Background Information.

Why Reform Is Needed

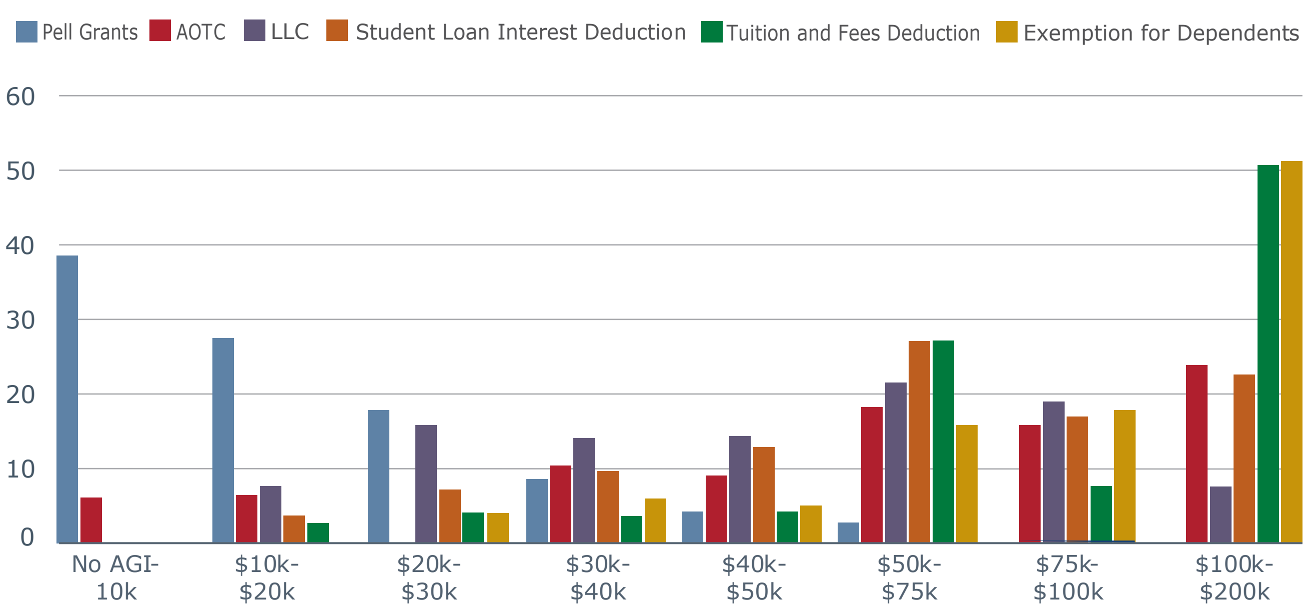
Currently tax-based student aid suffers from four critical flaws that limit its impact on college affordability, access, and completion:[ii]

1) Tax-based aid is poorly targeted.

Despite extensive research showing that low- and modest-income families are more likely to respond to changes in college costs and student aid, tax-based aid provides substantial support to higher-income families who are well beyond middle class (Figure 2).[iii] In 2013, the Tax Policy Center estimates that more than half of the benefits of the Tuition and Fees Deduction and the Exemption for Dependent Students will go to households with annual incomes of $100,000 or more. Nearly a quarter of American Opportunity Tax Credit (AOTC) benefits (24 percent) and Student Loan Interest Deduction benefits (23 percent) will go to families making more than $100,000 per year.[iv] (In 2012, most American

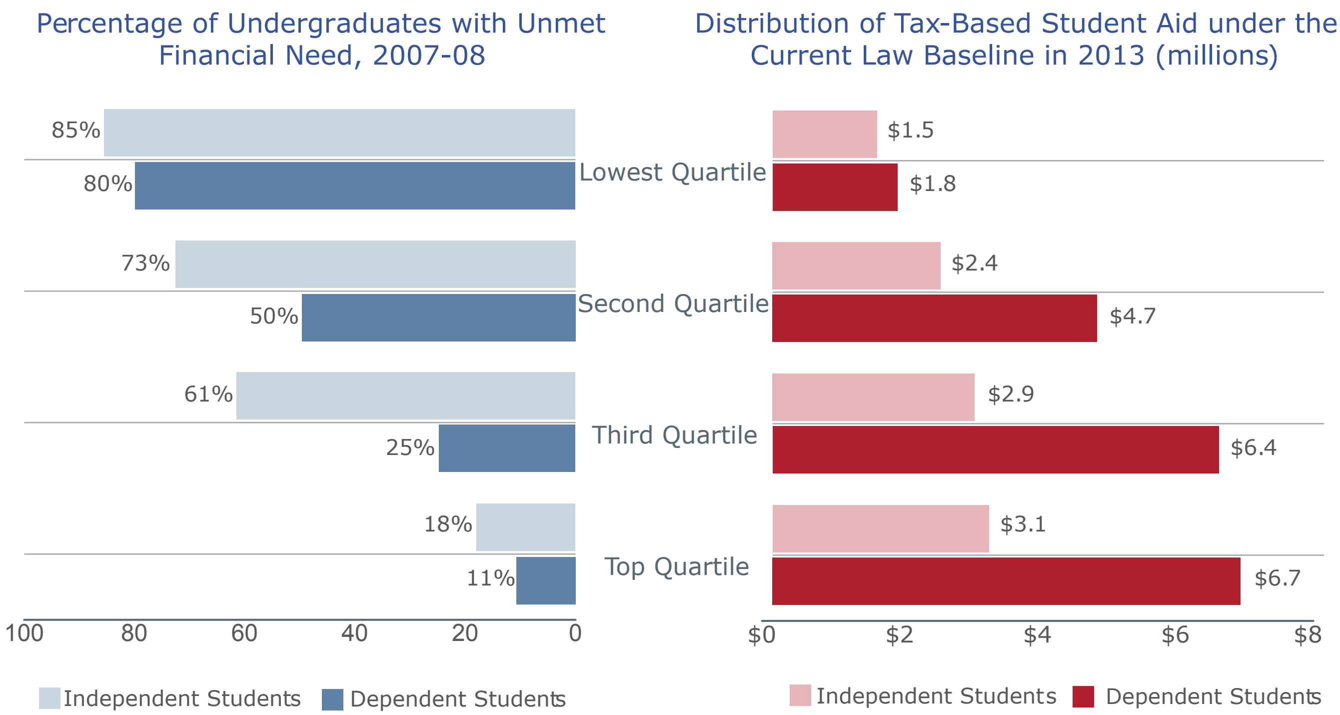
Figure 2. Tax-Based Student Aid is Poorly Targeted

Percentage of Benefit by Type and Income Category in 2013



Source: CLASP, based on data from the Tax Policy Center.

Figure 3. Students with Least Amount of Need Receive the Most Tax-Based Aid



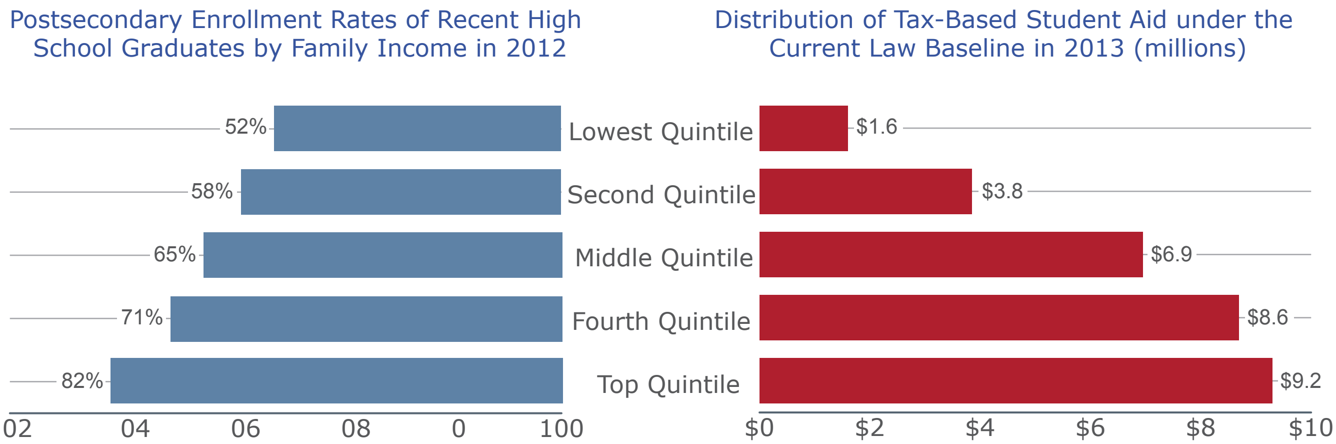
Source: CLASP, based on data from the U.S. Department of Education (NPSAS:08) and from the Tax Policy Center. The unmet financial need data is the most recent available from the federal government and will be updated when the relevant NPSAS:12 data is released in late 2013 or 2014.

households—almost 80 percent—had incomes below $100,000.[v]) Moreover, there are no income participation limits of any kind on federally-subsidized 529 college savings plans. As a result of this poor targeting, students from families with the least financial need receive the most tax-based aid (Figure 3).

We must urgently address the college affordability, access, and completion issues facing low-income families. Despite some progress, low-income students still attend college at lower rates than high-income students did 40 years ago.[vi] Further, the lowest-income students are only one-seventh as likely as their highest-income peers to attain a bachelor's degree by age 24.[vii] Not only does poor targeting blunt the impact of tax-based aid on socioeconomic mobility, it is also an extraordinarily inefficient way to promote college affordability and access because higher-income individuals are already very likely to attend college (Figure 4). One study found, for example, that for each student motivated to attend college (or enroll in more courses) by federal tax-based aid, as many as 13 other students receive tax subsidies without that aid changing their enrollment decisions.[viii]

There is also another dimension to poor targeting: currently, federal tax breaks for institutions of higher education—such as their ability to receive tax-deductible charitable donations and access tax-exempt bond financing— benefit a significant number of

Figure 4. Tax-Based Aid Largely Benefits Individuals Already Highly Likely to Attend College



Source: CLASP, based on data from Education Pays 2013 (the College Board) and the Tax Policy Center

institutions that perform especially poorly in enrolling low-income students or in helping students succeed. This includes over 100 four-year institutions with graduation rates below 20 percent.[ix] Students who attend these institutions often find themselves in worse financial positions following enrollment, because of out-of-pocket expenses and student loan debt incurred outside receipt of grant- and tax-based aid. In fact, students who leave higher education with debt but no degree are four times more likely to default on their student loans.[x]

2) Tax-based aid programs are complex and difficult to use.

Student aid provisions in the tax code include multiple tax credits, a variety of deductions, and numerous exclusions (Table 1). The IRS publication that explains the rules for education tax benefits is almost 90 pages long.[xi] Current tax benefits sometimes overlap, and taxpayers often do not choose the provision that would benefit them most. The Government Accountability Office (GAO) found, for example, that 40 percent of those who claimed the Tuition and Fees Deduction in 2009 would have been better off claiming the Lifetime Learning Credit.[xii] In addition, student aid experts agree that complexity reduces the effectiveness of aid by making it harder for students and parents to understand what help is available and how to apply for it.[xiii]

3) Tax-based aid does not reach students at the time college expenses are incurred.

The power of tax-based aid to provide incentives for enrollment, persistence, and completion is further diluted by the separation between action and benefit. Students and parents only receive this aid after filing their taxes, not when college bills are due. This greatly limits its usefulness to families who simply cannot afford to pay college costs up-front and wait for as long as 15 months for tax-based aid to arrive. The time lag makes it exceptionally difficult for students and families to determine whether they can afford college; undermines the likelihood they will enroll in the college that is best for them; and adds complexity to the higher education financing process by delivering tax aid on a different

Table 1. Current Tax-Based Student Aid Provisions

Aid Before College	Aid During College	Aid After College
• Exclusion of Coverdell ESA Earnings • Qualified Tuition Programs (Prepaid Plans and 529 Plans) • Education Exception to Additional Tax on Early IRA Distributions • Exclusion of Education Savings Bond Interest	• Exclusion of Scholarship, Fellowship, Grant Aid • American Opportunity Tax Credit (formerly the Hope Credit) • Lifetime Learning Credit • Tuition and Fees Deduction • Exemption for Dependent Students (Age 19-23) • Gift Tax Exemption for Tuition Payments • Exclusion of Employer-Provided Educational Assistance	• Student Loan Interest Deduction • Student Loan Forgiveness for Certain Professions

schedule than other forms of financial aid.

4) Lack of awareness limits the impact of tax-based aid.

Lack of awareness limits the reach of higher education tax benefits, as well as their ability to influence individual decisions about whether to enroll or persist in college. Many individuals receiving tax-based aid are not aware of it. According to one study, almost 60 percent of individuals who claim a higher education tax credit do not realize they have received help from the government to pay for college.[xiv] Others fail to claim benefits for which they are eligible. For example, a GAO study found that one in seven taxpayers—or 1.5 million tax filers—who were eligible for either the Tuition and Fees Deduction or the Lifetime Learning Credit in 2009 failed to claim those benefits.[xv] And unlike outreach around the Earned Income Tax Credit, there has been no concerted effort to make low-income families aware of and help them claim the refundable AOTC.

A Shared Agenda for Reform

Our reforms would ensure that tax-based student aid goes to low- and modest-income students who struggle most with college costs, rather than higher-income individuals who are already very likely to attend college without a tax incentive.

Poor targeting, complexity, delayed payment, and pervasive confusion among families about what help they can expect with college costs are serious shortcomings that can only be addressed through bold action, not incremental change. We have developed comprehensive recommendations that would go a long way toward fixing current problems with tax-based aid. Our reforms would ensure that tax-based student aid goes to low- and modest-income students who struggle most with college costs, rather than higher-income individuals who are already very likely to attend college without a tax incentive. We would eliminate overlapping tax benefits, make it easier for families to understand and claim tax-based student aid, and deliver aid when college bills are due. Further, we propose linking tax breaks for higher education institutions to their performance on college access and completion. Finally, we would reinvest any potential savings from our reforms into students. Every dollar should be used to improve college access, affordability, and success, including through funding for the Pell Grant program.

We hope this Shared Agenda can inform the efforts of Congress and the Obama Administration as they tackle comprehensive tax reform. Because it has been 27 years since the last overhaul of the tax code, we cannot afford to miss this rare opportunity to fix tax-based student aid. In addition, administrative action could be taken to improve these benefits. Even within the constraints of current law, much more can be done to help eligible students and parents become aware of and use tax-based student aid.

Table 2 summarizes our package of proposals, with revenue estimates from the Tax Policy Center where possible, and shows that our Shared Agenda can be accomplished in a fiscally responsible way.

Table 2. Summary of Shared Agenda for Reform

Consortium Proposals, By Goal of Reforms

Better Targeting

1. Make the AOTC permanent.
2. Phase out the AOTC between $80-120,000 for joint filers and $40-60,000 for single filers.
3. Make the AOTC fully refundable.
4. Coordinate AOTC benefits with Pell Grants.[1]
5. Phase out the Exemption for Dependent Students at the same income levels as the AOTC.[2]
6. Phase out the Student Loan Interest Deduction at the same income levels as the AOTC.
7. Better target the tax benefits of Qualified Tuition Programs (529s) through income limits and other reforms.
8. Limit the Exclusion for Employer Provided Educational Assistance to undergraduate certificates and degrees only.
9. Adopt a new institutional eligibility threshold for higher education tax benefits to colleges and universities.
10. Limit the tax exemption for interest earned on qualified 501(c)(3) bonds for private higher education institutions.
11. Improve transparency around institutional receipt of tax benefits through expanded reporting.

Simplification

12. Eliminate Lifetime Learning Credit.
13. Eliminate Tuition and Fees Deduction.
14. Eliminate Coverdell Education Savings Accounts.
15. Adjust the AOTC for inflation starting in 2018.
16. Replace the four-year limit on the AOTC with an equivalent lifetime dollar cap.
17. Eliminate taxation of Pell Grants.
18. Remove the lifetime ban on the AOTC for individuals convicted of a drug felony.

Timely Delivery of Tax Aid

19. Create a mechanism for delivering the AOTC at the time that college expenses are incurred, not just at tax time.

Outreach

20. Increase take-up and awareness of the AOTC through expanded outreach and increased collaboration by the Departments of Education and Treasury.

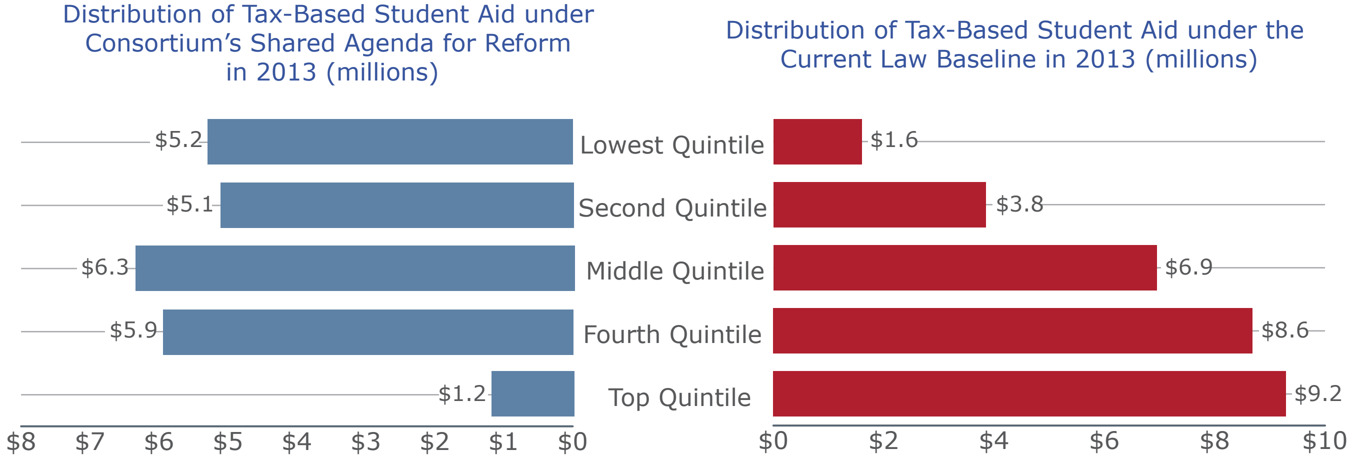
Revenue Impact of Consortium Proposals

Where possible, we have obtained Tax Policy Center estimates of the revenue impact of our proposals against the current law baseline. As shown below, our Shared Agenda results in substantial revenue savings which should be reinvested in students, including through funding for the Pell Grant program. These Tax Policy Center estimates cover the impact of recommendations numbered 1-3, 5-6, 12-13, and 15:

2013 to 2022	2014 to 2023
$24.3 billion in savings	**$16.2 billion in savings**[3]

The Tax Policy Center is unable to estimate the revenue impacts of our other proposals. However, in 2010, the Congressional Joint Committee on Taxation estimated the cost of the two Pell Grant provisions combined as $168 million over ten years (2011-2020).

Figure 5. Shared Agenda for Reform Shifts Aid toward Low- and Modest-Income Families



Source: CLASP, based on data from the Tax Policy Center

Our Shared Agenda would substantially realign the federal investment in tax-based student aid to maximize its impact on affordability, access, and completion, in contrast to the current misalignment of these tax expenditures. Under our proposals, tax-based student aid would go primarily to the low- and modest-income families and individuals who most struggle with college costs (Figure 5).

Goals and Recommendations

Our Shared Agenda is organized around four goals: better targeting, simplification, more timely delivery, and increased take-up and awareness.

BETTER TARGETING

Goal: Target tax-based student aid to low- and modest-income undergraduate students.

Proposed reforms should shift tax-based aid toward families in the bottom 80 percent of the income distribution, as measured by the Census Bureau. Target higher education tax breaks to institutions that meet at least a minimum responsibility threshold for enrolling low-income students and helping students persist and complete.

Discussion

As discussed above, the current structure of tax-based aid mainly helps higher-income families who require no financial incentive for college attendance. In our tax system, deductions and exemptions are worth more to those who earn more (they reduce taxable income and so have a higher value to those in higher tax brackets). Tax credits can be more useful to low- and modest-income families if they are made refundable. Of the two higher education credits currently available, the LLC is not refundable and the AOTC is only partially refundable (40 percent of the credit value).

[1] Pell Grants would be applied first to costs of attendance (such as room and board) that are not qualified expenses for the AOTC. Any remaining Pell Grant would continue to reduce the qualified expenses used to calculate the AOTC.
[2] Proposal to phase out exemption for dependent students above AOTC income thresholds does not affect the classification of full-time students age 19 to 23 as qualifying child dependents for other purposes such as head of household filing status and the EITC.
[3] Urban-Brookings Tax Policy Center Microsimulation Model (version 0613-1).

A second factor limiting tax-based aid to low- and modest-income students is that qualified expenses for credits and deductions include only tuition, fees, and in some cases course materials. For students attending lower-cost institutions, these qualified expenses comprise a small portion of their overall cost of attendance; other necessary expenses, such as room and board, transportation, and child care are larger factors. In fact, for academic year 2007-2008 (the most recent federal data available), tuition and fees on average accounted for only 19 percent of the cost of attendance for full-time students attending public two-year institutions.[xvi] After subtracting other grant aid, such as Pell Grants, from the calculation of qualified expenses (as is required currently), students may not have enough qualified expenses remaining to claim a credit, despite having high levels of unmet financial need.[xvii] Students at public two-year institutions had average unmet financial need of $4,500 in 2007-08.[xviii] This high unmet need has serious consequences for the ability of students to succeed in college. For example, two-thirds of young community college students work more than 20 hours per week to cover college and family costs, a level of work which research shows puts them at risk for not completing.[xix]

A third targeting issue is that some forms of tax-based aid largely benefit graduate students. For example, 64 percent of LLC benefits flow to graduate students, as do 40 percent of Exclusion for Employer-Provided Educational Assistance benefits. Given that individuals with a graduate degree earn, on average, at least twice as much as those with only a high school diploma,[xx] we believe we should prioritize helping those without a college degree before assisting those who have already completed at least an undergraduate education.

A fourth targeting issue centers on institutional accountability for higher education tax breaks. Institutions can benefit from various tax breaks—such as tax-exempt status and access to tax-exempt bond financing and the charitable deduction for their donors—even if they graduate very few of their students or enroll very few low-income students. This is contrary to the federal government's higher education investment goals of increasing college affordability, access, and completion.

Recommendations for Reform

Recommendation 1: Preserve the AOTC as the primary vehicle for tax-based student aid by making it permanent rather than allowing it to expire after 2017.

- The AOTC has many design advantages compared to the LLC or any of the deductions. It is focused on undergraduate education, is partially refundable, has a slightly more expansive definition of qualified expenses, and is available for four years. The AOTC is not perfect, but as a tax incentive to improve affordability, access, and completion, it is far superior to other tax-based aid. And the improvements we recommend would strengthen it further.

Recommendation 2: Lower income eligibility for the AOTC and double the length of the phase-out range.

Begin phasing out the credit at $80,000 for those who are married and filing jointly, which is approximately the median income level for such households.[xxi] End eligibility for the credit at $120,000 for individuals who are married filing jointly. Phase out the credit for single tax filers between $40,000 and $60,000.

- Lowering the AOTC's income phase-out ranges would focus its benefits on low- and modest-income families, making the federal investment more effective by concentrating it on individuals whose college enrollment and persistence decisions are most sensitive to cost. We note that even with our proposed lower phase-outs, more than 80 percent of families would continue to be eligible for the AOTC. Adjusting the phase-out range would also provide substantial revenue to fund improvements to the AOTC, such as greater refundability.

- Doubling the phase-out range for the AOTC from the current $20,000 to $40,000 (and from $10,000 to $20,000 for single filers) would reduce the effective marginal tax rate associated with the phase-out of tax benefits. A longer phase-out range reduces benefits more gradually as income increases. The effect of this more gradual phase-out for AOTC would be amplified if, as we propose, the same phase-out schedule were to be used for other higher education tax benefits as well.

Recommendation 3: Make the AOTC fully refundable.

- Currently, households can receive up to 40 percent of the AOTC as a refundable credit. Receipt of the remaining 60 percent is tied to the amount of their income tax liability. Making the AOTC fully refundable would ensure that the credit is worth the same to every individual with a given amount of qualified college expenses. Currently, a low-income family with, for example, $1,000 of qualified college expenses can receive only a $400 AOTC, whereas a higher-income family with $1,000 of expenses receives a $1,000 AOTC. Making the AOTC fully refundable would ensure that all students with similar expenses receive equal help from the AOTC in paying for college.
- Making the full credit refundable would help low-income students and parents better understand how big a credit they can expect to help them pay for college, since the credit value will be based solely on their qualified expenses up to the same maximum credit available to all students.

Recommendation 4: Coordinate AOTC benefits with Pell Grants, so that students can combine them to address unmet financial need and cover expenses up to the total cost of attendance.

Federal Pell Grants would first be applied to Pell-allowable expenses that are not eligible for the AOTC (e.g., room and board); after those expenses are paid for, any remaining grant amount would then reduce qualified tuition expenses for purposes of the AOTC.

- Currently, many Pell Grant recipients at lower-cost institutions receive little or no benefit from the AOTC because they must subtract other grant aid, such as Pell Grants, from the calculation of qualified expenses, leaving them with few or no qualified expenses remaining to claim the credit despite often having high levels of unmet financial need.
- Pell Grants are intended to address the total cost of attendance—not just tuition, fees, and books. Coordinating this grant aid with the AOTC would mean students could use the tax credit to cover tuition, fees, and books and use Pell Grants to cover remaining necessary costs—such as room and board, transportation, and child care—included in the total cost of attendance calculated under the federal need analysis. The portion of Pell Grants being applied to other Pell-qualified attendance costs would be exempt when calculating AOTC reductions.

Recommendation 5: Apply the same income limits and phase-outs to the Exemption for Dependent Students as we recommend for the AOTC.

- Currently, parents can claim full-time students ages 19 to 23 as dependents under the qualifying child rules. The Exemption for Dependent Students reduces 2013 taxable income by $3,900 for taxpayers with incomes below $300,000 ($250,000 for single filers). This is the worst-targeted of all the large higher education tax benefits. In 2013, more than half of the benefits from this exemption will go to tax filers with incomes of more than $100,000.[xxii]
- Phasing out the Exemption for Dependent Students at the same levels we propose

[The Exemption for Dependent Students] is the worst-targeted of all the large higher education tax benefits. In 2013, more than half of the benefits from this exemption will go to tax filers with incomes of more than $100,000.[xxii]

for the AOTC would substantially improve the targeting of this benefit and also save revenues that can be reinvested in improving the AOTC for low- and modest-income students and in Pell Grants. All parents would retain the ability to claim a full-time dependent student as a qualifying child for other tax purposes.

Recommendation 6: Apply the same income limits and phase-outs to the Student Loan Interest Deduction as we recommend for the AOTC.

- Even benefits for student loan borrowers are poorly targeted. Those who enter high-earning fields are disproportionately able to take advantage of the deduction—and benefit even more from it since they face higher marginal tax rates. Currently, tax filers with incomes of up to $155,000 per year can use the Student Loan Interest Deduction. According to estimates from the Tax Policy Center, 40 percent of the benefit of the Student Loan Interest Deduction in 2013 will go to individuals with incomes of more than $75,000 per year, and nearly a quarter of the benefits will go to those with annual incomes over $100,000.[xxiii]
- Preserving some relief to borrowers is important, given that recent college graduates have loan debt averaging $26,600.[xxiv] Under this proposal, the deduction would go to low- and modest-income students, helping them afford their student loan payments. At the same time, lowering the income limit and extending the phase-out range for this deduction would improve its targeting and free up resources that can be reinvested in expanding the AOTC for low-income students and in Pell Grants. This will have the effect of reducing student debt levels in the first place for borrowers who need it most.

Recommendation 7: Reform Qualified Tuition Programs to better target benefits and prevent abuse.

- Qualified Tuition Programs, also known as Section 529 plans, have grown rapidly over the last decade. Assets in these tax-subsidized college savings vehicles grew from $58.1 billion in 2003 to $205.7 billion in 2013.[xxv]
- These savings plans provide the large majority of their benefits to high-income individuals. According to the GAO, in 2009, the median income of households with either a Section 529 plan or Coverdell ESA was more than $120,000 per year.[xxvi]
- The consortium believes that the benefits of 529 plans should be better targeted and will explore various mechanisms for achieving this, such as setting meaningful contribution limits, establishing income limits, or changing the treatment of these assets in the Expected Family Contribution calculation under the Higher Education Act.

Recommendation 8: Limit the Exclusion for Employer Provided Educational Assistance to undergraduate education.

- In 2007, 46 percent of the recipients of Section 127 tax benefits for employer-provided educational assistance were graduate students. These employees benefited, on average, twice as much as recipients enrolled in undergraduate education, receiving an average of $3,701 in tax subsidies as compared to $1,849 for undergraduates. Recipients in graduate education were also much higher-paid than their undergraduate counterparts, with average annual earnings of $53,300 as compared to $33,707 for undergraduate employee recipients.[xxvii]

- As noted earlier, individuals in graduate programs can expect to have relatively high earnings on average after completing school compared to those who have no college degree. And because these workers already have an undergraduate degree, they are more able to afford school than workers without a college degree. Limiting this exclusion to undergraduate education would focus the benefits on those workers who most need further education and who have fewer resources to afford college.[xxviii]

Recommendation 9: Adopt a new institutional eligibility threshold for higher education tax benefits to colleges and universities.

- It is troublesome that the federal government is providing tax breaks (such as tax exempt status, charitable deduction eligibility, or access to tax-exempt bond financing) to institutions of higher education that fail to meet minimum college access and completion standards. Inadequate performance on the former suggests that an institution is not advancing a key mission of higher education, while inadequate performance against the latter suggests a poor federal investment. Metrics by which policymakers might measure institutional eligibility could include graduation rates, representation of low-income students, or other indicia to be developed. Our consortium will engage in extensive research and analysis to develop the details of this recommendation, including suggested demarcations of eligibility to support successful implementation.

Recommendation 10: Limit the tax exemption for interest earned on qualified 501(c)(3) bonds for private higher education institutions.

- Private colleges and universities can sell tax-exempt qualified 501(c)(3) bonds at a government-subsidized rate to raise capital for building construction or pay off previous debts. The primary beneficiaries of this government subsidy are private colleges and universities that issue the bonds (some of which have sizeable endowments) and bond purchasers at the highest marginal income tax rate—not students and families.
- The consortium believes these bonds should be limited and will explore various options for achieving this, such as: replacing the tax exemption for these bonds with a direct payment or tax credit to cover a portion of the bonds' interest; placing further restrictions on the use of funds from these bonds; or eliminating this financing mechanism for institutions that fail to meet minimum performance thresholds on student access and completion.

Recommendation 11: Improve transparency around institutional receipt of tax benefits.

- There is currently no information available about the amount of higher education tax benefits claimed by an institution's students or the amount an institution is receiving in its own tax benefits. This lack of transparency creates significant holes in understanding about the use and targeting of these benefits, as well as raises concerns about proper accountability to ensure benefits are received properly. We recommend that Treasury work with the Internal Revenue Service to produce public annual reports to Congress detailing the number and amount of higher education tax benefits broken down by institution.

SIMPLIFICATION

Goal: To create a system where students and families understand the benefits available to them and are able to easily claim benefits and make optimal choices. Proposals should eliminate redundancy and preserve or increase benefits that improve affordability, access, and completion for undergraduate students. Proposals should also seek to address any conflicting provisions and eliminate minor provisions that complicate the code.

Discussion

Research on other types of student aid finds that complexity reduces the impact of aid on college access and completion.[xxix] Simplifying the system to help students and parents more easily navigate tax-based aid could help them plan more effectively for postsecondary education. It would increase the odds that families choose the optimal tax-based aid benefit by reducing redundancies. Simplification also improves tax compliance and reduces tax filer errors. And in addition to simplifying tax-based aid, our recommendations below would result in better targeting.

Recommendations for Reform

Recommendation 12: Eliminate the Lifetime Learning Credit.

- The LLC has become increasingly redundant as benefits under the Hope Credit/AOTC have been expanded (from two years to four years, for example) and more students can claim the AOTC instead. Eliminating the LLC would simplify the tax code and reduce the risk that families claim a suboptimal benefit. In addition, nearly two-thirds (64 percent) of LLC benefits go to graduate students. As noted earlier, individuals with a graduate degree earn, on average, at least twice as much as those with only a high school diploma.
- While eliminating the LLC improves targeting and simplifies the tax code, it does negatively affect three other groups who are eligible for it but not eligible for the AOTC: students attending less than half-time; students who have already claimed higher education tax benefits for four calendar years; and students who are enrolled in job training courses at a Title IV-eligible institution but not seeking a certificate or degree. While we are concerned about the impact on less-than-half-time students, the fact that they are eligible for Pell Grants if they have low incomes may mitigate to some extent the effects of LLC ineligibility.
- We view as more serious the problem of how to meet the needs of students who must take longer than four calendar years to complete college, as more than half of undergraduates now attend part-time at some point during college.[xxx] Current law has two separate provisions about the length of time for which the AOTC is available, one which limits the AOTC to four calendar years and one which says the credit is allowed for the first four years of postsecondary education. These two rules come into conflict for students who cannot always attend full-time, often because they face financial pressures to work a substantial amount while in school.[xxxi] Adopting a lifetime cap on AOTC benefits equivalent to four years' worth of the credit (i.e. a $10,000 cap if the annual credit maximum is $2,500) is one way to solve this problem (see Recommendation 16).

Recommendation 13: Eliminate the Tuition and Fees Deduction.

- The Tuition and Fees Deduction is one of the most regressive tax-based aid benefits currently available. According to estimates from the Tax Policy Center, in 2013, more

College expenses are currently rising much faster than general inflation . . . adjusting the AOTC for inflation would provide some protection to students against higher education cost increases, while carving out time between now and 2018 to ramp up outreach efforts promoting the credit to the target population.

than half of this benefit will go to families earning over $100,000 per year.

- There is also significant overlap between those eligible to receive the LLC and the Tuition and Fees Deduction, adding unnecessary complexity to the system.

Recommendation 14: Eliminate Coverdell Education Savings Accounts (ESAs).

- Coverdell ESAs essentially provide a redundant benefit to 529 plans; more and more, they are becoming a subsidy for private elementary and secondary schools rather than a way to pay for college.
- Coverdell ESAs are very regressive. As mentioned above, the GAO reports that, in 2009, the median income of households with either a Section 529 plan or Coverdell ESA was more than $120,000 per year.[xxxii]

Recommendation 15: Adjust the AOTC for inflation beginning in 2018.

- College expenses are currently rising much faster than general inflation, reducing the net value of all forms of aid students receive. Eventually adjusting the AOTC for inflation would provide some protection to students against higher education cost increases, while carving out time between now and 2018 to ramp up outreach efforts promoting the credit to the target population.
- Doing so also provides predictability and stability for both the Internal Revenue Service and the taxpayers, as adjusting provisions in the tax code for inflation is typically the rule, not the exception.

Recommendation 16: Replace the four-year limit on the AOTC with an equivalent lifetime dollar cap.

- The criterion that a student can only claim the AOTC for four calendar years while also being eligible for the credit for four full years of postsecondary education creates confusion for academic institutions and students. As highlighted in a recent GAO report, the latter limit is not implemented uniformly and, as a result, some students receive the credit for more or less than the equivalent of four full academic years, adjusted for enrollment status.[xxxiii]
- The four-calendar-year standard punishes students who fluctuate between full- and part-time attendance. These "mixed enrollment" students now represent the majority of undergraduates.[xxxiv]
- A lifetime dollar cap would treat all students fairly, create uniformity across the system, and still preserve an incentive for students to complete. It could be set at a dollar amount that is equal to the current four-year limit, i.e. $10,000 (four years of a $2,500 maximum credit), and an annual maximum credit limit of $2,500 could be maintained to protect students against using up the lifetime limit too rapidly.

Recommendation 17: Eliminate the taxation of Pell Grants.

- Pell Grant recipients are typically the students most in need of additional financial assistance. The current policy of taxing Pell Grants spent on necessary educational expenses such as room and board does not make sense given high levels of unmet financial need and is unnecessarily punitive.

- Current taxation of Pell Grants also adds unnecessary complexity to the system, forcing students to track every Pell dollar.

Recommendation 18: Remove the lifetime ban on the AOTC for individuals convicted of a drug felony.

- Since laws with respect to possession or distribution of controlled substances differ dramatically from state to state, this provision unnecessarily complicates the tax code, reducing compliance and participation in tax aid. New research finds that a similar policy in the Higher Education Act (a two-year ban on federal Title IV financial aid to those convicted of a drug felony) did not deter young people from committing drug felonies but did delay their entry into college and reduced the odds they would ever attend college or complete a degree. This impact was largest for young people who lived in urban areas and whose mothers never attended college.[xxxv]

TIMELY DELIVERY OF AID

Goal: To deliver tax benefits in a way that increases take-up and maximizes their impact on affordability, access, and completion. Proposals to reform tax-based aid should consider alternative delivery options that ensure payments arrive when college costs are incurred, including advancing payments of tax-based aid to families or third-party payment mechanisms.

Discussion

Finding new ways to deliver the AOTC could increase its impact on affordability, access, and completion. Advance and third-party payment mechanisms have the potential to improve communication between the Treasury Department, families, and colleges about enrollment and expenses and to make claiming the credit simpler for families, all of which could improve tax compliance and increase take-up rates.

Advance or third-party payment of tax credits is not a new concept. Advance payment of the EITC existed for nearly 30 years before reporting and participation issues among employers and recipients led to its repeal in 2010.[xxxvi] The Health Coverage Tax Credit included as part of the Trade Adjustment Assistance program currently provides a credit for health insurance that is delivered monthly from the Treasury Department to the health plans. And most significantly, beginning in 2014 the Affordable Care Act will provide health insurance premium support through a tax credit that is paid monthly directly to insurance companies for millions of Americans. These types of mechanisms have not yet been attempted, however, in the tax-based student aid context.

Recommendations for Reform

Recommendation 19: Create a mechanism for timely delivery of the AOTC as college expenses are incurred.

- Options for timely delivery could include advance payment of tax aid to families or third-party payment mechanisms. These advance payments would be made closer to the start of each semester (or other academic period) based on the best available information about income and qualified expenses.
- Timely delivery could be combined with other steps to increase awareness among families of the AOTC and to make the credit easier to claim. These could

include adding AOTC information to the federal Financial Aid Shopping Sheet and the Student Aid Report; exploring the feasibility of an IRS portal for families with an AOTC estimator, similar to the existing EITC Assistant; and developing IRS online AOTC accounts for claiming the credits as either incremental payments through an advance AOTC option or as a year-end payment at tax time.

- In the coming months, our consortium will conduct research and analysis on various options to deliver the AOTC when college expenses are incurred and not just at tax time. We will examine previous and current efforts that deliver tax benefits through advance payment to glean lessons for the AOTC. We will develop options for new AOTC timely delivery mechanisms and evaluate these options based on a common set of criteria, such as the extent to which each option would increase take-up of the credit; strengthen the incentive for students to enroll, persist, and complete; impact college tuition and fee growth; and affect student receipt of other types of aid. In addition, we will assess the feasibility of implementation of each option and the risk of overpayments to families.

Finding new ways to deliver the AOTC could increase its impact on affordability, access, and completion. Advance and third-party payment mechanisms have the potential to improve communication between the Treasury Department, families, and colleges about enrollment and expenses and to make claiming the credit simpler for families

INCREASING TAKE-UP AND AWARENESS OF THE AOTC

Goal: To increase take-up and awareness of the AOTC, especially among low- and modest-income students and parents. Proposals should address both process changes as well as informational impediments to claiming the AOTC. Proposals should also engage all actors: institutions, the Departments of Education and Treasury, community organizations, and volunteer and commercial tax preparation entities.

Discussion

As discussed above, there is substantial room to improve take-up and awareness of tax-based aid in general, as well as the refundable portion of the AOTC specifically. Increasing participation in the refundable portion of the AOTC is of great interest to this consortium, since it is targeted to low- to modest-income families.

There are various policy levers available to policymakers and administrators to increase take-up and awareness of tax-based aid. For example, the IRS could increase data sharing with the Department of Education, work with commercial and volunteer preparers to use products that automatically detect for eligibility, or highlight the availability of the credit in any communications about costs and financial aid. The agency could also launch an outreach campaign similar to its EITC work.

Recommendations for Reform

Recommendation 20: The Departments of Education and Treasury should collaborate to identify which types of eligible individuals are not claiming the AOTC and work together to reach out more aggressively to these populations.

New statutory authority could be given to the Departments so they could link tax and financial aid data (with appropriate privacy safeguards) in order to coordinate tax-based aid with other federal student aid policies and better analyze the impact of tax aid.

- Education and Treasury could explore ways to streamline and accelerate claiming of the AOTC, such as some of the strategies suggested under Recommendation 19.
- Information on the AOTC could be added to the federal Financial Aid Shopping Sheet and FAFSA.
- The federal TRIO and GEAR UP programs, which target low-income, first-generation students, could help promote AOTC and provide resources to ensure students and families know how to claim the credit.
- Our consortium will conduct further research and analysis to develop more detailed reform recommendations in this area. Unfortunately, there are significant data limitations that inhibit our ability to understand the extent of the problem. There are, however, lessons that can be drawn from other arenas, such as EITC outreach efforts.

Conclusion

Tax-based student aid, now the largest form of federal student aid excluding loans, is long overdue for reform. With college increasingly unaffordable for many Americans, the nearly $34 billion federal investment in tax-based aid must be restructured to address the problems of poor targeting, complexity, delayed payment of needed benefits, and lack of awareness or confusion among families about the help that is available.

Our Consortium's recommendations would direct tax-based aid toward low- and modest-income students, rather than to higher-income individuals who are already highly likely to attend college. We would also make it easier for families to understand and claim tax-based student aid. Our simplification reforms would have the added advantage of increasing tax compliance and reducing errors. We would also hold institutions that receive federal tax breaks accountable for meeting minimum thresholds for advancing college access and completion goals. And we propose to reinvest all of the savings from reform of tax-based aid in students, including through funding for the Pell Grant program.

Our reform package is feasible, fiscally responsible, and aligns the enormous investment in tax-based student aid with national goals of improving college affordability, access, and completion. As Congress considers an overhaul of the tax system, we hope our recommendations will inform its actions.

---

[i] Estimates are from the President's FY14 Budget and the Department of Education's FY14 Budget Summary and Background Information.

[ii] It is important to note that no study to date has included the American Opportunity Tax Credit in its analysis. For a complete summary of the literature on the effectiveness of tax-based aid see, Reimherr, P., Strawn, J., Harmon, T., and Choitz, V. (2013). R*eforming Student Aid: How to Simplify Tax Aid and Use Performance Metrics to Improve College Choices and Completion*, pp. 21-22.

[iii] See Jackson, P. (2008). *Higher Education Tax Credits: An Economic Analysis. Congressional Research Service.* RL32507. Rechovsky, A. (2008). *Higher Education Tax Policies.* From the Effectiveness of Student Aid Policies: What the Research Tells Us. College Board, with the Support of the Lumina Foundation; Dynarski, S. (2006). *Oral Testimony Before the Senate Finance Committee* - http://www.finance.senate.gov/imo/media/doc/120506sdtest.pdf.

[iv] CLASP calculations from Tax Policy Center data. Tax Policy Center (2013). *Distributions of Education Incentives under the Current Law Baseline in 2013: All Students.*

[v] According to the Census Bureau, the income of households at the 80th percentile in 2012 was $104,096. Census Bureau, U.S. Department of Commerce. (2013). *Income, Poverty, and Health Insurance Coverage in the United States: 2012.*

[vi] National Center for Education Statistics. *Condition of Education* (2010) and *Digest of Education Statistics* (2012).

[vii] Mortenson, T. (2012). *Bachelor's Degree Attainment by Age 24 by Family Income Quartiles, 1970 to 2010.* Postsecondary Education Opportunity.

[viii] Turner, N. (September 2011). *The Effect of Tax-Based Federal Student Aid on College Enrollment.* National Tax Journal.
[ix] Education Trust analysis of 150% graduation rates in IPEDS 2011.
[x] Nguyen, M. (2012). *Degreeless in Debt: What Happens to Borrowers Who Drop Out.* Education Sector.
[xi] The Department of the Treasury, Internal Revenue Service. (2013). *Tax Benefits for Education: For use in preparing 2012 returns.* http://www.irs.gov/pub/irs-pdf/p970.pdf.
[xii] Government Accountability Office. (May 2012). *Improved Tax Information Could Help Families Pay for College.* GAO-12-560.
[xiii] Dynarski, S., Scott-Clayton, J. (2013). *Financial Aid Policy: Lessons from Research.* Working Paper 18710. National Bureau of Economic Research.
[xiv] Mettler, S. (2010). "Reconstituting the Submerged State: The Challenges of Social Policy Reform in the Obama Era." P*erspectives on Politics*, 2010: 803-824.
[xv] Government Accountability Office. (May 2012). *Improved Tax Information Could Help Families Pay for College.* GAO-12-560.
[xvi] CLASP calculations based on data from the 2008 National Postsecondary Student Aid Study (NPSAS).
[xvii] Choitz, V., Reimherr, P. (2013). M*ind the Gap: High Unmet Financial Need Threatens Persistence and Completion for Low-Income Community College Students.* CLASP.
[xviii] National Center for Education Statistics. (January 2011). *Trends in Student Financing of Undergraduate Education: Selected Years, 1995–96 to 2007–08.* NCES 2011-218.
[xix] Orozco, V., Cauthen, N.K. (2009). *Work Less, Study More, and Succeed: How Financial Supports Can Improve Postsecondary Success.* Demos. Scott-Clayton, J. (2012). *What Explains Trends in Labor Supply Among Undergraduates, 1970-2009?* NBER Working Paper 17744. National Bureau of Economic Research.
[xx] US Department of Labor, Bureau of Labor Statistics (2013). *Earnings and unemployment rates by educational attainment in 2012.* http://www.bls.gov/emp/ep_chart_001.htm.
[xxi] In 2012 the median income for married households was $75,694. Census Bureau, U.S. Department of Commerce. (2013). *Income, Poverty, and Health Insurance Coverage in the United States: 2012.*
[xxii] CLASP calculations from Tax Policy Center data. Tax Policy Center (2013). *Distributions of Education Incentives under the Current Law Baseline in 2013: All Students*
[xxiii] CLASP calculations from Tax Policy Center data. Tax Policy Center (2013). *Distributions of Education Incentives under the Current Law Baseline in 2013: All Students.*
[xxiv] Project on Student Debt. (2012). *Student Debt and the Class of 2011.*
[xxv] The College Board. (September 2013). *Trends in Student Aid 2013.*
[xxvi] Government Accountability Office. (May 2012). *Improved Tax Information Could Help Families Pay for College.* GAO-12-560.
[xxvii] Society for Human Resource Management and the National Association of Independent Colleges and Universities. (2009). *Who Benefits from Section 127? A Study of Employee Education Assistance Provided under Section 127 of the Internal Revenue Code.*
[xxviii] US Department of Labor, Bureau of Labor Statistics (2013). *Earnings and unemployment rates by educational attainment in 2012.* http://www.bls.gov/emp/ep_chart_001.htm.
[xxix] Dynarski, S., Scott-Clayton, J. (2013). *Financial Aid Policy: Lessons from Research.* Working Paper 18710. National Bureau of Economic Research.
[xxx] Shapiro, D., Dundar, A., Chen, J., Ziskin, M., Park, E., Torres, V., and Yi-Chen, C. (2012). *Completing College: A National View of Student Attainment Rates.* National Student Clearinghouse Research Center, National Student Clearinghouse.
[xxxi] After examining other possible reasons, Bound, Lovenheim, and Turner (2010) conclude that increased work by undergraduates likely explains most of the large increase in time to a degree observed over the past three decades. They note that time to degree increased substantially while public higher education resources were declining, family incomes were eroding relative to college costs, and students were working more hours, with low-income students at public institutions affected most. Bound, J., Lovenheim, M., and Turner, S. (2010). *Increasing Time to Baccalaureate Degree in the United States.* Population Studies Center, University of Michigan.
[xxxii] Government Accountability Office. (May 2012). *Improved Tax Information Could Help Families Pay for College.* GAO-12-560.
[xxxiii] Government Accountability Office. (May 2012). *Improved Tax Information Could Help Families Pay for College.* GAO-12-560.
[xxxiv] Shapiro, D., Dundar, A., Chen, J., Ziskin, M., Park, E., Torres, V., and Yi-Chen, C. (2012). *Completing College: A National View of Student Attainment Rates.* National Student Clearinghouse Research Center, National Student Clearinghouse.
[xxxv] Lovenheim, M., Owens, E. (2013). *Does Federal Financial Aid Affect College Enrollment? Evidence from Drug Offenders and the Higher Education Act of 1998.* NBER Working Paper No. 18749. National Bureau of Economic Research.
[xxxvi] Holt, S. (2011). *Ten Years of the EITC Movement: Making Work Pay Then and Now.* Published as part of the Brookings Institution's Metropolitan Opportunity Series.

Higher Education Tax Reform

A Shared Agenda for Increasing College Affordability, Access, and Success

The Reimagining Aid Design and Delivery (RADD) Consortium for Higher Education Tax Reform

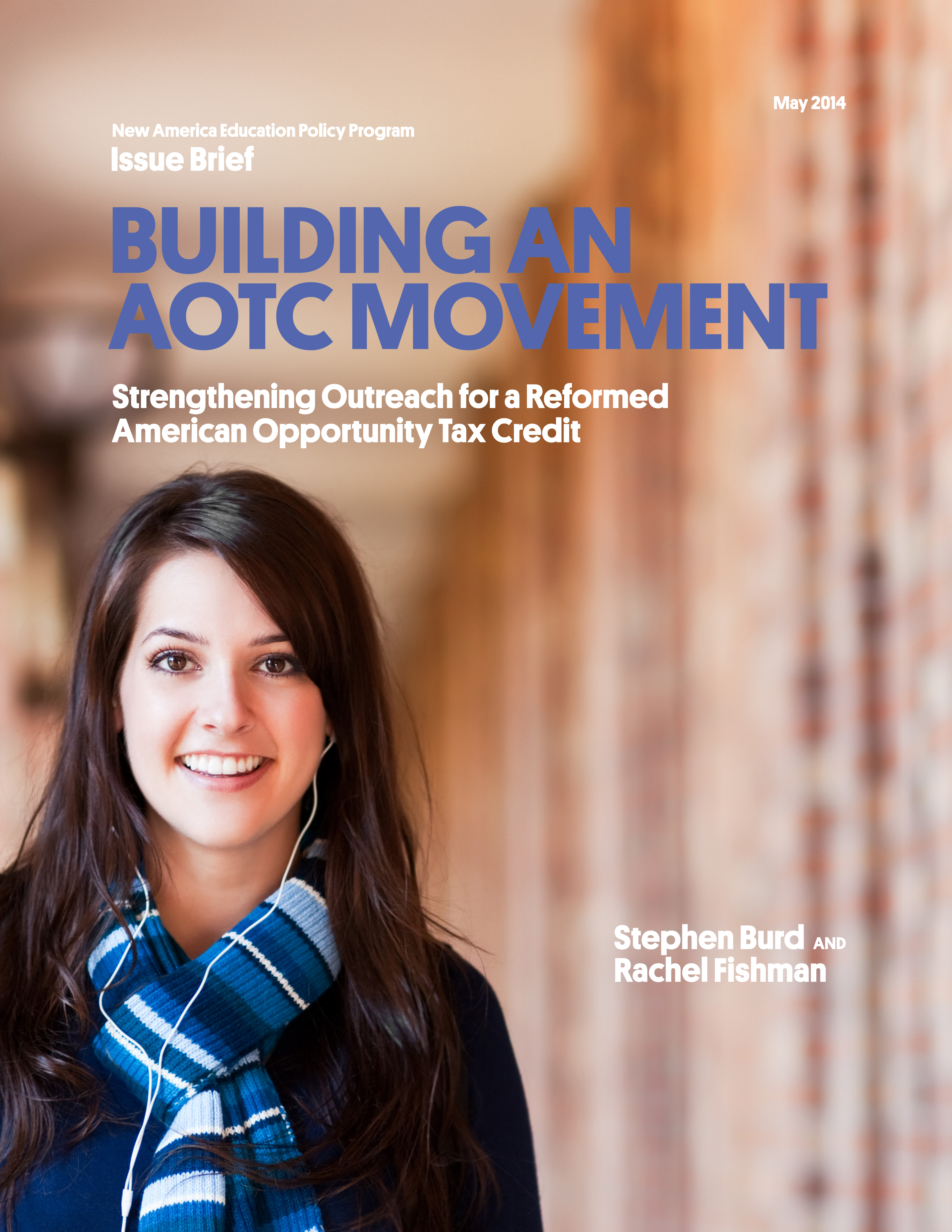
November 2013

CLASP
policy solutions that work for low-income people

YOUNGINVINCIBLES

NEW AMERICA FOUNDATION

The Education Trust



May 2014

New America Education Policy Program

Issue Brief

BUILDING AN AOTC MOVEMENT

Strengthening Outreach for a Reformed American Opportunity Tax Credit

Stephen Burd AND
Rachel Fishman

About the Authors
Stephen Burd is a senior policy analyst on New America's Education Policy Program. He can be reached at burd@newamerica.org.

Rachel Fishman is a policy analyst on New America's Education Policy Program. She can be reached at fishmanr@newamerica.org

This issue brief was prepared by New America's Education Policy Program as part of its participation in the Consortium for Higher Education Tax Reform. The Consortium is a partnership funded by the Bill & Melinda Gates Foundation as part of its Reimagining Aid Design and Delivery (RADD) initiative. In addition to New America, Consortium partners are the Center for Postsecondary and Economic Success (C-PES) at CLASP, the Education Trust, and Young Invincibles. Through its policy recommendations in *Higher Education Tax Reform: A Shared Agenda for Increasing College Affordability, Access, and Success* and through issue briefs such as this one, the Consortium is identifying problems with federal higher education tax policy and providing recommendations for redesign and reform.

About New America
New America is a nonprofit, nonpartisan public policy institute that invests in new thinkers and new ideas to address the next generation of challenges facing the United States.

The New America Education Policy Program's work is made possible through generous grants from the Alliance for Early Success; the Annie E. Casey Foundation; the Bill and Melinda Gates Foundation; the Evelyn and Walter Haas, Jr. Fund; the Grable Foundation; the Foundation for Child Development; the Joyce Foundation; the Kresge Foundation; Lumina Foundation; the Pritzker Children's Initiative; the William and Flora Hewlett Foundation; and the W. Clement and Jessie V. Stone Foundation.

Contents

Introduction

The Consortium for Higher Education Tax Reform has offered a set of proposals aimed at making tax-based student aid more generous for low- and moderate-income students. Along with simplifying and better targeting higher education tax benefits to families and institutions, the Consortium has recommended preserving the American Opportunity Tax Credit (AOTC) as the primary vehicle for tax-based student aid, making it 100 percent refundable, and evaluating early delivery of the credit at the time college expenses are incurred.

These reforms would ensure that tax-based student aid goes to the students who struggle most with college costs, rather than to higher-income individuals who are already very likely to attend college without a tax incentive. But the changes will only be beneficial to these students if they are aware that the AOTC exists and know how to claim it.

Today, too many families fail to claim higher education tax benefits for which they are eligible. For example, a Government Accountability Office (GAO) study found that one in seven taxpayers – or 1.5 million tax filers – who were eligible for either the Tuition and Fees Deduction or the Lifetime Learning Credit (LLC) in 2009 failed to claim those benefits. Another 237,000 of these filers made a "suboptimal choice," choosing a tax break that did not "maximize their potential benefits."[1]

Additionally, the Tax Policy Center estimates that one in four filers who are eligible for the AOTC – an annual income tax credit of up to $2,500 available to help students cover tuition, fees, and course materials for their first four years of college – don't actually receive the credit.[2] While 75 percent may seem to be a relatively high take-up rate, it likely masks a much lower take-up rate for low-income households who may not know the credit exists and who may not earn enough to pay federal income taxes.

One major obstacle that financially-needy students and their parents face with tax credits, unlike with other federal financial aid programs, is that they can't rely on colleges to help them claim their credits. Most financial aid offices share (at most) general information about the tax credits with students, and few, if any, provide individualized advice or assistance. As a result, students are largely on their own to learn about the tax credits and know how to claim them. As the GAO has written, this is no easy task: "Unlike Title IV [federal student aid] programs, users must understand the rules, identify applicable tax preferences, understand how these tax preferences interact with one another and with federal student aid, keep records sufficient to support their tax filing, and correctly claim the credit or deduction on their return."[3]

The federal government certainly doesn't make it easy for low-income students and their families to navigate the process. The applicable guidelines are embedded in a nearly 90-page IRS publication on higher education tax benefits. The whole process is confusing and unduly complex for many students and families who are not well-versed in the tax code.

Moreover, the lowest-income taxpayers are not required to file a tax return and may not realize that only by filing one can they access a refundable higher education tax credit. These students risk losing out on a benefit available to help them cover the cost of college.

A concerted effort will be needed to make low-income families aware of and help them claim the refundable AOTC. In this paper, we look at what can be learned from the vigorous outreach movement for the Earned Income Tax Credit (EITC), another refundable tax credit aimed at low- and moderate-income families. We then explore how an AOTC outreach effort should involve higher education institutions, the Departments of Education and Treasury, college outreach programs like TRIO and GEAR UP, and benefit access programs at community colleges. Given their constituencies, these are natural partners in getting the word out about higher education tax benefits. Commercial tax preparers such as Intuit and H & R Block should also be involved in outreach efforts, but with consumer protections in place to ensure that students receive the benefit to which they are entitled.

At a time when college tuition is on the rise but family income is stagnating, financially needy students should not miss out on a benefit they are eligible for simply because they don't know about it. A fully-refundable AOTC that is better targeted to low- and moderate-income students and that is delivered at the time college expenses are incurred could make the difference between whether or not a low-income student attends college.

Lessons on Outreach: The Earned Income Tax Credit

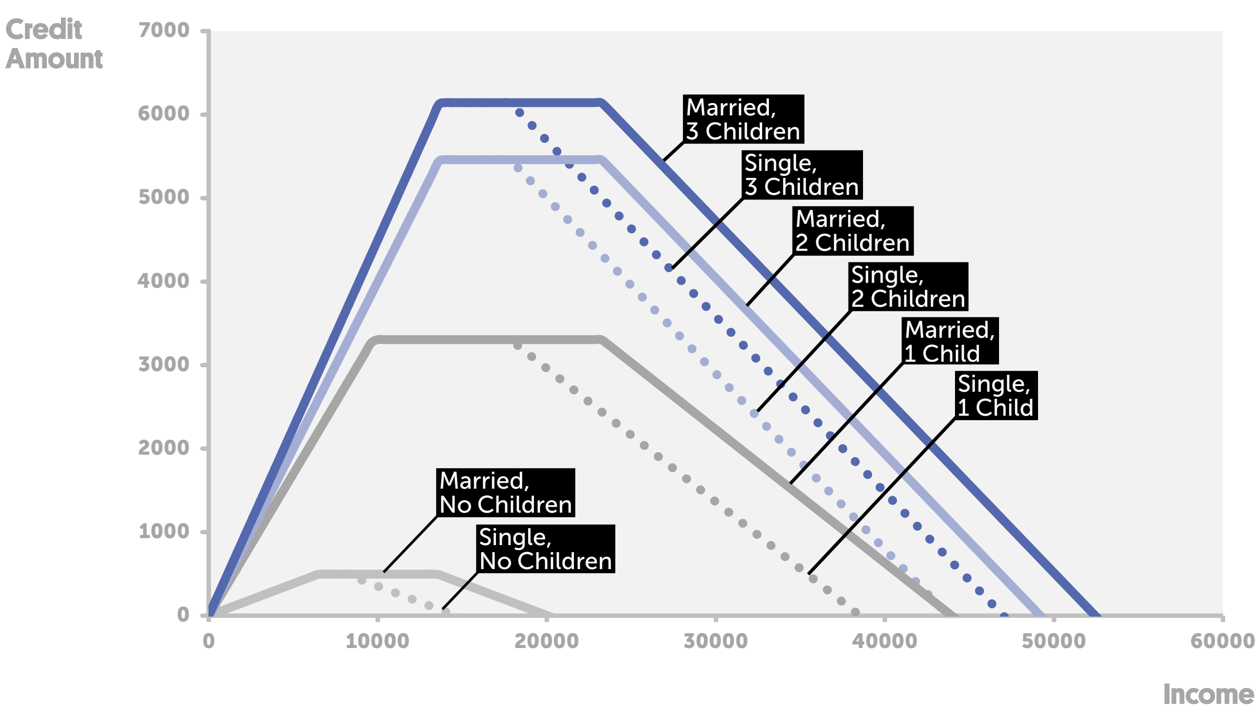
In looking for ways to increase outreach to low- and moderate-income households, it's helpful to look at the history of the EITC.

The EITC is a refundable, anti-poverty tax credit that works by supplementing the earnings of low-income workers, especially those with dependents, by reducing or eliminating their taxes.[4] The IRS estimates that the take-up rate for EITC in 2010 was 78 to 80 percent[5], which is a much higher rate than other federal benefit programs to low-income families such as Temporary Assistance to Needy Families (40 percent in 2005) and the Supplemental Nutrition Assistance Program (60 percent in 2005).[6]

Congress established the refundable EITC in 1975.[7] While the initial credit was relatively small, several bipartisan expansions starting in the 1980s caused it to become the largest federal aid program targeted toward the working poor.[8] Even though the United States has experienced numerous economic downturns since the creation of EITC, bipartisan support for the credit has increased over the years mainly because it provides financial support while offering incentives for being employed. For example, a family must have a wage earner in order to be eligible, and the more income a family earns, the larger credit received. Depending on family size and income, the credit reaches a maximum plateau that eventually declines as wages increase (see figure 1). In effect, the credit transfers supplemental income to low-income wage earners.[9] In 2012, for example, the EITC is estimated to have lifted at least 6.5 million individuals above the poverty line, including about 3.3 million children.[10]

Figure 1: Earned Income Tax Credit

Earned Income Tax Credit by Income, Marital Status, and Number of Children



Source: 2013 EITC parameters taken from http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=36

EITC's relatively high take-up rate is impressive given that the Tax Reform Act of 1986 both expanded EITC while increasing the personal exemption and standard deduction. In other words, while more families became eligible for EITC, fewer households were required to file a tax return.[11] The take-up rate is due in large part to an EITC movement that included community outreach and promotion, the Internal Revenue Service's Volunteer Income Tax Assistance (VITA) sites, commercial tax preparation for low-income taxpayers, and philanthropy.[12] Each outreach method is discussed briefly below:

Community Outreach and Promotion

The Center on Budget and Policy Priorities (CBPP), is a Washington-based, nonprofit policy organization that "works at the federal and state levels on fiscal policy and public programs that affect low- and moderate-income families and individuals."[13] In 1989, CBPP produced and distributed approximately 10,000 EITC English and Spanish outreach kits consisting of posters, fact sheets, and suggestions to community organizations such as the Center for Law and Human Services in Illinois and Children Now in California for conducting outreach campaigns. The kit was enhanced and expanded throughout the years to ensure optimal reach. In addition, the IRS created its own EITC materials for distribution at places such as public assistance agencies and grocery stores. Many mayors of large urban areas, like Richard Daley in Chicago, also created EITC outreach initiatives.[14]

VITA and Other Community Tax Programs

VITA sites were established by Congress in 1969 to help low-income tax filers receive free preparation of their returns. Many community organizations working with low-income families often referred these families to VITA sites during tax season. But VITA didn't have the capacity to handle these referrals. Eventually, outreach campaigns not only promoted existing VITA sites but also recruited new volunteers to serve at additional sites. In 2000 the IRS created the Stakeholder Partnerships, Education and Communication (SPEC) which focused on developing and supporting these community partnerships rather than directly supporting VITA sites. In addition, volunteer assistance efforts among tax professionals such as Community Tax Aid made inroads in various urban communities.[15]

Commercial Tax Preparation for Low-Income Tax Payers

The commercial tax industry includes large national chains like H&R Block and Liberty Tax Services and smaller, locally-owned, fly-by-night businesses that pop up during tax season. With the growth of EITC, commercial tax preparers offered families "instant refund" products like "refund anticipation loans" (RALs). It's important to note that these "instant refund" products are predatory—the commercial preparer lends the filer the expected refund amount plus a preparation fee plus additional fees at a high interest rate. As EITC became more generous, commercial preparers ensured that as many people who were eligible for the EITC applied in order to maximize their profits through large refunds.[16] Even without RALs or similar products, it was in the interest of commercial preparers to deliver large refunds to keep customers happy and willing to come back year after year for help filing taxes.

Philanthropy and National Networks

The Annie E. Casey Foundation (AECF) became a large funder of EITC outreach and policy work. The foundation supported CBPP's outreach efforts, provided financing to organizations such as the Brookings Institution to understand the impact of EITC, and funded local outreach campaigns in high-poverty urban areas like Milwaukee. National foundations and other interested national organizations also supported national networks to do EITC outreach work such as KIDS COUNT and the Economic Analysis and Research Network (led by the Economic Policy Institute).[17]

We can't isolate the variables that have contributed to the EITC's 78 to 80 percent take up rate, but it is likely that efforts like those mentioned above have helped. An outreach effort for AOTC can access existing infrastructure, like EITC did, and leverage it to better ensure low- and moderate-income families are claiming the benefits available to them.

Partners in Outreach

A national outreach campaign for the AOTC would include some of the same players as those involved in the EITC movement. But it would also take advantage of partners that are uniquely positioned to reach out to low- and moderate-students and their families. The remainder of this paper will focus on these partners and what they can contribute to this effort.

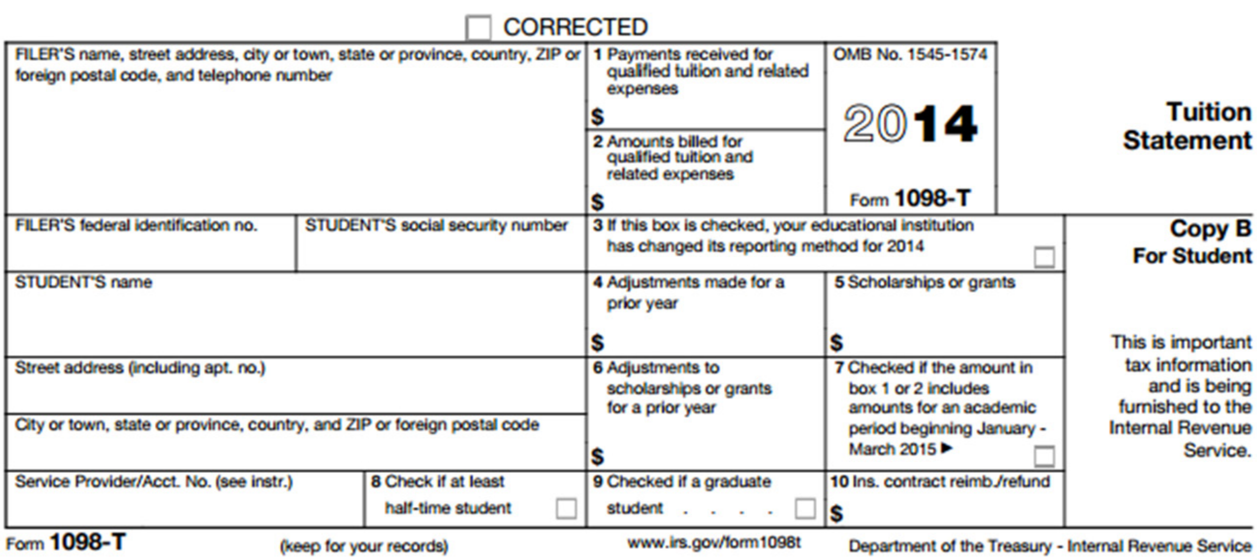
What Colleges Can Do

The largest form of federal student aid, excluding student loans, is delivered through the tax system. In 2012, the federal government spent nearly $34 billion on tax-based aid -- $1 billion more than the total spent on Pell Grants.

At a time when low- and moderate-income students are facing substantial amounts of unmet financial need at colleges, this tax-based student aid, if properly designed, could go a long way in helping them cover their funding gaps.[18] Colleges, however, generally do little to make financially needy students aware of higher education tax benefits. Colleges' only formal responsibility under these programs is to send students (and the Internal Revenue Service) a tax form that includes some of the information that they and their families can use when filing their taxes to claim a credit.[19] The IRS 1098-T form lists the students' qualified tuition and related expenses and the amount of grant and scholarship assistance they have received (see image 1). Most colleges do not include information with this form that promotes the tax breaks or encourages students to try to claim them.

While college financial aid administrators help low-income students obtain federal grants and loans, they are not tax professionals and therefore choose not to help these students and their families claim the tax benefits. Many financial aid officials are loathe to even to talk to students about the availability of these tax breaks for fear of taking on the legal risks of providing tax advice. At most, financial aid offices may have a webpage that lists the different programs and advises students to consult with a tax advisor to see if they are eligible for these benefits. They may also link to the IRS' "Publication 970: Tax Benefits for Education," a dense

Image 1: Colleges Send This 'IRS Form 1098-T Tuition Statement' to Students at Tax Time



CORRECTED

FILER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone number

1 Payments received for qualified tuition and related expenses
$

2 Amounts billed for qualified tuition and related expenses
$

OMB No. 1545-1574

2014

Form 1098-T

Tuition Statement

FILER'S federal identification no.

STUDENT'S social security number

3 If this box is checked, your educational institution has changed its reporting method for 2014

Copy B
For Student

STUDENT'S name

4 Adjustments made for a prior year
$

5 Scholarships or grants
$

This is important tax information and is being furnished to the Internal Revenue Service.

Street address (including apt. no.)

City or town, state or province, country, and ZIP or foreign postal code

6 Adjustments to scholarships or grants for a prior year
$

7 Checked if the amount in box 1 or 2 includes amounts for an academic period beginning January - March 2015 ▶

Service Provider/Acct. No. (see instr.)

8 Check if at least half-time student

9 Checked if a graduate student . . . .

10 Ins. contract reimb./refund
$

Form 1098-T (keep for your records) www.irs.gov/form1098t Department of the Treasury - Internal Revenue Service

90-page document that provides an overwhelming amount of information about the different higher education tax programs.[20]

In addition, aid administrators often don't talk about the tuition tax breaks because they generally don't consider these benefits to be a particularly useful form of financial aid – and for good reason. Overall, the government's multiple tuition tax credit and deduction programs are poorly targeted, with a substantial share of the tax-based aid going to higher income families. The current AOTC is only partially refundable, meaning that low-income households that don't earn enough to pay income taxes are not eligible for the full benefit. Perhaps most importantly for low-income students, tax-based aid does not reach students at the time college expenses are incurred. Students and parents only receive this aid after filing their taxes – which could be as long as 15 months after college bills are due.[21]

Providing a fully refundable AOTC in a timelier manner as the Consortium for Higher Education Tax Reform has proposed is an important step forward in helping the lowest-income students pay for college. But unless colleges play a more active role in promoting the AOTC, these students may never hear of it or take advantage of it.[22] Colleges should not hide behind the excuse of not being able to provide individual tax advice. They can certainly alert students to the availability of the tax credits and explain how they work without fear of repercussions.

Recommendations for Colleges

- Financial aid administrators should include a note on the financial aid award letters they send students alerting them to the availability of the AOTC and provide them a link to the IRS's information about the tax credits.[23]
- At tax time, financial aid administrators should organize "AOTC awareness" campaigns at their schools. They can put up posters and flyers in the aid office and around campus alerting students of their or their family's potential eligibility for benefits from this program. They can also use social media and text messaging to get the word out. And they can bring tax experts to their schools to talk to students about the program. Additionally, for traditionally-aged students whose parents might be claiming the credit, the financial aid office should offer sessions during parent orientations that explain the AOTC. Reminders should also be sent out to parents of dependent students during tax time.
- Financial aid administrators should contact low- and moderate-income students at their schools – and their parents or guardians - who have indicated on their FAFSAs that they did not receive a tuition tax credit to make sure that they are aware of the AOTC. During these conversations, aid officers can direct students and families to tax professionals (including VITA sites and year-round community tax programs) that can help families determine their eligibility and possibly claim the credit (even for prior years).
- Colleges should include supplementary material when they send the 1098-T form to students that highlights the benefits of a reformed AOTC and makes clear that the tax credit is fully refundable, and therefore available to low-income households who don't have any income tax liability. The document would also notify these households that they must file a tax return to receive the benefit.
- Colleges should support on-campus free tax preparation services, including classes that train accounting students to assist their peers.

What the Education Department Can Do

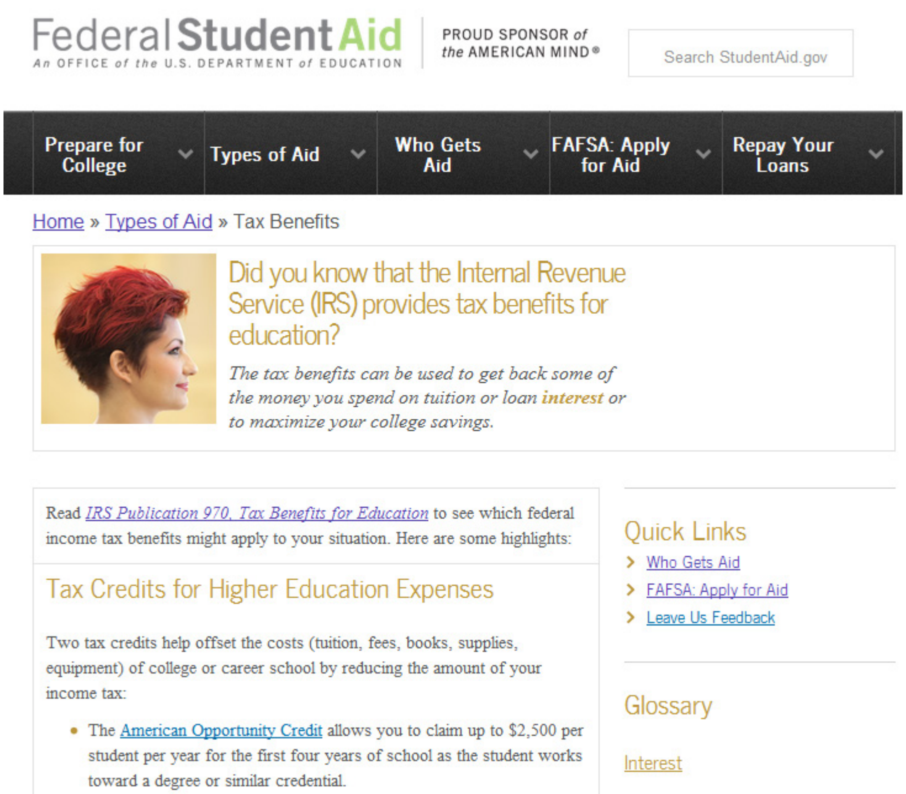
Every January, the U.S. Department of Education releases the Free Application for Federal Student Aid (FAFSA). This is the official start of financial aid season, with many students filling out the application to apply for financial aid for the following year. Unfortunately, the Education Department doesn't let students know on the FAFSA that they may be eligible for tax credits.

This is a missed opportunity. Many students don't make the connection that tax-based aid is financial aid since it is often divorced from when education expenses are incurred. With the FAFSA, students are trying to get aid for the following year. With tax filing, students are getting aid for the previous year.

The Education Department's primary method of getting the word out about the higher education tax credits is through its main consumer information website, studentaid.gov. There, the Department details the many forms student aid can take including grants, loans, and tax credits. When students navigate to the tax benefits page, they can learn about the AOTC and Lifetime Learning Credit, 529 plans, Coverdell Savings Accounts, and the Student Loan Interest Deduction (see image 2). While the site provides a thorough overview of higher education tax benefits for students and families, many of the links lead to IRS publications that are dense and difficult to understand. The website also assumes its users understand the value of tax credits and deductions and how they can actually help them—why, for example, a student or family would want to lower its income tax liability or why refundable credits are ideal.

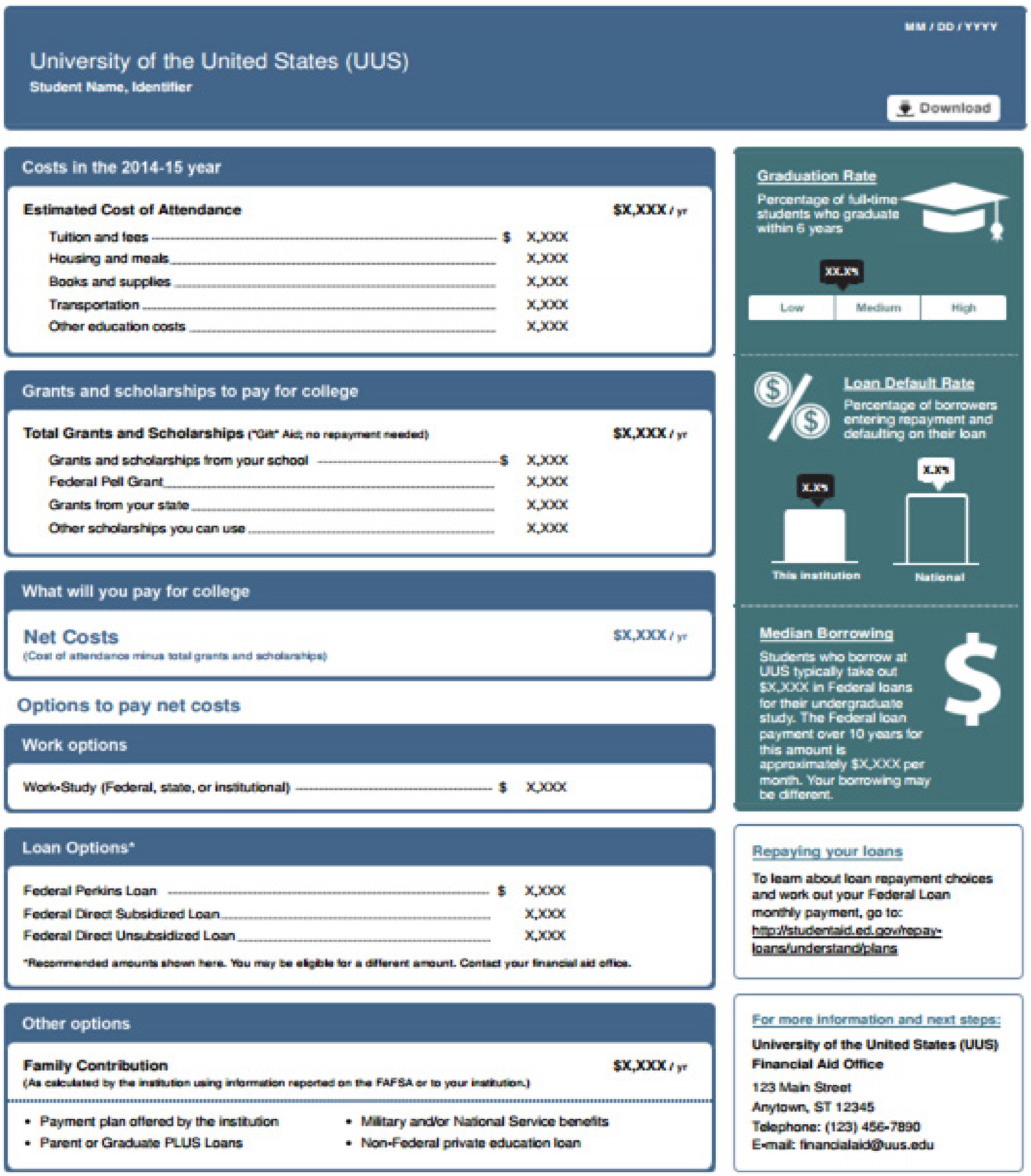
Image 2: Screen Capture of StudentAid.gov website.

Website address: http://studentaid.ed.gov/types/tax-benefits. (Taken February 14, 2014.)



Another way the Education Department provides financial aid information to students is through the Financial Aid Shopping Sheet. The Shopping Sheet is a standard financial aid disclosure form adopted by thousands of colleges and universities (see image 3). It gives students personalized information about their financial aid packages to help them understand how much gift aid they're receiving compared to self-help aid. It also details other options to help pay for college. The Shopping Sheet, however, neglects to make any mention of the tax credits that are available.

Image 3: Template of the U.S. Department of Education's Shopping Sheet



MM / DD / YYYY

University of the United States (UUS)
Student Name, Identifier

Download

Costs in the 2014-15 year

Estimated Cost of Attendance $X,XXX / yr

Tuition and fees	$	X,XXX
Housing and meals		X,XXX
Books and supplies		X,XXX
Transportation		X,XXX
Other education costs		X,XXX

Grants and scholarships to pay for college

Total Grants and Scholarships ("Gift" Aid; no repayment needed) $X,XXX / yr

Grants and scholarships from your school	$	X,XXX
Federal Pell Grant		X,XXX
Grants from your state		X,XXX
Other scholarships you can use		X,XXX

What will you pay for college

Net Costs $X,XXX / yr
(Cost of attendance minus total grants and scholarships)

Options to pay net costs

Work options

Work-Study (Federal, state, or institutional) $ X,XXX

Loan Options*

Federal Perkins Loan	$	X,XXX
Federal Direct Subsidized Loan		X,XXX
Federal Direct Unsubsidized Loan		X,XXX

*Recommended amounts shown here. You may be eligible for a different amount. Contact your financial aid office.

Other options

Family Contribution $X,XXX / yr
(As calculated by the institution using information reported on the FAFSA or to your institution.)

- Payment plan offered by the institution
- Parent or Graduate PLUS Loans
- Military and/or National Service benefits
- Non-Federal private education loan

Graduation Rate
Percentage of full-time students who graduate within 6 years
XX.X%
Low Medium High

Loan Default Rate
Percentage of borrowers entering repayment and defaulting on their loan
X.X% This institution
X.X% National

Median Borrowing
Students who borrow at UUS typically take out $X,XXX in Federal loans for their undergraduate study. The Federal loan payment over 10 years for this amount is approximately $X,XXX per month. Your borrowing may be different.

Repaying your loans
To learn about loan repayment choices and work out your Federal Loan monthly payment, go to: http://studentaid.ed.gov/repay-loans/understand/plans

For more information and next steps:
University of the United States (UUS)
Financial Aid Office
123 Main Street
Anytown, ST 12345
Telephone: (123) 456-7890
E-mail: financialaid@uus.edu

With a reformed and simplified AOTC, the Education Department should improve its outreach effort to ensure that low- and middle-income students are aware of the credit and how it can help them pay for college. The Education Department should also inform students about how they can file for the credit.

Recommendations for the Education Department

- Every student applying for federal financial aid must fill out a FAFSA. Recently, the Education Department released a "Data Retrieval Tool" on the electronic version of the FAFSA that allows students to link up with the IRS and retrieve their tax information to help pre-fill the FAFSA, greatly reducing the burden of filling out the application. The Education Department must let students and families know about the existence of the AOTC, either through this tool or by providing information about it on their Student Aid Report—a document students receive once their FAFSA has been processed.
- Studentaid.gov is a resource for students and families looking to get more information about federal financial aid. The Education Department recently overhauled the site to make it more user-friendly, including adding many graphics and videos along with clear and concise information. Even with the redesign, the tax benefits page could be much better. The Education Department should approach the information on this page as if a student or family has no idea what a tax credit is. Like the other "types of aid" pages on studentaid.gov, the tax benefits page should include helpful videos and infographics.
- The Department should also update the "Resource Center" of studentaid.gov. College access professionals and financial aid administrators access the Resource Center to print pamphlets and infographics that can be used to help inform students about the AOTC during tax time.
- Information about the AOTC should be included on the Financial Aid Shopping Sheet. If a reformed AOTC is delivered at the time expenses are incurred—as the Consortium has recommended—then the Financial Aid Shopping Sheet should include it as an option to pay for college during the academic year. If that change is not made, then the AOTC should still be mentioned so that students know it exists.

What the IRS Can Do

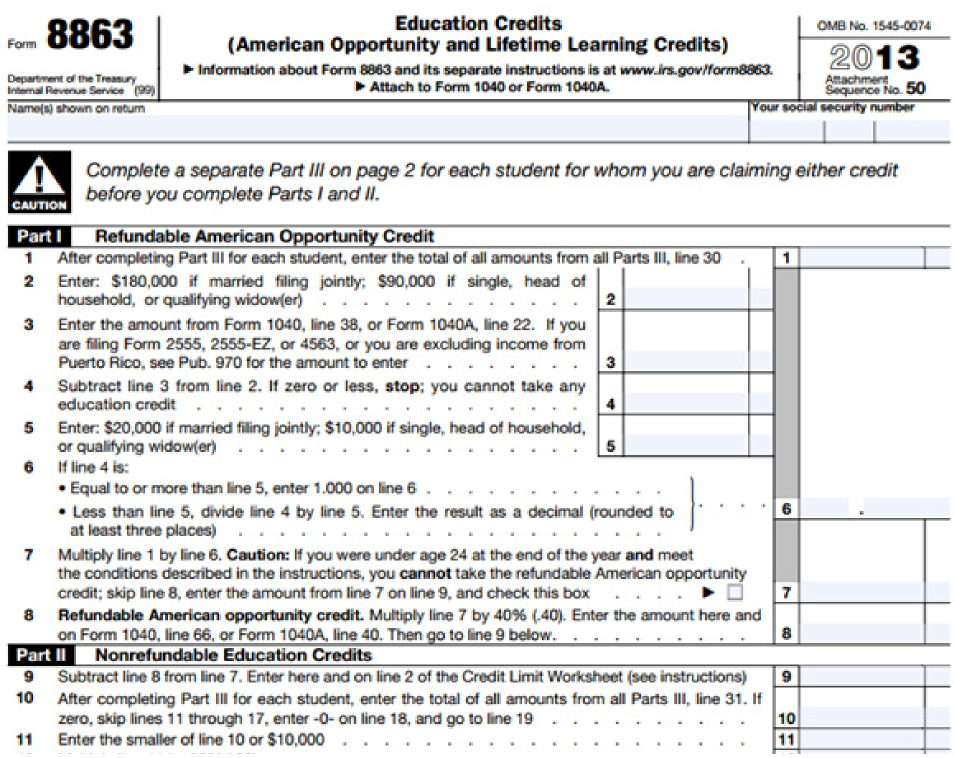
Low- and moderate-income families may not realize that education expenses they have incurred months earlier may be eligible for a refundable credit at tax time since the delivery timetable under current law is so removed from the rest of the financial aid process.

Even so, the Internal Revenue Service, as the public face of federal tax collection, has various methods to educate filers about higher education tax benefits. Since filing taxes can be complex, the IRS's efforts tend to over explain benefits with multiple caveats and thus don't help students and families quickly and easily understand whether they may be eligible and what benefit(s) they could claim.

Currently, the AOTC is claimed on a tax return once a filer fills out Form 8863, Education Credits. This complex two-page form has over 30 questions (see image 4). The instructions for filling out this form are seven pages. What's more, this form is just for credits and does not include any information about deductions. Since filers usually can't claim both an education deduction like the Tuition and Fees deduction and an education credit such as the AOTC, many filers who don't understand the difference between the two may make a decision that does not maximize their benefit. To help filers understand the different education tax benefits, the IRS annually publishes a guide, "Publication 970: Tax Benefits for Education." As previously mentioned, this guide is dense at over 90 pages long and does little to alleviate confusion for families.

Images 4: IRS Form 8863

This is a portion of the two-page "IRS Form 8863 Education Credits." This form is overly complex and comes with seven pages of instructions.


Form **8863**

Department of the Treasury
Internal Revenue Service (99)

Education Credits
(American Opportunity and Lifetime Learning Credits)
▶ Information about Form 8863 and its separate instructions is at *www.irs.gov/form8863.*
▶ Attach to Form 1040 or Form 1040A.

OMB No. 1545-0074
2013
Attachment Sequence No. **50**

Name(s) shown on return | Your social security number

CAUTION *Complete a separate Part III on page 2 for each student for whom you are claiming either credit before you complete Parts I and II.*

Part I Refundable American Opportunity Credit

1 After completing Part III for each student, enter the total of all amounts from all Parts III, line 30 . . . 1
2 Enter: $180,000 if married filing jointly; $90,000 if single, head of household, or qualifying widow(er) . . . 2
3 Enter the amount from Form 1040, line 38, or Form 1040A, line 22. If you are filing Form 2555, 2555-EZ, or 4563, or you are excluding income from Puerto Rico, see Pub. 970 for the amount to enter . . . 3
4 Subtract line 3 from line 2. If zero or less, **stop**; you cannot take any education credit . . . 4
5 Enter: $20,000 if married filing jointly; $10,000 if single, head of household, or qualifying widow(er) . . . 5
6 If line 4 is:
• Equal to or more than line 5, enter 1.000 on line 6 . . .
• Less than line 5, divide line 4 by line 5. Enter the result as a decimal (rounded to at least three places) . . . 6
7 Multiply line 1 by line 6. **Caution:** If you were under age 24 at the end of the year **and** meet the conditions described in the instructions, you **cannot** take the refundable American opportunity credit; skip line 8, enter the amount from line 7 on line 9, and check this box . . . ▶ ☐ 7
8 **Refundable American opportunity credit.** Multiply line 7 by 40% (.40). Enter the amount here and on Form 1040, line 66, or Form 1040A, line 40. Then go to line 9 below. . . . 8

Part II Nonrefundable Education Credits

9 Subtract line 8 from line 7. Enter here and on line 2 of the Credit Limit Worksheet (see instructions) 9
10 After completing Part III for each student, enter the total of all amounts from all Parts III, line 31. If zero, skip lines 11 through 17, enter -0- on line 18, and go to line 19 . . . 10
11 Enter the smaller of line 10 or $10,000 . . . 11

The IRS does provide filing assistance to low-income families to help overcome deduction and credit confusion through such efforts as VITA tax-preparation sites. However, it's important to note that the reach of VITA and other IRS tax preparation efforts has become limited. Recently the IRS reduced its assistance to taxpayers by closing many Taxpayer Assistance Centers and only providing referrals for where to receive return preparation assistance.

This year the IRS has initiated a broader strategy to increase oversight and outreach on refundable claims like the AOTC.[24] In an effort to ensure improved compliance among preparers that work with low- and moderate-income filers, the IRS has added a new section to its EITC website that clarifies the difference between the AOTC and the Lifetime Learning Education Credit. (For more on commercial preparers, see box on page 15.)

If policymakers make the AOTC fully refundable and better targeted to low- and middle-income families, the IRS would have to do much better outreach to ensure that the public is well-informed about the AOTC and knows where to turn for help both in claiming the credit and filing taxes.

Recommendations for the IRS

- At tax time, institutions of higher education send out Form 1098-T Tuition Statement that students use to claim tax credits. This form is a half-page and on the back explains in small font that "You, or the person who can claim you as a dependent, may be able to claim an education credit on Form 1040 or 1040A, only for the qualified tuition and related expenses that were actually paid in 20XX." This form does not go far enough in explaining what an education tax credit is. The IRS should consider making this form a full page with better explanations of education tax credits. Instead of naming it "Tuition Statement," it should be renamed to give filers a better understanding that they can use this form to receive a refundable credit.[25]
- The IRS needs to simplify the form (8863) required by filers to determine their eligibility for higher education tax credits. As mentioned, the form is two pages and includes seven pages of directions. The Consortium's proposed changes to the tax credits—such as the elimination of the Lifetime Learning Credit—would allow the IRS to make this form one page, and much more straightforward. The IRS could even explore whether in a reformed AOTC environment, Form 8863 would be necessary at all.[26]
- Currently the IRS informational website about VITA sites explains that volunteer preparers can "inform taxpayers about special tax credits for which they may qualify such as Earned Income Tax Credit, Child Tax Credit, and Credit for the Elderly or the Disabled."[27] The AOTC must be added to the list.

What TRIO and GEAR UP Can Do

Since the creation of the Higher Education Act in 1965, federal policymakers have supported multiple programs – including the federal TRIO and GEAR UP programs – aimed at raising the college aspirations and improving the academic preparation of disadvantaged students. These programs work with the very students that a redesigned AOTC would target. But due in part to financial advising concerns and the complexity of delivering financial aid through the tax code, neither the TRIO nor GEAR UP programs have made a concerted effort to let students know about higher education tax benefits.

The TRIO programs are the government's oldest college readiness programs, with some of them dating back to the mid-1960s. TRIO's eight college opportunity programs include many access and success initiatives that reach out to students before and during their college experience. TRIO's Talent Search and Upward Bound, for example, help students as early as junior high school with financial aid, college counseling, and tutoring. The Student Support Services (SSS) program provides academic tutoring and college advising assistance while students are in college. In addition, the Educational Opportunity Center (EOC) program provides counseling and information about college admissions and financial aid to traditionally-aged students as well as adult students looking to enroll in higher education.[28]

Congress has mandated that two-thirds of students served by the TRIO programs must be first-generation college enrollees and come from families with incomes at or below 150 percent of the federal poverty level.[29] As a result, TRIO programs currently serve almost 800,000 low-income students, including more than 7,000 students with disabilities, and 6,000 U.S. veterans.[30]

Created in 1998, the GEAR UP program is the first federal effort designed to focus primarily on helping better prepare and motivate low-income middle school students for college. GEAR UP is modeled mostly after the "I Have a Dream Program," which was started in 1981 by Eugene M. Lang, a successful businessman who promised full college tuition to a class of sixth graders at his old elementary school in New York City's East Harlem.[31]

Under the main part of GEAR UP, colleges, working with local educational agencies or school districts, apply to the Department of Education for grants to form partnerships with middle schools at which at least 50 percent of the students must be eligible for free or reduced price lunch. The colleges provide tutors and mentors who work with at least one entire grade of students at the school, starting no later than seventh grade, and then continue serving these students through high school graduation and, in many cases, through their first year of college.

Both the TRIO and GEAR UP programs should be important partners in outreach given the diverse and often difficult-to-reach students and families they work with.

“TRIO programs currently serve almost 800,000 low-income students, including more than 7,000 students with disabilities, and 6,000 U.S. veterans.

Recommendations for TRIO and GEAR UP

- Federal TRIO programs like Upward Bound are required to provide "education or counseling services designed to improve the financial literacy of students, including financial planning for postsecondary education."[32] As such, staff members should be trained to include AOTC when discussing federal financial aid options to students. With proper training, TRIO programs can provide assistance to students and families looking to learn more about federal financial aid options, including tax benefits, without fear of the repercussions of giving financial advice.
- TRIO EOCs oftentimes act like drop-in centers for students looking for help during the college admissions process. Many EOCs help students complete their FAFSA during tax time. As EOC advisors are going through tax documents to help students and families fill out the FAFSA, they should look to see if the family has filed for higher education tax credits. If the family was eligible, but neglected to take AOTC, counselors should be trained to inform them about the AOTC and how they can go about filing an amended tax return, even referring them to local VITA sites or other reputable tax preparers.
- GEAR UP leaders are in a good position to alert high school seniors and first-year college students who have participated in the program – as well as their parents or guardians -- about the availability of the AOTC. They should make clear that the tax credit is at least partially refundable and therefore available to low-income tax filers. They should also notify these individuals that their families must file a tax return to receive the benefits.
- In addition, as part of TRIO and GEAR UP grant applications, the Education Department should make notification of the AOTC a competitive priority element. This would provide an incentive to grant applicants to promise to do outreach in the hope of getting an extra point or two to win the grant.

What Benefit Access Programs Can Do

When it comes to serving low-income and working-class students, community colleges are the true workhorses of higher education. Many students who could benefit from refundable tax credits attend public two-year colleges. And there are organizations that try to help low-income community college students and their families claim the tuition tax breaks for which they are eligible, without charging them a cent.

One of the most ambitious is run by Single Stop USA, a New York-based non-profit organization. Since 2009, Single Stop has partnered with community colleges in seven states – including three of the largest community college systems in the country—to help low-income students on their campuses access all of the federal and state benefits they are entitled to, including the partially-refundable AOTC. These benefits are meant to supplement the federal student aid dollars these students have received from their schools' financial aid offices.[33]

Under these arrangements, Single Stop works with the schools to hire full-time site coordinators to work directly with students to help them find the resources they need to remain in school. Single Stop uses proprietary software to screen students to determine their eligibility for benefits. When a site coordinator finds low-income students who have not filed tax returns but could benefit from a refundable tax break like the AOTC or the EITC, that individual will send them to local tax professionals who have agreed to provide Single Stop students with free tax preparation services.

The organization believes that even a little bit of help to the most financially needy students can make the difference between whether they can complete their programs or drop out. "We want to make sure students don't have to make the tradeoff between attending college or putting food on the table or paying rent," Elizabeth Mason, chief executive and co-founder of Single Stop, has stated.[34] The organization's hope is that, in partnership with the schools and the Association of Community College Trustees, Single Stop will be a model that community colleges across the country will use to start their own "benefit access" programs.[35]

With funding from five foundations, the Center for Law and Social Policy (CLASP) and the American Association of Community Colleges (AACC) are leading a separate effort to increase low-income community college students' access to public benefit programs. The Benefits Access for College Completion (BACC) program is essentially an experiment to determine whether "providing students who are struggling to make ends meet with information about public benefits and assistance in applying for them will improve student success and college completion rates and reduce material hardship."[36]

The BACC program operates under the theory that many financially needy students don't access public benefits, including refundable tax credits, because they don't know the programs exist or that they are eligible for them. Others don't know how to apply for the benefits or where to seek help.[37]

To try to address these problems, CLASP, which is also a member of the Consortium for Higher Education Tax Reform, and AACC have awarded two-year competitive grants to seven community and technical colleges that have come up with creative plans to integrate benefit access programs with services they already provide on their campuses, such as financial aid counseling and registration. By wrapping these practices into existing operations, BACC aims to institutionalize these efforts so that they are sustainable at the colleges even after funding runs out.

According to Amy Ellen Duke-Benfield, a senior policy analyst at CLASP and director of BACC, the program takes an "opt out" approach, meaning that it gets information to students "in ways they can't avoid." At some of the schools, information about benefits is included in financial aid discussions and in the curriculum of financial literacy courses, or orientation and student success courses. Some of the institutions go as far as placing flyers about different programs in bathroom stalls. One college, which is making a huge push on food stamps, includes a screensaver about the Supplemental Nutrition Assistance Program (SNAP) on all of the computers on campus.[38]

Duke-Benfield doesn't see why similar efforts couldn't be taken by community colleges to raise awareness about a fully refundable AOTC. "Simply telling someone that something exists is not giving tax advice," she states.[39]

Recommendations for Promoting Benefit Access Programs

- Congress can create a new competitive grant program encouraging community colleges to establish benefit access programs on their campuses. The schools would be able to use at least a portion of the grants to partner with outside organizations that have experience in this field. Alerting students to the availability of the AOTC would be part of the mission of this program.
- Alternatively, the Department of Education and federal lawmakers could encourage community colleges that receive funds through the Title III Part A Strengthening Institutions program in the Higher Education Act to use the money to establish benefit access programs on their campuses. The schools would be able to use at least a portion of the grants to partner with outside organizations that have experience in this field. Community colleges that use funds for these purposes would be required to alert students to the availability of the AOTC.[40]

A Note about Commercial Tax Preparers

One reason that the EITC outreach campaign may have been successful was that the commercial tax preparation industry became aware of the refundable credit and ensured filers claimed it to maximize its own bottom line. The bigger the refund, the more satisfied the customer and the greater potential for fee income for the commercial preparer. Unfortunately, some of these fees have come from “early” or “instant” refund products that are predatory, siphoning money away from a low- or moderate-income family’s return so that these individuals are able to access needed money as soon as possible, even if it means losing some of it in the process.

For this reason, commercial tax preparers are not the best partners in AOTC outreach. But it’s important to keep in mind that they will be always be a player in outreach—families will continue to flock to commercial preparers for help during tax time. For example, during the 2012 filing season, 59 percent of EITC returns were from paid preparers whereas only 2 percent were volunteer-prepared. Commercial preparers (including software providers such as Intuit) are going to be a major force in AOTC credit awareness and delivery regardless. They constitute a broad and deep network that has proven effective with the EITC. However they also can present significant financial threats to low-income taxpayers.

Financial products and unscrupulous practices that prey on low-income families and cause them financial harm must be curbed. The IRS should make a concerted effort to ensure that families are aware of VITA sites, and communities must publicize any of their free filing options. Additionally, more must be done to increase public/private partnership models—such as Single Stop and the IRS Free File Alliance—which offer a balance of harnessing the power of the commercial sector while providing a level of consumer protection.

Conclusion

Reforming the AOTC to make it more beneficial for low- and moderate-income students who need the most help to afford college would be a major step forward to ensure higher education tax benefits are better targeted. But these changes won't amount to much if these financially needy students don't realize that the tax credits exist or understand how to claim them.

A vigorous outreach campaign, borrowing from the EITC movement, will be needed to make students aware of the refundable AOTC. The movement should be made up of partners that are well-positioned to reach out to low-income students and their families: colleges, the Education Department, the IRS, the federal TRIO and GEAR UP programs, and benefit access programs at community colleges, such as Single Stop.

Students and families shouldn't be at a financial aid disadvantage just because they don't understand the complexities of the federal government's tax code. All students should know about the higher education tax benefits available to them so that they have the most resources possible when it comes to planning and paying for college.

Notes

1 United States Government Accountability Office, "Improved Tax Information Could Help Families Pay for College," (Washington, DC: Government Accountability Office, 2012), accessed at http://www.gao.gov/products/GAO-12-560.

2 The Tax Policy Center provided this estimate to the Consortium for Higher Education Tax Reform.

3 Michael Brostek and George A. Scott, "Higher Education: Multiple Higher Education Tax Incentives Create Opportunities for Taxpayers to Make Costly Mistakes," Testimony before the U.S. House of Representatives Committee on Ways and Means' Subcommittee on Select Revenue Measures, May 2008.,

4 "Earned Income Tax Credit (EITC), Definition(s) of," Work and Family Researchers Network, accessed March, 11, 2014, http://workfamily.sas.upenn.edu/glossary/e/earned-income-tax-credit-eitc-definitions.

5 "EITC Participation Rate by States," Internal Revenue Service, accessed Marcy 3, 2014, http://www.eitc.irs.gov/EITC-Central/Participation-Rate.

6 "Taxation and the Family: What is the Earned Income Tax Credit?" Tax Policy Center, accessed October 22, 2013, http://www.taxpolicycenter.org/briefing-book/key-elements/family/eitc.cfm.

7 Alan Berube, Rewarding Work Through the Tax Code: The Power and Potential of the Earned Income Tax Credit in 27 Cities and Rural Areas (Washington, DC: The Brookings Institution, 2003), 2.

8 Ibid

9 Bruce D. Meyer, "The Effects of the Earned Income Tax Credit and Recent Reforms," in Tax Policy and the Economy, ed. Jeffrey R. Brown, vol. 24 (Chicago: University of Chicago Press: 2010), 154.

10 "Policy Basics: The Earned Income Tax Credit," The Center on Budget and Policy Priorities, accessed March 3, 2014, http://www.cbpp.org/cms/?fa=view&id=2505.

11 Steve Holt, Ten Years of the EITC Movement: Making Work Pay Then and Now (Washington, DC: Brookings, 2011), 2.

12 Holt, Ten Years of the EITC Movement, 2011, 2.

13 "What is the Center on Budget and Policy Priorities?" The Center on Budget and Policy Priorities, accessed October 22, 2013, http://www.cbpp.org/about/.

14 This is a synopsis of the community outreach and promotion subtopic in Holt, Ten Years of the EITC Movement, 2011, 2.

15 This is a synopsis of the community tax programs and IRS reorganization subtopic in Holt, Ten Years of the EITC Movement, 2011, 2-4.

16 This is a synopsis of the commercial tax preparation for low-income taxpayers subtopic in Holt, Ten Years of the EITC Movement, 2011, 3-4.

17 This is a synopsis of the philanthropy and national networks subtopic in Holt, Ten Years of the EITC Movement, 2011, 4-5.

18 The 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," (Washington, DC: The Center for Law and Social Policy, 2013), accessed http://www.clasp.org/resources-and-publications/publication-1/Nov2013RADD_TaxAid.pdf.

19 The 1098-T form is not as helpful to taxpayers trying to claim the AOTC as it may seem. For example, colleges tend to report the "payments received for qualified tuition and related expenses" or the "amounts billed for qualified tuition and related expenses" for the academic year, rather than the calendar year. Also, they do not include payments that students make for textbooks, even though this is an allowable expense under the AOTC.

20 IRS Publication 970, "Tax Benefits for Education," can be accessed at www.irs.gov/pub/irs-pdf/p970.pdf

21 The 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," (Washington, DC: The Center for Law and Social Policy, 2013), accessed http://www.clasp.org/resources-and-publications/publication-1/Nov2013RADD_TaxAid.pdf.

22 There may be some concern that the more attuned an institution becomes to using a tax credits as financial aid, the more likely they will be to raise tuition to soak up the extra benefit (known as the Bennett hypothesis). Bridget Terry Long explored the effects of the Hope and Lifetime Learning Tax Credit to see whether institutions responded to these credits by raising net prices, with mixed results. She found that "States and institutions appear to have responded to the HTC and LLTC. The analysis suggests that many states reacted by reducing appropriations to public two-year colleges at which students faced a lower marginal cost due to lower tuition levels. These results are robust to analysis within region. Moreover, there is some evidence to support that public two-year colleges responded to incentives created by the tax credits by raising tuition price beyond what can be explained by fluctuations in state support, and the responses were stronger for schools with a greater proportion of credit-eligible students." She did note that some states with large aid programs continued their support efforts even after introduction of HTC and LLTC. And the effect on price increases at public four-year institutions was mixed. For more information, see Bridget Terry Long, "The Impact of Federal Tax Credits for Higher Education Expenses," in College Choices:

The Economics of Where to Go, When to Go, and How to Pay for It, ed. Caroline M. Hoxby (Chicago: University of Chicago Press, 2004), 161.

23 Steve Holt of the Center for Postsecondary and Economic Success at CLASP (a member of the Consortium for Higher Education Tax Reform) has suggested that the IRS create a tool that will help students and families understand the AOTC and help estimate a student's or family's benefit. As part of this tool, students could select an Advance AOTC option that would advance payments early each academic period through an electronic funds transfer. For more information about the proposed tool and timely delivery of AOTC, read Steve Holt, "Help When It's Needed: Advancing the AOTC," (Washington, DC: CLASP, 2014).

24 "IRS Outreach and Compliance Efforts for Education Credits," Crosslink Professional Tax Software, accessed February 14, 2014, https://www.crosslinktax.com/support/tax_updates/IRS-Outreach-and-Compliance-Efforts-for-Education-Credits.asp

25 In Holt, "Help When It's Needed: Advancing the AOTC," he recommends doing away with form 1098-T in lieu of a better reporting mechanism. For more information, read Steve Holt, "Help When It's Needed: Advancing the AOTC," (Washington, DC: CLASP, 2014).

26 Elimination of Form 8863 is also discussed in Steve Holt, "Help When It's Needed: Advancing the AOTC," (Washington, DC: CLASP, 2014).

27 "Free Tax Return Preparation for You by Volunteers," IRS, accessed February 14, 2014, http://www.irs.gov/Individuals/Free-Tax-Return-Preparation-for-You-by-Volunteers.

28 "Federal TRIO Programs – Home Page," U.S. Department of Education, Office of Postsecondary Education, accessed February 14, 2014, http://www2.ed.gov/about/offices/list/ope/trio/index.html

29 "TRIO History," Council for Opportunity in Education, accessed February 14, 2014, http://www.coenet.us/coe_prod_imis/COE/TRIO/History/COE/NAV_TRIO/TRIO_History.aspx?hkey=89b3a80a-3a9e-4580-9fda-38156b9318f8.

30 Ibid

31 "About GEAR UP," National Council for Community and Education Partnerships, accessed February 14, 2014, http://www.edpartnerships.org/gear-up

32 "Legislation for TRIO Programs," U.S. Department of Education, Office of Postsecondary Education, accessed February 14, 2014, http://www2.ed.gov/about/offices/list/ope/trio/statute-trio-gu.pdf.

33 Sara Goldrick-Rab, Katharine Broton, Christin Gates, "Clearing the Path to a Brighter Future," (Madison, WI: University of Wisconsin, N.D.), accessed http://kresge.org/sites/default/files/White-paper-barriers-to-community-college%20access-success.pdf.

34 Jennifer Gonzalez, "Antipoverty Group Works With Community Colleges to Graduate More Students," The Chronicle of Higher Education, September 4, 2011, accessed February 14, 2014, http://chronicle.com/article/Antipoverty-Group-Works-With/128874/.

35 Goldrick-Rab, Broton, Gates, "Clearing the Path to a Brighter Future."

36 Amy Ellen Duke-Benfield, "The Connection Between Benefits and College Persistence and Completion" PowerPoint presentation, the Center for Law and Social Policy's Center for Postsecondary and Economic Success," Dec. 13, 2012, accessed http://www.wiche.edu/info/cacg/meetings/austin12/dukeBenfield.pdf.

37 Ibid.

38 Interview with Duke-Benfield.

39 Ibid.

40 Goldrick-Rab, Broton, and Gates made a similar recommendation in "Clearing the Path to a Brighter Future."

41 Rates calculated from the "SPEC database" an IRS-generated data source. They reflect returns filed between January 1, 2012 and June 30, 2012. The data is available from "Earned Income Tax Credit (EITC) Interactive," Brookings, accessed March 13, 2014, http://www.brookings.edu/research/interactives/eitc.

New America Education Policy Program
1899 L Street, NW
Suite 400
Washington DC 20036
Phone 202 986 2700
Fax 202 986 3696

www.newamerica.org
www.edcentral.org

Help When It's Needed:
Advancing The AOTC

June 2014

STEVE HOLT

CENTER for POSTSECONDARY and ECONOMIC SUCCESS at CLASP

Shutterstock photo credits:
PKChai
Dragon Images
Michael Jung
Wavebreakmedia
Sean Locke

Acknowledgments

This issue brief was prepared by the Center for Postsecondary and Economic Success (C-PES) at CLASP as part of its participation in the Consortium for Higher Education Tax Reform. The Consortium is a partnership funded by the Bill & Melinda Gates Foundation as part of its Reimagining Aid Design and Delivery (RADD) initiative. In addition to C-PES, Consortium partners are Young Invincibles, the New America Foundation's Education Policy Program, and the Education Trust. Through its policy recommendations in *Higher Education Tax Reform: A Shared Agenda for Increasing College Affordability, Access, and Success*[1] and through issue briefs, the Consortium is identifying problems with federal higher education tax policy and providing recommendations for redesign and reform.

About the Center for Postsecondary and Economic Success at CLASP

The Center for Postsecondary and Economic Success (C-PES) is a policy and advocacy initiative within CLASP. Its mission is to work for policies and investments that increase the number of low-income adults and disadvantaged youth who earn marketable postsecondary and industry credentials that are essential to opening doors to good jobs, career advancement, and economic mobility.

CLASP develops and advocates for policies at the federal, state, and local levels that improve the lives of low-income people. We work to strengthen families and create pathways to education and work. For more information, visit www.clasp.org.

Follow @CLASP_DC.

1 http://www.clasp.org/admin/site/publications/files/Nov2013RADD_TaxAid.pdf

Executive Summary

You've won a $2,500 college scholarship, but there's a catch: the money won't arrive until several months—or even a year—*after* you start college and have to pay for tuition and books. That's how the federal government delivers more than $20 billion annually in federal student aid through the American Opportunity Tax Credit (AOTC). Because students and families obtain the AOTC through the tax system, the aid can only be received after filing a return at year's end.

There's a better way to do this. Creating a process for more timely delivery of the AOTC would significantly improve college affordability, enabling more low-income students to enroll and stay in school. "Timely delivery" means students could receive the AOTC when college bills are due (in advance of filing a tax return). This issue brief provides policymakers with key design questions and evaluation criteria for timely delivery of the AOTC and proposes a new process for administering higher education tax credits that includes an *Advance AOTC*. This proposal would:

- Create My College Tax Credit Assistant, an IRS tool to help students and families understand the AOTC and claim this source of federal student aid.
- Make estimates available (through the Assistant) at any point in the college planning process to see how much AOTC may be available.
- Enable selection (through the Assistant) of the new *Advance AOTC* option each academic period.
- Require the U.S. Department of Education and higher education institutions to include information on the availability of the AOTC and the *Advance AOTC* in the Free Application for Federal Student Aid (FAFSA) and in financial aid award letters.
- Use the Assistant as a data hub to match enrollment and tuition and fees billing information, as provided by institutions, with tax return and other taxpayer-supplied data to facilitate credit administration and promote tax law compliance.
- Deliver *Advance AOTC* payments early each academic period by electronic funds transfer to participating students, using formulas that protect against paying more credit than is due.
- Facilitate (through the Assistant) year-end AOTC claims on tax returns, reconciling any *Advance AOTC* payments with the total credit due.
- Eliminate the need for problematic IRS Forms 8863 and 1098-T.

Through the new process, students will be better able to use this important source of federal assistance to plan for college, pay for school, and successfully complete their postsecondary education.

Help When It's Needed: Advancing the AOTC

Introduction

You've won a $2,500 college scholarship, but there's a catch: the money won't arrive until several months—or even a year—*after* you start college and have to pay for tuition and books. That's how the federal government delivers more than $20 billion annually in federal student aid through the American Opportunity Tax Credit (AOTC). Because students and families obtain the AOTC through the tax system, aid can only be received after filing a return at year's end.

There's a better way to do this. Creating a process for more timely delivery of the AOTC would significantly improve college affordability, enabling more low-income students to enroll and stay in school. "Timely delivery" means being able to receive the AOTC when college bills are due (in advance of filing a tax return). This issue brief provides policymakers with key design questions and evaluation criteria for timely delivery of the AOTC and proposes a new process for administering higher education tax credits that includes an *Advance AOTC*.

Section I of this brief describes the need for timely delivery. Section II lists questions and options to consider in designing a timely delivery process. Section III specifies criteria for evaluating different approaches to timely delivery. Section IV details our timely delivery proposal for an *Advance AOTC*, and Section V illustrates how the new process would work. Finally, Section VI assesses our *Advance AOTC* proposal using the evaluation criteria.

Section I: The Need for Timely Delivery of Tax-Based Student Aid

Current Process

Higher education tax credits (the AOTC and the Lifetime Learning Credit, or LLC) may be claimed on a tax return to offset a portion of the costs incurred for higher education. The two credits differ in amount, claimant eligibility, and expense qualification, but they use the same process for claiming and disbursing aid.[2]

Taxpayers (students or those claiming students as dependents) may claim the AOTC and the LLC using IRS Form 8863 as an attachment to their annual tax returns. They can use information provided by higher education institutions in the Form 1098-T information return to calculate credits; however, this information does not always directly translate to what can be claimed. Through Form 8863, a taxpayer provides information about each student for whom a credit is being claimed and the institution(s) attended; answers questions to assess eligibility; reports the amount of qualified higher education expenses incurred; and calculates the credit amount to include on the tax return. Taxpayers receive the credit as a reduction in the balance due on the return or as a higher refund.

The Timing Problem

The current process for claiming and receiving higher education tax credits fails to meet the needs of many of the students and families whom the credits are intended to benefit.

Higher education tuition and fees and course materials are expensive. The current tax credit disbursement process effectively assumes that students or their families have the financial means to pay these high costs and wait up to 15 months (depending on the timing of bill payment and tax filing) for partial reimbursement. This delay makes the tax credits much less effective for lower-income students (who typically have limited resources and poor access to financing) and lowers the visibility of the tax credits as a form of assistance for students. In practice, the credits primarily benefit more financially secure households who

2 For a summary of the features and differences of the AOTC and LLC, see the CLASP publication, *Reforming Student Aid: How to Simplify Tax Aid and Use Performance Metrics to Improve College Choices and Completion*. http://www.clasp.org/admin/site/documents/files/Final-RADD-WhitePaper-Feb-2013.pdf.

can afford college *without the tax-based assistance*.

By contrast, most student financial aid, such as grants or loans, is disbursed near the beginning of each semester or other academic period—concurrent with due dates for tuition payments and many other expenses. Higher education tax credits are the anomaly, despite being a major component of federal student aid.[3] Students rarely receive the credits during the semester when various other costs of being in school (such as housing, transportation, and child care) may need to be paid. Students with unmet financial need who could ultimately benefit from tax credit dollars may in the meantime be forced to resort to unsustainable strategies such as working too many hours or taking on high-cost debt. The resulting drain on personal and household resources makes it more difficult to stay and succeed in school.

Higher education tax credit disbursement is not linked to academic calendars and is not typically mentioned in financial aid award letters (such as the Department of Education's Financial Aid Shopping Sheet). Prospective students may be unaware that they have access to these credits as an additional way to offset some college costs. Because of this disconnect, tax credits can become irrelevant to financial planning for higher education—severely limiting their potential to improve college access through helping students and families see college as more affordable.

Promoting greater college affordability and access requires a viable method for disbursing federal higher education tax credits on a more timely basis, so that students and their families receive tax-based student aid when college bills are due rather than months later.

Timely Delivery Precedents

Timely delivery of federal tax credits is not a new concept. There are three tax credits that have or had a timely delivery option. From 1977 to 2010, a worker expecting to be eligible for the Earned Income Tax Credit (EITC) could annually file an IRS form with her employer requesting that a portion of the credit be disbursed in each paycheck. The employer would consult an IRS table (analogous to the withholding tables) to determine the amount corresponding to the period's gross pay; those dollars would then be added to the worker's paycheck, and the employer would deduct the total payments made from its quarterly tax payment to the IRS. The maximum amount that could be added to a weekly paycheck was about $35, but most of those using the option received much less. The employer would include the year's total Advance EITC (AEITC) payments on the employee's Form W-2, and the employee would subtract this amount from the full EITC claimed on her tax return. The employer role and paycheck-based timing were significant factors in the low participation rate and reporting irregularities that led to the option's repeal.[4]

The Health Coverage Tax Credit (HCTC) was a very small program enacted in 2002 to assist certain workers (in companies experiencing trade-affected job loss or a pension takeover) who had to pay the majority of their health insurance premiums.[5] Those eligible could choose to claim the credit monthly. The claimant paid the HCTC program 27.5 percent of the monthly premium; the credit covered the balance and the HCTC program disbursed the total premium payment to the health insurer. The HCTC could also be claimed on an annual basis by attaching a form to the tax return. With enactment of the Affordable Care Act, the HCTC was discontinued after 2013.

Beginning in 2014, income-eligible enrollees in health plans purchased through the Affordable Care Act insurance exchanges can choose to claim all or a portion of the anticipated health insurance premium tax credit on a monthly basis. The IRS pays the Advance Premium Tax Credit (APTC) directly to the insurer. The final credit for the year is determined through the tax return; after subtracting the total APTC paid on her behalf, the taxpayer may be able to claim a credit balance or need to repay a portion (that varies by income).

3 In Fiscal Year 2014, according to the President's FY15 Budget and the U.S. Department of Education's FY15 Budget Summary and Back ground Information, the federal government is investing $23.3 billion in the AOTC and LLC, as compared to $33.0 billion in Pell Grants.

4 Workers needed to declare their eligibility for income assistance to their employers, the amount of money available per paycheck was typically small, and recipients working for multiple employers were at risk of overpayment. Advances were made independently of the IRS, which depended for reconciliation and enforcement on year-end reporting (via wage statements and tax returns) that was often inaccurate.

5 A 2008 analysis indicated that the HCTC was subsidizing coverage for 16,000 households each month, representing low participation by eligible workers; there were high administrative costs resulting from the numerous monthly transactions associated with each beneficiary. Stan Dorn, "Health Coverage Tax Credits: A Small Program Offering Large Policy Lessons," Urban Institute, 2008.

Section II: Design Options for Timely Delivery

"Timely delivery" means claiming higher education tax credits in advance of filing a tax return. This section summarizes key issues involved in designing a timely delivery process and alternative approaches to consider.

Options for being eligible to claim the credit in advance

AOTC eligibility is tied to a student with qualified educational expenses. The credit is currently claimed on a tax return by the student or by someone claiming the student as a dependent. Eligibility for claiming an advance AOTC payment could be restricted by other considerations, such as the size of the anticipated AOTC, the number of students for whom a credit is being claimed, the refundability status of the credit claimed, the time of year during which qualified expenses are incurred, or the institution attended.

Options for initiating a claim for advance payment

The eligible claimant must signal the choice for an advance AOTC payment. This signal could be given directly to the IRS or communicated through a third-party intermediary, the institution, a state or local government, or some other entity. It could be done as part of another process (such as application for or acceptance of a financial aid award) or through a mechanism specific to the advance AOTC. The choice could be made once annually, once per academic year, once per academic period, or at some other frequency.

Options for calculating the advance payment amount

Currently, the AOTC claimed on the tax return is based on the household configuration (dependent vs. independent students), income, and any qualified higher education expenses declared. An advance payment could be based on information from a prior year's return or on projections of income and/or expenses. The qualified expenses could be determined from the institution's cost of attendance, amounts billed, or amounts received. All, or only some, of the expenses qualifying for the AOTC could qualify for the advance. The accelerated payments could be based on the full expected credit or some fraction of it.

Options for timing the advance payment

The advance AOTC payment could be disbursed in full or in part at the beginning of the tax (calendar) year or the academic year. This could be timed similarly to loans and grants to coincide with the beginning of each academic period. It could also be tied to when the IRS receives information about the institution, the household, or the student's expenses. The advance payments could be made in monthly or other periodic installments.

Options for disbursing the advance payment

Advance AOTC payments could be disbursed to the taxpayer, the student, the institution, a state or local government, or another third-party entity. Disbursement could be by check, through a dedicated prepaid debit card, or by electronic funds transfer to a regular or segregated account.

Options for reconciling the advance payments to the total credit for the tax year

Mechanisms such as the Advance Earned Income Tax Credit or Advance Premium Tax Credit base the amount advanced during the year on an estimate of the credit that will be payable for the tax year. The final amount of the credit is still calculated in the standard manner at tax time. The net amount payable when the tax return is filed is the full credit amount less the sum of the advance payments; advances in excess of the actual credit amount must be repaid in whole or in part. An alternative approach, used for tax credits in some other countries, is for advances to constitute a floor—protecting taxpayers from having to make repayments but allowing them to receive an additional amount if they turn out to qualify for a larger credit. Going further, the credit could be disconnected from the tax return for those claiming it in advance, with the calculations made in association with each disbursement considered final.

Section III: Evaluation Criteria for Timely Delivery Proposals

This Section specifies several criteria for evaluating proposals that seek to address the timely delivery problem for higher education tax credits.

Is the proposed process feasible for implementation?

Several actors could be involved in the implementation of a timely delivery process: taxpayers, students, institutions, the IRS, the U.S. Department of Education, other federal or state governmental agencies, or other third parties. Any proposed process must assure that these involved parties will be able to perform their expected roles.

To be feasible for students and their families, a new process cannot layer on more requirements; instead, it should make things simpler. Currently, credit claimants must negotiate on their own the process of learning about and obtaining the AOTC (although many are assisted by paid tax return preparers or return preparation software). The applicable guidelines are embedded in a 90-page IRS publication on higher education tax benefits. In using these guidelines to complete Form 8863 and claim the credit, taxpayers must rely on information provided by institutions in a format (Form 1098-T) that is not directly translatable to filling out Form 8863.

Proposals should respect the capacities of financial aid, registrar, and business offices at higher education institutions. Institutions already feel overly burdened with the current reporting requirements embodied by Form 1098-T.

The IRS faces tremendous challenges in managing a complicated tax code with limited resources. A process for timely delivery of the AOTC that adds new administrative burdens without providing additional resources or offering compensating benefits is unrealistic.

At present, the U.S. Department of Education and other governmental entities (such as state governments) have no role in administrating the AOTC. A timely delivery design could call upon their involvement. However, any such proposal would need to address the sizeable implementation challenges posed by novel intergovernmental cooperation arrangements.

Does the proposed process create significant risks for the public?

Any proposal should ensure the AOTC is properly targeted and reaches its intended beneficiaries. If not carefully designed, incremental disbursements (such as advance payments) can sometimes assist persons who are not the intended recipients. New avenues for receiving payments can create incentives and opportunities for criminals to commit fraud. Timely delivery proposals must include safeguards that promote program integrity.

Does the proposed process create significant risks for students and their families?

Proposals to implement timely delivery of the AOTC to students and their families should adhere to a "do no harm" principle. One risk to AOTC claimants is that they would see no net benefit from the credit with an alternative delivery model. This could occur if other sources of financial aid were reduced due to receipt of credit dollars during academic periods. Higher education institutions could react to the increased availability of resources by adjusting pricing. A more direct risk to taxpayers utilizing accelerated disbursement is that they could be required to repay AOTC funds based on a later reassessment of eligibility or credit size.

Is the proposed process likely to prove superior in achieving the desired outcomes for the AOTC?

Similar to the "do no harm" principle, any proposal to modify how the AOTC is claimed should be expected to result in outcomes superior to the status quo. There are four areas with particular promise for improving outcomes:

Take-up of assistance

The goal for higher education tax credits or any other form of student aid is participation by all those eligible for help and exclusion of those who do not qualify. This is optimal for achieving program outcomes. While there are no IRS data available on current take-up of the AOTC, it appears to be significantly short of full participation.[6] Proposed alterations should address this gap.

6 The Tax Policy Center calculates that 75 percent of students imputed to be eligible for the AOTC actually receive the credit, and it appears that the rate is lower for low-income students.

Access to higher education

A primary purpose of the AOTC is to reduce financial barriers to enrollment in higher education. The current disconnect between when costs must be paid and when credit assistance is available makes the AOTC less effective than it could be at improving access. Timely delivery proposals need to establish how the timing of payments in the new process would make college more affordable and enrollment more likely.

Student persistence and completion

Without sufficient financial aid, students often cannot stay in school or must work too many hours to make meaningful progress toward and complete a degree. Again, the AOTC is a key part of the federal government's response to the financial challenges students face. Approaches involving advance payment of credit dollars should be able to show how they are likely to improve student persistence and completion.

Tax law compliance

The tax system relies on voluntary taxpayer compliance overlaid with select enforcement activity. Making tax credit eligibility criteria and claiming processes clear and easy to understand facilitates voluntary compliance. Setting clear expectations for taxpayers, institutions, and others who are required to report information to the IRS promotes compliance through reliable information gathering. Improved data quality and availability, in turn, expedites IRS enforcement.

Does the proposed process reduce complexity?

The complexity of a proposed process is an important consideration in whether it can be feasibly implemented and achieve policy objectives. Across a wide range of governmental programs—the tax code especially—complexity has long been a major problem. Both policymakers and the general public are increasingly frustrated with byzantine rules and bureaucratic processes. Proposals to accelerate disbursement of the AOTC must be conscious of this.

Section IV: A Proposal for an Advance AOTC

Consistent with other recommendations of the Consortium for Higher Education Tax Reform, this brief presumes repeal of the LLC and focuses on a process for timely delivery of the AOTC. The Consortium recommends other improvements to the AOTC, such as full refundability and a lifetime cap in place of the current four-calendar-year limit. ***It is important to note that the proposal here for timely delivery is not dependent on those other program modifications.*** However, full refundability would remove some of the risk from advance payment, because it would ensure that the amount of the credit a student could receive would not change based on a loss of taxable income.

This section highlights key features of a new *Advance AOTC*, including its ability to eliminate some currently problematic IRS forms.

My College Tax Credit Assistant

The IRS will create an online interface for higher education tax credits called My College Tax Credit Assistant. The Assistant will have several functions, including estimating credit amounts, enrolling eligible student households for timely delivery, serving as a data hub, and facilitating year-end tax filing and credit reconciliation. Creation of the My College Tax Credit Assistant could be funded from savings achieved through enactment of the Consortium's Shared Agenda package of higher education tax reforms.

My College Tax Credit Assistant – Estimating the AOTC

The estimation function of My College Tax Credit Assistant will be similar to a current IRS tool—the EITC Assistant[7]—and will assist students and families with college planning. By entering information from the Student Aid Report (a summary the Department of Education provides to students of the information they have entered on the Free Application

7 The EITC Assistant is an online tool maintained in English and Spanish by the IRS that helps taxpayers determine eligibility for the Earned Income Tax Credit and calculate an estimated credit. The IRS states that the tool takes 15 to 20 minutes to complete. The tool is available here: http://apps.irs.gov/app/eitc2012/SetLanguage.do?lang=en.

for Federal Student Aid, or FAFSA[8]) or making their own projections, students will receive estimated AOTC amounts based on their income and household composition. The Assistant will provide multiple examples of total tuition and fees and course materials for different types of institutions (such as two-year public, four-year public, and four-year private).[9]

After receipt of financial aid award letters, students will be able to enter the estimated tuition and fees and obtain a more customized estimate of the AOTC.

Outreach to Students and Parents about the AOTC and Available Tools and Options

AOTC availability, including the *Advance AOTC* and a link to the My College Tax Credit Assistant, will be listed under "Other Options" on the Department of Education's Financial Aid Shopping Sheet form. The Financial Aid Shopping Sheet will also include the institution's Employer Identification Number (EIN) to facilitate signing up for the *Advance AOTC* through the Assistant (see below). Title IV institutions choosing not to use the Department of Education form would still be required to include these items in their award letters.[10]

My College Tax Credit Assistant – Selecting the *Advance AOTC*

My College Tax Credit Assistant will enable taxpayers to choose between claiming the AOTC as incremental payments through the *Advance AOTC* or as one year-end payment on their annual tax return.[11] Taxpayers will provide (and update) the names and Social Security Numbers of all students for whom the *Advance AOTC* is being claimed, the names and EINs of the institutions attended, and the account number and routing information for the depository account that will receive electronic transfer of the advance payments.[12]

Through My College Tax Credit Assistant, taxpayers will set the percentage of the available AOTC to be drawn down in advance. The maximum advance percentage will be 100 percent for taxpayers well below the income phase-out range of the credit and 75 percent for those near or in the phase-out range.[13] (If the Consortium's recommendation for full AOTC refundability were not adopted, a maximum advance percentage of 75 percent or less would be universal.[14]) Taxpayers applying funds from tax-preferred savings accounts to college expenses (such as a state 529 plan) will be reminded to consider this in choosing an advance percentage.[15]

My College Tax Credit Assistant – the Data Hub

The IRS will use My College Tax Credit Assistant as a real-time data hub to match taxpayer-supplied information with the most current institution-supplied enrollment and cost information (see sidebar) and pertinent information from its own files. When a taxpayer enrolls in the *Advance AOTC*, the IRS will populate the account with income and household information from the most recent prior-year tax return and update the account periodically based on later filings.[16]

8 In many cases, the FAFSA is populated with accepted income tax return data accessed electronically through the IRS Data Retrieval Tool, simplifying the process for families and enhancing data accuracy. Student families expecting significant changes in income or household configuration can still use their own projections.

9 For most students, the total qualified expenses examples would not need to be reduced by any anticipated Pell Grants, because the latter can be applied to costs of attendance beyond tuition, fees, and course materials. However, under current law, Pell grants applied to such costs must be treated as taxable income; the Consortium's Shared Agenda calls for eliminating all taxation of Pell Grants.

10 *Building an AOTC Movement: Strengthening Outreach for a Reformed American Opportunity Tax Credit*, a brief prepared for the Consortium's White Paper by the New America Foundation's Education Policy Program, provides more detail on how to increase outreach for the AOTC and any timely delivery option.

11 This brief envisions establishment of the *Advance AOTC* as an opt-in provision, leaving year-end payment in full as the default. This is especially wise during the early years of implementation as systems develop and mature. The enacting legislation could include an automatic (though repealable) trigger to convert to an opt-out (advance payment as default) process after a period of time (perhaps five years).

12 Taxpayers without a traditional financial institution account could use alternatives such as prepaid debit cards (perhaps including the Department of Treasury's Direct Express debit card). It would also be worth pursuing direct deposit with lenders to reduce outstanding principal balances on student loans.

13 The 75 percent maximum for taxpayers near or in the AOTC phase-out range provides a cushion in case annual income turns out to be higher than expected and a smaller total credit can be claimed. With a fully refundable AOTC, this risk of overpayment from increased income would be minimal for taxpayers well below the income phase-out, justifying the option to receive a 100 percent advance.

14 In the absence of full refundability, the estimated and actual AOTC amounts could vary due not only to shifts in income but also in household configuration, deductions and credits claimed, and other factors that affect the positive tax liability against which the non-refundable portion of the credit could be applied.

15 Expenses for which another tax benefit is being claimed are not qualified education expenses for the AOTC.

16 Retention of regularly updated data by the My College Tax Credit Assistant data hub could also enable longitudinal tracking of AOTC amounts received by taxpayers to facilitate administration of the dollar-based AOTC lifetime cap included in the Consortium's reform package (which calls for replacing the current four-year limit for AOTC receipt with an equivalent value, or maximum $10,000, lifetime cap).

Data Reporting

Timely delivery of the AOTC requires timely availability of pertinent data. At present, the only data reporting to the IRS is: 1) what higher education institutions provide about individual students after the end of each calendar year through the Form 1098-T information return; and 2) taxpayers' self-reporting through tax returns using Form 8863.

Timely delivery consists of IRS payments during the tax year based on expectations of taxpayer qualification. There is understandable concern that if those expectations prove inaccurate, there could be limited options for recovering potentially improper payments. Of course, this is already a concern with various aspects of the tax code under our system of voluntary compliance (including claims of the AOTC via tax returns). Nonetheless, there is heightened concern with advance payments; consequently, taxpayer self-reporting is not feasible as the basis for timely delivery.

Equally untenable is basing advances solely on institutional reporting of final non-refundable tuition and fees payments. Although this would most closely match the definition of AOTC qualified expenses, it would seldom be timely. Students at some institutions can pay over an extended period through payment plans, and the dates for course withdrawal with partial tuition refundability are typically relatively late in the academic period.

A balanced approach would permit advance payments of the AOTC on the basis of institutionally reported enrollment and net billings. These data are available at or near the start of the academic period. This would achieve the accelerated disbursement that is the essence of timely delivery.

One option may be augmenting the institutional reporting currently done through the National Student Clearinghouse. Most higher education institutions use the Clearinghouse[17] to meet Department of Education reporting requirements regarding student enrollment. If institutions are required to report to the IRS the net amount of tuition and fees billed[18] to the student each academic period (as well as enrollment status[19]), the Clearinghouse could help them fulfill this requirement. The IRS could periodically populate the data hub with enrollment and tuition and fees data from the Clearinghouse. Institutions not utilizing the Clearinghouse or choosing not to share their Clearinghouse data with the IRS would be able to report the required information directly to the IRS near the beginning of each academic period.

Institutional data reporting should be one-way, meaning that institutions will not be able to access IRS data from the data hub to determine taxpayer use of the AOTC.

Advance AOTC Payments

Taxpayers selecting the *Advance AOTC* through My College Tax Credit Assistant will receive a payment whenever new data on student enrollment and billed tuition and fees is matched through the data hub. The amount of the *Advance AOTC* payment will be the advance payment percentage rate selected by the taxpayer times the lesser of:

1) The billed tuition and fees amount for the current academic period;
2) (Until April 15) 50 percent of the earned[20] AOTC for the tax year, or (after April 15) the earned AOTC for the tax year;
3) The earned AOTC for the tax year less the sum of prior *Advance AOTC* payments for the tax year; or

17 The National Student Clearinghouse was founded in 1993 to support the student loan infrastructure. As of fall 2011, 93 percent of post secondary enrollment was included in Clearinghouse data. The coverage rate is very high for public institutions (over 99 percent for public four-year institutions) and private nonprofit schools and much lower for for-profit institutions (48 percent). There are also missing data—estimated at 3 percent to 7 percent—from records blocked (principally by students) under the Family Educational Rights and Privacy Act. Susan M. Dynarski, Steven W. Hemelt, and Joshua M. Hyman, *The Missing Manual: Using National Student Clearinghouse Data to Track Postsecondary Outcomes*, National Bureau of Economic Research, 2013.

18 To offer additional protection against overpayment, the reporting guidelines would require updating of the billed tuition and fees data to reflect in-period withdrawals and refunds; the revised amounts would be in the data hub and would affect the earned AOTC used to calculate any subsequent *Advance AOTC* payments.

19 Institutions would need to report whether the student is enrolled at least half-time. In addition, reporting at or after the beginning of the academic period that a student is enrolled would often reflect some student payment of tuition and fees, providing additional support for the qualification of billed tuition and fees amounts.

20 "Earned" refers to the total credit that would be payable based on the institution-reported tuition and fees amounts since the beginning of the tax year.

4) (If enacted) the maximum lifetime AOTC ($10,000)[21] less the sum of all prior AOTC payments (including advance payments).

To ensure the *Advance AOTC* is based on the most current information available, no advance payments will be made after April 15 if the taxpayer has not yet filed a prior year tax return.[22] Reports of billed tuition and fees made near the end of the calendar year for academic periods beginning in the next calendar year will be assigned to the latter. This will make it more likely that taxpayer payments and *Advance AOTC* payments occur during the same tax year.

The key driver for the timing of *Advance AOTC* payments will be IRS receipt and processing in the data hub of enrollment and cost information for the academic period. If institutions report within 30 days of the start of the academic period, the Department of the Treasury Financial Management Service (the federal government's disbursing agency) should be able to transfer funds into a taxpayer's designated depository account within the first 45 to 60 days of the period.

My College Tax Credit Assistant – Filing for the Year-End Credit

During the tax return preparation process, My College Tax Credit Assistant will serve as an online worksheet for all taxpayers claiming the credit, regardless of whether they received any *Advance AOTC* payments. All credit-claiming taxpayers will report the total tuition and fees actually paid during the tax year, as well as payments for other AOTC-qualified expenses (such as books and other course materials). Taxpayers will enter the AOTC amount determined through the account interface, which will automatically net out any *Advance AOTC* payments paid, on the tax return. The credit will (as it does now) reduce a taxpayer's tax balance due or increase her tax refund.

Protection Against Overpayments

Several program features lessen the chance that the credit will overpaid (occurring when the sum of *Advance AOTC* payments is greater than the total AOTC that can be claimed for the tax year and must be repaid). The calculation base for *Advance AOTC* payments will not include qualified expenses other than tuition and fees, meaning additional amounts will usually factor into the year-end calculation. Taxpayers who are likely to be subject to the credit phase-out will receive smaller *Advance AOTC* payments to reduce the risk of excessive payment. Year-end tuition and fee billings will be deemed to occur in the following tax year, and taxpayers will be further advised to pay for tuition and fees during the calendar year in which the corresponding *Advance AOTC* payment is made. The *Advance AOTC* calculation formula (see above) guards against overpayments. However, *Advance AOTC* overpayment could still occur if: a) the taxpayer received *Advance AOTC* payments for a student who is no longer claimed as the taxpayer's dependent; or b) the taxpayer's net payments for an academic period ended up being significantly less than the billed tuition and fees reported by the institution (for example, a student withdraws from classes early enough in the period to receive a partial refund) and the student did not incur additional tuition and fees expenses later in the tax year.

Elimination of Certain Tax Forms

Periodic institutional reporting of student enrollment and cost information to the IRS data hub will eliminate the need for the Form 1098-T information return. There is currently considerable variation among institutions in how they complete the form and the information they provide. The amounts reported on Form 1098-T are often not the amounts taxpayers should use to claim the AOTC, but the form's identity as an IRS document inevitably creates that impression.[23] The functionality of My College Tax Credit Assistant will also eliminate the need for Form 8863 (and its associated worksheets and lengthy instructions).[24]

---

21 The Consortium's Shared Agenda package recommends replacing the current four-year limit for AOTC receipt with an equivalent value lifetime cap.

22 The requirement to file a return by April 15 to receive *Advance AOTC* payments would limit the availability of the option for taxpayers choosing filing extensions. Taxpayers who did not file a prior-year return because they were not required to do so would be encouraged to file a return anyway if they wish to receive *Advance AOTC* payments.

23 "Determining Qualifying Expenses for Education Credits," published in 2014 by the National Community Tax Coalition, provides a descrip tion of the challenges faced by taxpayers in utilizing Form 1098-T: http://tax-coalition.org/program-resources/tax-preparation-services/quality-assurance/education-expense.

24 The Consortium's Shared Agenda package recommends elimination of the Lifetime Learning Credit. However, if that credit were to remain in place, it could also be administered through the My College Tax Credit Assistance interface and data hub.

Summary of Proposal's Design Elements

Who is eligible to claim the* Advance AOTC*?

The taxpayer—who may be the student or may be someone for whom the student is a dependent—claims the *Advance AOTC*, based on the student's qualified expenses.

How is a claim for* Advance AOTC *initiated?

The taxpayer signals the choice to receive advance payments by using a new IRS tool called My College Tax Credit Assistant and selecting the percentage of the available credit to be paid in advance.

What is the basis for calculating the* Advance AOTC*?

The *Advance AOTC* is based on the estimated full AOTC for the tax year, drawing income and household information from the most recently filed tax return. For example, an advance in January 2014 will be based on the tax year 2012 return. A subsequent advance in August 2014 will use a revised AOTC estimate based on the tax year 2013 return. Each *Advance AOTC* disbursement will be tied to billed tuition and fees for the current academic period reported by the student's institution.

The IRS applies the taxpayer's chosen advance payment percentage to the advanceable amount, which is based on billed tuition and fees (including updated data from prior academic periods), the currently estimated annual AOTC for the taxpayer, prior *Advance AOTC* payments during the tax year, and (potentially) credits received in prior years.

When is an* Advance AOTC *payment made?

An *Advance AOTC* payment is made as early during the academic period as the IRS receives and processes the enrollment and cost information from the college or university.

How is an* Advance AOTC *payment disbursed?

The Department of Treasury's Financial Management Service makes a single *Advance AOTC* payment for each academic period through electronic transfer to the depository account designated by the taxpayer through My College Tax Credit Assistant.

How are* Advance AOTC *payments reconciled to the final credit due?

All taxpayers claiming the AOTC determine the credit amount using a My College Tax Assistant worksheet and enter that on the tax return. As under current law (and similarly to other tax claims such as charitable contributions), taxpayers are responsible for determining how much they paid during the year for the AOTC-claimed students and reporting the total qualified expenses. For taxpayers receiving one or more *Advance AOTC* payments during the tax year, the Assistant reduces the AOTC to be claimed on the tax return by the total advance payments (in rare cases, this would be the amount to be repaid due to excessive advances).

Section V: Timely Delivery in Practice

This Section provides two examples illustrating how the *Advance AOTC* will work.

Traditional Student

Amy is graduating from high school in June 2014. She applies to four colleges and universities, is accepted to ABC College and DEF University, and decides to attend DEF. Her parents manage her financial aid process, pay for her unmet financial need, claim her as a dependent on their tax return, and have an adjusted gross income of $60,000.

This table shows a timely delivery process scenario for Amy:

February 2014	Amy's parents enter FAFSA information into My College Tax Credit Assistant to obtain projected credits for 2014 & 2015
May 2014	Amy's parents use My College Tax Credit Assistant to obtain estimated 2014 AOTC amount for consideration in accepting DEF's financial aid award
July 2014	Amy's parents use My College Tax Credit Assistant to select maximum available percentage (100 percent) for advance payment
August 2014	Amy receives bill for 1st semester tuition and fees (net of scholarships and grants) in the amount of $5,000 Amy's parents use loan funds to pay tuition and fees bill
September 2014	DEF reports Amy's 1st semester enrollment and tuition and fees billing to the My College Tax Credit Assistant data hub IRS processes information available in the data hub
October 2014	Amy's parents' bank account receives an *Advance AOTC* payment of $2,500 (applicable amount is the earned AOTC for 2014) Amy's parents use $2,500 to reduce outstanding loan principal
December 2014	Amy receives bill for 2nd semester tuition and fees (net of scholarships and grants) in the amount of $5,000
January 2015	Amy's parents use loan funds to pay tuition and fees bill DEF reports Amy's 2nd semester enrollment and tuition and fees billing to the IRS data hub IRS processes information available in the data hub
February 2015	Amy's parents' bank account receives an *Advance AOTC* payment of $1,250 (applicable amount is 50 percent of earned AOTC for 2015) Amy's parents use $1,250 to reduce outstanding loan principal Amy's parents file 2014 tax return, using My College Tax Credit Assistant to report qualified expenses and calculate full AOTC of $2,500 and net AOTC of $0 for entry on return
August 2015	Amy receives bill for 1st semester tuition and fees (net of scholarships and grants) in the amount of $6,500
September 2015	Amy's parents use loan funds to pay tuition and fees bill DEF reports Amy's 1st semester enrollment and tuition and fees billing to the IRS data hub IRS processes information available in the data hub
October 2015	Amy's parents' bank account receives *Advance AOTC* payment of $1,250 (applicable amount is earned AOTC for 2015 less February *Advance AOTC* payment) Amy's parents use $1,250 to reduce outstanding loan principal

Non-Traditional Student

Alex, age 30, has been taking courses off and on at GHI Community College to obtain a computer-aided design technology certificate, and has decided to finish up the program by taking several courses in the 2014 spring and summer sessions. He uses credit cards to pay for school. Alex files a tax return each year as a single person and has an adjusted gross income of $30,000.

This table shows a timely delivery process scenario for Alex:

January 2014	Alex receives bill for spring semester tuition and fees of $1,500 Alex selects GHI's monthly installment payment plan for tuition and fees and makes 1st payment of $375 using credit card Alex buys books for $250 using credit card Alex uses My College Tax Credit Assistant to select maximum available percentage (100 percent) for advance payment GHI reports Alex's spring semester enrollment and tuition and fees billing to the IRS data hub
February 2014	IRS processes information available in the data hub Alex's prepaid debit card (used by his employer for payroll) receives an *Advance AOTC* payment of $750 (applicable amount is 50 percent of earned AOTC for 2014) Alex uses $625 to pay off credit card and applies $125 to second tuition and fees installment
May 2014	Alex receives bill for summer session tuition and fees of $1,000 Alex selects GHI's monthly installment payment plan for tuition and fees and makes 1st payment of $500 using credit card Alex buys books for $250 using credit card GHI reports Alex's summer session enrollment and tuition and fees billing to the IRS data hub
June 2014	IRS processes information available in the data hub Alex's prepaid debit card receives an *Advance AOTC* payment of $1,000 (applicable amount is summer session tuition and fees) Alex uses $750 to pay off credit card and applies $250 to second tuition and fees installment
February 2015	Alex files 2014 tax return, using My College Tax Credit Assistant to report total qualified expenses of $3,000, calculates full AOTC of $2,250, and claims net AOTC of $500 on return

Section VI: Evaluating the *Advance AOTC* Proposal

This Section uses the evaluative criteria outlined in Section III to assess this brief's *Advance AOTC* proposal.

Feasibility of Implementation

Implementation feasibility requires that those involved in the process—taxpayers, students, higher education institutions, the IRS, and other third parties—are likely able to perform their expected roles.

The proposed process would most affect the IRS. The My College Tax Credit Assistant and its functionality represent a fundamental shift in tax administration, but it is likely that some form of electronic account management and real-time data matching will increasingly become the norm. In fact, the Assistant would be a reasonable test case for converting to a more dynamic process. The inclusion of resources for development of the new data infrastructure would enhance feasibility. As noted below, the new process would offer tremendous benefits to the IRS in improved compliance. Another advantage is that the proposal does not require the involvement of additional governmental entities.

The additional work for taxpayers in the AOTC process would be in the context of a financial aid process that already requires significant engagement. The information students and taxpayers would need to provide would be readily available. The experience of My College Tax Credit Assistant would be similar to other online interactions. The biggest challenge would likely be selection of an advance payment percentage, but this is analogous to the decision making required with student loans—and the Assistant can offer generic guidance.

Higher education institutions would have more frequent engagement, but this too would be in the reasonably familiar context of data reporting each academic period. Reporting billed tuition and fees in conjunction with enrollment verification would be new, but the data are readily available. This would replace the cumbersome Form 1098-T process that requires converting information from an academic year to a tax or calendar year.

Limitation of Risk

Risk management in this context refers both to program integrity (assisting intended beneficiaries and discouraging fraud and abuse) and participant experience (maintaining the AOTC's value and avoiding repayment obligations).

The proposed process would provide greater protection for the taxpaying public through pre-disbursement verification of probable credit eligibility, both for in-year advances and year-end tax return claims. Improved reporting and matching of data would enhance program integrity.[25] The accelerated availability of federal financial aid would improve program targeting through greater assistance to students who have inadequate cash flow to finance unmet need.

The proposed process—providing assistance directly to student households without reporting to the higher education institutions—would be unlikely to adversely affect either other sources of financial aid or net pricing. Although institutions could use available financial and household information to estimate independently an individual student's or a student population's possible assistance from the AOTC, the new process would not enhance that ability compared to current practice.

The greatest risk to taxpayers would be receipt of *Advance AOTC* payments in excess of the AOTC determined at year-end via the tax return. With a fully refundable credit, the proposal's combination of the maximum advance percentage applicable to higher-income households and the formula for calculating the amount of each advance would be protective for most claimants. There could be a repayment obligation for a taxpayer who received one or more advances but then was unexpectedly unable to include the qualifying student on her tax return. The other repayment situation could occur if the billed expenses reported by the institution were higher than the net amounts paid. This could arise with a student withdrawal that results in a partial refund of paid tuition or fees in the absence of incurring additional tuition and fees expenses later in the tax year—thus reducing qualifying expenses sufficiently to affect the AOTC calculation. This reflects a necessary balance: it is not possible to reduce the repayment risk to zero and still enable timely delivery.

Superiority in Achieving Program Outcomes

Any modifications for claiming the AOTC should enhance program outcomes, such as increasing credit take-up, improving access to higher education, encouraging student persistence and completion, and tax law compliance.

The proposed timely delivery process should increase AOTC take-up by making the credit more relevant and accessible to eligible households. The estimation and *Advance AOTC* enrollment tools in My College Tax Credit Assistant will better incorporate the credit into the financial aid process, in which most students and their families are already engaged.

The greatest strength of timely delivery would be making higher education more affordable on a real-time basis. The new process would help students and their families understand the role of tax-based federal financial aid as they consider affordability and financing packages. The current reliance on a payment occurring months after tuition bills are due would be replaced by funding that could be drawn down near the beginning of each academic period. This would dramatically reduce the period of time when students are forced to use debt financing to cover basic costs. Overall, improved financing would make college more accessible and improve the likelihood that students stay in school and graduate.

The new process would greatly enhance tax law compliance, because some independent verification of both student

25 In a review of potentially improperly claimed higher education tax credits, the Treasury Inspector General for Tax Administration identified use of Department of Education databases as a mechanism for improving compliance through verification of student enrollment. *Billions of Dollars in Education Credits Appear to Be Erroneous*, 2011, http://www.treasury.gov/tigta/auditreports/2011reports/201141083fr.pdf.

enrollment and the accrual of qualified expenses would precede disbursement of AOTC funds. The ambiguity and uncertainty associated with the Form 1098-T process would be eliminated. Taxpayers would have a clearer understanding of the role of the AOTC, eligibility criteria, and reporting requirements, likely resulting in greater voluntary compliance. The IRS would have much more detailed information available when needed for enforcement action.

Reduction of Complexity

When possible, proposed modifications to government programs should strive to reduce complexity.

On balance, the proposed timely delivery process is likely neutral with respect to complexity. The My College Tax Credit Assistant interface could be confusing for some, but it would also offer greater opportunities for clear communication of program goals and expectations. The formula for calculating the amount of each *Advance AOTC* payment is complex to describe, but it will be executed automatically by the Assistant and its structure is necessary for achieving other goals (such as reducing the risk of excessive payments). The use of an online worksheet as part of the tax return preparation process would be novel, but it would replace the daunting challenges posed currently by Forms 1098-T and 8863. For taxpayers facing accessibility challenges that would prevent direct use of My College Tax Credit Assistant, the IRS could provide a process for paper submission of the required data (analogous to paper return filing).

Conclusion

The American Opportunity Tax Credit constitutes one of the principal forms of federal assistance for higher education. As detailed in its Shared Agenda, the Consortium for Higher Education Tax Reform advocates making the AOTC the sole tax credit for higher education and targeting it to the students and families most in need of assistance. To be most effective, however, the AOTC needs to be more than just a line on year-end tax returns. There must be a process for advancing credit payments that better matches when students need the financial assistance to be able to enroll and stay in school.

The *Advance AOTC* will give student households the ability to draw down the AOTC incrementally near the beginning of each academic period. A new tool—My College Tax Credit Assistant—will further enhance the credit's role in the financial aid process by replacing problematic paperwork and enhancing compliance and enforcement. Students will be better able to use this important source of federal assistance to plan for college, pay for school, and successfully complete their postsecondary education.

CENTER *for* POSTSECONDARY *and* ECONOMIC SUCCESS *at* CLASP

www.clasp.org

Follow us @CLASP_DC

HIGHER EDUCATION

Tough Love:

Bottom-Line Quality Standards for Colleges

JUNE 2014

The Education Trust

TO THE POINT

- Roughly $180 billion in federal student aid and tax benefits are provided each year to colleges and universities with virtually no consideration of institution performance on low-income student access, degree-completion, and post-enrollment success measures.
- Some 600,000 undergraduates attend four-year colleges that fall below the barest minimum standards of institutional success, including dropout rates in excess of 85 percent. Over $15 billion is distributed annually to more than 300 colleges that qualify as engines of inequality, dropout factories, or diploma mills.
- Recommended is targeted assistance to persistently underperforming public and nonprofit colleges and tough consequences, including cutting off federal aid, for those institutions that fail to improve within a reasonable period of time.

The federal government provides roughly $180 billion in the form of student financial aid and tax benefits to American colleges and universities in a typical year.

When the checks are written, an institution's performance on access, completion, and post-enrollment success measures essentially doesn't matter.

Tough Love:
Bottom-Line Quality Standards for Colleges

BY MICHAEL DANNENBERG AND MARY NGUYEN BARRY

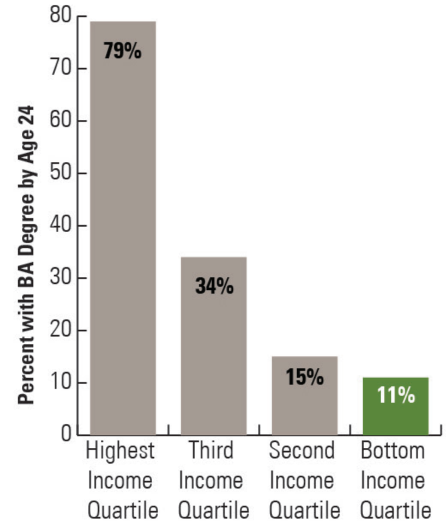
The world is changing. Physical stamina and a good work ethic are no longer enough to secure a stable future. Obtaining a quality education, especially a college education, is the surest way to gain a lasting foothold in today's economy.[1] Most Americans realize this, and as a result, college aspiration and college-going rates are rising among all demographic groups — rich, poor, white, and students of color.[2]

But U.S. college *graduation* rates are among the lowest in the developed world.[3] Less than two-thirds of students who start full time at a four-year college earn a degree from any college within six years of initial enrollment; among those who start at two-year colleges, fewer than a quarter earn a credential within three years of initial enrollment.[4] Moreover, the way federal and state governments currently finance higher education — mostly on the backs of students and their families — leaves both those who finish college and those who don't with unprecedented levels of debt. Just when they would normally be ready to buy a house, car, or make another major investment, many former students are struggling to meet — if not outright defaulting on — their student loan obligations.[5]

To make matters worse, college-going rates, graduation rates and rates of high student loan debt all track family income and race.[6] While roughly 8 out of 10 young people from families in the top income quartile earn at least a bachelor's degree, only 1 in 9 young people from families in the bottom income quartile do the same by age 24 (*Figure 1*). Similar disparities exist by race: Young white adults earn bachelor's degrees at nearly twice the rate of African Americans and nearly three times the rate of Latinos (*Figure 2*).

Some would argue these troubling trends are mostly about the students, many of whom arrive at college underprepared. But it turns out that at

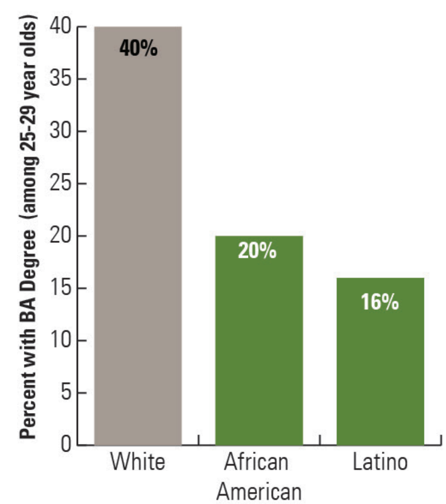
Figure 1: Young Adults From High-Income Families Are Seven Times More Likely Than Low-Income Students to Earn Bachelor's Degrees by Age 24



Source: Tom Mortenson, "Bachelor's Degree Attainment by age 24 by Family Income Quartiles, 1970-2010," (Oskaloosa, IA: Postsecondary Education Opportunity, 2012).

Figure 2: White Students Attain Bachelor's Degrees at Nearly Twice the Rate of African Americans and Three Times the Rate of Latinos

Bachelor's Degree Attainment of Young Adults (25-29-year-olds), 2013



Source: U.S. Census Bureau, Educational Attainment in the United States: 2013

Michael Dannenberg is director of higher education and education finance policy, and Mary Nguyen Barry is higher education research and policy analyst at The Education Trust.

PROPOSAL AT A GLANCE

THE EDUCATION TRUST'S PROPOSAL FOR MINIMUM INSTITUTION OF HIGHER EDUCATION PERFORMANCE STANDARDS

Raise the Floor Above the Current Bottom 5 Percent

Minimum Standards for Low-Income Student Access and Degree Completion

- Pell, full-time freshman enrollment: **17 percent**
- Six-year, full-time freshman graduation rate: **15 percent**
- Student loan repayment rate (optional interim proxy three-year cohort default rate: **28 percent**)

Time Frame for Improvement

- Fair notice of new minimum performance standards (at least one year)
- Opportunity to appeal designation for those institutions that may be the only option within a certain geographic area or that overwhelmingly serve non-first-time, full-time students but perform better with those students than with first-time, full-time students
- Federal monetary and technical assistance for institutions below graduation and loan repayment standards

Low-access colleges have **three** years to improve, succeeding if the average Pell enrollment rate over the next three years equals or exceeds 17 percent.

Low-graduation colleges have **four** years to improve, with two additional years if they are on track to graduate at least 15 percent of students by the end of six years, succeeding if the average graduation rate during this time frame equals or exceeds 15 percent.

Low-loan repayment colleges will also have time to improve. A specific time frame is to be determined upon availability of data, but should be, at a minimum, at least **three** years.

Sanctions for No Improvement

Low-access ***"Engines of Inequality"*** will be subject to losing institutional grant and tax benefits, including tax-exempt bonds to nonprofits and the charitable interest deduction to both the institution and affiliated foundations.

Low-graduation "***College Dropout Factories"*** and low-loan repayment "***Diploma Mills"*** will be subject to losing institutional grant and tax benefits as well as all eligibility to receive federal student aid, including grant, loan, and tax aid.

A Rolling Benchmark

As institutions evolve and improve over time, a new 5 percent standard will be updated every three to six years to encourage continuous improvement.

every level of preparation — from institutions that serve only impeccably prepared students to those that serve the most underprepared — some colleges consistently do a much better job than other institutions serving exactly the same kinds of students.

And yet, regardless of outcomes, nearly all colleges continue to receive taxpayer dollars, year after year after year. Federal dollars flow to institutions that graduate almost all their students and those that graduate almost none; institutions that serve their "fair share" of students from lower income families, and those that don't; and institutions whose students graduate with manageable debt and are able to turn their degrees into decent jobs that support loan repayment, as well as institutions whose students carry too much debt and leave with no degree or a worthless one.

In fact, the federal government provides roughly $180 billion in the form of student financial aid and tax benefits to American colleges and universities in a typical year. (*See "How Does the Money Flow?"*) When the checks are written, an institution's performance on these three critical measures — access, completion, and post-enrollment success — essentially doesn't matter.

This hands-off approach stands in stark contrast to what the federal government asks in return for a much smaller investment in elementary and secondary (K-12) education. To qualify for federal K-12 dollars each year, states and school districts have had to set improvement goals for every major demographic group of students they serve, and schools are held accountable for meeting those goals. Schools that consistently perform in the bottom 5 percent are subject to much stronger interventions.

The theory of action in higher education has been different. In a country with what has been viewed as the best higher education system in the world, the primary role of the federal government has been to help students from low-income families afford the cost of attendance. Basically, all that has been considered necessary to guarantee quality is a peer-review process called accreditation.

This policy framework might be acceptable if the United States was still comfortably ahead of its competitors in educating the nation and its future workforce. But postsecondary attainment levels of U.S. young adults have dropped from first in the world to middle of the pack.[7]

If we are to return to being a global leader in the education levels of our workforce, no involved party — high schools, government, or institutions themselves — can afford to sit idly by and watch while we fail to maximize our investment in the nation's future.

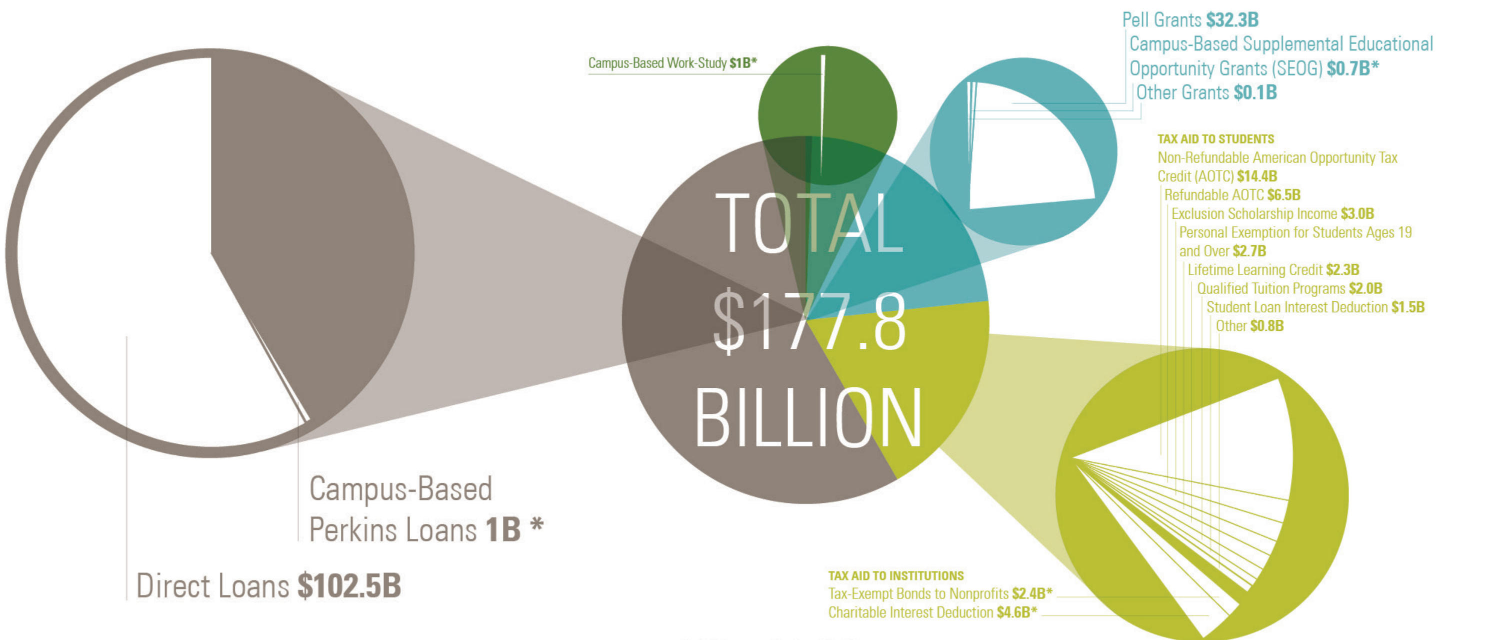
Fortunately though, some promising work is already underway.

- After years of academic standards that stopped well short of what colleges require for entry, state leaders have adopted new K-12 standards that match the skills and knowledge necessary for students to be truly college ready at the end of high school. These standards require more of both students and teachers; as implementation efforts proceed, college preparation levels are expected to rise.
- States have also stepped up to adopt goals and performance funding aimed at increasing degree completion. Already, 33 states have adopted college completion goals, and 27 have implemented or are in the process of implementing state funding systems that reward institutions for their performance with students.[8]
- Some colleges have shifted their focus away from just access to access *and success*, making student success an institutionwide priority. With strong campus leadership from university presidents and provosts and data systems that track student progression and credit accumulation, colleges like Florida State, Georgia State, and San Diego State have made major strides in graduating more of their students — especially students of color and low-income students — than peer institutions throughout the country.[9]

HOW DOES THE MONEY FLOW?

A finer lens on the nature of federal investment in higher education shows that resources are distributed to two main groups. There are: 1) **resources that go directly to colleges, universities, and affiliated foundations** in the form of tax breaks and grants that provide institutional support and student financial aid; and 2) **resources that go directly to students and families** in the form of tax credits and deductions, grants, and student loans. Some of these resources, like Pell Grants, are direct expenditures of federal dollars. Other benefits, like student loans, represent *outflows* of dollars, but do not equate to actual spending since the majority of these dollars will be paid back. And finally, benefits like tax credits, deductions, and other tax breaks typically offset tax obligations or promote investment in the form of higher charitable giving and also do not count as direct expenditures.

The $180 Billion Federal Investment in Higher Education Exists in Many Forms
Federal Investment in Higher Education by Type in Billions, FY 2013



*** Aid goes to institutions**
Source: Education Trust analysis, based on Federal Student Aid 2013 Annual Report: Dec. 2013 and Analytical Perspectives: Budget of the U.S. Government, Fiscal Year 2014: Office of Management and Budget.

Indeed, among all the major players, only the federal government sits passively on the sidelines, writing check after check for higher education with almost no consideration of institutional performance. In continuing to do so, the federal government undermines the message that results matter — and that what individual colleges do makes a difference.

So, how could the federal government play a more productive role — one that reinforces work that is already underway while mobilizing institutions that lag behind? **By establishing minimum performance standards that align with its core purposes for investing in financial aid — low-income student access and meaningful degree completion — and giving institutions several years to meet those standards.**

The process should start with minimum performance standards for four-year colleges. Their degree-oriented missions are clear, and publicly available data on completion are reasonably strong. Later, standards should also be set for two-year colleges. But because available data are weaker and their missions more complex — including transfer to a four-year college, short-term job training, and non-degree, lifelong learning opportunities — this will take additional time.

For K-12 education policy, both the executive branch and members of Congress over time have come to embrace a framework in which the focal point for targeted attention and intervention is chronically underperforming schools — the bottom 5 percent of all institutions.[10] Following that example, we suggest identifying a bottom 5 percent threshold for four-year colleges on access and success metrics.[i]

The basic idea is simple: Draw a line based on where the fifth percentile of institutional performance currently rests and make that the minimum standard all institutions should strive to surpass over the next several years.[ii] As is true in K-12, our analyses of the institutions that currently fall below that bottom 5 percent threshold suggest that not only are they low-performers relative to other institutions like them, but they are objectively low-performers.

To be clear and similar to K-12 precedent, we do not seek identification of exactly 5 percent of institutions each year. We also do not suggest immediately implementing sanctions for persistent underperformance. Rather, we propose:

- Fair notice of new minimum performance standards;
- Opportunity to appeal for those institutions that may be the only option within a certain geographic area or institutions that overwhelmingly serve non-first-time, full-time students and perform markedly better with those students than with first-time, full-time students;
- Additional financial and technical assistance for public and nonprofit private institutions struggling to meet success metrics to help them get up to par; and,
- Sanctions only for those that over three or four years do not meet the minimum benchmark on access and success measures. (*See "Proposal At a Glance."*)

But on this last point, the federal government must be clear: If, after receiving support and time to get better, exceptionally and persistently low-performing colleges do not improve, there must be consequences.

The goal should be to spur institutions to improve, not to shrink or close them. If we as a nation are to get the education of our workforce where it needs to be, we need more higher education capacity, not less. That said, experience teaches us that one more set of goals without consequences for not meeting them won't do the job. It won't galvanize the energy and resources necessary to make real improvements in education institutions. And it won't save students from the lifetime consequences of debt with no degree.

THE COST OF FAILING COLLEGES

Of the total $180 billion federal investment in higher education student aid made each year, over $100 billion is Title IV aid dispensed only to four-year colleges in the form of grant, work-study, and student loan resources (i.e., non-tax benefits). Of that $100 billion, **approximately $15 billion** is distributed to some 300 institutions that currently reside among the bottom 5 percent nationally in enrolling low-income students, graduating the students they serve, or graduating students with manageable debt and degrees that can support that investment without default.[iii]

For students, the consequences of grossly underperforming colleges are severe. Currently, **nearly 600,000 undergraduates** attend four-year institutions that rest in the bottom 5 percent of colleges nationally on student *success* metrics that measure the likelihood of graduating and repaying student loans.[11] Of these students, **an**

i. The sample of institutions used for the analysis in this paper includes all four-year schools that award bachelor's degrees that have had a cohort of first-time, full-time undergraduates within the last three years (N=2,220). The bottom 5 percent threshold only applies to colleges without missing data and that have at least 30 students in the given cohort (first-time, full-time freshmen for graduation rates and freshman Pell enrollment rates). Note that this paper uses data from the 2010-11 academic school year as the benchmark year to establish initial thresholds for consideration.

ii. After several years, a new bottom 5 percent threshold should be identified to encourage continuous improvement. The minimum performance standard, therefore, represents a rolling benchmark.

iii. Low-graduation University of Phoenix campuses *alone* account for over one-quarter ($4.1 billion) of the $15 billion federal student aid dollars distributed to colleges in the bottom 5 percent of access and success metrics. Source: Education Trust analysis of Title IV Program Volume Reports, from Federal Student Aid, U.S. Department of Education.

estimated 100,000 will default on their federal student loans within three years of exit.[12]

For first-time, full-time students attending one of the bottom 5 percent of colleges on graduation rates, the chances of leaving school with no degree are **nearly six times greater** than the chances of graduating.[13] New full-time students attending failing four-year colleges have only a *1-in-2* chance of making it to their second year. And the first-time, full-time freshmen we lose nationally after attending just *one year* at one of these schools leave with nearly $40 million in student loan debt,[14] which can have a tragic impact considering students who drop out with no degree face a fourfold increase in their likelihood of defaulting on their student loans.[15]

Likewise, there are serious consequences for talented students from low-income families who don't have a chance to attend the mostly elite colleges that rank in the bottom 5 percent on low-income student access. Many of these students will enroll in colleges of lesser quality, if any at all, negatively affecting their chances of earning a degree.[16] Completion rates for students who "under match," or enroll in less rigorous institutions than they are qualified for, are 15 percentage points lower than similarly well-prepared peers.[17] And students with some college but no degree have notably lower earnings than those who complete a bachelor's degree.[18]

THREE PROPOSED STANDARDS

Standard #1. A Bottom 5 Percent Standard for Fair Access: At Least 17 Percent of Full-Time Freshmen Are Pell Grant-Eligible

Highly selective, low-Pell institutions can enroll more low-income students without compromising admission standards

To judge an institution's service to low-income student access, analysts traditionally have relied on the percentage of full-time freshmen eligible for a Pell Grant.[19] It's not a perfect measure, because some lower income students — despite the best efforts of their colleges — don't fill out the necessary forms to receive a Pell Grant. But it's a well-accepted measure of the enrollment of low-income students.[20, iv]

Among all full-time freshmen enrolled at four-year colleges, roughly 4 in 10 (39 percent) are Pell Grant recipients. In colleges that fall in the bottom 5 percent, however, fewer than 17 percent of freshmen are Pell students, making these institutions engines of inequality in a country that already has too much.[v]

Universities falling below the 17 percent Pell threshold are mostly selective, private, and wealthy — some very wealthy — colleges (*Figures 3 & 4*). There are a handful of public institutions as well. Together though, these institutions have some of the largest endowments in the country. If their leaders wanted to, they could invest more

Figure 3: Which Colleges Are the "Engines of Inequality"?

What types of colleges are in the bottom 5 percent in Pell freshman enrollment?

# Public Colleges (% of Sector)	% of Bottom Five	# Nonprofit, Private (% of Sector)	% of Bottom Five	# For-Profit (% of Sector)	% of Bottom Five	Barron's Selectivity	FY2012 Endowment
16 (3%)	15%	89 (7%)	83%	2 (1%)	2%	80% in the top three levels of selectivity	Total: $168.8 billion Average: $1.7 billion Median: $550.3 million

Notes: Chart displays statistics for the 107 total colleges with Pell freshman enrollment rates below 17 percent. See Figure 4 for a sample listing of four-year colleges and universities that currently rank among the bottom 5 percent on low-income student college access and Appendix Table 1 for a full list.

Source: Ed Trust analysis of 2011 IPEDS data on Pell freshman enrollment, 2012 IPEDS data on endowment assets, and 2011 Barron's data on selectivity.

iv. Note that we have made a deliberate choice for the four-year sector in applying a threshold for the percentage of Pell students enrolled in the *freshman* class versus the percentage of Pell students enrolled among all *undergraduates.* This was meant to capture a measure of access alone and to remove the success component out of the picture because Pell students tend to have higher withdrawal rates and are less well-represented among upperclassmen.

v. We recognize that while some colleges may enroll more than 17 percent of Pell students, they may still charge students very high net prices, which doesn't make them paragons of socioeconomic mobility. Devising an affordability metric, however, is outside the scope of this paper. We will further investigate recommendations around a minimum affordability standard in a separate publication.

Figure 4: Sample Listing of Colleges Enrolling Fewer Than 17 Percent Pell Students in Fall 2010

College Name	% Pell Among 2010 Entering Class (2011 Benchmark Year)	FY2012 Endowment Funds
Washington University in St. Louis (MO)	6%	$5.3 billion
Princeton University (NJ)	11%	$17.4 billion
Yale University (CT)	13%	$19.3 billion
University of Chicago (IL)	15%	$5.7 billion
University of Virginia (VA)	13%	$4.7 billion

Notes: Full listing of colleges falling in bottom 5 percent in 2011 is in Appendix Table 1. All institutions serve at least 30 first-time, full-time students.

in identifying, recruiting, and enrolling more talented students from low-income families.

When pressed, leaders in these institutions typically argue they can't find more low-income students or cannot admit them without lowering institutional academic standards. But an examination of national college admissions test data and the actions of individual institutions indicate otherwise. The evidence suggests there are many more very high achieving young people from low-income families than currently enrolled in highly selective colleges.[21] Some institutions work at finding and supporting those students, while other institutions do not.

Middlebury College in Vermont, for example, in 2011 fell in the bottom 5 percent of all colleges in its enrollment of low-income students: 10 percent. Yet equally selective institutions like Amherst College and Vassar College enrolled more than twice as many low-income students, 23 and 27 percent respectively. We see the same variation in the public sector. The University of Virginia, which ranks in the bottom 5 percent on service to low-income students, enrolled only 13 percent Pell students in 2011, whereas the University of North Carolina–Chapel Hill and the State University of New York at Binghamton enrolled 20 and 26 percent Pell students, respectively. UNC–Chapel Hill and Binghamton University have comparable admissions standards to U.Va. and fewer financial resources. In fact, U.Va. is twice as wealthy as UNC–Chapel Hill and over 75 times as wealthy as Binghamton.[22]

More and more research on the "under matching" phenomenon indicates that higher Pell enrollments at some highly selective universities as compared with others are not a fluke: There are high-achieving, low-income students whose academic credentials place them well within the band of elite colleges' current admission standards but who for a variety of reasons do not apply to or enroll in these selective institutions. Nearly two-thirds of low-income students with high grades and SAT scores do not attend the most selective institutions for which they are qualified, compared with just over one-quarter of high-income students with similar academic credentials.[23]

Our own analysis of ACT data suggests the same — that if highly selective, low-Pell enrollment colleges really tried to become engines of *opportunity* instead of inequality, there are more than enough high-achieving, low-income students who already meet their admission standard of drawing freshmen from the top 10 percent of test-takers nationwide.[vi] Among ACT test-takers over the past three years, 20 percent of students scoring in the top 10 percent came from low-income families (self-identified as coming from families with incomes below $50,000, the rough threshold for Pell eligibility), making surpassing a 17 percent standard readily attainable without dramatically compromising admissions standards (*Figure 5*).

vi. The median SAT/ACT score equivalent among colleges in the bottom 5 percent was 1300 (out of 1600), which represents the top 10 percent of scorers according to College Board. While data was only available to us for ACT test-takers, that income data is more complete and reliable than the data available from College Board for the SAT. Moreover, if 20 percent of ACT test-takers are low-income, that suggests that a similar proportion — and larger pool of high-achieving, low-income students overall — should exist among SAT test-takers as well.

Figure 5: 20 Percent of Students Scoring Among the Top 10 Percent on the ACT Are Low-Income

ACT Percentile Rank and Score	Percent of Test-Takers Who Are Low-Income (<$50,000)
Top 1%: 33	12%
Top 5%: 30	17%
Top 10%: 28	20%
Top 15%: 26	21%
Top 20%: 25	23%

Source: Ed Trust analysis of 2011-13 ACT data.

Figure 6: In What Sector are the "College Dropout Factories" Located?

What types of colleges are in the bottom 5% in graduation rates?

# Publics (% of Sector)	% of Bottom Five	# Nonprofits (% of Sector)	% of Bottom Five	# For-Profits (% of Sector)	% of Bottom Five
12 (2%)	11%	34 (3%)	32%	59 (15%)	56%
# HBCUs (% of Sector)	% of Bottom Five	# HSIs (% of Sector)	% of Bottom Five	# Tribals (% of Sector)	% of Bottom Five
10 (12%)	10%	10 (8%)	10%	3 (38%)	3%

Notes: Chart displays statistics for the 105 total colleges that have graduation rates below 15 percent. Hispanic-serving institutions (HSIs) are defined here as public and nonprofit private institutions whose Hispanic FTE undergraduate enrollment comprises at least 25 percent of total FTE undergraduate enrollment. See Figure 7 for a sample listing of four-year colleges and universities that currently rank among the bottom 5 percent on graduation rates and Appendix Table 2A for a full list.

Source: Ed Trust analysis of 2011 IPEDS data.

Figure 7: Sample List of Colleges Graduating Fewer Than 15 Percent of Students in 2011

College Name	Sector	6-Year Graduation Rate in 2011 (Benchmark Year)
Concordia College-Selma (AL)	Nonprofit HBCU	3.4%
East-West University (IL)	Nonprofit	7.7%
Colorado Technical University-Online (CO)	For-Profit	9.4%
University of Phoenix-Philadelphia (PA)	For-Profit	10.7%
Louisiana State University-Alexandria (LA)	Public	12.1%

Notes: Full listing of colleges falling in bottom 5 percent in 2011 is in Appendix Table 2A. All institutions serve at least 30 first-time, full-time students.

Standard #2: A Bottom 5 Percent Standard for Education Success: Graduation Rates of at Least 15 Percent

Institutions with similar demographics can have very different outcomes — student demographics are not to blame

What do degree success rates look like at the fifth percentile among four-year colleges? Currently, the bottom 5 percent of colleges have *six-year* completion rates of 15 percent or lower. Over half of these college dropout factories are for-profit institutions; one-third are nonprofit privates; and one-tenth are publics.[vii] One-fifth are nonprofit minority-serving institutions; four-fifths are not. Many are largely online colleges (*Figures 6 & 7*). (*See "Are IPEDS Graduation Rates Valid to Use?"*)

Unlike the colleges that fall below our minimum access standard, institutions with success rates below the 15 percent standard do not serve mostly wealthy, high achievers. Rather, these colleges often serve students whose high schools left them underprepared for the rigors of postsecondary education; many are from low-income families and are members of racial or ethnic minority groups. Not surprisingly, when pressed about their success rates, leaders point not at their academic standards or institutional practices but at their students.

Certainly serving underprepared students makes graduating students more challenging. But the claim that these low-performing colleges are doing "about as well as can be expected" is a ruse. Hundreds of colleges prove that demographics are *not* destiny in higher education.

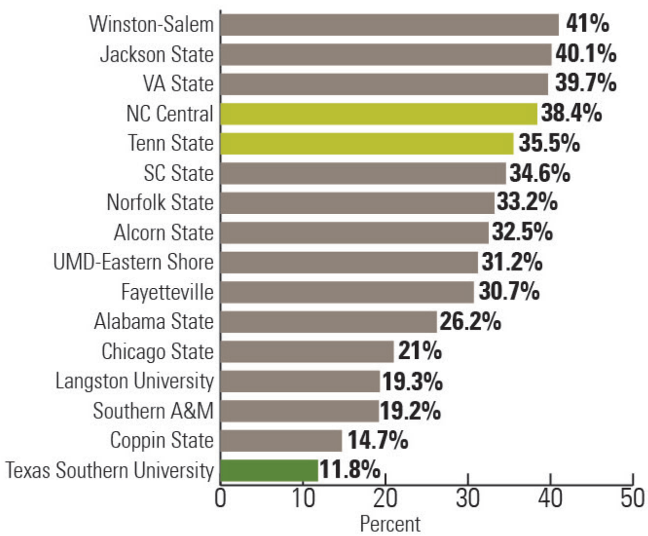
Texas Southern University, for example, fell in the bottom 5 percent of all institutions on graduation rates in 2011, graduating only 11.8 percent of its full-time freshmen within six years of initial enrollment. Some 80 percent of Texas Southern's freshmen are from low-income families (i.e., Pell Grant recipients); 90 percent are from underrepresented minority groups;

vii. A dropout factory in the K-12 context is a term coined by Bob Balfanz and Nettie Letgers referring to high schools with graduation rates below 60 percent. It has also been used in the higher education context in a 2010 *Washington Monthly* article by Ben Miller and Phuong Ly.

and many are weakly prepared for college, with a median SAT score of 800 out of 1600 and an average high school GPA of 2.7. But so too are the students at Tennessee State University and North Carolina Central University, yet they graduate at rates more than three times as high (35.5 percent and 38.4 percent, respectively). In fact, Texas Southern performs at the very bottom of its closest 15 peer institutions and has for many years (*Figure 8*). (*See "How Does Ed Trust Define Peer Groups?"*)

Figure 8: Even Among Similar Colleges, Wide Variation in Graduation Rates Exist

Overall 6-Year Grad Rates, 2011



Source: College Results Online, 2013.

These same differences are clear when we compare graduation rates of other bottom performers with institutions that are most like them. **Truett-McConnell College**, for example, a small private university in Georgia, had one of the lowest graduation rates among its peer group — graduating only 13.6 percent of students within six years of initial enrollment. Meanwhile, peers like Averett University in Virginia and Cazenovia College in New York serve similar students yet graduate them at much higher rates (41 percent and 49.5 percent respectively). Or take **Western International University**, a for-profit college located in Phoenix. In 2011, it graduated only *2 percent* of all full-time freshmen. Needless to say, many other for-profit peers have higher graduation rates.

Indeed, when viewed as a group, the performance of nearly all colleges with overall graduation rates of less than 15 percent — such as Texas Southern, Truett-McConnell, and Western International — are concentrated near the bottom of their respective peer groups. These college dropout factories typically and markedly underperform peer institutions serving similar students — almost 9 out of 10 fall in the bottom two quintiles of their "most similar" institutional peers (*Figure 9*). (*See "Applying the Graduation Standard at the Subgroup Level."*)

Standard #3. A Bottom 5 Percent Standard Indicating Preparation for Post-Enrollment Success: Student Loan Repayment Rates

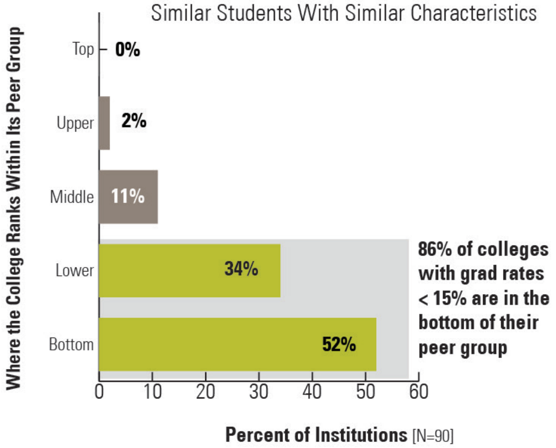
Institutions can protect students' debt investment by helping them graduate with meaningful degrees

So far, we've proposed minimum standards for access and completion. What about a minimum standard for quality? Might some schools grant degrees that aren't worth the paper on which they are printed? Would the absence of a quality standard encourage institutions to try to improve their completion rates by diluting degree-granting standards and simply passing through to graduation students who do not exhibit the knowledge and skills warranting a degree, effectively serving as "diploma mills"?

Frankly, we're not so worried because for years we have studied institutions that have vastly improved their levels of student success, and virtually all agree that the key is *raising* standards, not lowering them. Nevertheless, our experience with existing diploma mills — many of them for-profit institutions — convinces us that a post-enrollment success metric would be a valuable addition in any high-stakes environment.

But unlike in K-12 education, where states regularly assess student learning, there are no common, widely used assessments in higher education. Moreover, post-graduation earnings

Figure 9: Nearly 90 Percent of Colleges Graduating Fewer Than 15 Percent of First-Time, Full-Time Freshmen Perform Worse Than Peer Institutions Serving Similar Students With Similar Characteristics



Source: Ed Trust analysis of College Results Online peer groups.

data — which certainly could help identify diploma mills — are still spotty.

If it chose to, however, the federal government could readily collect institution-level data that would serve as a reasonable basis for establishing a minimum college quality standard: student loan repayment rates. Simply put, these rates would measure what percentage of the students in each institutional exit cohort were able to reduce the balance on their loans by at least a single dollar during the previous year.[24] Given that the federal role in higher education revolves so heavily around student financial aid and student loans in particular, this makes sense as a minimum quality standard, both from a student perspective and that of the taxpayer.

Student loans are by far the riskiest form of federal financial aid. Students who cannot meet their debt obligations either because they earn a degree with little economic value or because they earn no degree at all will confront life-damaging consequences of bad credit, including the inability to take on future debt — like a home mortgage or a car loan — and possibly even wage and tax garnishment.

Students whom colleges encourage to take on debt should have some minimal chance of graduating with a meaningful degree to support that investment. This is especially true for low-income students whose families do not have resources to help with education-related debt.

ARE IPEDS GRADUATION RATES VALID TO USE?

In order to receive federal financial aid, four-year institutions of higher education must calculate six-year graduation rates for all first-time, full-time students. This so-called "IPEDS graduation rate," like the Pell Grant-eligible freshman enrollment rate, isn't a perfect measure. It ignores the success of part-time and transfer students, and treats all students who leave school as dropouts even if they re-enroll elsewhere. Graduation rates would be a better performance metric if these problems were fixed in the IPEDS data collection, and we have long supported such efforts.[1]

It's important to note, however, that institution graduation rates typically remain the same, or even decrease, with the inclusion of transfer and part-time students. Including transfer students can nudge overall institution numbers up, but generally only by a percentage point or two.[2] But, because part-time students necessarily take longer to complete and complete at substantially lower rates, including such students generally *reduces* institution graduation rates.[3] On balance then, we submit the current IPEDS graduation rate metric is adequate to use — at least until we have more comprehensive data.

[1] See Ed Trust comments to the federal comment request on the Integrated Postsecondary Education Data System (IPEDS) 2013-2016.

[2] Ed Trust analysis of transfer graduation rates from our Access to Success Initiative. The Access to Success Initiative is a project of The Education Trust and the National Association of System Heads that works with 19 state public higher education systems to cut the college-going and graduation rate gaps for low-income and minority students in half by 2015. The 300 two-year and four-year campuses enroll more than 3.5 million students, nearly 900,000 students of color and over a million Pell Grant recipients.

[3] Ed Trust analysis of part-time graduation rates from our Access to Success Initiative. Also, Alexandria Walton Radford, et al., Persistence and Attainment of 2003-04 Beginning Postsecondary Students: After 6 Years (NCES 2011-151) (Table 1).

These students — a majority of federal student loan borrowers in a given year — need at least some basic level of protection from rip-off schools that are unusually likely to damage their futures.[25] A minimum standard based on student loan repayment rates can serve that protective role, while also helping to quantify the success of the federal investment.

Some might argue that the current cohort default rate standard the U.S. Department of Education uses is more than adequate as a protection against diluted degrees. We disagree. While three-year cohort default rates are currently the only quantitative metric the federal government uses to measure institutional quality, it's important to be clear about three of the measure's limitations: (1) default represents the *final* stage of financial distress; (2) the current institution eligibility threshold attached to the cohort default rate metric is arbitrary and fixed; and (3) if institutions have sufficient resources, they can fairly easily manipulate their cohort default rates. Some for-profit college corporations, for example, artificially keep their default rates low by pushing students into forbearance and deferment, thereby delaying defaults until after the time frame during which schools are held accountable for results.

Student loan repayment rates would be a much better measure of minimum institutional quality, because they reflect an ongoing record of whether former students have been able to make at least a single payment to reduce their federal student loan principal balance in the previous year. Colleges that have extremely low repayment rates are likely to have both unusually high dropout rates and unusually low employment rates, which are clear measures of quality problems.

A student loan repayment measure would protect against some of the limitations in using cohort default rates, since repayment rates are not as easy to manipulate and do not represent only the final stage of financial distress. Currently, however, repayment rates are not available by institution. We strongly encourage the Department of Education to collect and aggregate repayment rate data at the institution level; once that data is available, a bottom 5 percent threshold applicable to this new metric should be set.[viii] (*See "In the Meantime: Using the Cohort Default Rate to Identify the Bottom 5 Percent."*)

TIME AND SUPPORT FOR LOW-PERFORMING COLLEGES TO IMPROVE

Colleges that are low-performers on any of these three minimum benchmarks need fair notice of the new requirements (at least one year), an opportunity to appeal, and time to improve. Examples of successful appeals may include colleges that are the only postsecondary education option within a certain geographic area, or colleges that overwhelmingly serve *non*-first-time, full-time students and can provide evidence that they perform markedly better with those students than with first-time, full-time students.

Recognizing that low-performing colleges, especially nonprofit private and public institutions, are sometimes under-resourced, the federal government should be prepared — as it has been for the bottom-performing K-12 schools — to provide resources to support improvement efforts. For-profit institutions should not, however, receive additional federal funds under this proposal because the majority already receive 75 percent or more of their revenues from the federal government and because their explicit business model allows them to access capital needed to support student success.

Many of the problems underperforming institutions confront, however, likely transcend monetary issues. As has been true in K-12 education, it may take structural change and unorthodox authority for new leaders: Simply sending a new president into a low-performing college, but then tying his or her hands with archaic personnel or budget rules won't be sufficient.

---

viii. We recommend this until the day comes when an invalidating percentage of students are enrolled in income-based repayment, at which point a new metric for post-enrollment success should be determined. With 11 percent of borrowers enrolled in income-based repayment currently, we are far from that day.

IN THE MEANTIME: USING THE COHORT DEFAULT RATE TO IDENTIFY THE BOTTOM 5 PERCENT

Until overall loan repayment rates are made available by institution, one option to consider is to establish a bottom 5 percent threshold based on three-year cohort default rates. A bottom 5 percent threshold applied to fiscal year 2010 three-year cohort default rate data would yield a 28 percent benchmark,[1] meaning more than 1 in 4 former students are struggling to find a job with an adequate income to make student loan payments within three years of exit.

WHAT TYPES OF COLLEGES ARE IN THE BOTTOM 5 PERCENT IN COHORT DEFAULT RATES?

# Publics (% of Sector)	% of Bottom Five	# Nonprofits (% of Sector)	% of Bottom Five	# For-Profits (% of Sector)	% of Bottom Five
5 (1%)	4%	34 (3%)	30%	75 (19%)	66%
# HBCUs (% of Sector)	**% of Bottom Five**	**# HSIs (% of Sector)**	**% of Bottom Five**	**# Tribals (% of Sector)**	**% of Bottom Five**
16 (19%)	14%	18 (14%)	16%	0 (0%)	0%

Notes: Chart displays statistics for the 114 total colleges that have default rates exceeding 28 percent. Hispanic-serving institutions (HSIs) are defined here as public and nonprofit private institutions whose Hispanic FTE undergraduate enrollment comprises at least 25 percent of total FTE undergraduate enrollment. Twenty of these colleges also do not meet our proposed graduation rate benchmark of 15 percent. See Appendix Table 3 for a full listing of four-year colleges and universities that currently rank among the bottom 5 percent on default rates.

Source: Ed Trust analysis of official FY2010 three-year cohort default rate data from the Department of Education, and 2011 IPEDS data.

This difficulty may be a reflection of two major factors: 1) Either a college produces many dropouts with significant debt and no degree from which to reap increased earnings; or 2) a college produces graduates with high debt and degrees with scant economic meaning or value in the labor market. In either case, these institutions are not a good bet either for students or for federal dollars.

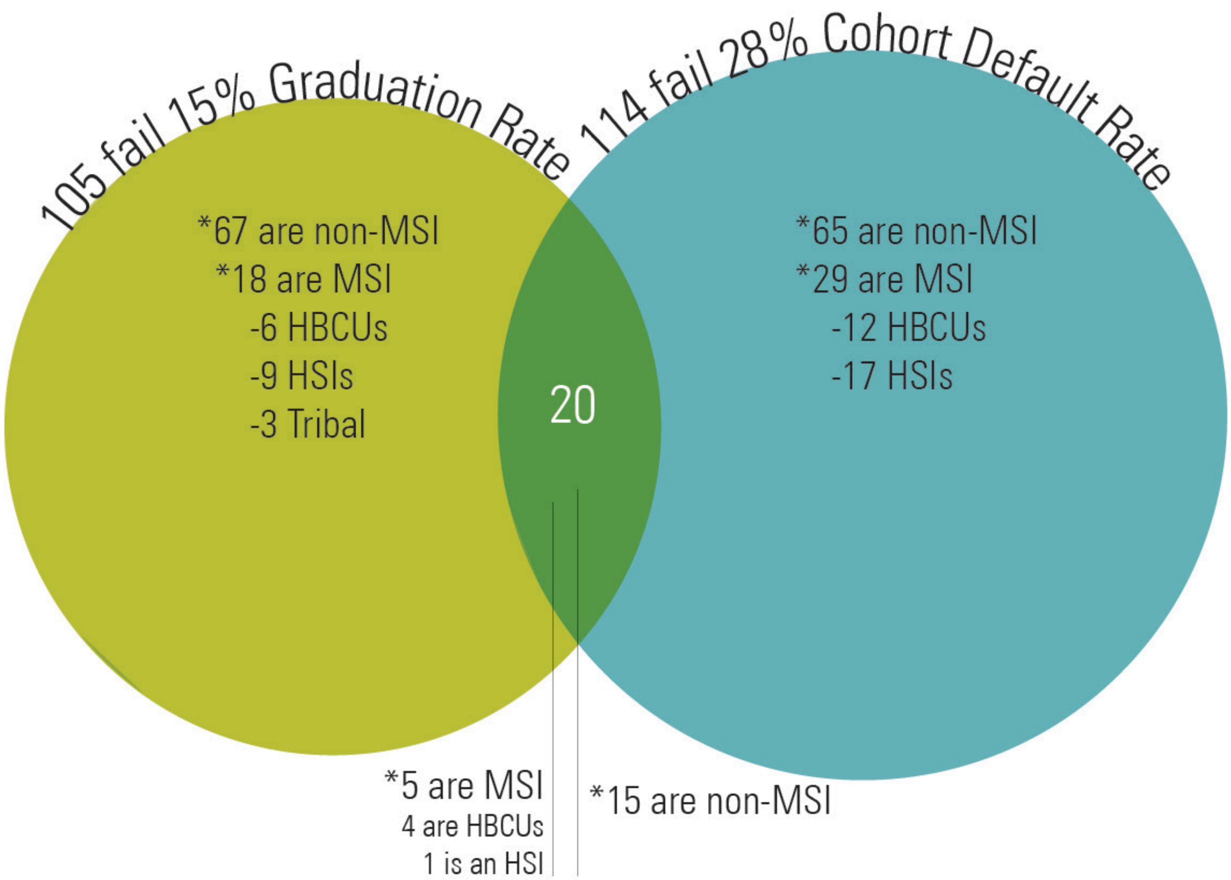
Similar to graduation rates — and as has happened in the past with cohort default rates — we expect that most of the institutions that initially fall below our recommended cohort default rate threshold will improve with a combination of attention and support. Institutions can improve their default rates not only by raising their graduation rates, but also by implementing concrete strategies to lower defaults, such as providing individual counseling on loan repayment options before and after students leave campus. In the past, we have seen a number of institutions, minority-serving institutions in particular, take serious, genuine, and coordinated action to work with their students in these ways, resulting in a significant reduction in school cohort default rates.[2]

Although graduation rates and default rates are correlated, among the bottom 5 percent of institutions on graduation rates and default rates, separately considered, only 20 colleges underperform on both measures, indicating that default rates do indeed point out something different than the graduation rate metric (*Figure A*).

1. In addition to reducing the current cohort default rate threshold from 30 percent to 28 percent under this option, we would also propose that institutions must maintain a three-year average default rate below 28 percent. Under current law, institutions are "safe" if they can keep their default rate below 30 percent in any given year. Moving to a three-year average would make institutions attend to the ability of their students to repay loans on a more consistent basis. Regardless, the 28 percent threshold could and should be regularly updated every few years, as we propose with our access and success metrics, to encourage continuous improvement.

2. Dillon, E. and Smiles, R. *Lowering Student Loan Default Rates: What One Consortium of Historically Black Institutions Did to Succeed,* Education Sector: 2010.

Figure A: How Would Default Rates Interact With Graduation Rates?



Notes: Minority-serving institutions (MSIs) are defined here as public and private nonprofit institutions designated as HBCUs, Hispanic-serving, or tribal.
Source: Ed Trust analysis of 2011 IPEDS graduation rate data and FY2010 cohort default rate data.

During a period of initial notice of underperformance, the federal government should support contracts between entities that have been successful in guiding institutional improvement and leaders (governing boards, state officials, and campus leaders) of public and nonprofit private institutions with low graduation and low loan repayment rates that show a commitment to improvement. Outside groups can help assess institutional challenges and provide recommendations for improvement, technical assistance, and support. Institution leaders can and should facilitate a campuswide culture of inquiry into student success and improvement.[26] Department of Education leaders should use their influence to broker assistance from major national foundations and corporations. The goal should be to improve institutions, not close them. (*See "It Can Be Done: Salish Kootenai College."*)

But all this support needs to be accompanied by clear deadlines and real consequences. Without those, state and institutional leaders won't have the leverage they need to bring about change fast enough to make a difference.

Three Years to Improve Pell Enrollment Rates

Colleges without at least 17 percent Pell student freshman enrollment will have three years to raise their enrollment of low-income students. This is a sufficient period of time for the admissions staff, enrollment management team, and other school administrators to adjust recruiting and financial aid practices to increase Pell enrollment in the freshman class. Consider the success of institutions like Franklin & Marshall College: Despite being in the bottom 5 percent of low-access colleges in 2011, Franklin & Marshall has since markedly improved low-income student enrollment, and did so quickly following a commitment by institution leadership. (*See "It Can Be Done: Franklin & Marshall College."*)

Based on the Franklin & Marshall example and our analysis of ACT data, we submit that a three-year improvement window provides institutions with sufficient time to exhibit meaningful growth; colleges will be deemed successful only if the average Pell freshman enrollment during the three-year improvement time frame is at least 17 percent. Averaging three years of enrollment information will help guard against any natural data fluctuations as well as deter an unintended consequence where institutions may enroll more low-income students only in one of three years to avoid sanctions (*Figure 10*).

Four Years to Improve College Graduation Rates

When and where leaders are truly intentional about all matters related to student success, colleges can change completion and post-enrollment success patterns even for students who are well into the undergraduate experience.[27] However, in order to provide institutions with a fair amount of time to intervene with an entire cohort of students and form practices that will permanently affect graduation rates, we propose providing institutions graduating less than 15 percent of first-time, full-time students at least *four years* to improve.

Moreover, at the end of four years, if an institution can furnish data showing that they are on track to graduate at least 15 percent of its students over the next two years (to align with a six-year graduation rate), the secretary of education should be able to grant those institutions an additional two-year

Figure 10: Timeline for Improvement

	1 YEAR	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	YEAR 6
ACCESS: 17% Pell Enrollment	RECEIVE NOTICE OF UNDER-PERFORMANCE	3 years to improve					
SUCCESS: 15% 6-Year Graduation Rate		4 years to improve				2-year grace period if on track to graduate 15+% of students	
POST-ENROLLMENT SUCCESS: Loan Repayment Rates or Revised CDR in Interim		3 years to improve					

grace period. To ensure meaningful, consistent improvement and provide some flexibility for natural data fluctuations, colleges will be considered successful if their average graduation rate during this improvement time frame is at least 15 percent.

Three Years to Improve Student Loan Repayment Rates

When student loan repayment rates become available at the institutional level and a bottom 5 percent threshold is established, colleges with low loan repayment rates should also receive time to improve. We suggest not making a decision on the specific time frame for improvement until the data becomes available, in order to determine a time period most appropriate to this metric. But we would suggest institutions should have at least three years to improve their repayment rates, and that upon notice of underperformance, institutions have to evidence at least a three-year average repayment rate that is above the threshold to demonstrate meaningful improvement.

The bottom 5 percent threshold suggested for each metric is meant to be updated and recalculated regularly to represent the evolution (and expected improvement) in the field on the whole. We recommend new bottom 5 percent thresholds be recalculated at the end of each improvement time frame: every three years for Pell freshman enrollment and repayment rates or cohort default rates, and every six years for graduation rates. These thresholds will continue to be updated over time until they are no longer needed, such as if all institutions enroll a proportion of low-income students that equals a high percentage of the national average of such students.

ULTIMATE CONSEQUENCES FOR CHRONIC LOW-PERFORMERS

If at the end of multi-year grace periods for improvement, relevant colleges *still* are not rising above the bottom 5 percent threshold established years prior, the federal government has to take the next step: reduce if not eliminate its financial investment in institutions that consistently fail to serve their students and the nation. Vulnerable students, first and foremost, and a finite public investment ultimately must be protected from continued harm.

In the case of chronically and dramatically low-performing colleges, the two categories of federal aid — (1) tax breaks and grants that go to colleges, universities, and affiliated foundations; and (2) tax benefits, grants, and loans that go to students and families — do little to promote the primary purposes of federal investment in higher education: low-income student access and degree completion. Indeed it could be argued that they serve instead to protect and even enhance the attractiveness of weak institutions, many of whose students would be better served elsewhere. We suggest federal resources be leveraged differently to better serve the national interest in improving postsecondary outcomes, especially for low-income students (*Figure 11*).

Figure 11: Summary Chart of Ultimate Consequences

	Institutional Tax	Institutional Grants	Student Tax	Student Grants & Loans
	Charitable deductions for institutions and their affiliated foundations	•TRIO •Campus-based aid •Competitive federal-state money	•AOTC •Lifetime learning credit •Student loan interest deduction •Personal exemption for students age 19 and over •Qualified tuition programs	•Pell •Stafford loans •PLUS loans
Access: Pell Enrollment "Engines of Inequality"	X	X		
Success: Graduation Rates "Dropout Factories"	X	X	X	X
Post-Enrollment Success: Loan Repayment Rates "Diploma Mills"	X	X	X	X

Engines of Inequality — Bottom Performers in Enrolling Students From Low-Income Families

Colleges that effectively and repeatedly *choose* to operate as engines of inequality, failing to enroll a bare minimum percentage of low-income students, should lose access to institution-based federal aid. If there is to be a shared responsibility for college access and success, then at some point the federal government should no longer permit low-access institutions of higher education — or their affiliated foundations — to take advantage of the tax code to receive tax-deductible charitable donations or institutional campus-based aid in the form of the Supplemental Education Opportunity Grant and federal work-study, or competitive federal dollars, including those awarded through the TRIO and GEAR UP programs and any future federal-state partnership initiative.[28]

The mostly selective, private, and fairly wealthy colleges that might be affected by this proposal may argue that their services — to teach, conduct research, and provide public service — are critical to the overall well-being of a democratic society; as such, they are fulfilling their mission as public charities and should continue to receive some federal tax relief. But colleges that receive their tax-exempt status on the basis of their *educational* mission have a primary responsibility to serve the public good through education. By not supporting even a minimum number of qualified, low-income students, they fail the public interest in a crucial way — by calcifying rather than ameliorating societal inequities.

For institutional grants, the federal government originally provided TRIO and campus-based aid as supplemental funds to help institutions of higher education and others provide outreach and support to students from disadvantaged backgrounds. But it's clear that those dollars are not achieving their intended impact at these colleges, if after repeated years, they still do not enroll a bare-minimum percentage of low-income students. These scarce funds would be better spent elsewhere, i.e., at institutions that do prioritize needy students and contribute to the public good.

To be clear, we recommend these colleges lose access only to institution-based aid, not that their students lose access to direct student-based financial aid. Our goal is to protect and help needy students. Low-income and hard-pressed, middle-income students who currently attend these low-access colleges will still maintain access to Pell Grants, federal student loans, and student tax benefits — particularly the American Opportunity Tax Credit — ensuring that they are able to continue to attend and complete their studies.

College Dropout Factories and Diploma Mills — Colleges Failing to Improve on Completion or Success

Postsecondary education institutions that continue to operate as college dropout factories after four-to-six years of consistent failure or continue to operate as diploma mills whose students cannot earn enough post-graduation to repay their loans without default should face serious consequences: They should be subject to losing not only institutional-based aid, but also eligibility to receive all forms of federal student-based aid, *including* federal student loans.[ix]

Why such a seemingly draconian step? Because prospective students should not enroll in these poor-performing institutions on the taxpayers' dime. It's neither an efficient nor effective use of finite public resources. And the virtual absence of institutional accountability makes the federal government complicit in harming vulnerable students who are highly likely to be financially injured by these institutions or at the very least lose ability to access time-restricted Pell Grant funds.

In the end, taking away all federal aid is the only way to send an unequivocal message to students

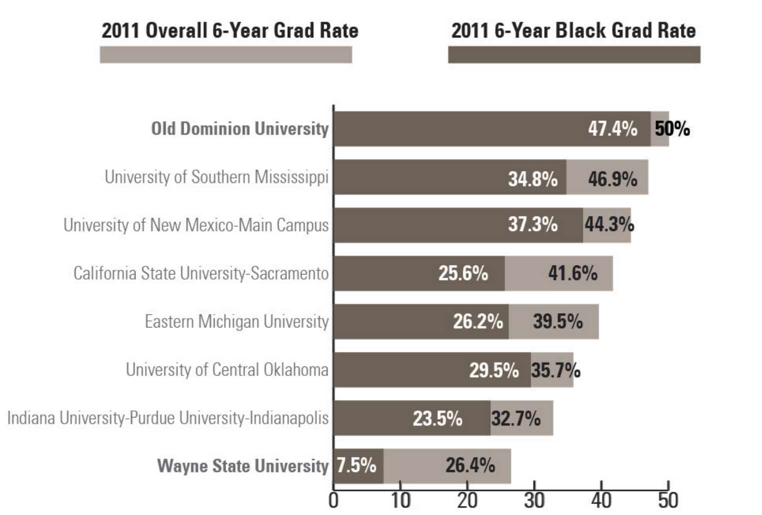
ix. There is, of course, the concern that if we cut off all federal aid, students still wanting to go to these schools will have to turn to private loans, which carry higher interest rates and less borrower protection. While that is a theoretical possibility, we think it's unlikely a private bank will lend to students to attend an institution labeled a college dropout factory or diploma mill. In fact, given how risky an investment these institutions of higher education are, it would make sense for the Consumer Financial Protection Bureau — a supervisor of private lending institutions — and/or bank regulators to consider regulating how much of a private lender's portfolio may be tied up in dropout factories and diploma mills.

APPLYING THE GRADUATION STANDARD AT THE SUBGROUP LEVEL

Should we apply the graduation standard to demographic subgroups? Graduation rate data make it very clear that at the aggregate level and at most institutions, there are significant differences in the rates at which different subgroups of students complete. On average, black, Latino and American Indian freshmen complete their degrees at rates far below those of white and Asian students.[1] The pattern is the same for Pell students.[2] But these gaps are not inevitable: At institutions that work hard to support their students, there are often small or no gaps between student groups.

Given that low-income students and students of color now constitute a majority of the young people in this country, it is important for the federal government to signal its concern about these gaps and the need for them to be closed.

Metrics to this effect could be included in any overall postsecondary accountability system. But there is no reason to wait for a comprehensive system to be developed, tested, and put into place. Instead, the federal government could send a powerful signal of its concern by applying a minimum graduation rate standard not just at the institution level, but also separately for every significant group of students. For example, while an institution might have an overall six-year graduation rate of 32 percent, if its graduation rate for, say, black or Latino students fell consistently below the 15 percent standard, that institution would have to work hard to improve its record. (*See Appendix Table 2B for a listing of colleges that serve one or more subgroups of students inadequately.*)



Source: College Results Online, 2013

Consider, for example, Wayne State University. Wayne State's overall six-year graduation rate in 2011 was 26 percent — nothing to write home about for sure. But the university did a particularly abysmal job serving African American students, over 90 percent of whom fail to complete a degree within six years of initial enrollment. That's right; Wayne State graduated less than 10 percent (7.5 percent in fact) of its African American students in 2011. It doesn't have to be this way: Old Dominion University in Virginia — a Wayne State peer serving a similar student body — graduated African American students at a rate nearly 40 percentage points higher (47.4 percent).

Clearly, Wayne State needs a push to address the needs of its black students more seriously. Its black-white graduation rate gap of 31 points is considerably larger than the national average of 23 points.[3] Yet Wayne State is not alone. Some institutions are clearly more vigilant than others at making sure all their students have the best possible chance of success.

Interestingly though, institutions like Wayne State may need a push for an even bigger reason. When we examined the subset of colleges with graduation rates below 15 percent for a particular subgroup(s), the majority of these institutions also have overall graduation rates that are substantially lower than their peer institutions. More than 8 in 10 fall toward the bottom of their peer groups. The median college within this group of institutions graduates only 23 percent of all students. So while these colleges may have overall graduation rates exceeding 15 percent, their overall performance with students is still lacking.

---

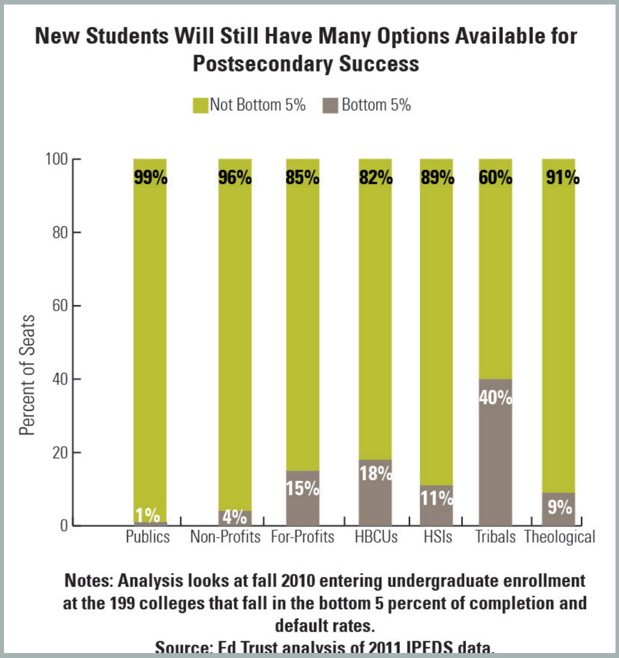
[1] National Center for Education Statistics (NCES), *Enrollment in Postsecondary Institutions, Fall 2012; Financial Statistics, Fiscal Year 2012; and Graduation Rates, Selected Cohorts, 2004-2009, First Look* (Table 3).

[2] Ed Trust analysis of 2003-04 Beginning Postsecondary Students survey, from the U.S. Department of Education.

[3] NCES, *Enrollment in Postsecondary Institutions, Fall 2012; Financial Statistics, Fiscal Year 2012; and Graduation Rates, Selected Cohorts, 2004-2009, First Look* (Table 3).

RESTRICTING CHOICE?

Some low-performing institutions on graduation rates or default rate metrics are for-profits or minority-serving institutions. While we expect most of these institutions to improve with the pressure and support provided in this proposal, some observers may still be concerned that this proposal would restrict student choice within particular sectors.



Let's examine the numbers. Currently 600,000 undergraduates — representing 6 percent of all undergraduates and just slightly over 10 percent of African American, Hispanic, and American Indian students — are concentrated in institutions that are bottom performers on our proposed student success measures.[1] If these bottom performers don't improve after time and support to do so, and tough sanctions take effect, will new students seeking an education at a for-profit, online, or minority-serving institution continue to have options to receive a college education at the same type of institution?

In every case, the answer is yes. Regardless of institution type, only a small percentage of seats are affected. The only exception is tribal colleges, and many of these are likely to be exempted based on geographic isolation.

1. This includes first-time, returning, full-time, and part-time students attending the 199 colleges that fall in the bottom 5 percent on graduation rates and student loan default rates. Student loan default rates are a proxy for those institutions that might underperform on a loan repayment metric.

HOW DOES ED TRUST DEFINE PEER GROUPS?

For the past 10 years, The Education Trust, through its *College Results Online* Web tool, has established a methodology to identify each college's group of peer or "similar" institutions. Our algorithm is public and has been vetted by a series of outside technical experts over the years.

For public and private nonprofit institutions, we have identified 12 institutional and student-related characteristics that significantly predict six-year graduation rates. Our 2011 peer groups, for example, were based on the following variables:

Institutional Characteristics

- Sector (public vs. private)
- Size (number of Full-Time Equivalent undergraduates)
- Status as a commuter campus
- Barron's admission selectivity
- Student-related expenditures per Full-Time Equivalent undergraduate
- Carnegie classification
- Percent of degrees awarded in STEM

Student Characteristics

- Estimated median SAT or ACT equivalent of freshman class
- Average high school GPA among college freshmen
- Percent of Pell recipients among full-time freshman class
- Percent of undergraduates enrolled part-time
- Percent of Full-Time Equivalent undergraduate students age 25 and over

The same algorithm can't be used for for-profit institutions because certain variables are not available and/or applicable to this sector (e.g., SAT, Barron's, GPA). Instead, we use filters on the same characteristics to ensure similar colleges are compared to each other.

See our *Frequently Asked Questions section* at www.collegeresults.org for more information, including weights associated with each characteristic utilized in identifying peer groups.

that these schools will not serve them well and they should enroll elsewhere. Sadly, it may also be the only way to send an unequivocal message to those who run these institutions that it is neither ethical nor acceptable to take hard-earned money from students when you don't have the capacity to see them through to the degrees they seek. Notice of non-eligibility for federal student aid should be prominently displayed on institutions' admission pages and on financial aid award letters, including the standardized Financial Aid Shopping Sheet for participating institutions, among other consumer warnings, to warn new students that they will not be eligible for financial aid at these low-performing colleges.

To be absolutely clear, any revocation of student-based aid eligibility should only be applicable to newly admitted students, not currently enrolled students.[29] Students who are already enrolled should be permitted to conclude their studies. However, we do recommend the Department of Education provide those eligible for federal financial aid with strong consumer warnings informing them of the institution's record of graduating students and/or leading them to default. (*See "Restricting Choice?"*)

CONCLUSION

Our public priority should be to increase the access and success of needy students to postsecondary education, not to protect the financial interests of institutions of higher education regardless of their quality or service to the nation. No longer should federal higher education money flow unabated and unquestioned to institutions that neglect their public duty to educate successfully the students they admit and to enroll low-income students at least at a bare-minimum level.

We understand that the consequences we suggest for bottom performers that don't improve are severe. But they are by no means out of line with the consequences for underserved students — the nearly 600,000 undergraduates attending the schools that fall below our minimum standards for success and the estimated 100,000 of them who will default on student loans. These students are at risk of facing both a lifetime of debt and no degree.

And let's be clear: Establishing rigorous minimum performance benchmarks is particularly important at a time when federal dollars are, and will remain for the foreseeable future, scarce. In such a climate, serving students effectively, accountability for results, and efficiency of performance are of increased importance.

This scarcity of resources is what led states to set goals, experiment with performance-based funding, and set minimum institutional success standards to access state financial aid.[x] It's time for the federal government to do its part as well, instead of continuing to write $180 billion in checks to colleges every year and asking for virtually nothing in return. ■

x. The California Cal Grant program, for example, requires participating institutions to have a graduation rate that is at least 30 percent or a three-year cohort default rate below 15.5 percent.

IT CAN BE DONE

SALISH KOOTENAI COLLEGE

By Mandy Zatynski

At Salish Kootenai College, a small, tribal school in Montana, about half of all incoming students start in at least one remedial (or non-credit-bearing) course. Nearly one-quarter end up in three remedial courses: reading, math, and writing. Evidence indicates that students who are placed in remedial, or developmental education, courses are at a higher risk of dropping out, and those who don't will often take longer to complete their degrees.[1] A few years ago, students at Salish Kootenai were no different. In 2009, less than half of remedial students completed their courses; even fewer were successful once they got to gateway, or entry-level, 101 courses.

Photo courtesy of Salish Kootenai

So college administrators decided to look at the structures needed to support remedial students. What they found was disjointed efforts and departments that only complicated pathways for students. "There's a tendency to think that the student is the problem," says Stacey Sherwin, director of institutional effectiveness at Salish Kootenai. "We found that a lot of times, it was the institution that was the problem."

Salish Kootenai is in Pablo, Mont., a town surrounded by national forests in the northwest corner of the state. The college sits on the Flathead Indian Reservation and prides itself on catering to the specific needs of Native students. More than three-quarters of students are Native, almost 9 in 10 freshmen receive Pell Grants, and more than half of the student population is 25 years or older.[2] For these reasons and based on averages at other institutions with comparable populations, using a predicted vs. actual regression methodology, The Education Trust predicted Salish Kootenai to graduate only 10 percent of its students. But the college's actual graduation rate is more than four times that — 43 percent — thanks to deliberate efforts to streamline processes and strengthen supports for students, many of whom are first-generation or lack academic preparation for college-level work.

Improvements have included revamped assessments that better place students into appropriate courses, more meaningful advising procedures that doubly ensure students' coursework matches their abilities and academic goals, and a new department to oversee — and coordinate — all of it. This prevents mishaps like simultaneously enrolling students in remedial reading and a scientific literature course. Scenarios like these weren't an entirely uncommon occurrence, said Stephen McCoy, director of academic success. According to the college's internal assessment in 2009, about 20 percent of remedial students were simultaneously enrolled in courses in which they were unlikely to succeed. The new advising structure, however, now gives students a remediation-focused adviser, who ensures student course schedules make sense.

These new efforts came at a cost, but officials found financial support through external grants. A $100,000 Wal-Mart grant helped establish the new department of academic success, which became a go-to hub for remedial students and their advisers, and a $400,000 grant from the Lumina Foundation helped administrators collect data to better identify the obstacles students faced on the


Photo courtesy of Salish Kootenai

way to graduation. "Often what manifests itself as an academic problem," said McCoy, "is rooted in what research calls a 'non-cognitive factor' or a 'soft skills factor.'"

Take, for example, a student who struggles with math. Does that student have the self-efficacy and the study skills necessary to succeed in that class? In many cases, McCoy said, they found that students don't. To address this, faculty attended professional development sessions that taught them how to work with low-skill, adult learners and help them be successful, not just in their class specifically, but as a student generally. Now, the engineering department dedicates more time toward helping students understand the vocabulary central to the coursework. Students learn the roots of words and draw their meanings on note cards, a technique pitched in one of the professional development sessions. That foundation allows students to grasp complex topics more easily later on, McCoy says.

Remedial completion rates now reach as high as 80 percent. "Everybody talks about breaking down silos between academics and student support services," says Sherwin, "but we actually did it." And administrators have taken note: Once they saw the successes with remedial students, they turned their attention toward students who receive financial aid, but are on academic suspension, which puts that critical money at risk.

For these students, the college now offers an "academic improvement waiver." It's funded through federal money the college receives for its Native population, and it pays for the student's full-time tuition for one quarter while they work to re-instate themselves. In exchange, students must take an Academic Success 101 course, which instills a lot of the soft skills that McCoy references, including everything from identity and motivation to note-taking and study habits. Students must also take a personal employment class, which gauges their interests and strengths to ensure they have chosen a career where they'll find success. Finally, students must take a series of Friday seminars, which build on the topics covered in Academic Success 101. Perhaps most important, the college requires students with these waivers to take one core class as well, all in the grand plan to ensure they stay on track toward graduation. Since the waivers were introduced two years ago, almost three-quarters of students have been reinstated for the next quarter. Although McCoy acknowledges that doesn't mean they stay out of academic trouble, he adds, "They would have been done and gone if they hadn't been here." ■

---

[1] Complete College America. *Time is the Enemy:* Sept. 2011.

[2] College Results Online, www.collegeresults.org

IT CAN BE DONE

FRANKLIN & MARSHALL COLLEGE

By Mandy Zatynski

Franklin & Marshall College is a small but prestigious liberal arts school in Pennsylvania. Like many such institutions, few in its student body of 2,400 come from low-income families. But in the past few years, that has started to change. In fall 2008, only 5 percent of all F&M students received a Pell Grant, one of the lowest percentages in the country. Just three years later, however, it was 17 percent. Why the shift, and how did they do it?

Photo courtesy of Franklin & Marshall College

It started with the college's board of trustees agreeing that the reflected imbalance in diversity didn't align with the college's mission. Trustees also concluded that it wasn't good for students' educational experience. But the board knew it would cost them precious resources to radically increase the amount of need-based aid necessary to attract more low-income students and students of color without reducing aid to current students. And they knew it would take a strong leader to transition the campus community to serving a broader population.

So, beginning in early 2008, the board started to redirect more money toward financial aid, mostly by reducing planned budget surpluses. By the summer, they approved a plan to gradually phase out non-need-based aid in favor of boosting the pot of funds for need-based aid. By the time they launched a search for a new president in 2010, they looked for a leader who would promote access and continue what they had started. What the board did with money — increasing the financial aid budget from $5.8 million to $11.3 million over five years — the new president, Dan Porterfield, augmented with programming.

At the core of the new programming in support of economic diversity was relationship-building. F&M worked to identify K-12 schools and networks, like KIPP, that predominantly serve talented low-income students and build partnerships that introduce enrolled teens to college life and expectations. The college created F&M College Prep, now in its fourth year, to bring high-achieving, first-generation students to campus the summer before their senior year of high school. Students must have a 3.3 GPA or rank in the top 5 percent of their class, and they must demonstrate some leadership experience at their school. For three weeks, participants live on campus, take two courses with F&M faculty (from environmental science to creative writing), and participate in other activities, like seminars on financial aid, that aim to acclimate students to the college-going lifestyle. F&M also pays a $500 stipend to each student who completes the program in an attempt to make up any summer earning potential they lost. The goal, in the end, is that these students apply to their dream schools — even if that doesn't mean F&M. Thus far, all 156 students who have participated in F&M College Prep have been accepted into college, including such selective institutions as the University of Texas at Austin, University of California–Berkeley, Brown University, and Harvard University. More than 90 percent of students actually go — and more than a quarter of them go to F&M.

F&M also works with the National College Advising Corps to provide college counseling to 15 rural schools in Pennsylvania. In addition, for a decade, it has maintained a relationship with the Posse Foundation, which promotes college access and youth leadership development, offering full-tuition scholarships to 10 high-achieving students of color from New York City and most recently, Miami. In particular, F&M targets prospective students with interests in STEM-related careers, in part because of its strong math and science offerings, but also because leaders know those careers are in demand.

Porterfield says other schools can do the same, identify their own programmatic strengths and then form partnerships with like-minded networks that will attract not only students in those programs, but also those students' communities. "The big advantage of the Posse relationship is that you not only identify students who are a great fit for your school, but you develop some inroads into those students' high school communities, which can open pipelines beyond what the formal Posse pipeline brings," he says.

Additionally, F&M works to keep introductory class sizes small, encouraging more faculty-student engagement and letting more students know of the resources and help available to them. Other efforts focus on drawing the connection between school and work, like a new pilot program this year that identifies work and internships in the community that align with students' career interests. Upperclassmen pursue these opportunities as part of their work-study program, collecting a stipend from the university while also doing work that matters to them. F&M added a new leadership position to its general operating budget, the senior associate dean for planning and student outcomes, who is charged with assessing all of its programming, whether it's working, and how it can be improved.

There's no regression analysis, but

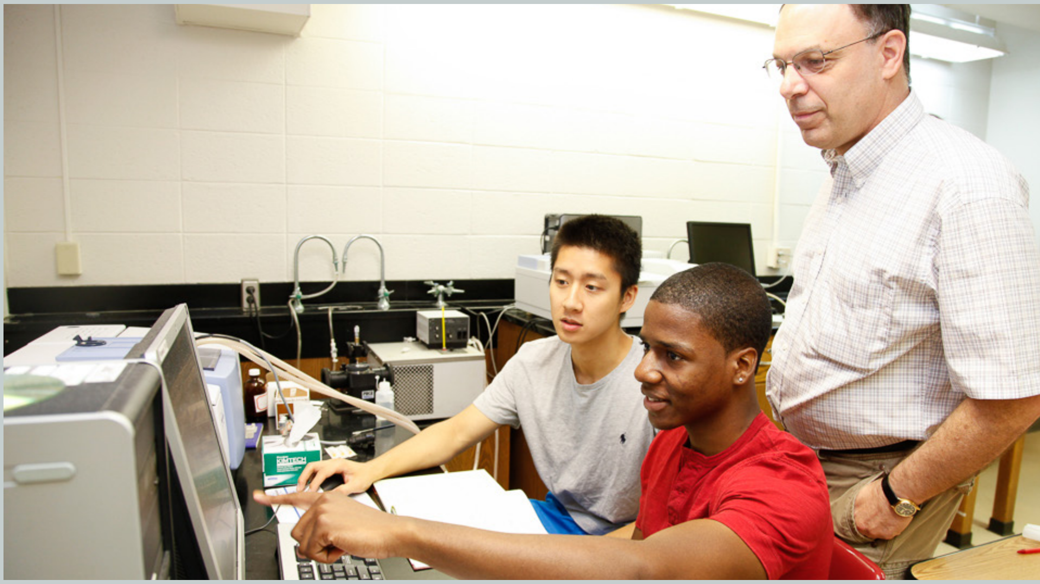


Photo courtesy of Franklin & Marshall College

through these and other supports at F&M, the retention of its Pell students is actually higher than the freshman class and first-generation students. Comparatively, 92 percent of the freshman class as a whole returned, and 96 percent of first-generation students did.

F&M leaders say much of this couldn't have been accomplished without the significant commitment to need-based financial aid made back in 2008. Thanks to the additional grants, F&M has attracted more than triple the number of Pell Grant recipients it did then. The college now meets the full demonstrated need of every student who enrolls. (To pay for this, college leaders reduced their annual surplus and now project expenses more precisely.) They've also phased out almost all non-need-based aid with the exception of a few endowed scholarships for the arts. "We've achieved more goals than just increasing Pell [Grant-eligible] students by increasing financial aid," Porterfield says. "We're trying to attend to all students' financial need."

This summer, the college plans to launch a fundraising campaign solely centered on financial aid — something it hasn't done before. Porterfield is cautious. He and other leaders know little about how this campaign will be received and whether donors will contribute with the same enthusiasm as they have in the past. But one thing is for certain: F&M more than tripled its Pell enrollment rate in just three years. Their efforts were aggressive, their goals — ambitious, but not impossible.

"This is do-able. Some of the gains we've made … are achievable with thoughtful and intentional effort," Porterfield says. "This is not a matter of moving mountains."

TABLE 1: COLLEGES IN THE BOTTOM 5% FOR NOT ENROLLING AT LEAST 17% PELL FRESHMEN

				ID Year	Y1 Status
Name	**State**	**Sector**	**Median SAT/ACT of Enrolled Students (2011)**	**% Pell (2011)**	**% Pell (2012)**
Auburn University	AL	Public	1225	14%	13%
California Institute of Technology	CA	Nonprofit	1525	9%	11%
California Polytechnic State University	CA	Public	1205	14%	14%
Claremont McKenna College	CA	Nonprofit	1390	15%	10%
Harvey Mudd College	CA	Nonprofit	1485	12%	13%
Pitzer College	CA	Nonprofit	1270	14%	10%
Pomona College	CA	Nonprofit	1470	15%	16%
University of San Diego	CA	Nonprofit	1210	16%	15%
Santa Clara University	CA	Nonprofit	1230	16%	13%
Scripps College	CA	Nonprofit	1360	15%	11%
Stanford University	CA	Nonprofit	1455	16%	16%
West Coast University-Los Angeles	CA	For-Profit	N/A	15%	45%
University of Colorado-Boulder	CO	Public	1165	16%	17%
Colorado College	CO	Nonprofit	1315	12%	10%
Colorado Heights University	CO	Nonprofit	N/A	4%	N/A*
Connecticut College	CT	Nonprofit	N/A	13%	16%
Quinnipiac University	CT	Nonprofit	1090	16%	14%
Trinity College	CT	Nonprofit	1285	13%	10%
Wesleyan University	CT	Nonprofit	1395	16%	21%
Yale University	CT	Nonprofit	1490	13%	12%
American University	DC	Nonprofit	1280	15%	24%
Catholic University of America	DC	Nonprofit	1110	12%	12%
George Washington University	DC	Nonprofit	1290	13%	12%
Georgetown University	DC	Nonprofit	1400	14%	16%
University of Delaware	DE	Public	1185	13%	12%
Beacon College	FL	Nonprofit	N/A	10%	24%
Embry Riddle Aeronautical University-Worldwide	FL	Nonprofit	N/A	13%	28%
University of Chicago	IL	Nonprofit	1480	15%	11%
Northwestern University	IL	Nonprofit	1445	15%	14%
University of Notre Dame	IN	Nonprofit	1450	12%	12%
Centre College	KY	Nonprofit	1280	16%	17%
Tulane University	LA	Nonprofit	1315	13%	11%
Bentley University	MA	Nonprofit	1210	16%	14%
Boston College	MA	Nonprofit	1340	16%	12%
Emerson College	MA	Nonprofit	1240	14%	19%
Northeastern University	MA	Nonprofit	1310	13%	13%
Stonehill College	MA	Nonprofit	N/A	14%	12%
Tufts University	MA	Nonprofit	1425	10%	11%
Worcester Polytechnic Institute	MA	Nonprofit	N/A	15%	15%
Franklin W. Olin College of Engineering	MA	Nonprofit	1455	14%	10%
Johns Hopkins University	MD	Nonprofit	1395	12%	13%
Loyola University-Baltimore	MD	Nonprofit	1198	14%	14%
University of Maryland-College Park	MD	Public	1290	15%	15%
Ner Israel Rabbinical College	MD	Nonprofit	N/A	15%	22%
St Mary's College of Maryland	MD	Public	1235	14%	19%
Bates College	ME	Nonprofit	N/A	13%	12%
Colby College	ME	Nonprofit	1335	10%	11%
University of Michigan-Ann Arbor	MI	Public	1300	15%	16%
Carleton College	MN	Nonprofit	1400	13%	14%
Washington University in St Louis	MO	Nonprofit	1470	6%	6%
Davidson College	NC	Nonprofit	1345	13%	12%
Duke University	NC	Nonprofit	1435	13%	14%
Elon University	NC	Nonprofit	1215	10%	11%
High Point University	NC	Nonprofit	1075	12%	14%
Wake Forest University	NC	Nonprofit	N/A	14%	14%
Dartmouth College	NH	Nonprofit	1450	13%	13%
Princeton University	NJ	Nonprofit	1490	11%	12%
Colgate University	NY	Nonprofit	1365	11%	11%
Cooper Union for the Advancement of Science and Art	NY	Nonprofit	1365	13%	19%
Cornell University	NY	Nonprofit	1400	15%	17%
Jewish Theological Seminary of America	NY	Nonprofit	1350	0%	0%
The Juilliard School	NY	Nonprofit	N/A	11%	25%
Marist College	NY	Nonprofit	1160	15%	15%
Rabbinical Seminary of America	NY	Nonprofit	N/A	11%	18%
Torah Temimah Talmudical Seminary	NY	Nonprofit	N/A	16%	18%
Kenyon College	OH	Nonprofit	1340	10%	7%
Oberlin College	OH	Nonprofit	1365	10%	9%
Bucknell University	PA	Nonprofit	1300	11%	9%
Carnegie Mellon University	PA	Nonprofit	1400	13%	15%
Dickinson College	PA	Nonprofit	1284	12%	10%
Franklin and Marshall College	PA	Nonprofit	N/A	13%	17%
Gettysburg College	PA	Nonprofit	1300	13%	12%
Haverford College	PA	Nonprofit	1395	16%	14%
Lafayette College	PA	Nonprofit	1275	8%	13%
Lehigh University	PA	Nonprofit	1305	16%	14%
Muhlenberg College	PA	Nonprofit	1240	8%	9%
Pennsylvania State University-Main	PA	Public	1195	16%	15%
University of Pennsylvania	PA	Nonprofit	1440	16%	17%
University of Pittsburgh	PA	Public	1260	16%	16%

Saint Joseph's University	PA	Nonprofit	1120	12%	10%
Swarthmore College	PA	Nonprofit	1435	14%	17%
Villanova University	PA	Nonprofit	1300	11%	13%
Bryant University	RI	Nonprofit	1140	14%	17%
Providence College	RI	Nonprofit	1160	16%	16%
Roger Williams University	RI	Nonprofit	1075	14%	14%
Furman University	SC	Nonprofit	1275	16%	12%
Rhodes College	TN	Nonprofit	1260	16%	19%
Sewanee-The University of the South	TN	Nonprofit	1260	16%	19%
Vanderbilt University	TN	Nonprofit	1430	13%	14%
Rice University	TX	Nonprofit	1440	16%	17%
Southern Methodist University	TX	Nonprofit	1245	15%	15%
Texas Christian University	TX	Nonprofit	1165	14%	11%
Brigham Young University-Provo	UT	Nonprofit	1260	16%	18%
College of William and Mary	VA	Public	1350	10%	9%
Christopher Newport University	VA	Public	1200	16%	18%
James Madison University	VA	Public	1145	14%	14%
University of Richmond	VA	Nonprofit	1280	14%	15%
Strayer University-Virginia	VA	For-Profit	N/A	16%	8%
Virginia Tech	VA	Public	1220	15%	15%
University of Virginia	VA	Public	1335	13%	12%
Virginia Military Institute	VA	Public	1135	16%	16%
Washington and Lee University	VA	Nonprofit	1385	11%	11%
Middlebury College	VT	Nonprofit	1385	10%	10%
Gonzaga University	WA	Nonprofit	1185	16%	19%
Whitman College	WA	Nonprofit	1325	14%	10%
Bellin College	WI	Nonprofit	1125	0%	N/A*
University of Wisconsin-Madison	WI	Public	1260	15%	16%

Notes: Colleges must have at least 30 full-time freshmen in the 2010-2011 school year to be identified as falling in the bottom 5 percent of Pell freshman enrollment rates. Y1 status shows how these institutions are performing one year later but should be interpreted with caution: To allow for natural data fluctuations, our proposal stipulates that colleges will only be considered successful if their three-year weighted average, after the identification year, surpasses the 17 percent Pell benchmark. Colleges marked "N/A*" had a cohort size fewer than 30 full-time freshmen in the subsequent year. Their Pell rates, however, will still be used in calculating a three-year weighted average to determine whether they surpass the 17 percent Pell benchmark after three years.

Source: 2011 and 2012 Integrated Postsecondary Education Data System (IPEDS) Pell data.

TABLE 2A: COLLEGES IN THE BOTTOM 5% FOR FAILING TO GRADUATE AT LEAST 15% OF ALL FRESHMEN

			ID Year	Y1 Status
Name	**State**	**Sector**	**Overall Grad Rate (2011)**	**Overall Grad Rate (2012)**
Concordia College-Selma	AL	Nonprofit, HBCU	3.4%	5.5%
ITT Technical Institute-Bessemer	AL	For-Profit	9.3%	14%
Arkansas Baptist College	AR	Nonprofit, HBCU	4.2%	4.8%
University of Phoenix-Little Rock	AR	For-Profit	9.7%	15.3%
University of Phoenix-Northwest Arkansas	AR	For-Profit	7.9%	20.3%
Western International University	AZ	For-Profit	2.4%	2.6%
University of Phoenix-Online	AZ	For-Profit	6.2%	4.3%
Yeshiva Ohr Elchonon Chabad	CA	Nonprofit	14.6%	36.4%
University of Phoenix-San Diego	CA	For-Profit	12.4%	14.4%
University of Phoenix-Sacramento Valley	CA	For-Profit	10.7%	16.2%
Colorado Technical University-Colorado	CO	For-Profit	8.5%	19%
Colorado Technical University-Greenwood	CO	For-Profit	7%	N/A*
Colorado Technical University-Online	CO	For-Profit	9.4%	9.5%
University of the District of Columbia	DC	Public, HBCU	8%	15.8%
Carlos Albizu University-Miami	FL	Nonprofit, HSI	8.8%	N/A*
Hodges University	FL	Nonprofit, HSI	12.5%	N/A*
University of Phoenix-North Florida	FL	For-Profit	14.8%	18.8%
Thomas University	GA	Nonprofit	7.5%	14.3%
Truett-McConnell College	GA	Nonprofit	13.6%	9.4%
University of Phoenix-Atlanta	GA	For-Profit	14.1%	13.5%
University of Phoenix-Columbus	GA	For-Profit	10.1%	15.6%
University of Phoenix-Hawaii	HI	For-Profit	13.3%	26.7%
University of Phoenix-Des Moines	IA	For-Profit	10%	N/A*
University of Phoenix-Idaho	ID	For-Profit	9.1%	8.8%
East-West University	IL	Nonprofit	7.7%	8.7%
Hebrew Theological College	IL	Nonprofit	5.7%	8.8%
Holy Cross College	IN	Nonprofit	12.7%	19.9%
ITT Technical Institute-Fort Wayne	IN	For-Profit	9.1%	N/A*
ITT Technical Institute-Indianapolis	IN	For-Profit	8.3%	10.5%
University of Phoenix-Indianapolis	IN	For-Profit	5.3%	14.1%
University of Phoenix-Wichita	KS	For-Profit	12.8%	1.5%
ITT Technical Institute-Louisville	KY	For-Profit	14.7%	18.2%
University of Phoenix-Louisville	KY	For-Profit	4.9%	N/A*
Louisiana State University-Alexandria	LA	Public	12.1%	13.5%
University of Phoenix-Louisiana	LA	For-Profit	13.6%	17.9%
Boston Architectural College	MA	Nonprofit	9.1%	6.8%
Coppin State University	MD	Public, HBCU	14.7%	17%
University of Maryland-University College	MD	Public	10.3%	4.3%
Baker College of Owosso	MI	Nonprofit	13%	11.1%
University of Phoenix-Metro Detroit	MI	For-Profit	11.4%	10.5%
University of Phoenix-West Michigan	MI	For-Profit	7.1%	14.4%
University of Phoenix-Minneapolis/St Paul	MN	For-Profit	6.8%	12.9%
ITT Technical Institute-Earth City	MO	For-Profit	10.7%	11.1%
Harris-Stowe State University	MO	Public, HBCU	8.5%	8.2%
University of Phoenix-St Louis	MO	For-Profit	7.6%	10.2%
University of Phoenix-Kansas City	MO	For-Profit	12.9%	13.3%
University of Phoenix-Springfield	MO	For-Profit	10.9%	9.7%
University of Phoenix-Charlotte	NC	For-Profit	9.9%	16.3%
University of Phoenix-Raleigh	NC	For-Profit	6.8%	12.1%
Turtle Mountain Community College	ND	Nonprofit, Tribal	0.7%	N/A*
Rabbinical College of America	NJ	Nonprofit	12.1%	N/A*
Yeshiva Toras Chaim	NJ	Nonprofit	2.9%	2.2%
Western New Mexico University	NM	Public, HSI	12.5%	16.2%
Great Basin College	NV	Public	7.7%	14.3%
ITT Technical Institute-Henderson	NV	For-Profit	11.9%	N/A*
International Academy of Design and Technology-Henderson	NV	For-Profit	11.9%	36.4%
Mirrer Yeshiva Cent Institute	NY	Nonprofit	6.1%	15.4%
Rabbinical College of Long Island	NY	Nonprofit	3%	2.6%
Talmudical Seminary Oholei Torah	NY	Nonprofit	2.2%	3.5%
Torah Temimah Talmudical Seminary	NY	Nonprofit	5%	2.6%
Yeshivat Mikdash Melech	NY	Nonprofit	2.7%	N/A*
Yeshiva of the Telshe Alumni	NY	Nonprofit	2.6%	N/A*
DeVry College of New York	NY	For-Profit	14.4%	24.5%
Chancellor University	OH	For-Profit	4.8%	4.6%
University of Phoenix-Cincinnati	OH	For-Profit	8.8%	3.2%
Bacone College	OK	Nonprofit	4.2%	9.5%
Oklahoma State University Institute of Technology-Okmulgee	OK	Public	1.1%	missing
University of Phoenix-Oklahoma City	OK	For-Profit	13.9%	11.9%
University of Phoenix-Tulsa	OK	For-Profit	13.4%	13.8%
University of Phoenix-Philadelphia	PA	For-Profit	10.7%	9%
University of Phoenix-Pittsburgh	PA	For-Profit	5.9%	N/A*
Harrisburg University of Science and Technology	PA	Nonprofit	9.1%	N/A*
National University College-Bayamon	PR	For-Profit	9.3%	5.5%
National University College-Arecibo	PR	For-Profit	14.3%	12.2%
University of Puerto Rico-Utuado	PR	Public, HSI	12.1%	20.8%
Universidad Del Este	PR	Nonprofit, HSI	12.5%	22.5%
EDP College of Puerto Rico Inc-San Juan	PR	Nonprofit, HSI	10.9%	25%
Caribbean University-Vega Baja	PR	Nonprofit, HSI	12.8%	29.4%
Oglala Lakota College	SD	Public, Tribal	4.5%	1.3%
Sinte Gleska University	SD	Nonprofit, Tribal	4.7%	N/A*
ITT Technical Institute-Nashville	TN	For-Profit	13.8%	12.5%
LeMoyne-Owen College	TN	Nonprofit, HBCU	14.9%	8.1%
Victory University	TN	For-Profit	10.3%	13.2%

ITT Technical Institute-Knoxville	TN	For-Profit	11.8%	9.5%
ITT Technical Institute-Cordova	TN	For-Profit	13.8%	16.7%
University of Phoenix-Nashville	TN	For-Profit	14.1%	9.6%
University of Houston-Downtown	TX	Public, HSI	14.7%	11.9%
Jarvis Christian College	TX	Nonprofit, HBCU	14.3%	13.3%
Paul Quinn College	TX	Nonprofit, HBCU	5.4%	0.6%
Texas College	TX	Nonprofit, HBCU	6.4%	17.1%
Texas Southern University	TX	Public, HBCU	11.8%	12%
University of Phoenix-Dallas	TX	For-Profit	7.1%	15.7%
Baptist University of the Americas	TX	Nonprofit, HSI	10.3%	N/A*
American InterContinental University-Houston	TX	For-Profit	13.8%	24.4%
University of Phoenix-Austin	TX	For-Profit	12.2%	12.5%
Stevens-Henager College of Business-Provo	UT	For-Profit	4.9%	41.5%
ITT Technical Institute-Norfolk	VA	For-Profit	10%	2%
University of Phoenix-Northern Virginia	VA	For-Profit	8.5%	N/A*
University of Phoenix-Richmond	VA	For-Profit	3.4%	3.9%
Heritage University	WA	Nonprofit, HSI	12.3%	16%
University of Phoenix-Western Washington	WA	For-Profit	14.5%	14.7%
ITT Technical Institute-Greenfield	WI	For-Profit	14.3%	5.4%
University of Phoenix-Milwaukee	WI	For-Profit	9.6%	6.8%
Mountain State University	WV	Nonprofit	11.6%	missing
Salem International University	WV	For-Profit	13.6%	11.3%

Notes: Colleges must have at least 30 full-time freshmen in the 2005 fall cohort to be identified as falling in the bottom 5 percent of 2011 graduation rates. Y1 status shows how these institutions are performing one year later but should be interpreted with caution: To allow for natural data fluctuations, our proposal stipulates that colleges will only be considered successful if their four-year weighted average, after the identification year, surpasses the 15 percent graduation rate benchmark.

Colleges marked "N/A*" had a cohort size fewer than 30 full-time freshmen in the subsequent year. Their graduation rates, however, will still be used in calculating a four-year weighted average to determine whether they surpass the 15 percent graduation rate benchmark after four years.

Source: 2011 and 2012 Integrated Postsecondary Education Data System (IPEDS) Graduation Rate data.

TABLE 2B: COLLEGES IN THE BOTTOM 5% FOR NOT GRADUATING AT LEAST 15% OF ANY SUBGROUP

			ID Year	
Name	**State**	**Sector**	**Overall Grad Rate (2011)**	**Subgroup Grad Rate (2011)**
University of North Alabama	AL	Public	27.4%	11.9% (Black)
Talladega College	AL	Nonprofit, HBCU	20%	14.2% (Black)
University of Alaska-Anchorage	AK	Public	25.3%	11.8% (Hispanic) 9.1% (Am. Indian)
University of Phoenix-Phoenix-Hohokam	AZ	For-Profit	16.7%	13.9% (Hispanic)
University of Arkansas at Little Rock	AR	Public	21.2%	13.6% (Black)
University of Arkansas at Monticello	AR	Public	23.2%	10.9% (Black)
Academy of Art University	CA	For-Profit	34.5%	14.3% (Hispanic)
Westwood College-Los Angeles	CA	For-Profit	15.4%	8.2% (White)
Metropolitan State College of Denver	CO	Public	21.4%	13.7% (Hispanic)
Gallaudet University	DC	Nonprofit	41.4%	14.3% (Black)
Augusta State University	GA	Public	22.3%	13.3% (Black)
International Academy of Design and Technology-Chicago	IL	For-Profit	18.1%	12.7% (Black)
Northeastern Illinois University	IL	Public, HSI	23.1%	8.6% (Black)
Indiana University-Purdue University-Fort Wayne	IN	Public	25.6%	11.9% (Black) 13.0% (Hispanic)
University of Southern Indiana	IN	Public	34.3%	10.5% (Black)
Indiana University-South Bend	IN	Public	22.2%	6.5% (Black)
Indiana University-Northwest	IN	Public	23.1%	11.3% (Black)
Purdue University-Calumet	IN	Public	27.7%	14.1% (Black)
Iowa Wesleyan College	IA	Nonprofit	25.2%	12.1% (Black)
Kentucky State University	KY	Public, HBCU	21.4%	14.3% (White)
Louisiana College	LA	Nonprofit	31.1%	13.3% (Black)
University of New Orleans	LA	Public	38.1%	12.1% (Black)
Baker College of Flint	MI	Nonprofit	16.7%	3% (Black)
Lake Superior State University	MI	Public	35.3%	13.3% (Am. Indian)
Lawrence Technological University	MI	Nonprofit	43.9%	11.1% (Black)
Wayne State University	MI	Public	26.4%	7.5% (Black)
Missouri Baptist University	MO	Nonprofit	27.8%	14.3% (Black)
Missouri Western State University	MO	Public	27%	9.3% (Black)
Eastern New Mexico University	NM	Public, HSI	23.9%	8.7% (Black)
New Mexico Highlands University	NM	Public, HSI	20.9%	12.1% (White)
CUNY York College	NY	Public	19.8%	14.4% (Hispanic) 12.8% (White)
SUNY Empire State College	NY	Public	18.7%	9.3% (Black)
Methodist University	NC	Nonprofit	38.6%	14.5% (Black)
University of Akron	OH	Public	38%	9.8% (Black)
Cleveland State University	OH	Public	29.9%	13.1% (Black) 13.0 (Hispanic)
DeVry University-Ohio	OH	For-Profit	32.9%	12.2% (Black)
Kent State University-Stark	OH	Public	23.5%	6.5% (Black)
Ohio University-Chillicothe	OH	Public	15.1%	14.7% (White)
Youngstown State University	OH	Public	35.2%	12.5% (Black)
Cameron University	OK	Public	19%	7.9% (Am. Indian)
Southwestern Oklahoma State University	OK	Public	32.9%	5.7% (Hispanic)
DeVry University-Texas	TX	For-Profit	18.8%	13.2% (White)
The University of Texas-Brownsville	TX	Public, HSI	17.4%	8.1% (White)
Wayland Baptist University	TX	Nonprofit	37.4%	14.6% (Hispanic)
The University of Virginia's College-Wise	VA	Public	38.8%	6.5% (Black)
Concord University	WV	Public	33.5%	14.3% (Black)
University of Wisconsin-Parkside	WI	Public	27.7%	14.3% (Black)
University of Phoenix-Bay Area	CA	For-Profit	18.6%	6.3% (Black)

University of Phoenix-Southern California	CA	For-Profit	15%	12% (Black)
Western Governors University	UT	Nonprofit	18.4%	7.2% (Black) 13.2% (Hispanic)
University of Phoenix-South Florida	FL	For-Profit	20.4%	14.9% (Hispanic)
University of Phoenix-Houston	TX	For-Profit	16.1%	13.9% (White)
Westwood College-Chicago Loop	IL	For-Profit	17.9%	10% (Black)
University of Phoenix-Memphis	TN	For-Profit	15.4%	14.5% (Black)

Notes: Colleges must have at least 30 full-time freshmen in any of the five major subgroups (black, Hispanic, American Indian, white, Asian) in the 2005 cohort to be identified as falling below the bottom 5 percent 2011 overall graduation rate standard.

Source: 2011 Integrated Postsecondary Education Data System (IPEDS) Graduation Rate data.

TABLE 3: COLLEGES IN THE BOTTOM 5% FOR HAVING MORE THAN 28% OF STUDENTS DEFAULT ON STUDENT LOANS

			ID Year
Name	**State**	**Sector**	**3-Year Cohort Default Rates (FY2010)**
Concordia College-Selma	AL	Nonprofit, HBCU	33.0%
Talladega College	AL	Nonprofit, HBCU	36.7%
ITT Technical Institute-Bessemer	AL	For-Profit	29.2%
Virginia College-Birmingham	AL	For-Profit	28.2%
Virginia College-Huntsville	AL	For-Profit	28.2%
Arkansas Baptist College	AR	Nonprofit, HBCU	33.6%
University of Arkansas at Pine Bluff	AR	Public, HBCU	29.2%
ITT Technical Institute-Little Rock	AR	For-Profit	29.2%
ITT Technical Institute-Tucson	AZ	For-Profit	29.2%
ITT Technical Institute-Tempe	AZ	For-Profit	29.2%
Le Cordon Bleu College of Culinary Arts	AZ	For-Profit	28.5%
ITT Technical Institute-Rancho Cordova	CA	For-Profit	29.2%
California College-San Diego	CA	For-Profit	29.3%
ITT Technical Institute-San Diego	CA	For-Profit	29.2%
ITT Technical Institute-San Dimas	CA	For-Profit	29.2%
ITT Technical Institute-Orange	CA	For-Profit	29.2%
ITT Technical Institute-Sylmar	CA	For-Profit	29.2%
ITT Technical Institute-Torrance	CA	For-Profit	29.2%
ITT Technical Institute-San Bernardino	CA	For-Profit	29.2%
ITT Technical Institute-Oxnard	CA	For-Profit	29.2%
ITT Technical Institute-Lathrop	CA	For-Profit	29.2%
College America-Denver	CO	For-Profit	35.1%
ITT Technical Institute-Thornton	CO	For-Profit	29.2%
College America-Colorado Springs	CO	For-Profit	35.1%
College America-Fort Collins	CO	For-Profit	35.1%
Potomac College-Washington	DC	For-Profit	32.8%
ITT Technical Institute-Tampa	FL	For-Profit	29.2%
Lincoln College of Technology-West Palm	FL	For-Profit	31.3%
ITT Technical Institute-Lake Mary	FL	For-Profit	29.2%
ITT Technical Institute-Jacksonville	FL	For-Profit	29.2%
ITT Technical Institute-Fort Lauderdale	FL	For-Profit	29.2%
ITT Technical Institute-Miami	FL	For-Profit	29.2%
Bauder College	GA	For-Profit	29.0%
ITT Technical Institute-Duluth	GA	For-Profit	29.2%
ITT Technical Institute-Kennesaw	GA	For-Profit	29.2%
ITT Technical Institute-Boise	ID	For-Profit	29.2%
East-West University	IL	Nonprofit	30.5%
ITT Technical Institute-Mount Prospect	IL	For-Profit	29.2%
ITT Technical Institute-Orland Park	IL	For-Profit	29.2%
ITT Technical Institute-Fort Wayne	IN	For-Profit	29.2%
ITT Technical Institute-Indianapolis	IN	For-Profit	29.2%
ITT Technical Institute-Newburgh	IN	For-Profit	29.2%
ITT Technical Institute-Louisville	KY	For-Profit	29.2%
ITT Technical Institute-Saint Rose	LA	For-Profit	29.2%
Pine Manor College	MA	Nonprofit	31.5%
ITT Technical Institute-Eden Prairie	MN	For-Profit	29.2%
ITT Technical Institute-Earth City	MO	For-Profit	29.2%
Missouri Tech	MO	For-Profit	39.1%
ITT Technical Institute-Arnold	MO	For-Profit	29.2%
ITT Technical Institute-Kansas City	MO	For-Profit	29.2%
Rust College	MS	Nonprofit, HBCU	32.0%
South College-Asheville	NC	For-Profit	31.7%
Heritage Bible College	NC	Nonprofit	29.4%
Livingstone College	NC	Nonprofit, HBCU	32.4%
Saint Augustine's University	NC	Nonprofit, HBCU	30.6%
ITT Technical Institute-Omaha	NE	For-Profit	29.2%
ITT Technical Institute-Albuquerque	NM	For-Profit	29.2%
ITT Technical Institute-Henderson	NV	For-Profit	29.2%
Globe Institute of Technology	NY	For-Profit	35.9%
Bryant & Stratton College-Parma	OH	For-Profit	30.3%
Central State University	OH	Public, HBCU	31.2%
Bryant & Stratton College-Cleveland	OH	For-Profit	30.3%
Bryant & Stratton College-Eastlake	OH	For-Profit	30.3%
Bacone College	OK	Nonprofit	32.0%
Langston University	OK	Public, HBCU	32.5%
Oklahoma State University Institute of Technology-Okmulgee	OK	Public	30.5%
ITT Technical Institute-Portland	OR	For-Profit	29.2%
Cheyney University of Pennsylvania	PA	Public, HBCU	28.2%
American University of Puerto Rico	PR	Nonprofit, HSI	31.2%
Caribbean University-Bayamon	PR	Nonprofit, HSI	29.9%
Caribbean University-Carolina	PR	Nonprofit, HSI	29.9%
Pontifical Catholic University of Puerto Rico-Arecibo	PR	Nonprofit, HSI	28.6%
Pontifical Catholic University of Puerto Rico-Ponce	PR	Nonprofit, HSI	28.6%
Inter American University of Puerto Rico-San German	PR	Nonprofit, HSI	28.9%
Inter American University of Puerto Rico-Aguadilla	PR	Nonprofit, HSI	28.9%
Inter American University of Puerto Rico-Arecibo	PR	Nonprofit, HSI	28.9%
Inter American University of Puerto Rico-Barranquitas	PR	Nonprofit, HSI	28.9%
Inter American University of Puerto Rico-Metro	PR	Nonprofit, HSI	28.9%
Inter American University of Puerto Rico-Ponce	PR	Nonprofit, HSI	28.9%

Inter American University of Puerto Rico-Fajardo	PR	Nonprofit, HSI	28.9%
Inter American University of Puerto Rico-Guayama	PR	Nonprofit, HSI	28.9%
Inter American University of Puerto Rico-Bayamon	PR	Nonprofit, HSI	28.9%
Pontifical Catholic University of Puerto Rico-Mayaguez	PR	Nonprofit, HSI	28.6%
Caribbean University-Ponce	PR	Nonprofit, HSI	29.9%
Caribbean University-Vega Baja	PR	Nonprofit, HSI	29.9%
Allen University	SC	Nonprofit, HBCU	35.3%
Benedict College	SC	Nonprofit, HBCU	32.9%
Morris College	SC	Nonprofit, HBCU	28.8%
ITT Technical Institute-Greenville	SC	For-Profit	29.2%
ITT Technical Institute-Nashville	TN	For-Profit	29.2%
ITT Technical Institute-Knoxville	TN	For-Profit	29.2%
ITT Technical Institute-Cordova	TN	For-Profit	29.2%
Jarvis Christian College	TX	Nonprofit, HBCU	50.6%
Southwestern Christian College	TX	Nonprofit, HBCU	32.7%
Texas College	TX	Nonprofit, HBCU	34.6%
ITT Technical Institute-Murray	UT	For-Profit	29.2%
Stevens-Henager College-Ogden	UT	For-Profit	34.1%
Stevens-Henager College of Business-Provo	UT	For-Profit	34.1%
Stevens-Henager College-Murray	UT	For-Profit	34.1%
Stevens-Henager College-Logan	UT	For-Profit	34.1%
Bryant & Stratton College-Virginia Beach	VA	For-Profit	30.3%
Bryant & Stratton College-Richmond	VA	For-Profit	30.3%
Centura College-Virginia Beach	VA	For-Profit	32.0%
Sanford-Brown College-Vienna	VA	For-Profit	31.6%
ITT Technical Institute-Norfolk	VA	For-Profit	29.2%
ITT Technical Institute-Richmond	VA	For-Profit	29.2%
ITT Technical Institute-Springfield	VA	For-Profit	29.2%
ITT Technical Institute-Chantilly	VA	For-Profit	29.2%
Potomac College-Herndon	VA	For-Profit	32.8%
ITT Technical Institute-Greenfield	WI	For-Profit	29.2%
Bryant & Stratton College-Milwaukee	WI	For-Profit	30.3%
ITT Technical Institute-Green Bay	WI	For-Profit	29.2%
Bryant & Stratton College-Wauwatosa	WI	For-Profit	30.3%

Notes: Colleges must have at least 30 students in the 2010 cohort entering repayment to be considered falling in the bottom 5 percent of cohort default rates.

Source: FY2010 Default Data from Federal Student Aid, U.S. Department of Education.

ENDNOTES

1. Bhashkar Mazumder, "Upward Intergenerational Economic Mobility in the United States" (Washington, D.C.: Economic Mobility Project, Pew Charitable Trusts, 2008); Ron Haskins, Harry Holzer and Robert Lerman, "Promoting Economic Mobility by Increasing Postsecondary Education" (Washington, D.C.: Economic Mobility Project, Pew Charitable Trusts, 2009). According to the Economic Mobility Project at Pew Charitable Trusts, those who have finished four years of college see no racial gap in economic mobility: Both whites and blacks in this group experience very high rates of upward mobility. A follow-up report also found that poor children are four times more likely to become rich if they attain a four-year college degree than they are if they don't earn a bachelor's.
2. Undergraduate enrollment trends from 1960 to 2012 can be found at: U.S. Department of Education, National Center for Education Statistics, "The Digest of Education Statistics 2013," Tables 302.20 and 302.30 (Washington D.C.: 2013). Postsecondary expectations of 12th-graders from 1981 to 2004 can be found at: U.S. Department of Education, National Center for Education Statistics, "The Condition of Education 2006," Indicator 23 (Washington, D.C.: 2006).
3. Organisation for Economic Co-operation and Development, "Education at a Glance 2013," Chart A4.2 (Paris: Organisation for Economic Co-operation and Development, 2013).
4. Education Trust analysis of "Beginning Postsecondary Students Study (BPS), 2003-04" (Washington, D.C.: U.S. Department of Education, National Center for Education Statistics), http://nces.ed.gov/surveys/bps/.
5. Donghoon Lee, "Household Debt and Credit: Student Debt" (New York: Federal Reserve Bank of New York, February 2013). According to the Federal Reserve Bank of New York, total student loan balances almost tripled between 2004 and 2012, with nearly one-third of borrowers in repayment delinquent on student debt. The higher burden of student loans and higher delinquencies may affect borrowers' access to other types of credit (auto, credit, mortgage) and the performance of other debt.
6. U.S. Department of Education, National Center for Education Statistics, "Enrollment in Postsecondary Institutions, Fall 2012; Financial Statistics, Fiscal Year 2012; and Graduation Rates, Selected Cohorts, 2004-2009, First Look," Table 3 (Washington, D.C.: U.S. Government Printing Office, December 2013); College Board, "Trends in Student Aid 2013: Median Debt Levels of 2007-08 Bachelor's Degree Recipients by Income Level," Figure 2010_9 (New York: College Board, 2013); College Board, "Who Borrows Most? Bachelor's Degree Recipients with High Levels of Student Debt," Table 5 (New York: College Board, 2010).
7. Organisation for Economic Co-operation and Development, "Education at a Glance 2013" (Paris: Organisation for Economic Co-operation and Development, 2013).
8. Dennis P. Jones, "Outcomes-Based Funding: The Wave of Implementation" (Washington, D.C.: Complete College America and National Center for Higher Education Management Systems, October 2013). Currently, 33 states are part of the Complete College America Alliance of States. To become a member, a state's governor, in partnership with its colleges and universities, pledges to make college completion a top priority and commits to: 1) establish annual state and campus-specific completion goals through 2020; 2) collect and report common measures of progress; and 3) develop action plans and move key policy levers.
9. Joseph Yeado, Kati Haycock, Rob Johnstone, and Priyadarshini Chaplot, "Learning From High-Performing and Fast-Gaining Institutions" (Washington, D.C.: The Education Trust, January 2014).
10. Mass Insight Education, "State Education Agencies — Creating Proof Points and Scaling Results" (Washington, D.C.: Mass Insight Education, June 2012); *Strengthening America's Schools Act of 2013* bill summary. For example, the State Fiscal Stabilization Fund within *The American Recovery and Reinvestment Act of 2009*, the School Improvement Grant, and 2009 Race to the Top required grantees to focus on the persistently low-achieving schools — the bottom 5 percent — as a condition to receive federal dollars. More recently, both the waiver application granting states flexibility from the Elementary and Secondary Education Act's (ESEA) accountability provisions and the Senate ESEA reauthorization bill required states to identify and support "priority schools," those that had been identified as the lowest achieving 5 percent of each Title I elementary and secondary schools in the state.
11. Calculation includes first-time, returning, full-time, and part-time students attending the colleges that fall in the bottom 5 percent on graduation rates and student loan default rates. Student loan default rates were chosen as a proxy for those institutions that might underperform on a loan repayment metric, for which institution-level data is not available.
12. Education Trust analysis of Integrated Postsecondary Education Data System (IPEDS) and FY2010 three-year cohort default rate, 2011 (Washington, D.C.: U.S. Department of Education, National Center for Education Statistics), http://nces.ed.gov/ipeds/.
13. Education Trust analysis of Integrated Postsecondary Education Data System (IPEDS), Graduation rate data, 2011 (Washington, D.C.: U.S. Department of Education Statistics, National Center for Education Statistics), http://nces.ed.gov/ipeds/.
14. Education Trust analysis of Integrated Postsecondary Education Data System (IPEDS), Graduation rate, net price and average student loan data for 2010 freshman class, 2011 (Washington, D.C.: U.S. Department of Education Statistics, National Center for Education Statistics), http://nces.ed.gov/ipeds/.
15. Mary Nguyen, "Degreeless in Debt: What Happens to Borrowers Who Drop Out" (Washington, D.C.: Education Sector, 2012).
16. William G. Bowen, Matthew M. Chingos and Michael S. McPherson, *Crossing the Finish Line: Completing College at America's Public Universities* (Princeton, New Jersey: Princeton University Press, 2009). According to *Crossing the Finish Line*, among highly qualified students eligible to attend a highly selective college, more than 40 percent "under match": 30 percent enroll at a less selective college, 1 percent enroll at an HBCU, 3 percent enroll at a two-year college, and 9 percent do not go to college at all, according to National Student Clearinghouse data.
17. Bowen et al., *Crossing the Finish Line*.
18. Sandy Baum, Jennifer Ma, and Kathleen Payea, "Education Pays 2013: The Benefits of Higher Education for Individuals and Society," Figure 1.1: Median Earnings and Tax Payments of Full-Time Year-Round Workers Ages 25 and Older by Educational Level, 2011 (Washington D.C.: College Board, 2013).
19. Education Trust, "The Access to Success Initiative Technical Appendix in Replenishing Opportunity in America: The 2012 Midterm Report of Public Higher Education Systems" (Washington, D.C.: Education Trust, 2012). The Education Trust and its Access to Success Initiative have used Pell receipt as an indicator of income status because of its close reflection to the national proportion of first-time, full-time students who come from families with incomes below $50,000, the approximate income eligibility threshold for Pell Grants. Using the 2012 National Postsecondary Student Aid Survey, we find that the percentage of four-year, college-entering students with Pell Grants (42 percent) was the same as the percentage of students with incomes below $50,000 — approximately 40 percent. It is also the only income measure that is widely available across institutions, systems, and states.
20. Education Trust analysis of National Postsecondary Student Aid Study (NPSAS), 2011-12 (Washington, D.C.: U.S. Department of Education, National Center for Education Statistics), http://nces.ed.gov/surveys/npsas/. Over 90 percent of Pell Grant recipients come from families with incomes of $50,000 or less, the bottom 40 percent of the national income distribution. In fact, many Pell recipients are extremely low-income. One-quarter come from families with incomes of $6,000 or less.
21. Education Trust analysis of ACT data, 2011-13 (Iowa City, Iowa: ACT, Inc.); Bowen et al., *Crossing the Finish Line*.
22. U.S. Department of Education, National Center for Education Statistics, Integrated Postsecondary Education Data System (IPEDS), Endowment assets, 2011-12 (Washington, D.C.: U.S. Department of Education, National Center for Education Statistics). According to 2012 IPEDS data, U.Va.'s FY2012 endowment assets were valued at $4.7 billion, compared

with $2.2 billion at UNC-Chapel Hill and $62 million at Binghamton University.

23. Bowen et al., *Crossing the Finish Line*.
24. U.S. Department of Education, Office of Federal Student Aid, 2011 "Gainful Employment Data," https://studentaid.ed.gov/about/data-center/school/ge/data. According to the 2011 Gainful Employment Informational Rates, repayment rates measure the percent of the GE program's former students who are repaying their federal student loans, weighted by the original outstanding principal loan balances. Students would be considered repaying their loans if they reduced the principal balance by at least one dollar in the most recently completed fiscal year.
25. Education Trust analysis of National Postsecondary Student Aid Study, 2011-12 (Washington, D.C.: U.S. Department of Education, National Center for Education Statistics), http://nces.ed.gov/surveys/npsas/. National Postsecondary Student Aid Study 2011-12 indicates that 62 percent of students who received federal student loans also received Pell Grants.
26. Yeado et al., "Learning From High-Performing and Fast-Gaining Institutions."
27. Yeado et al., "Learning From High-Performing and Fast-Gaining Institutions."
28. Michael Dannenberg and Mamie Voight, "Doing Away With Debt: Using Existing Resources to Ensure College Affordability for Low and Middle-Income Families" (Washington, D.C.: The Education Trust, February 2013); Daniel J. Hurley, Thomas L. Harnisch, and Barmak Nassirian, "A Proposed Federal Matching Program to Stop the Privatization of Public Higher Education" (Washington, D.C.: American Association of State Colleges and Universities, January 2014); Elizabeth Baylor and David A. Bergeron, "Public College Quality Compact for Students and Taxpayers" (Washington, D.C.: Center for American Progress, 2014). President Barack Obama has repeatedly called for a shared responsibility between states and higher education institutions — working with the federal government — to promote access, affordability, and attainment in higher education.
29. Regulations already permit an institution to use funds received under Pell, ACG, SMART, TEACH, a campus-based program, or direct loans, or to request additional funds from the secretary of education if the institution does not possess sufficient funds or if the commitment to the student was made before the end of the participation in the Title IV program. See 34 CFR 668.26. If an institution closes before all students have completed their programs, a teach-out plan must be submitted to the department that provides for the equitable treatment of students. The plan may also include a teach-out agreement between institutions. See 34 CFR 602.24(c).

ABOUT THE EDUCATION TRUST

The Education Trust promotes high academic achievement for all students at all levels — pre-kindergarten through college. We work alongside parents, educators, and community and business leaders across the country in transforming schools and colleges into institutions that serve all students well. Lessons learned in these efforts, together with unflinching data analyses, shape our state and national policy agendas. Our goal is to close the gaps in opportunity and achievement that consign far too many young people — especially those who are black, Latino, American Indian, or from low-income families — to lives on the margins of the American mainstream.

ACKNOWLEDGEMENTS

The Education Trust is grateful to the Bill & Melinda Gates Foundation and Lumina Foundation for providing support for the development of this publication. The views expressed herein are those of the authors and do not necessarily represent those of the foundations, their officers, or employees.

The Education Trust

1250 H STREET, NW, SUITE 700, WASHINGTON, D.C. 20005
P 202-293-1217 F 202-293-2605 WWW.EDTRUST.ORG

Tax-Exempt Borrowing at Postsecondary Institutions: How Reforming Tax-Exempt Bonds Can Improve Student Outcomes and Save the Government Money

By

Rory O'Sullivan and Portia Boone

May 2014

YOUNG INVINCIBLES
together, invincible

Acknowledgements

This project would not have been possible without the generous support of the Bill and Melinda Gates Foundation. The authors would also like to thank Steve Holt and Reid Setzer for their comments, edits, and support throughout the project. We are grateful for the valuable contributions of Nicholas Kelly and his preliminary research on this topic. Finally, we appreciate the excellent work of Julian Aldana, Jessica Adair, RaeAnn Roca-Pickett, Colin Seeberger, and Katherine Schaller for their help with graphic design and distribution.

Introduction

Postsecondary credentials lead to higher incomes, better health,[1] and intergenerational mobility as well as social benefits such as a more productive workforce,[2] and greater economic growth.[3] The federal government rightly invests in students and institutions in a variety of ways. In times of tight budgets however, it is critical that we make every dollar count. One area of higher education finance ripe for reform is tax-exempt borrowing available to many postsecondary institutions.

The IRS normally taxes the interest payments made to investors in bonds, but excludes the interest payments on tax-exempt bonds from the gross income of bondholders. This benefit attracts a number of investors to the higher education bond market and allows many colleges and universities to borrow money at discounted rates. Subsidies come in the form of governmental bonds for public schools and 501(c)(3) qualified private activity bonds for private nonprofit institutions.

Tax-exempt bonds, however, have serious and well-documented shortcomings. The interest subsidies are difficult to target, allowing high-income investors to capture significant windfalls intended for educational institutions. Only a fraction of every dollar spent makes its way to the beneficiaries. Moreover, qualifying higher education institutions can receive subsidized borrowing regardless of how well they serve their students.

While eliminating tax-exempt borrowing for postsecondary institutions is a direct means of lowering government costs and eliminating the windfall for wealthy investors, adopting such a measure without providing a realistic alternative would present a number of challenges. Such a change could increase borrowing costs for schools and exacerbate resource disparities between schools of varying levels of selectivity. Recently, the federal government has experimented with improved approaches to bond subsidies, including the use of tax-credit bonds. We propose a similar approach here:

• Replace tax-exempt bonds for postsecondary institutions with redesigned direct pay tax-credit bonds
• Eliminate subsidies entirely to low performing institutions
• Redirect government savings into the Federal Pell Grant Program

This solution would allow institutions to retain access to reduced borrowing costs while eliminating unnecessary federal spending on tax exemptions for high-income investors. Further, it would avoid subsidizing schools that fail to adequately serve their students. In both cases, savings would go toward Pell Grants, a much more direct means of increasing college access and success.

We begin the paper by providing an overview of tax-exempt borrowing in higher education, examining its impact at colleges and universities. Next, we summarize the well-known critiques of tax-exempt borrowing. The final portion of this paper highlights various options for reform including eliminating the tax exemption for bonds issued by public universities and private nonprofit institutions, establishing more defined guidelines for the use of bond proceeds, and replacing tax exemption with a more efficient tax-credit system. We conclude by proposing that subsidized borrowing should only be extended to schools that meet basic metrics in the areas of access, affordability, and completion.

Tax-Exempt Borrowing in the Field of Higher Education - The Need for Reform

Key Terms
Bond: A type of debt instrument similar to an IOU. Governments, municipalities, and corporations issue bonds to raise money from investors willing to lend them money for a set amount of time. Issuers--the governments, municipalities, and corporations borrowing money--promise to pay investors a specified rate of interest over the life of the bond. Issuers also repay the principal, or face value of the bond, when the bond "matures" (reaches the date on which the issuer agreed to repay the bond in full).[1]
Issue: Describes both the process of offering securities such as stocks and bonds to raise funds and the set of financial instruments (stocks, bonds, etc.) released into the market in a single offering.[4]
Issuer: The legal entity that develops and sells securities (ex. notes, debentures, stocks, and bonds) to provide revenue for its operations.[5] Governments, municipalities, and corporations all function as issuers of bonds.

Conduit Borrowers: Entities such as private nonprofit colleges and hospitals that borrow using government issued bonds are called "conduit" borrowers. Although state and local governments technically issue the bonds, conduit borrowers generally agree to repay the issuer, who in turn makes the interest and principal payments to investors. The issuer is usually not required to pay bondholders in the event that the conduit borrower fails to make payments.[6]	
Education bonds: In this paper, the term "education bonds" encompasses the tax-exempt borrowing available to public and private postsecondary institutions in the form of governmental bonds and 501(c)(3) qualified private activity bonds respectively.	
Taxable bond: Taxable bonds are debt instruments in which the investor must pay taxes on the returns (i.e. interest payments) he or she receives from holding the bond. An investor's return may be subject to taxes at the local, state, or federal level (at each individual level or in combination). Most bonds issued are taxable bonds.[7]	
Tax-exempt bond: Tax-exempt bonds are bonds in which the income produced (i.e. interest payments to investors) is excluded from the investor's gross income for federal tax purposes,[8] making such earnings exempt from federal income tax.[9]	
Marginal tax rate: Marginal tax rate is the amount of tax paid on an additional dollar of income. Marginal tax rates rise as income rises, because the federal government taxes high earners at greater rates than low-income earners.[10]	
Coupon rate: A bond's coupon rate (i.e. interest rate) is the amount the bondholder will receive in the form of interest payments. Investors calculate a bond's coupon as a percentage of the bond's face value. For example, an investor who purchases a bond with a face value of $1,000 and a 10% coupon will receive a total of $100 in interest payments per year.[11]	
Market clearing price: The price at which consumers purchase 100% of the products producers take to market, with nothing left over.[12] For purposes of this paper, the market clearing price is the price for bonds at which issuers can sell all of the bonds they issue.	
Market clearing buyer: The market clearing buyer is the purchaser of the last remaining bond in an issue where bonds supplied equal bonds demanded. Issuers set the interest rate on tax-exempt bonds at the rate that will equalize the supply and demand for tax-exempt bonds. To be motivated to purchase tax-exempt bonds, investors need a return that is equal to or higher than the after-tax yield (return) they could obtain from comparable taxable bonds. In essence, they need to be able to make just as much, if not more, money from investing in tax-exempt bonds as they would from investing in taxable bonds to make the purchase worthwhile. Therefore, the interest rate on tax-exempt bonds and the amount by which tax-exempt borrowing lowers the cost of borrowing for colleges and universities depends on the marginal tax rate of the market clearing buyer.[13]	
Capital Projects: Capital projects are relatively large-scale initiatives, which require the use of significant amounts of financial and human capital to complete.[14] Examples include infrastructure projects such as roads, dams, and machinery maintenance[15] as well as the building of concert halls, academic buildings, athletic centers, and the upkeep of dormitories.[16]	

How Education Bonds Work

THE FEDERAL GOVERNMENT

The federal government exempts the interest earned from holding certain bonds, such as education bonds, from taxes.

INVESTORS

Investors seek to purchase tax-exempt education bonds because the return on these bonds is equal to or higher than the return on comparable taxable bonds.

STATE AND LOCAL GOVERNMENTS

State and local governments finance higher education by issuing tax-exempt bonds for use by postsecondary institutions. Bonds issued by state and local governments on behalf of *public* institutions are called governmental bonds. Bonds issued by state and local governments on behalf of *private* nonprofit institutions for tax-exempt purposes are called qualified private activity bonds.

INVESTORS

Investors purchase the bonds "issued" by the schools (in many instances, issued by state and local governments on behalf of schools). When investors purchase education bonds, they are loaning money to postsecondary institutions, money that schools pay back to investors along with regular interest payments.

POSTSECONDARY INSTITUTIONS AND STUDENTS

Although state and local governments formally issue the bonds, postsecondary institutions function as "conduit borrowers." Postsecondary institutions, rather than state and local governments, are responsible for making regular interest payments to investors.

Postsecondary institutions use the money investors loan them (i.e. the proceeds from the sale of education bonds) to fund capital projects such as the construction and renovation of dormitories and sports facilities.

Overview

Postsecondary institutions enjoy a number of benefits including exemption from federal income tax, the ability to receive contributions that donors may later deduct from their taxable income, and the ability to fund capital projects through tax-exempt debt.[17] State governments and local governments issued approximately $290 billion in tax-exempt bonds in 2007, a dramatic increase over the $100 billion dollars in tax-exempt bonds issued in 1990.[18] The bonds come in two forms--governmental bonds and qualified private activity bonds. The former comprised approximately seventy percent of the bonds issued in 2007, and the latter nearly thirty percent.[19]

Governmental bonds are issued by state and local governments to finance public functions such as highways and schools.[20] Bonds that the government repays using government funds also qualify as governmental bonds.[21] As institutions operated by the state, public colleges and universities may use governmental bonds to finance their operations, including renovation and construction projects.[22] Public institutions access tax-exempt borrowing through municipal or publicly sold debt[23] in the form of revenue bonds and general obligation bonds.[24] The proceeds from a specific project or undertaking (ex. highway tolls or lease fees) secure revenue bonds.[25] However, the issuers of general obligation bonds secure these bonds with the "full faith and credit" of the state, city, or government entity issuing the bond.[26] This means that the state, city, or government entity issuing general obligation bonds can levy taxes to repay the bond if necessary.[27]

Private nonprofit institutions access tax-exempt borrowing through qualified 501(c)(3) private-activity bonds.[28] State and local governments issue these bonds on behalf of "non governmental persons," a term which includes 501(c)(3) organizations.[29] The IRS only considers private activity bonds as "qualified" and eligible for tax-exempt interest payments if issuers use the bonds for specified purposes in accordance with the requirements of the Internal Revenue Code.[30] Qualified private activity bonds include exempt facility bonds, qualified mortgage bonds, and, most relevant here, the qualified 501(c)(3) bonds available to private nonprofit colleges and universities.[31] Institutions must use tax-exempt qualified 501(c)(3) bond proceeds to finance property owned by the 501(c)(3) or a governmental unit.[32] Proceeds must also support the organization's charitable purpose. The capital projects (ex. the building and renovation of dormitories, auditoriums, etc.) that schools finance using qualified 501(c)(3) private activity bonds often qualify as appropriate projects for bond funding under the code.[33] The 501(c)(3) must own all development financed by the bond issue and devote no more than five percent of the net proceeds of the bonds towards private business use.[34] The tax-exempt bonds sold by nonprofit schools can be sold publicly or sold to institutional investors, mutual funds, and individuals through underwriters or placement agents.[35]

Distinctions	Governmental Bonds	501(c)(3) QPABs
Who issues these bonds?	**State and local governments, and in some cases public colleges and universities.** States vary in the amount of freedom they allow public colleges and universities to issue debt.[36] While some states give public institutions the legal authority to issue bonds directly, a number of states require public institutions to issue bonds through some type of governmental agency (usually a state or local government agency). Private nonprofit colleges and universities borrow through a similar process).[37]	**State and local governments.** Private institutions cannot issue bonds directly.[38] Nonprofit private institutions must use separate public entities (i.e. conduit issuers) to issue bonds because, with limited exceptions, the Internal Revenue Code only allows public entities to issue tax-exempt bonds.[39] Conduit issuers include entities like the California Municipal Finance Authority[40] and Virginia College Building Authority.[41] When a governmental agency serves as a conduit issuer, it does not implicate its own full faith and credit or that of the state or political subdivision of which it is a part.[42]
Are these bonds tax-exempt?	**Yes**	**Yes**
What entities can use these bonds?	**States and local governments use governmental bonds to finance facilities that are owned, controlled, or operated by those governments.** Public postsecondary institutions, as government entities directly controlled by state governments, also have access to governmental bonds.[43]	**501(c)(3) organizations, such as private nonprofit institutions, using the proceeds of the bond for a permitted use.**[44]

Financial Impact of Tax-exempt Education Bonds

The Joint Committee on Taxation (JCT) found that the cost of allowing postsecondary institutions to borrow using tax-exempt debt, measured in terms of foregone revenue, was approximately $5.5 billion in 2010.[45] In a 2013 report, the JCT estimated that these bonds will cost the federal government approximately $18.2 billion between 2013 and 2017.[46]

According to Bond Buyer, higher education bond sales reached $27.22 billion in 2012.[47]

This includes all bonds sold by and for colleges and universities—those issued by private nonprofit, for-profit and public schools themselves as well as bonds issued by state and local conduit authorities and direct issuers.

As for bonds issued by postsecondary institutions, in 2011 colleges and universities issued $8.72 billion in bonds over 167 issues, down 39.7% in total dollar volume from 2010.[48] The National Association of College and University Business Officers estimates that the tax-exempt status of these bonds generates savings to schools of $415,000 for every $1,000,000 borrowed over the course of a 30-year term.[49] These savings result from the lower interest rates that issuers pay out on tax-exempt bonds. The money colleges and universities save as a result of issuing tax-exempt debt is essentially an expenditure for the federal government in the form of foregone revenue.[50]

While sector-wide information on the types of colleges and universities that use qualified tax-exempt 501(c)(3) bonds is limited, a review of the financial statements of various schools shows that a number of schools use these bonds. Users vary in size, selectivity, and enrollment size. However, the financial statements show that the proceeds of these bonds generally go towards funding capital projects and to refinance or refund prior bond issues.

Examples of Colleges and Universities Using Tax-Exempt Bonds

Institution	Public vs. Private	Endowment	Conduit Issuer	Bond Revenue Expenditure	Examples of Capital Projects at Selected School
Cornell University	Private	$4,946,953,425[51]	Ex. In 2006-2007, the Dormitory Authority of the State of New York (DASNY) issued $250 million of tax-exempt revenue bonds on behalf of Cornell University for refunding purposes and to facilitate a number of construction, renovation, and maintenance projects.[52]	Improvements to facilities and capital projects, Project costs, capitalized interest, bond issuance costs, and to refinance debt swap termination payments.[53]	Big Red Marching Band Practice Facility, Bradfield Hall Building systems upgrade, Klarman Hall (Humanities Building), Law School Expansion Phase-I, Network Connectivity Program, among others.[54]

[1] Estimates obtained from a 2010 Congressional Budget Office Report on Tax Arbitrage by Colleges Universities. The report did not state whether the 1990 estimate was adjusted for inflation. *See* Congressional Budget Office, *Tax Arbitrage by Colleges and Universities* (Washington, DC: 2010), 3, http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/112xx/doc11226/04-30-taxarbitrage.pdf.

Farleigh-Dickinson University	Private	$34,904,073[55]	Ex. The New Jersey Educational Facilities Authority issued bonds worth $51,925,000 on behalf of Farleigh Dickinson University in 2014.[56]	Capital Projects and Facilities[57]	Renovations to the Kron Administration Building to enhance admissions and bursarial services; creation of a pedestrian thoroughfare in Teaneck; Renovations to science laboratories, the science building, and the library on the Florham-Madison Campus, among others.[58]
Virginia Commonwealth University	Public	$438,139,742[59]	Ex. In 2005, the Virginia College Building Authority (VCBA) sold $115.9 million of its Educational Facilities Revenue Bonds, Series 2005A. VCBA sold the proceeds of the bonds to purchase institutional notes from eight higher education institutions, including Virginia Commonwealth University (VCU). VCU used the proceeds of the notes to finance capital projects.[60]	Capital Projects.[61]	A variety of projects including the construction of residence halls, parking decks, and student recreational facilities.[62] Examples include construction of the Grace Street Parking Decks, Grace Street Housing, and site preparation for the School of Medicine.[63]

Harvard University	Private	$30,745,534,000[64]	Ex. The Massachusetts Development Finance Agency sold $601 million of tax-exempt bonds on behalf of Harvard University in 2010.[65]	Redemptions, refinancings and the funding of various capital projects and acquisitions.[66]	Renovation of Harvard Art Museums, 32 Quincy Street Renovation, Science Center plaza project to create a unique common space at the center of the campus.[67]
University of Iowa	Public	$981,104,000[68]	Ex. The University of Iowa Facilities Corporation ("the Corporation") is a nonprofit corporation of the State of Iowa with the authority to borrow money and issue bonds for purposes that benefit the state and the University of Iowa.[69] In 2012, the Corporation issued $12,555,000 of tax-exempt revenue bonds on behalf of the University of Iowa.[70]	Construction of facilities, refunding of the outstanding principal of prior bond issuances.[71]	Roy J. and Lucille A. Carver Biomedical Research Building Project, [72] refunding the outstanding principal of the Board's Utility System Revenue Bonds, S.U.I. 2002 and pay the costs of issuing the bonds.[73] (Note: Here, the term "Board" refers to the Board of Regents, State of Iowa, the governing body for Iowa's public universities.[74])

Uses of Proceeds from Tax-Exempt Bonds Issued on Behalf of Colleges and Universities in Nine States, 2003		
	Number of Issues	**Percentage of Issues**
Construction and/or Expansion of Buildings		
- Academic buildings	42	40
- Residence halls	34	32
- Student centers	8	8
- Athletic facilities	11	11
Equipment	10	10
Maintenance/Safety	45	43
Total	105	N/A

Source: Congressional Budget Office based on data provided by issuing authorities in nine states. Included in Tax Arbitrage by Colleges and Universities, April 2010, http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/112xx/doc11226/04-30-taxarbitrage.pdf

Notes: The number of issues in the various categories adds to more than 105 and the percentage of issues in each category adds to more than 100 percent because many projects span multiple categories.

N/A = Not Applicable

Problems with Tax-Exempt Bonds: Inefficiency, Poor Targeting, and Regressivity

Exempting bond interest from taxation may have begun with good intentions, but suffers from two flaws:

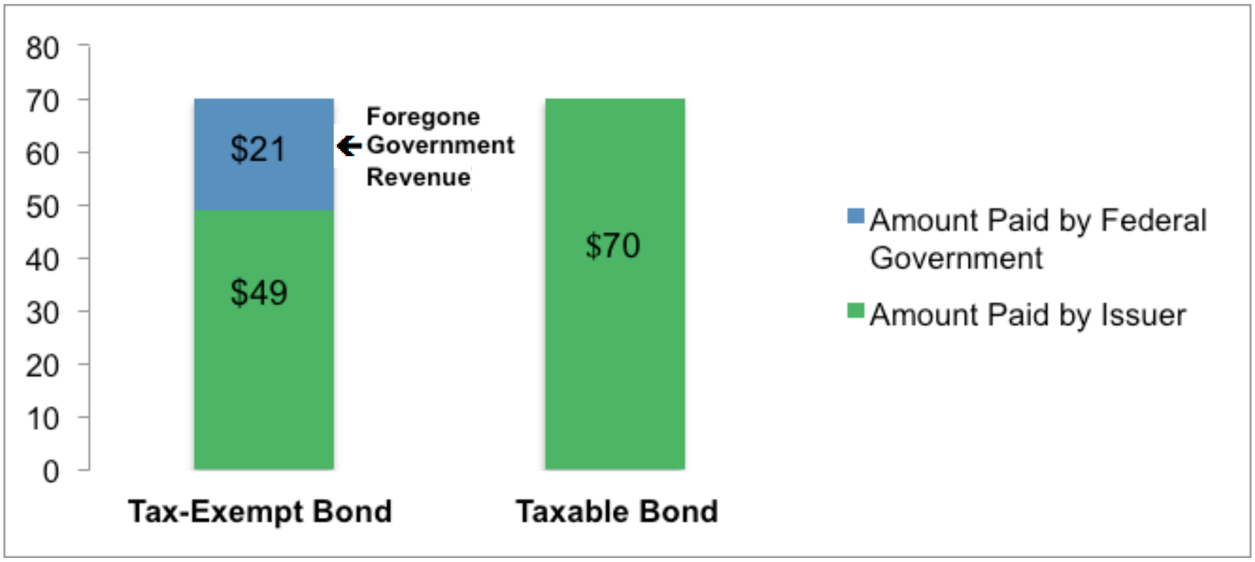
1) **Inefficiency:** Tax-exempt borrowing costs the federal government more than the benefit received by colleges and universities (i.e. the money post-secondary institutions save through issuing tax-exempt bonds)[75]
2) **Poor targeting:** Subsidies go toward high-earners rather than schools and students most in need of aid

1. Inefficient Government Spending

The first type of inefficiency draws from the extra money the government spends per each dollar of aid to schools. Income tax exemption on 501(c)(3) bonds and municipal bonds allows schools to issue bonds with lower interest rates than comparable taxable bonds. However, in a competitive market, the interest an investor receives on a tax-exempt bond will equal the investor's return after taxes on a taxable bond. The investor's return on a taxable bond is equal to the interest paid on the bond minus taxes paid on the interest.[76] The amount of taxes investors pay depends on their marginal tax rate,[77] a rate that is determined by the investor's income.[78]

For example, investors with a marginal tax rate of 30 percent would receive an equal amount of interest income from a $1,000 tax-exempt bond with an interest rate of 4.9 percent or a $1,000 taxable bond paying 7.0 percent before taxes and 4.9 percent after taxes. Both types of bonds have annual interest expenses of 7 percent, or $70 in interest payments to investors.[79] (.07 (7 percent in interest) x $1,000 = $70) In the case of the taxable bond, the issuer pays the full 7 percent ($70). However, in the case of the tax-exempt bond, the school pays the interest rate of 4.9% ($49 in interest payments), while the federal government "pays" the remaining 2.1%, by not collecting the $21 that would have been paid to the government if the 7 percent interest payment was taxed at a marginal tax rate of 30 percent.[80] 0.3 (30% marginal tax rate) x 7 percent interest rate = 2.1 percent of interest payment in foregone taxes. 2.1 percent of a $1,000 bond (0.021 x 1,000) = $21).

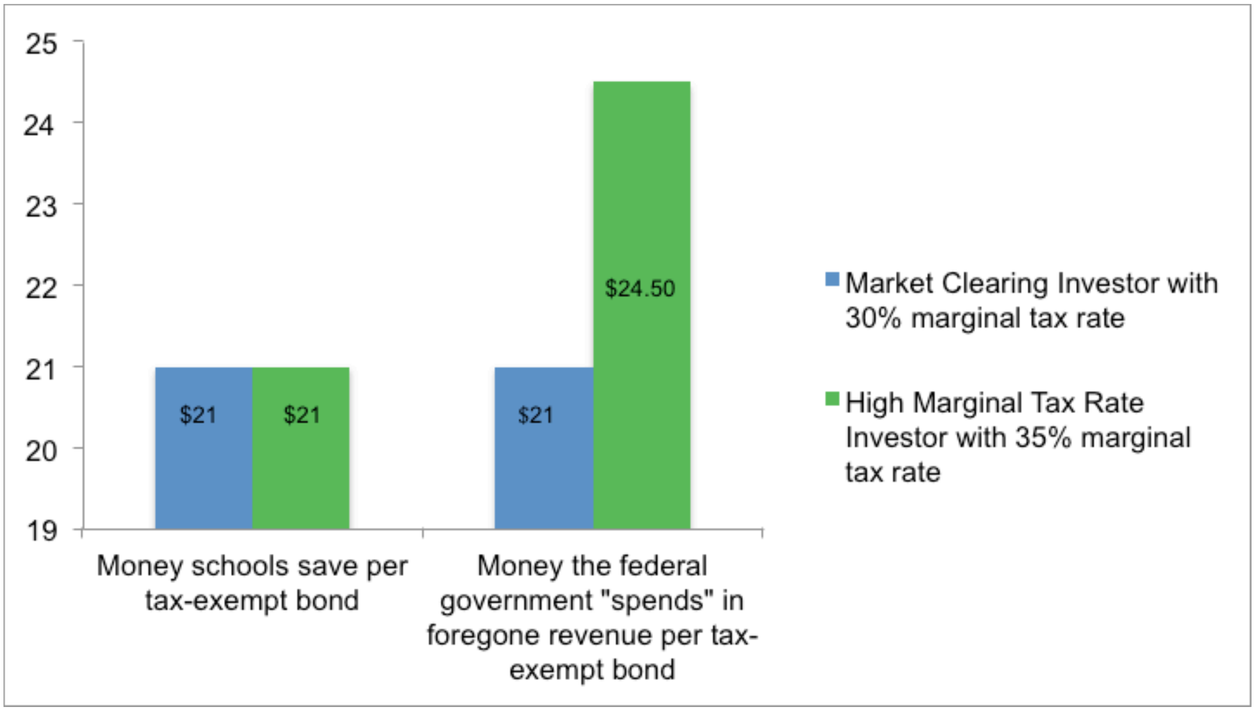
Amount of $70 Interest Payments Paid by Issuers and the Government for a $1,000 Bond with a Coupon (Interest Rate) of 7 Percent



However, the marginal tax rates for investors vary depending on their income. Issuers of tax-exempt bonds set the interest rates on their bonds at a level that will attract the "market clearing" investor, the buyer who would be willing to purchase the last remaining bond of an issue. If the interest rate were set lower than the market clearing rate, the issuer would be unable to sell all of the bonds in the issue; if the interest rate were set higher, the issuer would be paying more than necessary to sell the bonds. The differences between the marginal tax-rate of the market clearing investor and the higher marginal tax rate of wealthier buyers often results in the government spending more in foregone tax on interest than the amount of benefits received by schools in the form of tax exemption.[81]

In the example above, suppose that the market clearing investor had a marginal tax rate of 30 percent. However, most of the purchasers of tax-exempt bonds were in a 35 percent tax bracket. The government would "spend" $24.50 each year by failing to tax the $70 of interest income at the investor's 35 percent rate.[82] However, the total savings in the borrowing costs of colleges and universities would only be $21 (market clearing marginal tax rate of 30 percent x $70 = $21). These differences in tax rates result in the government paying $1.17 ($24.50/$21) for every dollar of tax-exempt assistance to state and local governments for bonds bought by investors in the 35 percent income tax bracket (an excess cost of $0.17 per dollar).[83] The extra costs incurred by the government for each dollar of assistance to state governments, schools, or any other entity with access to tax-exempt borrowing represent a major inefficiency in this system of borrowing. In 2007, the Congressional Budget Office (CBO) analyzed the difference in interest rates between taxable high-grade corporate bonds and tax-exempt municipal bonds of a similar grade. The CBO found that the market clearing investor had a marginal income tax rate of 21 percent[84] compared to the highest marginal income tax rate of 35 percent.[85]

School Savings vs. Government Cost for $1,000 Tax-Exempt Bond by Marginal Tax Rate



2. Regressivity and Poor Targeting

A second problem with tax-exempt borrowing is that it assists high-earners rather than the students who most need assistance or the schools that educate those students.[86] The amount by which the benefits captured by investors exceed the benefit to the issuer (via cost savings) increases as the investor's marginal tax rate increases. Various studies show that only approximately 80 percent of the tax expenditure from tax-exempt bonds benefits state and local governments, while high tax bracket investors capture the remaining 20 percent.[87]

High marginal tax rate investors "capture" this portion of the savings from tax-exempt borrowing because issuers set the interest rates on tax-exempt bonds at rates much higher than the lowest interest rates the wealthiest investors are willing to accept. As previously discussed, issuers set the coupon value (interest rate) for tax-exempt bonds to attract the market clearing investor rather than the wealthiest investors. This means that issuers set interest rates on tax-exempt bonds high enough to ensure that the market clearing investor will earn an amount equal to or higher than what he or she would earn with a comparable taxable bond.[88]

Building off of the examples referenced above, the market clearing investor would receive the same return of $49 by investing in a $1,000 tax-exempt bond with a coupon (interest rate) of 4.9 percent or a taxable bond with a coupon of 7 percent before taxes and

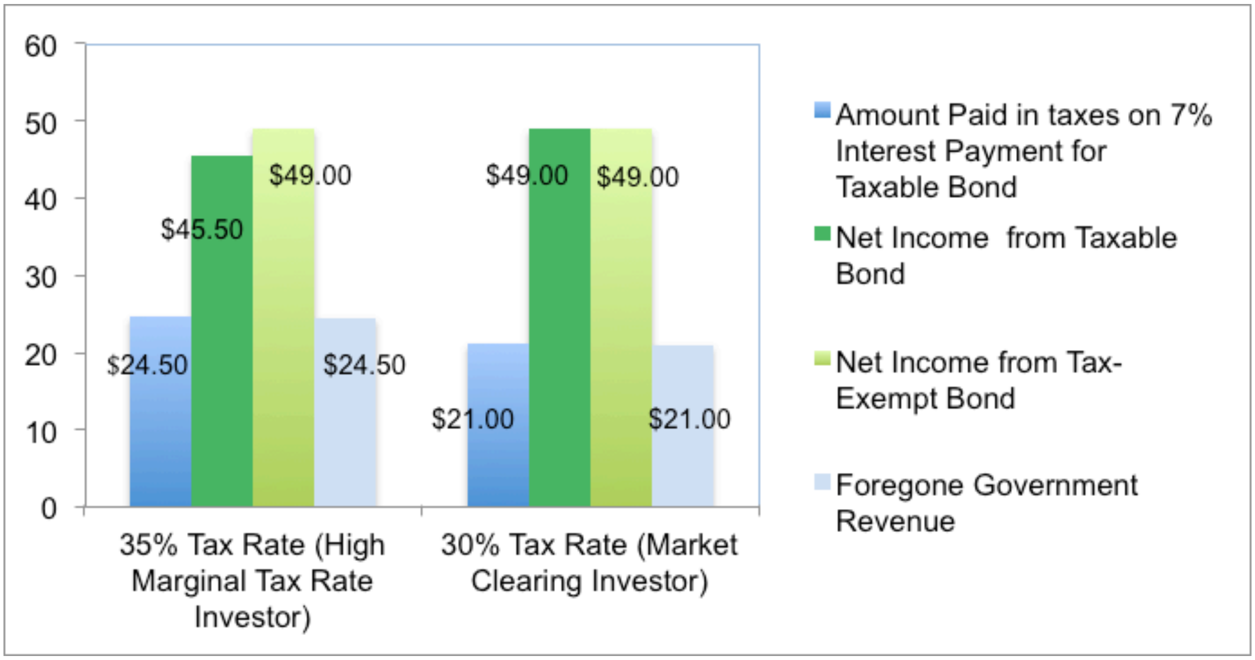
4.9 percent after taxes. Thus, a 4.9 percent return is the lowest interest rate the market clearing investor, with a marginal tax rate of 30 percent, would be willing to accept for a tax-exempt bond. However, high marginal tax rate investors would accept a rate of only 4.55 percent return on a tax-exempt bond, a rate well below the 4.9 percent return that is actually offered.[2]

High marginal tax rate investors would be willing to accept a lower interest rate on tax-exempt bonds because their after-tax return on a taxable bond would be comparatively smaller than that of the market clearing investor. A 7 percent pre-tax return on a $1,000 bond taxed at a 35 percent marginal tax rate for wealthier investors (instead of the 30 percent tax rate for the market clearing investor) would leave that investor with an after-tax return of only 4.55 percent. (0.35 (marginal tax rate) x 7 percent (pre-tax return) = 2.45 percent gone to taxes) (7 percent pre-tax interest minus 2.45 percent in taxes = 4.55 after-tax interest earnings) High marginal tax rate investors receive interest payments of $49 on a $1,000 tax-exempt bond, $3.50 more than the $45.50 they would have received with a comparable $1,000 taxable bond. (0.0455 (4.55 percent after-tax earnings) x 1,000 = 45.50) Thus, wealthy investors in this example "capture" $3.50 in additional interest earnings when investing in tax-exempt bonds.

Type of Investor	Amount Paid in Taxes on 7% Interest for Taxable Bond	Net Income from Taxable Bond	Net Income from Tax-exempt Bond	Foregone Government Revenue
35% Tax Rate (High Marginal Tax Rate Investor)	$24.50	$45.50	$49.00	$24.50
30% Tax Rate (Market Clearing Investor)	$21.00	$49.00	$49.00	$21

2 *See* Jason Van Bergen, "Weighing the Tax Benefits of Municipal Securities," accessed March 12, 2014,
http://www.investopedia.com/articles/04/072804.asp. Before investors purchase a tax-exempt bond, they must determine if the savings from the tax-exempt bond will be enough to make up for the lower yield compared to taxable bonds. As such, the yields on municipal bonds (of which education bonds are a subset) are often measured in terms of the taxable interest rate that would be required to provide the same after-tax interest rate on a taxable bond. The formula for determining the equivalent taxable interest rates for municipal bonds is R(te) = R(tf)/(1 - t). Where R(tf) = the interest rate paid on the tax-free municipal bond, t = the investor's marginal tax rate, and R(te) = the rate of a taxable bond that would deliver the same yield to an investor with a marginal tax rate of "t." If we insert the values from the example of the high marginal tax rate investor (35% marginal tax rate) above into the equation, we see that an interest rate of 4.55 percent on a tax-exempt bond corresponds with an equivalent taxable interest rate of 7 percent. *R(te) = 0.0455 / (1 - 0.35) = 0.07 (7 percent taxable interest rate).*

Income and Foregone Government Revenue for a $1,000 Bond with a 7% Coupon (Rate of Return)



The difficulty of targeting the indirect subsidy that accompanies tax-exempt bonds also limits the government's ability to channel benefits to the students with the greatest need and the postsecondary institutions that satisfy basic accountability metrics. Under the current system, state and local governments make tax-exempt debt available to any qualifying nonprofit college or university regardless of the institution's commitment to admitting low-income students, providing generous financial aid awards, ensuring that students complete college, or assisting them with finding employment when they leave.

Equally important, every dollar that the government spends in benefitting colleges and universities through tax-exempt debt is a dollar that could be used to increase educational access for students. As previously mentioned, many colleges and universities use the proceeds from tax-exempt private activity bonds to fund construction affiliated with capital improvements and to refinance or refund prior bond issues. While these expenditures benefit students indirectly through enabling schools to undertake construction and renovation projects that may enhance student quality of life, they do not assist current and prospective students with addressing one of the greatest barriers to access--paying for college tuition.

Options for Reform

The inefficiencies and extra costs to the government associated with qualified 501(c)(3) bonds and governmental bonds create much room for improvement. The following section provides a number of viable alternatives. These options continue to assist schools without placing an unnecessary burden on federal taxpayers.

Option 1: Removing Tax Exemption for Tax-Exempt Education Bonds and Investing the Government Savings into Pell Grants

One means of addressing the inefficiencies and poor targeting associated with tax-exempt borrowing is to eliminate tax-exempt higher education bonds entirely and invest the savings in the Federal Pell Grant Program. There are several advantages to this approach. Chief among them is a switch in priorities from subsidizing capital investments at universities to making college more affordable for low-income students. Research suggests that a student's level of unmet need is a stronger predictor of a student's likelihood of persisting in school than is percentage of gift aid. Federal grants can help reduce levels of unmet need and increase the persistence of low-income students once they have enrolled in college.[89] Other studies suggest that non-loan aid such as grants and scholarships have a stronger impact on student persistence than loans.[90] These results are promising and suggest that a stronger investment in the Pell Grant Program could lead to higher completion rates for low and moderate-income students. Moving investments in tax expenditures that have no link to student success to Pell Grants that do would be a step forward for students and taxpayers.

Even if schools could no longer issue federal tax-exempt bonds, many could still take advantage of income tax exemptions offered in several states.[3]

State and local governments could continue to offer tax-exempt bonds on behalf of private nonprofit postsecondary institutions, but pay the interest to bondholders out of governmental funds, essentially allowing schools to continue borrowing tax-free. A similar borrowing framework provides tax-exempt financing for professional sports stadiums on behalf of state and local governments.[91] A number of states, including Maryland, New

3 In 1988, the U.S. Supreme Court overturned its former decision in Pollock v. Farmer's Loan Trust Company, a case that held that federal taxation on interest earned from certain state bonds violated the constitutional doctrine of intergovernmental immunity. In South Carolina v. Baker (1988), the Court found that the tax exemption of interest income from state debt obligations is not constitutionally protected, but is dependent upon statute or regulation. Under current law, Congress has the right to tax interest income from state bonds. However, Congress has not chosen to do so to date. *See* Dennis Zimmerman, "Tax-exempt bonds," accessed March 12, 2014, http://www.taxpolicycenter.org/taxtopics/encyclopedia/Tax-exempt-bonds.cfm. Whether or not Baker will retain its status as the authoritative case on this issue remains to be seen. In light of the jurisprudence of the Roberts Court (2005-present) supporting the residual sovereignty of states, it is possible that Baker could be revisited and successfully challenged in future years. (Ex. In National Federation of Independent Business (NFIB) v. Sebelius (2012)), the Supreme Court ruled that the Affordable Care Act's Medicaid expansion was unconstitutionally coercive of states because it gave states inadequate notice for voluntary consent and would potentially cut off all federal Medicaid funds for states that failed to comply. *See* Kaiser Family Foundation, *A Guide to the Supreme Court's Decision on the ACA's Medicaid Expansion* (Menlo Park, CA: 2012), 1, 8, http://kaiserfamilyfoundation.files.wordpress.com/2013/01/8347.pdf.

Jersey, and New York, have implemented programs that offer state-funded grants to private colleges and universities for capital improvements.[92]

However, states may wish to end subsidies for the same reason the federal government should. In that case, colleges and universities may still be able to borrow affordably without the aid of government subsidies. Some institutions have already explored using taxable bonds as an additional source of funding. For example, a number of schools recently issued 100-year bonds that faired well in the marketplace.[93] Institutions such as Ohio State University, the Massachusetts Institute of Technology, and the University of Southern California have raised funds using long-term debt such as century bonds. In February of 2012, the University of California system issued a taxable 100-year bond and experienced so much demand that it raised its initial offer of $500 million to $860 million.[94] Taxable bonds allow schools more flexibility than tax-exempt bonds, which can only be used for nonprofit activities. On the other hand, taxable long-term debt is rare for most institutions and will probably only be accessible to established institutions with the ability to inspire confidence in investors.[95]

While reinvesting government savings into the Pell Grant Program would go far towards encouraging access and completion among low-income students, this policy is not without its challenges.[4] Congress funds the Pell Grant Program through the annual appropriations process.[96] The authority for discretionary spending lies in annual appropriation acts controlled by the House and Senate Budget Committees. A shift to a discretionary spending appropriation would increase Congress's ability to control and target the benefits from tax-exempt borrowing. But appropriations can be reduced, shifted, or cut, meaning that

4 Note on additional potential effects of eliminating tax exempt borrowing for schools without providing an alternative form of discounted borrowing: If the federal government chooses to eliminate tax-exempt borrowing for postsecondary institutions, it is possible that public institutions could retain access to discounted borrowing in the form of general obligation bonds. As previously noted, state and local governments can fund the operation of government facilities (including public colleges and universities) by issuing general obligation bonds and revenue bonds. Municipalities secure 501(c)(3) qualified private activity bonds and revenue bonds (the second type of governmental bond available to public institutions) with the revenue generated by the project being funded. However, municipalities do not secure general obligation bonds with the proceeds from any single project. Municipalities secure these bonds with the credit and taxing power of the state or local government itself. As such, general obligation bonds work differently than revenue bonds and QPABS and are fundamentally connected to the concept of state sovereignty.

It is unclear how the Supreme Court would rule concerning the federal government's ability to restrict a state government's freedom to support postsecondary institutions using general obligation bonds. The Court could potentially consider such a restriction an impermissible erosion of state authority. If federal law eliminated tax-exempt borrowing for revenue bonds and QPABS, but allowed states to continue funding postsecondary institutions using general obligation bonds, public institutions would essentially retain a benefit (tax-exempt borrowing) no longer available to private institutions. While a detailed examination of this question falls outside the scope of this paper, it is worth noting that redesigned taxable education bonds would address this concern, allowing continued access to discounted borrowing for public and private institutions.

there is no guarantee that the entirety of the money saved would go towards supporting higher education.

Nevertheless, the additional partial entitlement funding allocated to the Pell Grant Program through the Health Care and Education Reconciliation Act of 2010 ("The Reconciliation Act") is one example of a means of increasing the likelihood that government savings will actually make it to the Pell Grant Program. Similar to the solution proposed here, the Reconciliation Act permanently reduced the cost of federally-backed student loans by eliminating subsidies for private lenders and investing the cost savings in the Pell Grant Program.[97] The Act uses mandatory funding (in lieu of appropriations) to provide a supplemental award for all Pell Grant recipients. Unlike discretionary spending, mandatory spending is governed by statute. Programs funded by mandatory spending receive funds automatically and are not generally funded by annual appropriations.[98] The supplemental award comprises a relatively small percentage of the Pell Grant award, amounting to an estimated $785 of the maximum Pell Grant award of $5,645 for the 2013 to 2014 school year.[99] The government could reallocate the savings from reforming tax-exempt bonds into this stream to bolster the Pell Grant Program.

The elimination of tax exemption for education bonds could also create financial challenges for schools and students. Removing the tax exemption for education bonds would immediately increase borrowing costs for schools as they would be forced to raise their interest rates to compete with the interest levels of comparable taxable bonds. However, the specific amount of this increase in cost will depend on the yield spread (the difference in an investor's rate of return for one bond versus another)[100] between tax-exempt bonds and the new, taxable bonds schools would use after the elimination of the exemption. The elimination of the tax exemption could also lead to a widespread decrease in schools' credit ratings, as the cost of borrowing through bonds would be immediately higher to compensate for the lack of tax benefit. Rate decreases could, in turn, lead to a second increase in borrowing costs as schools compensated investors for riskier lending.

Decreased access to low-cost borrowing could also exacerbate the divergence between institutions with large endowments and wealthy alumni and those without these resources. Moody's rating service predicts a negative credit outlook for the majority of less selective schools. Lower-rated schools and recently-established schools would be particularly impacted by the removal of tax exemption for education bonds because they have less access to the alternative fundraising options available to other schools.[101]

Thirty-nine of the over 3,000 colleges and universities in the United States have endowments exceeding one billion dollars.[102] Public universities or university systems account for eleven of these schools. However, elite public and private universities have the greatest access to the largest endowments and highest amounts of annual giving.[103] Additionally, despite the large endowments of some public institutions and university systems, public universities generally have less access to philanthropic gifts than private institutions and rely more heavily on debt to finance capital projects.[104]

A final challenge to eliminating the tax exemption for education bonds and reinvesting the resources in Pell is the anticipated pushback from many within the higher education community. While this change would increase efficiency and directly aid students, it may prove too politically challenging to implement. As a result, it is worth considering additional avenues for reform.

Option 2: Restricting the Use of the Bonds to the Capital Projects that will Benefit Students Most

An additional option for modifying tax-exempt higher education bonds is through creating more specific guidelines governing bond proceeds. Current law allows schools a wide degree of latitude in using the proceeds from both governmental bonds and 501(c)(3) qualified private activity bonds.[105] Issuers must use the bonds for governmental functions and must limit the proportion of proceeds that go to private businesses.[106] The primary restriction the IRS places on 501(c)(3) organizations is that they use the proceeds of tax-exempt qualified bonds to finance property owned by the 501(c)(3) or a governmental unit. Schools can use bonds to fund the purchase or construction of a number of projects such as classrooms, libraries, laboratories, auditoriums, buses, vans, computers, technology, recreational facilities, and administrative facilities.[107] Schools may also use the proceeds of qualified 501(c)(3) bonds to support their working capital expenditures.[108]

Policymakers could modify these rules to require that the proceeds go towards the renovation of existing academic buildings and the development of new academic capital projects. For example, the Qualified Zone Academy Bond program uses a similar restriction, requiring that at least 95 percent of bond proceeds be used for "rehabilitating or repairing school facilities, providing equipment, developing course materials, or training…school personnel."[109] A similar policy would both ensure that colleges and universities can spend money on capital projects that will enhance the academic experience of students and prevent schools from indiscriminately using debt to finance additional projects and pass on the costs to students.

This option could serve as a means of ensuring that schools do not expend valuable federal resources on unnecessary construction. Such restrictions could also lead to lower levels of debt among the nation's colleges and universities. Debt levels for the over 500 postsecondary institutions rated by Moody's more than doubled from 2000 to 2011.[110] The trend of increasing debt is affecting colleges and universities across the country of all types--both private and public schools, and institutions of varying levels of selectivity.[111]

Moody's noted that colleges and universities had over $200 billion dollars in outstanding debt in 2011.[112] The 224 public universities rated by Moody's had a combined total of $122 billion in outstanding debt in 2011 compared to $53 billion in inflation adjusted debt in 2000.[113] While some schools borrowed money to cover expenses after the financial crisis, most schools borrowed to fund capital projects, which were often undertaken to attract better students[114] and faculty.[115]

In many instances, increases in construction and indebtedness are directly linked to increases in cost of attendance for students and higher student debt levels.[116] Schools make the interest and principal payments for many bonds from the school's general revenue, which is comprised of fees collected from tuition, room and board, state appropriations and a percentage of endowment returns.[117] Students attending smaller colleges with few sources of revenue besides tuition pay for a larger portion of institutional debt than students attending wealthy institutions with diversified sources of funding.[118]

Tighter restrictions on the use of the proceeds from tax-exempt bonds could indirectly decrease tuition by decreasing the number of capital projects completed by schools, thus decreasing the amount of debt schools take out each year. However, greater restrictions on the use of education bonds could also lead to tuition costs that equal or exceed those of today if schools continue to pursue ambitious capital projects that are funded through increases in tuition or special fees.

While debt levels have increased at postsecondary institutions, the amount of resources available to schools has declined sharply. Total cash, pledged gifts, and investments managed by colleges and universities fell by over 40 percent relative to the amount colleges and universities owe.[119] The recession of 2007 to 2009[120] intensified the funding challenges faced by many institutions. Enrollment rates are decreasing at many institutions while revenue from traditional sources such as tuition, state appropriations, and endowment returns remains limited.[121]

While a valuable option for reform, placing restrictions on the usage of the proceeds of tax-exempt financing for schools raises a number of concerns. For example, it is difficult to determine exactly which types of capital expenditures most encourage student access and completion. Student dormitories can increase access by providing housing to students and increasing schools' capacity to accept more students (of course financial capacity is another matter). Academic buildings, laboratories, and lecture halls are surely indispensable to the educational process. Buildings such as student unions and fitness centers may seem unnecessary at first glance, but they may encourage completion by enhancing student quality of life. Schools also need access to resources to ensure that they keep aging buildings safe and in good repair. While some schools issue tax-exempt bonds to fund capital projects with the purpose of attracting better students and faculty, other schools take on debt to finance necessary renovations.[122]

In the following section, we propose a solution that will avoid the difficulties arising from tight restrictions on the proceeds of education bonds. Replacing tax-exempt education bonds with tax credit bonds will allow the government to assist schools more efficiently.

Option 3: Redesigned, Taxable Education Bonds

A final option for reform is to redesign the structure of governmental and qualified 501(c)(3) bonds issued on behalf of public and private nonprofit postsecondary institutions. Redesigned, taxable education bonds structured to work like tax credit bonds would enable the federal government to provide a targeted, direct benefit to schools while eliminating unnecessary government expenditure. The money the government saves by eliminating the tax exemption of interest paid on education bonds should be invested in the Federal Pell Grant Program. This proposal would improve efficiency and limit regressivity while avoiding the pain of eliminating subsidized bonds to post-secondary institutions altogether. As a result, it is our preferred reform.

Tax credit bonds provide a federal tax credit to bondholders in place of tax exemption or a cash interest payment. Bondholders must report the tax credit as income but can later subtract the amount of the tax credit from their total tax due.[123] Although tax credit bonds come in a number of forms, most tax credit bonds provide the holder with a federal tax credit equal to a percentage of the bond's par value (face value) for a set term of years.[124] The tax credit the bond issuer receives is generally set at the current yield on comparable taxable bonds. Issuers of tax credit bonds do not pay interest to bondholders because these interest payments are fully subsidized by the government.[125]

In 2004 the Congressional Budget Office examined various alternatives to the current tax-exempt structure of municipal bonds. The CBO noted that a redesigned tax credit bond in place of current municipal bonds could deliver the same benefit to state and local governments at a lower cost to the federal government. The government would ultimately spend less because carefully crafted tax credit bonds could cost the government less per each dollar of aid to schools.

The redesigned tax credit bonds would consist of two components: A taxable interest payment from the bond issuer (ex. the postsecondary institution) and a taxable tax credit paid to bondholders by the federal government.[126] The federal government would determine the amount of the tax credit and ensure that the combined total of the federal tax credit and payment from the school to the bondholders would equal the interest income on a similar taxable bond.[127] The federal government would also have to structure the tax-credit in such a way that the interest costs to state and local governments would equal the cost they would have borne if the bonds had been issued as tax-exempt debt.

The money the government would save for each dollar of aid to postsecondary institutions by using a redesigned education bond should be invested into the Federal Pell Grant Program. (Ex. $0.17 in the example below, the difference between the cost to the government per dollar of tax-exempt aid to schools funded by high marginal tax rate investors ($1.17) minus the cost to the government for each dollar of aid provided to schools using a tax-credit system ($1.00) could be reinvested into the Federal Pell Grant Program).

Redesigned Education Bonds in Practice

Traditional Tax-Exempt Borrowing……..

Market Clearing Interest Rate: 30% (This is the marginal tax rate of the investor who would purchase the last remaining bond in an issue of tax-exempt bonds)

Price of Bond: $1,000

Tax-Exempt Bond and Taxable Bond Equilibrium Point: Investors with a marginal tax rate of 30 percent would be willing to purchase either:

1) A $1,000 tax-exempt municipal bond with an interest rate of 4.9 percent (on which no federal taxes would be paid); OR

2) A $1,000 taxable bond paying 7 percent before taxes and 4.9 percent after taxes

> Note: 30 percent of the 7 percent return, or 2.1 percent ($21 = 2.1% of $1,000), is paid in taxes.
>
> Note: 7 percent return - 2.1 percent = 4.9 after-tax interest return to bondholder, which equals the rate of return on the tax-exempt bond.

Reduction in the Borrowing Costs of Schools: $21 per bond issued, the amount of taxes the market clearing investor would have had to pay on the $1,000 taxable bond paying 7 percent at a 30 percent marginal tax rate. The interest on tax-exempt bonds is set at the rate of the market-clearing investor.

Cost to the Federal Government for Each Dollar of Assistance to Schools for High Marginal Tax Rate Investors (35% tax rate): $1.17, an amount that equals the amount of foregone revenue (the amount of money that would have been paid to the government under a taxable bond) for a tax-exempt bond purchased by a high marginal tax rate investor ($24.50) divided by the amount of foregone revenue for a tax-exempt bond set at the market clearing rate of 30 percent ($21). $24.50/$21 = $1.17.

Under a Redesigned Subsidized Borrowing System…..

Taxable Interest Payment to Bondholders: All purchasers of $1,000 bonds would receive a taxable interest payment of $49 (4.9 percent) from schools -- the same interest the school would have paid on a tax-exempt bond set at the market- clearing rate.

Tax Credit for Bondholders: The federal government would pay bondholders a tax-credit of $21, a sum that would substitute for the $21 of interest costs that schools would have had to pay on a taxable bond and equal the savings they would have received on a tax-exempt bond. (See above: 2.1 percent of the return was paid in taxes at the market-clearing rate of 30 percent on a taxable $1,000 with a 7 percent return. $1,000 x 0.021 (or 2.1%) = $21).

Reduction in the Borrowing Costs of Schools: $21, the amount of the government tax credit to bondholders.

Cost to the Federal Government for Each Dollar of Assistance to Schools for High Marginal Tax Rate Investors (35% tax rate): $1.00. The federal government's cost would equal the $21 tax credit regardless of whether the marginal tax rate of the investor was 30 percent or 35 percent because the amount of the tax credit is the same for each investor. $21 in savings for schools divided by $21 in federal tax credit per investor =$1.00, an efficient government expenditure that eliminates excess spending.

The federal government would not suffer any loss in revenue under this system because both the school's interest payment to bondholders ($49) and the federal tax credit paid to bondholders ($21) would be taxed at each bondholder's marginal tax rate.[5]

Build America Bonds are a special subset of tax credit bonds established by the American Recovery and Reinvestment Act in (2009). The program was intended to assist municipal issuers with navigating the credit constraints in the market resulting from the recession.[128] Municipalities issued bonds with taxable coupon payments but received a payment from the federal government to subsidize the cost of borrowing.[129] Through this process, the program sought to allow municipalities to borrow more affordably and attract new groups of investors such as pension funds and 401(k) accounts that were not attracted by the tax exemption structures of traditional municipal debt.[130]

The Recovery Act created three types of Build America Bonds--Direct Pay Build America Bonds, Tax Credit Build America Bonds, and Recovery Zone Economic Development Bonds. Two of these, Direct Pay BABS and Tax Credit BABs, are pertinent to this paper. The most common BABs were Direct Pay BABs, which accounted for over 97 percent of the total bonds issued under the Build America Program. Unlike tax-exempt bonds, direct payment bonds are taxable but provide a direct payment from the federal government to the issuer at some portion of the bond's interest payment. The federal government paid issuers of Direct Pay BABs a subsidy worth 35 percent of the interest that must be paid to bondholders. This subsidy lowered the overall cost of borrowing for municipalities, allowing them to offer higher interest rates. Municipalities ultimately only paid 65 percent of the interest cost on each direct pay BAB issued.[131]

A number of studies examine the success of Build America Bonds and find that BABs lowered the cost of borrowing by state and local governments by at least 54 basis points. Another study found that using BABs in place of traditional tax-exempt debt lowered the average cost of financing by at least 54 basis points.[132] Similarly, a 2010 U.S. Treasury Report noted that Build America Bonds provided savings compared to traditional tax-

5 This example and the text used in the description are derived from: Congressional Budget Office, "Tax-Credit Bonds and the Federal Cost of Financing Public Expenditures, http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/56xx/doc5624/07-08_taxcreditbonds.pdf. However, we have replaced the terms "state and local governments" in this example with the term "schools" to reflect the colleges and universities that function as the bond issuers for purposes of this issue brief.

exempt municipal bonds and that the savings were greater at longer maturities.[133] The report pointed to these trends to support the hypothesis that Build America Bonds were successful in attracting non-traditional municipal bond investors such as retirement accounts with long-term obligations, leading to a dramatic decrease in borrowing costs at longer maturities.[134]

The government can borrow more efficiently using either a traditional tax credit bond, or a redesigned tax credit bond similar to direct pay BABs that incorporates direct government subsidies. Redesigned tax-credit bonds modeled after direct pay BABs are the stronger choice for a number of reasons. A number of studies show that direct payments to issuers often provide them with deeper subsidies than the provision of a tax credit represents to bondholders.[135] Direct pay Build America Bonds were also more attractive to investors than traditional tax-credit bonds were in past years.[136] Direct payment BABs enjoyed a great deal of success during the years in which they were authorized (2009-2010) and constituted an important source of financing for state and local governments.[137] Similarly structured direct pay tax-credit education bonds are likely to enjoy comparable success and benefit from access to a much larger pool of investors in the global market for taxable bonds.[138]

Minimum Consumer Standards: A Necessary Component of Reform

Regardless of the nature of reform to tax-exempt borrowing for postsecondary institutions, school accountability metrics should go hand in hand with changes to the borrowing framework. Tax subsidized borrowing is a privilege intended to support educational institutions and the contributions they make to society. If education bonds continue to receive subsidies, colleges and institutions must do their part to ensure that their students succeed. Whether in the form of a tax exemption or tax credit, the benefit of federally subsidized borrowing should only extend to colleges and universities that satisfy basic accountability standards.

Making federally subsidized borrowing contingent upon school performance would incentivize schools to increase access for students, support students throughout their time in school, and prepare them for success after graduation. Accountability metrics measuring need-based aid, overall completion rates, completion rates for low-income and underrepresented students, the percentage of students receiving Pell Grants, and affordability would provide an excellent start towards achieving this goal.

In their paper *How Low is Too Low: Getting All Colleges Over Bottom Line Quality Standards*, The Education Trust provides a framework for what school accountability should look like in practice. The implementation of their accountability recommendations regarding access for low-income students, graduation rates, and post college success would help to ensure that the benefit of discounted borrowing only goes to the postsecondary institutions meeting basic accountability thresholds.

- **Pell Freshmen Enrollment of 17%:** More than 90 percent of Pell Grant recipients fall within the bottom 40 percent of the national income distribution, coming from families with $50,000 or less.[139] Nearly a quarter of all Pell recipients come from families with adjusted gross incomes of only $6,000 or less.[140] Thirty-nine percent of all freshmen enrolled in four-year colleges receive Pell Grants.[141] However, at the colleges that fall into the bottom five percent of institutions enrolling Pell eligible students, fewer than 17 percent of incoming freshmen are Pell students.[142] Studies demonstrate that the bottom five percent of schools could admit more Pell eligible students without compromising the rigor of their admissions standards.[143] A benchmark of 17 percent Pell eligible freshmen enrollment should be a prerequisite to receiving discounted borrowing.

- **Graduation Rates of 15%:** Ed Trust noted that among four-year colleges, the bottom five percent of colleges have six-year completion rates of 15 percent or lower.[144] This failure to graduate students has real world effects on the success of students after college, making them nearly six times as likely to leave college with debt and no degree as they are to actually complete their degree programs.[145] Postsecondary institutions should meet a threshold of a 15 percent graduation rate before receiving access to federally subsidized borrowing.

- **Low Student Loan Default Rates:** Cohort default rates provide insight into whether an institution is preparing its students to succeed, successfully manage loan payments, and translate their education into viable career prospects.[146] The bottom 5 percent threshold on three-year cohort default rates produces a 28 percent benchmark.[147] This means that over 25 percent of graduates have trouble making loan payments. The government should link the availability of federally subsidized borrowing to an institution's ability to prepare its students for success after graduation. As Ed Trust notes, default rates are an imperfect measure of institutional success because 1) schools with enough resources can manipulate cohort default rates, and 2) cohort default rates only measure how many students reach the final stage of financial distress.[148] Ed Trust also notes that student loan repayment rates could provide a better measure of institutional quality. Unlike cohort default rates, repayment rates measure whether or not students have been able to make at least one payment to reduce their federal student loan balance in the past year.[149] As a metric that 1) reflects a form of student distress other than default and 2) is more difficult for schools to manipulate, student loan repayment rates would be less susceptible to some of the limitations of default rates.[150] Unfortunately, repayment rates are not currently available by institution.[151] The Department of Education should make collecting information on repayment rates at the institutional level a priority so that this valuable information will be available in future years. Although subject to limitations, cohort default rates are readily available and can provide valuable information on institutional quality until more comprehensive data is available.[152] A benchmark of cohort default rates of no more than 25 percent per graduating class would be a strong start towards encouraging schools to more adequately prepare students for the job market.

Conclusion

Federal taxpayers spend billions each year on tax benefits to postsecondary institutions. However, this method of delivering subsidies is inherently flawed. Tax-exempt bonds are inefficient, expensive, and regressive. Wealthy investors capture a significant portion of the benefit intended for educational institutions. The benefits that do fall to educational institutions are enjoyed by a wide range of schools, regardless of how they perform on accountability metrics such as access and completion.

Though eliminating tax-exempt debt entirely and investing the savings in Pell Grants would create a more efficient and better-targeted system, this approach would also be politically challenging to implement. Restructuring tax-exempt bond financing for post-secondary institutions through tax credit bonds would improve the current system while alleviating many of the concerns raised by other reform options. Schools will not face higher borrowing costs because the federal government will pay the difference between the lower interest payment the school would pay on a tax-exempt bond and the higher interest rate paid for taxable bonds. Additionally, schools will continue to have access to a wide variety of capital projects. The government will be able to provide the same benefit to colleges and universities at a lower cost because federal expenditure will only be as high as the tax credit or direct payment provided, regardless of the marginal tax rate of individual investors. The government can reallocate savings into the Federal Pell Grant Program, making a real impact on the ability of students to access and complete college. Finally, redesigned education bonds will encourage higher standards of quality in higher education because they will only be available to schools meeting basic accountability metrics.

End Notes

1. Alisa Cunningham, "The Broader Societal Benefits of Higher Education," accessed March 18, 2014, 1, http://jcu.edu/academic/planassess/planning/files/Planning%20articles/Broader%20Social%20Benefits.pdf.

2. Collegeboard, Sandy Baum, Jennifer Ma, Kathleen Payea, *Education Pays: The Benefits of Higher Education for Individuals and Society* (2013), accessed March 25, 2014, 5-6, https://trends.collegeboard.org/sites/default/files/education-pays-2013-full-report.pdf.

3. Economic Policy Institute, "A Well-Educated Workforce is Key to State Prosperity," accessed March 17, 2014, http://www.epi.org/publication/states-education-productivity-growth-foundations/.

4. "Issue," accessed March 13, 2014, http://www.investopedia.com/terms/i/issue.asp.

5. "Definition of Issuer," accessed March 13, 2014, http://www.investopedia.com/terms/i/issuer.asp.

6. "Bonds," accessed March 13, 2014, http://investor.gov/investing-basics/investment-products/bonds#.UyKfjV7hPOU.

7. "Taxable Bond," accessed March 13, 2014, http://www.investopedia.com/terms/t/taxablebond.asp.

8. Internal Revenue Service (IRS), *Tax-Exempt Private Activity Bonds* (Washington, DC: 2002), accessed March 13, 2014, 1, http://www.irs.gov/pub/irs-pdf/p4078.pdf.

9. "Definition of 'Tax-Exempt Security,'" accessed March 13, 2014, http://www.investopedia.com/terms/t/tax_exempt_security.asp.

10. "Marginal tax rate," accessed March 13, 2014, http://www.investopedia.com/terms/m/marginaltaxrate.asp.

11. "Bond Basics: Characteristics," accessed March 14, 2014, http://www.investopedia.com/university/bonds/bonds2.asp.

12. "Market clearing," accessed March 13, 2014, http://www.economicsonline.co.uk/Competitive_markets/Market_equilibrium.html.

13. Frank Samartino, *Testimony Before the Senate Finance Committee* (Washington, DC: 2012), "Federal Support for State and Local Governments through the tax-code," accessed March 13, 2014, 5-6, http://www.cbo.gov/sites/default/files/cbofiles/attachments/04-25-TaxCodeTestimony.pdf.

14. "Definition of Capital Project,'" accessed March 13, http://www.investopedia.com/terms/c/capital-project.asp.

15. Ibid.

16. "Our Projects," accessed March 13, http://lbre.stanford.edu/dpm/our_projects.

17. Congressional Budget Office, *Tax Arbitrage by Colleges and Universities* (Washington, DC: 2010), 2, http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/112xx/doc11226/04-30-taxarbitrage.pdf

18. Ibid., 3.

19. Ibid.

20. Joint Committee on Taxation, *Background and Present Law Relating to Tax Benefits for Education* (Washington, DC: 2012), 23, https://www.jct.gov/publications.html?func=startdown&id=4474.

21. Ibid.

22. Ibid.

23. NACUBO, *Preserve Tax-Exempt Bond Financing* (Washington, DC: 2013), http://www.nacubo.org/Documents/BusinessPoli-

cyAreas/NACUBOTaxTEBonds2013%20(3).pdf.

24. "The Basics of Municipal Bonds," accessed March 18, 2014, http://www.investopedia.com/articles/bonds/05/022805.asp.

25. "Definition of Revenue Bond," accessed March 18, 2014, http://www.investopedia.com/terms/r/revenuebond.asp.

26. "Bonds," accessed March 13, 2014, http://investor.gov/investing-basics/investment-products/bonds#.UyMiXb99FUQ.

27. Ibid.

28. NACUBO, *Preserve Tax-Exempt Bond Financing*.

29. Joint Committee on Taxation, *Background and Present Law Relating to Tax Benefits for Education* (Washington, DC: 2012), 23, https://www.jct.gov/publications.html?func=startdown&id=4474.

30. Ibid.

31. Joint Committee on Taxation, B*ackground and Present Law Relating to Tax Benefits for Education*, 23-24.

32. Internal Revenue Service (IRS), *Tax-Exempt Private Activity Bonds* (Washington, DC: 2002), 2.

33. James P. Monacell and Benjamin Brooks, "Bond Practice, When a Project is Finance-able," accessed March 17, 2014, http://www.sgrlaw.com/resources/briefings/bond_practice/460/.

34. Chuck Katz, "Public Finance Primer," accessed March 18, 2014, http://www.drinkerbiddle.com/files/Publication/5aef3d42-2948-4537-a5f7-05311be9aeb9/Presentation/PublicationAttachment/014270c4-dd5a-4227-a4dd-19f82d405e80/Public%20Finance%20Primer.pdf.

35. Monacell and Brooks, "Bond Practice."

36. Kevin Kiley, "Building With Your Hands Tied," *Inside Higher Ed*, accessed March 20, 2014, http://www.insidehighered.com/news/2012/04/26/kentucky-limits-debt-issuance-hinder-university-constructions.

37. National Association of College and University Attorneys (NACUA), Stephen E. Weyl and Ronald F. Rodgers, *Tax-Exempt Bonds: Considerations for College and University In-House Counsel* (Washington, DC: 2006), accessed March 20, 2014, 1-2, fn 3, http://70.32.97.65/resources/resources/Tax-ExemptBonds.pdf.

38. Ibid., 2.

39. Roger L. Davis, *Nonprofit Corporations: Borrowing with Tax-Exempt Bonds* (City not given: 2001) accessed March 20, 2014, 32, http://www.orrick.com/Events-and-Publications/Documents/172.pdf.

40. California State Auditor, *Conduit Bond Issuers* (Sacramento, CA: 2012), accessed March 25, 2014, http://www.bsa.ca.gov/pdfs/reports/2011-118and2011-613.pdf.

41. Department of the Treasury, Commonwealth of Virginia, "Debt Issuing Entities and Committees Supported by Debt Management," accessed March 24, 2014, https://www.trs.virginia.gov/debt/.

42. NACUA, Weyl and Rodgers, *Tax-Exempt Bonds Considerations for College and University In-House Counsel*, 1-2, fn 3.

43. Joint Committee on Taxation, *Background and Present Law Relating to Tax Benefits for Education*, 2012, 23.

44. Internal Revenue Service (IRS), *Tax-Exempt Bonds for 501(c)(3) Charitable Organizations* (Washington, DC: 2001), accessed Feb. 11, 2014, 2-3, http://www.irs.gov/pub/irs-pdf/p4077.pdf.

45. Congressional Budget Office (CBO), *Tax Arbitrage at Colleges and Universities*, 1.

46. Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012 to 2017* (Washington, DC: 2013), accessed Feb. 11, 2014, https://www.jct.gov/publications.html?func=startdown&id=4503.

47. NACUBO, *Preserve Tax-exempt Bond Financing*.

48. "2011 in Statistics," accessed Feb. 11, 2014, http://www.bondbuyer.com/pdfs/2012_bb_stats_supp.pdf.

49. NACUBO, *Protect Tax-Exempt Bond Financing* (Washington, DC: Date not given), accessed Feb. 11, 2014, http://www.nacubo.org/Documents/BusinessPolicyAreas/TaxExempt%20Bonds.pdf.

50. Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong., 2nd sess.* (Washington: GPO,1984), p. 930 via Steven Maguire, Congressional Research Service, *Private Activity Bonds: An Introduction* (Washington, DC: 2006), 2-3, http://www.policyarchive.org/handle/10207/bitstreams/19149.pdf.

51. "Cornell University," accessed April 8, 2014, http://colleges.usnews.rankingsandreviews.com/best-colleges/cornell-university-2711.

52. Dormitory Authority of State of New York, *2007 Annual Report* (City not specified: 2007), accessed April 8, 2014, 8-9, http://www.dasny.org/dasny/contact/DAannual07.pdf; "New Issue DAC Bond," accessed 3April 8, 2014, 1, http://www.dfa.cornell.edu/cms/treasurer/debt/external/upload/2006A.pdf.

53. "Private Use Policy and Guidelines," accessed April 8, http://www.dfa.cornell.edu/treasurer/debt/privateuse/guidelines.cfm.

54. "Approved Capital Projects," accessed April 8, 2014, http://www.fs.cornell.edu/fs/projects/intro.cfm.

55. "Farleigh Dickinson University," accessed April 8, 2014, http://colleges.usnews.rankingsandreviews.com/best-colleges/fairleigh-dickinson-university-8770.

56. New Jersey Educational Facilities Authority, "Recent Financings," accessed April 8, 2014, http://www.njefa.com/njefa/activity/recent/2014/.

57. "Post-Issuance Tax-Exempt Bond Compliance Policy," accessed April 8, 2014, http://view.fdu.edu/files/postissuancetaxexemptbondcompliancemarch72012final.pdf.

58. "Innovative Programs Introduced, Capital Projects Progress," accessed April 8, 2014, http://www.fdu.edu/newspubs/insidefdu/0009/programs.html.

59. "General Information," accessed April 9, 2014, http://colleges.usnews.rankingsandreviews.com/best-colleges/virginia-commonwealth-university-3735.

60. Virginia College Building Authority, *Annual Report on the Virginia College Building Authority's Financial Statements (Unaudited) for the Year Ending June 30, 2005* (Richmond, VA: 2005), http://leg2.state.va.us/DLS/h&sdocs.nsf/682def7a6a969fbf85256ec100529ebd/e53464601d72215e85256f4600728d77?OpenDocument.

61. "VCU Tax-Exempt Debt Compliance Policy," accessed April 9, 2014, http://www.assurance.vcu.edu/Policy%20Library/Tax-Exempt%20Debt%20Compliance%20Policy.pdf.

62. Virginia Commonwealth University, "Funding Source," accessed April 9, 2014, http://www.fmd.vcu.edu/cp/funding.html.

63. Virginia Commonwealth University, "May 2011 Summary of Major Capital Projects," accessed April 9, 2014, http://www.fmd.vcu.edu/capsummar1.pdf.

64. "Harvard University," accessed April 9, 2014, http://colleges.usnews.rankingsandreviews.com/best-colleges/harvard-university-2155.

65. "Harvard Issues $601 Million of Municipal Bonds at Yields Below AAA Debt," accessed April 8, 2014, http://www.bloomberg.com/news/2010-11-09/harvard-sells-601-million-of-munis-at-yields-below-aaa-debt.html.

66. "Harvard Issues $601 Million of Municipal Bonds at Yields Below AAA Debt," accessed April 18, 2014, http://www.bloomberg.com/news/2010-11-09/harvard-sells-601-million-of-munis-at-yields-below-aaa-debt.html; "Moody's Assigns Aaa Rating to Harvard University's (MA) Series 2010B Tax-Exempt 2010 Taxable Fixed-Rate Bonds, Use of Proceeds," accessed April 18, 2014, https://www.moodys.com/research/MOODYS-ASSIGNS-Aaa-RATING-TO-HARVARD-UNIVERSITYS-MA-SERIES-2010B-New-Issue--NIR_16693346.

67. "Harvard Planning and Project Management," accessed April 8, 2014, http://home.hppm.harvard.edu.

68. "University of Iowa, General Information," accessed April 8, 2014, http://colleges.usnews.rankingsandreviews.com/best-colleges/university-of-iowa-1892.

69. "Company Profit for the University of Iowa Facilities Corp," accessed April 8, 2014, http://www.bloomberg.com/quote/27683MF:US/profile.

70. "Revenue Refunding Bonds, Series 2012," accessed April 8, 2014, http://emma.msrb.org/ER579828-ER450245-ER852832.pdf; "Carver Biomedical Research Building," accessed April 8, 2014, http://maps.uiowa.edu/cbrb.

71. Revenue Refunding Bonds, Series 2012," accessed April 8, 2014, http://emma.msrb.org/ER579828-ER450245-ER852832.pdf; "Moody's Assigns Aa1 Rating to University of Iowa's Facilities Corporation's Revenue Refunding Bonds, Series 2011,Outlook is Stable," accessed April 8, 2014, https://www.moodys.com/research/MOODYS-ASSIGNS-Aa1-RATING-TO-UNIVERSITY-OF-IOWA-FACILITIES-CORPORATIONS-New-Issue--NIR_16972249.

72. "Revenue Refunding Bonds, Series 2012," accessed April 8, 2014, http://emma.msrb.org/ER579828-ER450245-ER852832.pdf.

73. "Moody's Assigns Aa1 Rating to University of Iowa's Facilities Corporation's Revenue Refunding Bonds, Series 2011, Outlook is Stable," accessed April 8, 2014, https://www.moodys.com/research/MOODYS-ASSIGNS-Aa1-RATING-TO-UNIVERSITY-OF-IOWA-FACILITIES-CORPORATIONS-New-Issue--NIR_16972249.

74. "Moody's Assigns Aa1 Rating to University of Iowa's Facilities Corporation's Revenue Refunding Bonds, Series 2011, Outlook is Stable," accessed April 8, 2014, https://www.moodys.com/research/MOODYS-ASSIGNS-Aa1-RATING-TO-UNIVERSITY-OF-IOWA-FACILITIES-CORPORATIONS-New-Issue--NIR_16972249; "Frequently Asked Questions About the Board of Regents, State of Iowa, What is the Board of Regents?," accessed April 8, 2014, http://www.regents.iowa.gov/FAQ/faq.html.

75. Congressional Budget Office (CBO), *Tax-Credit Bonds and the Federal Cost of Financing Public Expenditures* (Washington, DC: 2004), 4, http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/56xx/doc5624/07-08_taxcreditbonds.pdf.

76. Ibid.

77. Ibid.

78. "Marginal Tax Rate," accessed February 14, 2014, http://www.investopedia.com/terms/m/marginaltaxrate.asp.

79. Example derived from: CBO, *Tax-Credit Bonds and the Federal Cost of Financing Public Expenditures* (Washington, DC: 2004), 4, http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/56xx/doc5624/07-08_taxcreditbonds.pdf.

80. Example derived from: CBO, *Tax-Credit Bonds and the Federal Cost of Financing Public Expenditures* (Washington, DC:

2004), 4, http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/56xx/doc5624/07-08_taxcreditbonds.pdf.

81. CBO, *Tax-Credit Bonds and the Federal Cost of Financing Public Expenditures*, 4.

82. Ibid, 5.

83. Ibid.

84. Congressional Budget Office (CBO)/Joint Committee on Taxation, Subsidizing Tax Preferred Infrastructure Investment with Tax-Preferred Bonds (Washington, DC: 2009) , accessed April 9, 2014, 43-45, http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/106xx/doc10667/10-26-taxpreferred-bonds.pdf.

85. "2007 Tax Bracket Rates," Bankrate.com, accessed February 14, 2014, http://www.bankrate.com/finance/money-guides/2007-tax-bracket-rates.aspx.

86. Harry Galper, et al, Tax Policy Center, *Who Benefits from Tax-Exempt Bonds?: An Application of the Theory of Tax Incidence* (Washington, DC: 2013), 18, http://www.urban.org/UploadedPDF/412905-who-benefits-from-tax-exempt-bonds.pdf; Dennis Zimmerman, "Tax-Exempt Bonds," Tax Policy Center, http://www.taxpolicycenter.org/taxtopics/encyclopedia/Tax-exempt-bonds.cfm.

87. Congressional Budget Office (CBO), *Testimony by Frank Sammartino, Assistant Director for Tax Analysis, before the Committee on Finance, United States Senate* (Washington, DC: 2012), 7, http://www.cbo.gov/sites/default/files/cbofiles/attachments/04-25-TaxCodeTestimony.pdf.

88. CBO, *Testimony by Frank Sammartino, Assistant Director for Tax Analysis, before the Committee on Finance, United States Senate*, 5-6. For more information on what influences an investor's decision to purchase municipal bonds (of which education bonds are a subset) see, Jason Van Bergen, "Weighing the Tax Benefits of Municipal Securities," accessed March 12, 2014, http://www.investopedia.com/articles/04/072804.asp; "Marginal tax rate," accessed March 13, 2014, http://www.investopedia.com/terms/m/marginaltaxrate.asp.

89. Marilee Bresciani and Lewis Carson, "A Study of Undergraduate Persistence by Unmet Need and Percentage of Gift Aid," NASPA Journal, Vol. 40, no. 1, (2002): 121, http://www.uccs.edu/Documents/retention/2002%20Study%20of%20Undergraduate%20Persistence%20by%20Unmet%20Need%20and%20Percent.pdf.

90. Marilee J. Bresciani and Lewis Carson, "A Study of Undergraduate Persistence by Unmet Need and Percentage of Gift Aid," 105.

91. Congressional Research Service (CRS), *Tax-Exempt Bonds and the Economics of Professional Sports Stadiums* (Washington, DC: 2006), http://www.policyarchive.org/handle/10207/bitstreams/302.pdf.

92. Rute Pinhel, Research Analyst, CT Office of Legislative Research, *State-Funded Capital Grant Programs for Private Colleges and Universities* (Hartford, CT: 2007), http://www.cga.ct.gov/2007/rpt/2007-R-0569.htm.

93. "Investors, Issuers Plan for 2112 With 'Century Bonds,'" accessed April 9, 2014, http://www.forbes.com/sites/thestreet/2012/04/12/investors-issuers-plan-for-2112-with-century-bonds/.

94. "The Other Debt Crisis," accessed April 9 2014, http://www.insidehighered.com/news/2012/04/10/public-universities-will-take-more-debt-states-decrease-spending-capital-projects.

95. Ibid.

96. New America Foundation, "Federal Pell Grant Program," http://febp.newamerica.net/background-analysis/federal-pell-grant-program.

97. Ibid.

98. Congressional Budget Office (CBO), "Frequently Asked Questions About CBO Cost Estimates," accessed February 18, 2014, http://www.cbo.gov/about/our-products/ce-faq.

99. New America Foundation, "Federal Pell Grant Program."

100. "Definition of Yield Spread," Investopedia.com, accessed March 18, 2014, http://www.investopedia.com/terms/y/yieldspread.asp.

101. D. Bruce Johnstone, *University Revenue through Philanthropy: International Perspectives* (Buffalo, NY: 2004), 3, http://www.intconfhighered.org/BruceJohnstone.pdf.

102. Ibid.

103. Ibid.

104. Ibid.

105. Internal Revenue Service, *Tax-Exempt Bonds for 501(c)(3) Charitable Organizations* (Washington, DC: 2001), 3, http://www.irs.gov/pub/irs-pdf/p4077.pdf.

106. James P. Monacell and Benjamin Brooks, "Bond Practice: Overview of Bond Financing for Nonprofit Schools," accessed April 10, 2014, http://www.sgrlaw.com/resources/briefings/bond_practice/461/.

107. Ibid.

108. Internal Revenue Service, Tax-Exempt Bonds for 501(c)(3) Charitable Organizations (Washington, DC: 2001), 3, http://www.irs.gov/pub/irs-pdf/p4077.pdf.

109. Steven Maguire, Congressional Research Service (CRS), *Tax Credit Bonds: Overview and Analysis* (Washington, DC: 2010), 7-8, http://www.nabl.org/uploads/cms/documents/CRS_Report_on_TCBs2.pdf.

110. Andrew Martin, "Building a Showcase Campus, Using an I.O.U.," The New York Times, 2012, http://www.nytimes.com/2012/12/14/business/colleges-debt-falls-on-students-after-construction-binges.html?pagewanted=all&_r=0.

111. Andrew Martin, "Building a Showcase Campus, Using an I.O.U.," *The New York Times*, December 13, 2012, http://www.nytimes.com/2012/12/14/business/colleges-debt-falls-on-students-after-construction-binges.html?pagewanted=all&_r=0.

112. Andrew Martin, "Building a Showcase Campus, Using an I.O.U."

113. Ibid.

114. Ibid.

115. Kevin Killey, "The Other Debt Crisis."

116. Andrew Martin, "Building a Showcase Campus, Using an I.O.U."

117. Ibid.

118. Ibid.

119. Ibid.

120. Bureau of Labor Statistics, *The Recession of 2007-2009* (Washington, DC: 2012), 1, http://www.bls.gov/spotlight/2012/recession/pdf/recession_bls_spotlight.pdf.

121. Andrew Martin, "Building a Showcase Campus, Using an I.O.U."

122. Ibid.

123. Congressional Budget Office (CBO), *Tax-Credit Bonds and the Federal Cost of Financing Public Expenditures* (Washington, DC: 2004), 2, http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/56xx/doc5624/07-08_taxcreditbonds.pdf.

124. Steven Maguire, Congressional Research Service, *Tax Credit Bonds: Overview and Analysis* (Washington, DC: 2010), 3, http://www.nabl.org/uploads/cms/documents/CRS_Report_on_TCBs2.pdf.

125. Ibid.

126. Congressional Budget Office (CBO), *Tax-Credit Bonds and the Federal Cost of Financing Public Expenditures* (Washington, DC: 2004), 6, http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/56xx/doc5624/07-08_taxcreditbonds.pdf.

127. Ibid.

128. See M.A. Scott and J.B. Shoeven, *The Build America Bonds Program: Savings Opportunities and Efficiency Improvements from Subsidizing Taxable Municipal Debt* (Stanford, CA: 2012), https://economics.stanford.edu/files/MitchelScottHonorsThesis2012.pdf.

129. Andrew Ang, Vineer Bhansali, Yuhang Xing, National Bureau of Economic Research, *Build America Bonds* (Cambridge, MA: 2010), 1, http://www.nber.org/papers/w16008.pdf?new_window=1.

130. MA Scott and JB Shoven, *The Build America Bonds Program: Savings Opportunities and Efficiency Improvements from Subsidizing Taxable Municipal Debt*, 1.

131. Ibid, 9.

132. MA Scott and JB Shoven, *The Build America Bonds Program: Savings Opportunities and Efficiency Improvements from Subsidizing Taxable Municipal Debt*, 16, 37; Gao Liu and Dwight Denison, Indirect and Direct Subsidies for Cost of Government Capital: Comparing tax-exempt bonds and build America Bonds (Albuquerque, NM: 2011), 18, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1764703.

133. MA Scott, JB Shoven, *The Build America Bonds Program: Savings Opportunities and Efficiency Improvements from Subsidizing Taxable Municipal Debt*, 16.

134. Ibid.

135. "Subsidizing Infrastructure Investment with Tax-Preferred Bonds," accessed April 9, 2014, http://www.cbo.gov/publication/24982.

136. "CBO Testified on Federal Support for State and Local Governments Provided Through the Tax Code," accessed April 9, 2014, http://www.cbo.gov/publication/43195.

137. Ibid.

138. See SIFMA, "Build America Bonds Resource Center--Overview," accessed April 9, 2014, https://www.sifma.org/issues/capital-markets/municipal-securities/build-america-bonds/overview/.

139. Education Trust analysis of the 2011-12 National Postsecondary Student Aid Study, from the U.S. Department of Education. The Education Trust, *How Low is Too Low: Getting All of Our Colleges Over Bottom Line Quality Standards* (Washington, DC: 2014), 6, accessed March 24, 2014.

140. Ibid.

141. The Education Trust, *How Low is Too Low: Getting All of Our Colleges Over Bottom Line Quality Standards*, 7.

142. Ibid.

143. Ibid, 8.

144. The Education Trust, *How Low is Too Low: Getting All of Our Colleges Over Bottom Line Quality Standards*, 9.

145. Ibid.

146. Ibid, 13.

147. Ibid.

148. The Education Trust, *How Low is Too Low: Getting All of Our Colleges Over Bottom Line Quality Standards*, 14.

149. Ibid.

150. Ibid.

151. Ibid.

152. The Education Trust, *How Low is Too Low: Getting All of Our Colleges Over Bottom Line Quality Standards*, 14.