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AN EDUCATION TAX PLAN TO SPUR SAVINGS, NOT DEBT

One of the most controversial aspects of the recent budget resolution is tax relief earmarked for higher education. In fact, the only point on which all parties can agree is that something should be done. Since 1980, college costs have skyrocketed, rising by 221 percent, while general inflation and family income have increased by only about 80 percent.

The issue facing Congress is what form of tax relief would help financially strapped families afford college education for their children, yet do so without violating sound tax policy, encouraging more debt, or inducing colleges to raise tuition. One approach—education investment accounts (EIAs)—passes these tests.

American families are forced to incur tremendous debt to finance higher education for their children. Students themselves leave college with huge loans to repay. According to the Education Resources Institute, Americans have incurred more debt to finance college since 1990 than during the 1960s, 1970s, and 1980s combined. The reason is twofold: (1) the federal government subsidizes student debt while penalizing family savings, and (2) families never can be certain what college will cost when their children are ready to enroll. Saving under such conditions is difficult.

The President's plan—a tax credit of up to $1,500 for each of the first two years of higher education—does not promote family savings and does not address the uncertainty of college costs. It is generally agreed that the President's plan would do more harm than good. Explains Senator Robert Kerrey (D–NE), "What I see...is an accumulation of debt on students that does not cause me to be terribly enthusiastic about providing a tax exemption that basically could...add inflationary pressure on the cost of education, making the current problem worse, and...encourage people to accumulate more debt precisely at the time when it seems to me they are going way beyond what is acceptable."

At the same time, a number of other plans on the table do promote family savings rather than encourage student debt. Most prominently, House Ways and Means Committee Chairman Bill Archer (R–TX) has included strong savings proposals in his proposed FY 1998 tax relief package (which also includes the President's tax credit). Senator Paul Coverdell (R–GA) introduced a bill to create special EIAs that families could use to save tax-free for college. Representatives Nancy Johnson (R–CT) and Kay Granger (R–TX) each introduced a bill to do the same. Senators Mitch McConnell (R–KY) and Bob Graham (D–FL) introduced a bill to make the buildup of earnings in state-based savings plans tax-free.

Each of these plans has positive as well as negative aspects. Together, they represent a good foundation from which to craft significant tax relief for families and students who save for college–one that is both good tax policy and good education policy. Specifically, the reconciliation package should do four things to help families facing spiraling college costs:

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1. **Create a new "back-ended" HOPE education investment account.** This new savings vehicle would allow families to deposit after-tax income or existing assets into a long-term savings account or a prepaid tuition plan and withdraw the money and earnings later without paying additional taxes. No limit should be placed on the amount of money that can be contributed to this account; limiting annual contributions to $1,000 or any other arbitrary amount would not allow families to save enough to pay the tuition costs at many colleges. Although several bills have been introduced that would create back-ended savings accounts, all of them include a limit on annual contributions.
2. **Make the buildup of earnings in all state-based and private savings plans free of double taxation.** Many existing savings programs are prepaid tuition plans that allow families to purchase a unit of education at a particular school for a specific date in the future. These programs encourage savings for college and eliminate the uncertainty of future college costs by allowing families to lock in today's tuition rates. To date, more than 42 states and several private schools and businesses have established or are studying the feasibility of tuition savings plans. Currently, federal taxes on the buildup of earnings in state plans are deferred until the student enrolls in college. Private plans do not have any special tax treatment; taxes are paid each year. All the savings plans should be granted the same tax-free status so that, regardless of how families choose to save for higher education, they will not be penalized.
3. **Give more flexibility to families to save, invest, and spend their income on higher education.** Families should be permitted to save for college as they see fit. Therefore, contributions to the HOPE EIA should not be limited to cash; contributions of stocks, bonds, prepaid tuition contracts, and other savings vehicles also should be allowed. Nor should lawmakers limit the range of individuals eligible to donate funds to any particular student's account. For example, grandparents may have stocks they wish to give to their grandchildren to help pay for college. Instead of giving the stocks to the child directly, they could donate them to the child's HOPE account. Students then would be able to sell the stocks to pay for college without paying taxes.
4. **Ensure that families can transfer financial assets—including prepaid tuition contracts—into and out of HOPE education investment accounts.** EIAs should be flexible enough to accommodate a family's changing needs. For example, families that move from state to state, or that are unhappy with their current method of saving for college, should be able to trade an asset in their children's HOPE account—including a state or private prepaid tuition contract—for another asset or contract that better suits their circumstances. Individual retirement accounts (IRAs) currently benefit from this treatment; an individual unhappy with the performance of a specific mutual fund within an IRA can sell the holdings in that fund and purchase another. The key is that the increase in the value of the account would be realized tax-free, no matter how the money in the account is invested.

As Congress considers the details of the portion of the tax bill earmarked for higher education expenses, Members should work to craft a policy that is good higher education policy *and* good tax policy. By adopting these four components, Congress and the President can help financially strapped families afford college for their children in a way that does not violate sound tax principles, encourage families to go further into debt, or lead to future tuition hikes.

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