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LETTER OF TRANSMITTAL

December 22, 1998

To the Members of the Joint Economic Committee:

Transmitted hereby is a *Compendium of Studies on Targeted Tax Policies*. It is comprised of four Joint Economic Committee staff studies.

The views expressed in these papers are those of the authors and do not necessarily represent the views of the individual Members of the Joint Economic Committee.

Sincerely,

Jim Saxton,
Chairman.

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THE INEFFICIENCY OF TARGETED TAX POLICIES

A JOINT ECONOMIC COMMITTEE REPORT

Jim Saxton (R-NJ)
Chairman

Joint Economic Committee
United States Congress

April 1997

Executive Summary

A number of proposals for tax relief have been introduced by members of Congress from across the political spectrum. Disagreement now lies in how the tax relief should be delivered. In his fiscal year 1998 budget, President Clinton unveiled a targeted tax-cut program which would reward tax credits to certain groups for certain activities. Many economists and policy analysts would prefer a more general, broad-based approach to tax cuts which would not single out specific activities for preferential treatment. Specifically, targeted tax policies are economically inefficient and may encourage abuse of the tax system.

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THE INEFFICIENCY OF TARGETED TAX POLICIES

A number of proposals for tax relief have been introduced by Members of Congress from across the political spectrum. Disagreement now lies in *how* the tax relief should be delivered. In his fiscal year 1998 budget, President Clinton unveiled a targeted tax-cut program which would reward tax credits to certain groups for certain activities. Many economists and policy analysts would prefer a more general, broad-based approach to tax cuts which would not single out specific activities for preferential treatment. Specifically, targeted tax policies are economically inefficient and may encourage abuse of the tax system.

I. TARGETED TAX CUTS AND STANDARDS OF GOOD TAX POLICY

Virtually all economists agree with Joseph Stiglitz, former Chairman of President Clinton's Council of Economic Advisers, that "Three main traits define a well-designed tax system: fairness, economic efficiency and simplicity."[1] Generally, targeted tax policies do not meet any of these three criteria. Furthermore, they can easily lead to abuse in the current political system.

Economic Efficiency

All taxes distort behavior and reduce economic efficiency to some extent. The goal for policy-makers is to implement tax policies which minimize these distortions. In general, broad-based tax reductions are less disruptive to the market allocation of resources than are targeted tax policies such as tax credits. Targeting adversely affects economic efficiency through three main channels: resource allocation, incentives, and administrative costs.

Resource Allocation

Targeted tax credits artificially lower prices of government-approved activities while increasing other prices throughout the economy. The distortion of relative prices alters taxpayers' behavior and disrupts the efficient operation of markets. In effect, the government, rather than the market, determines where resources should be allocated. When resources are allocated by political decisions, they are diverted from more productive uses, thus undermining economic growth.

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[1] Council of Economic Advisers, *Economic Report of the President*, February 1996, U.S. Government Printing Office, Washington, D.C., p. 84.

In contrast, broad-based tax reductions minimize distortions in resource allocation because relative prices remain unchanged. In this way, the tax policy is guided by neutrality, permitting market incentives to allocate resources to their most highly valued uses. In addition, broad-based reductions in the marginal tax rates[2] imposed on working, saving, and investment would encourage these activities and increase the flow of resources into production, thus boosting prospects of long-term economic growth.

Incentive Effects

Taxes affect economic behavior and decision-making, which in turn affects the economy. Economists disagree about the size of the economic impact, but the direction is clear -- *cuts in marginal tax rates stimulate economic growth.* In general, broad-based tax reductions are more conducive to economic growth because they provide incentive effects that increase the flow of resources to production.

There are two main reasons why the incentive effects of a broad-based tax reduction are superior to those of narrowly targeted tax policies such as tax credits. First, broad-based tax reductions tend to lower marginal tax rates in the economy, thus increasing the resources available for long-term economic growth. Narrowly targeted tax credits do not have this effect because they do not lower the marginal tax rate. While the effects of broad-based tax incentives on economic growth should not be overstated, it must be recognized that even modest beneficial effects on the economy are important in the long term.

Second, narrowly targeted tax measures cannot increase overall economic activity, but only rearrange it in a less efficient manner. Certain activities may be promoted, but this will be at the expense of other activities which are already operating efficiently in the market. For example, a tax credit for education may alter educational decisions to some extent, but it does not lower marginal tax rates on working, saving or investment. A tax policy heavily reliant on targeted tax credits will leave tax rates unchanged at best, or will even tend to raise tax rates in the long run. The net effect at the margin is to substitute activities favored by the government for market driven activities; to substitute less efficient for more efficient use of resources; and to exert

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[2] The marginal tax rate is the fraction of an *additional* dollar of income that must be paid in taxes. It is the key determinant behind individuals' decisions to work, save, and invest because it influences the relative prices of alternative activities.

upward pressure on tax rates that would undermine economic growth, not enhance it.

Administrative Costs

Since tax credits can only be claimed under certain conditions, the Internal Revenue Service (IRS) must incur administrative costs to ensure the conditions are met. The more targeted the tax credit, the higher the costs incurred for record keeping, tracking, monitoring and filing. This directly reduces the benefit of a tax credit and further diverts resources away from more productive uses.

Fairness

Targeted tax policies are generally unfair because they do not apply equal tax treatment to similarly situated taxpayers. In other words, households with the same ability to pay taxes may be taxed differently depending on their composition or consumption choices. In essence, targeting is a way of using tax incentives to get Americans to do what the government wants them to do -- those who do not comply, do not receive the tax break.

Simplicity

Targeting creates a labyrinth of deductions, exclusions, and credits that complicate the tax code, raising the IRS's administrative costs and taxpayers' compliance costs. The IRS estimates that taxpayers spent 5.1 billion hours in 1995 complying with corporate and individual income tax laws.[3] These unrecorded costs, which include the time spent reading, understanding, filing, and consulting professionals, may well exceed the recorded administrative costs incurred by the IRS.

More importantly, targeting creates ample loopholes in the system, the abuse of which further increases the cost of the tax cut by lowering the government's revenue. Broad-based tax reductions, on the other hand, simplify the tax code, thereby reducing administrative and compliance costs. By eliminating the many exceptions and loopholes in the tax code, they also reduce an individual's ability to exploit the system.

Furthermore, targeting increases the power of the government by allowing the government the discretion to become increasingly involved in taxpayers' activities and spending choices. Activities more efficiently administered in the market place, thus become complicated with red tape and bureaucracy.

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[3] *Investor's Business Daily*, "Flat Tax Gains For All," January 24, 1996.

Potential Abuse in the Political System

Targeted tax policies may be abused if tax credits are rewarded on the basis of political clout rather than sound policy. By rewarding tax credits to a few favored groups, the government motivates others to lobby for similar preferential treatment. In this way, targeted tax credits invite powerful special interests into the political system as different groups use their money and influence to win the government's favor.

In turn, tax credits can easily be used as political handouts disguised as social or economic policy because they are easier to implement than spending increases. They are politically popular because they provide benefits to a few individuals at the expense of the rest of the taxpaying population. The ability to concentrate benefits and diffuse costs minimizes the opposition against their use.

II. Targeting Education and Employment

President Clinton recently proposed a very targeted tax-relief program in his 1998 budget. While targeted tax cuts are used on both sides of the political divide, the Administration's proposals have received widespread attention because of their size and significance. To advance two of his major goals over the next four years, President Clinton has proposed tax credits for education and for businesses who hire long-term welfare recipients.

Tax Credits for Education

The fundamental goal of President Clinton's education plan is to "open the doors of college to all."[4] The $51 billion package would refund up to $1,500 to students in each of the first two years of college provided they earn at least a "B" average. Alternatively, families with annual incomes under $100,000 could deduct up to $10,000 for each child enrolled in college. The proposal also increases the size of the federal Pell Grant program by expanding eligibility and raising the maximum amount of a grant from $2,700 to $3,000. Finally, the plan allows for expanded Individual Retirement Accounts (IRAs) from which tax-free withdrawals can be made for educational purposes.

There is broad agreement that education is an important investment in human capital. However, many economists, policy makers, university officials, and even some top-ranked members of President Clinton's administration are skeptical that a targeted tax credit is the best way to boost college enrollment.

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[4] President Clinton, *State of the Union* Address, February 4, 1997.

One of the most widely cited criticisms is that a targeted tax credit will mainly benefit students who would have gone to college anyway, while very little of the money will go to the poorest families who need it most. Even with the proposed increase in the size of the Pell Grant program, the value of the grant would still be 27 percent lower than it was in 1980 because of higher tuition costs. Lawrence Gladieux, executive director for policy analysis at the College Board, commented that the plan "tips the benefits so heavily to the more advantaged in our society that I have great misgivings....this is clearly an upper-income program."[5] If the fundamental purpose of the program is to boost college enrollment for the poor, Gladieux argues that it would be far more efficient to simply shift more money into Pell Grants, although this idea would be politically unpopular in the era of small government.[6]

Education analysts worry that the tax credit may distort behavior and create a range of unintended side effects. For example, the $1,500 tax credit is slightly higher than the average tuition cost at most community colleges, potentially giving colleges an incentive to raise tuition. In addition, the "B" average requirement may pressure professors into raising grades for students who are desperate to qualify for the aid. The "B" requirement may also impose a large administrative burden on the IRS by making it necessary to monitor grades.

Alternatively, a broad-based tax rate cut would provide families with additional income which could be spent on education if needed, without unfairly redistributing the benefits or introducing distortions.

Tax Credits for Employment

Another goal of President Clinton's agenda is to move an additional one million people off the welfare roles by the year 2000. To help achieve this goal, the Administration has proposed a tax credit for businesses that hire long-term welfare recipients. The plan would allow businesses to claim a 50 percent credit on the first $10,000 of wages paid to qualified welfare recipients for the first two years of employment. The plan has already sparked a great deal of criticism based on an earlier version of the program called the Targeted Jobs Tax Credit. The Targeted Jobs Tax Credit was enacted in 1978 and expired on December 31, 1994. Its poor success record has left many analysts doubting if the President's proposal will achieve its goal.

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[5] *Washington Post*, February 3, 1997, "Education Aid at What Cost?"

[6] *New York Times*, November 3, 1996, "An Economic Lesson: The Candidates' Plans for Education."

Charles Masten, the Inspector General at the U.S. Department of Labor who conducted an audit of the Targeted Jobs Tax Credit program, stated that it had "virtually no impact on employers' decisions to hire members" of these groups.[7] The audit showed that nearly 92 percent of the workers hired would have been hired anyway. Auditors estimated that the program cost $374 million a year and produced benefits of only $147 million a year, an economic loss of 63 cents for each dollar of total costs. Masten concluded that "the tax credit was a windfall for employers since the program [was] inconsequential in encouraging the employment" of welfare recipients and other groups it was intended to help.[8]

The targeted tax plan did not seem to achieve its goal, but it did encourage more lobbying activity. *The New York Times* reported that "Earlier versions of the tax credit spawned a whole industry of personnel consultants who did the paper work necessary to get the tax credit for employers. These companies became potent lobbyists for the tax credit."[9] Moreover, Linda Levine of the Congressional Research Service stated that "A number of studies found that employers did not significantly change their recruitment policies, but instead relied upon consulting firms to determine which of their newly hired workers coincidentally were members of the eligible population."[10]

Administration officials have pointed out that the new proposal was designed with criticism of the old one in mind. It is doubtful that the problems have been adequately addressed; nonetheless, the Targeted Jobs Tax Credit provides a good example of the inefficiency and potential manipulation that may arise from the use of targeted tax credits.

III. CONCLUSION

By artificially distorting relative prices, targeted tax rate cuts alter taxpayers' choices and disrupt the efficient operation of markets. Their inefficiency prevents policy makers from lowering the tax rate to the greatest extent possible, so that tax credits have little, if any, impact on working, saving and investing. Targeting may provide tax relief to

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[7] *New York Times*, "Clinton Will Seek Tax Break to Ease Path Off Welfare," January 28, 1997.

[8] *Ibid.*

[9] *Ibid.*

[10] *Ibid.*

certain groups of taxpayers, but it can actually undermine efficiency and economic growth. Furthermore, targeted tax policies can be inequitable, complicated, and easily abused.

In contrast, broad-based tax reductions minimize loopholes in the tax code, allowing for the lowest tax rates possible. The lower tax rates encourage work, saving, and investment so that more resources may be channeled toward production. Given broad-based and targeted tax rate cuts of the same size, broad-based tax rate cuts produce lower tax rates, stronger incentives, and greater economic growth.

Shahira ElBogdady Knight
Economist

THE ADMINISTRATION'S PROPOSAL FOR A TUITION TAX CREDIT

A JOINT ECONOMIC COMMITTEE REPORT

Jim Saxton (R-NJ)
Chairman

Joint Economic Committee
United States Congress

February 1997

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 ADMINISTRATION'S PROPOSAL FOR A TUITION TAX CREDIT

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 that 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.[11] 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

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

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.[12] 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."[13]

The benefits to some students could be offset by the higher tuition rates paid by all. Increases would have a disproportionate effect on

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[12] 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.

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

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.[14]

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 10 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.

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

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.

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."[15] 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

[15] 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.

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 courses 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.[16] 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

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[16] *Washington Post*, January 29, 1997.

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.[17] 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.[18] 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.[19]

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

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[17] *Washington Post*, February 3, 1997.

[18] 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.

[19] *Tax Notes*, December 16, 1997.

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), thereby permitting the increased efficiency and lower costs of a simpler tax code with lower marginal rates that provide 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.

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THE WELFARE-TO-WORK TAX CREDIT

A JOINT ECONOMIC COMMITTEE REPORT

Jim Saxton (R-NJ)
Chairman

Joint Economic Committee
United States Congress

March 1997

Executive Summary

The Administration has proposed a Welfare-to-Work Tax Credit aimed at providing job opportunities for long-term welfare recipients. Several studies have shown that an earlier version of the plan which used tax credits to subsidize wages of target groups was not an effective or economical way of helping target group members obtain jobs. It is unlikely that the proposed differences between the Welfare-to-Work Tax Credit and its predecessor will effectively address the shortcomings of the earlier plan. Furthermore, the proposed plan may create other problems and inefficiencies which are common to targeted tax credits of its kind.

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THE WELFARE-TO-WORK TAX CREDIT

The challenge of moving welfare recipients from the welfare rolls to the payrolls is not new; and using tax credits to subsidize the wages of hard-to-employ individuals, such as welfare recipients, has been a familiar response to the challenge for over 20 years. Businesses that hire welfare recipients face the potential risk that the individuals may be less productive or less skilled than other employees. It is hoped that wage subsidies will compensate employers for this risk, while providing welfare recipients the opportunity to develop the skills and experience necessary to secure long-term, unsubsidized jobs.

In the latest effort to move individuals from welfare to work, President Clinton has proposed the Welfare-to-Work Tax Credit (WWTC), which is similar to an earlier program called the Targeted Jobs Tax Credit (TJTC). An audit of the TJTC program, conducted by the Inspector General (IG) of the U.S. Department of Labor, concluded that the TJTC was "not an effective or economical means of helping target group members obtain jobs."[20]

The Administration claims that the WWTC was designed with criticism of the old plan in mind, but it is doubtful that the proposed changes will effectively address the problems which riddled the TJTC program. In particular, it is not clear that the WWTC will provide greater incentives for employers to change their hiring decisions. Furthermore, the WWTC may create other problems and economic inefficiencies which are common to narrowly targeted tax credits.

THE PROGRAMS AND PROPOSALS

Targeted Jobs Tax Credit

The TJTC program was enacted in 1978 to help provide job opportunities for specific groups which normally experience high unemployment rates.[21] The program permitted businesses to claim a tax credit if they hired eligible members from the target groups. Employers could claim 40 percent of the first $6,000 of wages paid during the first year of employment (for a maximum credit of $2,400

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[20] Office of Inspector General, U.S. Department of Labor, *Targeted Jobs Tax Credit Program: Employment Inducement or Employer Windfall?*, August 1994.

[21] The TJTC replaced the New Jobs Tax Credit which was not focused on chronically unemployed target groups.

per worker), provided the worker was employed for at least 90 days, or 120 hours.[22,23] The firm's wage deduction for tax liability had to be reduced dollar for dollar by the amount of the credit.

The targeted population included persons with disabilities referred from state or Department of Veteran Affairs vocational rehabilitation; economically disadvantaged youth (including cooperative education students), summer youth, Vietnam-era veterans, and ex-felons; and recipients of Supplemental Security Income (SSI), General Assistance, or Aid to Families with Dependent Children (AFDC). The Lower Living Standard Income Level (LLSIL) was used to determine whether individuals were "economically disadvantaged."

Since its inception, TJTC was amended almost a dozen times in attempt to correct several of the program's shortcomings. The tax credit expired on December 31, 1994.

Work Opportunity Tax Credit

The Work Opportunity Tax Credit (WOTC), implemented on October 1, 1996, replaced the TJTC program. Under WOTC, the tax credit was lowered to 35 percent of the first $6,000 of wages (for a maximum credit of $2,100 per worker), and the minimum retention period was extended to 180 days, or 400 hours.[24] Like the TJTC, wage deductions must be reduced by the amount of the credit.

The groups targeted under WOTC were slightly modified from the earlier program. Recipients of SSI benefits or General Assistance were excluded from the target list, while certain recipients of food stamps were added.[25] The minimum time period of required AFDC/

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[22] For summer youth employment, the tax credit was equal to 40 percent of the first $3,000 of wages, and the minimum employment period was 14 days, or 20 hours. Initially, it had been 85 percent of the first $3,000 of wages earned.

[23] The amount of the credit was reduced over time. When TJTC was originally enacted, the credit equaled 50 percent of the first $6,000 of wages in the first year, and 25 percent of the first $6,000 of wages in the second year. The minimum retention period was added in 1986 with the passage of the Tax Reform Act of 1986.

[24] For summer youth employment, the tax credit is equal to 35 percent of the first $3,000 of wages, and the minimum employment period is 20 days, or 120 hours.

[25] The proposed budget seeks to expand the group of qualified food stamp recipients.

welfare assistance was extended from at least 90 continuous days under TJTC to nine months under WOTC; and eligibility was extended to some family members of welfare recipients. Finally, qualified youth must reside in empowerment zones or enterprise communities instead of qualifying under LLSIL guidelines.

WOTC is due to expire on September 30, 1997, but the proposed budget seeks to extend the credit for an additional year.

Welfare-to-Work Tax Credit

The proposed WWTC would amend the WOTC program by adding long-term welfare recipients to the list of target groups. The tax credit would cost $287 million, between 1998-2002, to be wholly financed through the elimination of purported corporate subsidies.[26] Employers could claim a 50-percent credit on the first $10,000 of wages paid to qualified welfare recipients for the first two years of employment. Thus, the maximum credit per worker is $5,000 per year for two years. Qualified wages would include the employer's cost of educational assistance, health care and dependent care.

The targeted group would include: 1) members of families that have received assistance from AFDC (or successor programs) for at least 18 consecutive months ending on the hiring date; 2) members of families who have received a total of 18 months of family assistance (consecutive or not) after the date of the credit's enactment, provided they are hired within two years of the date that the 18-month total is reached, and 3) members of families who are no longer eligible for family assistance because of Federal or state-time limits, as long as they are hired within two years of the date they became ineligible for family assistance.

REVIEW OF THE INSPECTOR GENERAL'S AUDIT[27]

The economic efficiency and social benefits of the WWTC can be assessed by analyzing the TJTC on which it was based. A comprehensive audit of the TJTC program was conducted by the Office of Inspector General at the Labor Department to determine whether the program was an effective, economical means of providing employment for target group members. The review covered the program's activities

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[26] This figure is the Office of Management Budget's estimate of lost revenue only. It does not include appropriations for administrative costs.

[27] *Op. Cit., Targeted Jobs Tax Credit Program: Employment Inducement or Employer Windfall?*, pp. 16 - 32

between July 1, 1991 through June 30, 1992 (Program Year 1991). The IG concluded that the program had virtually no impact on inducing employers to hire members of the target group and recommended the program be discontinued after its expiration.

- **Would employers have hired the applicants without a tax credit?**

  Based on interviews with employers and job applicants, it was estimated that, nationally, 92 percent of the employees hired under TJTC would have been hired even if the tax credit was not available. In most cases, employers did not change their hiring practices to actively recruit members of TJTC target groups. Instead, they determined which new hires coincidentally fit TJTC eligibility. Of the employers surveyed, 86 percent determined TJTC eligibility *after* a job offer was made. The audit report states, "Our findings indicate that most of the individuals certified for TJTC would have been hired even without the incentive. Consequently, the program is a windfall for employers who hire participants they would have employed in the absence of TJTC."

- **What did the TJTC program cost, and what were its benefits during the audit period?**

  During Program Year 1991, it was estimated that the program cost about $374 million in administrative costs and tax credits, but generated wage benefits of only $140 million to employees who would not have been hired without the program. In other words, costs exceeded benefits by approximately $234 million, so that the program lost 63 cents for each dollar of total costs.

- **What impact did the program have upon target group members?**

  Auditors assessed the impact of the program on the TJTC participants to determine whether the program helped improve their standard of living and long-term job prospects. The study compared information on individuals' TJTC jobs with jobs they held before and after their TJTC employment. The results are outlined below.

  1) On average, the program did not improve individuals' earnings, although small gains did occur for those who obtained work after their TJTC employment. The average annual earnings for TJTC employees were $7,738, only $928 above the poverty level guidelines for a family of one.

Thirty-seven percent of the workers sampled were paid at or below minimum wage. The table below shows that the average starting salary of TJTC jobs was $4.96, an amount less than the average earned in previous or subsequent jobs. Although earnings increased slightly in jobs held after TJTC employment, the increase is thought to be more related to the general transition to the workforce than to participation in the TJTC program.[28]

TJTC Employment Does Not Substantially Improve Participants' Earning or Hours Worked

	Prior to TJTC	Starting TJTC	Ending TJTC	After TJTC
Average Wage	$5.22	$4.96	$5.36	$5.52
Average Hours/Week	32	30	31	34
Source: Office of Inspector General, U.S. Department of Labor.				

2) The table above also shows that the program did not substantially increase the number of hours worked in one week. Sixty-one percent of the employees worked only part time.
3) Sixty-five percent of the TJTC jobs and subsequent jobs offered no fringe benefits. This is a slight improvement from jobs held before TJTC of which 79 percent offered no benefits. The auditors found that, aside from on-the-job training and orientation offered to all new hires, employers offered very little formal skills training, vocational education or higher education training.
4) In general, TJTC jobs required no special qualifications or skills. The large majority of the jobs consisted of cashiers/ checkers, grocery clerks, nurse aides, fry cooks, food cashiers/order takers, waiters/waitresses, and janitorial housekeepers. Overall, the audit concluded that "TJTC employment mirrored other low-paying, low-skilled positions in the employee's work history... *[the]* data

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[28] General Accounting Office, *Targeted Jobs Tax Credit*, February 1991, p. 25.

regarding jobs on which tax credits are being allowed cause us to question the value of the program."

5) In comparing retention periods between TJTC workers and a similar group from the general labor force, it was found that TJTC workers remained with their employer longer although turnover rates for both groups were high. After five quarters, 76 percent of TJTC workers had left their employers compared to 84 percent from the general work force.

In conclusion, the IG's audit recommended that the program be discontinued after its expiration on December 31, 1994. The report states:

> We do not believe the program has met *[its]* objective...we believe target group members were hired because there was a match between the employers' needs for inexpensive labor in high-turnover occupations, and willing individuals -- who are often members of the target groups -- to work for low wages in jobs which require little education or skill.

WILL THE WWTC WORK?

Several studies concurred with the IG's findings. Linda Levine, a specialist in labor economics at the Congressional Research Service, concluded in her review of the TJTC program that:

> The TJTC cannot be considered a success in light of most studies' findings. The program helped relatively few members of its eligible population get jobs. Moreover, TJTC-eligibles typically were employed in subsidized jobs of short duration, which could not have afforded them much chance to acquire the skills and experience that might qualify them for unsubsidized jobs.[29]

Former Secretary of Labor, Robert Reich, referred to another study in a speech before the Center for National Policy in 1994:

> ...according to recent studies by Cornell University's John Bishop and Grinnel [sic] College's Mark Montgomery, at least 70% of these workers would

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[29] Congressional Research Service, *The Targeted Jobs Tax Credit, 1978-1994*, September 1995, p. 21.

> have been hired even without their employers receiving a tax break...Investing scarce resources in programs that don't deliver cheats workers who require results and taxpayers who finance failure.[30]

Differences Between the WWTC and the TJTC

Why would the Administration put forth a proposal so similar to a program that was deemed a failure? According to Gene Sperling, Director of the National Economic Council, the WWTC was designed to account for the shortcomings of earlier versions of the plan. There are four main differences between the WWTC and its predecessor:

1) The tax credit is enhanced. Employers can claim 50 percent of the first $10,000 of wages per year for two years, as opposed to the TJTC which allowed 40 percent of the first $6,000 of wages to be claimed for only one year.
2) The definition of "qualified" wages is expanded. Under TJTC, qualified wages included wages paid to an employee for job-related services rendered. The WWTC treats the employer's cost of education and training assistance, health care and dependent care as qualified wages.
3) Long-term welfare recipients and their families are targeted. Eligible participants must receive welfare assistance for at least 18 months, while the TJTC's requirement was only 90 days.
4) The minimum retention period is longer. Employers could claim the TJTC after a worker was employed for at least 90 days, or 120 hours. The WOTC increased the minimum retention period to 180 days or 400 hours.

Financial Incentives

A fundamental problem with the TJTC program was its failure to change employers' hiring decisions. The WWTC seeks to correct this shortcoming by providing "powerful new, private-sector financial incentives" for businesses to hire targeted individuals.[31] However, the nature of subsidized employment, and the greater risk associated with hiring long-term welfare recipients, greatly lowers the enhanced incentives in the WWTC. Consequently, it is very unlikely that the WWTC will yield more successful results.

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[30] *Op. Cit., Targeted Jobs Tax Credit Program: Employment Inducement or Employer Windfall?*, p. 3.

[31] *Budget of the United States*, Fiscal Year 1998, p. 106.

The increase in the maximum amount of the tax credit should provide greater incentives for businesses to hire welfare recipients. However, the larger size of the tax credit may only offset the higher potential risk an employer faces when hiring an individual who has received assistance for 18 months instead of 90 days. The longer individuals remain on welfare, the more likely they are to lose basic skills compared to other employees. The tax credit *must* be larger under the WWTC to compensate for the possibility of hiring a less productive worker. The net effect on incentives is at least partially neutralized.[32]

Furthermore, data from the IG's audit suggest that the maximum amount of the credit will not be available to most firms. If WWTC jobs resemble TJTC jobs, which they likely will, then the average employee will work part time at or near the minimum wage. Even with higher minimum wage laws, the average worker will earn less than $10,000 annually preventing the employer from claiming the maximum credit.

Including the cost of education assistance, health care and dependent care as qualified wages can increase the size of the credit for employers who pay their WWTC workers less than $10,000 annually. However, the majority of subsidized jobs do not offer these types of fringe benefits. The IG's audit showed that 65 percent of TJTC employers did not offer any fringe benefits, and educational assistance was largely limited to on-the-job training and orientation. To the extent that subsidized jobs do not offer benefits, the inclusion of such costs in the definition of qualified wages will not have a significant impact on the amount of the credit employers can claim. As a result, the value of the credit is lowered, thereby reducing the associated incentives.

By extending the credit's availability to two years, the Administration means to further increase employers' financial incentives. However, the short duration of most subsidized jobs will not allow employers to take full advantage of the credit in the second year. The IG's audit found that only 24 percent of TJTC workers remained with their employer for five quarters. If the same statistic holds for WWTC employment, the availability of the credit in the second year will be largely irrelevant. In fact, the TJTC was also

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[32] The value of the credit is also lowered because tax deductions for wages must be reduced by the amount of the credit.

available for two years when the program was originally enacted, but the passage of the Tax Reform Act of 1986 eliminated the credit in the second year.

Finally, increasing the minimum retention period under WOTC will reduce churning. Churning occurs when employers manipulate turnover rates to maximize their tax credit by hiring several workers for short periods of time. With rapid turnover, employees do not have time to acquire the skills and experience they need to obtain unsubsidized jobs. However, the benefit must be weighed against the cost. Requiring employers to retain workers for longer periods of time may discourage them from hiring high-risk employees altogether.

Nonetheless, Rahm Emanuel, a senior adviser to President Clinton, insists the tax credit will be more effective than earlier plans because it is "just one piece of an overall strategy to make work more attractive than welfare."[33] Other pieces of the strategy include child care, higher minimum wages, health insurance for people leaving welfare, and transportation to get people to their jobs. The proposed "Welfare-to-Work Jobs Initiative" is also expected to facilitate the transition. This initiative would provide states with $3 billion of funding over three years (to be financed through the elimination of corporate subsidies) for job placement and job creation. States would be given flexibility to use the funds in innovative ways to design welfare reform plans suited to their particular needs.

Making "work more attractive than welfare" is an important component of welfare reform. However, while such initiatives may make welfare recipients more willing to work, they do not make businesses more willing to hire them. Thus, the Welfare-to-Work Jobs Initiative does nothing to improve the effectiveness of the proposed tax credit.

Overcoming the Stigma

A study by Gary Burtless, an economist at the Brookings Institution, found that employers often stigmatize job-seekers who were covered by a government subsidy. He noted that "People got fewer job offers if they mentioned to employers that they were covered by this tax subsidy. The result was exactly reverse of what we anticipated."[34] Former Secretary of Labor Robert Reich stated, "What

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[33] *The New York Times,* "Clinton Will Seek Tax Credit for Hiring Welfare Recipients," January 28, 1997.

[34] *Ibid.*

worries me about tax credits to induce employers to hire people off welfare is that they may become a sort of stigma. It's like a scarlet letter - a sign to employers that this person could not otherwise get a job."[35]

To many employers, the financial incentive is not enough to compensate for the risk of hiring a potentially unproductive employee. This sentiment was expressed by Earl Graves, publisher of *Black Enterprise* magazine, when he told President Clinton at a recent roundtable discussion that it was unfair to expect businesses to "...sacrifice profit margins in order to do the government's job...It is my job.to focus on the bottom line...Our elected officials cannot and should not give false hope to people, leading them to believe that businesses will hire them for jobs which require skills they do not have."[36]

POTENTIAL COSTS OF THE WWTC

It is unlikely that the differences between the WWTC and the TJTC will be sufficient to address the problems which occurred under the TJTC program. Furthermore, targeted tax incentives, such as the WWTC, may create several harmful side effects.

Displacement and Perverse Incentive Effects

Targeted tax policies are often zero-sum games where one individual's gain is someone else's loss. Linda Levine noted that because of windfalls and substitution, a targeted tax credit may create no new jobs, "Instead, the same number of jobs are redistributed among different groups of people."[37] This occurs because employers do not create new jobs for program participants; they simply replace ineligible workers with eligible workers.

Under the WWTC, long-term welfare recipients may find jobs at the expense of other needy individuals who are not members of the eligible population. In effect, welfare recipients will have an advantage over others who are competing for entry level positions -- many of whom may be prior recipients of public assistance who do not qualify for the program, and who are struggling to stay off welfare. Such competition creates perverse incentive effects. Individuals may

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[35] *Ibid.*

[36] *Washington Post*, "Clinton Welfare Outreach Nets an Earful," February 19,1997.

[37] *Op. Cit., The Targeted Jobs Tax Credit, 1978-1994*, p. 20.

go on welfare, or stay on it longer than they otherwise would have, in order to qualify for the program.

Inefficiency

Using tax incentives to manipulate the labor market reduces economic efficiency. By subsidizing the wages of low-skilled workers, the WWTC will make low-skilled labor relatively less expensive than other productive inputs. If the WWTC achieves its goal, employers will substitute away from high-skilled labor and capital towards low-skilled labor. In the long run, this displacement will lower overall productivity and detract from economic growth.

A more efficient solution would be the institution of more broad-based tax incentives which would boost economic growth. This would provide businesses with growth opportunities so they can *create* new jobs for welfare recipients without sacrificing productivity or displacing other needy workers.

Special Interest Powers

Targeted tax incentives inevitably create loopholes which businesses seek to exploit. Consequently, some of the biggest proponents of an employment tax credit are not the job-seekers, but the employers and consultants who may receive windfalls. *The New York Times* reported that the TJTC program "...spawned an entire industry of personnel consultants who did the paperwork necessary to get the tax credit for employers. These companies became potent lobbyists for the tax credit."[38] Since its inception in 1978, the TJTC lapsed three times before its final expiration at the end of 1994. Each time the program lapsed, businesses and consultants successfully lobbied to renew the tax credit. The WWTC is subject to the same abuses and special interest pressures that occurred under the TJTC program.

CONCLUSION

The Administration's proposal for a Welfare-to-Work Tax Credit has not adequately addressed the problems which plagued its predecessor program, the Targeted Jobs Tax Credit. As a result, it is unlikely that the program will efficiently achieve its goal of providing new job opportunities for long-term welfare recipients. In particular, it is not clear that the proposed tax credit will provide stronger incentives to persuade employers to hire long-term welfare recipients.

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[38] *The New York Times*, "Clinton Will Seek Tax Credits for Hiring Welfare Recipients," January 27, 1997.

Historically, subsidized jobs have been part-time, low-paying, low-skilled, short-term positions which do not substantially improve the employee's standard of living or long-term job prospects. Therefore, it is questionable whether employment tax credits are an effective use of taxpayers' dollars.

A more efficient plan would provide broad-based tax incentives to boost economic growth and stimulate job creation. Expanding unsuccessful government programs is not the solution to the welfare-to-work challenge.

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COLLEGE AFFORDABILITY: TUITION TAX CREDITS VS. SAVING INCENTIVES

A JOINT ECONOMIC COMMITTEE REPORT

Jim Saxton (R-NJ)
Chairman

Joint Economic Committee
United States Congress

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Abstract

Despite government efforts to improve college affordability over the years, it is now clear that federal aid programs have fallen short of their expectations: tuition continues to rise, more students graduate with larger debts, government costs have grown dramatically, and affordability for the neediest students has declined. This paper examines the shortcomings of the federal aid system that have contributed to these trends and considers the most effective federal policies to expand educational opportunities. In particular, it considers the use of tuition tax credits and expanded Individual Retirement Accounts, two of the largest educational provisions contained in the Balanced Budget Act of 1997.

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College Affordability: Tuition Tax Credits vs. Savings Incentives

Executive Summary

Education is an important means of investing in human capital. Accordingly, the government has played an active role in financing higher education in order to provide universal access to college. Despite government efforts to improve college affordability, federal aid programs have fallen short of their expectations.

- **Tuition continues to rise.** The price of higher education has nearly doubled over the past 15 years and continues to rise. The average annual cost of attending private and public institutions in 1995 was $17,000 and $6,000, respectively, when room and board were included.
- **College affordability is declining.** Despite a 65 percent increase in federal aid over the past 10 years, college affordability is declining. As the size and cost of the student loan programs continues to grow, more funding is being shifted toward loans for middle- and upper-income families, leaving less money to finance grants and other need-based programs for the poor. Moreover, grants as a percentage of all federal aid have fallen by 36 percent, and educational opportunities for the poor have declined. The increase in the availability of student loans does not necessarily reflect an increase in the well being of middle- and upper-income families since tuition increased by approximately 45 percent over the past 10 years, offsetting much of the benefits of the increased funding. Overall, the federal aid system is heavily dependent on student debt, even for the most disadvantaged families
- **The participation gap between low- and high-income students is widening.** The prospect of incurring large debts has discouraged many low-income students from attending college altogether. As a result, the participation gap between low- and high-income students has increased by 22 percent since 1980. These trends have occurred for several reasons.
- **Colleges have little incentive to control costs and tuition.** By increasing the availability of federal aid, the government increases the stream of revenue available to colleges, thus encouraging them

to raise costs and justify tuition hikes. Colleges thus largely absorb increased funding.

- **The market for higher education is distorted.** The structure of federal aid allows private institutions to price discriminate so that colleges can extract the maximum amount of revenue from each student and raise their prices above the competitive level.
- **Middlemen receive much of the benefit from federal subsidies.** In 1992, 6 million students received some form of federal aid costing taxpayers $11 billion. Of this amount, $6 billion represented the cost of subsidizing financial institutions and student loan defaults. Thus students do not receive the full economic benefit of federal aid and taxpayers finance a wasteful system.

Families would benefit from alternative federal aid policies that provide more benefits to more students at a lower cost. The Balanced Budget Act of 1997 provides several tax benefits to expand educational opportunities. Two of the largest are tuition tax credits, called HOPE Scholarships, and expanded benefits for Individual Retirement Accounts (IRAs).

HOPE SCHOLARSHIP

The use of tuition tax credits is similar to past government policies that have merely increased the amount of aid available to families without addressing the underlying problems of the federal aid system that cause tuition to rise in the first place. As a result, tuition tax credits may well contribute to the problems of the federal aid system instead of improving college affordability.

- There is broad agreement that the HOPE Scholarship will lead many institutions to raise their prices in order to absorb the additional stream of revenue.
- Since the HOPE Scholarship is designed to primarily benefit middle- and high-income families, it will not provide new educational opportunities for children in the poorest families.
- In the short run, the HOPE Scholarship will allow some families to send their children to more expensive schools and it may reduce the amount of financial aid for which many families qualify. In the long run, the benefits will accrue to institutions of higher education rather than to students.
- Claiming the HOPE Scholarship may subject many middle-income families to the alternative minimum tax (AMT), which was designed to only affect upper-income taxpayers. Thus families

with incomes as low as $41,350 may not receive the full benefit of the credit, even in the short run.

Expanded IRAs

The Balanced Budget Act of 1997 provides several education saving incentives through the expansion of traditional IRAs and the creation of education saving accounts similar to IRAs. Saving incentives can improve college affordability for families across the income spectrum.

- Expanded IRAs provide families with appropriate opportunities and incentives to save for their children's higher educational expenses, thereby reducing their reliance on student loans. As families become financially independent, the cost and size of the student loan programs will be reduced since demand for student loans will fall.
- Government savings can be diverted to grants and other need-based programs for the poor.
- Expanded IRAs can control tuition inflation by restoring competition to the market for higher education. Colleges and universities will have an incentive to control costs and improve productivity since they will be more reliant on private financial assets than on federal subsidies.
- Families that use their own financial assets to pay for higher education will be motivated to make more responsible decisions regarding where their children go to school and what programs they enter, thus maximizing their children's educational return.

Although the newly enacted IRA provisions provide important benefits for higher education, a more aggressive expansion of IRAs would provide greater benefits to families. If the maximum annual deductible contribution is raised and penalty-free withdrawals are allowed for more family expenses, IRAs can become an important saving vehicle for middle-income families. Aside from the tax benefits provided to families, expanded IRAs can also promote economic growth by potentially raising the national saving rate.

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

COLLEGE AFFORDABILITY: TUITION TAX CREDITS VS. SAVINGS INCENTIVES

In the 1960s, Nobel Laureate Gary Becker introduced the concept of human capital—the widely accepted notion that human qualities such as skills, knowledge, and the ability to think critically are important sources of economic growth. Education is a primary means of investment in human capital. Education helps individuals develop abilities and skills that increase their future productivity, thereby providing new opportunities for economic growth. It is also the primary vehicle by which cultural values are conveyed from one generation to the next.

Because education is so important to individuals and to the economy, the government has played an active role in financing higher education so that all individuals can have an opportunity to attend college. Initially, federal aid was limited to the most disadvantaged students, but over time, aid was extended to most students regardless of financial need or academic merit. Despite the government's efforts to improve college affordability, it is now clear that federal aid programs have fallen short of their expectations: tuition continues to rise, more students graduate with larger debts, government costs have grown dramatically, and affordability for the neediest students has declined.

This paper reviews the shortcomings of the federal aid system and examines the most effective policies to expand educational opportunities. In particular, it considers the use of tuition tax credits and expanded Individual Retirement Accounts (IRAs), two of the largest educational provisions contained in the Balanced Budget Act of 1997.

The evidence presented in the paper suggests that tuition tax credits may well contribute to the problems of the federal aid system. In contrast, expanded IRAs can provide long-term solutions to college affordability by providing families with appropriate incentives and opportunities to save for their children's education. The use of IRA savings for college education will encourage schools to control costs, lower tuition, and improve quality since they will have to compete for private financial assets rather than rely on federal subsidies. The expansion of IRAs can also generate additional benefits for families and can promote economic growth by raising the national saving rate.

The first section of this paper describes the historic role of the federal government in higher education and trends in college affordability. Section two considers some of the fundamental

shortcomings of the federal aid system that have contributed to these trends. Section three compares the use of tuition tax credits and expanded IRAs in light of the problems discussed throughout the paper. The paper concludes by discussing additional economic benefits of IRAs.

I. The Role of the Federal Government

Background[39]

Historically, the federal government played a very small role in higher education. It did not regulate the activities of post-secondary institutions nor did it provide them with federal funds. However, the Higher Education Act (HEA) of 1965 established a commitment by the federal government to equalize opportunities in higher education. Title IV of HEA created grants and campus-based programs for disadvantaged students and their families. Title IV also helped middle-income students through the creation of federally guaranteed, but minimally subsidized, private loans. The guaranteed loan program was supposed to be smaller and much less costly than federal grants.

During the 1970s, various legislation expanded the provisions of Title IV. The needs test for guaranteed loans was eliminated, making federal aid widely available to students across the income spectrum. Federal aid was also extended to non-traditional students such as part-time students, students attending for-profit trade schools, and students without high school diplomas or equivalency.

The growth of the student loan programs during the 1970s created mounting costs for the government as more middle- and upper-income families took advantage of the generous terms offered by subsidized loans. Between 1970 and 1980, guaranteed student loans increased by 180 percent after adjusting for inflation, from $3.9 billion to $10.9 billion annually;[40] and government costs increased by 350 percent, from $625 million to $2.9 billion.[41] Realizing that these growing costs

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[39] Michael Mumper, *Removing College Price Barriers (*New York: State University of New York Press, 1996).

[40] The College Board, *Trends in Student Aid: 1986 to 1996*, September 1996, Table B.

[41] U.S. Department of Education, *FY1994-FY1996 Federal Student Loan Programs Data Book*, Office of Post-Secondary Education Policy Planning and Innovation Policy Budget and Analysis Staff Policy Budget and Development Unit, August 1, 1997.

were unsustainable, efforts were made in the 1980s to reduce the size of the student aid programs by focusing federal support on the neediest families. Although the needs test for subsidized loans was reinstated, other cost-reducing efforts were derailed in Congress and federal support for student aid programs continued to increase throughout the 1980s.

Legislation in 1992 expanded the availability of federal aid by establishing unsubsidized student loans so that nearly anyone wanting to attend college could take out a loan. As students began graduating with larger debts and as default rates began rising, new provisions were enacted to facilitate loan repayment and curb defaults. In 1995, all forms of federal aid totaled $37 billion, an amount equal to 74 percent of all student aid funding.[42]

Trends in College Affordability

Many education analysts believe that past legislation has not made college more affordable, it has simply made it easier to take out loans, thus increasing families' reliance on loans and increasing pressure on the Treasury. Dr. Michael Mumper of the State University of New York notes that the federal aid programs have made a significant contribution to higher education over the years, but they have also produced some discouraging results:

> Since the early 1980s, the net price[43] of a college education has increased rapidly, the participation gap between upper- and lower-income students has expanded, and the focus of government subsidies has shifted from the most needy students to middle- and upper-income students. As a consequence, the goal of universal access to higher education is further away in the mid-1990s than it has been in more than a decade.[44]

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[42] *Op. Cit., Trends in Student Aid: 1986 to 1996.*

[43] The difference between tuition and educational funds which do not have to be repaid such as scholarships or grants. This represents the amount the family must finance on its own.

[44] *Op. Cit., Removing College Price Barriers,* p. 215.

Rising Tuition

The price of higher education has nearly doubled over the past 15 years and continues to rise. After adjusting for inflation, average undergraduate tuition at private institutions increased from $6,200 per year in 1980 to $11,800 per year in 1995; and average tuition at public institutions rose from approximately $1,100 per year to about $2,100 per year over the same time period. When the price for room and board is included, the average annual cost of attending private and public institutions in 1995 was $17,000 and $6,000 respectively.[45]

Shift in Federal Aid

The composition of federal aid has changed substantially over time. Originally, federal aid was primarily awarded in the form of grants and other need-based programs for low-income families that did not need to be repaid; but now, federal aid is primarily provided in the form of student loans. Figure 1 and the accompanying table show that student loan programs are consuming an increasingly larger portion of federal aid at the expense of grants and work-study programs for the poor. Over the past decade, student loans as a percentage of all federal aid have increased by 27 percent while the share of grants has fallen by

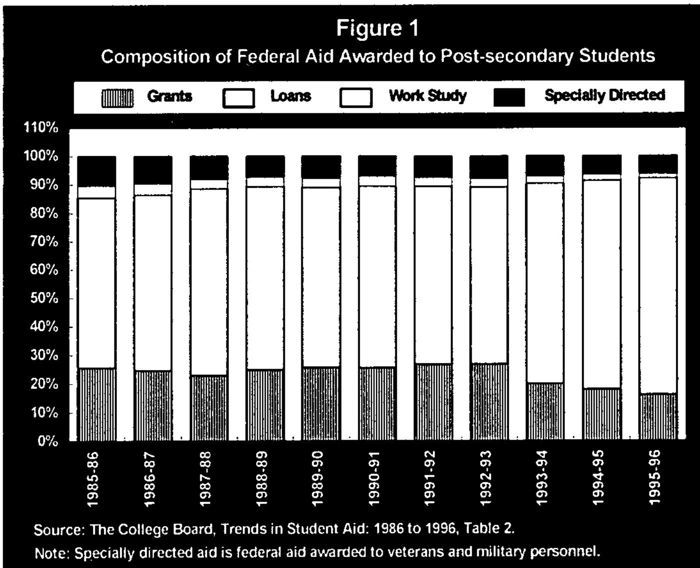

Figure 1
Composition of Federal Aid Awarded to Post-secondary Students

Source: The College Board, Trends in Student Aid: 1986 to 1996, Table 2.
Note: Specially directed aid is federal aid awarded to veterans and military personnel.

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[45] U.S. Department of Education, National Center for Education Statistics, *Digest of Education Statistics 1996* (Washington, DC: Government Printing Office, 1996), Table 309.

36 percent. Thus contrary to the original goals of the HEA, federal aid now targets middle- and upper- income students instead of disadvantaged students. Moreover, as the size and cost of the student loan programs has increased, less money has been left over to finance grants and other need-based programs for low-income families.

Table 1

Composition of Federal Aid Awarded to Post-Secondary Students

Academic Year	Grants	Loans	Work Study	Specially Directed
1985-86	25%	60%	4%	10%
1986-87	25%	62%	4%	10%
1987-88	23%	66%	3%	8%
1988-89	25%	64%	3%	8%
1989-90	26%	63%	3%	8%
1990-91	26%	64%	3%	7%
1991-92	27%	63%	3%	8%
1992-93	27%	62%	3%	8%
1993-94	20%	70%	2%	7%
1994-95	18%	73%	2%	7%
1995-96	16%	76%	2%	6%

Source: The College Board, *Trends in Student Aid: 1986 to 1996, Table 2.*
Note: Specially directed aid is federal aid awarded to veterans and military personnel.

Declining Affordability

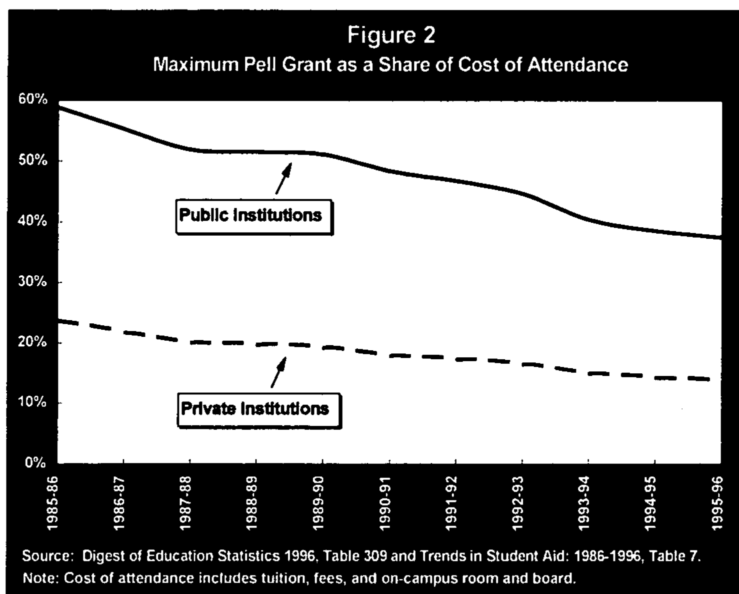
Despite a 65 percent increase in government support for student aid programs over the past 10 years, college has become less affordable for the most disadvantaged students. The combination of less government funding and higher tuition has greatly reduced the value of need-based programs. For example, the Pell Grant, which is the largest federal grant program for the poor, has declined considerably in value over the past decade.

Figure 2 shows that the value of the Pell Grant as a share of attendance costs has declined by 37 percent for public institutions and by 42 percent for private institutions. The Balanced Budget Act of 1997 includes funding to increase the value of the maximum Pell Grant from $2,700 to $3,000, but this increase will still leave Pell Grants grossly undervalued. As a result, many low-income families have found it necessary to take out loans for college. The prospect of incurring large debts has discouraged many low-income students from

attending college altogether, thereby lowering the participation rates for low-income students relative to high-income students as shown in Table 2. In addition, the increase in student loan funding over the past 10 years does not necessarily reflect an increase in the well being of middle- and upper-income families since tuition increased by approximately 45 percent over the same time period.

In brief, the federal aid programs, which were intended to equalize opportunities in higher education, have actually contributed to a larger disparity over the past decade. Government intervention has transformed the system into one heavily dependent on student debt, even for the most disadvantaged students. In addition, federal aid now targets middle- and upper-income students contrary to the original intentions of the HEA.

Figure 2
Maximum Pell Grant as a Share of Cost of Attendance



Source: Digest of Education Statistics 1996, Table 309 and Trends in Student Aid: 1986-1996, Table 7.
Note: Cost of attendance includes tuition, fees, and on-campus room and board.

This transformation has mainly occurred because the structure of the federal aid system is inherently flawed and could be improved upon to provide greater benefits to students. Federal financing of higher education does not provide colleges with appropriate incentives to restrain spending and therefore encourages tuition hikes. The inefficient structure of student loan programs has broken down the marketplace for higher education by eroding price competition among schools and artificially inflating student demand. As a result, tuition

continues to rise, college affordability continues to decline, and taxpayers continue to pay more for less valuable programs.

Table 2

Percent of Recent High School Graduates Enrolled in College by Family Income

October	Low	Medium	High
1980	32.5	42.7	65.2
1981	33.6	49.3	67.6
1982	32.8	41.7	71.7
1983	34.6	45.4	70.2
1984	34.5	48.4	74.0
1985	40.2	50.7	74.5
1986	33.9	48.4	71.4
1987	36.9	49.9	74.0
1988	42.5	54.7	72.8
1989	48.1	55.4	70.9
1990	46.7	54.5	76.5
1991	39.5	58.4	78.2
1992	40.9	56.9	80.9

Source: L. Gladieux and A. Hauptman, *The College Aid Quandry,* Table 5.
Note: Low income is defined as the bottom 20 percent of all family incomes, high income as the top 20 percent of all family incomes, and middle income as the 60 percent in between.

II. Problems with the Federal Aid System

Federal Aid and Tuition Inflation

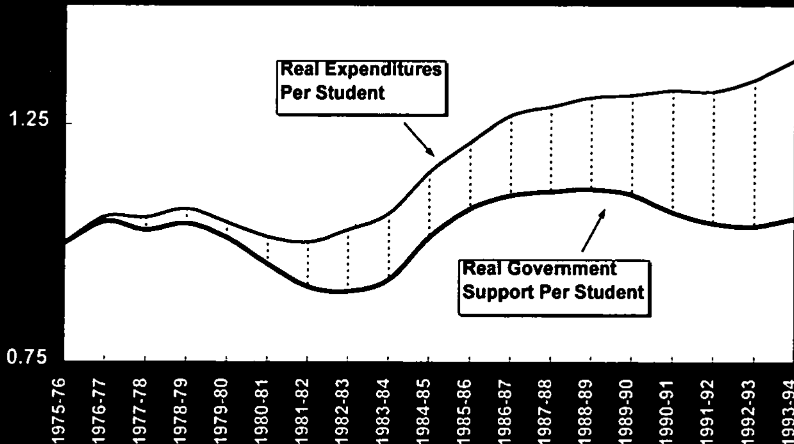
The steep increase in tuition is largely attributable to a growth in college costs during the 1980s. College administrators contend that changing demographics in higher education since 1980 have necessitated an increase in costs in order to provide a high quality education to a more diverse student body. They argue that government appropriations to higher education did not keep pace with rising expenditures. As shown in Figure 3, government funding per full-time equivalent (FTE) student grew in pace with inflation between 1975 and 1993, but college spending per FTE student rose by 38 percent. College leaders argue that the government's failure to increase funding when costs were rising necessitated an increase in tuition to make up the shortfall.

However, many education experts believe that the fundamental problem in higher education is not a deficiency of government funding, but uncontrolled spending by colleges and universities.[46] They argue that, even though some of the increased spending may have been necessary due to the labor-intensive nature of higher education, a large part was unnecessary and extravagant. Much of the spending was merely an attempt by colleges to keep enrollment high in order to attract more state funding and did nothing to improve the quality of education. Thomas Sowell of the Hoover Institution at Stanford University notes that colleges and universities have expanded their bureaucracies, overseas facilities, and programs beyond what was needed to meet demand or improve educational quality.[47]

Figure 3

Government Support to Higher Education vs. College Expenditures

(Per Student, 1975-76 = 1)



Source: Department of Education, Digest of Education Statistics, Tables 196, 324, 332.

Note: Real government support per student does not include federally supported student aid received through students.

The evidence suggests that the structure of the federal aid system has contributed to the problem of uncontrolled costs and associated tuition hikes. Institutions generally base their spending decisions for the following year on the amount of revenue they project to earn in that year. The more money they expect to earn from various sources, the

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[46] Thomas Sowell, *Inside American Education* (New York: The Free Press, A Division of Macmillan, Inc., 1993), pp. 113-121.

[47] *Ibid.*

more spending they decide to undertake. The wide availability of federal aid thus encourages increased spending and subsequent tuition hikes.

Dr. Sowell provides the following example to illustrate this point: College X can charge $8,000 per student for tuition and cover its costs. The average family can afford $9,000 for tuition (based on a federal formula). If College X sets tuition at $8,000, it will receive no funding in the form of federal student aid. On the other hand, if College X sets tuition at $12,000, not only will it extract the additional $1,000 from the family, but it will also receive $3,000 of federal aid from each student. Thus, the school increases spending and justifies a tuition increase on the basis of rising costs. Classrooms remain full because the wide availability of student loans artificially inflates demand at any tuition price. This logic especially applies to private institutions that have more control over setting tuition. However, tuition hikes typically reverberate throughout higher education. For instance, tuition increases at private colleges in the early 1980s were followed by proportional price increases at public institutions.

Thus, the inherent problem with the federal aid system is that colleges and universities have little incentive to contain costs, boost productivity, or lower tuition. By increasing the availability of student aid and by making it easier to take out student loans, the government increases the stream of revenue available to institutions of higher education. Schools respond by increasing their expenditures and raising tuition to absorb the growing stream of revenues.

Past government efforts to improve college affordability have not addressed this problem. Instead of finding ways to fight tuition inflation, the government has simply made more federal aid available to more students so they can afford the higher tuition. Thus the benefits of additional federal subsidies are largely absorbed by schools, not students. An effective federal aid system must provide colleges with incentives to restrain costs and boost productivity so tuition can be kept from rising in the first place. Such incentives are grossly lacking from the current system.

Federal Aid and the Market for Higher Education

In general, industries which benefit from government subsidies are able to raise prices above their competitive levels. The same holds true in higher education—federal subsidies allow colleges and universities to charge artificially high prices, thereby distorting the

market for higher education and eroding price competition among schools.

Dr. Sowell notes that "like monopolistic price discriminators in the commercial world, private colleges and universities set an unrealistically high list price and offer varying discounts. In academia, the list price is called tuition and the discount is called 'financial aid'."[48] Institutions use a federal formula to determine the amount each family can reasonably pay for tuition. The school's financial aid office then determines what type of aid package will be offered to each student. The package may include a combination of institutional aid and federal aid. By setting tuition at an artificially high level, institutions can charge each family the maximum amount it can afford and offer varying financial aid packages to supplement the remainder of the bill. Since students attending more expensive schools are eligible for more federal aid, the school can increase its federal aid revenue by charging a higher tuition. At the same time, institutional aid acts like a tuition discount that allows private universities and colleges to earn the greatest amount of revenue from each student.

This practice of maximizing revenue by offering different customers different prices is referred to as "price discrimination." Perfect price discrimination is very difficult to practice in the business sector for at least two reasons. First, the product sold must be non-transferable or else customers who pay a low price can resell the product and steal high price customers away from the business. Second, to effectively price discriminate, companies need to know a good deal of information about each customer's willingness to pay for the product. In higher education, these two obstacles are largely overcome. Financial aid packages cannot be transferred among students and information about a family's financial resources is easily accessible from financial aid applications.

Public schools cannot price discriminate like private schools because they are much less reliant on institutional aid. However, the wide availability of federal aid makes it easier for them to inflate their prices above the competitive level. In turn, easy access to financial aid also inflates the demand for higher education at any level of tuition. As a result, the entire market for higher education is inefficiently distorted.

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[48] *Ibid.*, p. 120.

Guaranteed Student Loans

Guaranteed Student Loans, which were renamed the Federal Family Education Loan (FFEL) program after 1992, have provided important educational opportunities for millions of students. However, their structure is extremely inefficient so that a large portion of their economic benefit does not accrue to students. John Hood of the John Locke Foundation notes that in 1992, six million students received some form of federal aid at a cost of $11 billion to taxpayers. Of that $11 billion, $6 billion represented costs of subsidizing banks and paying for defaults.[49] Thus, over half of the benefit of federal subsidies did not go to students, but to middlemen. A different structure of providing financial resources could provide more assistance to more students in a more cost-effective manner.

The government subsidizes student loans to compensate lenders for the high risk associated with these loans, thus shifting the risk from private financial institutions to taxpayers. The government pays the interest on most student loans[50] while a student is in school. The loans are then insured against default and guaranteed by the federal government. If a student defaults on a loan, the debt is turned over to a guarantee agency that fully compensates the lender. The guarantee agency, in turn, attempts to collect the overdue balance, but can be fully reimbursed by the government during its collection effort. The guarantee agency is entitled to a 100 percent reimbursement from the government and 30 percent of any funds it manages to recover. In 1991, guarantee agencies collected over $600 million in this manner.[51] That same year, nearly one-fourth of all borrowers defaulted on their loans, costing taxpayers $2.2 billion.[52]

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[49] John Hood, "How to Hold Down College Tuition Costs," *Consumers' Research,* October 1993.

[50] The FFEL program includes Stafford subsidized loans, Stafford unsubsidized loans (that were created in 1992), Supplemental Student Loans (that were discontinued in 1994), and Parent Loans for Undergraduate Students (which are given to parents). All of these loans are guaranteed by the federal government, but the government pays the interest only on Stafford subsidized loans, which comprise the majority of all loans under the FFEL program.

[51] *Op. Cit., FY1994-FY1996 Federal Student Loan Programs Data Book*

[52] *Ibid.*

It is clear that guaranteed loans create perverse incentives for lending institutions and guarantee agencies. John Hood notes that "in virtually every instance, it pays for lenders and guaranty agencies to let students default—the former are fully reimbursed and save collection costs, while the latter are fully reimbursed and may even get back more than 100 percent of the value of the loan."[53] Consequently, a large percentage of federal expenditures is not transferred to students, but to middlemen who continue to profit handsomely at the expense of taxpayers who subsidize student loan defaults.

This system is extremely costly to students who do not receive the full economic benefit of government subsidies and to taxpayers who subsidize the profits of banks and guarantee agencies. Low-income students are disproportionately burdened because more money is diverted from need-based programs to finance the growing costs of guaranteed loans. In 1992, the terms of government reimbursement were modified to reduce the cost of the program; and in 1993, Congress enacted a direct lending program aimed at eliminating subsidies to middlemen. Direct lending allows the federal government to lend money directly to institutions that in turn distribute the money to students. Currently, the FFEL and direct lending program operate side by side, but it is too soon to judge the success of the new program.

III. TAX BENEFITS FOR HIGHER EDUCATION

Tuition Tax Credits

The cornerstone of the newly enacted education initiatives is a tuition tax credit called the HOPE Scholarship. The HOPE Scholarship provides families with a non-refundable tax credit of up to $1,500 against income tax liability for the first two years of post-secondary education. According to the U.S. Department of Treasury, the HOPE Scholarship will cost $35 billion over five years and $94 billion over 10 years. In addition, taxpayers will be allowed to claim a Lifetime Learning tax credit worth up to $1,000 for post-secondary education beyond the first two years.

The use of tuition tax credits to help families pay for college is similar to past government policies which have merely increased the funding available to pay for tuition without addressing the underlying problems of why tuition rises in the first place. As a result, the HOPE

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[53] *Op. Cit.*, "How to Hold Down College Tuition Costs."

Scholarship may well contribute to the problems of the federal aid system instead of providing long-term solutions.

Rising Tuition

There is broad agreement that tuition tax credits would lead many post-secondary institutions to raise their prices. The effect would be most pronounced in public two-year institutions where average yearly tuition is $1,245. Since eligible families can claim up to $1,500 against their tax liability, families will be indifferent between paying $1,245 or $1,500--demand for a two-year college education is the same at either price. Thus, any public institution which charged less than $1,500 could increase its tuition without losing students or government funds.[54]

The availability of the tax credit will also affect tuition at private and public four-year institutions. Schools will realize that the tax credit increases a family's financial resources by $1,500. This will be taken into account when schools calculate a family's expected contribution. Once again, tuition will be set high enough to absorb the additional stream of revenues.

Affordability

The HOPE Scholarship is designed to primarily benefit middle- and upper-income families since the credit is not available to financially disadvantaged families with no income tax liability. As a result, the HOPE Scholarship probably will not encourage the enrollment of students who otherwise would not go to college. It is believed that the HOPE Scholarship will have two effects in the short run. First, it will allow students who are already bound for college to attend more expensive schools. Second, by increasing a family's after-tax income, it will reduce the amount of student loans for which families qualify.[55] In the long run, tuition tax credits will mainly generate large windfalls for institutions of higher education so that the benefit of this subsidy program will accrue to schools rather than to students.

In addition, the interaction between the HOPE Scholarship (and other newly enacted tax credits) and the alternative minimum tax

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[54] Joint Committee on Taxation, "Analysis of Proposed Tax and Saving Incentives for Higher Education," April 15, 1997.

[55] Jane Bryant Quinn, "New Tax Credits May Bring Cuts in Student Aid," *The Washington Post (Business)*, August 31, 1997.

(AMT) may substantially reduce the value of the credit for many middle-income families.[56] The AMT was designed to ensure that wealthy taxpayers, who shelter their incomes from taxation, pay a minimum amount of tax. The AMT requires that taxpayers first calculate their tax liability with all of their deductions and exemptions, then recalculate it using a complicated AMT formula. The individual must pay the greater of the two tax liabilities. Since the newly enacted tax credits, including the HOPE Scholarship, can reduce tax liability by a substantial amount, claiming the credits may subject many middle-income families to the AMT, thereby reducing the value of the tax credits. For instance, *The Washington Post* provides the following example: A family earning $64,100 per year with two children in college would normally pay $6,743 in taxes if filing jointly. If the family claims the HOPE credit for one child ($1,500) and the Lifetime Learning credit ($1,000) for the other, their tax liability would be reduced to $4,243. However, under the AMT calculation, the family's tax liability is $4,966. Since the AMT is the greater of the two amounts, the family must pay the AMT, thus reducing the value of the HOPE Scholarship by $723. According to the minority staff of the House Ways and Means Committee, this interaction may affect a substantial number of middle-income taxpayers with incomes as low as $41,350. Thus, because the tax credits were not designed to offset the AMT, many middle-income families will be subjected to this upper-income tax. As a result, many middle-income families will not receive the full benefit of the HOPE Scholarship, even in the short run.

In sum, tuition tax credits are similar to past government policies which simply provide more aid instead of providing colleges with incentives to control costs and tuition inflation. In fact, the Administration does not believe that cost containment is a reasonable objective. At a Brookings Institution conference on higher education, David Longanecker of the Department of Education (DOE) "made it clear that the Clinton Administration does not see tuition growth and cost containment as a federal responsibility."[57] Instead, it is an issue for states and trustees. Thus, the Administration feels that college

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[56] Albert B. Crenshaw, "Now You See It, Now You Don't: Tax Law to Make Benefits Disappear," *The Washington Post (Business),* September 17, 1997.

[57] Lawrence Gladieux and Arthur Hauptman, *The College Aid Quandary* (Washington, DC: The Brookings Institution, 1995), p. 62.

affordability is a federal responsibility, but the root of the problem is not.

Expansion of IRAs

The current financial aid system may discourage parents from saving for education because a family's savings can reduce a student's eligibility for grants and scholarships. Families whose financial assistance is reduced based on their level of savings thus face an implicit tax. As a result, many parents save too little for their children's education.

The Balanced Budget Act of 1997 includes several incentives aimed at increasing private saving for education. The new law gradually doubles the income limits for which tax deductible contributions to IRAs are phased out, making IRA saving plans available to more middle-income families. In addition, penalty-free withdrawals will be allowed to pay for higher educational expenses. Parents will also be able to contribute $500 per child, per year to separate education IRAs. Contributions to education IRAs will be nondeductible, but distributions will not be subject to taxation.[58] These new IRA rules will allow families to accumulate tax-free savings for educational expenditures, thus encouraging families to save for their children's education.

Enhanced saving incentives can help improve college affordability. Dr. Mumper states that "...there is powerful theoretical and anecdotal evidence that a soundly designed and broadly accessible program to encourage college savings can be a useful part of a comprehensive government effort to improve college affordability."[59] By reducing families' reliance on student loans and allowing them the opportunity to finance educational expenses from their own financial resources, expanded IRAs can restore price competition to the

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[58] Retirement IRAs are front-loaded; meaning that taxpayers can exclude IRA contributions from income when calculating their income tax liability. However, distributions from the IRA are subject to taxation. In contrast, education IRAs will be back-loaded; meaning that contributions are not tax deductible, but distributions are not subject to taxation. In general, the two types of IRAs are equivalent unless the taxpayer moves into a different tax bracket between the time the contribution is made and the time the distribution is withdrawn.

[59] *Op. Cit., Removing College Price Barriers*, p. 186.

marketplace for higher education and reduce government costs. Government savings can then be diverted to federal grants to help equalize opportunities for financially disadvantaged students.

Maximizing Educational Return

Expanded IRAs will provide families with opportunities to reduce their tax liabilities and accumulate enough savings to pay for a substantial amount, if not all, of their children's education. Families who use their own financial assets to pay for higher education, rather than government subsidized funds, will be encouraged to make more responsible decisions regarding where their children go to school and what programs they enter. John Hood points out that no mechanism exists today to make sure children are attending schools with a good money's worth and entering programs that will likely land them a job after they graduate.[60] Thus unwise decisions are made which are costly to students and taxpayers.

For instance, DOE reported that 200,000 students enroll in beauty school each year despite an oversupply of one million cosmetologists nationally. Many beauty school students drop out or cannot find jobs when they graduate, thus failing to repay $100 million worth of loans each year. Consequently, taxpayers spend about $31,000 in student aid for every cosmetology license that is issued in the United States.[61]

Subsidizing the Poor

The most commonly cited criticism against expanded IRAs for education is that low-income families would not be able to participate since they do not have enough financial resources to save, and they do not have any income tax liability from which contributions can be deducted. However, expanded IRAs can reduce the cost of the federal aid programs by making middle- and upper-income families less reliant on student loans. This in turn would allow federal funds to target low-income families through more valuable grants and work-study programs as originally intended by the HEA. Thus middle- and high-income students can benefit because they will be able to graduate with less debt; low-income students will benefit because federal subsidies can be redirected to need-based programs.

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[60] *Op. Cit.*, "How to Hold Down College Tuition Costs."

[61] Thomas Toch, " Defaulting the Future," *U.S. News & World Report*, June 21, 1993.

Cost Containment and Tuition

With families more reliant on personal financial assets, the government can reduce the size of the student loan programs by awarding student loans on the basis of financial need or academic merit. This could create three desirable effects. First, the reduction in the availability of "easy money" would deflate the artificially high demand for post-secondary education that now exists. If families rely on their own financial resources for the bulk of educational expenses, then demand should fall in line with what the free market would dictate.

Second, reduced reliance on financial aid would undermine a school's ability to increase tuition since federal aid could not easily supplement a family's expected contribution. As mentioned earlier, schools can more easily raise tuition because tuition hikes are met with more federal aid. If federal aid is limited, then schools would truly have to compete for private assets, giving them incentives to provide a high quality education at a low cost.

Third, linking student aid to academic merit would motivate children to work harder during high school. Tuition tax credits, on the other hand, make two years of higher education a universal right for all students, thereby reducing students' incentives to do well in high school.

Expanded IRAs will provide families with appropriate incentives and opportunities to accumulate enough private savings to afford their children's education. As families become financially independent, they will grow less reliant on student loans, thus reducing the cost and size of the federal aid system. Government savings can be partially used to restore the value of need-based programs for low-income students. The reduction in federal subsidies would restore competitive pressures to the marketplace for higher education, giving institutions an incentive to control costs, improve productivity, and contain tuition. Thus expanded IRAs can help improve college affordability.

IV. Economic Benefits of IRAs

Benefits for Taxpayers

In addition to the benefits provided for education, expanded IRA incentives can generate other benefits for American families as well. In general, IRAs provide three important tax benefits. First, front-loaded IRAs allow taxpayers to deduct IRA contributions from income, thereby lowering income tax liability for the year in which the contribution is made. Second, IRAs allow families to defer their taxes to a time when their marginal tax rate may be lower. Families can

deduct their contributions when they fall within a high tax bracket and withdraw the funds at a time when they fall within a lower tax bracket. Third, income earned in the account (inside build up) is not taxed.

In addition, IRA investments can yield higher returns than tax-free investments. Normally, tax-free investments, such as municipal bonds, yield lower rates of return than investments that are subject to taxation. Consequently, a family will not necessarily increase its after-tax rate of return by investing in tax-free investments. However, savings in IRAs can be invested in a wide range of assets including otherwise taxable assets with higher yields. Thus the family receives the tax benefit offered by the IRA and the higher yield offered by a taxable investment. As a result, the family can earn a higher rate of return on an IRA investment than what could be earned from a tax-free non-IRA investment.

The new tax legislation has made important progress in the expansion of IRAs by making IRAs available to more middle-income families and by providing saving incentives for higher education. However, it falls short in three respects. First, the contribution limit of $2,000 per year is too low to provide families with appropriate opportunities to amass a significant amount of savings. The maximum contribution must be raised to provide families with incentives to substantially increase their personal savings.

Second, studies have shown that many individuals do not participate in IRAs because of the restrictions on IRA distributions. Distributions from retirement IRAs are subject to a penalty if withdrawn before the age of 59½. Penalty-free withdrawals should be allowed for a variety of purposes to encourage families to participate in IRA saving.

Third, the new law creates several different types of IRAs for different purposes, thus complicating the tax code. Families who want to take advantage of IRA benefits will have to determine which IRA saving plan is best for them and many may have to seek professional assistance. The added complication may discourage some families from participating in IRA saving altogether.

If the contribution limit were raised above $2,000 and penalty-free withdrawals were allowed for a wider variety of expenses, then traditional retirement IRAs can potentially become an important saving vehicle for middle-income families. Such expansions would allow families to accumulate a significant amount of savings to finance retirement, educational expenses, and other important expenses a

family might incur. Thus taxpayers could become financially independent and less reliant on the federal safety net. In addition, since individuals are generally the best investors of their own money, expanded IRAs can allow families to increase their incomes beyond what the government can provide for them through bloated, inefficient federal programs.

Benefits for the Economy

Expansion of IRA benefits can promote economic growth through its impact on saving and investment. Investment is important to the economy because it increases the domestic stock of capital, thereby promoting economic growth and productivity improvements. A larger, more productive economy generates new jobs, higher wages, and better living standards.

Investors have two sources of funds available to them: national saving (the sum of private and government savings) and foreign saving. If national saving falls short of investment demand, investors can borrow funds from foreign sources. Thus the availability of foreign funds allows investment to increase even if national saving is low. However, reliance on foreign saving can create three undesirable effects. First, the profits from the investment flow overseas. Second, the debt must be repaid with interest so that the net wealth inherited by future generations is lower than it otherwise would be. Third, when investment demand exceeds national saving, there is upward pressure on interest rates. Thus, a high national saving rate is desirable because it reduces investors' reliance on foreign money.

However, many economists argue that the national saving rate in the United States is too low because the tax code discourages private saving and encourages consumption. For instance, savings are subject to several levels of taxation, but consumption of certain products is rewarded through tax credits and deductions. The expansion of IRAs clearly helps reduce this bias by providing taxpayers with incentives to save. Expansion of IRAs thus promotes economic growth by increasing saving and investment.

There are some analysts who dispute the economic benefits of IRAs. According to these analysts, IRAs do not attract new saving, they merely encourage taxpayers to shift their existing savings into IRA investments. To the extent that net saving does not increase, the effects of IRAs on the economy are limited.

The empirical studies on IRA saving effects have produced mixed results. However, many notable studies conclude that IRAs do in fact

represent new saving. Some of the most distinguished studies have been conducted over the past several years by James Poterba of M.I.T., Steven Venti of Dartmouth College, and David Wise of Harvard University.

Poterba, Venti, and Wise (PVW) point out that the key obstacle to determining the saving effect of IRAs is saver heterogeneity. In other words, some people save and others do not--those who are inclined to saving tend to save more in all forms. For example, families with IRAs have more conventional savings than families without IRAs. Controlling for heterogeneity is extremely important in determining whether IRA contributions increase net saving. PVW use several different methods to control for heterogeneity which they believe sufficiently address the problems presented by this issue. They conclude that "the weight of the evidence, based on many non-parametric approaches...provides strong support for the view that contributions to both IRA and 401(k) plans represent largely new saving...We believe the evidence is strong in all cases"[62]

They note that several other studies using different methods have arrived at different conclusions. The most commonly cited study indicating that IRAs have no saving effect was conducted by Gale and Scholz (GS) in 1994. PVW reviewed the analysis used in this 1994 study and found that "their conclusions are inconsistent with the raw data and their formal model does not provide reliable information on the extent of substitution."[63] In specific, to estimate their model, GS deleted a large number of observations from their sample data. Although there is nothing wrong with deleting observations from the data, PVW show that the estimates in the GS study are extremely sensitive to exactly which observations are deleted and "the deletions that were made essentially determine the conclusions that GS report."[64] In addition, PVW point out that other limitations of the methodology used by GS seriously undermine the reliability of the GS study.

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[62] James Poterba, Steven Venti, and David Wise, "Personal Retirement Saving Programs and Asset Accumulation: Reconciling the Evidence," *National Bureau of Economic Research*, May 1996, p. 94.

[63] *Ibid.*

[64] *Ibid.*

The PVW study provides compelling evidence that IRA contributions do in fact represent an increase in new saving. Consequently, their expansion should generate important benefits for the economy.

V. CONCLUSION

Although the federal aid system has helped millions of students over the years, it has also contributed to some discouraging trends: tuition is rising, federal aid is shifting away from low-income students, and the value of need-based programs for the poor is declining.

These trends have occurred because the federal aid system is inherently flawed and could be improved upon to provide greater benefits to students. Federal financing of higher education does not provide colleges with incentives to restrain costs, and therefore encourages tuition hikes. The inefficient structure of student loans has broken down the marketplace for higher education by eroding price competition among schools and artificially inflating student demand. Past legislation to improve college affordability has simply increased the funding available to students instead of addressing the fundamental problems of cost containment and tuition inflation. As a result, increased federal subsidies have not necessarily improved the well being of student loan recipients. Students would benefit from alternative policies that expand educational opportunities in a more efficient and cost-effective manner.

The HOPE Scholarship recently enacted into law will not improve college affordability because it fails to address the core problems of the federal aid system. Instead, tuition tax credits will only create windfalls for colleges that adjust their tuition upward to absorb the additional revenue.

A more effective solution may be the expansion of IRAs which provide families with incentives to increase their savings for education. By reducing families' reliance on student loans and allowing them the opportunity to finance educational expenses from their own financial resources, expanded IRAs can restore price competition to the marketplace for higher education and provide colleges with incentives to reduce costs, contain tuition, and improve quality. Furthermore, reduced reliance on student loans can lower government costs, allowing the savings to be diverted to federal grants for the poor. Although the IRA expansion provisions contained in the new law are limited, there is evidence to suggest that more aggressive expansion could provide more significant benefits for families and the economy.

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