Getting Serious About Lifelong Learning:

Improving the Use and Value of the Hope and Lifelong Learning Tax Credits for Working Adult Students

Policy Brief

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STRATEGIES FOR REGIONAL DEVELOPMENT

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Background

The demand for skilled workers in today's economy is clear.

Changes in technology and how companies do business have resulted in increased demand for skilled workers. This demand for employees with at least some post-secondary education will be even greater in the future. The link between increased demand for skills and a growing wage gap also is clear. Over the last 20 years, workers with higher levels of education have seen their real wages increase, and those with a high school diploma or less have experienced real wage declines. The compounding effects of significant wage gains for more educated workers and the real wage losses for high school graduates have resulted in a significant wage gap. Over a lifetime, this wage gap is $1 million between workers with bachelor's degrees or higher and high school graduates with no post-secondary credentials.

This trend toward more education and higher skills is a wake-up call for workers, and is significant for employers and our economy.

Employer surveys continually report that they cannot find the skilled workers they need. Employment projections predict the skills squeeze will not be alleviated with our current post-secondary education strategy. Even if more secondary students attend college directly after high school and graduate, they will add only a net gain of perhaps 3 million workers with college credentials to the workforce by 2020. Given the Bureau of Labor Statistics projection of 15 million new jobs requiring at least some post-secondary education by then, employers and this country will face a skills gap of 12 million workers without post-secondary education.

Workers know they need more education, and millions are pursuing it. However, if this country is to address the looming gap between the supply and demand for educated workers, we will need to do more to assist even greater numbers of workers in investing in their own career education.

Unfortunately, low skilled working adults do not receive much support for post-secondary education.

Most federal and state student financial aid programs are not designed to assist working adult students seeking post-secondary education. Employer-based tuition reimbursement programs may in fact exacerbate the wage gap as they target better educated and higher paid workers. Research findings presented in this report show that, as currently structured, the Hope Scholarship and Lifetime Learning Tax Credits also fall far short in meeting this challenge.

An aggressive policy response from federal and state governments is needed to help workers access and succeed in post-secondary education.

- ***Individual workers*** need better information about the returns to post-secondary education and information on how to get it, as well as financial and other supports.
- ***Employers*** must better understand the productivity returns to investments in workforce skills and must see clear incentives to make these investments and to help their workers make them.
- ***Post-secondary educational institutions*** need strong encouragement and assistance in developing the programs and credentials that work for working adults.

Key Findings

This Policy Brief summarizes the key findings and four recommendations from a larger study that investigated the Hope Scholarship and Lifetime Learning Tax Credits. The full report from the study can be found on the FutureWorks' website.

The Hope Scholarship (Hope) and Lifetime Learning Tax Credits (LLTC) were introduced by The Taxpayer Relief Act of 1997 to increase college affordability and to encourage lifelong learning. The two credits were designed to complement each other by targeting different groups of students.

While the Hope may be used only for a student's first two years of post-secondary education, the LLTC is available for unlimited years to those taking classes beyond their first two years of college including college juniors and seniors, graduate students, and working adults pursuing lifelong learning.[i]

Eligible expenses for each credit include only tuition and required fees at an educational institution eligible for aid administered by the federal Department of Education (DOE). Tax filers may claim tuition and fee amounts after subtracting grants, scholarships, and other tax-free educational assistance including Pell Grants, employer-provided education assistance, and Veteran's educational assistance.[ii]

The Hope provides a credit equal to 100% of the first $1,000 plus 50% of the next $1,000 of net tuition and fees paid during the tax year, for a maximum credit of $1,500. The student must be enrolled at least half-time (at least six credit hours per semester, which typically is two classes) and pursue a degree or other recognized educational credential in order to be eligible.

In contrast, individuals are not required to enroll at least half-time or pursue an educational credential in order to be eligible for the LLTC. ***This makes the LLTC available to adults taking an occasional college course or to those enrolled in any course aimed at acquiring or improving job skills and it could include adult basic education and English for speakers of other languages***. Currently, the LLTC is equal to 20% of the first $10,000 of net tuition and fees, for a maximum credit of $2,000. Both credits reduce the amount of taxes filers owe.

The Hope credit can be claimed for multiple eligible students in a family; whereas, the LLTC is capped at $2,000 per tax return, no matter the number of students in the family or the amount of their combined educational expenses. Families are allowed to claim the LLTC for some members and the Hope credit for others in the same year. However, the same student cannot take both credits.

The benefits of the tax credits phase out for higher-income taxpayers. The phase out begins at an adjusted gross income (AGI) of $83,000 for a joint return ($41,000 for single filers) with no benefit for families with incomes above $103,000 ($51,000 for single).[iii] With these relatively high thresholds, tax credits for higher education expenses have the most extensive eligibility of any federal program. In comparison, Pell Grants are strictly limited to families with incomes below $40,000. Nearly 90 percent of Pell Grant funds are awarded to families with incomes under $30,000 and 54 percent of those families have incomes under $10,000.[iv]

FutureWorks investigated the current use of the Hope and LLTC using three primary data sources: Internal Revenue Service's Statistics of Income, the National Household Education Survey, and the National Postsecondary Student Aid Survey.

Overall, we found that the tax filers who benefited the most from these higher education tax credits were those who claimed them on behalf of dependent college students. Those who benefited the least were students who claimed the credit(s) for their own or their spouse's educational expenses and who did not indicate that they were "students" on their income tax return.

Based on our research findings, we conclude that the Hope and LLTC are not working effectively to address the significant education and skill shortages in America's workforce. They are not inducing greater numbers of working adults who need to upgrade their education and skills to earn post-secondary credentials. They are not supporting those who are currently enrolled to any significant degree. As a policy device to address the employment and economic challenges discussed above, the higher education tax credits as currently marketed and structured do not work well.

These conclusions lead us to recommend the following changes to the education tax credits. These changes are aimed at making both credits more accessible and beneficial for working adults who pursue the post-secondary educational credentials needed in today's economy.

Our recommendations are based on maintaining the Hope and LLTC as two separate credits. However, as we studied the myriad of alternative structures, we considered the potential advantages and feasibility of simply merging the two credits into one. This is not one of our formal recommendations below; however, it is an option for expanding the credits and simplifying the tax code that could be considered.

Highlights from the Research

- 7.2 million filers received $5.2 billion in credits in 2001 (the latest year with available data);
- Only 21% of adults in the general population had heard of the credits in 2001;
- Of adult students enrolled in college, only 1/3 had used or planned to use the credits in 2001;
- 44% of the filers received a Hope credit only and they received 60% of the total benefits; 52% received a LLTC only and they received 31% of the benefits; and 5% received both credits and they received 9% of the benefits;
- The mean credit for Hope recipients was $969 and the mean for LLTC was $432;
- Filers who received the credit on behalf of a dependent college student received the highest credits ($1,104 mean Hope and $578 mean LLTC);
- Filers who received the credit for their own or their spouse's educational expenses and indicated that they were primarily students received the next highest ($935 mean Hope and $536 mean LLTC); and
- Filers who received the credit for their own/spouse's expenses but did not indicate that they were primarily students received the lowest amounts ($881 mean Hope and $361 mean LLTC).

Recommendations

Recommendation 1: Raise Awareness of the Hope Scholarship and Lifetime Learning Tax Credits

Specifically, work with employers to market and improve the take-up rate of the education tax credits among workers. Also, implement a national media campaign with targeted mailings from the government, post-secondary schools, community-based organizations, and other institutions to increase awareness of both the need to earn post-secondary credentials and the credits available to help fund this education.

Justification: Only 21% of all adults in the general public in 2001 had heard of the education tax credits, and only 17% of working adults without a bachelor's degree had heard of them. These percentages decline with lower levels of education and income as well as among Hispanic adults and those for whom English is not their primary language. Also, among enrolled college students, only one-third of independent students - many of whom are working adults - who were apparently eligible actually claimed an education tax credit in the 1999-2000 school year. Clearly, if these tax credits are to have any impact on helping workers engage in lifelong learning, more adults will need to know about and use them.

Estimated Projected Cost: If we assume that marketing increases the take-up rate by 30%, this would increase the number of filers who received a credit from 7.2 million in 2001 to 9.36 million and increase the tax expenditure from $5.2 billion to $6.76 billion – an increase of just over $1.5 billion.[v]

Recommendation 2: Increase the Percentage of Qualified Educational Expenses Allowed Under the Lifetime Learning Tax Credit

Specifically, increase the percentage from the current 20% of the first $10,000 spent on qualified expenses (tuition and fees) to 50% and cap the credit at $2,000.

Justification: The current structure of the Lifetime Learning Tax Credit limits most of the benefit to full-time students who attend higher cost institutions. It minimally benefits students who attend lower cost institutions, *i.e*., community colleges, and who are enrolled less than full-time, *i.e*., many non-traditional students, especially working adults. For example, traditional full-time students at public colleges spend an average of $3,750 for tuition and fees – well below the $10,000 maximum allowed for the Lifetime Learning Tax Credit. Working adult students often attend school part-time or less-than-half-time and spend closer to $500 to $700 in eligible expenses (tuition and fees) annually.

With an increase in the percentage of qualified expenses allowed as a tax credit from 20% to 50%, traditional students at public institutions would receive an average benefit of around $1,875 instead of only $750 and working adult students would receive an average benefit of closer to $250 to $350 instead of the current $100 to $140. This change would increase the benefit to students attending lower-cost institutions and to those attending less than half-time *without harming current beneficiaries of the program, including, those who already get the maximum $2,000 credit.*

IRS data from 2001 underscores the need for this change to the LLTC. The mean tax credit amounts received by filers who appear to be working adults are high enough that we conclude that these working students are spending closer to $2,000 on tuition and fees, which is considerably higher than the national averages of $500 to $700. This indicates that the current recipients of the credits are attending more expensive institutions and/or enrolled closer to full-time. To better reach working adult students who can only afford to pay lower tuition and fees, better marketing is needed, and working adults need to anticipate enough benefit from the credits to incur education costs and then file for the credit.

This change in the structure of the LLTC is especially important for working adult students who rarely benefit from traditional forms of federal or state student financial aid such as Pell Grants and Stafford and direct student loans. Because they have relatively high earnings compared to traditional college students and because they often attend school on a limited part-time basis, they do not qualify for most aid programs. Working adults with modest incomes also rarely receive help from their employers through tuition reimbursement programs for post-secondary education. Making the education tax credits useful for this group is especially important and promising.

This change also brings the Lifetime Learning Tax Credit into parity with the Hope Scholarship Credit. The current disparities in the structure of the two credits are inequitable and confusing. This change will bring them more in line with each other and could help to simplify the filing process for taxpayers.

Estimated Projected Cost: An increase in the LLTC percentage from 20% to 50% (capping the total credit to $2,000) is a 250% increase for individual credits. The mean LLTC in 2001 was $431, and a 250% increase would result in a mean credit of $1,078. This is within the $2,000 credit cap; therefore, we can apply the percentage increase to the aggregate with some confidence. A 250% increase on the $1.6 billion total LLTC credits in 2001 results in a total increase of $2.4 billion for this recommendation.

Caveat: Current law allows for a credit of up to $2,000 under the Lifetime Learning Tax Credit (20% of the first $10,000 spent on qualified expenses of tuition and fees). This structure presents a possible point of contention regarding the Hope Scholarship Tax Credit, which allows for only a $1,500 credit. *Under current law*, if eligible for either credit, the astute tax filer will claim the higher of the two credits – the Lifetime Learning Tax Credit – if he or she has more than $7,500 in qualified expenses. At this level, this filer currently could receive either a maximum $1,500 Hope Credit or a minimum $1,500 up to a maximum $2,000 Lifetime Learning Tax Credit.

The recommendation here – to increase the LLTC from 20% to 50% – exacerbates this tension. *With this recommended change,* filers who could qualify for either credit are likely to chose the LLTC if they have more than $3,000 in qualified expenses because it would yield a higher benefit (as opposed to $7,500 under current law). At $3,000 or more in qualified expenses, they could receive only a $1,500 Hope Credit, but they could alternatively receive at least a $1,500 LLTC and, to the extent their expenses are above that threshold, even more – up to $2,000.

This tension could make the Hope Scholarship Credit irrelevant for many filers. We would not recommend reducing the current LLTC credit maximum from $2,000. The best option to preserve use of the Hope Scholarship Credit for students in their first two years of post-secondary education is to re-structure it so that it is always slightly more beneficial for these tax filers. To accomplish that, the maximum Hope Credit should be increased to more than $2,000. In any case, this tension already exists to some degree in the current tax law.

Recommendation 3:
Expand the Definition of "Qualified Expenses" for Both Education Tax Credits

Specifically, include in the definition of "qualified expenses," not only the direct costs of attending school, *i.e*., tuition, fees, and room and board; but also indirect costs, *i.e*., books, supplies, equipment, transportation, child care, and others as currently defined by the U.S. Department of Education in Title IV student aid formulas. Currently the definition limits qualified expenses to tuition and fees only.

Justification: Even by increasing the percentage of qualified expenses as recommended in #2 above, many working adult students will have no access to the maximum credit. The real costs of attending college are those above and beyond tuition and fees; our research has found that these costs – including books, supplies, equipment, transportation, and child care – can be up to four times what these students pay in tuition and fees, amounting to $1,000 to $2,000 annually.

It is important to note that this change will benefit only those students who do not already receive financial aid to cover these expenses. Both education tax credits already stipulate that tax filers can only include in "qualified expenses" those amounts above and beyond what is covered by tax-free education assistance and refunds, including the tax-free parts of scholarships and fellowships, Pell grants, employer-provided educational assistance, Veterans' educational assistance, and any other nontaxable payments other than gifts or inheritances received as educational assistance. Therefore, the educational tax credits target well those students who do not already receive aid, and this change brings tax credit aid into parity with other forms of student aid.

Estimated Projected Cost: Increasing the amount of eligible expenses must be considered for the Hope and LLTC credits separately. In 2001, the mean Hope credit was $980, compared to the maximum credit of $1,500. Doubling the expenses that students claim does not double the mean credit because the maximum credit is still $1,500. If all 3.2 million filers (2001 Hope numbers) received the maximum Hope credit of $1,500, total Hope costs would be $4.8 billion. As many Hope filers are already close to the maximum credit, we estimate only a 55% increase from the 2001 total Hope credits of $3.1 billion, or an additional $1.7 billion.

For the Lifetime Learning Tax Credit, the average individual credit was $431. If the expansion of the qualified expenses doubles the net costs on which a student can claim credit, this increases the average LLTC to $864 (based on the current 20% claim rate). This amount is within the $1,000 credit cap in 2001 and the $2,000 current cap. If 3.7 million LLTC filers (2001 numbers) each claim a mean credit of $864, the total cost of the credits is $3.2 billion, a $1.6 billion increase over the 2001 cost of $1.6 billion in credits.

In total, this recommendation could cost roughly $8 billion, compared to the $4.7 billion spent on these credits in 2001 ($5.2 billion minus the $500 million for filers who received both credits; this population would have to be more closely analyzed to understand how the recommendation would affect them and, therefore, total costs). This is a $3.3 billion increase over 2001 cost figures.

Recommendation 4: Make Both the Hope Scholarship and Lifetime Learning Tax Credits Refundable

Specifically, using the guidelines for the Earned Income Tax Credit, change the Hope and Lifetime Learning Tax Credits to allow low-income working adult students to keep their full credit, including the portion above any tax liability they have.

Justification: Because the education tax credits simply reduce filers' tax liability, those working adult students who do not owe taxes will not benefit from the credits, even though they have paid for tuition and fees just as tax-owing working adult students have. At a minimum, in 2001, a married tax payer with a family of four must have had at least $19,200 in adjusted gross income to owe taxes, and often, this amount is closer to $22,000 after families qualify for child tax credits and dependent care tax credits. At this income level, families also would qualify for the Earned Income Tax Credit, wiping out even more of their tax liability.

Analysis of IRS data indicates that very lowest income recipients of the credits benefit very little from the credits. The mean Hope credit for filers who had an adjusted gross income of less than $10,000 and who received the credit for their own or their spouse's educational expenses was $195, compared to the overall average for all income ranges of $892. The mean LLTC for these filers was $173, compared to the overall mean of $393. Filers with adjusted gross incomes of $10,000 to under $20,000 received a mean Hope credit of $758 and a mean LLTC of $446.

Of course, there are several reasons for this disparity, including the likelihood that low-income students attend lower cost institutions. However, many of these students have such low tax liabilities that they cannot receive full benefit from the education tax credits (the fact that they even owed any taxes at this income level indicates that they probably are single adults with no dependents).

Most low-income working adult students receive aid for college only from the Lifetime Learning credit, due to their limited enrollments, so it is most important to focus refundability on this credit. However, making the Hope Credit refundable would also be beneficial. Some low-income working adults, especially those who are closer to traditional college age and do not have dependents, may be enrolled at least half-time and could use the financial support from a refundable Hope Credit. In fact, analysis of IRS data found that 58% of Hope recipients in 2001 filed their own taxes and received the credit for their own educational expenses. Many were low-income, and could potentially gain significant benefit from a refundable credit.

Estimated Projected Cost: In 2001, 1.4 million of the 7.2 million (19%) of tax filers who received an education tax credit had incomes below $20,000. Due to their low incomes, almost all will qualify for some student financial aid. If all of the Hope and LLTC filers in 2001 with incomes below $20,000 received a maximum refundable credit ($1,500 for Hope and $2,000 for LLTC), the total cost would be $2.3 billion. This amount is just $1.5 million over the current cost for this group of $760 million in 2001.

Making Choices

Taken separately, these four recommendations would cost a total of roughly $8.7 billion (2001 dollars). This estimate does not take into account the increased expenditures if all four recommendations were to be adopted simultaneously, which would result in a higher cost estimate. However, none of these recommendations rely on another other to have an impact on working adult students; therefore, the fiscal impact could be cushioned by phasing in their implementation or by implementing only select recommendations.

We have presented our recommendations above in priority order. Under any circumstances, the education tax credits must be better marketed (recommendation #1). If the Hope and Lifetime Learning Tax Credits are to have any impact on addressing the education and skills challenge described above, more than one-fifth of working adults must know about them. This means marketing the higher education tax credits to potential students in order to draw more working adults into post-secondary education. Although it is also important to market the credits to currently enrolled working adults to inform them of additional financial support, it is most important to bring new working adult students into higher education.

Recommendation #2 is designed to have a targeted and “high value” impact specifically for working adult students, most of whom can attend college only less-than-half-time and will spend nowhere near $10,000 annually. Because they are more likely to benefit from the Lifetime Learning Tax Credit and not the Hope, working adults will benefit the most by making this credit more valuable for students at low-cost institutions.

Recommendation #3 does increase the value of the credits for working adult students, but it affects Hope as well and is less directly targeted to working adults. However, this recommendation already has been proposed in the Congress and is likely to have great political appeal precisely because it does benefit all students (or their parents) who are eligible for the credits.

Finally, recommendation #4 about refundability would certainly benefit low-income working adult students. However, if the goal is to impact as great a number of working adult students as possible, this recommendation as a stand-alone ranks last. The primary reason is that low-income working adults often cannot afford to attend college even with tax credit aid. Secondarily, the tax credits allowed are “net” of grants and scholarships; therefore, low-income students who receive this type of aid may not qualify for any significant tax credit.

At the end of the day, if we are serious about supporting working adults in earning post-secondary credentials and engaging in lifetime learning, we will find ways to make higher education policies, institutions, and systems more “working-adult friendly.” This nation will face a daunting education and skills deficit challenge within the next two decades and we will solve it only by getting working adults back into post-secondary education or in for the first time.

Many new student aid policy strategies will be required to “ramp up” the production of educated and skilled workers. The higher education tax credits are a promising strategy, and they could make a big difference. However, our research reveals that major changes in their marketing and structure are needed in order to produce that greater impact.

Getting serious about lifetime learning will require getting more use and benefit out of the Hope and Lifetime Learning Credits.

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For the full report, see our website at www.futureworks-web,com

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[i] The Hope credit can be claimed for only two tax years, even if it takes a student longer to complete his or her first two academic years (freshman and sophomore years).
[ii] Tuition and fees minus these tax-free and non-loan sources of student aid is considered "net tuition and fees."
[iii] AGI is total income minus deductions for items such as alimony, student loans, IRAs, and medical savings accounts. For most taxpayers, AGI is equal to total income.
[iv] Kane, Thomas (1999) *The Price of Admission*. Washington, D.C.: Brookings Institution Press.
[v] All cost estimates in this paper are preliminary and should be interpreted only as a rough estimate of the potential cost. They are all based on 2001 data on number of tax credit recipients and credit amounts allowed. Additionally, the cost estimate for each recommendation considers only that recommendation. Further analysis of the interaction between the recommendations and resulting costs should be made when considering specific recommendations together.