

THE ADMINISTRATION'S PROPOSAL FOR A TUITION TAX CREDIT

A JOINT ECONOMIC COMMITTEE REPORT



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Executive Summary

The Administration's proposal for a tuition tax credit does not adhere to the principles of good economic design for the tax laws, is of limited value as an incentive for post-secondary enrollment to students at the margin, creates minimal stimulus for economic growth, and has the potential for producing a heavy regulatory burden and high administrative cost.

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The Clinton Administration has proposed a tax credit for tuition payments as a stimulus for investment in human capital and economic growth. This paper presents a review of the efficiency and equity issues in the use of the tax law as a vehicle for promoting social goals. It describes the economic standards for evaluation of tax law proposals and comments on the tuition tax credit proposal in the context of these standards.

THE PROPOSAL

On June 4, 1996, the Clinton Administration proposed an income tax credit of \$1,500 applicable to the cost of the first two years of post-secondary education. The credit could be applied to education or training at four-year colleges, community colleges, or proprietary training schools. This amount is set at the current average cost of tuition at a community college. It would supplement a previous Administration proposal for a \$10,000 a year tuition tax deduction.

The "Hope Scholarship," as the credit is called, supports the Administration's announced goal of establishing a universal standard of at least 14 years of schooling. The \$1,500 credit for each student could be claimed for a taxpayer's education or that of a spouse or dependents. Each student would be required to maintain a B-grade average and avoid felony drug offenses. The benefit would be phased out for joint filers with adjusted gross incomes between \$80,000 and \$100,000 and for single taxpayers between \$50,000 and \$70,000 and would be reduced by the amount of any other non-taxable Federal education grants received by the student.

To make the proposal deficit-neutral, the Administration raises revenue from a combination of actions: decreasing the amount of multinational corporations' export sales income that could be treated as being derived from foreign sources; auctioning 25 megahertz of the radio spectrum previously reserved for the digital audio radio service; and imposing an international aviation passenger departure fee. An additional budget offset is generated by a reduction in the revenue loss from the proposed \$10,000 educational deduction, reflecting eligible taxpayers' selection of the credit rather than the deduction.

The Administration presents the tuition tax credit as a policy for middle-class tax relief which will encourage economic growth and provide additional advantages to lower-income students. These students would not normally involve themselves in the more complicated process of applying for loans and grants or would not be willing to burden themselves with debt. To solve this problem, the tax credit is designed to be available to all eligible students: it does not involve the uncertainty associated with applying for and awaiting approval of loans and grants. As a credit, it provides a relatively greater subsidy for lower-income students per dollar of lost revenue than the Administration's proposed deduction, because the poor face lower marginal tax rates. With the deduction, for example, a filer facing a 28 percent marginal tax rate and deducting the maximum

\$10,000 would value the proposed deduction at \$2,800, while a filer in the 15 percent bracket would receive a benefit of only \$1,500 for the same deduction. In the case of the credit, all filers who have at least a \$1,500 tax liability would value the credit at that amount.

THE HOPE SCHOLARSHIP AS AN ECONOMIC PROPOSAL

The Administration's proposed tax package of the credit and the deduction is unique in that it marks a shift in Federal education policy by making the tax code a major subsidy mechanism. The credit proposal in particular is noteworthy because of its implications for Federal regulation of educational aid and the creation of new requirements for reporting and compliance for millions of taxpayers. These areas until now have been outside the jurisdiction of the Internal Revenue Service.

The broad impact of the tax law makes it necessary for policy makers to consider efficiency, equity, and cost in the design of tax policy. Good design will permit the most efficient allocation of society's limited resources, establish fairness in the structure of compulsive payments to the government, and minimize the resources required to collect revenues and enforce the law. Such standards optimize both the economy's rate of growth and individual living standards and permit the greatest freedom of choice. Most of the regulatory issues surrounding the tuition tax credit have yet to be addressed in detail, but the proposal as it stands can be evaluated conceptually against these standards.

Market Failures, Government Failures and Educational Subsidies

Free markets sometimes fail to incorporate all social costs and benefits. Typically, the market system produces the highest standards of living for individuals in society by moving toward a result in which each additional resource unit creates the same increase in social benefit in each use. In other words, the market tends to equate marginal social benefits to the marginal social costs of moving these resources from other uses. If, however, the market decisions of individuals do not consider the additional benefits to society which might apply, including faster economic growth and greater political stability, governments may intervene to remedy the shortfall. Investment in education is one activity where the social gains usually exceed the benefits to the individual decision maker and is one in which a case for some government action could be made. The need for government action can also be argued in order to correct a bias against human capital investment, because our property rights system does not permit contracts allowing a person to sell a claim against his future work effort. There is no way to capture the repayment stream if the investor is other than the person in whom the investment is made. Thus, compared to investment in physical capital, investment in human capital possibly may be less than optimal and in need of supplement.

Though the free-market system does not function perfectly, the possibility of market failure must be weighed against that of government failure. Among the sources of government failure are the inefficiencies of the bureaucracy and the tendency of the political system to respond to special-interest pressures. Complex government programs like the Hope Scholarship are particularly subject

to inefficiencies and mismanagement. The Federal Family Education Loan Program, for example, with its complicated rules applying to millions of students and thousands of schools suffers from managerial weaknesses that in 1991 generated \$3.6 billion in taxpayer payments on defaulted loans.¹ Also, in a democratic political system, unconstrained legislatures are often more responsive to the pressures brought to bear by those receiving concentrated benefits from government action than to the interests of taxpayers among whom the costs of such actions are widely dispersed.

Efficiency Considerations

Economists generally accept the market-price mechanism as the most efficient system for controlling the economy and believe that it maximizes the welfare of market participants, if left undistorted. The first generally accepted goal, therefore, in administering a tax system is to minimize market-price distortions. This concept is known as efficiency. It means that the revenue collection system should function without changing relative prices among goods, services, and factors of production, so that there is no effect on the decisions of individuals about how they consume, work, or invest. An efficient tax code would not contain scores of exemptions, credits, deductions, and other exceptions to the basic provisions of the code needed for raising revenues, unless there is a clearly identified need.

Tax policy should permit the market system to ensure maximum flexibility for consumers and the owners of the factors of production. One test of the efficiency of a proposal is the degree to which participants maintain their freedom to choose among options. The tuition tax credit, however, is very limited in the way it may be used. For example, the Administration wants it to be available only for the first two years of post-secondary education, which limits students and their families in the efficient use of financial aid. Likewise, the B-average requirement, which may force students to seek easier academic programs, is more limiting than the C-average necessary for graduation.² Other limitations apply as well.

There is one potentially important way in which the credit may prove to be inefficient as an incentive for investment. If the credit were claimed by large numbers of current students, institutions of higher education may choose to increase tuition and thereby offset, at least partially, the tax benefits to students. There is no conclusive evidence that increased government subsidies mean increased tuition rates, but a number of analysts see a connection between the increase in government subsidies and the increase in tuition and fees in recent years. For example, the American Council on Education, which represents colleges, notes, "College prices have continued to rise because the market has been able to bear the increases. Most institutions have been able to raise tuition and still have full classrooms."³

¹ United States General Accounting Office, *High Risk Series: Guaranteed Student Loans*, December 1992.

² Possible scenarios for seeking relief from the B-average rule include enrolling at less challenging institutions, selecting easier courses, or gravitating to teachers who grade less severely.

³ Quoted in Robert J. Samuelson, "The Hypocrisy Scholarship," *The Washington Post*, February 12, 1997.

The benefits to some students could be offset by the higher tuition rates paid by all. Increases would have a disproportionate effect on low-income students because they tend to be less sophisticated with respect to the process for obtaining financial aid as an offset to tuition increases. In addition, low-income students are subject to the same tendency of students in general to look more at explicit tuition prices as the chief factor in their investment decision rather than the net cost calculated with grants, loans, or tax relief included.⁴

Another efficiency issue is whether there is need for another broad subsidy to solve the theoretical problem of the market's failure to invest sufficiently in human capital. In addressing market failures, it is impossible to have a clear measure of the shortfall being addressed, but this should not prevent policy makers from asking whether the current subsidy level is sufficient in light of alternative social requirements. There already exists a considerable higher-education subsidy. Current state-level direct subsidies to post-secondary institutions are about \$48 billion a year, and the Federal direct subsidy is \$26 billion. In addition, the Federal government sponsors \$32 billion in student aid in the form of outright grants, subsidized loans, veterans assistance, and unsubsidized loans--an increase in real terms of 68 percent in the last ten years. In fact, subsidies are so substantial that tuition covers less than half of college costs on average. Better return on government subsidies may be possible by targeting low-income students, shifting resources to primary or secondary school subsidies, or improving the delivery programs for existing targeted subsidy efforts. These issues need to be reviewed before another broad subsidy is created.

Equity in the Tax Law

A second goal in the design of tax law is fairness or equity. Generally, as a revenue-raising matter, the law should treat all members of the same group equally, with income level being the usual determinant for defining groups. "Horizontal" equity refers to the similar treatment of everyone in the same income class. In addition, the current U.S. standard is one which also seeks proportional sacrifice--that sacrifice should be proportional to income, as with progressive income tax schedules--known as "vertical" equity.

Equity in revenue collection typically takes a back seat in discussions of tax policies designed to address social problems. For instance, the tax credit proposal violates the horizontal equity standard for the income group by giving the credit to only a few in the group. The social goal becomes the defining measure of fairness. Thus, the equity in a program with social goals must be measured in the context of the need for the program. One of the problems generated by growing tuition costs is a disparity between the enrollment of high and low-income youth. This indicates that there is a need to address the education of the disadvantaged. Compared to the Administration's tax deduction proposal, the tuition tax credit does favor those with less income by phasing out the credit for wealthier taxpayers. It is designed, in part, to adhere to the principle of vertical equity.

⁴ Gary Orfield, "Money, Equity and College Access," *Harvard Educational Review*, Fall, 1992.

Part of the equity issue facing policy makers in student subsidy design, however, is how well low-income families respond to available subsidies. Family income seems to be the key variable in predicting whether a young person will make the investment. This may be related to difficulties in learning about and applying for educational assistance. Like most students, lower income students appear to respond primarily to the gross tuition price without considering possible subsidies. In addition, low-income families are less aware of the aid opportunities like Pell Grants for which they would easily qualify, and, when faced with aid applications, have problems in understanding the technical language used to instruct them in describing their financial assets.

As a subsidy to lower income families, the tax credit proposal has several deficiencies. One problem is that the credit would be subtracted from Pell Grants and some other public subsidies. The Pell Grants, in particular, are the chief direct grant subsidy for low-income students, and any offsets between these two programs greatly reduces the progressivity of the credit proposal. At least one educational expert sees the proposal as a “grossly unfair tilting of resources away from students who have the greatest need in favor of higher-income families.”⁵ A second problem arises with the likelihood that low-income families will not overcome cultural and administrative hurdles and take advantage of the subsidy. The design of the subsidy also needs to address the special needs of low-income families having little experience with complex application forms, with a reluctance to be encumbered with debt, and with a preference for certainty as to the availability of funds. In this case, the tax credit is easier to apply for than most financial aid packages, and it is available to all with tax liability who are eligible, thereby increasing the student’s ability to rely on the subsidy. The timing of the payment, however, especially a credit coming after the tax year, may require the student to secure a loan.

Administrative Costs

Good tax policy design should also minimize the cost of revenue collection; and, if the code is employed as a means for executing social policy objectives, movement toward the desired goal should also be maximized at the least possible administrative cost. These costs include, on the government side, the money spent on administrative staff to ensure enforcement, and, for the taxpayer, the time and effort expended to understand the law, to calculate obligations, and to hire any expert advisors.

The restrictions on the use of the credit announced thus far--such as the artificially high minimum grade requirement, the applicability of the credit only to the first two years of post-secondary schooling, and the prohibition on the subsidy of hobbies--add to complexity and administrative cost, both for the taxpayer and the government. For example, because the proposal omits hobbies as a subsidized educational pursuit, there will need to be a fairly detailed description of what qualifies as a hobby. Eventually the issue of taxpayer intent in selecting specific course s

⁵ Lawrence E. Gladieux, Executive Director for Policy Analysis for the College Board, quoted in “GOP Queries White House on Tuition Tax Breaks Plan,” *The Washington Post*, January 23, 1997.

will complicate regulation writing. An estimate of administrative cost must await the writing of regulations and guidelines, but concerns about further intrusion by the government into academic records is just one example of the types of costs, both financial and social, at issue. Treasury officials have apparently expressed concerns over the possibility of fraud in the Hope Scholarship program, evidence of the need for considerable regulatory effort on their part if the program were enacted.⁶ New regulatory, reporting, and compliance requirements for taxpayers and schools will broaden the powers of the Internal Revenue Service in the field of education.

Revenue Loss

Revenue loss to the Treasury is a measure of alternatives foregone to the policy maker--alternative tax reductions or new spending programs--and is a proxy for the real cost of the proposal. The revenue loss per new student for the tuition tax credit will be significant, since studies have provided little evidence of increased enrollment rates from previous subsidy efforts. Treasury Secretary Rubin has objected to the credit proposal on the grounds that the subsidy would only go to students who were already planning to enroll.⁷ High cost per student suggests a need to look at alternative approaches to encouraging low-income enrollment such as streamlining the application process or lowering the cost of getting information about student aid.

Economic Growth

Investment in human capital, like investment in physical capital, will increase the productivity of the economy, but the success of the tuition tax credit strategy depends on two key assumptions. The first is that more students will enroll in post-secondary programs as a result of the subsidy. Studies of educational enrollment patterns generally do not provide a clear answer to the question of how subsidies affect enrollment, but most evidence finds little support for the notion that subsidies by themselves encourage significant numbers of students to enroll.⁸ From this perspective alone, the economic stimulus may be negligible.

The second assumption is that post-secondary schools will not raise their tuition rates. A tuition increase would not only offset some or all of the effects of this subsidy on potential students but also discourage currently enrolled students. One perverse result might be that states with community college tuition rates below the level of the subsidy will automatically increase rates as a means of extracting an indirect subsidy from the Federal government.⁹

⁶ *Washington Post*, January 29, 1997.

⁷ *Washington Post*, February 3, 1997.

⁸ Thomas J. Kane, "Rising Public College Tuition and College Entry: How Well Do Public Access Subsidies Promote Access to College?" Working Paper 5164, National Bureau of Economic Research, July 1995.

⁹ *Tax Notes*, December 16, 1997.

Stimulus to economic growth also depends upon how the proposal is financed within the context of overall national resource use--that is, consideration of the alternatives foregone. In the case of a tax reduction, disincentives are inherent in the fiscal changes planned to "pay" for the tax reduction in a deficit-neutral environment. The Administration is proposing \$4 billion in revenue increases annually from existing and proposed programs to pay for this credit, and, as a general rule, these increases themselves usually will have disincentive effects in the markets to which they apply. Among other sources, these disincentives could arise as the result of the international aviation departure fee and the tax increase for multinational corporations.

In the macroeconomic context, spending levels are a reasonable measure of the total burden of government programs on the more efficient private sector of the economy and more relevant to the issue of stimulus than revenue levels. Since spending levels are not reduced by this tax credit proposal, it is difficult to argue that there is any fiscal stimulus from a purely macroeconomic perspective. Raising taxes in another segment of the economy, as this proposal does, or borrowing in capital markets to cover revenue losses, does little to stimulate the economy, since the burden on the private sector workhorse is not reduced.

In general, the tax credit might well induce some new students to enroll, but real economic growth seems unlikely given the potential for high administrative costs, inefficiencies, and offsetting disincentives.

CONCLUSION

The Administration's Hope Scholarship will be a program with a significant regulatory burden that does not address investment and growth as effectively as would providing opportunities for the more efficient private sector to allocate resources. From the perspective of efficient tax design and productive investment, a reasonable alternative would be the removal of the many special provisions in the law (which as a group tend to neutralize the advantages sought by the special interests who supported them), permitting the increased efficiency and lower costs of a simpler tax code with lower marginal rates provide the economic stimulus.

From the education policy side, there should be a targeted assistance program for low-income students, with programmatic changes designed to overcome the special hurdles associated with understanding existing aid programs. The Congress recently increased Pell Grant funding by \$1 billion to \$5.9 billion and raised the work-study appropriation by 35 percent to \$830 million. As a complement to these initiatives, policy makers should consider ways to overcome the difficulties facing disadvantaged families in learning about and applying for student aid. Counseling programs at public schools or community-based organizations might serve this need.