

The Thomas A. Roe Institute for Economic Policy Studies

May 22, 1997

HIGHER EDUCATION TAX PROPOSALS: THE RIGHT AND WRONG WAYS TO TAKE THE ANXIETY OUT OF PAYING FOR COLLEGE

John S. Barry
Policy Analyst

INTRODUCTION

President Bill Clinton claims that the recent budget deal with Congress will dedicate as much as \$35 billion of the \$85 billion tax package to help American families meet the costs of higher education. The Administration insists this \$35 billion in higher education tax relief will be realized through the President's Hope and Opportunity for Postsecondary Education (HOPE) scholarship. The President's plan to address the difficulties families face when paying for college, however, is the wrong policy for America. Moreover, if \$35 billion is to be dedicated to making higher education affordable for American families and students, there are far better alternatives to the President's plan.

Foremost among the many problems presented by President Clinton's plan is that it would create yet another middle-class entitlement. In addition, it would require students to maintain at least a B average to continue the credit, thereby subjecting families and students to undue scrutiny by the Internal Revenue Service (IRS); cause grade inflation, thus deflating the value of an education even further; and leave parents with no assurance that they would be eligible for the credit, forcing them to continue trying to save enough money for the full cost of education or to be prepared to go deeply into debt. Finally, the President's \$1,500 tax credit would make an already complex federal tax code even more complicated.

Any plan meant to help parents and students prepare for college expenses must avoid these pitfalls. The right approach to higher education financing policy would be to help

families meet rising college costs by enabling them to save more of their own hard-earned money. In addition, wise reform would seek to remove some of the anxiety caused by constantly fluctuating tuition prices by encouraging savings plans to enable parents to lock in a predetermined tuition rate. Any proposal also should be good long-run tax policy: It should remove the double taxation that currently exists on savings and not bring additional confusion to an already overly complex tax code. Specifically, Congress should:

- **Make the buildup of earnings in all state-based savings plans tax-free.** To date, 42 states either have implemented some form of tax-favored education savings plan or are studying the feasibility of such a program. This is a wonderful example of federalism at work, and the states should be afforded as much latitude as possible. One way to do this is by making the buildup of earnings in state-sponsored tuition savings plans tax-free.
- **Extend the same tax status to earnings in private savings plans.** Many of the state plans are limited to public schools within an individual state's boundaries. This points out the need for complementary private plans, and some private schools and savings institutions already are investigating this option. These private initiatives should be afforded the same tax treatment as state-sponsored tuition savings plans enjoy.
- **Create back-ended super education savings accounts (super-ESAs).** Similar to those made to a super IRA (individual retirement account), contributions to a back-ended super-ESA would be made in after-tax dollars and could be withdrawn by the student tax-free. Each super-ESA could contain several different investment vehicles, just as any specific IRA may contain holdings in several different mutual funds. A Texas student, for example, might invest half his money in a Texas TOMORROW contract and the other half in a regular mutual fund. This flexibility is important because it allows students and parents to diversify their accounts (always a sound investment strategy).
- **Allow transferability of specific savings vehicles between different students' super-ESAs.** Parents and students should be granted the flexibility not only to diversify their super-ESA holdings, but also to exchange those holdings for other investment vehicles if their situations change. If the Texas student's family moves to Virginia, for example, he should be able to trade his Texas TOMORROW contract for a Virginia prepaid bond without being penalized. An entire private higher education bond market could develop.

If an agreement has been reached to dedicate more of the overall tax relief package to higher education than would be necessary for the above proposals, then the following actions—which are consistent with other aspects of the proposed tax package and maintain flexibility for families to meet their changing education needs—should be taken:

- **Expand the \$500-per-child tax credit to cover all dependent children, specifically those who are 18 to 21 years of age.** By and large, dependent children between the ages of 18 and 21 are college students. Extending the \$500 credit to include them without imposing limitations would benefit families struggling to pay for their children's higher education. The \$500 could be used for any family expense, such as transportation to and from school, books, or room and board. Moreover, an extended \$500-per-child credit would not penalize

A Family Dedicating the Entire \$500-per-Child Tax Credit for 21 Years Could Pay for Their Child's Entire Education at an Average Public University or More than a Year's Worth at a Typical Private University

	Public University	School Years That Tax Credits Will Buy		Private University	School Years That Tax Credits Will Buy	
		Clinton's Tax Credit	\$500 Tax Credit		Clinton's Tax Credit	\$500 Tax Credit
Alabama	U. of Alabama at Birmingham	1.3	5.8	Spring Hill College	0.2	1.0
Alaska	U. of Alaska Fairbanks	1.4	6.5	Sheldon Jackson College	0.3	1.3
Arizona	U. of Arizona	1.6	7.4	Prescott College	0.3	1.2
Arkansas	U. of Arkansas	1.4	6.1	John Brown University	0.4	1.5
California	U. of California - Los Angeles	0.8	3.2	Loyola Marymount University	0.2	0.8
Colorado	U. of Colorado at Denver	1.4	6.6	Regis University	0.2	0.9
Connecticut	U. of Connecticut	0.8	3.2	Saint Joseph College	0.2	0.9
Delaware	U. of Delaware	0.8	3.3	Wesley College	0.3	1.2
Florida	Florida State University	1.7	7.9	Barry University	0.3	1.0
Georgia	U. of Georgia	1.2	5.3	Mercer University	0.2	0.9
Hawaii	U. of Hawaii-Manoa	2.0	9.5	Chaminade University of Honolulu	0.3	1.1
Idaho	U. of Idaho	1.9	8.9	Albertson College of Idaho	0.2	0.8
Illinois	U. of Illinois at Chicago	1.1	4.7	Loyola University College	0.2	0.9
Indiana	Indiana University - Bloomington	0.8	3.6	Huntington College	0.3	1.2
Iowa	U. of Iowa	1.3	5.6	Drake University	0.2	0.8
Kansas	U. of Kansas	1.7	8.0	Benedictine College	0.3	1.2
Kentucky	U. of Kentucky	1.3	5.9	Centre College	0.2	0.9
Louisiana	U. of New Orleans	1.3	5.6	Loyola University in New Orleans	0.3	1.0
Maine	U. of Maine	0.9	3.8	Westbrook College	0.3	1.0
Maryland	U. of Maryland College Park	0.9	4.0	Loyola College	0.2	0.8
Massachusetts	U. of Massachusetts - Amherst	1.4	6.1	Regis College	0.2	0.9
Michigan	U. of Michigan - Dearborn	0.9	4.0	Northwood University	0.3	1.2
Minnesota	U. of Minnesota Twin Cities	0.9	3.8	Saint Mary's College of Minnesota	0.3	1.1
Mississippi	Mississippi State University	2.5	5.9	Millsaps College	0.5	2.0
Missouri	U. of Missouri Columbia	0.8	3.6	Saint Louis University	0.2	0.9
Montana	U. of Montana - Missoula	1.2	5.4	Carroll College	0.3	1.2
Nebraska	U. of Nebraska at Lincoln	1.4	6.3	Creighton University	0.3	1.1
Nevada	U. of Nevada Las Vegas	1.6	7.6	Sierra Nevada College	0.3	1.3
New Hampshire	U. of New Hampshire	0.8	3.4	Daniel Webster College	0.2	0.9
New Jersey	Rutgers University	0.8	3.3	Seton Hall University	0.3	1.0
New Mexico	U. of New Mexico	1.5	6.9	College of Santa Fe	0.3	1.0
New York	SUNY at Albany	0.9	3.8	Saint Johns University - New York	0.3	1.2
North Carolina	U. of North Carolina at Chapel Hill	3.4	21.5	Wake Forest University	0.2	0.8
North Dakota	U. of North Dakota	1.2	5.2	Jamestown College	0.4	1.5
Ohio	Ohio State University	0.9	3.9	University of Dayton	0.2	1.0
Oklahoma	Oklahoma State University	1.6	7.3	University of Tulsa	0.2	1.0
Oregon	U. of Oregon	0.9	3.8	University of Portland	0.2	0.9
Pennsylvania	Pennsylvania State University	0.6	2.4	Drexel University	0.2	0.9
Rhode Island	U. of Rhode Island	1.0	4.3	Bryant College	0.2	0.9
South Carolina	U. of South Carolina at Columbia	0.9	3.9	Wofford College	0.2	0.9
South Dakota	U. of South Dakota	1.8	8.7	Augustana College	0.3	1.0
Tennessee	U. of Tennessee - Knoxville	1.4	6.3	Maryville College	0.2	1.0
Texas	Texas A&M University	3.3	20.5	Rice University	0.3	1.0
Utah	U. of Utah	1.2	5.3	Westminster College of Salt Lake City	0.3	1.3
Vermont	U. of Vermont	0.5	2.0	Trinity College of Vermont	0.3	1.0
Virginia	U. of Virginia	0.8	3.3	Washington and Lee University	0.2	0.8
Washington	Washington State University	1.0	4.5	Gonzaga University	0.2	0.9
West Virginia	West Virginia University	1.4	6.2	University of Charleston	0.3	1.2
Wisconsin	U. of Wisconsin - Milwaukee	1.0	4.4	Marquette University	0.2	0.9
Wyoming	U. of Wyoming	1.2	5.3	(no private schools listed)		

Note: School costs are based on 1996-97 figures. Amount saved based on assumed 8% nominal return on savings and 3% inflation rate, adjusted to 1996 dollars.
Source: Heritage calculations, based on tuition costs obtained online from CollegeNET. <http://www.collegenet.com>

high-achieving students who receive merit-based scholarships or other financial aid, because their families could use the extra \$500 for additional needs.

- **Make the \$500-per-child tax credit refundable against an employee's payroll taxes to cover all college-bound students.** This would allow a family with two children and an income tax liability of \$800, for example, to have its entire income tax payment "erased," in addition to receiving back an additional \$200 previously paid out in payroll taxes. All families would have the means to pay for college, because a family that chose to dedicate the entire \$500-per-child tax credit to savings for higher education would accumulate enough money over 18 years to pay for the average tuition at a public university.

The President's higher education proposal does nothing to control the high costs of college tuition. It does not remove the anxiety families feel when faced with uncertain future tuition rates, and it would increase the intrusive nature of the existing federal income tax code. The alternative is to get to the root of the problem by allowing families with college-bound children to keep more of their own hard-earned money and by encouraging saving for higher education. The steps outlined above will do just that.

WHAT'S WRONG WITH THE PRESIDENT'S PLAN

Criticism of President Clinton's plan has been widespread and politically diverse (see Appendix). Specifically, there are six major drawbacks to the Administration's \$1,500 tax credit:

- **President Clinton's proposed \$1,500 tax credit for the first two years of higher education would further inflate tuition costs for all students.** In effect, the President's plan would make students and parents indifferent to additional tuition increases of up to \$1,500 because the federal government is paying the bill. This detrimental effect has been noted by observers from across the ideological spectrum, including *Reason* magazine and the American Association of State Colleges and Universities.

Even worse, the President's plan is good only for the first two years of college. Thus, students and families are stuck with the full cost—newly inflated by as much as \$1,500—of the third and fourth years of college. Moreover, because many students now find it necessary to attend college for more than four years to complete their degrees, the President's tax credit actually could cost them more than it saves them.

- **President Clinton's tax credit ignores the anxiety of families faced with uncertain college costs.** The problem is not just that college costs a lot, but that the cost is uncertain. This makes it difficult for families to know how much they must put aside, or what debt they or their children will have to incur, to pay for a college education. Over the past decade, increases in annual private college costs have fluctuated between 5 percent and 8.6 percent. Increases in tuition at public universities have fluctuated even more.

To understand just how big a difference this fluctuation makes in a family's financial planning, consider a young couple saving for their newborn child's college costs. If tuition and fees at a private university keep rising at the same rate they have risen over the past few years, these parents will have to come up

with just over \$100,000—in today's dollars—when their child heads off to college. If costs rose two percentage points faster than today's pace, or more like the average increase since 1980, the tab would be over \$150,000, while two points less would mean about \$75,000. Such financial uncertainty makes planning difficult at best.

A flat \$1,500 tax credit does nothing to address either these wide fluctuations in tuition inflation or the anxiety such fluctuations cause in families trying to prepare for college expenses. In addition, the President's plan might add to this uncertainty because students might or might not be able to make the grades required to take advantage of the tax credit.

- **President Clinton's tax credit would subject families and students to undue scrutiny by the IRS.** The President's plan requires students to receive a B average or better to receive the \$1,500 credit. This represents an unfair intrusion into the lives of American families. As if it were not enough that they already are required to report every detail of their financial lives to the IRS, they would have to send along their children's report cards as well.

The President's grade requirement also would lead to a significant increase in grade inflation. Colleges and universities would be loath to give out any grade lower than a B if they knew that this would cause a student (and ultimately the school itself) to lose the federal tax credit. On the other hand, if these schools did continue to issue grades below B, families of students earning, for example, a C average still would have to plan on spending the full amount for college and find a way to finance that amount.

- **President Clinton's tax credit would benefit relatively few middle-class families.** In particular, it would benefit few if any low-income families, and even these families would be hurt because they would be disqualified—dollar for dollar—from receiving other needs-based assistance. This is a point emphasized by Lawrence Gladieux, Executive Director of Policy Analysis at the College Board, and Robert Reischauer, a Senior Fellow in Economic Studies at the Brookings Institution and former Director of the Congressional Budget Office.¹ Even Deputy Secretary of the Treasury Lawrence Summers has admitted the President's plan is not designed to benefit low-income families, and instead is meant to help those who already can afford college: "I do not think there is any question that this program is going to benefit a very, very large number of families who would have sent their kids to college anyway and I think that is appropriate because this is, after all, a middle class tax relief program."²

At the other end of the income scale, the President's plan is means-tested so that the credit is phased out for joint tax filers with incomes between \$80,000 and \$100,000 and for individual filers with incomes between \$50,000 and \$70,000. Any family with an income above these limits would be ineligible for the credit.

1 Lawrence E. Gladieux and Robert O. Reischauer, "Higher Tuition, More Grade Inflation," *The Washington Post*, September 4, 1996, p. A15.

2 Lawrence Summers, statement before Committee on Finance, U.S. Senate, April 16, 1997.

Therefore, only middle-income families would benefit from the President's plan—and it is a bad deal even for them because, in order to claim the credit, taxpayers must already have spent the money. In other words, the credit would arrive after the fact, often after a family has gone into debt to pay the bill when it was due. Because the President's plan depends on a student's receiving a grade point average of B or better and remaining drug-free, families could never be sure they still qualify for the credit. Parents would have to find a way to pay the full cost if the student slipped below a B average.

- **President Clinton's tax credit would introduce one more layer of complexity into the already convoluted and unfair federal income tax code.** In poll after poll, Americans say that the complexity of the federal income tax is a major concern. This complexity costs Americans more than 5.4 billion hours per year and \$157 billion just to fill out their federal tax forms.³ President Clinton's plan would compound this problem by carving out another tax credit and forcing families to deal with all the additional paperwork, additional forms, and additional wasted time required to take advantage of it.
- **President Clinton's tax credit would establish yet another middle-class entitlement.** President Clinton openly admits that his \$1,500 credit is meant to make at least two years of college universally available to American students. It is ironic that while Washington and the rest of the country are trying to grapple with the long-term financial crisis in America's existing middle-class entitlements, such as Medicare and Social Security, President Clinton wants to create an entirely new entitlement. Instead of looking for excuses to create new federal entitlement programs, Congress and the President should look for ways to return more responsibility to the states and to America's families.⁴

THE RIGHT APPROACH TO MAKING COLLEGE AFFORDABLE

Congress and the President have an opportunity to help make higher education affordable for America's families by encouraging savings and allowing families to keep more of their hard-earned money. Moreover, these steps can be taken within a framework designed to balance the budget and within the confines of the relatively small tax relief package to which Congress and the President have agreed.

Specifically, lawmakers should:

- **Make the buildup of earnings in all state-based savings plans free of double taxation.** To date, 42 states either have implemented some form of tax-favored education savings plan or are studying the feasibility of such a program.⁵ These programs range from simple savings trust funds to complex prepaid tuition plans that allow parents to purchase a unit of education (say a semester) at a school within their state for a specific date in the future. As Peter Mezereas,

3 Daniel J. Mitchell, "577,951.692.634 Reasons...and Counting: Why a Flat Tax Is Needed to Reform the IRS." Heritage Foundation *Background* No. 1107, April 2, 1997.

4 For more information on entitlements, see Stuart M. Butler and John S. Barry, "Solving the Problem of Middle-Class Entitlements," in Stuart M. Butler and Kim R. Holmes, eds., *Mandate for Leadership IV: Turning Ideas Into Actions* (Washington, D.C.: The Heritage Foundation, 1996), pp. 271–314.

5 For an overview of the state-based plans, see College Savings Plans Network, National Association of State Treasurers, *Special Report on State College Savings Plans* (Lexington, Ky.: Council of State Governments, 1996).

Executive Director of the Massachusetts prepaid tuition plan, explains, "These plans are a way to lock in tomorrow's tuition at today's rates."⁶

The state plans are textbook examples of federalism at work because each plan is designed differently, depending on a state's demographic composition and the institutional structure of its higher education system. These efforts should be afforded the maximum latitude as existing programs are refined and more states establish new ones. The best way to afford flexibility is to make the buildup of earnings in state-sponsored tuition savings plans tax-free. This also would benefit families and students who have invested for their college education through state-sponsored savings plans. The Safe and Affordable Schools Act of 1997 (S. 1)⁷ and the College Savings Act of 1997 (S. 594) both contain such a provision.

- **Extend the same tax treatment to earnings in private savings plans.** The state plans are not flawless, however. Many are limited to public universities within an individual state's boundaries, so even though parents are guaranteed that they are saving enough for college, their choices may be limited to a small set of schools. Also, the full faith and credit of the state supports many of these state plans. Therefore, if a program were to run into financial trouble, state taxpayers probably would be required to pay for its restoration. Such reservations point to the need for complementary private plans.

Some private savings instruments have been developed already. For example, the College Savings Bank of Princeton, New Jersey, offers the CollegeSure[®] Certificate of Deposit, a federally insured savings vehicle whose rate of return is tied to an index of tuition inflation at 500 public and private colleges and universities.⁸ The CollegeSure[®] CD is more flexible than the state plans because the savings can be used at any school in the United States and can be applied toward tuition, room, board, or any other cost associated with a student's education. Because the CD is indexed, the purchaser knows the investment will cover average increases in college costs—although it does not lock in a specific amount of education at any particular institution.

Many private schools and college associations also are looking into prepaid tuition programs for future students. The Associated Colleges of the South, a consortium of 13 private schools located throughout the southern states, has expressed the greatest interest to date, and has gone so far as to investigate the legal implications of such a plan. Other associations, leagues, and independent schools are sure to follow, thereby extending the benefits of prepaid plans to a larger group of future students.

The Safe and Affordable Schools Act includes a provision to make earnings on private plans tax-free.

6 Interview with the author, November 12, 1996. The Massachusetts U-Plan, created in 1995, is one of the most flexible state prepaid plans in existence because it includes tuition contracts redeemable at both public and private schools.

7 For a full analysis of S. 1, see Nina H. Shokraii and John S. Barry, "Two Cheers for S. 1: The Safe and Affordable Schools Act of 1997," *Heritage Foundation Issue Bulletin* No. 232, May 14, 1997.

8 College Savings Bank information brochure, "CollegeSure[®] Certificate of Deposit: The Guaranteed Way to Save for College," 1996.

- **Create back-ended super education savings accounts (super-ESAs).** Similar to contributions to a super-IRA, contributions to a back-ended super-ESA would be made in after-tax dollars and withdrawn by the student tax-free. This approach compares favorably with current tax law, which requires that donations to any savings account be in after-tax dollars, then taxes the interest earnings on that account each year, and then taxes any accrued capital gains when savings are redeemed. Thus, families and students who save for college are penalized by a double taxation on their savings. Super-ESAs would end this tax penalty and allow families to save more cost-effectively.

Also, each super-ESA could contain several different investment vehicles, just as any specific IRA may contain holdings in several different mutual funds. This is important because it allows parents to diversify their college savings while maintaining their tax-free earnings on the account as a whole.

S. 1 would establish such accounts. The language of the bill, however, should be modified to eliminate the \$1,000 annual contribution limit and the cash-only contribution limitation.⁹

- **Allow transferability of specific savings vehicles between super-ESAs.** Parents and students should be granted the flexibility not only to diversify their super-ESA holdings, but also to exchange those holdings for other investment vehicles if it is advantageous to do so. For example, parents living in Virginia may purchase prepaid tuition bonds to the University of Virginia for their child's super-ESA. If they move to Delaware, they should be able to trade the Virginia bond on the open market for a similar bond redeemable at a school in Delaware. Again, the key would be to extend to families as much flexibility as possible so that they can meet their changing needs without penalty.

An entire private higher education bond market might develop from this flexibility. In such a market, independent investors or schools would offer bonds denominated in education units (semesters or credit hours, for example) at particular schools. Parents could purchase the bonds for the year in which their child was expected to enter college. But there would be an additional choice: A parent could buy a "call" option at a small price for the right to buy a bond at a later time at a fixed price. That time might be when the family could expect a higher income, or when the parents sold their house and became "empty nesters." As with any other futures market, parents would be locking in a future price without paying for the product today.

Not only would this allow parents to be sure that their savings were sufficient to pay for the educational needs of their children at a particular college, but they could trade one bond for another bond good at a different college if their means or desires changed. In other words, a market would develop in which investors who held a bond for one school could trade the bond with other investors who held bonds redeemable at another school.

If (as is likely) schools themselves were the issuers of such bonds, they also would benefit. By issuing bonds, they could raise money to build additional

⁹ Shokraii and Barry, "Two Cheers for S. 1."

classrooms, upgrade computer systems, or pay for any number of other capital-intensive projects. Issuing bonds would be attractive to schools that otherwise would have to borrow money from a bank or solicit private donations. The bondholders also would represent a pool of potential future students.

With a few minor clarifications, S. 1 would allow for the full transferability of individual savings vehicles between super-ESAs.

- **Expand the \$500-per-child tax credit to cover all dependent children.** Most versions of the \$500-per-child tax credit under discussion would limit the credit to dependent children under the age of 18.¹⁰ Congress and the President could strengthen the \$500-per-child tax credit and assist families with children in college by extending the credit so that it also covers dependent children who are 18 to 21 years of age. By and large, dependent children between the ages of 18 and 21 are college students. Extending the \$500 credit to cover these 7.2 million children would benefit families struggling to pay for higher education without imposing any limitations. The \$500 could be used for any family expense, including transportation to and from school, books, and room and board. Moreover, an extended \$500-per-child credit would not penalize high-achieving students who receive merit-based scholarships or other financial aid, because the family could use the extra \$500 to meet additional needs.¹¹
- **Make the \$500-per-child tax credit refundable against an employee's payroll taxes to cover all college-bound students.** Tax relief that is meant to help families paying for higher education should not be an afterthought and should not be limited to a small fraction of the college-bound population. Yet this is exactly what the President has done by making his \$1,500 credit non-refundable. Lawrence Summers went to great lengths to stress this fact when testifying before Congress recently:

[T]his is, after all, a middle class tax relief program.... I think it is very important to understand that this is a program that was designed as a middle class tax relief program that will have the additional benefit of encouraging something that I think we in this country all want to encourage, which is people going to college.¹²

By making the \$500-per-child tax credit refundable against a worker's payroll taxes, Congress and the President could extend tax relief to those who need it most. Refundability would allow even families that do not pay \$500 in federal income taxes to be eligible for the entire \$500-per-child credit. For example, a family with two children and an income tax liability of \$800 would have its entire income tax payment erased and recover an additional \$200 already paid in payroll taxes.

Under such a proposal, all families would have the means to pay for college because a family that chose to dedicate the entire \$500-per-child credit to savings for higher education would accumulate enough money over 21 years to

10 President Clinton's original proposal would have limited the credit to children under age 13.

11 The President's \$1,500 credit, on the other hand, can be applied only against tuition expenses. Thus, if a student is receiving any other financial aid, he is ineligible—dollar for dollar—for the credit.

12 Summers, statement to Senate Finance Committee.

pay for the average tuition at a public university (see Table 1).¹³ If the \$500 credit was refundable, all families—not just those in the middle class—would have this opportunity.

In short, making the \$500-per-child tax credit refundable against a worker's payroll taxes and providing the super-ESA as a savings vehicle would help not only those who already can afford college, but also those who today find it impossible to send their children to college.

OTHER OPTIONS

Creating super-ESAs and extending the \$500-per-child tax credit to cover all college-bound students are the proper starting points in addressing the anxiety that families feel when preparing for college. Several other refinements and extensions would strengthen this approach. For example:

- **Permit the rollover of existing savings into a super-ESA.** Many families already have saved for their children's higher education despite the penalty imposed by the tax code. These families should be allowed to roll these savings into a super-ESA and withdraw the principal and buildup of earnings tax-free. Because the interest earned on savings for college currently is taxed as income each year, a rollover provision would be of limited value to most families. Many families, however, save for college by investing in mutual funds, stocks, and bonds. Under current tax law, when they sell these assets to finance their children's education, they have to pay a capital gains tax on the increase in value. Allowing the rollover of these assets into a super-ESA would let families sell them without paying the capital gains tax as long as the proceeds were used to pay for education-related expenses.
- **Permit parents to borrow against their IRAs.** Another option would be to allow parents to borrow against their IRAs tax-free to finance their children's education. This would allow families to borrow tax-free from their own savings and then pay it back into the IRA over a scheduled period. Thus, individual savings for retirement are maintained, and parents can use their savings to pay for college without incurring a tax penalty or assessment.
- **Extend coverage of super-ESAs to all levels of education.** Many analysts and lawmakers have proposed general super-ESAs to allow families to save for all levels of education, not just for undergraduate college. This is a natural extension of the alternative approach put forth in this paper.
- **Support other creative higher education financing ideas.** There are a number of innovative ways to help families meet the high and uncertain costs of college. Congress and the President should ensure that federal policy does not keep them from being tried. Human Capital Resources, a company based in New York, has developed what amounts to a mutual fund that invests in students instead of companies. Investors give money to students to pay for their education, and the students repay the money as a percentage of their income

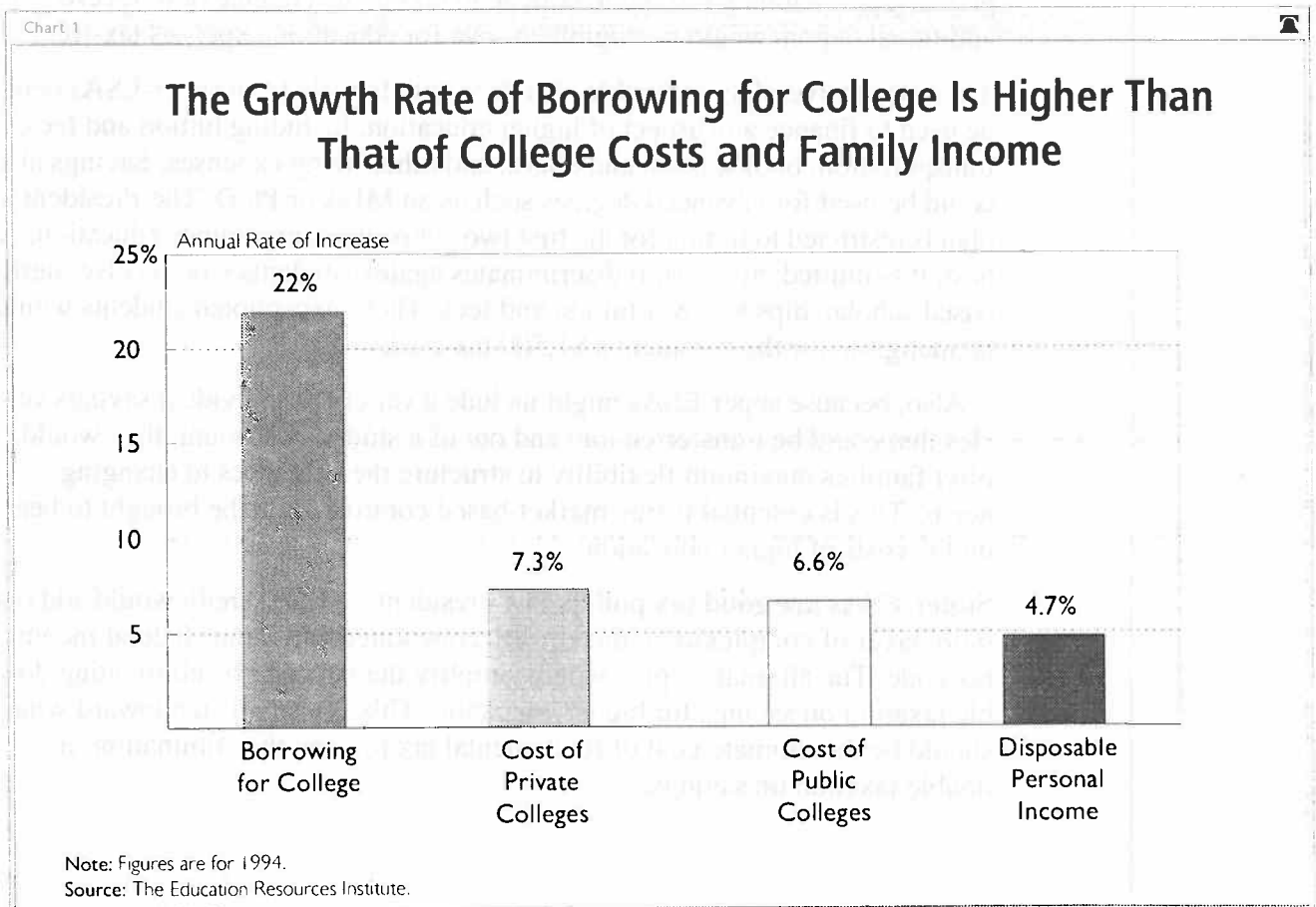
13 For additional details, see John S. Barry, "Balanced Budget Talking Points #3: What a Balanced Federal Budget with Tax Cuts Would Mean for Family College Costs," Heritage Foundation *F.Y.I.* No. 77, December 4, 1995.

over a predetermined period of time (usually ten years). Essentially an equity investment in human capital, this is just one of many innovative ideas that could be implemented if the federal government were to remove some of the barriers to their development.

ADVANTAGES OF THE ALTERNATIVE APPROACH

This alternative approach to preparing for higher education costs has several important advantages. Specifically:

- **It encourages savings rather than debt.** Because the federal government taxes savings twice and subsidizes higher education loans, many families find that they must incur tremendous debt to send their children to college. According to the Education Resources Institute, “In the 1990s, students have borrowed as much as was borrowed in all of the 1960s, 1970s, and 1980s combined.”¹⁴ This trend cannot continue. Any higher education tax relief must make it more attractive for American families to save for their children’s education than to rely on the federal government and incur years of costly debt. The alternative plan would do just that by ending the unfair penalty on families who work hard and save for their children’s education.



14 “College Debt and the American Family,” report from the Education Resources Institute and the Institute for Higher Education Policy, September 1995, p. 6.

- **More students would benefit.** By the Administration's own estimates, only about 4.2 million students would benefit annually from the President's \$1,500 tax credit.¹⁵ In contrast, more than 50 million children in 28 million families would be eligible each year for a refundable \$500-per-child tax credit.¹⁶ Moreover, every one of these potential college students would be able to establish a super-ESA and save for college tax-free. Even limiting the potential beneficiary population to likely college students, based on historical college enrollment patterns, nearly 20 million American children would benefit annually from the alternative proposal.
- **More assistance is available for these students.** The maximum tax relief offered by President Clinton's tax credit is \$3,000 over the lifetime of each student. The maximum benefit to students under the alternative plan would be considerably higher: more than \$16,000 if the entire \$500-per-child tax credit were dedicated to savings for higher education each year (see Table 1).
- **Students are eligible every year they are in school.** The President's \$1,500 tax credit is limited to the first two years of higher education. Moreover, students are ineligible if they already have completed the first two years of college. The alternative plan would extend throughout a student's academic career. Any student could use the super-ESAs, regardless of the level of education completed. Thus, adults returning to college to complete a degree or to receive an additional degree would be eligible to save for education expenses tax-free.
- **The alternative plan is flexible.** Tax-free withdrawals from super-ESAs could be used to finance any aspect of higher education, including tuition and fees, transportation, books, room and board, and other living expenses. Savings also could be used for advanced degrees such as an MBA or Ph.D. The President's plan is restricted to tuition for the first two years of undergraduate education. At best, it is limited; at worst, it discriminates against students who receive merit-based scholarships to cover tuition and fees. These exceptional students would be ineligible for the President's \$1,500 tax credit.

Also, because super-ESAs might include a variety of individual savings vehicles that could be transferred into and out of a student's account, they would offer families maximum flexibility to structure their finances to changing needs. This is essential if true market-based controls are to be brought to bear on the costs of higher education.

- **Super-ESAs are good tax policy.** The President's \$1,500 credit would add one more layer of complexity to the already convoluted and unfair federal income tax code. The alternative plan would simplify the tax code by eliminating double taxation on savings for higher education. This is a small step toward what should be the ultimate goal of fundamental tax reform: the elimination of double taxation on savings.

15 "President Clinton's Hope and Opportunity for Postsecondary Education (HOPE) Act of 1997," available on the U.S. Department of Education's Web site at <http://www.ed.gov/HOPE/part1.htm> as of May 11, 1997.

16 Based on 1994 Internal Revenue Service Public Use data and the Current Population Survey for 1996.

- **The alternative plan would help control tuition inflation.** One of the worst things about federally subsidized college loans and grants (and education-specific tax credits) is that colleges have no incentive to control the cost of education. By promoting savings and maintaining family control over education spending, the alternative proposal would help control tuition inflation. Such innovations as prepaid tuition plans and tradable education bonds also would bring market controls to bear on tuition inflation rates.
- **Savings can help eliminate the uncertainty of future college costs.** Because state and private prepaid tuition plans would flourish under the super-ESA proposal, families would be able to lock in tomorrow's tuition at today's rates. Thus, one of the major causes of anxiety among families planning for college would be eliminated. The President's plan would do nothing to help end the uncertainty of future college costs.

CONCLUSION

To his credit, President Clinton has drawn attention to the difficulties American families face in trying to pay for their children's college education. Unfortunately, the President's solution is another version of the old story that a good punch to the stomach is enough to make someone forget about his headache. The Administration's inappropriately titled HOPE scholarship is the wrong approach to the twin problems of the magnitude and perpetual uncertainty of college costs. In fact, it would make matters worse.

The right approach is to allow American families to keep more of their hard-earned money, to stop penalizing them for saving for college, and to encourage them to invest in higher education savings plans. The creation of super-ESA accounts and the extension and refundability of the \$500-per-child tax credit would do just that. Moreover, this approach is fully achievable within the broad outlines agreed to by the President and Congress in this year's budget deal.

APPENDIX: WHAT PEOPLE ARE SAYING ABOUT THE PRESIDENT'S PLAN

And so Clinton's tax credits for B's and education-as-an-entitlement philosophy can only do harm.

— Virginia Postrel¹⁷

While tuition tax relief may be wildly popular with voters and leave Republicans speechless, it won't achieve the president's worthy objectives for education, won't help those most in need and will create more problems than it solves.

— Lawrence E. Gladieux
and Robert O. Reischauer¹⁸

What I see as I look at this situation, is an accumulation of debt on students that does not cause me to be terribly enthusiastic about providing a tax exemption that basically could do two things that could be very bad. It could add inflationary pressure on the cost of education, making the current problem worse, and it could encourage people to accumulate more debt precisely at the time when it seems to me they are going way beyond what is acceptable.

— Senator Robert Kerrey (D-NE)¹⁹

Generally, tax deductibility can be expected to have some inflationary impact because it constitutes a third-party (federal) price discount that would, over time, be shared in some fashion not only by the buyer (students) in the form of lower effective tuition costs, but also by the seller (institutions) in the form of somewhat higher nominal prices.

— American Association of
State Colleges and Universities²⁰

Clinton's bad idea is a \$1,500 tax credit on tuition for the first two years of college.... An unintended consequence of Clinton's plan is that it would make college students paying less than \$1,500 in tuition unconcerned about tuition increases.

— David Henderson, *Fortune*²¹

17 Virginia Postrel, "Clinton's College Plan: Educational Inflation," *The Washington Post*, March 30, 1997, p. C1.

18 Gladieux and Reischauer, "Higher Tuition. More Grade Inflation."

19 Statement of Senator Robert Kerrey during Senate Finance Committee hearing, April 16, 1997.

20 "Middle Class Tax Cut Proposals Examined," *Memo to the President*, American Association of State Colleges and Universities, February 24, 1995, p. 3.

21 David R. Henderson, "Two Bad Tax Cuts," *Fortune*, March 17, 1997, p. 38.

The [President's] proposal is another step toward a new middle-class entitlement: a federally subsidized college education for families with incomes as high as \$100,000 a year.... But politicians' enthusiasm for middle-class tax breaks may blind them to alternative, perhaps wiser ways to ensure that those who might benefit from college can afford to go.

— David Wessel²²

The Administration's Hope Scholarship will be a program with a significant regulatory burden that does not address investment and growth as effectively as would providing opportunities for the more efficient private sector to allocate resources.

— Representative Jim Saxton (R-NJ)
Chairman, Joint Economic Committee²³

Even if you are keen for, say, Clinton's multibillion-dollar tax subsidies for college students (which will likely translate into tuition increases), you might ask yourself if they are more valuable than the other domestic programs they are supposed to supplant.

— Jodie T. Allen²⁴

Speaking as a columnist who moonlights as a professor, I say that President Clinton's Hope Scholarship is Excedrin Headache 101.... [T]he Hope Scholarship is a half-tablet of aspirin. It might relieve a bit of pain for the upper middle class on April 15. It does nothing to get rid of our educational migraine.

— Derrick Z. Jackson²⁵

[T]he tuition tax credits will be inducements to hundreds of other institutions, public and private, to ratchet up charges and reduce efforts, already minimal, to make their programs more efficient, drop obsolescent courses, shut down marginal research projects and hold down costs.

— Peter Schrag²⁶

22 David Wessel, "The Outlook: Washington," *The Wall Street Journal*, December 30, 1996, p. A1.

23 Report, *The Administration's Proposal for a Tuition Tax Credit*, Joint Economic Committee, U.S. Congress, 105th Cong. 1st Sess., February 1997, p. 7.

24 Jodie T. Allen, "Budget Bunk," *Slate*, May 10–12, 1997, p. 13.

25 Derrick Z. Jackson, "Clinton's 'Plan B' will give teachers a headache," *The Boston Globe*, February 12, 1997, p. A19.

26 Peter Schrag, "Tuition Aid for...?" *The Sacramento Bee*, February 5, 1997, p. B6.

