[JOINT COMMITTEE PRINT]

ANALYSIS OF PROPOSED TAX AND SAVINGS INCENTIVES FOR HIGHER EDUCATION

SCHEDULED FOR A PUBLIC HEARING

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON APRIL 16, 1997

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on April 16, 1997, on certain education and training tax proposals. This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes certain tax proposals for education and training contained in (1) the President's fiscal year 1998 budget;[1a] (2) Title III ("Affordable College Act") of S. 1 ("Safe and Affordable Schools Act of 1997"), introduced on January 21, 1997, by Senator Coverdell and others;[2] (3) S. 12 ("Education for the 21st Century Act"), introduced on January 21, 1997, by Senator Daschle and others; and (4) S. 2 ("American Family Tax Relief Act"), introduced on January 21, 1997, by Senator Roth and others. The pamphlet also analyzes certain issues relating to such proposals.[3]

Part I of the pamphlet is a summary of present-law tax incentives and direct spending programs for education. Part II describes certain education and training tax proposals, and provides background information with respect to such proposals. Part III is an analysis of certain economic issues relating to the proposals.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Analysis of Proposed Tax and Savings Incentives for Higher Education* (JCS-9-97), April 15, 1997.

[1a] The President's education and training tax proposals (other than the IRA withdrawal provision for education expenses) were introduced by Senators Daschle and Kennedy (by request) in S. 559 ("Hope and Opportunity for Postsecondary Education Act of 1997") on April 10, 1997. Title I ("Higher Education Tax Incentives Act") of S. 559 contains the tax provisions.

[2] This bill is described in Joint Committee on Taxation, *Description of Title III ("Affordable College Act") of S. 1 ("Safe and Affordable Schools Act of 1997")* (JCX-1-97), January 21, 1997.

[3] Certain of the education tax proposals described herein are also described in Joint Committee on Taxation, *Analysis of Proposed Tax Incentives for Higher Education* (JCS-3-97), March 4, 1997.

I. PRESENT LAW

A. Tax Incentives for Education

In general

Taxpayers generally may not deduct education and training expenses. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment (Treas. Reg. sec. 1.162-5). However, education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses meet the above-described criteria for deductibility under section 162 and only to the extent that the expenses, along with other miscellaneous deductions, exceed 2 percent of the taxpayer's adjusted gross income (AGI).

Exclusion for employer-provided educational assistance

A special rule allows an employee to exclude from gross income for income tax purposes and from wages for employment tax purposes up to $5,250 annually paid by his or her employer for educational assistance (sec. 127). In order for the exclusion to apply certain requirements must be satisfied, including a requirement that not more than 5 percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance program can be provided for the class of individuals consisting of more than 5-percent owners of the employer and the spouses or dependents of such more than 5-percent owners. This special rule for employer-provided educational assistance expires with respect to courses beginning after June 30, 1997[4] (and does not apply to graduate level courses beginning after June 30, 1996).

For purposes of the special exclusion, educational assistance means the payment by an employer of expenses incurred by or on behalf of the employee for education of the employee including, but not limited to, tuition, fees, and similar payments, books, supplies, and equipment. Educational assistance also includes the provision by the employer of courses of instruction for the employee (including books, supplies, and equipment). Educational assistance does

[4] The statutory language of the Small Business Job Protection Act of 1996 provides that the exclusion expires with respect to courses beginning after June 30, 1997. The legislative history, however, indicated Congressional intent to extend the exclusion for employer-provided educational assistance only with respect to courses beginning before June 1, 1997.

not include tools or supplies which may be retained by the employee after completion of a course or meals, lodging, or transportation. The exclusion does not apply to any education involving sports, games, or hobbies.

In the absence of the special exclusion, employer-provided educational assistance is excludable from gross income and wages as a working condition fringe benefit (sec. 132(d)) only to the extent the education relates to the employee's current job (as determined under sec. 162).

Exclusion for interest earned on savings bonds

Another special rule (sec. 135) provides that interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.[5] "Qualified higher education expenses" include tuition and fees (but not room and board expenses) required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at certain colleges, universities, or vocational schools. The exclusion provided by section 135 is phased out for certain higher-income taxpayers, determined by the taxpayer's modified AGI during the year the bond is redeemed. For 1996, the exclusion was phased out for taxpayers with modified AGI between $49,450 and $64,450 ($74,200 and $104,200 for joint returns). To prevent taxpayers from effectively avoiding the income phaseout limitation through issuance of bonds directly in the child's name, section 135(c)(1)(B) provides that the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are at least 24 years old.

Qualified scholarships

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. There is, however, no dollar limitation for the section 117 exclusion, provided that the scholarship funds are used to pay for tuition and required fees. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for education below the graduate level provided to employees of certain educational organizations. Section 117(c) specifically provides that the exclusion for qualified scholarships does not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship.

[5] If the aggregate redemption amount (i.e., principal plus interest) of all Series EE bonds redeemed by the taxpayer during the taxable year exceeds the qualified education expenses incurred, then the excludable portion of interest income is based on the ratio that the education expenses bears to the aggregate redemption amount (sec. 135(b)).

Student loan forgiveness

In the case of an individual, section 108(f) provides that gross income subject to Federal income tax does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers (e.g., providing health care services to a nonprofit organization). Student loans eligible for this special rule must be made to an individual to assist the individual in attending an education institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses (in contrast to tax-free scholarships under section 117, which are limited to tuition and required fees). In addition, the loan must be made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation. Thus, loans made with private, nongovernmental funds are not qualifying student loans for purposes of the section 108(f) exclusion. As with section 117, there is no dollar limitation for the section 108(f) exclusion.

Qualified State prepaid tuition programs

Section 529 (enacted as part of the Small Business Job Protection Act of 1996) provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. "Qualified higher education expenses" are defined as tuition, fees, books, supplies, and equipment required for the enrollment or attendance at a college or university (or certain vocational schools). Qualified higher education expenses do not include room and board expenses. Section 529 also provides that no amount shall be included in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary (e.g., when the beneficiary attends college) will be included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent receives a refund) will be included in the con-

tributor's gross income to the extent such amounts exceed contributions made by that person.

Individual Retirement Arrangements ("IRAs")

An individual may make deductible contributions to an individual retirement arrangement ("IRA") for each taxable year up to the lesser of $2,000 or the amount of the individual's compensation for the year if the individual is not an active participant in an employer-sponsored qualified retirement plan (and, if married, the individual's spouse also is not an active participant). Contributions may be made to an IRA for a taxable year up to April 15th of the following year. An individual who makes excess contributions to an IRA, i.e., contributions in excess of $2,000, is subject to an excise tax on such excess contributions unless they are distributed from the IRA before the due date for filing the individual's tax return for the year (including extensions). If the individual (or his or her spouse, if married) is an active participant, the $2,000 limit is phased out between $40,000 and $50,000 of adjusted gross income ("AGI") for married couples and between $25,000 and $35,000 of AGI for single individuals.

Present law permits individuals to make nondeductible contributions (up to $2,000 per year) to an IRA to the extent an individual is not permitted to (or does not) make deductible contributions. Earnings on such contributions are includible in gross income when withdrawn.

An individual generally is not subject to income tax on amounts held in an IRA, including earnings on contributions, until the amounts are withdrawn from the IRA. Amounts withdrawn from an IRA are includible in gross income (except to the extent of nondeductible contributions). In addition, a 10-percent additional tax generally applies to distributions from IRAs made before age 59½, unless the distribution is made (1) on account of death or disability, (2) in the form of annuity payments, (3) for medical expenses of the individual and his or her spouse and dependents that exceed 7.5 percent of AGI, or (4) for medical insurance of the individual and his or her spouse and dependents (without regard to the 7.5 percent of AGI floor) if the individual has received unemployment compensation for at least 12 weeks, and the withdrawal is made in the year such unemployment compensation is received or the following year. If a self-employed individual is not eligible for unemployment compensation under applicable law, then to the extent provided in regulations, a self-employed individual is treated as having received unemployment compensation for at least 12 weeks if the individual would have received unemployment compensation but for the fact that the individual was self-employed. The exception to the additional tax ceases to apply if the individual has been reemployed for at least 60 days.

B. Background Data on College Enrollment and Costs

Since 1990, more than 14 million students have enrolled annually in post-secondary education or training programs, with approximately 78 percent enrolled in public institutions and 22 percent in private institutions in 1994. The full-time equivalent enrollment has exceeded 10 million in every year since 1990. Of all those

enrolled in 1994, 61 percent were enrolled in four-year institutions. From the average high school sophomore class in 1980, 66.4 percent had enrolled in some form of post-secondary education or training program by 1992. During this period, 7.9 percent had attained an associate's degree, 20 percent had attained a bachelors degree, 2.7 percent had attained a master's degree, and 1.1 percent had attained a doctorate or professional degree.[6]

In every year since 1981, the costs of attending a two- or four-year college have risen faster than the rate of inflation; by contrast, in the late 1970s, college costs lagged behind inflation. Table 1 below details average tuition and fees by type of college in both current and constant (inflation adjusted) dollars since 1986. Since 1976, college tuition and fees generally have risen 70 percent more than the economy's overall price level. For the 1975-76 academic year, the total cost[7] of attending a four-year private college averaged $4,391 (tuition and fees of $2,240) and the total cost of attending a four-year public college averaged $2,679 (tuition and fees of $578). For the 1986-87 academic year, the comparable total cost figure had risen to $9,755 (tuition of $6,581) for a four-year private college and to $3,921 (tuition of $1,285) for a four-year public college. By the 1995-96 academic year, the comparable total cost figure had risen to $17,631 (tuition and fees of $12,432) for a four-year private college and to $6,283 (tuition and fees of $2,860) for a four-year public college.[8] For the 1995-96 academic year, the average cost of tuition and fees at a two-year public college was $1,387.

Over the past decade, governmental funding of higher education has declined as a share of total funding. Table 2 reports the revenues of all institutions of higher education by source. The table documents that as a source of all revenues Federal funds have remained relatively constant while State and local funding has declined. Tuition and fees have increased in importance while other private funding has increased modestly. As Table 2 details, State and local contributions have not declined in dollar terms and, in fact, grew 7-percent faster than inflation over the period 1985 to 1994.

[6] National Center for Education Statistics, *The Condition of Education 1996*.

[7] "Total cost" includes tuition and fees, and on-campus room and board costs.

[8] U. S. General Accounting Office, *Higher Education: Tuition Increasing Faster Than Household Income and Public Colleges' Costs* (GAO/HEHS-96-154), August 1996; Center for Education Statistics, *The Condition of Education 1987*; and Susan Boren, "Selected Tables and Readings Related to College Cost," Congressional Research Service, Library of Congress, September 16, 1987.

Table 1.—Average Undergraduate Tuition and Fees, 1986–87 Through 1995–96

Year	Current dollars				Constant 1995 dollars			
	Private four-year	Private two-year	Public four-year	Public two-year	Private four-year	Private two-year	Public four-year	Public two-year
1986–87	6,581	3,816	1,285	657	9,016	5,228	1,761	900
1987–88	7,048	4,265	1,485	739	9,273	5,612	1,954	972
1988–89	8,004	4,411	1,578	799	10,071	5,550	1,985	1,005
1989–90	8,663	4,638	1,696	841	10,395	5,566	2,035	1,009
1990–91	9,340	4,990	1,908	906	10,622	5,675	2,170	1,030
1991–92	9,812	5,294	2,107	1,022	10,814	5,835	2,322	1,126
1992–93	10,449	5,754	2,334	1,116	11,168	6,150	2,495	1,193
1993–94	11,007	6,228	2,535	1,245	11,465	6,487	2,640	1,297
1994–95	11,719	6,128	2,705	1,310	11,868	6,206	2,739	1,327
1995–96	12,432	6,350	2,860	1,387	12,264	6,264	2,821	1,368

Notes.—Tuition averages apply to undergraduate costs only, and are weighted by enrollment. Tuition is based on 30 semester or 45 quarter hours.

Source: U.S. General Accounting Office, *Higher Education: Tuition Increasing Faster Than Household Income and Public Colleges' Costs* (GAO/HEHS–96–154), August 1996.

Table 2.—Current Funds and Revenues of All Institutions of Higher Education by Source, Selected Years, 1985–86 Through 1993–94

[Amounts in millions]

Year	Tuition and fees		State and local sources		Federal sources		Other sources		Total	
	Dollar	Percent	Dollar	Percent	Dollar	Percent	Dollar	Percent	Dollar	Percent
1985–86	23,117	29.2	32,456	40.9	10,466	13.2	13,259	16.7	79,299	100.0
1989–90	33,926	31.1	41,989	38.4	14,016	12.8	19,310	17.7	109,242	100.0
1993–94	48,647	34.9	46,909	33.7	18,678	13.4	25,098	18.0	139,331	100.0

Source: U.S. Department of Education, "Current Funds Revenues and Expenditures of Institutions of Higher Education: Fiscal Years 1986 through 1994," as reported in Wayne C. Riddle, "State Roles in Post Secondary Education and the Higher Education Act (HEA): Options for HEA Reauthorization," Congressional Research Service, Library of Congress, Report No. 97–40EPW, December 23, 1996, p. 40.

C. Federal Direct Aid to Students for Post-Secondary Education

In general, prior to receiving any Federal grant or subsidized loan, a student must undergo a "need analysis" to establish his or her financial eligibility. Financial eligibility is determined by a formula established in Title IV of the Higher Education Act, the Federal law that authorizes direct student aid programs. The formula generally calculates the amount that a student and his or her family can contribute to the costs of attending the student's post-secondary educational institution (including tuition and fees, room and board, supplies, transportation, and other miscellaneous expenses), based on the costs of attendance and the assets of the student and his or her family. These calculations are used to determine which students are eligible to receive Pell Grants and subsidized Stafford Loans and the amounts they are eligible to receive. Financial aid administrators then use this information to determine which students are eligible for other types of Federal student aid and the amounts they are eligible to receive. The result of this process is that eligible students generally receive an aid package that consists of funds from several Federal programs, and also includes State and private funds. The following is a description of current Federal direct aid programs for post-secondary education.

Grant programs

Pell Grants

Pell Grants provide a foundation of financial aid, to which aid from other Federal and non-Federal sources may be added. Students must apply for a Pell Grant before their eligibility for other Federal student aid programs is determined. To qualify, the student must be an undergraduate enrolled at least half-time. In addition, the student or his or her parents must satisfy a needs test based on the student's or parents' current income and accumulated assets.

The maximum Pell Grant award for the 1997-98 academic year is $2,700; no repayment is required. The President's fiscal year 1998 budget proposes to increase the maximum award by $300 to $3,000 for the 1998-99 school year. Pell Grants generally are available for no more than five years of undergraduate study. Pell Grants are awarded without regard to the school the student chooses to attend.

For academic year 1995-96, approximately 3.8 million undergraduates received Pell Grants. Over 91 percent of the recipients came from families with annual incomes of $30,000 or less; these recipients received approximately 95 percent of total award dollars.[9]

Supplemental Educational Opportunity Grants

A Federal Supplemental Educational Opportunity Grant ("FSEOG") is an award for undergraduates with exceptional financial need, with priority given to Pell Grant recipients. One of the

[9] Data compiled by the National Association of Independent Colleges and Universities ("NAICU").

three so-called "campus-based" programs for Federal student aid [10], FSEOG funds are matched 25 percent by colleges and universities. As a grant, it does not have to be repaid. The maximum FSEOG is $4,000 per year. The size of the grant a student receives depends upon need and the availability of FSEOG funds at the school.

In academic year 1995-96, approximately 980,000 students received FSEOG awards. The average award was $745. Most FSEOG awards are provided to student from low- and moderate-income families. In academic year 1993-94, 79 percent of dependent undergraduate recipients came from families with incomes of less than $30,000.[11]

State Student Incentive Grants

State Student Incentive Grants ("SSIG") provide grants to those States which establish a scholarship program and use State funds partially to match the Federal funds. Federal funds must be matched at least 50 percent at the State level. The States establish the eligibility criteria and the amount each student receives. In contrast to the Pell Grant and FSEOG programs, SSIG grants are available to undergraduates and graduate students. Generally, however, over 90 percent of SSIG recipients are undergraduates.

In academic year 1995-96, approximately 650,000 students received SSIG awards. The average award was approximately $1,000. The median family income of SSIG award recipients is $12,053.[12]

Loan programs

Federal Stafford Loans

Federal Stafford Loans are the Federal Government's primary source of self-help aid to post-secondary students (both undergraduates and graduate students). The loans are available either as (1) direct loans from the government through the William D. Ford Federal Direct Loan Program (such loans are called "Federal Direct Stafford/Ford Loans"), or (2) loans from a bank, credit union, or other lender that are guaranteed by the Federal government under the Federal Family Education Loan ("FFEL") Program. Stafford Loans may be subsidized on the basis of financial need; unsubsidized loans are available regardless of financial need. With a "subsidized loan," interest does not begin to accrue until the repayment period begins (generally six months after a borrower graduates, leaves school, or drops below half-time enrollment). To qualify for a Stafford Loan, a student must be enrolled at least half-time in an eligible program and must satisfy certain other eligibility criteria. Dependent undergraduate students can borrow in accordance with the following limits:

[10] The other "campus-based" programs (Federal Work-Study and Federal Perkins Loans, described below) also require a matching amount to be paid by the school itself or by a State entity.
[11] Data compiled by NAICU.
[12] Data compiled by NAICU.

Table 3.—Federal Direct Stafford/Ford Loan Limits

Academic level	Dependent student	Independent student	
	Total subsidized & unsubsidized	Plus additional unsubsidized only	Total amount
Annual Limits			
First-year undergraduate:			
Full year	$2,625	$4,000	$6,625
⅔ up to full year	$1,750	$2,500	$4,250
⅓ up to ⅔ year	$875	$1,500	$2,375
Second-year undergraduate:			
Full year	$3,500	$4,000	$7,500
⅔ up to full year	prorated	$2,500	prorated
⅓ up to ⅔ year	prorated	$1,500	prorated
Third-year / remainder undergraduate:			
Full year	$5,500	$5,000	$10,500
Less than full year	prorated	prorated	prorated
Graduate / professional student	$8,500 subsidized + $10,000 unsubsidized = $18,500		
Aggregate Debt Outstanding			
Undergraduate	$23,000		$46,000
Graduate / professional student	$65,500 subsidized + $73,000 unsubsidized = $138,500 (including undergraduate loans)		

Source: Congressional Research Service, The Library of Congress, "The Federal Direct Student Loan Program," Margot A. Schenet, updated October 16, 1996.

The interest rate on Stafford Loans (Federal Direct Stafford/Ford Loans or FFEL Stafford Loans) issued after July 1, 1994, is adjusted annually and can never exceed 8.25 percent. There are four repayment options available to Federal Direct Stafford/Ford Loan borrowers. Under the Standard Repayment Plan, a borrower repays a fixed amount each month for up to 10 years. The Extended Repayment Plan permits a borrower to extend repayment over a period that is 12 to 30 years, depending on the loan amount. Under the Graduated Repayment Plan, monthly payments increase over the repayment period, which generally is 12 to 30 years. Finally, under the Income-Contingent Repayment Plan, the monthly payments are based on the former student's annual income and the outstanding loan amount. After 25 years, any remaining balance on the loan is forgiven. FFEL Stafford Loans disbursed after July 1, 1993, can be repaid using a standard, graduated, or income-sensitive repayment plan, but must be repaid within 10 years.

Approximately 465,000 Federal Direct Stafford/Ford Loans were provided to undergraduate and graduate students in academic year

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1994-95. 65 percent of these direct loans were subsidized and 29 percent were unsubsidized; the remainder were Federal Direct Stafford/Ford PLUS Loans (described below). The average subsidized loan was $3,701 and the average unsubsidized loan was $3,617.[13]

In fiscal year 1995, 3.7 million subsidized Stafford Loans and 1.8 million unsubsidized Stafford Loans were provided to students under the FFEL Program. In academic year 1992-93, 52 percent of the subsidized FFEL Stafford Loan recipients came from families with annual incomes of $30,000 or less. Nearly 88 percent of the borrowers who received subsidized FFEL Stafford Loans were undergraduates. The average FFEL Stafford Loan for undergraduates was $2,673; the average loan for graduate students was $5,924. The average FFEL Stafford Loan for all students was $3,070.[14]

Perkins Loans

Federal Perkins Loans are low-interest loans (currently five percent) for undergraduate and graduate students with exceptional financial need. They are administered by participating schools and funded through Federal appropriations and institutional matching funds (25 percent matching).

The student may borrow up to $3,000 for each year of undergraduate study (with a maximum of $15,000 as an undergraduate). Graduate students may borrow up to $5,000 per year of study, with a maximum total of $30,000 for all undergraduate and graduate/professional education.

No payment of principal or interest is required until nine months after the student graduates or leaves school. A Federal Perkins Loan may be canceled in the event of the death or permanent disability of the borrower, or if the borrower performs certain teaching, military or public service. The Higher Education Amendments of 1992 broadened the category of statutory cancellations for Federal Perkins loans, which has resulted in increasing usage of such cancellation provisions by borrowers in recent years. Current cancellation conditions for Federal Perkins Loans are listed below in Table 4.

[13] Data compiled by NAICU from information provided by the College Board.
[14] Data compiled by NAICU.

Table 4.—Conditions for Discharge or Cancellation of Indebtedness for Federal Perkins Loans

Cancellation condition	Amount cancelled
Borrower's local permanent disability or death	100%.
Full-time teacher in a designated elementary or secondary school serving students from low-income families	Up to 100%.[1]
Full-time special education teacher—includes teaching children with disabilities in a public or other non-profit elementary or secondary school	Up to 100%.[1]
Full-time qualified professional provider of early intervention services for the disabled	Up to 100%.[1,2]
Full-time teacher of math, science, foreign languages, bilingual education, or in other fields designated as teacher shortage areas	Up to 100%.[1,3]
Full-time employee of a public or non-profit child or family service agency providing services to high-risk children and their families from low-income communities	Up to 100%.[1,2]
Full-time nurse or medical technician	Up to 100%.[1,2]
For loans made on or after November 29, 1990—service as full-time law enforcement or corrections officer	Up to 100%.[4]
Full-time service as a staff member in the educational component of a Head Start Program	Up to 100%.[5]
Service as a Vista or Peace Corps Volunteer	Up to 70%.[5]
Service in the Armed Forces	Up to 50% in areas of hostilities or imminent danger.[5]
Bankruptcy	In some cases.[6]
Closed School (before student could complete program of study) or False Loan Certification	No.

[1] For loans received on or after January 1, 1986.
[2] This benefit applies to Federal Perkins loans made on or after July 23, 1992.
[3] Seven years must have passed between the date the loan became due and the date the borrower files for bankruptcy (not counting deferment periods).
[4] Service qualifies for deferment also for loans made on or after July 1, 1993.
[5] Service qualifies for deferment also.
[6] If seven years have not passed, cancellation is possible only if the bankruptcy court rules that repayment would cause undue hardship.

Source: U.S. Department of Education, Student Financial Assistance Programs, "The Student Guide, 1996–97".

In academic year 1995-96, approximately 776,000 students received Perkins Loans. The average loan amount was $1,342. In

academic year 1993-94, 48 percent of the dependent undergraduate Perkins Loan recipients came from families with annual incomes of $30,000 or less. Approximately 88 percent of recipients of Perkins Loans were undergraduates.[15]

PLUS Loans (Loans for Parents)

PLUS Loans are for parent borrowers and are available through both the Federal Direct Stafford/Ford Loan program and the FFEL program. PLUS Loans are not need-based. The interest rate on PLUS Loans is variable, but can never exceed 9 percent.

PLUS Loans enable parents to borrow the student's costs of attendance, minus any other financial aid received by the student. Repayment of PLUS Loans must begin 60 days after the final loan disbursement. With respect to Federal Direct Stafford/Ford PLUS Loans, parents may choose the Standard, Extended, or Graduated Repayment options (described above). The income-contingent repayment option is not available for Federal Direct Stafford/Ford PLUS Loans. FFEL Plus Loans must have a minimum annual payment of $600 and a maximum repayment period of 10 years.

For the academic year 1994-95, approximately 32,550 Federal Direct Stafford/Ford PLUS Loans were issued, with an average loan amount of $5,749. In fiscal year 1995, approximately 298,000 FFEL PLUS Loans were issued. Approximately 25 percent of FFEL PLUS recipients came from families with annual incomes of less than $30,000.[16]

Consolidation Loans

Consolidation loans enable a borrower to combine different types of Federal student loans into one loan to simplify repayment, and perhaps to gain additional deferment possibilities. Consolidation loans are available under both the Federal Direct Stafford/Ford Loan and FFEL loan programs; however, the terms of consolidation loans vary under each program.

There are three types of consolidation loans under the Federal Direct Stafford/Ford Loan program--Direct subsidized consolidation loans, Direct unsubsidized consolidation loans, and Direct PLUS consolidation loans. FFEL borrowers may consolidate using a Direct consolidation loan. The interest rate on the subsidized and unsubsidized loans varies, but cannot exceed 8.25 percent. The interest rate on Direct PLUS consolidation loans also varies, but cannot exceed 9 percent. The four repayment options that are available to Federal Direct Stafford/Ford Loan borrowers are available for the consolidation loans, except that the income-contingent repayment option is not available for Direct PLUS consolidation loans.

There are two types of consolidation loans under the FFEL program--subsidized and unsubsidized. Federal Direct Stafford/Ford Loans may not be consolidated under an FFEL consolidation loan. The interest rate on FFEL consolidation loans is the weighted average of the original interest rates of the loans being consolidated.

[15] Data compiled by NAICU.
[16] Data compiled by NAICU.

Work-study programs

Federal Work-Study Program

The Federal Work-Study ("FWS") Program provides wage subsidies to colleges for jobs held by undergraduate and graduate students who need financial aid. Federal work-study funds are matched 25 percent by colleges, universities, or nonprofit or governmental entities where the students are employed. The student must be paid at least the Federal minimum wage, but may be paid more depending upon the type of work. A student's award of FWS funds depends upon level or need and the availability of funds at the school, and other sources of aid. Institutions are currently required to spend at least 5 percent of their Work-Study allocation to pay students working in community service jobs. The President's fiscal year 1998 budget would increase Federal work-study funding by 3 percent, to $857 million.

In academic year 1995-96, approximately 708,000 students received FWS awards. The average award was $1,065. In 1993-94, 49 percent of the dependent undergraduate recipients of FWS awards came from families with incomes of $30,000 or less. Approximately 95 percent of all recipients were undergraduates.[17]

AmeriCorps

The AmeriCorps program provides full-time educational awards in return for work performed by a student in an approved community service job. The community service work can occur before, during, or after the student receives post-secondary education, and the award monies may be used either to pay current educational expenses or to repay outstanding Federal student loans.

[17] Data compiled by NAICU.

II. DESCRIPTION AND BACKGROUND OF PROPOSALS

A. Tax Incentives for Education Expenses

1. Tuition tax credit

a. HOPE scholarship tuition tax credit (President's Fiscal Year 1998 Budget and sec. 102 of S. 559)

Description of Proposal

Individual taxpayers would be allowed to claim a non-refundable credit against Federal income taxes up to $1,500 per student per year for tuition and required fees (but not room and board expenses) for the first two years of the student's post-secondary education in a degree or certificate program. The education expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent. The credit would be available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education. With respect to each student, a taxpayer may claim either the credit or the proposed above-the-line deduction (described below). If, for any taxable year, a taxpayer chooses to claim a credit with respect to a particular student, then the proposed above-the-line deduction will not be available with respect to that particular student for that year (although the proposed deduction may be available with respect to that student for other taxable years, such as after the student completes two years of college and no longer is eligible for the credit). For one taxable year, a taxpayer may claim the proposed above-the line deduction for education expenses with respect to one student and also claim the credit with respect to other students. An eligible student would not be entitled to claim a credit under the proposal if that student is claimed as a dependent for tax purposes by another taxpayer. If a parent claims a student as a dependent, any education expenses paid by the student would be treated as paid by the parent for purposes of the proposal.

With respect to each individual student, a taxpayer is limited to a tuition tax credit of the lesser of the qualified education expenses incurred during the taxable year with respect to that student or the maximum credit amount. The maximum credit amount for a taxable year would be $1,500, reduced by any Federal educational grants, such as Pell Grants, awarded to the student for that year (or for education beginning in the first three months of the next year, if credits are claimed based on payments for that education). Beginning in 1998, the maximum credit amount would be indexed for inflation, rounded down to the closest multiple of $50.

The maximum credit amount would be phased out ratably for taxpayers with modified AGI between $50,000 and $70,000 ($80,000 and $100,000 for joint returns). Modified AGI would in-

clude taxable Social Security benefits and amounts otherwise excluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions). Modified AGI for purposes of the credit would be determined without regard to the proposed above-the-line deduction for higher education expenses (described below) in cases where the credit is claimed with respect to one student and the deduction is claimed with respect to another student in the same taxable year. Beginning in 2001, the income phase-out ranges would be indexed for inflation, rounded down to the closest multiple of $5,000.

The credit would be available for "qualified higher education expenses," meaning tuition and fees required for the enrollment or attendance of an eligible student (e.g., registration fees, laboratory fees, and extra charges for particular courses) at an eligible institution. Charges and fees associated with meals, lodging, student activities, athletics, insurance, transportation, books, and similar personal, living or family expenses would not be included. The expenses of education involving sports, games, or hobbies would not be qualified higher education expenses unless this education is part of a degree program.

An eligible student would be one who is enrolled or accepted for enrollment in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible institution of higher education. The student must pursue a course of study on at least a half-time basis. In addition, for a student's qualified higher education expenses to be eligible for the credit, the student must not have been convicted of a Federal or state felony consisting of the possession or distribution of certain drugs, and generally cannot be a nonresident alien. Furthermore, a taxpayer would be entitled to the credit for a student in a second taxable year only if the student obtained a qualifying grade point average for all previous post-secondary education. Generally, this would be an average of at least 2.75 on a 4-point scale, or a substantially similar measure of achievement.[18]

Eligible institutions would be defined by reference to section 481 of the Higher Education Act of 1965. Such institutions generally would be accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also would be eligible institutions. The institution must be eligible to participate in Department of Education student aid programs.

Qualified education expenses generally would include only out-of-pocket tuition and fees. Qualified education expenses would not include expenses covered by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total tuition and required fees would be reduced by scholarship or fellowship grants excludable from gross income under present-law section 117 and any tax-free veteran's educational benefits. In addition, qualified education

[18] Institutions that do not use a 4-point grading scale would be allowed to retain their own system while still allowing their students to qualify for the credit; these institutions will determine what measure under the system they use reasonably approximates a B- GPA.

expenses would be reduced by the interest from U.S. savings bonds that is excludable from gross income under section 135 for the taxable year. However, no reduction of qualified education expenses would be required for a gift, bequest, devise, or inheritance within the meaning of section 102(a). If a student's education expenses for a taxable year are deducted under any section of the Code (including the proposed above-the-line deduction for education expenses), then no credit would be available for such expenses.

The credit would be available in the taxable year the expenses are paid, subject to the requirement that the education commence or continue during that year or during the first three months of the next year. Qualified higher education expenses paid with the proceeds of a loan generally would be eligible for the credit (rather than repayment of the loan itself). The credit would be recaptured in cases where the student or taxpayer receives a refund (or reimbursement through insurance) of tuition and fees for which a credit has been claimed in a prior year.

The Secretary of the Treasury (in consultation with the Secretary of Education) would have authority to issue regulations to implement the proposal, including regulations providing appropriate rules for recordkeeping and information reporting. These regulations would address the information reports that educational institutions would file to assist students and the IRS in determining whether a student meets the eligibility requirements for the credit and calculating the amount of the credit potentially available. Where certain terms are defined by reference to the Higher Education Act of 1965, the Secretary of Education would have authority to issue regulations, as well as authority to define other education terms as necessary.

Effective Date

The proposal would be effective for payments made on or after January 1, 1997, for education commencing on or after July 1, 1997.

b. Refundable credit for higher education tuition and fees (sec. 101 of S. 12) (Senator Daschle and others)

Description of Proposal

The proposal is similar to the President's proposed HOPE scholarship tuition tax credit (described above), except that (1) the proposed credit under S. 12 would be refundable; (2) the maximum credit amount of $1,500 per student under S. 12 would not be reduced by any Federal education grants, such as Pell grants, awarded to the student for the year (although, as under the President's proposal, qualified education expenses generally would include only out-of-pocket tuition and fees, reduced by qualified scholarships and other excludable education benefits); (3) the proposed credit under S. 12 would be available only if the student had attained a GPA of at least 2.75 on a 4-point scale (or a substantially similar measure of achievement) for his or her high school education (in contrast to the President's proposed credit, which would be available for a second taxable year only if the student obtained a qualifying grade point average for all previous post-secondary edu-

cation); and (4) half-time students would be eligible for a credit under S. 12 of up to $750 for each of four taxable years (i.e., until the student had completed the equivalent of two full-time academic years).

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1997.

c. Background regarding Georgia HOPE scholarship program

The proposed $1,500 tax credit for the first two years of college education is reported to be modeled after the "HOPE" scholarship program[19] operated by the State of Georgia. The following is a description of the Georgia program, which is a *direct* financial aid program that provides scholarship awards to certain Georgia residents who attend an in-State educational institution. The Georgia program does *not* provide any tax incentives for education--that is, the Georgia program does not provide for tax credits (or deductions) against any taxes otherwise owed under the State's tax system.

The Georgia program--which began in 1993 and is funded by State lottery revenues--has been described as the most ambitious State scholarship program in the nation. Under the program, residents who have a B average in high school (grades 9-12) are entitled to a scholarship covering the cost of tuition (and mandatory fees, but not room and board expenses) to attend a State-owned college, university or technical institute. In addition, HOPE scholarship recipients at public institutions receive an allowance up to $100 per academic quarter to purchase books. Full-time enrollment is not required for HOPE scholarship recipients attending public colleges or universities or public technical institutes.[20] If a student with a B average in high school decides to attend an in-State, *private* college or university, then the Georgia program grants a scholarship to the student up to $3,000 per year.[21] In contrast to the Georgia program's rule for students who attend public institutions, HOPE scholarship recipients at private colleges or universities are required to be full-time students.[22] HOPE scholarships may be ap-

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[19] The acronym "HOPE" stands for Helping Outstanding Pupils Educationally.

[20] Students at public colleges or universities may receive free tuition (and waiver of mandatory fees) for up to 180 credit hours, which is equivalent to four years of full-time enrollment. Students at public technical institutes may receive free tuition (and waiver of mandatory fees) for a total of two programs of study leading to a certificate or diploma. If a student attends a public technical institute as part of a certificate or diploma program (as opposed to a degree program), then there is no requirement that the student have a B average in high school.

[21] Until recently, students attending an in-State private college were granted a $1,500 scholarship under the Georgia program, but this amount has been increased to $3,000 per year for students beginning college after the summer of 1996. In addition, whenever a Georgia resident attends an in-State private college, the State makes a separate $1,000 "equalization grant" on behalf of the student. Such "equalization grants" to private colleges have been made by the State for many years prior to the inception of the HOPE scholarship program, in recognition of the fact that tuition at public colleges is partially subsidized by Georgia taxpayers.

For-profit schools meeting certain standards (such as being accredited and in existence for 10 years) are eligible to participate in the Georgia program. Bible colleges are excluded from participation.

[22] Until recently, the requirement that a student have at least a B average in high school and maintain such an average in college did *not* apply to students attending private colleges.

Continued

plied only to tuition and mandatory fees not covered by Pell or other Federal grants received by the student. The HOPE scholarship program does not provide benefits for students who attend out-of-State institutions. There currently are no income limitations governing eligibility for a HOPE scholarship.[23]

Students (other than those enrolled in certificate or diploma programs at public technical institutes) must maintain a B average in their post-secondary studies in order to continue to be eligible for the HOPE scholarships.[24] Under a recent modification to the Georgia program, the determination whether a student attained at least a B average in high school will be based on certain "core" curriculum courses (i.e., English, math, science, social studies, and foreign languages) rather than the student's entire course load.[25] Eligible students cannot have been convicted of a felony drug offense, which is also a requirement under Federal education financial aid programs.

Approximately 250,000 students have received scholarships under the Georgia program since its inception in 1993. Of these students, 84,244 students received scholarships worth $177 million to attend public colleges and universities, 100,502 students received scholarships worth $65 million to attend public technical institutes, and 49,272 students received scholarships worth $81 million to attend private colleges and universities.[26] Governor Zell Miller has stated that, since the program's inception, college attendance in south Georgia (for instance) has increased from nine percent of high school graduates to 24 percent of such graduates.[27] In north Georgia, which includes Atlanta, college attendance reportedly has increased by about 40 percent.[28]

Because the Georgia program does not provide benefits to students who attend out-of-State schools, there is a financial incentive for high school graduates with a B average or better to attend an in-State school, particularly an in-State public school on a free-of-charge basis (other than room and board expenses). Thus, it appears that some of the more qualified high-school students in Georgia have decided to attend college in-State, with the result that

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Residents of Georgia who earn a general education development ("GED" or high school equivalency) certificate awarded by the Georgia Department of Technical and Adult Education are eligible for a one-time $500 HOPE voucher that can be used at a public or private in-State institution within 24 months of the date of the GED (or 52 months for military personnel).

[23] When the Georgia program began in 1993, scholarships were granted only to students with annual family incomes of less than $66,000. In 1994, the income limit was raised to $100,000. The income limitation was abolished in 1995.

[24] However, a student at a public technical institute must be making satisfactory progress to maintain eligibility.

Beginning in 1995, students returning to college after being in the work force for several years become eligible for HOPE scholarships in their junior and senior years if they attain a B average in their first two years back. In addition, the Georgia program has been modified so that students who lose their scholarship because they do not maintain a B average will have a chance to get their scholarship back by improving their grades in a later year.

[25] A recent study found that 44 percent of 1994-1995 freshmen who received a scholarship under the Georgia program would not have qualified if their GPA had been based only on "core" academic courses. The "core" course requirement will be effective for students graduating from high school in the year 2000 or later.

[26] In addition, 12,595 GED recipients used $500 vouchers (totaling $6 million) to attend a public or private institution. A total of 64,321 GED recipients have been issued such vouchers.

[27] In this regard, it is not clear whether "college attendance" includes enrollment in a certificate or diploma program at a public technical institution.

[28] See transcript of June 4, 1996, press briefing held at Princeton University by White House Press Secretary Mike McCurry, Deputy Assistant to the President for Economic Policy Gene Sperling, Assistant to the President for Policy Development Bruce Reed, and Governor Zell Miller of Georgia.

academic credentials of entering freshmen at some Georgia schools have improved since the inception of the HOPE scholarship program, and the number of Georgia students attending college in neighboring States has decreased.[29]

2. Deduction for education tuition and fees

a. Education and job training tax deduction (President's Fiscal Year 1998 Budget and sec. 103 of S. 559)

Description of Proposal

Individual taxpayers would be allowed an above-the-line deduction for qualified higher education expenses paid during the taxable year for the education or training of the taxpayer, the taxpayer's spouse, or the taxpayer's dependents at an institution of higher education. The deduction would be allowed in computing a taxpayer's AGI and could be claimed regardless of whether the taxpayer itemizes deductions. In 1997 and 1998, the maximum deduction allowed per taxpayer return would be $5,000. After 1998, the maximum deduction would increase to $10,000. The maximum deduction would not vary with the number of students in a taxpayer's family. A taxpayer may claim the deduction for a taxable year with respect to one or more students, even though the taxpayer also claims a proposed HOPE scholarship tuition tax credit (discussed previously) for that same year with respect to other students. With respect to each student, a taxpayer must choose between claiming the proposed credit or the deduction. If, for any taxable year, a taxpayer chooses to claim the proposed credit with respect to a particular student, then the deduction will not be available with respect to that particular student for that year (although the deduction may be available with respect to that student for other taxable years, such as after the student completes two years of college and no longer is eligible for the credit). A student would not be eligible to claim a deduction under the proposal if that student is claimed as a dependent for tax purposes by another taxpayer. If a parent claims a student as a dependent, any education expenses paid by the student would be treated as paid by the parent for purposes of the proposal. In contrast to the proposed HOPE scholarship tuition tax credit, there would be no limit on the number of taxable years for which the proposed deduction for qualified higher education expenses could be claimed with respect to a particular student.

The maximum deduction would be phased out ratably for taxpayers with modified AGI between $50,000 and $70,000 ($80,000 and $100,000 for joint returns). Modified AGI would include taxable Social Security benefits and amounts otherwise excluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions) and would be determined without regard to the deduction allowed by the proposal. Beginning in 2001, the income phase-out ranges would be indexed for inflation, rounded down to the closest multiple of $5,000.

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[29] The State of Georgia reports that 97 percent of the entering in-State freshmen at the University of Georgia received HOPE scholarships for the Fall 1996 quarter, which represents over 80 percent of all entering freshmen at the university. At the Georgia Institute of Technology, 96 percent of entering in-State freshmen received HOPE scholarships.

The deduction would be available for "qualified higher education expenses," meaning tuition and fees required for the enrollment or attendance of an eligible student (e.g., registration fees, laboratory fees, and extra charges for particular courses) at an eligible institution. Charges and fees associated with meals, lodging, student activities, athletics, insurance, transportation, books, and similar personal, living or family expenses would not be deductible. The expenses of education involving sports, games, or hobbies would not be qualified higher education expenses unless this education is part of a degree program (or lead to improvement or acquisition of job skills).

An "eligible student" generally would be one who is enrolled or accepted for enrollment in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an institution of higher education. The student must pursue a course of study on at least a half-time basis. However, a student taking a course to improve or acquire job skills also would be an eligible student for purposes of the deduction. In contrast to the proposed HOPE scholarship tuition tax credit (described previously), there are no requirements for purposes of the deduction that the student maintain any grade point average or be free of felony drug convictions. An eligible student generally could not be a nonresident alien.

Eligible institutions would be defined by reference to section 481 of the Higher Education Act of 1965. Such institutions generally would be accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also would be eligible institutions. The institution must be eligible to participate in Department of Education student aid programs.

Qualified education expenses generally would include only out-of-pocket tuition and fees. Qualified education expenses would not include expenses covered by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the deduction. Thus, total tuition and required fees would be reduced (prior to the application of the $5,000 or $10,000 deduction limitation) by scholarship or fellowship grants excludable from gross income under present-law section 117 and any tax-free veteran's educational benefits.[30] In addition, qualified education expenses would be reduced by the interest from U.S. savings bonds that is excludable from gross income under section 135 for the taxable year. However, no reduction of qualified education expenses would be required for a gift, bequest, devise, or inheritance within the meaning of section 102(a). If a student's education expenses for a taxable year are deducted under any other section of the Code, then such expenses would not be deductible under the proposal.

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[30] For example, if during a taxable year, a taxpayer pays $8,500 for college tuition, but receives a $4,000 tax-free scholarship to cover some of those same tuition expenses, then the taxpayer would be deemed to have paid $4,500 of qualified higher education expenses under the proposal.

The deduction would be available in the taxable year the expenses are paid, subject to the requirement that the education commence or continue during that year or during the first three months of the next year. Qualified higher education expenses paid with the proceeds of a loan generally would be eligible for the deductible (rather than repayment of the loan itself). Normal tax benefit rules would apply to refunds (and reimbursement through insurance) of previously deducted tuition and fees, making such refunds includable in income in the year received.

The Secretary of the Treasury would be granted authority to issue regulations to implement the proposal, including rules requiring record keeping and information reporting.

Effective Date

The proposal would be effective for payments made on or after January 1, 1997, for education commencing on or after July 1, 1997.

b. Deduction for higher education expenses (sec. 102 of S. 12) (Senator Daschle and others)

Description of Proposal

The proposal is similar to the President's proposed education and job training deduction (described above), except that the maximum deduction allowed per taxpayer return would be $5,000 for 1998 and 1999, and would be $10,000 for 2000 and subsequent years.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1997.

3. Deduction for student loan interest

a. Deduction for interest on education loans (sec. 304 of S. 1) (Senator Coverdell and others)

Description of Proposal

Certain individuals who have paid interest on qualified education loans would be allowed to claim an above-the-line deduction for such interest expenses, up to a maximum deduction of $2,500 per year. The deduction would be allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. Months during which the qualified education loan is in deferral or forbearance would not count against the 60-month period. No deduction would be allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

A qualified education loan generally would be defined as any indebtedness incurred to pay for the qualified higher education expenses of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending (1) higher education institutions and certain area vocational education schools (i.e., eligible educational institutions defined in Code section 135(c)(3)), or (2) institutions conducting in-

ternship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training. Qualified higher education expenses would be defined as the student's cost of attendance as defined in section 472 of the Higher Education Act of 1965 (generally, tuition, fees, room and board, and related expenses), reduced by (1) any amount excluded from tax under section 135 (i.e., United States savings bonds used to pay higher education tuition and fees), and (2) the amount of the reduction described in section 135(d)(1) (i.e., scholarships received by the beneficiary that are excludable from gross income under section 117, certain other tax free educational benefits, payments for educational expenses under a qualified State tuition program, and distributions from a Bob Dole education investment account). Such expenses must be paid or incurred within a reasonable period before or after the indebtedness is incurred, and must be attributable to a period when the student is at least a half-time student.

The deduction would be phased out ratably over the following modified adjusted gross income ("modified AGI") ranges: single individuals ($45,000-$65,000) and joint filers ($65,000-$85,000). The beginning of the phaseout ranges (but not the size of the phaseout range) would be indexed for inflation for taxable years beginning after 1997. Modified AGI would be defined as the taxpayer's AGI (1) increased by the amount otherwise excluded from gross income under Code section 135, 911, or 933, and (2) calculated after the inclusion of Social Security benefits in income, the deduction for contributions to individual retirement arrangements, and the limitations on passive losses.

Any person in a trade or business or any governmental agency that receives $600 or more in qualified education loan interest from an individual during a calendar year would be required to provide an information report on such interest to the IRS and to the payor.

Effective Date

The provision would be effective for payments of interest due after December 31, 1996, on any qualified education loan. Thus, in the case of already existing qualified education loans, interest payments would qualify for the deduction to the extent that the 60-month period has not expired. For purposes of counting the 60 months, any qualified education loan and all refinancing (that is treated as a qualified education loan) of such loan would be treated as a single loan.

b. Deduction for interest on education loans (sec. 103 of S. 12) (Senator Daschle and others)

Description of Proposal

The proposal is similar to the proposed deduction for student loan interest provided for by S. 1 (described above), except that: (1) the maximum deduction under S.12 would not be limited to any set dollar amount but would be limited to interest paid by the taxpayer during the taxable year on qualified education loans; (2) the proposed deduction under S. 12 (which would be based on the amount of interest paid by the taxpayer) would be phased out ratably for

single taxpayers with modified AGI between $50,000 and $70,000 and married taxpayers filing a joint return with modified AGI between $80,000 and $100,000; (3) the proposed deduction under S. 12 would be available (subject to the AGI phaseout) for any year in which interest is paid by the taxpayer on a qualified education loan (in contrast to the proposed deduction under S. 1, which would be available only for interest paid during the first 60 months in which interest payments are required); and (4) the proposed deduction under S. 12 would be available only for interest paid on a loan used to pay tuition and required fees (but not room and board expenses) of the taxpayer or the taxpayer's spouse, and not interest paid on a loan used to pay educational expenses of a dependent child of the taxpayer.

Effective Date

The proposal would be effective for interest payments due and paid after December 31, 1997, on a qualified education loan.

4. Tax incentives for expansion of student loan forgiveness (President's Fiscal Year 1998 Budget and sec. 104 of S. 559)

Description of Proposal

The proposal would expand section 108(f) so that an individual's gross income does not include forgiveness of loans made by tax-exempt charitable organizations (e.g., educational organizations or private foundations) if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance outstanding student loans and the student is not employed by the lender organization. As under present law, the section 108(f) exclusion would apply only if the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers. Under the proposal, no explicit requirement of community service would apply.[31]

The section 108(f) exclusion also would be expanded to cover forgiveness of direct student loans made through the William D. Ford Federal Direct Loan Program where loan repayment and forgiveness are contingent on the borrower's income level.

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[31] However, in written testimony prepared for the House Committee on Ways and Means on February 11, 1997, Treasury Secretary Robert Rubin stated that the income exclusion for certain student loan forgiveness is conditioned on a student's commitment "to perform community or public service at low pay for a certain period of time."

It is commonly believed that a community or public service requirement is contained in present-law section 108(f). In fact, however, no such explicit requirement exists. Rather, like the proposal, present law requires merely that the student work in certain professions for any of a broad class of employers. Because the present-law provision applies only to student loans from Federal, State or local government sources, it is generally assumed that the governmental entities involved in the loan programs will require some sort of public benefit in exchange for the loan forgiveness.

In the case of student loans made by nongovernmental lenders, such as charities, this assumption may not suffice to ensure community or public service and a specific legislative requirement may be necessary. For example, a provision similar to the President's proposal was included in H.R. 11 in 1992 (vetoed by President Bush). That provision would have expanded section 108(f) so that an individual's gross income did not include discharge-of-indebtedness income from the cancellation of a loan made by an educational organization to assist the student in attending the educational organization. However, the H.R. 11 provision specifically required that student loans made by such educational organizations from their endowment funds be discharged pursuant to a program of the educational organization designed to encourage students to "serve in occupations with unmet needs or in areas with unmet needs."

Effective Date

The proposal would be effective with respect to amounts otherwise includible in income after the date of enactment.

Background

A major change in the delivery of Federal student loans occurred in 1993. The Student Loan Reform Act (SLRA), part of the Omnibus Budget Reconciliation Act of 1993, converted the Federal Family Education Loans (FFEL), which were made by private lenders and guaranteed by the Federal Government, into direct loans made by the Federal Government to students through their schools (the William D. Ford Direct Loan Program).[32] The Direct Loan Program began in academic year 1994-95 and is to be phased in, with at least 60 percent of all student loan volume to be direct loans by the 1998-1999 academic year.

Federal Direct Loans include Federal Direct Stafford/Ford Loans (subsidized and unsubsidized), Federal Direct PLUS loans, and Federal Direct Consolidation loans. (Part I.B. contains a description of these and other Federal direct aid programs for post-secondary education). The SLRA requires that the Secretary of Education offer four alternative repayment options for direct loan borrowers: standard, graduated, extended, and income-contingent. However, the income-contingent option is not available to Direct PLUS borrowers. If the borrower does not choose a repayment plan, the Secretary may choose one, but may not choose the income-contingent repayment option.[33] Borrowers are allowed to change repayment plans at any time.

Under the income-contingent repayment option, a borrower must make annual payments for a period of up to 25 years based on the amount of the borrower's Direct Loan (or Direct Consolidated Loan), adjusted gross income (AGI) during the repayment period, and family size.[34] Generally, a borrower's monthly loan payment is capped at 20 percent of discretionary income (AGI minus the poverty level adjusted for family size).[35] If the loan is not repaid in full at the end of a 25-year period, the remaining debt is canceled by the Secretary of Education. There is no community or public service requirement.

As of May 1, 1996, 15 percent of the Direct Loan borrowers in repayment had selected the income-contingent option.[36] Among those who choose the income-contingent repayment option, the Department of Education has estimated that slightly less than 12 per-

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[32] For a comprehensive description of the Federal Direct Loan program, see U.S. Library of Congress, Congressional Research Service, *The Federal Direct Student Loan Program*, CRS Report No. 95-110 EPW, by Margot A. Schenet (Washington, D.C.), updated October 16, 1996.

[33] Defaulted borrowers of direct or guaranteed loans may also be required to repay through an income-contingent plan for a minimum period.

[34] The Department of Education recently revised the regulations governing the income-contingent repayment option. The new plan was effective July 1, 1996. See *Federal Register*, December 1, 1995, pp. 61819-61828.

[35] If the monthly amount paid by a borrower does not equal the accrued interest on the loan, the unpaid interest is added to the principal amount. This is called "negative amortization." Under the income-contingent repayment plan, the principal amount cannot increase to more than 110 percent of the original loan; additional unpaid interest continues to accrue, but is not capitalized.

[36] *The Federal Direct Student Loan Program*, p.12. The Department of Education estimates that approximately 60 percent of borrowers will be in a repayment plan other than the standard 10-year repayment plan.

cent of borrowers will fail to repay their loans in full within 25 years and, thus, will have the unpaid amount of their loans discharged at the end of the 25-year period.[37]

5. Exclusion of Federal work-study payments (sec. 305 of S. 1) (Senator Coverdell and others)

Description of Proposal

Amounts received by an individual for services performed pursuant to a Federal work-study program operated under section 441 of the Higher Education Act of 1965 would be excluded from the gross income of the individual.

Effective Date

The provision would be effective for taxable years beginning after December 31, 1996.

Background

Pursuant to the Federal work-study program authorized by section 441 of the Higher Education Act of 1965 (codified at 42 U.S.C. 2751 et seq.), the Secretary of Education is authorized to enter into agreements with certain educational institutions, under which Federal funds are granted to the institution to assist the institution in the operation of a work-study program to provide students who have demonstrated financial need with part-time employment at the institution itself or at nonprofit or governmental organizations. Under such work-study programs, the Federal share of the compensation paid to the student generally may not exceed 75 percent of the total compensation paid to the student under the program.

6. Employer-provided educational assistance

a. Extend exclusion for employer-provided educational assistance

i. Extension of exclusion for employer-provided educational assistance (President's Fiscal Year 1998 Budget and sec. 105 of S. 559)

Description of Proposal

Under the proposal, the exclusion for employer-provided educational assistance would be extended through December 31, 2000, and the provision limiting the exclusion to undergraduate courses would be retroactively repealed.

Effective Date

The extension of the exclusion would be effective for taxable years beginning after December 31, 1996. The repeal of the limitation on the exclusion to undergraduate education would be effective for graduate level courses beginning after June 30, 1996.

[37] See *Federal Register*, September 20, 1995, p. 48849.

ii. Extension of exclusion for employer-provided educational assistance (sec. 302 of S. 1) (Senator Coverdell and others)

Description of Proposal

Under the bill, the exclusion for employer-provided educational assistance would be made permanent and the provision limiting the exclusion to undergraduate courses would be retroactively repealed.

Effective Date

The repeal of the limitation on the exclusion to undergraduate education would be effective for graduate level courses beginning after June 30, 1996. The permanent extension of the exclusion would be effective for taxable years beginning after December 31, 1996.

b. Small business tax credit for employer-provided educational assistance (President's Fiscal Year 1998 Budget and sec. 106 of S. 559)

Description of Proposal

The proposal would provide a temporary 10-percent income tax credit for small businesses with respect to expenses incurred for education of employees by third parties under a qualified employer-provided educational assistance program (as defined under sec. 127). The credit would be available to employers (including self-employed individuals) where the business has average annual gross receipts of $10 million or less for the prior three years.

Effective Date

The proposal would be effective for payments made in taxable years beginning after December 31, 1997, and before January 1, 2001, with respect to expenses incurred during those years.

B. Tax-Related Education Savings Incentives

1. Bob Dole education investment accounts (sec. 301 of S. 1) (Senator Coverdell and others)

Description of Proposal

Individual taxpayers would be allowed to make nondeductible annual cash contributions up to $1,000 into a "Bob Dole education investment account" (referred to as an "education investment account") on behalf of a child under the age of 18. Generally, no more than one such account could be maintained to benefit any one child. An education investment account could be maintained at a bank or as part of a qualified State tuition program.

Distributions from an education investment account would be excluded from gross income, except that to the extent that a distribution is not used for qualified higher education expenses, the earnings portion of the distribution would be included in gross in-

come.[38] Distributions (of both contributions and earnings) made other than to cover qualified higher education expenses would be subject to a 10-percent penalty tax. However, the 10-percent penalty tax would not apply in the case of any distribution made on account of death or disability of, or a scholarship received by, the beneficiary of the account. Any amounts remaining in an education investment account would be deemed to be distributed at the time the beneficiary of the account becomes 30 years old.

Qualified higher education expenses would be defined as the student's cost of attendance as defined in section 472 of the Higher Education Act of 1965 (generally, tuition, fees, room and board, and related expenses). Qualified higher education expenses would be reduced by any scholarships received by the beneficiary that are excludable from gross income under section 117, certain other tax free educational benefits, and payments for educational expenses made under a qualified State tuition program.

As with present-law IRAs, contributions made to an education investment account prior to April 15th may be treated as made during the preceding taxable year. An individual who makes excess contributions to an education investment account (i.e., contributions in excess of the $1,000 limit) would be subject to an excise tax on such excess contributions unless they are distributed from the account before the due date for filing the individual's tax return for the year (including extensions). Rules would be provided governing permissible investments of education investment accounts, similar to present-law rules governing IRAs.

Effective Date

The provision would be effective for taxable years beginning after December 31, 1996.

2. Allow tax-free withdrawals from qualified State tuition programs (sec. 303 of S. 1) (Senator Coverdell and others)

Description of Proposal

Distributions from a qualified State tuition program (as defined under present-law sec. 529) made to, or on behalf of, a designated beneficiary to cover qualified higher education expenses would not be included in the gross income of the beneficiary (or any contributor to the qualified State tuition program). Amounts distributed to a beneficiary that are not used for qualified higher education expenses would be included in the gross income of the beneficiary (even if the distribution is made on account of a scholarship received by, or disability of, the beneficiary) to the extent that such amounts exceed contributions made on behalf of the beneficiary. Any amounts returned to a contributor (e.g., when a parent receives a refund) would be included in the gross income of the con-

[38] If a distribution is not used for qualified higher education expenses, the taxable earnings portion of the distribution would be determined in the manner provided for by present-law section 72.

tributor to the extent that such amounts exceed contributions made by that person.[39]

In addition, the definition of the term "qualified higher education expenses" would be expanded to include costs of attendance as defined in section 472 of the Higher Education Act of 1965 (thus, including room and board expenses).

Effective Date

The provision would be effective for distributions made in taxable years beginning after December 31, 1996.

3. IRA withdrawals for higher education expenses

a. Special purpose withdrawals and investment in qualified State tuition programs (President's Fiscal Year 1998 budget)

Description of Proposal

The proposal would provide that the 10-percent early withdrawal tax would not apply to distributions from deductible IRAs or from nondeductible Special IRAs if the taxpayer used the amounts to pay qualified higher education expenses of the taxpayer, the taxpayer's spouse, or the taxpayer's child or grandchild (whether or not a dependent).

The penalty free withdrawal would be available for "qualified higher education expenses," meaning tuition and fees required for enrollment or attendance at an educational institution. Charges and fees associated with meals, lodging, student activities, athletics, insurance, transportation, books, and similar personal, living or family expenses would not be qualified higher education expenses. In addition, the expenses of education involving sports, games, or hobbies would not be qualified higher education expenses unless this education is part of a degree program (or leads to improvement or acquisition of job skills).

The proposal would provide that any IRA assets can be invested in qualified State tuition program instruments. To the extent the instrument is converted into tuition and fees, the account holder would be treated as receiving a distribution equal to the cost of such tuition and fees as of the time of conversion. Further, such a deemed distribution would be treated as a special purpose withdrawal for qualified higher education expenses, and thus would not be subject to the 10-percent additional tax on early withdrawals. The income tax treatment of the deemed distribution would depend on whether the instrument is held by an IRA or a Special IRA.

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[39] Distributions that are not used for qualified higher education expenses would be included in the gross income of the distributee in the same manner as provided under present-law section 72 to the extent not excluded from gross income under any other provision of the Code.

Effective Date

The proposal would be effective on January 1, 1997.

b. IRA withdrawals for higher education expenses (sec. 406 of S. 2)(Senator Roth and others)

Description of Proposal

The proposal would permit withdrawals from an IRA that would be exempt from income tax and from the 10-percent early withdrawal tax if made for the qualified higher education expenses of the individual, the spouse of the individual, or any child, grandchild, or ancestor of the individual or the individual's spouse.

For purposes of this provision, qualified higher education expenses would be defined as the student's cost of attendance as defined in section 472 of the Higher Education Act of 1965 (generally, tuition, fees, room and board, and related expenses). Qualified higher education expenses would be reduced by any amount excludable from gross income under section 135 relating to the redemption of a qualified U.S. savings bonds and certain scholarships and veterans benefits.

Effective Date

The provision would be effective for distributions after December 31, 1996.

III. ECONOMIC ANALYSIS

A. The Economics of Subsidizing Education

Overview of the goals of subsidies

All levels of government make substantial direct expenditures to subsidize post-secondary education.[40] In addition, private educational organizations channel gifts from private persons into subsidies for the education of other persons. By exempting such organizations from the income tax and permitting the gifts to such organizations to be deductible, additional implicit subsidies under the Internal Revenue Code are created for education. Other subsidies for education provided by the Internal Revenue Code permit students to receive tax-free qualified scholarships and tax-free cancellation of certain governmental student loans. Students and parents also are provided the benefit of deferral of tax on the earnings of contributions to qualified State prepaid tuition programs, and an exclusion from income is provided to low and middle income taxpayers who use U.S. savings bonds to pay for post-secondary education.[41] The list of subsidies for education would be further lengthened by proposals to create tax credits for tuition, permit tax deductions for tuition, create savings incentives for education, permit deduction for student loan interest, expand the exclusion from income for canceled student loans, exclude Federal work study payments from income tax, extend certain exclusions for educational expenses undertaken by employers, and provide a credit for certain educational expenses undertaken by employers. Analysts attempt to analyze subsidies in terms of their efficiency, equity, and administrability. In this regard, subsidies to post-secondary education have been argued to improve both economic efficiency and to promote economic equity.

Efficiency as a goal of subsidies to education

Since the time of Adam Smith, economists generally have had a predilection for favoring the outcomes of the free market and have reasoned that taxes or subsidies in the market generally lead to inefficient outcomes. That is, taxes or subsidies distort choices and divert resources from their highest and best use. However, economists also recognize that sometimes markets do not work efficiently. Economists observe that the consumption or acquisition of certain goods may create spillover, or external, effects that benefit society at large as well as the individual consumer who purchases the good. A good example of such a good is a vaccination. The individual who is vaccinated benefits by not contracting an infectious

[40] Part I.B., above, describes certain Federal aid programs that subsidize the acquisition of post-secondary education.

[41] Part I.A., above, describes tax benefits under present law that subsidize education.

disease, but the rest of society benefits as well, because by not contracting the disease the vaccinated individual also slows the spread of the disease to those who are not vaccinated. Economists call such a spillover effect a "positive externality."[42] On his own, the individual would weigh only his own reduced probability of contracting the disease against the cost of the vaccination. He would not account for the additional benefit he produces for society. As a result, he might choose not to be vaccinated, even though from society's perspective total reduction in the rate of infection throughout the population would be more than worth the cost of the vaccination. In this sense, the private market might produce too little of the good. The private market outcome is inefficiently small. Economists have suggested that the existence of positive externalities provides a rationale for the government to subsidize the acquisition of the good that produces the positive externalities. The subsidy will increase the acquisition of the good to its more efficient level.

While much evidence suggests that job skill acquisition and education benefit the private individual in terms of higher market wages,[43] many people have long believed that education also produces positive externalities. Commentators argue that the democracy functions better with an educated populace and that markets function better with educated consumers. They observe that education promotes innovation and that, because ideas and innovations are easily copied in the market place, the market return (wage or profit) from ideas and innovations may not reflect the full value to society from the idea or innovation. Just as the single individual does not appreciate the full benefit of a vaccination, a single individual may not be able to reap the full benefit of an idea or innovation. Thus, it is argued, subsidies for education are needed to improve the efficiency of society.

On the other hand, recognizing that a subsidy might be justified does not identify the magnitude of the subsidy necessary to promote efficiency nor the best method for delivery of the subsidy. It is possible to create inefficient outcomes by over-subsidizing a good that produces positive externalities. Given that the United States already provides substantial subsidies to post-secondary education, without some empirical analysis of the social benefits that would arise from creating new subsidies, it is not possible to say whether such subsidies would increase or decrease economic efficiency.

Some observers note that, aside from potential spillover effects that education might create, the market for financing education may be inefficient. They observe that while investors in housing or other tangible assets have property that can be pledged to secure financing to procure the asset, an individual cannot pledge his or her future earnings as security for a loan to obtain education or

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[42] For a more complete discussion of the notion of "positive externality" see, Harvey S. Rosen, *Public Finance*, (Homewood, Illinois: Irwin), 1988, pp. 142-146. Rosen discusses the notion of positive externality as applied to education. Rosen notes (pp. 144-145), "That college increases productivity may be true, but *as long as the earnings of college graduates reflect their higher productivity, there is no externality* [Rosen's emphasis]."

[43] Kevin Murphy and Finis Welch, "Wage Premiums for College Graduates: Recent Growth and Possible Explanations," *Education Researcher*, 18, May 1989, pp. 17-26. Murphy and Welch document that, between 1981 and 1986, the average wage of workers with 16 years of schooling was 58.4 percent higher than the average wage of workers with 12 years of schooling. This college wage premium represented the largest such premium during the period of their study, 1963 through 1986.

training designed to increase the individual's future earning potential. This inability to provide security for education loans constrains borrowing as an alternative to finance education for some taxpayers. Taxpayers who cannot borrow to finance education or training may forgo the education or training even though it would produce a high return for the investor. This inefficiency in the market for education finance may offer a justification for public subsidies. The inefficiency in the market for financing likely is most acute among lower-income taxpayers who generally do not have other assets that could be pledged as security for an education loan. This suggests that this potential source of market inefficiency also relates to the considerations of equity as a rationale for subsidies of education (discussed below).

Equity as a goal of subsidies to education

As noted above, there is evidence indicating that education and training are rewarded in the market place. Recognizing this market outcome, some argue that it is appropriate to subsidize education to ensure that educational opportunities are widely available, including to those less well off in society. Commentators argue that education can play an important role in reducing poverty and income inequality. They observe that even if there were no positive externalities from education, promoting economic equity within a market economy provides a basis for subsidizing education.[44] If equity is the goal of expanded subsidies to education, the cost of the subsidies should be weighed in terms of the private benefits received by the target groups, rather than the social benefits that might be generated by any possible spillovers.

B. Treatment of Education Expenses Under an Income Tax

Educational expenditures

Students and their families incur direct educational expenses when they pay tuition and fees. Federal, State, and local governments and private persons make expenditures on behalf of students by funding State and local and private educational institutions.[45] Such expenditures by governments or private persons are equivalent to the government or private person transferring funds to the student which the student subsequently pays over to the educational institution. Lastly, students incur implicit expenditures for education by choosing schooling over the alternative of taking a job and earning a wage. The time spent in school means forgone income. Alternatively viewed, it is as if the student worked, was paid, and used the wages to purchase education. Analysts have concluded that the largest cost of obtaining an education come from forgone wages.[46]

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[44] For a cautionary note on the importance of the subsidy given, see Dennis Zimmerman, "Expenditure-Tax Incidence Studies, Public Higher Education, and Equity,"*National Tax Journal*, 26, March 1973. Zimmerman finds that the subsidy structure can just as easily promote a less equal distribution of lifetime income.

[45] Table 2 in Part I.B. reports that Federal, State and local, and private expenditures accounted for 65 percent of post-secondary educational revenues for the 1993-94 academic year. Tuition accounted for 35 percent.

[46] See Michael J. Boskin, "Notes on the Tax Treatment of Human Capital," in Department of the Treasury, *Conference on Tax Research, 1975* (Washington, D.C.: Department of the Treasury), 1977, pp. 185-195.

Post-secondary education helps individuals develop general analytic and reasoning skills (e.g., problem solving) and often job specific skills (e.g., nursing training) that enhance the student's ability to earn a future income. In this way, expenditures on education are like an investment in a capital good: an outlay is made in the present for a machine that will produce income over a number of years in the future. It is because of this similarity that economists often refer to expenditures on education as investment in "human capital." However, some part of expenditures on post-secondary education are not as obviously investments in human capital but are more like consumption. For example, the chemical engineering student who takes an elective course in the history of music probably would not find her future earning potential increased by that particular elective. It is difficult to determine for any given student what portion of post-secondary education represents consumption and what portion represents investment in human capital.

The distinction between education as investment and education as consumption is not important to the efficiency/externality rationale for providing a subsidy to education, as externalities can arise from either consumption or investment. However, the distinction between education as investment and education as consumption is important to the equity rationale for providing a subsidy to education, as the equity rationale generally is based upon education as an investment in future earning potential. The distinction between education as investment and education as consumption also is important for analysis of the income tax treatment of expenditures on education - that is, should education expenses be deductible to properly measure a taxpayer's net income?

Educational expenses under a theoretical income tax

Under a theoretical income tax, any expenditures undertaken in the present for returns that are expected in the future should be capitalized and recovered as the future returns are earned. Consumption expenditures are neither deductible nor amortizable under a theoretical income tax. Thus, certain expenditures on education should be capitalized by the taxpayer and recovered against future earnings. As discussed above, the relevant expenditures to be capitalized would only be those that represent investments in human capital,[47] not those related to consumption. Of course, making such decisions would be quite difficult in practice. For example, the would-be chemical engineer of the example above may not know whether her future employment will be in the chemical industry or perhaps as a chanteuse, making it difficult to know how to account for the costs of the chemical engineering courses and the music course. Many educational expenses are paid by a parent on behalf of a student. In such case, the theoretical income tax would permit amortization only by the student.

Educational expenses under the present-law income tax

As discussed above, there are three types of expenditures made by students on their education: (1) direct payment of tuition; (2)

[47] For a discussion of government policy towards human capital investment see, C. Eugene Steuerle, "How Should Government Allocate Subsidies for Human Capital?" *American Economic Review*, 86, May 1996, pp. 353-357.

payment via implicit transfers received from governments or private persons; and (3) forgone wages. The present-law income tax treats direct payments of tuition as consumption, neither deductible nor amortizable. By not including the implicit transfers from governments or private persons in the income of the student, present-law offers the equivalent of expensing of those expenditures undertaken on behalf of the student by governments and private persons. This treatment that is the equivalent of expensing also is provided for direct transfers to students in the form of qualified scholarships excludable from income. Similarly, because forgone wages are never earned, the implicit expenditure incurred by students forgoing present earnings also receive expensing under the present-law income tax.

The theoretical income tax would have all expenditures toward investment in human capital capitalized and recovered against the student's future earnings. Expensing is more generous cost recovery than is capitalization and amortization.[48] By permitting the equivalent of expensing for the indirect expenditures related to a student's education (and direct expenditures made in the form of qualified scholarships), the present-law income tax subsidizes investment in human capital relative to investment in physical capital. On the other hand, the present-law income tax generally permits no recovery of the direct tuition costs paid by the student.[49] The present-law treatment of out-of-pocket tuition costs paid by the student might be viewed as disfavoring the acquisition of human capital *relative* to physical capital. Because the indirect expenditures (i.e., government and private transfers and forgone earnings) vary by individual and educational institution, it is not possible to conclude to what extent the relative subsidy is offset by the nonbeneficial treatment accorded direct expenditures (e.g., out-of-pocket tuition costs). In addition, the present-law income tax does not attempt to discern the extent to which any expenditures are for investment as opposed to consumption. This might suggest that present law relatively subsidizes education on net. On the other hand, the direct expenditures require out-of-pocket cash flows by the student or his parents and therefore might be more critical to the decision to invest in education or training. Because no part of such expenditures is treated like investment under present law, investment in education may be relatively discouraged.

C. Issues Related to Tax Incentives for Education

1. Tuition tax credits and a deduction for certain education and job training expenses

In general

The President's proposed HOPE tax credit would provide a 100-percent credit for qualified educational expenditures up to an annual limit of $1,500. The credit could be claimed by the student or the student's parents (subject to a phase-out of the credit based on

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[48] Under simplifying assumptions, the expensing of investment is economically equivalent to the nontaxation of the returns to that investment. Amortization attempts to measure, and tax annually, the return to the investment.

[49] An exception to this statement is the education expenses paid with interest earned on U.S. savings bonds by low and middle-income taxpayers.

AGI). The credit could be claimed only for the student's first two years of post-secondary education (and only if the student attains a B-minus average for the first year). The President's deduction proposal would permit an above-the-line deduction of up to $10,000 per year for qualified educational expenditures made by the student or the student's parents or grandparents (regardless of the student's academic performance).

The tuition tax credit proposed in S. 12 is similar to the HOPE tax credit, except that it would be refundable and the maximum credit amount of $1,500 would not be reduced by any Federal education grants. In addition, the GPA requirements are somewhat different, as are the eligibility rules for half-time students. The S. 12 deduction proposal also is similar to the President's proposal, except that the maximum deduction allowed per taxpayer return would be $5,000 for 1998 and 1999, and would be $10,000 for 2000 and subsequent years.

The "tax price" of expenditures on education

Generally, the value of a deduction can be equated to a credit at a rate equivalent to the taxpayer's marginal tax rate. Assume a taxpayer makes $1,000 of educational expenditures. If a taxpayer in the 28-percent marginal tax bracket deducts $1,000 of expenditures, the taxpayer's income tax liability falls by $280. This would be equivalent to permitting the same taxpayer to claim a 28-percent credit against his or her tax liability for the $1,000 of expenditures. The effect under either a deduction or a credit is that the taxpayer's out-of-pocket expenditure is reduced to $720, because although he or she paid over $1,000, his or her income tax liability fell by $280. Thus, economists sometimes say that the deduction or credit reduces the "price" of education to 72 cents per dollar of educational expenditure. Viewed from this perspective, the tuition tax credit proposals create a lower price of education (at least with respect to the first $1,500 of expenses spent for each student). In fact, because the credit rate is 100 percent, the price of educational expenditure is zero for the first $1,500 of qualified expenditures. In contrast, under the deduction the price of educational expenditure varies with the taxpayer's marginal tax rate and would be $1.00 for taxpayers in the zero bracket, $0.85 for taxpayers in the 15-percent bracket, $0.72 for taxpayers in the 28-percent bracket, $0.69 for taxpayers in the 31-percent bracket, $0.64 for taxpayers in the 36-percent bracket, and $0.604 for taxpayers in the 39.6-percent bracket.[50] (Under the proposals, income limitations based on AGI make it unlikely that any taxpayers in the 31-, 36- or 39.6-percent brackets could claim the deduction, effectively making their price of education $1.00.[51])

Thus, the proposed tuition tax credits would provide a lower price of education than does the deduction. However, because of the limitation on qualified expenditures, the tuition tax credits would not always provide a lower total cost of education. Once the tax-

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[50] This is the usual statement that a deduction creates a price of the deductible activity equal to one minus the taxpayer's marginal tax rate.

[51] The foregoing ignores the proposal's potential interaction with Pell Grants or other public or private financial aid. Changes in other financial aid would alter the effective "price" of educational expenditures calculated in this and subsequent examples.

payer has exceeded $1,500 in qualified expenditures his or her price of education rises to $1.00 per dollar of education expenditure.[52] Under the deduction, the price of education generally remains constant at the one minus the taxpayer's marginal tax rate until $10,000 of qualified expenditures have been made. Thus, if a taxpayer in the 28-percent tax bracket[53] incurs $5,500 in qualified expenditures, the deduction would reduce his or her tax liability by $1,540 while the credit would produce a tax reduction equal to the limit of $1,500.[54]

This discussion of the tax price of education does not depend upon viewing education as consumption or as investment in human capital. The price of the consumption is lowered and the price of the investment is lowered. By lowering the price of education, one would expect the demand for additional education to increase. The price decrease is limited to certain taxpayers by the income limitation, the nonrefundability of the tax credit or deduction, and by the expenditure limitation. The income limitation implies the price of education remains $1.00 per dollar of expenditure on education for those taxpayers above the income phaseout range of the credit and deduction. For taxpayers with incomes sufficiently low that they have no tax liability under present law, neither the HOPE credit nor the deduction offer any benefit as they are nonrefundable. For these taxpayers, the price of education also remains $1.00 per dollar of expenditure on education. Further, some taxpayers incur more than $10,000 of qualified education expenditures annually. For these taxpayers, the price of obtaining additional training in any given year (for example, enrolling in an additional course or for the summer term) also is $1.00 per dollar of expenditure on education.[55] One would not expect the tax credit or deduction to change the demand for education by taxpayers in these three circumstances. Unlike the HOPE credit, the proposed tuition tax credit of S. 12 would continue to offer low-income taxpayers a price of zero on the first $1,500 of qualified education expenses because it is refundable.

Education as investment in human capital

As discussed above, under a theoretical income tax, all expenditures on education would be capitalized and recovered as the student earns labor income in the future to the extent that the expenditures represent investment in human capital rather than consumption. Present law effectively expenses all indirect expenditures on education but generally provides no recovery for that por-

[52] Also, once the student enters his or her third full year of study the taxpayer can no longer claim either proposed tuition tax credit. The taxpayer may claim the deduction, however. Hence, in the third year the price on the first $1,500 of tuition may rise from $0 to some positive price less than $1.00 per dollar of expenditure.

[53] This example uses a taxpayer in the 28-percent marginal tax bracket because, all else equal (e.g., student GPA), a taxpayer in the 15-percent marginal tax bracket will always prefer the credit. At an expenditure of $10,000 in qualified expenses a taxpayer in the 15-percent marginal tax bracket is indifferent between claiming the $1,500 credit or the $10,000 deduction.

[54] In terms to the tax price analysis, using the deduction, the taxpayer would pay a price of $0.72 per dollar of expenditure for each of the $5,500 expended for a net cost of $3,960. If the taxpayer were to claim the credit, the taxpayer would pay a price of $0 for the first $1,500 expended, and a price of $1.00 for next $4,000 expended, for a total net cost of $4,000.

[55] There is no limitation on the number of years that a taxpayer could deduct qualified expenditures. Some taxpayers could find it in there interest to stretch their education over a longer period of time to take advantage of the reduced price offered by the deduction.

tion of direct out-of-pocket expenditures that might reasonably be classified as investment in human capital. The deduction for qualified expenses would provide expensing for direct expenditures. The credit, because it is at a rate of 100 percent, is equivalent to expensing more than the first $1,500 of tuition.[56] As discussed above, expensing is a more beneficial treatment of capital recovery than is amortization. Generally, both the credit and the deduction would provide greater benefit to an additional $1,000 invested in human capital than to an additional $1,000 invested in physical capital which must recover its cost over time through claiming depreciation expenses.

Not all investments in human capital would be able to take advantage of this favorable cost recovery under the proposals. As discussed above, this favorable cost recovery is limited to certain taxpayers by the income limitation, the nonrefundability of the tax credit or deduction, and by the expenditure limitation. Some argue that, if the purpose of permitting a deduction for educational expenses is to better measure income by exempting the investment component of education, then the benefits of more accurate cost recovery should be available to all taxpayers.

Both the tax credit and the deduction would permit a taxpayer other than the student to claim the tax benefit accorded qualifying expenditures. Frequently, a student's parent is in a higher tax bracket than is the student. Even upon graduation and the commencement of employment, the former student is often in a lower tax bracket than was his or her parents at the time the expenses were incurred and deducted under the proposal. Hence, the deduction may be made against a higher marginal tax rate (the parent's) than the tax rate that applies subsequently to the income earned on that educational investment. This would make the deduction or credit even more valuable as an incentive to invest in human capital. On the other hand, a student generally is in a lower tax bracket when educational expenditures are incurred than when the return on that investment (wages) is earned. If the student were to claim the deduction, the deduction might be applied against a zero tax bracket or against a marginal tax rate below that which will apply for much of the lifetime of subsequent earnings. This would make the deduction or credit less valuable as an incentive to invest in human capital.

Who benefits from the tax credit and deduction?

The immediate beneficiaries of the proposed tax incentives for education provided by the tax credit or deduction are taxpayers who incur education expenses. By providing an exemption from income, the deduction generally would provide more benefit to higher-income taxpayers than to lower-income taxpayers. However, no benefit is provided to taxpayers with AGI in excess of $100,000 (joint returns). Individuals without any income tax liability would not receive any benefit from the deduction.

The recipients of the education also could benefit, because generally additional education or training increases an individual's

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[56] For example, for a taxpayer in the 28-percent marginal tax bracket, the $1,500 credit is equivalent to deducting $5,357, or more than three times the $1,500 tuition payment.

earning potential. However, some would argue that to the extent these incentives would not lead to more individuals enrolling in post-secondary education or training programs, there would be no benefit to society as a whole because they would have obtained the training even if no such incentives were enacted. The recipients may benefit by completing their education with a smaller burden of debt than they otherwise would have incurred. However, the benefit the parents may expect to receive from the tax credit or deduction might induce parents to save less money for their children's education that they otherwise would. If so, this inducement could decrease the national saving rate, possibly leading to slower economic growth. It also could mean the student's burden of debt upon graduation is not markedly different than that he or she otherwise would have incurred.

Some of the benefit of the incentives may accrue to the educational institutions and their employees, rather than to the taxpayers and their children. As discussed above, the effect of the credit and deduction is to reduce the price of education for a large number of potential students. Some believe that such incentives, by increasing the demand for post-secondary education, would drive up the prices that educational institutions and their employees charge for their services.[57] To that extent, higher prices could transfer the benefit from the taxpayer to the educational institution. Whether, or by how much, the prices charged by educational institutions might increase would depend on the supply of such education. In the short run, the number of qualifying institutions is fixed. These institutions could increase enrollments, although in the short run many may not have the physical facilities or personnel to do so. An increase in demand with no change in supply usually results in higher prices for a product (higher tuition) in which case some of the benefits of the credit and deduction may be transferred to the educational institution. Even if tuition does not increase, some of the benefits of the credit and deduction may be transferred to the educational institution because increasing enrollments with little or no change in facilities or personnel may lead to a reduced quality of the education product. On the other hand, over time post-secondary educational institutions have demonstrated an ability to accommodate additional students. For example, college enrollments in 1996 were 15 percent greater than they were in 1981 and nearly 50 percent greater than in 1973.[58]

The effect on tuition might be greatest at public two-year colleges. In the 1992-93 academic year, average tuition and fees of full-time students were $1,387.[59] These averages imply that some

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[57] See Michael Rothschild and Lawrence J. White, "The University in the Marketplace: Some Insights and Some Puzzles," in Charles T. Clotfelter and Michael Rothschild (eds.), *Studies of Supply and Demand in Higher Education*, (Chicago: The University of Chicago Press), 1993. Rothschild and White observe that universities do compete in the marketplace, but may not set prices as high as the market can bear. Instead, they charge what might otherwise be termed "below market tuition" and selectively choose students permitted to enroll.

[58] U.S. Department of Education, Office of Educational Research and Improvement, National Center for Education Statistics, *The Condition of Education 1996*, NCES 96-304 (Washington, D.C.: U.S. Government Printing Office), 1996. The figures reported were for all institutions. The growth in enrollments has been greatest among public two-year institutions, 18.5 percent since 1981. The comparable figure for private two-year institutions was 15.4 percent, 12.8 percent for public four-year institutions, and 17.5 percent for four-year private institutions.

[59] See Table 1 in Part I.B., above. For the 1992-93 academic year, an estimated 1.4 million were enrolled full-time in public two-year colleges and an additional 3.9 million students were

institutions are charging less than $1,500 for full-time tuition. Less than 28 percent of the enrolled students at these institutions, or their families, had incomes in excess of $60,000.[60] Thus, most might be expected to qualify for the proposed tuition tax credits. As explained above, for such families the tax price of the first $1,500 in tuition and fees would be zero for two years worth of expenses. This suggests that the family would see a $1,500 tuition charge as equivalent to a zero charge and if market forces set tuition one would predict tuition for two-year programs to be no less $1,500 per year. Of course, tuition at *public* institutions is not determined solely by market forces. Yet, any government running such an institution and charging less than $1,500 for full-time tuition would see that setting full-time tuition at $1,500 would not effect its students and is equivalent to receiving a grant of funds from the Federal Treasury. More generally, to the extent any institution charges less than $1,500 for full-time tuition and fees and serves a clientele that can claim the credit, the increase in demand engendered by the credit might result in a prices increasing to at least $1,500.

Whether, or to what extent, tuition charges will increase in response to the increase in demand will determine the effect of the proposals on enrollment. Empirical studies show that both tuition levels and financial aid can affect the enrollment in higher education. The evidence suggests the effects are larger among students who attend low-cost schools or who come from lower income families.[61] To the extent increases in tuition do not fully offset the tax savings, enrollment at these institutions and by these students may increase. On the other hand, some research suggests that tuition changes may have more of an effect than net cost changes.[62] That is, enrollment is subject to "sticker shock" and a one dollar increase in tuition does more to discourage enrollment than a one dollar increase in financial aid (or tax reduction) does to encourage enrollment.

2. Deduction for interest on education loans

S. 1 would permit up to $2,500 of interest on qualified education loans to be deducted by individuals as an above-the-line deduction. S. 12 would provide a deduction for student loan interest similar to the one provided for by S. 1, except that a taxpayer would be permitted to deduct interest paid on a qualified education loan; the deduction would not be subject to a dollar cap.

To the extent deductibility reduces the cost of debt associated with education expenses, this provision may reduce the cost of education and thereby make college more affordable to a greater number of individuals. Also, it is argued that student loans often im-

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estimated to be enrolled part-time. In 1992-93, tuition and fees paid by part-time students averaged $347 per student. National Center for Education Statistics, *The Condition of Education 1996*, p.217.

[60] The percentage is based on 1992-93 enrollments. National Center for Education Statistics, *The Condition of Education 1996*, p. 217.

[61] Bob Lyke, "Tuition Tax Credit and Deduction: Issues Raised by the President's Proposals," Congressional Research Service, Report No. 96-607 EPW, July 3, 1996, provides a brief review of this literature.

[62] *Ibid.*

pose a heavy burden on graduates at the beginning of their careers; interest deductibility under the bills may ameliorate this burden.[63]

S. 1 and S. 12 would reduce education costs only to the extent that debt is incurred. Because the bill may reduce the effective cost of debt relative to other financing methods, opponents may argue that interest deductibility might encourage students to assume additional debt instead of using current earnings or previous savings for education expenses.

Further, it is argued that the deductibility of student loan interest might benefit predominantly middle- and upper-income taxpayers, since college graduates generally earn higher levels of income than individuals who do not attend college. Higher-income taxpayers may benefit more than lower-income individuals because the value of the deduction would be great for taxpayers in higher tax brackets. Also, the highest level of loans generally would be obtained by students who continue on with professional or graduate education and who typically would have higher income levels during the repayment period.

On the other hand, the highest income earners are excluded from the benefits of both proposals as the benefit is phased out for taxpayers with modified AGI above certain levels. In addition, some argue that the benefits of deductibility would accrue more to lower- and middle-income individuals because higher-income individuals may not need to borrow to finance education costs. To the extent that higher-income students would borrow to take advantage of the deduction while spending their resources on other goods or services, however, this argument may not be as persuasive.

Some believe that interest deductibility is desirable to alleviate the excessive burden that student loan repayments place on some graduates. To the extent any excessive burden stems from low income or unemployment rather than high levels of debt, the effect of deductibility of interest payments might provide limited relief. For Federally subsidized loans, a reduction in repayment rates or increased deferments might be of greater value in reducing the burden on lower-income graduates than would interest deductibility.

3. Expansion of student loan forgiveness and exclusion of work-study income from tax

Under a theoretical income tax, and generally in present law, forgiveness of indebtedness is treated as taxable income to the debtor. An exception to this rule is provided in current law relating to forgiveness of indebtedness for certain loans made by the Federal Government, State governments, and certain instrumentalities of State or local governments. The proposal would expand this rule to loans made for education by any tax-exempt charitable organization. Also under present law, the value of a qualified scholarship, generally limited to tuition and fees, is excludable from the income

[63] See Figures 1 and 2 in Part III.D., below, for data on the debt burden of college graduates. The U.S. Department of Education, National Center for Education Statistics, *1993 Baccalaureate and Beyond Longitudinal Study First Follow-Up* reports that 1992-1993 college graduates who took loans to finance their college education graduated with an average college loan debt of $10,167. Figure 2 shows that the monthly college loan payment of the majority of recent college students is between $50 and $99.

of the recipient regardless of the organization making the scholarship.

A charitable organization could help a student finance his or her tuition and fees by making a loan to the student or granting a scholarship to the student. In neither case are the funds received by student includable in taxable income. Economically a subsequent forgiveness of the loan converts the original loan into a scholarship. As noted in Part III.B., above, exempting a scholarship or loan forgiveness is equivalent to permitting a deduction for tuition paid. An individual who benefits from a loan forgiveness would not be subject to the $10,000 limitation on deduction of tuition and fees, nor would the individual be subject to the income limitations. In addition, as under present law, loan forgiveness can apply to a loan that covers living expenses as well as tuition and fees.

Similarly, permitting exclusion of Federal work study payments from taxable income also converts the payment into the equivalent of a scholarship. As with loan forgiveness, work study payments are not directly tied to tuition payments and may be used to finance a student's living expenses. In addition, it also may permit the student or his or her family effectively to exclude more than $10,000 in educational expenses annually (when taking into account all excludible education benefits) . Unlike loan forgiveness, to qualify for Federal work study payments a student must have demonstrated financial need. This involves a family income test, though not the same income test applied by the tuition tax credit and educational expense deduction proposals discussed in Part III.C.1. above.

4. Issues related to income exclusion of certain employer-provided educational assistance and a small business tax credit for employer-provided educational assistance

The exclusion for employer-provided educational assistance programs is aimed at increasing the levels of education and training in the workforce. Employer-provided educational assistance benefits may serve as a substitute for cash wages (or other types of fringe benefits) in the overall employment compensation package. Because of their favorable tax treatment, benefits received in this form are less costly than cash wages in terms of the after-tax cost of compensation to the employer-employee pair.

The tax treatment serves to subsidize the provision of education and could lead to larger expenditures on education for workers than would otherwise occur. This extra incentive for education may be desirable if some of the benefits of an individual's education accrue to society at large (through the creation of a better-educated populace or workforce). In that case, absent the subsidy, individuals would underinvest in education (relative to the socially desirable level) because they would not take into account the benefits that others indirectly receive. To the extent that expenditures on education represent purely personal consumption, a subsidy would lead to overconsumption of education.

Because the present-law section 127 provides an exclusion from gross income for certain employer-provided education benefits, the value of this exclusion in terms of tax savings is greater for those taxpayers with higher marginal tax rates. Thus, higher-paid indi-

viduals, individuals with working spouses, or individuals with other sources of income may be able to receive larger tax benefits than their fellow workers.

In general, in the absence of section 127, the value of employer-provided education is excludable from income only if the education relates directly to the taxpayer's current job. If the education would qualify the taxpayer for a new trade or business, however, then the value of the education generally would be treated as part of the employers taxable compensation. Under this rule, higher-income, higher-skilled individuals may be more able to justify education as related to their current job because of the breadth of their current training and responsibilities. For example, a lawyer or professor may find more courses of study directly related to his or her current job and not qualifying him or her for a new trade than would a clerk.

The exclusion for employer-provided educational assistance is meant to counteract this effect by making the exclusion widely available. Proponents argue that the exclusion is used primarily useful to non-highly compensated employees to improve their competitive position in the work force. In practice, however, the scant evidence available seems to indicate that those individuals receiving employer-provided educational assistance are somewhat more likely to be higher-paid workers.[64] The amount of the education benefits provided by an employee also appears to be positively correlated with the income of the recipient worker. Such evidence is consistent with the observation that the exclusion is more valuable to those individuals in higher marginal tax brackets. A reformulation of the incentive as an inclusion of the value of benefits into income in conjunction with a tax credit could make the value of the benefit more even across recipients subject to different marginal tax brackets.[65]

The proposed credit for small business would reduce the cost of training expenses that might be undertaken by those employers. Such employers may find it more cost effective to provide additional training because of the reduction in cost. However, by requiring training to be provided by a third-party, the credit biases the type of training that is encouraged. This may limit the efficacy of the credit. On the other hand, permitting a credit for training provided in-house would create potentially difficult issues of expense allocation, compliance, and tax administration.

D. Issues Related to Savings Incentives for Education

Nearly 50 percent of 1993 college graduates graduated in debt as a result of their college expenses. (See Figure 1.) These data may understate the extent to which debt is used to finance college expenses because Figure 1 reports only debt owed by the college graduate, not his or her parents. Some see such data as evidence that parents are not saving adequately for their children's education.

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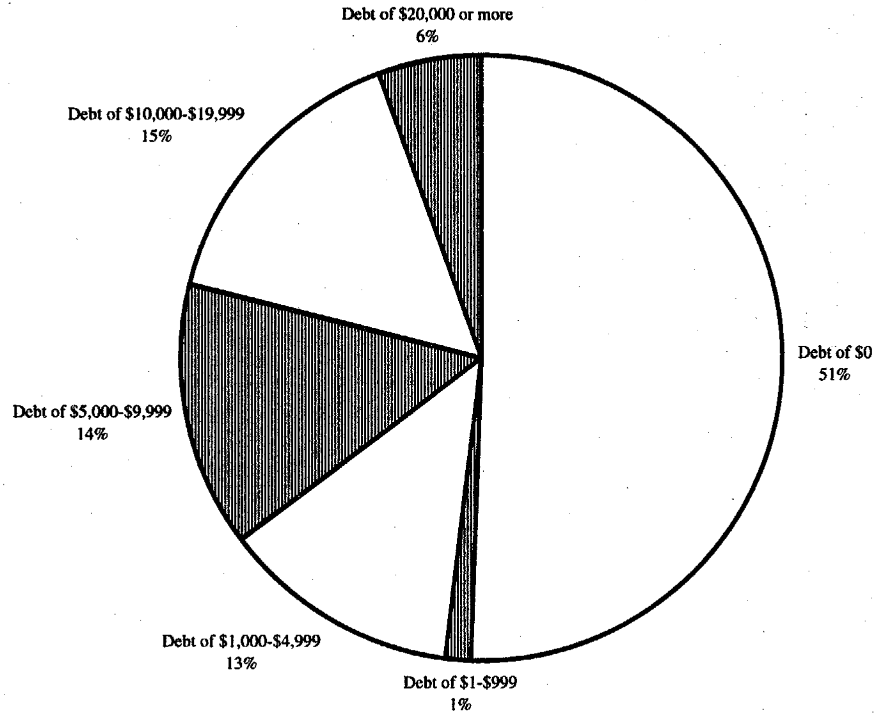
[64] See, for example, Coopers & Lybrand, "Section 127 Employee Educational Assistance: Who Benefits? At What Cost?", June 1989, p. 15, and Steven R. Aleman, "Employer Education Assistance: A Profile of Recipients, Their Educational Pursuits, and Employers," Congressional Research Service, Report No. 89-33 EPW, January 10, 1989, p. 9.

[65] If the credit were nonrefundable, then to the extent that a taxpayer reduces his or her tax liability to zero, he or she may not be able to receive the full value of the credit.

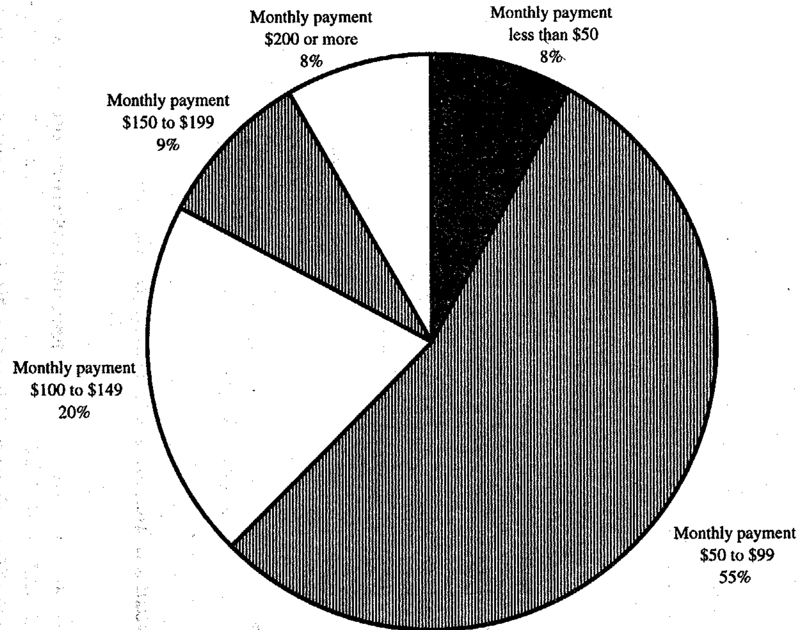
They are concerned that the necessity to undertake debt and the prospect of future debt service payments may discourage some individuals from obtaining post-secondary education. Figure 2 shows that more than one-third of freshmen who enrolled in 1989, and undertook an education loan at that time, were paying $100 per month or more in debt service four and one half years later. Oppositely viewed, these data show that a slight majority of recent college graduates graduated with no personal education debt and that more than 60 percent of those with education debt had monthly debt service requirements of less than $100.

Figure 1.--Total Indebtedness of 1992-1993 Bachelor's Degree Recipients



Source: U.S. Department of Education, National Center for Education Statistics, 1993 Baccalaureate and Beyond Longitudinal Study First Followup.

Figure 2.--Average Monthly Loan Payment as of Spring 1994 of College Freshman Who Borrowed in 1989-90 and Are Repaying Their Loan



Source: U.S. Department of Education, National Center for Education Statistics, 1990 Beginning Postsecondary Students Longitudinal Study Second Followup.

S. 1 would provide tax incentives for education by creating education investment accounts and permitting tax-free withdrawals from qualified State tuition plans. These proposals would provide tax incentives to encourage parents to save to finance the post-secondary education of their children. Both proposals would exempt from income tax the earnings from qualified investments if both the principal and earnings from the investments are used to finance qualified education expenditures.

The President's proposal would allow penalty-free withdrawals from deductible IRAs or from nondeductible Special IRAs if the taxpayer used the amounts to pay qualified higher education expenses of the taxpayer, the taxpayer's spouse, or the taxpayer's child or grandchild (whether or not a dependent). S. 2 would allow penalty- and tax-free withdrawals from IRAs if the funds were used to pay the qualified higher education expenses of the individual, the spouse of the individual, or any child, grandchild, or ancestor of the individual or the individual's spouse.

Provisions of present law providing saving incentives

Present law contains various tax incentives for savings, some earmarked for education and others not. For example, as described in Part I above, low and middle income taxpayers may exclude the earnings on U.S. savings bonds when used to pay qualified education expenses. Taxpayers may contribute funds to qualified State tuition plans, the earnings on which are untaxed until their withdrawal. Other incentives, while not earmarked for education, may provide the opportunity to save for education expenses. Given the existence of these tax-preferred savings instruments, some argue that additional savings incentives are not justified.

For example, under certain circumstances, benefits accrued under a qualified pension plan may be borrowed or withdrawn to pay education expenses. Interest earned on a life insurance contract accrues annually (inside buildup). The interest income which has accrued to the policy is subject to taxation on a tax-deferred basis. The policy could be redeemed to pay education expenses. Alternatively, a loan against the cash surrender value of a life insurance contract can be used to pay education expenses, generally without current tax on the inside buildup. Parents can establish a trust under section 2503(c), the income of which may be taxed at lower marginal tax rates than the parents' rate; the trust can then be used to pay education expenses. In addition, assets may be shifted to children and receive the benefit of the children's lower marginal tax rates if the children are over 14 years old.

Nonetheless, some commentators argue that the existing tax incentives are insufficient to encourage systematic, long-term saving for education expenses, which have risen rapidly in recent years (see Table 1). They argue that the national saving rate is too low and further inducements to save are warranted. Moreover, they argue that the economy would benefit from having a more educated, more skilled labor force. Additional incentives to save for education eventually would induce more individuals to acquire post-secondary education or training.

Deferral vs. exemption

Exempting income from taxation is always more valuable to the taxpayer than deferring taxation on the same income. For example, if $1,000 could be invested for 10 years to earn eight percent annually and those earnings were exempt from taxation, this investment would have accumulated $1,158.93 in interest by the end of the 10-year period. If the earnings instead were taxed annually to a taxpayer at the 28-percent marginal tax rate, the accumulated interest, net of taxes, would be $750.71 after 10 years. If the earnings were not taxed annually, but rather the tax was deferred and assessed on the accumulated interest at the end of the 10-year period, the value of the taxpayer's net earnings would be $834.43. In this example, deferral increases the taxpayer's return by 11.2 percent over the 10-year period compared to annual taxation. Exemption is 38.9 percent more beneficial than deferral over the same period.

The benefit of tax exemption generally is greater to a higher-income taxpayer than a lower-income taxpayer, because the tax liability saved per dollar of tax-exempt income is greater for taxpayers in higher tax brackets. The benefit of deferral depends not only on the taxpayer's current tax rate, but also on his or her future tax rate. The benefit of deferral is increased for a taxpayer who currently is taxed at a high marginal rate, but who can defer the tax liability until a lower marginal rate applies. The benefit of deferral is decreased if the taxpayer currently is taxed at a low marginal rate and defers the tax liability to a year when a higher marginal tax rate applies. In this circumstance, because of the taxpayer's low initial tax rate, the taxes deferred may actually be worth less than the taxes owed at the later date when the taxpayer is in a higher tax bracket.

Who benefits from savings incentives for education?

The immediate beneficiaries of tax incentives to save for education are parents who want to fund future education expenses of their children. By providing an exemption from income, the education saving proposals of S. 1 and penalty-free IRA withdrawals generally would provide more benefit to higher-income taxpayers than to lower-income taxpayers. Individuals without any income tax liability at the time the savings are used to pay for education would not receive any income tax benefit from these proposals but would benefit from the elimination of the penalty tax on early withdrawals.

The recipients of the education also could benefit, because generally additional education or training increases an individual's earning potential. In addition, the recipients may benefit by completing their education with a smaller burden of debt than they otherwise would have incurred. However, some would argue that to the extent these incentives would not lead to more individuals enrolling in post-secondary education or training programs, there would be no benefit to the recipients since they would have obtained the training even if no such incentives were enacted.

Some of the benefit of the proposed tax incentives for savings may accrue to the educational institutions and their employees, rather than to the taxpayers and their children. As discussed in

Part III.C.1., above, some believe that such incentives, by increasing the demand for post-secondary education, would drive up the prices that educational institutions and their employees charge for their services. To that extent, higher prices could transfer the benefit from the taxpayer to the educational institution.[66]

The benefit the parents may receive from tax exemption or deferral can significantly increase the rate of return on saving for education. This higher return might induce parents to save money for their children's education that they otherwise would spend on current consumption. If so, this inducement could increase the national saving rate, leading to greater economic growth.

Equity considerations

Some believe it is inappropriate to permit any taxpayer an exemption, full or partial, for interest on savings for education. Such a full or partial exemption is equivalent to a deduction for tuition costs. They argue that such a deduction more often benefits higher-income taxpayers than lower-income taxpayers, and that it is inappropriate to extend tax incentives to save to higher-income taxpayers because they already possess the means to save for their children's education without added inducement. Others argue that the costs of education have risen for everyone and that broadly applicable tax incentives are justified. Benefits for higher-income taxpayers could be restricted in a number of ways. The amount of the annual contribution could be limited. For example, S. 1 limits the amount of annual contributions that may be contributed to an individual education savings account (although no contribution limit would apply in the case of savings through qualified State tuition programs). Likewise, annual contributions to IRAs are limited. Another alterative for limiting the benefits for higher-income taxpayers would be that the tax benefits could be phased out, as is the case for U.S. savings bonds under present law. Also, under present law, certain higher-income taxpayers may not make deductible contributions to IRAs.

Experience with IRAs prior to the restrictions imposed by the Tax Reform Act of 1986 on contributions by higher-income individuals indicated that, although many lower-income individuals contributed to IRAs, the percentage of participation was greatest among higher-income taxpayers. Higher-income taxpayers made larger contributions as well. Taxpayers with adjusted gross incomes in excess of $50,000 constituted approximately 29 percent of all IRA contributors, but accounted for more than 35 percent of IRA contributions during 1985.

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[66] Part III.C.1. suggested that the strongest effect on prices might occur among those two-year public colleges that currently charge a full-year tuition of less than $1,500. With a general saving incentive, the effect on tuition would only be expected to occur differentially across different types of educational institutions to the extent that the saving incentive differentially affects the increase in demand for different types of institutions. For example, if the increased saving induced by the incentive makes more students apply to private four-year colleges than to public four-year colleges, the tuition of the private colleges might be more likely to increase than the tuition of the public colleges.

Savings incentives for education and the national savings rate

Some argue that, as a nation, we save too little. The savings proposals would increase the after-tax return for savings, thereby making saving a relatively more attractive option than current consumption. As a result, the taxpayer may choose to save more. However, if the taxpayer saves with certain goals or target amounts in mind, increasing the net return to saving could lead the taxpayer to save less because the same after-tax amount could be saved with a smaller investment of principal. For example, a taxpayer in the 28-percent marginal bracket may set aside $1,300 today to help defray tuition expenses 15 years from now. If the taxpayer's investment earns eight percent annually and those earnings are taxed annually, 15 years from now his investment will be worth $3,000. If the taxpayer could defer the tax owed on the earnings for 15 years, an investment of only $1,025 today would be worth $3,000 15 years from now. Empirical investigation of the responsiveness of personal saving to after-tax returns provides no conclusive results. Some find personal saving responds strongly to increases in the net return,[67] while others find little or a negative response.[68]

Creating new tax-favored saving arrangements does not necessarily create new saving. The higher net return and the increased awareness of the need to save for college expenses, which could arise from the private market advertising for education savings accounts or the sale of education savings bonds, could induce taxpayers to save more. On the other hand, the taxpayer might merely transfer existing savings accounts into a tax-advantaged education account. The proposed structure for education savings bonds, education savings accounts, and the education savings trust is similar in structure to present-law deductible and nondeductible individual retirement accounts ("IRA").[69] Some believe that IRAs have been responsible for new saving, i.e., saving which would not otherwise have occurred.[70] Others argue that IRAs have for the most part been financed by taxpayers either shifting funds from their existing holdings of securities into IRAs, or by placing in IRAs funds which they would have saved anyway.[71]

Coordination with other financial aid

Children of parents who have not accumulated sufficient funds to pay for college expenses are often eligible for other financial aid, either private or governmental (see Part I.B., above, for information on direct Federal aid programs for post-secondary education). In general, eligibility for this aid depends upon parents' and child's current income and parents' accumulated assets. The greater this income and the greater their accumulated assets, the less likely the

[67] See M. Boskin, "Taxation, Saving, and the Rate of Interest," *Journal of Political Economy*, April 1978, 86.

[68] See G. von Furstenberg, "Saving," in H. Aaron and J. Pechman (eds.), *How Taxes Affect Economic Behavior*, Brookings Institution, 1981.

[69] For a more in-depth discussion of the theory and evidence relating to IRAs and saving, see Joint Committee on Taxation, *Description and Analysis of Tax Proposals Relating to Individual Saving and IRAs* (JCS-2-97), March 3, 1997, pp. 44-51.

[70] See, James M. Poterba, Steven F. Venti, and David A. Wise, "How Retirement Saving Programs Increase Saving," *Journal of Economic Perspectives*, 10, Fall 1996.

[71] See, Eric M. Engen, William G. Gale, and John Karl Scholz, "The Illusory Effects of Saving Incentives on Saving," *Journal of Economic Perspectives*, 10, Fall 1996.

student will qualify for financial aid. Reducing the amount or likelihood of Federal or other aid to the student who have savings imposes an implicit tax on the accumulation of assets. This might reduce the effectiveness of these proposals in stimulating saving for college education.

Two recent studies have examined the effects of financial aid on decisions to save for education. One study examines the "uniform methodology," which was the ability-to-pay formula for financial aid administered by the College Entrance Examination Board and commonly used by post-secondary educational institutions throughout the 1980s. This study estimated that, by basing financial aid on accumulated assets and income from those assets, financial aid formulas had the effect of imposing a "tax" at a rate of between 22 percent and 47 percent on the capital income of families that are eligible for college scholarships. These "taxes" would be in addition to Federal and State income taxes. This may induce families that potentially might qualify for financial aid to reduce their saving for their children's education.[72] The second study finds that the "congressional methodology," the methodology that replaced the uniform methodology in 1990s and generally applies to students receiving Federal aid, also penalizes saving. This study emphasizes that the effective tax rates depend upon the number of children for which the family hopes to provide a college education and the type of assets in which the family undertakes its saving. This study finds that, if a family invested one dollar in a bond that paid a 10-percent rate of interest and if the family had eight years worth (e.g., two children) of education to finance, the congressional methodology would reduce the eventual purchasing power of the one dollar to 25 cents. On the other hand, if the one dollar were invested in an asset that paid no dividends but offered the potential of capital appreciation, the congressional methodology would reduce the eventual purchasing power of the one dollar to 53 cents.[73]

Coordination of tax-preferred education savings with other forms of aid to education finance may be needed to improve the efficacy of such proposals. Requiring that the proceeds of an educational savings accounts not be included in any computation of Federal, State, or private financial aid would remove the implicit penalty on accumulation, but it also means that certain programs designed to aid lower-income families may be opened to families with significant assets.[74]

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[72] Martin Feldstein, "College Scholarship Rules and Private Saving," *American Economic Review*, 85, June 1995, pp. 552-566. Feldstein calculates that "the estimated parameter values imply that the scholarship rules induce a typical household [in 1986] with a head aged 45 years old, with two precollege children, and with income of $40,000 a year to reduce accumulated financial assets by $23,124, approximately 50 percent of what would have been accumulated without the adverse effect of the scholarship rules" (p. 566).

[73] Aaron S. Edlin, "Is College Financial Aid Equitable and Efficient?" *Journal of Economic Perspectives*, 7, Spring 1993, pp. 143-158. Edlin notes that, in addition to whatever effect this might have in discouraging saving for education, the congressional methodology also "gives parents a strong incentive to put their assets in stocks that pay low dividends, or other instruments that provide no income" (p. 147) or even "art or jewelry that may be reasonable stores of value, but that need not be reported on the Financial Aid Form" (p. 152).

[74] For instance, S. 218 ("Growing the Economy for Tomorrow: Assuring Higher Education is Affordable and Dependable Act," introduced by Senator Biden on January 28, 1997) provides for tax-preferred education savings accounts and specifically provides that, for purposes of all Federal means-tested programs, the balance in any education savings account (and any income from such an account) shall not be treated as an asset (or income) of the individual for whom the account is established or of any parent of such individual.

Some would argue that it is appropriate to ask those who have accumulated assets to assume a greater burden of the expense of education from their own sources. Others would respond that this encourages people not to save for their children's education but rather to rely on subsidies provided by Federal, State and private programs, and it penalizes those parents who do sacrifice to save for their children's education by denying direct financial aid to their children.

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