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A REPORT CARD ON THE CONGRESSIONAL HIGHER EDUCATION TAX PROPOSALS

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INTRODUCTION

The House Ways and Means Committee and the Senate Finance Committee have completed work on the tax relief component of this year's budget reconciliation, and the bills are headed for a floor vote this week. Both tax-writing committees have based their work on an agreement reached earlier in the year among President Bill Clinton, House Speaker Newt Gingrich (R–GA), and Senate Majority Leader Trent Lott (R–MS). In a letter to President Clinton, Speaker Gingrich and Senator Lott summarized the agreement by promising that any final bill would include "roughly $35 billion over five years for post-secondary education, including a deduction and a tax credit." Gingrich and Lott continue, "We believe this package should be consistent with the objectives put forward in the HOPE scholarship and tuition tax proposals contained in the Administration's FY 1998 budget to assist middle class parents."

Working within these confines, both committees have reported bills that include a mix of good and bad education tax policy. Both bills include policies that will help families save for college; the savings plans are good long-term tax policy as well as good education policy. But the measures also include a modified version of President Clinton's HOPE scholarship, an ill-advised tax credit that would further inflate the cost of college and complicate an already overly complex federal tax code.

Because there are differences between the House and Senate bills, they must be reconciled and then approved by the full Congress before being sent to President Clinton for signing. Thus, there is still time during floor action to build upon the positive aspects of the existing tax bills and remedy the bad policy. Paying for college is one of the most important goals of most American families. It is important, therefore, that lawmakers pass a bill that is not only politically popular but also good tax and education policy.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

Table 1

Congressional Higher Education Tax Proposals Report Card

Senate Finance Committee Proposal	Grade
Administration's HOPE scholarship tax credit	D-
Education IRAs — allow contributions of up to $2,500 annually; mandate $500 per-child tax credit be deposited for children ages 13 to 16	C
Penalty-free IRA withdrawals for qualified education expenses	A-
Deduction for undergraduate expenses paid through prepaid tuition programs	A-
Permanent extension of employer-provided educational assistance	A
Student loan interest deduction ($2,500 above-the-line deduction)	D-
Overall Grade for Senate Bill	**C-**

House Ways and Means Committee Proposal	Grade
Administration's HOPE scholarship tax credit	D-
Education Investment Accounts — limit contributions to $5,000 per year	A-
Penalty-free IRA withdrawals for qualified education expenses	A-
Deduction for undergraduate expenses paid through prepaid tuition programs	A-
Permanent extension of employer-provided educational assistance	A
Overall Grade for House Bill	B+

Proposal No. 1: Administration's HOPE Scholarship Tax Credit, as Modified[1]

Grades: Senate: D–
House: D–

Good Point: Provides some tax relief for American families.

Bad Points: Would fuel tuition inflation; ignores the anxiety families feel when faced with uncertain college costs; would benefit relatively few middle-class families; would complicate an already convoluted and unfair tax code; and would establish another middle-class entitlement.

Recommendations: Eliminate the President's HOPE scholarship from the final tax bill. Instead, extend the $500-per-child tax credit to cover college-age dependents between the ages of 17 and 21.[2]

1 The Administration's original proposal was a non-refundable tax credit of up to $1,500 for students in their first two years of post-secondary education. Students would be required to earn at least a B average during their first year to be eligible for the credit during their second year.

2 For a full discussion of this recommendation, see John S. Barry, "Higher Education Tax Proposals: The Right and Wrong Ways to Take the Anxiety Out of Paying for College," Heritage Foundation *Backgrounder* No. 1118, May 22, 1997.

Criticism of the Administration's HOPE scholarship (as included in both the Senate and House bills) has been widespread.[3] Observers from across the spectrum—from former Congressional Budget Office director Robert Reischauer to the American Association of State Colleges and Universities—have noted that President Clinton's plan would make students and parents indifferent to tuition increases because the federal government would be paying the bill. 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. In addition, it would encourage colleges to raise tuition to "capture" the value of the scholarship credit themselves, hurting families that do not qualify and reducing the benefit to those that do.

Moreover, President Clinton's credit would compound the problem of a convoluted and unfair tax code by forcing families to deal with all the additional paperwork, additional forms, and additional wasted time required to take advantage of yet another tax credit. In essence, President Clinton's proposal would establish another middle-class entitlement. It is ironic that, while the vast majority of Americans are calling for a simpler tax code and the fundamental reform of existing entitlements such as Medicare and Social Security, President Clinton wants to create an entirely new entitlement by further complicating the existing federal income tax code.

A far better approach would be to extend the $500-per-child tax credit to cover all dependent children, including those between the ages of 17 and 21. Extending the $500 credit to cover these 10 million children would benefit families that are struggling to pay for college without imposing any limitations and without creating an entirely new entitlement through the tax code. 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.[4]

Proposal No. 2: Education Savings Accounts

Grades: Senate: B
House: A–

Good Points: Would end the double taxation of savings for higher education expenses; would end the penalty families currently face when saving for college vis-à-vis debt financing, which currently is subsidized by the federal government.

Bad Points: Would limit the amount of money families can save tax-free through Education Savings Accounts. In addition, the Senate bill would mandate that families with children aged 13 to 16 deposit the $500-per-child credit into an education savings account.

Recommendations: Remove the proposed limitations on contributions to the education investment accounts. Remove the forced-savings provisions now in the Senate bill.

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3 See Appendix for a collection of comments on President Clinton's proposed HOPE credit.

4 The HOPE scholarship, on the other hand, can be applied only against tuition and related expenses. Thus, if a student is receiving any other form of financial aid, he becomes ineligible for the credit.

Both the proposals would create back-ended education investment accounts (EIAs). As with a super-IRA (individual retirement account), contributions to a back-ended EIA 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 account be in after-tax dollars, then taxes the interest earnings on that account each year, and then taxes any accrued capital gains when the savings are redeemed. Thus, families and students who save for college are penalized—especially when compared with student debt financing, which is subsidized by the federal government. EIAs created by the Senate and House bills would end this tax penalty and allow families to save more cost-effectively.

Both bills, however, contain limits on the amount of savings that can accumulate tax-free in a student's EIA, which would severely reduce the value of the accounts to parents and students. The House bill would limit savings by capping annual contributions to a student's EIA at $5,000 per year for a maximum of ten years. The Senate bill is even worse in that it would cap annual contributions to a student's EIA at $2,500 per year. With the caps, neither plan would enable families to save enough money for many schools in the United States. In fact, even if a family were to save the maximum amount allowable, they would be able to save only enough for about three years at the average private university.[5]

The Senate bill, in addition to capping annual contributions, would impose an unconscionable mandate on American families: It would require that families with children between the ages of 13 and 16 deposit the $500-per-child tax credit (being offered as a separate component of the complete tax bill) into an EIA. Such a mandate infringes on the right of parents to decide how best to use the money for their children, and denies low-income families the ability to use the money for more pressing, day-to-day expenses.

Proposal No. 3: Penalty-free IRA Withdrawals for Qualified Education Expenses

Grades: Senate: A–
House: A–

Good Points: Would end the double taxation of savings for higher education expenses; would end the penalty families currently face when saving for college vis-à-vis debt financing subsidized by the federal government.

Bad Points: Neither proposal includes an increase in the annual contribution limit to IRAs, making it difficult for families to save both for retirement and their children's education.

Recommendation: Increase the annual contribution limit to IRAs so that families are able to save for all of their lifetime needs including college and retirement.

Many Americans depend on saving for their retirement through IRAs. An IRA allows individuals to deduct from their taxable income contributions made to a special account earmarked for retirement. The build-up of earnings within the account is not taxed until the individual withdraws the money—as long as the individual is at least 59-and-one-half years old. If the individual has not reached this minimal retirement age and must withdraw money from his IRA, then the individual must pay taxes on the earnings and a one-time tax penalty for withdrawing the funds early.

5 Assumes an average four-year cost for tuition, fees, and room and board of $13,000. This estimate is based on information provided by the National Center for Education Statistics, U.S. Department of Education, "Basic Student Charges at Postsecondary Institutions: Academic Year 1994–95," November 1995.

Both the Senate and House bills would eliminate this penalty for early withdrawal as long as the money is spent on medical or education expenses or for the purchase of a first home. This is sound policy because it increases the individual's flexibility to structure savings to meet lifetime goals.

Lawmakers should remember that many Americans depend on the savings they have accumulated in their IRAs to pay for necessary living expenses during their retirement years, and allowing penalty-free withdrawals for home purchases or education and medical expenses (often expenses that are incurred earlier in life) may deplete the retirement savings of these individuals. Therefore, Congress and the President should make sure that individuals have the opportunity to fully replenish their retirement accounts after making a substantial withdrawal from their IRAs. Alternatively, the $2,000-per-year limit on contributions could be increased to allow taxpayers enough of a buffer to save for retirement and education, health, and home expenses.

Proposal No. 4: Prepaid Tuition and Other Savings Plans

Grades: Senate: A–
House: A–

Good Points: Would remove the anxiety families feel when faced with uncertain future college costs; would provide a safe and convenient savings vehicle for college expenses; would eliminate federal taxes on the interest earnings that savers reinvest in state prepaid college tuition plans; would eliminate the equivalent tax on similar plans offered in the private sector.

Bad Points: The House version would limit tax-free use of prepaid programs to $10,000 per year and $40,000 per student. Likewise, the Senate version would limit contributions to prepaid plans to no more than $2,500 per year.

Recommendation: Eliminate the proposed contribution caps so that all earnings in all private and state tuition savings programs are tax-free.

The problem is not just that college costs a great deal, but that the cost is uncertain, making it difficult for families to know how much they must put aside to pay for their children's education. Prepaid tuition plans remove this anxiety by ensuring families that they are saving exactly enough to pay for the education of their children. That is because through the prepaid programs families purchase a unit of future education—say a semester—at today's tuition rates. As Peter Mezereas, 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] To date, 16 states have implemented some form of prepaid tuition plans.[7] In addition, several private schools and companies have expressed great interest in establishing private prepaid tuition plans. All of these efforts should be encouraged—as both the House and Senate bills would do—by making earnings in the 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 discussion of these and other savings plans, see Stuart M. Butler and John S. Barry, "Taking the Anxiety out of Paying for College: A Bond Market for Higher Education," Heritage Foundation *Backgrounder* No. 1101, January 31, 1997. See also, College Savings Plans Network, National Association of State Treasurers, *Special Report on State College Savings Plans* (Lexington, Ky.: Council of State Governments, 1996).

The problem with both plans is that they would cap the amount that could be saved through prepaid plans. Again, this limitation would not allow families to save enough for a full education at many colleges and universities in the United States.

Proposal No. 5: Extension of Employer-Provided Educational Assistance

Grades: Senate: A
House: A

Good Points: Would allow businesses to deduct all business-related expenses from income taxes; in line with fundamental tax reform.

Bad Points: None.

Recommendation: Retain the extension of employer-provided educational assistance.

It is increasingly important that firms not only hire educated employees but that they train them on a continual basis. Continuing employee education, therefore, is now a legitimate business expense. As with any necessary business expense, the cost of an employee's education should not be included in that employee's taxable income. Moreover, the expense should be deductible from the firm's taxable income. This is not only good education policy, but also good tax policy because it is in line with fundamental tax reform.

Proposal No. 6: Student Loan Interest Deduction

Grades: Senate: D–
House: A *(no provision)*

Good Point: Provides tax relief for young Americans just entering the workforce.

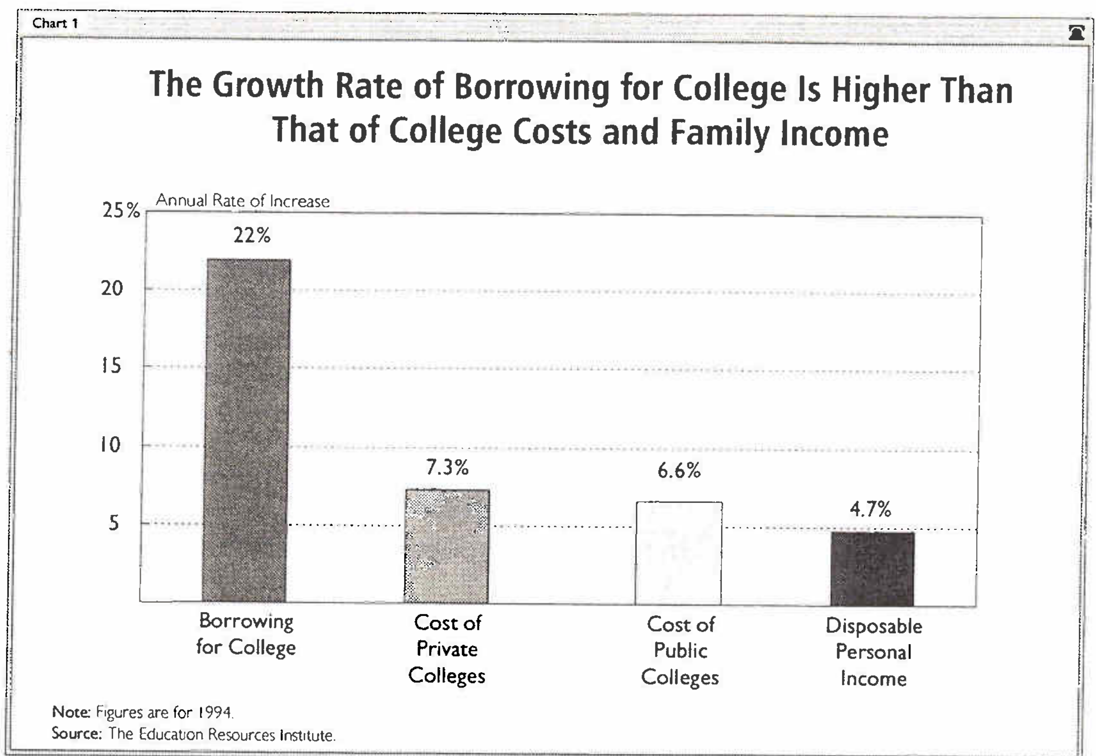
Bad Points: Further subsidizes student debt; bad tax policy.

Recommendation: Eliminate this proposal.

American families and students have already incurred too much debt in financing college. According to the Education Resources Institute, Americans have incurred more debt to finance college since 1990 than during the 1960s, 1970s, and 1980s combined.[8] In fact, during 1994 alone, the growth rate of borrowing for college was three times higher than the growth of tuition and more than four times the growth of family income. The last thing American students need is more debt.

Yet, more debt is precisely what extended interest deductibility would encourage. By allowing young workers to deduct their interest payments from taxable income, this proposal would further subsidize debt, especially compared to savings for higher education. As a result, students would incur even more debt and further decrease their take-home pay during their early working years—precisely the time in which they need the money the most.

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



CONCLUSION

Any final tax bill, as it relates to higher education, should make it more attractive for American families to save money for their children's education than to rely on the federal government and incur years of costly debt. The Senate and House both receive passing grades in reaching this goal, yet both could be substantially improved.

In general, Congress should avoid plans, such as President Clinton's HOPE credit, that would lead to greater inflation in tuition and that ignore the anxiety families feel when faced with high and uncertain future college costs. Congress also should avoid any mandates or limits on the amount of money families choose to set aside for college, as well as policies such as interest deductibility that would further subsidize student debt. Finally, Congress should make it as easy and flexible as possible for families to save for college, rather than incur years of burdensome debt. These principles—and specifically the recommendations outlined above—could earn lawmakers an A for higher education tax policy in 1997.

Appendix: What People Are Saying About President Clinton's $1,500 HOPE Scholarship

Although the House and Senate have modified the Administration's HOPE scholarship (by eliminating the ill-fated grade requirement and making the credit good for up to 50 percent of the first $3,000 of higher education expenses), there are still many problems with the plan. Various observers from across the political spectrum have spoken out against President Clinton's plan. As Congress and the Administration move forward to fill in the details of the budget agreement, they would be wise to keep in mind the comments of these observers.

> I compared our initiative to Horace Mann's nineteenth-century advocacy of free public schools....[Secretary of the Treasury] Rubin dismissed the idea as "political"—the most venal word in his vocabulary.
>
> —Dick Morris,
> political consultant[9]

> 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 Gladieux,
> College Board,
> and Robert Reischauer,
> Brookings Institution[10]

> 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)[11]

> 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

9 Dick Morris, *Behind the Oval Office: Winning the Presidency in the Nineties* (New York: Random House, 1997), pp. 223–224.

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

11 Statement of Senator Robert Kerrey (D–NE) during Senate Finance Committee hearing, April 16, 1997.

(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 Universities[12]

[The President's] plan is classic Clinton: It's full of glorious goals (every student should read at eight, two years of college should be as common as high school); the details are confusing (there are partial subsidies for school construction and vague "standards" for public schools); and many proposals, if enacted, would worsen what Clinton promises to improve.

—Robert J. Samuelson,
The Washington Post[13]

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[14]

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 Wessel,
The Wall Street Journal[15]

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 Committee[16]

Even if you are keen for, say, Clinton's multibillion-dollar tax subsidies for college students (which will likely translate into tuition increases), you

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

13 Robert J. Samuelson, "The Hypocrisy Scholarship," *The Washington Post,* February 12, 1997, p. A23.

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

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

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

might ask yourself if they are more valuable than the other domestic programs they are supposed to supplant.

—Jodie T. Allen,
Slate[17]

Since the President's tax credit proposal for tuition applies only to the first two years of college, students could experience higher tuition costs in their third and fourth years—diluting or wiping out any benefit they might have received in the first two years.

—National Center for Policy Analysis[18]

[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 Schrag,
The Sacramento Bee[19]

But as they scrutinize the emerging details of Clinton's plan, economists, some congressional leaders and even university officials who want more federal aid say they are worried that the president's proposal is fraught with as many risks as rewards.

—Rene Sanchez and Clay Chandler,
The Washington Post[20]

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. Jackson,
The Boston Globe[21]

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

—Virginia Postrel,
Reason[22]

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17 Jodie T. Allen, "Budget Bunk," *Slate*, May 10–12, 1997, p 13.
18 "Daily Policy Digest," National Policy Forum, February 10, 1997.
19 Peter Schrag, "Tuition Aid for...?" *The Sacramento Bee,* February 5, 1997, p B6.
20 Rene Sanchez and Clay Chandler, "Education Aid at What Cost?" *The Washington Post,* February 3, 1997, p. A1.
21 Derrick Z. Jackson, "Clinton's 'Plan B' will give teachers a headache," *The Boston Globe,* February 12, 1997, p. A19.
22 Virginia Postrel, "Clinton's College Plan: Educational Inflation," *The Washington Post,* March 30, 1997, p. C1.