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Folder Title:
HOPE [Hope and Opportunity for Postsecondary Education] Briefing Binder [1]

Stack:	Row:	Section:	Shelf:	Position:
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PHOTOCOPY
PRESERVATION

River Rd

from main rd
near
15600 Sugarland

-
- name the rd as Great Heron Rd
 - an area (reserve)
 - Cherry Hill
 - identify those in rd - hds (hwy, identify reserves
to address (eg. stw, rd etc)

Comparison of Selected Higher Education Tax Proposals

	Administration	Rangel Proposal	Archer Proposal	Roth Mark
HOPE tax credit (For first two years of college only. None of the proposals have a B-average requirement or a Pell offset)	Up to a \$1,500 tax credit for the first two years	Phases in the Administration's \$1,500 tax credit	50% tax credit on up to \$3,000 of tuition for the first two years of college	For community colleges and technical schools: 75% tax credit on up to \$2,000 of tuition For other colleges: 50% tax credit on up to \$3,000 of tuition
Tuition deduction for life-long learning	Deduction up to \$10,000 of tuition per family per year for life-long learning	Phases in a 20% credit on up to \$10,000 of tuition (max value of \$2,000) for life-long learning	Figleaf deduction: deduction for up to <i>\$10,000 of interest accrued</i> in a prepaid tuition account that is used for <i>undergraduate</i> education	None
Total for HOPE and tuition deduction:	Phased in to cost \$35 billion	\$37 billion	\$22 billion	\$20 billion
Total for all education:	Over \$35 billion (No precise number)	\$42 billion	\$31 billion	\$32 billion
Section 127 (Employer-provided education)	Support extension for undergraduate and graduate education through at least 2002 (\$3.7 billion) (FY98 Budget extended it only through 2000)	Permanent extension for undergraduate and graduate education (\$3.4 billion)	Extends it for only 6 months and only for undergraduates (\$0.2 billion)	Permanent extension for undergraduate and graduate education (\$3.5 billion)
Student loan interest deduction	Support it but it was not in our FY98 Budget	None	None	Restores interest deduction (\$2,500 above the line deduction) (\$1.1 billion)

PRAISE FOR PRESIDENT CLINTON'S ANNOUNCEMENT OF AMERICA'S HOPE SCHOLARSHIPS

- **Senator Bob Dole:** "President Clinton had an idea that was pretty good and that was credits for two-year college students." [Source: Senator Bob Dole, Indianola Iowa campaign event, February 3, 1996]
- **Rep. John Kasich (R-OH):** Response to a question on the President's HOPE Scholarships "...If the President wants to reduce government, empower people, let people keep more of what they earn, I'm all for it. ...I think it is a great idea." [Source: *CNN*, "Moneyline with Lou Dobbs," May 4, 1996]
- **Governor Zell Miller (D-GA),** "I'm here to tell you this program will work. It's something that will make a difference in the lives of the people of this country. I've seen it work..." [Source: *The Philadelphia Inquirer*, June 6, 1996]
- **Whit Ayres, GOP Pollster.** "The HOPE scholarship has been remarkably successful," [Source: *The Atlanta Constitution*, June 5, 1996]
- **Brit Hume, ABC News:** "Basically, the President is offering everybody in America one year of college, tuition-free" [June 5, 1996]
- **Arnold Packer, Johns Hopkins University's Institute for Policy Studies.** "It seems at first blush to be a good idea. There's a shortage of people with enough education in the work force, and there is evidence, that rising costs are a factor: Over the last few years, tuition has steadily gone up and we've seen a diminution of attendance at community colleges." [Source: *Wall Street Journal*, June 5, 1996]
- **David Pierce, Director of the American Association of Community Colleges.** "Chances are this type of initiative will cause students to enroll in universities, I tend to think there is an overall benefit to all students at all institutions." [Source: *The USA Today*, June 6, 1996]
- **New York Times Editorial:** "[President Clinton] would give a \$1,500 a-year tax credit for two years to families earning up to \$100,000 a year and paying college tuition... The idea of a tuition tax credit is better than anything Mr. Dole has offered. The credit subsidizes education -- a better idea than Mr. Dole's proposal to cut gasoline taxes, which subsidize pollution." [Source: *New York Times Editorial*, June 5, 1996]
- **Washington Post Editorial:** "Americans are now entitled to 12 years of public education. As the President himself observed yesterday, this [America's HOPE Scholarship] would basically extend the system to 14 years -- make two years of college as universal as four...of high school." [Source: *Washington Post*, May 5, 1996]
- **San Francisco Chronicle:** "Hurray for College Tax Credit...the government could hardly make a better investment in the nation's future. ...And the President deserves praise -- not

Dole's knee-jerk political sneering -- for spelling out precisely how he would pay for the plan without increasing the deficit." [Source: San Francisco Chronicle, June 5, 1996]

- **Ronald Temple, Chancellor of City Colleges of Chicago:** "In Chicago alone, it would certainly open the door to literally thousands of young and not-so-young people who would otherwise not pursue the option of a college degree," [Source: The Chicago Tribune, June 6, 1996]
- **Wall Street Journal.** "President Clinton has put his finger on the problem: Many Americans feel priced out of college, yet higher education is the 'key to a successful future' in an economy that increasingly shortchanges workers. ...To that end, he significantly expanded on his existing proposal for an income-tax deduction covering as much as \$10,000 in post-secondary tuition costs each year for families with annual incomes up to \$100,000. The new plan also would offer a \$1,500 annual tax credit for two years, enough to cover the tuition costs of most community colleges or provide a down payment at four-year institutions." [Source: Wall Street Journal, June 6, 1996]
- **Charleston Gazette.** "Plan makes college affordable. ...President Clinton recognizes both the importance of a college education and the difficulty most families have in affording ever-increasing tuition." [Charleston Gazette, Charleston SC, 6/7/96]
- **Hartford Courant.** "President Clinton the other day came up with yet another proposal to help overwhelmed families pay for college. Good for him." [Hartford Courant, 6/7/96]
- **Washington Post.** "The President's plan follows another that he made last year -- also still shelved in Congress -- to offer \$10,000 annual tax deductions for higher education. His Administration is also pressing to expand college work-study programs, increase the size of Pell Grants to the neediest college students, and allow more students to pay back their tuition loans at a rate based largely on how much income they earn after graduating." [Washington Post, 6/8/96]

June 5, 1997

OFFICE OF THE PRESIDENT

P.O. Box 687

(413) 597-4233

Dear Colleague:

I have just returned from the spring meeting of the Board of Directors of the National Association of Independent Colleges and Universities, and was struck again by the signal importance of the current tax debate in Washington. We in independent higher education have an enormous stake in its outcome.

An agreement has been reached between the President and congressional leaders to balance the federal budget by the year 2002. Most of us have heard that a part of that deal, "roughly \$35 billion," was set aside for a system of higher education tax credits and deductions along the lines of the President's proposal.

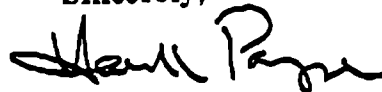
Let me underscore that this \$35 billion for higher education is by no means assured. The total cost of all tax cuts agreed to (including Hope, child tax credits, capital gains, etc.) far exceeds the total amount available. However, with a greater effort on our part, it is very possible that a comprehensive package of education tax incentives could be enacted in the next few months to include a Hope credit and deduction, savings incentives, the removal of the cap on tax-exempt bond financing, a student loan interest deduction, and the extension of §127 (employer-provided education assistance). The President and the Congress need to hear from us that all these proposals have merit.

This is a generational opportunity. It is not an overstatement to say that the outcome of the current debate in Washington could rival in stature the GI Bill of 1944 and the Higher Education Act of 1965.] *

Therefore, I urge you to take the time right now to call or write each of your congressional representatives. Tell them that the use of the tax code is an appropriate vehicle for helping students and their families pay for college, and ask them to work with the President and their colleagues on both sides of the aisle to help shape a tax package to encourage families to save for college, to help families that are paying tuition, and to assist students that are repaying their student loans.

Please do this in the next several days -- the major decisions are likely to be made this month. Also, please engage faculty, students, staff and parents in any way possible. Many thanks for your efforts. I truly believe that if you call Congress now, you will be helping to build a legacy of opportunity that will endure well into the next century.

Sincerely,



Harry C. Payne

Chair, NAICU Board of Directors

Telefax: (413) 597-4015

THE CALIFORNIA STATE UNIVERSITY
OFFICE OF THE CHANCELLOR

March 18, 1997

The Honorable William Jefferson Clinton
The President of the United States

The Honorable Trent Lott
Majority Leader
United States Senate

The Honorable Newt Gingrich
Speaker of the House
U.S. House of Representatives

The Honorable Richard Riley
Secretary of Education

Dear Sirs:

Both the Clinton Administration and the Congress have put forward important and substantial tax proposals to help low-income families, middle class families, and working adults finance higher education.

We commend the President for his exemplary leadership in proposing Hope scholarships, a \$10,000 tax deduction for education, and a significant expansion of the Pell grant program. We commend members of Congress of both parties for their suggestions to let families use IRAs without penalty for education, to restore the deductibility of interest on student loans and to make employer provided educational assistance a permanent part of the tax code.

These proposals would, if enacted, help millions of low and middle income families finance higher education. Such a step would pay enormous dividends--both individual and social--in the years ahead.

We strongly encourage Congress and the President to work cooperatively to develop these ideas and pledge to assist both parties to enact legislation that achieves our mutual objectives of providing assistance to students from different socio-economic backgrounds.

Barry Munitz

Signed on behalf of all 23 presidents by Barry Munitz,
Chancellor, The California State University

Black enrollment at college on rise

Georgia outpaces nation as HOPE helps fuel boom

By Gail H. Towns
STAFF WRITER

Over the last 10 years, black enrollment at Georgia's public colleges has doubled, far outpacing national growth rates among both blacks and whites.

College educators say there is no single explanation for the boom, which shows no signs of slowing. Instead, they point to several factors, such as the availability of more financial aid, including lottery-funded HOPE scholarships and special efforts to expose black children to colleges earlier.

Black enrollment in Georgia's public colleges grew from 21,524 students in 1985 to 43,609 in 1994, a 99.8 percent increase. During the same period, white enrollment in state schools grew 22 percent, from 120,264 to 146,607 students.

"One of the things we cannot overlook in Georgia is HOPE," said Joseph Silver, a state vice chancellor who has helped develop a statewide program to encourage high school and middle school students to go to college.

"It's really opened up doors for students that could not formerly afford to go to school. Now if a student does what he or she is supposed to do, they'll see that they can get it and go to college."

Black enrollment in Georgia is increasing more than twice as fast as it is throughout the country. Recent figures released by the New York-based College Fund/UNCF found that black enrollment at U.S. colleges and universities grew by about 40 percent from 1 million students in 1976 to more than 1.4 million in 1994, the latest year for which all figures were available.

During the same period, national enrollment among whites rose to 10.4 million — an increase of about 15 percent.

In sheer numbers, DeKalb College has seen the largest gain in black students in Georgia, soaring from 1,322 in 1986 to 4,345, a 185 percent increase. Georgia State University and Georgia Southern University have seen only slightly smaller numerical gains among their African-American populations.

Georgia State, which has seen a 1,903 student increase, has worked hard to lure more black youngsters to school, officials there said.

"Once you get a certain number of [black] students and get beyond the critical mass, they feel comfortable on campus and feel they're a part of what's going on," said Jim Scott, Georgia State's vice president of student life and

enrollment. "That's when they begin to feel that they're not just here taking classes... and that word gets back to their friends and guidance counselors."

Enrollment at the state's public black campuses — Albany State, Fort Valley State and Savannah State universities — has grown by more than 1,200 each.

Considerable gains also have been made in Atlanta's four historically black — but private — colleges: Clark Atlanta University, Morehouse, Spelman and Morris Brown colleges have seen increases in applications and enrollments and now stand at nearly 12,000 students combined. But proportionately, the growth isn't as large — they had about 10,000 in 1992.

Despite the gains, black students still face stiff challenges in getting into colleges and graduate schools. In addition to faring worse than their white counterparts on the SAT and graduate exams, they also have a tougher time funding their college years.

Nationally, black students are more likely than white students to drop out of college, and they still are more dependent upon financial aid. One-third of black students enrolled in four-year schools have family incomes below \$20,000, compared with about 9 percent of whites.

About 20 percent of Georgia's black college students receive the state's lottery-funded HOPE scholarship, which covers the cost of tuition for students who enter college with a B average and maintain it.

ATLANTA JOURNAL APR 10 1997

59,840 pre-k spaces available

The state Office of School Readiness has announced grants to schools and child-care centers to serve up to 59,840 children this fall in the free lottery-funded pre-kindergarten program.

Children 4 years old on or before Sept. 1, 1997, are eligible for the program, which provides a 180-day preschool, with 6 1/2 hours of instruction daily.

Parents have told laws chairs and camped out before

drives at some child-care centers in metro Atlanta to be assured of a space in the program. Most centers register students on a first-come, first-served basis. Child-care providers say many parents sign up on more than one waiting list.

Mike Vollmer, director of the state Office of School Readiness, had asked that all centers hold registration in April but said that some programs started registering children early. Vollmer also said his office is going to try to do a better job of pinpointing

where the program has vacancies and where there are students who aren't being served.

Vollmer's office will randomly audit centers to assure that they are offering a quality program, have the required number of students and are appropriately and adequately supplied.

Low-income families are eligible for free meals and extended day services in the program. Centers may charge up to \$17 per week for meals and up to \$75 per week for caring for children outside the pre-k program.

601-9027

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Family input of procedures?

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To Take

62223

Deliver ASA:

5-year cost
in billions

DEMOCRATIC ALTERNATIVE

I. Education Tax Benefits

A. Hope credit as proposed by the Administration with the following changes:

1. Eliminate the provision reducing the limitation on the credit by the amount of Pell Grants and other nontaxable Federal grants. These grants will be treated like other scholarship grants, offsetting tuition expenses but not reducing the limitation on the credit.
2. Eliminate the B- grade requirement and substitute a requirement for satisfactory academic progress.
3. Allow the credit against the minimum tax.
4. Phase in the limitation on the credit as follows: \$1,100 for 1997, 1998 and 1999, \$1,200 for 2000, and \$1,500 for 2001 and thereafter.

The alternative substitutes a 20 percent nonrefundable HOPE credit for tuition costs for the Administration's deduction. The credit would be available after student ceases to be eligible for phased-in \$1,500 HOPE credit described above. The credit would be allowable against the minimum tax. The limitation on the amount of expenses for which the credit is allowable is phased in as follows: \$4,000 for 1997, 1998, 1999, \$5,000 for 2000, \$7,500 for 2001, \$10,000 for 2002 and thereafter.

\$37.0

- #### B. Permanent extension of exclusion of employer-provided educational assistance and reinstatement of exclusion for graduate education. The reinstatement of the exclusion for graduate education would take effect for courses beginning after June 30, 1997.

3.4

- 2 -

5-year cost
in billions

- C. The education zone proposal from H.R. 1512. The proposal permits local governments to issue up to \$10 billion per year for 5 years of interest-free bonds to assist elementary and secondary schools (either in empowerment zones or enterprise communities or with at least 35-percent poor students) which join with a private business in a partnership to improve education. The business would be required to make contributions to the partnership.

1.6

II. Family Credit

An income tax credit per child for children under age 18 to begin in 1998; the credit would be \$300 in 1998, 1999, and 2000, \$500 in 2001 and thereafter; phased out for families with incomes between \$60,000 - \$75,000 and unavailable to those with more than \$75,000; refundable to the extent of the employee share of payroll taxes and allowed before the EITC.

71.2

III. Capital Gains

- A. President's exclusion of \$500,000 on sale of a principal residence.
- B. Allow deductibility of losses on sale of a principal residence.
- C. Allow an 18 percent rate (7.5 percent for taxpayers in 15-percent bracket) on capital gains, up to a lifetime cap of \$600,000, generated by capital assets not publicly traded on established markets; require a 3-year holding period.

1.9

3.8

5.7

IV. Estate Tax Relief

The alternative includes an additional exclusion for family-owned business interests:

- A. The limitation on the exclusion would be \$400,000 except that so much of the exclusion that is not claimed on the death of the first spouse may be claimed by the estate of the other spouse. This permits family-owned business interests with values up to \$2 million to pass with no estate tax in the case of a married couple.

- 3 -

5-year cost
in billions

- B. The provision would take effect for decedents dying after December 31, 1997.

1.9

V. Extenders

- A. The research credit would be extended for one year.

2.1

- B. The provision permitting fair-market value deduction for contributions of appreciated stock to private foundations would be extended for one year.

0.1

- C. The work opportunity tax credit would be extended for one year with the following modifications:

1. The credit would be expanded to cover certain individuals losing their eligibility for food stamps as contained in the Administration's proposal. This change would be effective for individuals hired after date of enactment through September 30, 2000.

0.2

2. The credit would be modified as provided in H.R. 1729 to increase the credit rate to 40 percent and provide a lower credit for workers not meeting 400 hour requirement.

0.5

- D. The Orphan Drug Credit would be made permanent.

0.2

VI. Other Presidential Initiatives

The alternative includes the following tax provisions as recommended in the President's budget:

- A. Expansion of empowerment zones and enterprise communities. The President's proposal would be modified by requiring that three of the additional empowerment zones would be designated in areas with distressed financial service industries meeting the requirements of the Kennelly bill, H.R. 2015 and financial service industries in those areas would be treated as qualified businesses, eligible for otherwise available tax benefits.

1.0

- 4 -

5-year cost
in billions

B.	Brownfield tax incentives. The President's proposal would be modified by including the provisions of H.R. 523 that permit tax-exempt qualified redevelopment bonds to be used to pay environmental remediation expenses for qualified sites.	1.2
C.	Tax credit for investment in community development financial institutions.	*
D.	Welfare-to-Work Tax Credit.	0.3
E.	Equitable tolling of statute of limitations for incapacitated taxpayers.	0.1
F.	Extension and modification of Puerto Rico tax credit.	0.7
G.	Foreign sales corporation benefits for licensed software.	0.6
H.	District of Columbia tax incentives.	0.3
	TOTAL	\$133.7

*Less than \$50 million.



National Association of Graduate-Professional Students, Inc.

NEWS RELEASE

June 11, 1997

Contact: Bryan Hannegan, (714) 824-1133

Kevin Boyer, (847) 256-1562

Jonathan Wharton, (202) 223-3791

Tax Bill Assaults Graduate Teachers and Researchers

"It feels like *deja vu* all over again," says national student group.

Washington, DC . . . Rep. Bill Archer (R-TX), Chair of the House Ways and Means Committee, released his tax proposals this week and graduate students throughout the U.S. have found themselves, once again, in the crosshairs of Congressional Budget Cutters. This time, however, the tax committee has targeted graduate teaching and research assistants, graduate students who teach up to 40% of the courses on some of the nation's largest university campuses and conduct a large portion of the nation's technological, defense, medical, engineering, chemical and other research.

"This isn't tax relief that will help make education more accessible," said Bryan Hannegan, a graduate student at the University of California/Irvine and President of the National Association of Graduate-Professional Students (NAGPS). "The proposed changes in the tax code could push people out of graduate school due to costs, could force universities to dramatically increase teaching and research assistant salaries, could increase tuition for undergraduates throughout the US, and could dramatically reduce the value of our nation's research dollars - much of it federal money."

The proposed provision would eliminate a subsection 117(d) of the tax code that presently allows universities to waive the tuition of its graduate teaching and research assistants in return for the services provided by the student. The tax code specifically excludes this tuition waiver from income tax. "This makes sense since the student never even sees the actual money," said Hannegan. The provision is widely used by universities to make graduate school affordable to students, to recruit highly-qualified graduate students, and to lower labor costs, thus keeping tuition lower.

- more -

June 11, 1997

Page 2 of 2

"Eliminating the exclusion from tax of these tuition waivers would have a catastrophic effect on students, as well as the entire education system," said Kevin Boyer, NAGPS Executive Director. In some cases, students receive a \$10,000 stipend per year for serving as a teaching assistant. Tuition waivers can have a value of up to \$20,000 per year at some institutions. The Chairman's tax provision would force the student to pay taxes on \$30,000 in "income," despite the fact that the student would only have \$10,000 in "cash income" from which to pay the tax. If a student pays 20% of his/her income in tax, the "stipend" has a after-tax-value of \$8,000 now. Paying 20% of \$30,000 (\$6,000) reduces the \$10,000 "stipend" to an after-tax-value of \$4,000 - a 50% cut in net income.

Boyer notes that three other provisions in the tax code also target graduate/professional students. 1) The HOPE scholarships will be available only to those in the first 2 years of post high school education; 2) The deduction for higher education expenses specifically excludes graduate school; and, 3) the extension of the Employer Provided Educational Assistance portion of the tax code (Section 127) applies only to undergraduate courses.

In addition, the Student Loan Interest Deduction does not appear in the Chairman's tax proposal, despite promises by both presidential campaigns in 1996 and widespread support from both sides of the aisle in the Congress.

"Graduate students should feel betrayed by this tax proposal," said Boyer. "Not only does it contain odious provisions that are sure to make graduate school unaffordable for millions of Americans throughout the next decade, but it fails to deliver on promises made by Congressional Republicans during the last election campaign. This tax proposals smells more and more like budget proposals in 1995 in which students were targeted for \$30 billion in budget cuts. Cutting funding to students - at all levels - was a bad idea then and it is a bad idea now. We should be focusing on improving access to graduate education, concentrating on spiraling graduate debt, and encouraging all forms of investment in graduate education by students, universities and employers. This tax proposal is a dramatic step in the wrong direction."

NAGPS Board members and students will take their message to Congress next week during a June 19 Lobby Day in Washington, DC. More information about the NAGPS Lobby Day, including press activities, may be found at the NAGPS web site at <http://www.nagps.org/NAGPS/> under "Student Aid Awareness" links.

A copy of the Chairman's mark can be found on the web at:
<http://gop.house.gov/taxrelief/060997Description.htm>

Provisions identified above can be found in sections

- * II-A-1 Chairman excludes grad students from HOPR)
- * II-A-2 Chairman excludes grad students from education tax deductions)
- * II-B-1 Chairman taxes employer provided educational assistance for graduate students)
- * II-B-4 Chairman taxes graduate teaching/research assistant tuition waivers).

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

June 10, 1997

The Honorable Bill Archer
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

As Congress begins to consider the tax bill, we wanted to bring to your attention the strong support of the education constituencies for the President's education tax initiatives. Letters from these constituent groups are enclosed for your review. We hope that you will consider the views, as well as the President's as you finalize the tax bill.

If you have any questions, please feel free to contact either one of us on these very important tax initiatives.

Sincerely,

Robert E. Rubin

Richard Riley

Enclosures



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

June 10, 1997

The Honorable Charles B. Rangel
Ranking Democrat
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Rangel:

As Congress begins to consider the tax bill, we wanted to bring to your attention the strong support of the education constituencies for the President's education tax initiatives. Letters from these constituent groups are enclosed for your review. We hope that you will consider the views, as well as the President's as you finalize the tax bill.

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Sincerely,

Robert E. Rubin

Richard Riley

Enclosures

 **CENTER ON BUDGET
AND POLICY PRIORITIES***June 10, 1997***NEW FEATURES OF ARCHER PLAN INCREASE PLAN'S REGRESSIVITY**

Several unexpected features of the Archer plan increase its regressivity. First, the plan denies the child credit to four million children in lower-middle income families that would have received the credit under early versions of the child credit. The plan denies the credit to these children by limiting the credit to families that have an income tax liability *after* the earned income tax credit is computed. Earlier versions of the credit would have provided it to families that had an income tax liability *before* the EITC is computed.

This change would deny the credit to several million families in the \$15,000 to \$30,000 range and would raise to 40 percent the proportion of children that would fail to qualify for the credit because their families' incomes are not high enough. While reducing the number of lower-middle-income children qualifying for the credit, the Archer plan does not scale back the number of children at higher income levels who qualify for it. While 40 percent of children would not qualify for the credit because their families' incomes are not high enough, fewer than three percent would fail to qualify because their families' incomes are too high.

Changes in Education Proposals

The Archer plan also alters the Clinton proposal for a deduction of up to \$10,000 a year for postsecondary education costs in a way that makes it valuable to high-income families. The Clinton proposal would have limited the full value of this deduction to tax filers with incomes below \$80,000 and phased it out between \$80,000 and \$100,000. The Archer plan places no income limits on this deduction. Like other deductions, this deduction would be worth more than twice as much to families in the top tax brackets — the 31 percent, 36 percent, and 39.6 percent tax brackets — as to those in the 15 percent bracket. The families that would gain the most from this proposal are those that need no government subsidies to send their children to college.

Finally, the plan changes the \$1,500 tuition credit from a credit for 100 percent of the first \$1,500 in tuition costs to a credit for 50 percent of the first \$3,000 in tuition costs. Students with a \$1,500 tuition cost thus would get a tax credit of \$750 instead of \$1,500. Students from near-poor and lower-middle-income families are more likely to attend community colleges with modest tuition than are students from upper-middle income families. As a result, the change in this credit is likely to have an adverse effect primarily on students of more modest means.



CENTER ON BUDGET AND POLICY PRIORITIES

June 10, 1997

ARCHER TAX PLAN MAKES HEAVY USE OF DEVICES TO KEEP COSTS OF UPPER-INCOME TAX CUTS ARTIFICIALLY LOW IN EARLY YEARS

Net Cost in Second 10 Years Estimated at \$650 Billion to \$750 Billion

The tax cut plan unveiled June 9 by Rep. Bill Archer, Chairman of the House Ways and Means Committee, contains an array of tax cuts that are designed in a manner to keep their costs artificially low in the initial five-year and ten-year periods. The costs of these tax cut eventually grow rapidly, however, and become much more expensive.

Earlier Center on Budget and Policy Priorities analyses concluded that the tax cuts emanating from the budget agreement were likely to be designed in a heavily backloaded manner. But the Archer plan is even more backloaded than the Center's earlier analyses had suggested it was likely to be, largely because several of the tax cuts that primarily benefit high-income individuals are designed in a manner that keeps their costs lower than had been anticipated in the initial years, allowing Rep. Archer to shoehorn even more tax cuts than the Center had forecast into his tax package. Moreover, some of the tax cuts added as a result of the additional room that the more extreme backloading measures create are themselves backloaded.

The Joint Tax Committee revenue tables on the Archer proposal show that:

- The cost of Rep. Archer's tax cuts will start to explode toward the end of the 10-year period, growing 32 percent in just the final two years of the period. Between 2005 and 2007, the cost of the Archer tax cuts jumps \$5 billion a year, a level of growth that would continue for a number of years thereafter.
- Some 44 percent of the \$250 billion cost of the tax cut over the 10-year period — or \$110 billion — is packed into the last three years of this period.
- The net tax cut would lose \$41.8 billion in 2007, the tenth year. This is two and one-half times the \$17 billion annual average cost of the tax cut in the first five years.

The costs of key elements of the Archer tax cut would continue to mushroom long after 2007. Rep. Archer's estate tax cut would phase in through 2014. The capital

gains indexing provisions and the Individual Retirement Account tax cuts would continue to grow substantially for long periods as well.

Based on the Joint Tax Committee's estimate of the year-by-year costs of the tax cut in the first 10 years and the design of these proposals, we estimate the Archer tax proposals are likely to lose *between \$650 billion and \$750 billion* in the second 10-year period, from 2008 through 2017. (See box on page 4.) This is the period when the baby boom generation begins to retire and deficits are forecast to rise to alarming levels that will damage the economy unless unprecedented austerity measures are instituted.

Most of the provisions of the Archer plan that are heavily backloaded have a common characteristic — they provide most of their tax cut benefits to high-income individuals. The backloading of those provisions enables Rep. Archer to fit his extensive array of tax cuts within the cost constraints the budget agreement establishes for the initial five-year and ten-year periods. The backloading devices also serve to mask the fact that when fully in effect, the Archer tax plan is heavily tilted toward those on the upper rungs of the economic ladder.

- The four tax provisions of the Archer proposal most heavily skewed to taxpayers at high income levels are the capital gains, IRA, estate tax, and corporate alternative minimum tax provisions. CBO analysts have found that the five percent of individuals with incomes exceeding \$100,000 receive 75 percent of capital gains income in any year. They would secure the lion's share of the Archer capital gains tax cuts.

In the IRA area, the bottom two-thirds of tax filers already are eligible for IRA tax breaks; the principal effect of the IRA tax break in Rep. Archer's plan is to restore generous IRA tax preferences to the top third of filers. Past experience with IRAs demonstrates that when they are available to households at all income levels, they are used much more heavily by high-income taxpayers than by others. In addition, IRA tax preferences are worth more to those in the top income tax brackets than to those in lower brackets. A Joint Tax Committee analysis several years ago estimated that 95 percent of the tax benefits of restoring generous IRA tax preferences to those now ineligible for them would accrue to the top fifth of taxpayers.

In the estate tax area, the Archer proposal raising the amount of an estate exempt from tax would benefit heirs of the top two percent of estates; other estates already are exempt from this tax.

Finally, CBO analyses assume that the benefits of reducing the corporate alternative minimum tax would be distributed among individual

taxpayers in accordance with their ownership of capital. As a result, the Archer proposal to reduce this tax — and then to eliminate it in 2006 — would principally benefit those with high incomes.

With the exception of the corporate AMT provision, all of these primarily upper-income tax cuts are heavily backloaded. They are designed so their costs remain small between now and 2002 but then rise substantially.

- *In fact, the combined cost of these four upper-income tax cut provisions is greater just in 2007 than the combined cost for the entire period from 1997 through 2002.* The Joint Tax Committee tables show these four provisions will result in a combined revenue loss of \$24 billion in 2007. This is one-fourth more than the revenue loss of \$19 billion these provisions would engender for the years from 1997 through 2002 combined.

The capital gains, estate tax, and IRA provisions all make heavy use of gimmicks — including delayed effective dates, slow phase-ins, and timing shifts in revenue collections — to minimize the revenue losses these tax cuts cause during the first five years as well as for several years thereafter. Their costs then begin to rise sharply, with the pace at which these costs increase accelerating in 2006 and 2007.

- For example, the Archer proposal to institute capital gains indexing is designed so taxpayers would not begin using it to lower their capital gains taxes until 2004. It would have no cost in years before that. The cost of this provision then climbs rapidly each year after 2004. By the end of the initial 10-year period, the overall cost of the Archer capital gains tax cut is rising at a clip of nearly \$2 billion a year.
- Moreover, the Archer indexing proposal is designed in such a way that it *increases* tax collections by about \$10 billion to \$12 billion in 2002. This increase in collections consists largely of revenue the government otherwise would collect in later years anyway; the Archer capital gains indexing proposal results in this revenue being collected in 2002 instead. Partly as a result of this maneuver, the Archer capital gains tax proposals would result in a \$2.7 billion revenue *increase* from 1997 to 2002, according to the Joint Tax Committee. Then from 2003 to 2007, the Archer capital gains tax cuts would lose \$37.6 billion, with the loss growing steadily larger each year. By 2007, the loss equals \$10.8 billion. In subsequent years, the loss would rise to much higher levels.
- The Archer IRA proposals are designed to defer most of the revenue loss they cause until after the end of the 10-year period. They also are engineered so billions of dollars in taxes the federal government normally

Cost in Second Ten Years Likely to Be \$650 Billion to \$750 Billion

The cost of the tax package rises sharply between the eighth and the tenth year. The backloading gimmicks responsible for this rise will continue to push up the cost of the tax cuts in years after 2007. As a result, the tax cut is likely to lose between \$650 billion and \$750 billion in the 10-year period from 2008 through 2017. Several methods of estimating the cost of the tax cuts during the second 10-year period produce similar results.

One conservative method of estimation is to assume that the cost of the tax cuts will grow by the same dollar amount in each year from 2008 through 2017 as the average amount that the Joint Tax Committee revenue tables show the cost will grow from 2004 through 2007. Using that assumption, the annual cost of the tax cut would rise from \$41.8 billion in 2007 to \$85 billion in 2017. Estimated in this manner, the total cost of the tax cut in the 10-year period from 2008 through 2017 would be \$655 billion.¹

Using the average annual increment in cost between 2004 and 2007 as the basis for projection, however, does not fully capture the *rate* at which the tax cut is growing in cost at the end of the first 10 years. For a number of reasons, capital gains indexing, the backloaded IRAs, and some of the estate tax provisions are likely to continue for a number of years to rise in cost at rates similar to the rates at which these provisions are growing at the end of the ten-year period. In the case of capital gains indexing, the cost would continue to grow at a rapid rate until the average number of years for which assets being sold that qualify for inflation-adjustment stabilizes, which would be sometime in the middle of the second decade after enactment. Similarly, backloaded IRAs generally are estimated not to reach a stable cost until withdrawals balance new deposits, probably sometime in the latter part of the second decade after enactment. In addition, the rate of growth of the estate tax provisions would remain high; the phased-in increase in the amount of an estate excluded from taxation, for example, would not reach its full cost until the end of the second decade after enactment.

Thus an alternative, still-conservative estimate would assume that the average rate at which the tax cut would grow between 2004 and 2007 would continue through 2010; for the remaining seven years through 2017, the growth in cost is assumed to fall back to the rate of GDP growth.² Under these assumptions, the cost in the 10-year period from 2008 through 2017 would be \$670 billion.

As noted, however, the high rate at which the tax cut is growing at the end of the first 10 years is likely to continue for more than three years beyond the initial ten. A third potential method of estimation would assume that the average rate at which the tax cut would grow between 2004 and 2007 would continue through 2012, the middle of the second decade after enactment. For the remaining five years through 2017, the growth in cost is assumed — under this third method — to fall back to the rate of GDP growth. This assumption may be conservative because the cost of the estate tax cut (and probably of some of the other tax reductions as well) would clearly rise at a faster rate than GDP in years from 2013 through 2017. Under this set of assumptions, the cost of the tax cut would rise from \$41.8 billion in 2007 to \$97 billion in 2017, and the cost in the 10-year period from 2008 through 2017 would be \$750 billion.

¹ The increases in cost of the Archer tax cuts are \$2.7 billion from 2004 to 2005, \$5.2 billion from 2005 to 2006, and \$5.0 billion from 2006 to 2007. The average increase of \$4.3 billion understates the extent to which the tax package is growing at the end of the initial 10-year period.

² GDP growth is assumed to be 4.6 percent each year. This is the growth rate for the years 2006 and 2007 in the Congressional Budget Office's March 1997 baseline.

would collect after 2002 (and largely after 2007) would be collected between 1999 and 2002 instead. As a result, the Joint Tax Committee tables show the quite-generous IRA tax breaks in the Archer plan would lose a mere \$35 million from 1997 through 2002. From 2003 to 2007, the revenue loss would total \$12.9 billion. In 2007, the loss would equal \$4.6 billion in a single year and be growing at a rate of more than \$1 billion a year. Ultimately, the annual revenue loss from this provision would reach double-digit levels.

- The estate tax cuts in the Archer plan are noteworthy for the slow pace at which these cuts would be phased in. The Archer proposal raises the estate tax exemption from \$600,000 to \$1 million over 17 years. The exemption reaches the \$1 million level in 2014. Only a fraction of its full costs are felt in the initial 10-year period.

The estate tax provisions would lose \$3.6 billion in the first five years but \$16.9 billion in the second five years. In 2007, the loss would equal \$5 billion in a single year. At that point, the revenue loss from this provision is rising at a rate of about \$1 billion a year, a rate of increase that would continue throughout most or all of the second 10 years after enactment of the legislation.

When the upper-income tax cut provisions of the Archer plan are considered together, the magnitude of the backloading of these provisions becomes evident.

- As noted, the Joint Tax Committee tables show that the capital gains, IRA, estate tax, and corporate alternative minimum tax provisions of the Archer plan would lose a total of \$18.9 billion during the years through 2002. In the second five years — from 2003 through 2007 — the revenue loss from these four provisions jumps to \$84.5 billion, more than four times as much as the loss in the initial five-year period.
- Because of their backloaded nature, these four upper-income tax cut provisions account for less than 15 percent of the gross cost of the tax package in the first five years. By 2003 they account for 30 percent of the gross cost of the package. By 2005, they account for 36 percent of the gross tax cuts in the tax package. By 2007, the figure is 43 percent. By about 2010, the upper-income provisions, which concentrate the bulk of their benefits among a small fraction of the population, would account for a majority of the gross tax cuts in the package.

Furthermore, these percentage figures do not reflect several other major tax cuts in the package — such as the \$10,000-a-year education tax

deductions, which places no income limit on the taxpayers who can claim it, and the weakening of the individual alternative minimum tax — that would confer a sizable share of their tax cut benefits on high-income taxpayers. Eventually, the Archer plan becomes a piece of legislation whose predominant effect is to provide upper-income tax relief and enlarge the after-tax incomes of those in the wealthiest strata of society.

These tax cuts would mushroom in cost just as the baby boom generation is beginning to retire. Both CBO and GAO long-term forecasts indicate that deficits will shoot up in the baby boom generation's retirement years, as Medicaid, Medicare and Social Security costs rise substantially while the ratio of workers to retirees falls. These long-term forecasts show that deficits are expected to reach levels in these years that would cause serious damage to the economy over time.

Furthermore, some of the principal upper-income tax cuts in the Archer plan — in particular, the capital gains indexing and backloaded IRA provisions — are designed in a fashion that makes them *irreversible*. Future Congresses could not undo the swelling revenue losses these provisions would have caused, no matter how large the budget deficit was becoming. This is because the capital gains indexing and backloaded IRA provisions utilize devices that induce taxpayers, primarily at high income levels, to pay billions of dollars in additional taxes in the next five years in exchange for very large tax breaks for decades thereafter. Essentially, large future tax cuts would be "sold," with the selling price being pre-payment of certain tax amounts in years through 2002. Once taxpayers have entered into such a bargain and paid substantial additional taxes upfront to purchase large tax breaks for years to come, the government cannot renege on the future tax reductions.

Moreover, the billions of dollars in additional taxes that would be paid in the next five years are taxes that otherwise would largely be collected in subsequent decades. Once these taxes are accelerated into the initial five-year period, they cannot be collected again in the future. The revenue "hole" created in future years is permanent. As a result, a substantial portion of the backloaded revenue losses the Archer plan creates would be locked in permanently.

New Features of Archer Plan Increase Plan's Regressivity

Several unexpected features of the Archer plan increase its regressivity. First, the plan denies the child credit to four million children in lower-middle income families that would have received the credit under early versions of the child credit. The plan denies the credit to these children by limiting the credit to families that have an income tax liability *after* the earned income tax credit is computed. Earlier versions of the credit would have provided it to families that had an income tax liability *before* the EITC is computed.

This change would deny the credit to several million families in the \$15,000 to \$30,000 range and would raise to 40 percent the proportion of children that would fail to qualify for the credit because their families' incomes are not high enough. While reducing the number of lower-middle-income children qualifying for the credit, the Archer plan does not scale back the number of children at higher income levels who qualify for it. While 40 percent of children would not qualify for the credit because their families' incomes are not high enough, fewer than three percent would fail to qualify because their families' incomes are too high.

Changes in Education Proposals

The Archer plan also alters the Clinton proposal for a deduction of up to \$10,000 a year for postsecondary education costs in a way that makes it valuable for high-income families. The Clinton proposal would have limited the full value of this deduction to tax filers with incomes below \$80,000 and phased it out between \$80,000 and \$100,000. The Archer plan places no income limits on this deduction. Like other deductions, this deduction would be worth more than twice as much to families in the top tax brackets — the 31 percent, 36 percent, and 39.6 percent tax brackets — as to those in the 15 percent bracket. The families that would gain the most from this proposal are those that need no government subsidies to send their children to college.

Finally, the plan changes the \$1,500 tuition credit from a credit for 100 percent of the first \$1,500 in tuition costs to a credit for 50 percent of the first \$3,000 in tuition costs. Students with a \$1,500 tuition cost thus would get a tax credit of \$750 instead of \$1,500. Students from near-poor and lower-middle-income families are more likely to attend community colleges with modest tuition than are students from upper-middle income families. As a result, the change in this credit is likely to have an adverse effect primarily on students of more modest means.

Press Conf.

- Access
- Access
- Life (ing)

Archer don't permit the mark, they miss the point.

Spans

they might be direct benefits in low & middle -

- savings incentives are endogenous
- tax relief for low & moderate
- incl. student loans

low. last week - 6 elements compared

- In Pres. plan, we see map of them.

- In W&M, we see several

Bill w/ Admin & Congress. -

Peter McQuinn - NSU LGC

- challenges accessibility & affordability.

- Admin's proposals go a long way in that direction.

- Admin prop. is disconn. in CC's

- E. Chapman's death is written in pencil so it can be disp. open in the coming weeks.

Here

- Lifelong Learning

- \$10,000 info (ag. 100) - incentive to support for continuing ed'n & lifelong learning.

- Sec. 127 - Repubs - Person.

Pres. - 3 yrs

Wash. - only first end of this year.

Exp. for maintaining skill base of Am. workforce.

Q3

IMA for ed'n?

- not part of \$35 bill.

yes outside -

- IMA

- 100 ex. 6000

- Sec. 127

- Drop in minority interests (ARK Energy)
+ Cost of Red'n...
- Decline of bill as % of cost...

McCa → Fisher & Co are so high income.

- Fraud on the Ch. Matter...

• Sec. 127 unnecessary of a \$12,000 deduction...

Camp's Mtg.

- Dist's ??

- Case examples...

- Warren - Another plan down a back road to add info
etc off a cliff if we sample a/rx.

- Rd. is gone

Comparison of Selected Higher Education Tax Proposals

	Clinton Administration	Rangel Proposal	Archer Proposal	Roth Mark
HOPE tax credit (For first two years of college only. None of the proposals have a B-average requirement or a Pell offset)	Up to a \$1,500 tax credit for the first two years	Phases in the Administration's \$1,500 tax credit	50% tax credit on up to \$3,000 of tuition for the first two years of college	For community colleges and technical schools: 75% tax credit on up to \$2,000 of tuition For other colleges: 50% tax credit on up to \$3,000 of tuition
Tuition deduction for life-long learning	Deduction up to \$10,000 of tuition per family per year for life-long learning	Phases in a 20% credit on up to \$10,000 of tuition (maximum value of \$2,000) for life-long learning	Deduction only for up to \$10,000 of <i>interest accrued</i> in a prepaid tuition account that is used for <i>undergraduate</i> education	None
Total for HOPE and tuition deduction:	Phased in to cost \$35 billion over 5 years	\$37 billion	\$22 billion	\$20 billion
Section 127 (Employer-provided education)	Supports extension for undergraduate and graduate education through at least 2002	Permanent extension for undergraduate and graduate education	Extends it for only 6 months and only for undergraduates	Permanent extension for undergraduate and graduate education
Student loan interest deduction	Supports restoration of a student loan interest deduction	None	None	Restores interest deduction (\$2,500 above the line deduction)



UNITED STATES DEPARTMENT OF EDUCATION

PUBLIC AFFAIRS

FOR IMMEDIATE RELEASE
June 9, 1997

Contact: Rick Miller
(202) 401-3026

**STATEMENT BY U.S. SECRETARY OF EDUCATION RICHARD W. RILEY
regarding Congressman Archer's tax proposal**

Congressman Archer's proposed revisions for the President's HOPE Scholarship carry a message of despair for America's lower- and middle-income students and families.

Congressman Archer's plan does not meet the letter or the spirit of the budget deal reached by the Congressional leadership and President Clinton -- an agreement that called for \$35 billion over five years for the President's HOPE Scholarship and \$10,000 tuition tax deduction.

By allowing only a 50 percent tuition tax credit up to a value of \$1,500, Mr. Archer's plan disadvantages students financially for choosing to attend a more affordable community college or low-cost four-year institution. This undercuts the basic premise of President Clinton's HOPE Scholarship -- to make the 13th and 14th years of education as universally accessible as the previous 12 years of school. Additionally, Mr. Archer's proposal does away with the lifelong availability of tax benefits as written in President Clinton's plan, ignoring the needs of working Americans to upgrade their skills throughout their career.

President Clinton's plan for higher education-related tax cuts invests in people by helping lower- and middle-income families to meet the costs of college and lifelong learning.

###

Major Tax Cut Provisions in the Ways and Means Chairman's Mark (1)

(1998 Income Levels)

Family Economic Income Class (2) (000)	Number of Families (millions)	Average Tax Change (\$)	Total Tax Change		Tax Change as a Percent of:	
			Amount (3) (\$M)	Percent Distribution (%)	Current Federal Taxes (4) (%)	Family Economic Income (%)
0 - 15	18.5	-14	-268	0.4	-2.87	-0.17
15 - 30	21.8	-62	-1363	1.9	-2.72	-0.28
30 - 40	12.1	-167	-2014	2.8	-3.24	-0.48
40 - 50	9.7	-333	-3234	4.5	-4.43	-0.74
50 - 60	7.9	-453	-3567	5.0	-4.54	-0.83
60 - 75	9.4	-548	-5159	7.2	-4.30	-0.82
75 - 100	11.7	-837	-9794	13.8	-4.88	-0.97
100 - 200	15.6	-1492	-23269	32.7	-5.37	-1.13
200 & over	3.9	-5663	-22164	31.1	-5.24	-1.23
Total (5)	111.3	-640	-71191	100.0	-4.90	-0.96

Department of the Treasury
Office of Tax Analysis

June 11, 1997

- (1) This table distributes the estimated change in tax burdens due to the major tax cut proposals in the Ways and Means Chairman's Mark which include the following: i) child and dependent care tax credits, ii) a modified HOPE scholarship tax credit, iii) a deduction for education expenses paid through State-sponsored prepaid tuition programs; iv) education investment accounts and private prepaid tuition programs; v) American Dream IRAs; vi) Capital gains provisions (lower individual and corporate rates, indexing of individual gains, and \$500,000 exclusion for gains on a principal residence); v) individual AMT change and corporate AMT repeal; vi) District of Columbia tax incentives; and vii) safe harbor for independent contractors.
- (2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and under-reported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.
- (3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the American Dream and education accounts, the change is measured as the present value of the tax savings from one year's contributions. The effect of the capital gains provision is based on the level of capital gains realizations under current law.
- (4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.
- (5) Families with negative incomes are included in the total line but not shown separately.

Very Preliminary**Major Tax Cut Provisions in the Ways and Means Chairman's Mark (1)**

(1998 Income Levels)

Family Economic Income Quintile (2)	Number of Families (millions)	Average Tax Change (\$)	Total Tax Change		Tax Change as a Percent of:	
			Amount (3) (\$M)	Percent Distribution (%)	Current Federal Taxes (4) (%)	Family Economic Income (%)
Lowest (5)	21.6	-17	-357	0.5	-2.84	-0.17
Second	22.2	-76	-1691	2.4	-2.75	-0.31
Third	22.3	-295	-6574	9.2	-4.17	-0.69
Fourth	22.3	-623	-13856	19.5	-4.49	-0.86
Highest	22.3	-2172	-48354	67.9	-5.31	-1.17
Total (5)	111.3	-640	-71191	100.0	-4.90	-0.96
Top 10%	11.1	-3089	-34406	48.3	-5.20	-1.18
Top 5%	5.6	-4577	-25517	35.8	-5.22	-1.21
Top 1%	1.1	-12247	-13741	19.3	-5.29	-1.30

Department of the Treasury
Office of Tax Analysis

June 11, 1997

- (1) This table distributes the estimated change in tax burdens due to the major tax cut proposals in the Ways and Means Chairman's Mark which include the following: i) child and dependent care tax credits, ii) a modified HOPE scholarship tax credit, iii) a deduction for education expenses paid through State-sponsored prepaid tuition programs; iv) education investment accounts and private prepaid tuition programs; v) American Dream IRAs; vi) Capital gains provisions (lower individual and corporate rates, indexing of individual gains, and \$500,000 exclusion for gains on a principal residence); vii) individual AMT change and corporate AMT repeal; viii) District of Columbia tax incentives; and ix) safe harbor for independent contractors.
- (2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and under-reported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.
- (3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the American Dream and education accounts, the change is measured as the present value of the tax savings from one year's contributions. The effect of the capital gains provision is based on the level of capital gains realizations under current law.
- (4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.
- (5) Families with negative incomes are excluded from the lowest quintile but included in the total line.

NOTE: Quintiles begin at FEI of: Second \$16,950; Third \$32,563; Fourth \$54,758; Highest \$93,222; Top 10% \$127,373; Top 5% \$170,103; Top 1% \$408,551.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.
June 11, 1997

SECRETARY OF THE TREASURY

The Honorable Charles B. Rangel
Ranking Democratic Member
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Charlie:

I want to commend you and the other Democratic members of the Ways and Means Committee and the caucus for your tax proposal.

If we are going to continue to invest in education and the rest of our successful economic strategy, any tax cut package must meet four basic tests. First of all, it must reflect the terms of the bipartisan budget agreement. Second, the tax cuts must be designed to help the economy continue to grow. Third, the tax cut must not disproportionately benefit upper-income families. Fourth, a tax cut must genuinely expand educational opportunities for Americans of all ages. Your overall package meets those tests. The Republican House proposal does not.

We are particularly pleased that your proposal gives American families the help they need to make investments in education and lifelong learning. The decision to include a HOPE scholarship proposal mirrors our initiative to make education more affordable and to make the 13th and 14th grades universal. You have improved our initial proposal by allowing students who receive Pell Grants and still pay tuition to receive the HOPE scholarship. We fully endorse that change. Although our tuition deduction plans differ in some particulars, we are pleased that your proposal incorporates the full \$10,000 tax benefit for tuition paid -- regardless of its source. Like our proposal, your tuition plan will help families who are not wealthy enough to pay for the entire amount of tuition out of savings and are therefore forced to borrow. It would also help Americans undertake lifelong learning so that they can take advantage of the opportunities -- and meet the challenges of the new economy.

We are pleased that your proposal includes a refundable child tax credit which will help millions of working families raise their children. We are extremely encouraged that your proposal would allow a low-income family to receive both the child credit and their full Earned Income Tax Credit.

- 2 -

At the same time, your proposal includes several of the President's priorities that were part of the budget agreement -- including an expansion of Empowerment Zones and Enterprise Communities, the Brownfield tax incentives and the Welfare-to-Work tax credit. Your proposal also addresses many of the President's other priorities -- including a permanent extension of the exclusion for employer-provided educational assistance and tax credits for investment in Community Development Financial Institutions.

In sum, your tax cut plan is a welcome and important proposal. While we continue to analyze specific provisions, we support the overall structure of the plan. We hope that members of both parties will give it careful consideration and will work with us to enact a tax cut package that meets our four tests.

Sincerely,

A handwritten signature in dark ink, appearing to be "R. Rubin", with a stylized flourish above the name.

Robert E. Rubin



U.S. DEPARTMENT OF EDUCATION

FAX TRANSMISSION

Office of the Secretary
600 Independence Avenue, SW
Washington, D.C. 20202
Office: (202) 401-8450
Fax: (202) 401-0596

TO: BOB SHIREMAN **DATE:** June 17, 1997

FAX : 456 - 2223

FROM: Susan Frost
Senior Advisor to the Secretary

SUBJECT:

COMMENTS: FYI - Barry Munitz's effort

3 PAGES TOTAL!



BETH B. BUEHLMANN
DIRECTOR

THE CALIFORNIA STATE UNIVERSITY

OFFICE OF FEDERAL RELATIONS
400 NORTH CAPITOL STREET, N.W. • SUITE 873
WASHINGTON, D.C. 20001-1512
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FAX COVER SHEET

DATE: June 16, 1997

TO: Dan
TELEFAX: 401-0596

FROM: Beth B. Buehlmann

NUMBER OF PAGES: 2
(INCLUDING COVER)

COMMENTS:

Please note that I would appreciate it if Susan/you could get a copy of the attached message to David Longanecker, Mike Smith and the Secretary. The people receiving this message today are campus presidents in the appropriate states of members of the Finance Committee.

One point of feedback for you, from the conversations that have been held, the response is that the Members are impressed with the contacts they are receiving and have indicated that they were wondering where higher education was on this issue. Good reinforcement for the next time we need to educate the field!

Printed By: Beth Buehlmann 6/16/97 12:59 PM
From: Joy Phillips (6/16/97)
To: Sylvia Griffith
CC: Beth Buehlmann
BCC:
Priority: Normal

Page: 1

Date sent: 6/16/97 7:16 AM

Office of the
Chancellor

Phone: (562) 985-2800 Fax: (562) 985-2808
E-mail: Joy_Phillips@CALSTATE.EDU

6/16/97

7:10 AM

to be faxed. Beth, we're swamped so wanted you to know we'll get to you as soon as we can.

To: Those addressed

From : BM

Subject: Further background for Senate Finance Committee deliberations

We are deeply grateful for your timely and very strong assistance in the discussion of higher education's economic future. You have noted by now the action of the House Ways and Means Committee, and attention is turning to the Senate, where the Democratic Caucus meets on Tuesday.

It is vital that we continue this strong background education effort on the Senate side, particularly since several of our key contacts have indicated how important it has been to receive Presidential-level communication on the broad policy issues.

Please do everything possible to reiterate or confirm contacts today so that the Tuesday discussion will reflect our best collective interests.

bcc: Beth Buehlmann Could you please get this to Susan Frost and David Longanecker so that Mike Smith and Secretary Riley are alert to what we are doing and also whatever the appropriate White House call is as well.



UNITED STATES DEPARTMENT OF EDUCATION

THE DEPUTY SECRETARY

600 Independence Avenue, SW
FOB-10, Rm 6261
Washington, DC 20202-0500

Telephone Number: (202) 401-1000

Fax Number: (202) 401-3095

FAX COVER SHEET

TO:

Bob Shurman

FAX:

456-2223

FROM:

Mike Smith

NUMBER OF PAGES TO FOLLOW, INCLUDING COVER SHEET:

11

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Bob S.

FAX TRANSMISSION

THE BROOKINGS INSTITUTION

Economic Studies Program

1775 Massachusetts Avenue, NW

Washington, DC 20036

Tel: 202/797-6056

Fax: 202/797-6181

To: *Marshall Smith*

Date: June 5, 1997

Fax #: 202-401-3095

Pages: 2, including this cover sheet.

From: Robert Reischauer

Subject: Brown Center on Education Policy Discussion of Tax Proposals for Post-Secondary Education

Comments:

I thought you might find this interesting.

A Saving Oriented Suggestion for the Tax-Based Education Provisions of the FY1998 Reconciliation Bill

Taxpayers could establish an educational saving account for each dependent child who was eligible for the child tax credit or a single account for all the family's children. If the taxpayer requested and provided the routing number, the IRS could deposit the child tax credit amount directly into the account. Alternatively, the family could make a deposit into the account of an amount not to exceed the child tax credit for which it was eligible. Earnings on balances in these educational saving accounts would not be subject to income tax if the proceeds were used for tuition and fees. If withdrawn before such expenses were incurred or if the child did not go on to post-secondary school or did not incur any eligible expenses while in school, the accumulated earnings would be taxed upon withdrawal at regular tax rates plus a small penalty. (Alternatively, unused balances could be rolled over into the taxpayer's IRA.) The balances in these accounts would have to be withdrawn before the child listed on the account reached a certain age (for example, 27) unless the child was enrolled in a degree/certificate granting program at that time.

While the child tax credit would not be refundable, those without positive tax liability would not be excluded from this program. An amount equal to a fraction of the credit (50 percent, for example) would be deposited in an account held by the Treasury in the child's name. Families that currently do not have to file an income tax return would have to file a return to be eligible for this benefit. Balances in these "education grub-stake" accounts would be invested in government securities. Statements would be sent to the families each year reporting the balances in these accounts and the size of the accumulation that might be available when the child reached age 18. This might encourage children in low-income families and their parents to view post-secondary education as a viable option while the children were young and enhance school performance and retention. If the child incurred tuition expenses for post-secondary education, the institution could bill the child's account directly for amounts that did not exceed the account balance. Balances that remained in these grub stakes accounts after the child reached 27 years of age would revert to the Treasury or could be left for later use as life-time learning accounts.

Families with positive tax liabilities might be permitted to match, on a fractional basis, deposits made into educational savings accounts.

Educational expenses would not be a permissible use of tax-advantaged retirement IRA balances.

Robert D. Reischauer
The Brookings Institution
(202) 797-6056
May 27, 1997

FAX TRANSMISSION

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To: *Marshall Smith* **Date:** June 5, 1997
Fax #: *401-3095* **Pages:** 9, including this cover sheet.
From: Robert Reischauer (797-6056) and
Lois Rice (797-6117)
Subject: Brown Center on Education Policy Discussion of Tax Proposals for Post-
Secondary Education

Comments:

I thought you might find this interesting.



THE BROOKINGS INSTITUTION

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ECONOMIC STUDIES PROGRAM

Brown Center on Education Policy

**May 28th Discussion
 at The Brookings Institution**

of

Tax Incentives for Post-Secondary Education and Training

LIST OF PARTICIPANTS

David W. Breneman
 Gary Burtless
 William Gale
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 Thomas Kane
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THE BROOKINGS INSTITUTION BROWN CENTER ON EDUCATION POLICY

SUMMARY OF DISCUSSION ON TAX-RELATED EDUCATION PROVISIONS

The May 1997 bipartisan budget agreement reserved about \$35 billion over the fiscal 1998-2002 period for tax policies intended to assist students and their families meet the costs of post-secondary education and training. The Brown Center on Education Policy of the Brookings Institution convened a group of economists and education policy analysts on May 28th to discuss the most effective use of these resources. The discussion focused on the question of how to design tax-related provisions for education to maximize their efficiency, equity and coherence with other federal, state, and institutional aid efforts.

This document summarizes the group's discussion. While there was wide agreement on many issues, no effort was made to achieve unanimity. Therefore, not all of the participants (see attached list) endorse all of the recommendations.

Executive Summary

The group agreed on the following points:

- There should be either a tax credit or a tax deduction for educational expenses, but not both.
- The cumulative benefits of student aid programs and tax policies should be distributed as progressively as possible.¹ To further enhance progressivity in the distribution of tax benefits, the following steps could be taken:
 - Adopt a tax credit rather than a deduction because the tax benefits would be more progressively distributed.
 - Make the size of the tax credit independent of the student's Pell Grant award.
 - Make the tax credit refundable to those whose tax liability was less than the credit. Because of the administrative and other difficulties entailed in refundability, there should be an exploration of ways in which educational institutions might administer the credit for those students with little or no tax liability.

¹ The attached graph shows the distribution by income and by institutional type of Pell Grant, loan subsidies, and tax benefits under the President's initial proposals and with a tax credit only, both nonrefundable and refundable.

- If a deduction is granted for interest on student loans, target the tax benefit on borrowers whose interest payments exceed a certain percentage of their income.
- While efforts to encourage more savings are laudable and important, provisions which reduce the burden of current tuition expenses either through a tax credit or a deduction could reduce overall incentives to save for future college expenses.
- None of the savings proposals currently under active consideration are likely to significantly increase savings for college.
 - The use of existing IRAs—without penalty—to meet college expenses could lead to reducing overall savings as well as depriving individuals of much needed assets for their retirement.
 - Further extending tax benefits for state prepaid tuition plans could lead to higher tuitions in the future and provide disproportionate benefits to high-income families who can afford to invest in such plans.
- Possibly the most important step policymakers could take to encourage more savings for college would be to remove or lessen the disincentives which currently exist in calculating family contributions in student aid formulas. At a minimum, the formulas should treat students' assets similarly to the treatment accorded to parental assets.

Background

It was the consensus of the group that early childhood, elementary, and secondary education, rather than post-secondary education are the areas most in need of additional investment. The group also would prefer that any new federal resources for higher education focus on existing student aid programs rather than on new tax policies. Given the parameters of the current debate, however, the group limited its discussion to tax initiatives for post-secondary education.

The federal government currently spends about \$12 billion a year on student aid programs through its grant, loan, and work-study programs and provides about \$4 billion a year in tax expenditures for post-secondary students and institutions. The goals of the student aid programs have been to stimulate greater access, allow increased choice, and improve retention in post-secondary education and training, particularly for low and moderate income students. The group agreed that these were the appropriate objectives, as well, for any tax-based proposals. In addition, the group identified two other criteria that it thought should guide the formulation of any new tax-based education policies.

- *First, any new tax provisions for education should be relatively easy for the IRS to administer and enforce and should not impose undue burdens on students, their families, or post-secondary institutions.*

- *Second, the cumulative effect of federal student aid spending and tax benefits for post-secondary education should be distributed in a progressive fashion, a condition which some of the current proposals do not meet.*

Both of these criteria require a much greater degree of coordination between student aid programs and tax policies than has historically been the case.

In theory, the group felt it would be desirable to use federal post-secondary assistance to encourage higher quality and better performance throughout the educational system. Some supported the President's effort to use the tax code to accomplish these goals, although they would have focused on a student's academic performance in high school rather than in college. Others felt that the administrative difficulties entailed in monitoring educational performance and quality at either educational level outweighed the potential benefits of using the tax code for this purpose. The group agreed, however, that it would be desirable to increase the performance-based component of the student-aid programs and any improvement along these lines should be carried over to the tax provisions as well.

The discussion of alternative policies covered three types of tax proposals: 1) tax benefits for current education expenditures, 2) the tax treatment of student loan interest, and 3) tax incentives for savings. The group did not discuss, in any detail, the question of extending employer-paid tax benefits for training or retraining.

Tax Benefits for Current Education Expenditures

The group concluded that there should *not* be both a credit and a deduction for educational expenses. It is both bad tax and bad public policy to give taxpayers a choice of the tax breaks they may take for the same activity. Having both a credit and a deduction would add complexity to the tax code, confuse students and their parents, and encourage even more gaming of dependency status than now occurs.

A majority of the group consider a credit preferable to a deduction, primarily because it would be easier to distribute benefits progressively under a credit than under a deduction. Those who preferred a deduction over a credit argued that a deduction would make the tax treatment of post-secondary tuition expenses more consistent with the tax treatment of other human capital expenditures.

The group then discussed the desirable features of a tuition tax credit, including:

Amount of Tuition Covered. The group agreed that there should be a maximum credit which covered a portion of tuition rather than on a dollar-for-dollar basis, as proposed in the President's Hope Scholarship. There was disagreement, however, over what percentage of tuition should be covered by the credit. A credit which covers a high percentage of tuition--say 80 percent--provides a greater degree of access to the lowest

priced institutions than would a smaller percentage--say 30 or 40 percent--as long as a limit in the range of \$1000 to \$2000 is placed on the credit's maximum size. Much larger limits on the amount of the credit would increase the proportion of tax benefits going to students attending higher-priced private institutions. The larger the percentage of tuition covered by the credit, a higher proportion of tax benefits will go to students attending public institutions. But the smaller the percentage of tuition covered by the credit, the more resistance institutions would face if they try to raise tuitions in response to the credit. A smaller percentage of tuition also has the advantage of differentiating more among students who face differing costs of attendance.

Offsets for Grant Aid. The group agreed that when calculating the size of the credit, grant aid should not be offset against the amount of the credit as proposed in the President's Hope Scholarship. At a minimum, a student's Pell Grant should be subtracted from tuition as was proposed in the President's tax deduction to enhance the progressivity of the credit. But benefits would be distributed even more progressively if the tax credit calculation recognized that Pell Grants provide for both tuition and living expenses. This could be done in one of two ways:

- One approach would be to apply the credit percentage to the tuition paid by the student less any grant aid or tuition discount provided by the institution itself or the state.
- A second approach would be to apply the credit percentage against a combination of tuition *plus* a standard amount for living expenses (which is the practice currently used in calculating Pell Grant awards). In other words, Pell grants, other federal aid, state and institutional grants and discounts would be subtracted from a student's total costs of attendance before applying the credit percentage. Under this approach, however, the credit still would be limited to the amount of tuition paid by the student so that no student would be compensated for more than tuition expenses.

Refundability. The group agreed that the most important provision for improving the progressivity of the distribution of tax benefits would be to make the tax credit refundable to students or families who have no tax liability or have liabilities less than the credit. The group recognized, however, that there would be additional administrative complications and potential for abuse if cash payments were made to students on their behalf. The group, therefore, thought it worthwhile to explore ways in which any refundable portion of the credit could be administered by post-secondary institutions. For example, institutions might make a loan for tuition to such students and this loan would be canceled in the following year when the IRS sent to the school the refundable portion of the credit.

Coverage. It was the consensus of the group that, if the President's tax deduction proposal were dropped, the credit should be available for four years of undergraduate education. A minority of the group felt the credit should be available to less-than-half-time students, particularly full-time workers who are paying tuition for courses that are job-related. This

would complement existing provisions for employer-paid tuition benefits. A majority of the group did not think the tax credit should be extended to graduate studies.

Income Limits: The majority of the group believed that the tax credit should have a standard income cutoff which reflects the national distribution of income. Some suggested a level equal to one and one-half times the median income of families with at least one dependent between the ages of 15 and 17, or approximately \$70,000.

Maximum Benefit: The group did not directly address the size of the maximum credit, other than to recognize that, like the income phase-out and cutoffs, it would be a function of budgetary constraints.

Tax Treatment of Student Loan Interest

The group recognized that there is considerable interest in Congress and among educational associations to allow student and parent borrowers to deduct interest on college loans from their taxable income, irrespective of whether the taxpayer itemizes deductions. The group did not believe that this would be good public policy. The distribution of benefits from such a provision would be regressive and could encourage an even greater utilization of loans as a means of paying for college expenses, even among those who are fully capable of meeting those costs.

If policymakers feel some tax relief for those with educational loans is necessary, the group thought that relief should be limited to those whose interest burdens were large relative to their incomes. This could be accomplished through a tax credit equal to a portion of the interest payments made on student loans each year that exceeded some percent (for example, 6 percent) of a former student's adjusted gross income for that year. Such a credit would provide benefits largely to those with relatively large loan balances and who earn modest incomes after completing their schooling. The majority of the group felt that this credit should not be available to parents who borrow in the federal loan programs. Of importance also would be the design of the provision so that it does not encourage excessive borrowing.

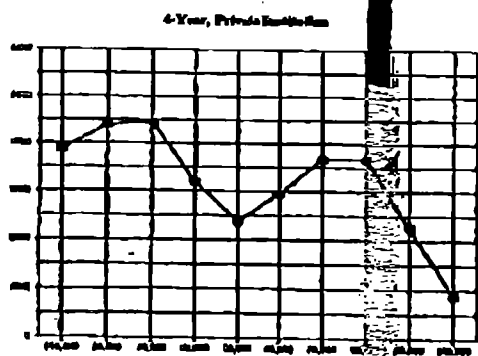
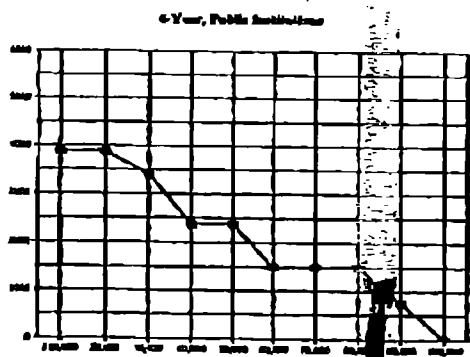
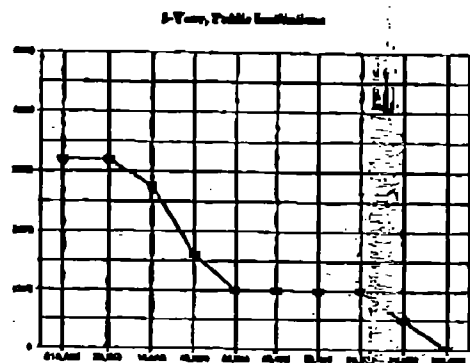
Incentives for College Savings

The group was critical and unenthusiastic about the many proposals suggested to foster greater savings for college. Encouraging greater private saving for post-secondary education costs and other purposes is important, but the group felt that the primary effect of the current proposals would be to encourage families to shift existing assets into designated educational accounts. Thus, the increase in overall savings would be small relative to the size of the revenue loss to the Treasury.

Moreover, the group emphasized that the adoption of any tax credit or deduction for current educational expenses is likely to reduce the incentive for people to save.

Pell Grants, Loan Subsidies, and Various Tax Plans for Post-Secondary Education: Distribution by Family Income, for Freshmen

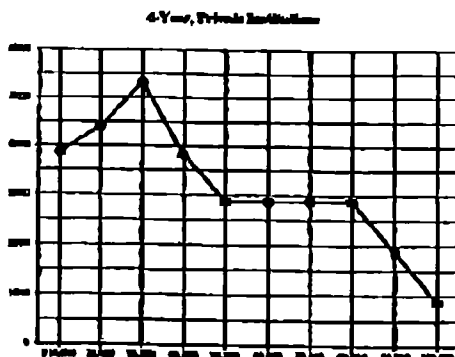
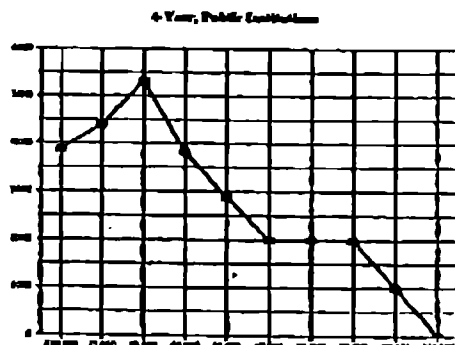
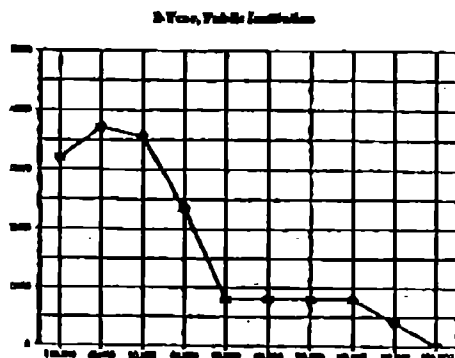
Clinton Proposal



Pell Grant maximum of \$3,000

Non-Refundable Tax Credits offset by Pell Grants or Deductions

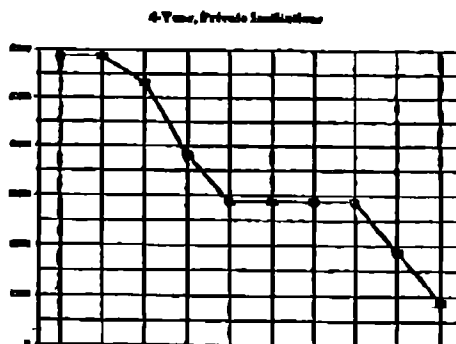
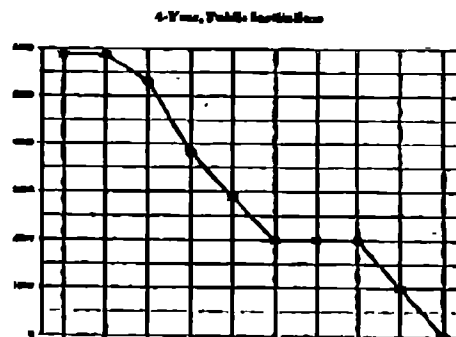
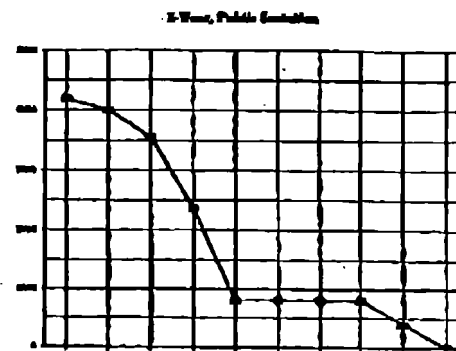
Non-Refundable Tuition Credits



Pell Grant maximum of \$3,000

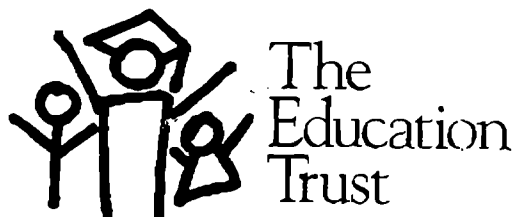
Non-Refundable, 80% Tuition Tax Credits, maximum of \$2,000, not offset by Pell Grants

Refundable Tuition Credits



Pell Grant maximum of \$3,000

Refundable, 80% Tuition Tax Credits, maximum of \$2,000, not offset by Pell Grants



June 16, 1997

The Honorable William Roth
Chairman
Senate Finance Committee
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Roth,

The \$35 billion in new student aid under the jurisdiction of the Finance Committee provides you and the members of the Senate Finance Committee with an historic opportunity to narrow the college-going gap that separates low-income Americans from others. You can expand college access by providing struggling families with the help that they need to send their children to college. And you can provide significant new assistance to the middle class. All this can be accomplished within the \$35 billion available for higher education by 1) making the Hope Tax Credit fully refundable and 2) eliminating the \$10,000 tuition deduction contained in the President's higher education proposals.

For millions of Americans, a college education has been the surest bridge to self-sufficiency and a secure place in the labor force. At the end of the 20th century, a college education is more important than it has ever been. College graduates earn double the wages that high school graduates do, and they are twice as likely to be employed as are high school graduates. But BA degrees—and the benefits and opportunities that they afford—are moving beyond reach of many families, especially those at the lower end of the income range.

In 1980, the cost of a year of attendance at a public four year college equaled 12.5% of the annual income of the lowest income families; by 1995 families in the lowest income quintile would have to marshal a staggering 25% of their income to pay for one year at a public four-year college. Meanwhile, the percentage of annual income required to meet a year's cost at a four-year public college rose from 1.6% to just 2.4% for the wealthiest 20% of Americans between 1980 and 1995.

These cost increases have taken place in the context of a wide and stubborn gap between the college participation rates of the affluent and the poor. A young person raised in a household with income in the top 20% is six times as likely to earn a BA by age 28 as is a young person raised in a family with income in the bottom 20%.

The proposed non-refundable tax credit and a large tax deduction for tuition simply will not close the gap because their benefits will not reach those who most need help—those with the lowest incomes. These families have too little income to have any tax liability or too little federal tax liability to claim the full value of the credit.

Nationally, 30% of all families with children have too little income to get any assistance from a non-refundable tax credit and 42% of all families with children have too little federal tax liability to claim the full \$1,500. By providing little or no help to families at the lower end of the income range and generous benefits to families at the top of the income range—through the \$10,000 deduction—the President's proposal threatens to widen, not narrow, the college going gap.

The Honorable William Roth
June 16, 1997
Page 2

A fully refundable Hope Scholarship could help narrow the gap and open the door to college to millions of young people who would otherwise be locked out of the mainstream of our society. Clearly, a fully refundable Hope Scholarship would cost more than the non-refundable Hope contained in the President's proposal. To accommodate a fully refundable Hope within the agreed upon \$35 billion, we urge you to strike the \$10,000 tuition deduction from the President's package and replaced it with a less costly, but far more important, deduction for the interest on student loans.

Together, a fully refundable Hope Scholarship and a deduction for interest on student loans form the core of a package that can provide benefits to both low- and middle- income families—and can begin to narrow the college participation gap. Together they cost less than the full \$35 billion allocated to the Finance Committee, leaving funds available for other initiatives, including: tax-free educational savings accounts, expansion and permanent extension of tax exemptions for employer-provided education assistance, and tax exemption for work study income, scholarships, and fellowships.

Our organizations look forward to working with you and other members of the Finance Committee to craft legislation that assists the middle class, while responsibly delivering benefits to those who are struggling to reach it.

Acorn
Center for Law and Education
Education Trust
Lawyers Committee for Civil Rights Under the Law
Mexican American Legal Defense and Education Fund (MALDEF)
MANA
National Association of Social Workers
National Consumer Law Center, Higher Education and Training Access Project
National Black Caucus of State Legislators
National Council of Churches
National Council of La Raza
National Council of Negro Women
National Puerto Rican Coalition
National Urban League
Rainbow/ Push Coalition
U.S. Public Interest Research Group, Higher Education Project
U.S. Student Association

cc: Secretary Robert Rubin, U.S. Department of Treasury
Secretary Richard Riley, U.S. Department of Education
Members of the Senate Finance Committee

JUN 11 1997 08:55AM TIAA-CREF

NO. 551

P. 1

IMPACT OF REVOCATION OF 30-YEAR-OLD TAX EXEMPTION FOR PENSIONS PROVIDED BY TEACHERS INSURANCE AND ANNUITY ASSOCIATION - COLLEGE RETIREMENT EQUITY FUND (TIAA-CREF)

- The Archer Mark Press Release describes Sec. 1055 of the Archer Mark as the "repeal of 1986 rifle-shot tax relief granted to certain insurance companies..." In fact, the "tax relief" granted to TIAA goes back to 1918! [CREF was created in 1952 to provide variable benefits and has been tax-exempt ever since.]
- In 1986, Congress decided to make "commercial insurance" operations conducted by tax-exempt organizations, subject to tax by enacting sec. 501(m) of the IRC. As a result of sec. 501(m), TIAA's nonpension insurance business is taxable.
- At the same time, Congress enacted a provision [Sec. 1012(C)(4)(b) of the Tax Reform Act of 1986] that would specifically preserve the longstanding exemption for TIAA-CREF's pension business. This provision reflected Congress's understanding of TIAA-CREF's unique role as the retirement plan for the nation's universities, colleges and other educational and research institutions.
- Sec. 1055 of the Archer Mark revokes TIAA-CREF's tax exempt status as of 1/1/96.
- TIAA-CREF has been tax-exempt for almost 80 years and it is patently unfair to revoke this historic status.
- Any change to the tax status of a pension system which supports 2 million participants and 6,000 educational and research institutions should be carefully thought through, with full hearings and analysis.
- Retirement savings are now tax-exempt for all U.S. workers. To impose an indiscriminate tax on the retirement plan for teachers is not only unfair but also conflicts with other provisions in the Archer Mark which recognize the need to encourage both education and retirement savings.
- Since the late teens the Treasury has confirmed TIAA-CREF's tax-exempt status because its character dictates that it exclusively "aid and support" nonprofit, charitable educational and research organizations, including state supported colleges and universities, on the most low cost, cost efficient basis possible.
- Sec. 1055 would affect payment of benefits to TIAA-CREF's policyholders significantly. The Ways and Means Committee estimates the proposal would rise \$1.5 billion over the next 10 years, reducing benefits by at least 3 to 5%, and perhaps more.



Teachers Insurance and Annuity Association
College Retirement Equities Fund

730 Third Avenue
New York, NY 10017-3206

P. 2
John H. Biggs
Chairman and
Chief Executive Officer
212 916-4280

June 10, 1997

The Honorable
Daniel Patrick Moynihan
U. S. Senate
464 Russell Office Building
Washington, D. C. 20510

Dear Senator Moynihan:

It has just come to my attention that a provision in the tax relief proposal drafted by Representative Bill Archer, Chairman of the House Ways and Means Committee, would repeal TIAA-CREF's tax-exempt status, held since the company was founded in 1918. In the 1986 Tax Act, Congress imposed a tax on TIAA-CREF's non-pension business and continued the exemption for its pension business, since all pension plans are tax-favored.

I am shocked that the Congress would reconsider now this careful and deliberate decision reached in 1986. As you well know, TIAA-CREF constitutes the principal retirement system for most of the colleges and universities--public and private, undergraduate as well as graduate--in the United States. A repeal would adversely affect the pensions of nearly two million teachers, researchers, educators, and their staff across the country.

Retirement savings are now tax-exempt for all workers. To impose an indiscriminate tax only on the retirement plan for teachers is unfair. Furthermore, such punitive action against the educational community is diametrically opposed to current bipartisan efforts to improve educational opportunities for our nation's youth. It is simply bad public policy to discourage commitment to the teaching profession.

Your leadership and commitment in 1986 were instrumental in protecting this tax-exempt status, which is of fundamental importance to the participants who expect to receive fully adequate pensions from TIAA-CREF in the future.

I earnestly request an opportunity to speak with you about this highly inappropriate and punitive proposal at your earliest possible convenience. Please let me know if a meeting in the very near future is a possibility. I look forward to hearing from you.

With best wishes and thanks for your attention.

Sincerely,

A handwritten signature in dark ink, appearing to read "John H. Biggs".
John H. Biggs

**SEC. 1055. TERMINATION OF CERTAIN EXCEPTIONS FROM RULES
RELATING TO EXEMPT ORGANIZATIONS WHICH PROVIDE COMMERCIAL-TYPE
INSURANCE.**

(a) **In General.**--Subparagraphs (A) and (B) of section 1012(e)(4) of the Tax Reform Act of 1986 shall not apply to any taxable year beginning after December 31, 1997.

(b) **Special Rules.**--In the case of an organization to which section 501(m) of the Internal Revenue Code of 1986 applies solely by reason of the amendment made by subsection (a)--

(1) no adjustment shall be made under section 481 (or any other provision) of such Code on account of a change in its method of accounting for its first taxable year beginning after December 31, 1997, and

(2) for purposes of determining gain or loss, the adjusted basis of any asset held on the 1st day of such taxable year shall be treated as equal to its fair market value as of such day.

(c) **Reserve Wearing after June 8, 1997.**--Any reserve wearing after June 8, 1997, by an organization described in subsection (b) shall be treated as occurring in such organizations 1st taxable year beginning after December 31, 1997.

(d) **Regulations.**--The Secretary of the Treasury or his delegate may prescribe rules for providing proper adjustments for organizations described in subsection (b) with respect to short taxable years which begin during 1998 by reason of section 243 of the Internal Revenue Code of 1986.

5. Repeal grandfather rule with respect to pension business of certain insurers

Present Law

Present law provides that an organization described in sections 501(c)(3) or (4) of the Code is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance. When this rule was enacted in 1986, certain treatment (described below) applied to Blue Cross and Blue Shield organizations providing health insurance that (1) were in existence on August 16, 1986; (2) were determined at any time to be tax-exempt under a determination that had not been revoked; and (3) were tax-exempt for the last taxable year beginning before January 1, 1987 (when the present-law rule became effective), provided that no material change occurred in the structure or operations of the organizations after August 16, 1986, and before the close of 1986 or any subsequent taxable year.

The treatment applicable to such organizations, which became taxable organizations under the provision, is as follows. A special deduction applies with respect to health business equal to 25 percent of the claims and expenses incurred during the taxable year less the adjusted surplus at the beginning of the year. An exception is provided for such organizations from the application of the 20-percent reduction in the deduction for increases in unearned premiums that applies generally to property and casualty insurance companies. A fresh start was provided with respect to changes in accounting methods resulting from the change from tax-exempt to taxable status. Thus, no adjustment was made under section 481 on account of an accounting method change. Such an organization was required to compute its ending 1986 loss reserves without artificial changes that would reduce 1987 income. Thus, any reserve weakening after August 16, 1986 was treated as occurring in the organization's first taxable year beginning after December 31, 1986. The basis of such an organization's assets was deemed to be equal to the amount of the assets' fair market value on the first day of the organization's taxable year beginning after December 31, 1986, for purposes of determining gain or loss (but not for determining depreciation or for other purposes).

Grandfather rules were provided in the 1986 Act relating to the provision. It was provided that the provision does not apply to that portion of the business of the Teachers Insurance Annuity Association-College Retirement Equities Fund which is attributable to pension business, nor does the provision apply with respect to that portion of the business of Mutual of America which is attributable to pension business. Pension business means the administration of any plan described in section 401(a) of the Code which includes a trust exempt from tax under section 501(a), and plan under which amounts are contributed by an individual's employer for an annuity contract described in section 403(b) of the Code, any individual retirement plan described in section 408 of the Code, and any eligible deferred compensation plan to which section 457(a) of the Code applies.

Description of Proposal

The proposal would repeal the grandfather rules applicable to that portion of the business of the Teachers Insurance Annuity Association-College Retirement Equities Fund which is attributable to pension business and to that portion of the business of Mutual of America which is attributable to pension business. The Teachers Insurance Annuity Association and College Retirement Equities Fund and Mutual of America would be treated for Federal tax purposes as stock life insurance companies. A fresh start would be provided with respect to changes in accounting methods resulting from the change from tax-exempt to taxable status. Thus, no adjustment would be made under section 481 on account of an accounting method change. The Teachers Insurance Annuity Association and College Retirement Equities Fund and Mutual of America would be required to compute ending 1997 loss reserves without artificial changes that would reduce 1998 income. Thus, any reserve weakening after June 8, 1997, would be treated as occurring in the organization's first taxable year beginning after December 31, 1997. The basis of assets of Teachers Insurance Annuity Association and College Retirement Equities Fund and Mutual of America would be deemed to be equal to the amount of the assets' fair market value on the first day of the organization's taxable year beginning after December 31, 1997, for purposes of determining gain or loss (but not for determining depreciation or for other purposes).

Effective Date

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

America would be deemed to be equal to the amount of the assets' fair market value on the first day of the organization's taxable year beginning after December 31, 1997, for purposes of determining gain or loss (but not for determining depreciation or for other purposes).

Effective Date

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

A Comparison of HOPE Scholarship Programs

Question: Which students are eligible to participate in the *Georgia HOPE Scholarship* program and how does this compare to the *Clinton-Gore* plan?

Answer: Both plans have several common features. For example, students must not have been convicted of a drug-related offense. Also, the value of each scholarship is based on net tuition paid. However, there are a number of important differences:

	CLINTON-GORE	GEORGIA
Academic requirements	None	High school "B" average; cumulative 3.0 GPA in college
Eligible institutions	Two- and four-year colleges, universities, and for-profit trade and technical schools	Georgia public and private (not- for-profit) two- and four-year colleges and universities
Eligible students	U.S. taxpayer or taxpayer's dependent Enrolled, or accepted for enrollment, at an eligible institution	Georgia resident Public institutions: 1993 or later high school graduate Private institutions: 1996 or later high school graduate
Attendance intensity	At least half-time	Public institutions: all students, including less than half-time Private institutions: full-time
Scholarship amount	Up to \$1,500	Public institutions: tuition and fees plus a \$100/quarter book allowance (\$50 for half-time) Private institutions: \$3,000/year
Scholarship term	Two years	Public institutions: until completion of BA/BS degree Private institutions: four years
Income limits	\$70,000/\$100,000 (single or head of household/married)	None
Net tuition paid	Tuition and fees less all nontaxable grants	Tuition and fees less Federal grants

**Estimated 1997-98 Tuition and Fees Required at
Public 2-Year Institutions**

Percentage of Students Paying

State	Percent with Tuition \$1,000 or Less	Percent with Tuition \$1,200 or Less	Percent with Tuition \$1,400 or Less	Percent with Tuition \$1,500 or Less	Percent with Tuition \$1,501 or More
Alabama	45%	49%	66%	80%	20%
Alaska	0%	0%	0%	0%	100%
Arizona	100%	100%	100%	100%	0%
Arkansas	72%	90%	98%	100%	0%
California	98%	98%	100%	100%	0%
Colorado	16%	24%	37%	48%	52%
Connecticut	0%	0%	0%	0%	100%
Delaware	0%	0%	100%	100%	0%
Florida	10%	58%	98%	98%	2%
Georgia	46%	60%	92%	94%	6%
Hawaii	100%	100%	100%	100%	0%
Idaho	0%	100%	100%	100%	0%
Illinois	2%	17%	48%	86%	14%
Indiana	0%	0%	0%	0%	100%
Iowa	0%	0%	0%	0%	100%
Kansas	9%	16%	94%	100%	0%
Kentucky	12%	85%	90%	90%	10%
Louisiana	52%	68%	100%	100%	0%
Maine	0%	0%	0%	0%	100%
Maryland	0%	0%	0%	0%	100%
Massachusetts	0%	0%	0%	0%	100%
Michigan	0%	0%	12%	20%	80%
Minnesota	0%	0%	0%	0%	100%
Mississippi	49%	100%	100%	100%	0%
Missouri	6%	12%	70%	98%	2%
Montana	0%	0%	44%	60%	40%
Nebraska	0%	40%	99%	99%	1%
Nevada	36%	90%	90%	90%	10%
New Hampshire	0%	0%	0%	0%	100%
New Jersey	0%	0%	0%	0%	100%
New Mexico	99%	99%	99%	99%	1%
New York	0%	0%	0%	0%	100%
North Carolina	100%	100%	100%	100%	0%
North Dakota	0%	0%	17%	17%	83%
Ohio	0%	0%	0%	0%	100%
Oklahoma	14%	56%	80%	80%	20%
Oregon	0%	2%	45%	55%	45%
Pennsylvania	0%	1%	1%	7%	93%
Rhode Island	0%	0%	0%	0%	100%
South Carolina	24%	88%	89%	89%	11%
South Dakota	0%	0%	0%	0%	100%
Tennessee	10%	100%	100%	100%	0%
Texas	81%	92%	93%	94%	6%
Utah	0%	2%	20%	34%	66%
Vermont	0%	0%	0%	0%	100%
Virginia	0%	0%	0%	0%	100%
Washington	2%	2%	8%	60%	40%
West Virginia	2%	42%	42%	44%	56%
Wisconsin	0%	0%	0%	0%	100%
Wyoming	29%	100%	100%	100%	0%
Percent Total	35%	47%	59%	66%	34%
Average Tuition	\$556	\$697	\$822	\$887	\$2,067
Total Average Tuition	\$1,288				

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The College Board

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① articles on pre-paid

② College Savings Plans Network

by Michael A. Olivas

Prepaid Tuition Plans Come of Age

Problems and Prospects

*The success
of prepaid
tuition plans
may prove
to be their
Trojan Horse,
says
the author.*

PREPAID postsecondary tuition plans, which are operational in a dozen states, work on a very simple premise: Parents or grandparents deposit (either as a lump sum or as monthly payments) an amount that guarantees sufficient funds to pay tuition and fees for a student at a specified time in the future. Thus, if, in my home state of Texas, 1996 tuition at public colleges is \$10,000 for four years, that \$10,000 (plus a small fee) invested today in our prepaid tuition plan, the Texas Tomorrow Fund, will be guaranteed to cover my newborn daughter's four years of tuition and fees in 2014—when she graduates from high school. The state can guarantee the return on such a contract by virtue of pooled assets and careful actuarial practices.

At one time, especially during the pendency of the complex litigation over the Michigan and Kentucky funds' tax status, I was concerned, like many other observers, with the viability of the programs. However, I no longer believe this to be a problem. Certainly federal tax law is fluid, but I believe that even under the most negative tax determination (i.e., in the case where the program is *not* tax exempt) a state program could still maintain itself by amortizing the tax burden across all contracts. This frees me to be in favor of such plans, but constructively critical of their details.

I now fear the programs' likelihood of success, not their possible failure. My concerns fall in three primary areas: equity, institutional implications, and legislative implications.

Equity

The bottom line for supporting prepaid tuition programs is that they provide an investment vehicle for parents, grandparents, and others that guarantees a return on their investment sufficient to pay for a specific amount of tuition in years to come. By pooling the funds and gaining a certain market leverage, a well-run fund can get a better return on the money than individual investors. Furthermore, these programs can anticipate future tuition levels and predict with relative certainty how much has to be paid out at a certain time in the future. Thus, if run

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Prepaid Tuition Plans Come of Age

properly, they almost cannot lose. Program costs are either included as a cost of doing business—as part of the long-term “float”—or as a premium, for example, a set fee or sliding percentage paid by the purchaser. Unless bond markets crash or there is a cataclysmic occurrence such as the Orange County default, actuaries can predict the cash flow, program participation ratios, and other technical details.

I predict Texans will participate in record numbers in the Texas Tomorrow Fund, far surpassing Floridians, who support the country's premier program. But it is very likely to be wealthy and upper-middle-class families who will profit from this venture, as has been seen in other states. For example, Michigan sold its first contract in 1988. In 1990, partially in reaction to this particular criticism, the Michigan Education Trust (MET) board changed its way of selling contracts to allow purchasers to spread the payments over a period of time on an installment plan. It was anticipated that this would permit families with lower incomes to participate, especially since the size of monthly payments is often more relevant to low-income consumers than is the total obligation.

The availability of a monthly payment option (MPO) reduced the “skewedness” of the original MET purchaser profile, but not by a substantial margin. In 1990, the richest two-fifths of the Michigan population with children had purchased 61 percent of the MPO contracts. Figures for Florida suggest that purchasers in that state were also among its more advantaged citizens. This imbalance, combined with the original state investment to start the program, is a remarkable, and remarkably regressive, redistribution of state resources to the relatively wealthy. Any bailout of a troubled plan would

come from the state's general revenues—requiring all Texans to pay for the advantaged purchasers' continued advantage. This happened in Ohio recently, where general state revenues of \$1 million were used to reduce the price of the plan tuition units, which were felt to be overpriced.

Paradoxically, the clear indication of state investment, willingness to use a state's full faith and credit, and incorporation of general revenues into the program are the signposts that the IRS and judges will look for in determining whether a prepaid tuition fund is tax exempt. If all the program participants share proportionately in a loss—for example, from bad investments or another shortfall, as happened in Kentucky's Educational Savings Plan Trust—the plan may be seen as a “trust,” a pooled arrangement that is not tax exempt. However, on equity grounds, these programs should be constituted so that the taxpayers will contribute very few general fund dollars to either the start-up or any bailout provisions. It seems very unfair to tax those who cannot afford or who are unable to attend college so that their more advantaged neighbors can do so more easily. I do not believe the poor should have to help provide wealthier parents with an additional savings vehicle for their children to go to college and more easily consume the considerable state investment already in place. This is particularly true at a time when the federal government is in a pell-mell rush to create similar tax subsidies, which are sure to be regressive.

Institutional Implications

The implications for institutions must also be considered. I fear that at some point institutional behavior will change, so that admission might be predicated upon ability to pay. Let me paint a picture, borrowing from what has taken place in Florida, whose demographics resemble those of Texas. Florida has sold nearly 250,000 contracts, and soon will have 300,000 contracts in play, spread over approximately 20 years; this includes a range of children from the newborn to college seniors using their paid-for benefits.

Let us assume that 10,000 plan-funded freshmen are competing for spots in Texas institutions, and 500 to 1,000 want to attend Rice, Trinity, Baylor, and Southwestern,

Prepaid tuition plans, like the Texas Tomorrow Fund, must carefully balance tuition rates and investment rates. How states maintain this equilibrium will determine the long-term appeal of such plans.



the most elite private institutions in the state. This leaves 9,000 to 9,500 funded students applying to the University of Texas (UT), Texas A&M, Texas Tech, the University of Houston, and the other public and private two- and four-year colleges. The admission pressure upon the University of Texas and Texas A&M, already evident as they scale back to more manageable size, will become enormous. Now, suppose you are the admission director of UT considering two equally qualified students. One is fully funded and the other will require a combination of state, federal, and scarce institutional funding. Who are you going to admit? Mind you, being born into a family that saves for college is no reflection of a student's personal character: indeed, growing up successfully in a family *without* financial resources has often been seen as evidence of the qualities we seek in a candidate.

Moreover, I do not exaggerate the admission pressures. Because of Texas's booming economy and other factors, current enrollment has slackened somewhat, and in our strictly enrollment-driven system, there is some slight current underutilization of higher education, some "excess capacity." The Texas Higher Education Coordinating Board data conservatively predict, however, that in 15 short years, there will be 180,000 more students

clamoring for higher education in Texas. In addition, if minority achievement increases as much as we hope, we could have 400,000 more students by 2010. So, let's say we split the difference: By 2010 we will have 290,000 more students than we do today. This is nine *additional* Universities of Houston. Moreover, a prepaid tuition plan will stimulate savings and likely stimulate college attendance. Even if the savings go to substantially the same students who would have enrolled without a Texas Tomorrow Fund, attendance is bound to increase—in fact, the fund is *designed* to stimulate college attendance and college investment. As a result, there will probably be a greater need for college seats in Texas.

Thus, I believe my admonitions about the merging of admission and ability to pay are conservative, and the pressures at the institutional level will be irresistible. While the programs do not guarantee admission to any student, it will certainly create higher expectations about admissibility on the part of all parents. Those whose children are not admitted are likely to become an angry cohort of taxpayers, and no warning label or disclaimer about admission standards will serve to placate this group.

(continued on page 30)



Prepaid Tuition Plans

(continued from page 5)

Legislative Implications

This leads to my third major concern, the legislative fallout from a successful prepaid tuition plan. After 10 years of a successful, widely advertised plan, there will be a very large accumulated pool of money, completely dedicated to higher education. For example, in 1993 alone, Florida accumulated a pooled fund of \$340 million; even Michigan, with its adverse tax ruling and suspended sales for reorganization, received over \$500 million in one year. My question (or fear) is: Will a state legislature continue to appropriate general revenues for an enterprise that has so many potential guaranteed-paid applicants in the pipeline? What will happen if the answer is to free tuition to rise to market levels? Prepaid tuition plans, actuarially premised upon steady, predictable tuition rates, will find it difficult to maintain their balance if tuition rates exceed investment rates. Any ratcheting effect will doom the careful equilibrium necessary for balancing both ends of the equation.

Where will Texas get the funds to build the nine new University of Houston campus-equivalents in 15 years? State support for higher education in Texas has declined as a portion of overall expenses, and the state historically ranks low in per capita support of postsecondary education. The Texas Tomorrow Fund, instead of being a wonderful device for stimulating parental savings, could become an attractive nuisance—either by dampening legislative support for general institutional appropriations or by driving up tuition rates.

As a corollary concern, the Texas legislation provides virtually no control over fees. A cynic might observe that the Texas legislature has enacted a silent fee system to disguise its political unwillingness to take the heat for raising tuition rates. One good thing to come from this legislation may be a more open consideration of fees, tuition, and residency requirements in Texas. All of these details have real institutional consequences.

In my discussion here, I have tried to show the promise and the pitfalls of prepaid tuition programs. The Trojan Horse here is not likely to be a plan's failure, but its probable success. How Texas and other states handle these issues may say as much to future generations as how they handle adversity. =

Recruiting Minority Students

(continued from page 17)

Multiculturalism and diversity, however, like most of the social gains of the 1960s, have lately been stripped of any sense of struggle on college campuses and elsewhere. These concepts too often translate into saying that all racial and ethnic groups are the same. They are not. We are not. One factor that distinguishes African Americans and Latinos from other ethnic groups is that when we come to the new multicultural center on campus for an open exchange and dialogue, we bring with us our historic



Cultural identities should not separate people from their neighbors.

leadership role as a driving force for social justice and social change in this country.

Our history, particularly that of the African-American community, is one of constant political and social struggle against poverty, racism, and injustice. Our gains have benefited all people, not just African Americans and Latinos, because our struggle has been one for democracy, a fight for participation by all people.

To me and many other admission counselors I have met, supporting minority recruitment was a way to change the world. In the past, affirmative action did not mean one race getting an unfair advantage over other races, as it is frequently seen today. It meant supporting programs that would ultimately help everyone. And there are examples in college admission of gains by people of color that have benefited everyone. Early minority recruitment efforts at private universities brought a greater acceptance for all students. Just behind minority recruitment efforts came the recruitment of students from poor rural farms and the sons and daughters of coal miners and auto workers—whose admission test scores were more comparable to those of blacks and Latinos than to their counterparts in wealthy suburbs.

Many students of color have misinterpreted the phrase *historic leadership role* to mean that they should be the chairperson of every organization or movement they join. No, fulfilling our historic leadership role is much more complex. It is an important part of the history and cultural identity of what it means to be Chicano. It is also a commitment to social change and to improving everyone's welfare. It means going beyond history and knowing our roots. While I am a strong believer in teaching our history and being proud of our heritage, I think that cultural identities that stem from looking back instead of looking forward keep our people separated from their neighbors. Instead, we need to create new social roles that are consistent with human compassion, decency, and democracy, and that

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LIST OF OBJECTIONABLE ITEMS IN CHAIRMAN'S MARK

6/10/97

- The proposal provides indexing for certain capital assets beginning in 2001. The proposals to index certain capital assets and lower the rate of tax on capital gains provide a double benefit to taxpayers, substantially overcompensating them for the effects of inflation. The package would disproportionately benefit the wealthy over lower- and middle-income wage earners. The provision would also have an explosive revenue cost in years after 2007, possibly jeopardizing all our important work on deficit reduction. In addition, the proposal is so enormously complex and difficult to administer that, to quote the New York State Bar Association, indexing is "fundamentally flawed" and would create problems that would "overwhelm taxpayers and the IRS."
- Allowing the \$500 child credit only after application of the earned income tax credit (EITC) is unfair to poor families. This proposal would stack the \$500 child credit after the EITC (the reverse of the stacking order in the President's proposal). If this approach were adopted, families would not be entitled to the \$500 child credit unless they had income tax liability after claiming the EITC, adversely affecting millions of low income families. For example, a family with two children and a \$25,000 income would get nearly \$1,000 less tax relief under the Chairman's proposal than under the Administration's.
- The education package is insufficient and unfair to for lower-income students. The proposal falls nearly \$4 billion short of the agreed goal of \$35 billion in tax cuts for education. Furthermore, as compared to the President's proposals, it directs more benefits toward middle- and upper-income families while reducing the benefits to lower-income families who rely on loans and grants to finance their education.
- The HOPE credit would be cut to 50% of tuition expenses, halving the value of education benefits for millions of students attending community colleges and other low-cost institutions.
- The tuition deduction would be available only if education expenses are paid from certain education savings plans. Because there would be no general tuition deduction and no student loan interest deduction, the proposal offers low-income students and students who must borrow to pay tuition no help beyond the first two years of higher education.
- Tax-free savings offered through new education investment accounts and the opportunities for tax-deferred saving through private prepaid tuition plans are overly generous to upper income families, since they have neither income limits nor contribution limits. This would give high-income taxpayers the incentive to use these vehicles to save tax-free, even if they never intended to use the savings for education expenses.
- The proposal would extend the exclusion for employer-provided education assistance only to the end of 1997, not to the end of 2000 as the President proposed, and would not reinstate the exclusion for graduate study.
- The American Dream Savings Account proposal is not sufficiently targeted. Assuming that the

proposal (like prior Republican proposals) allows contributions to back-loaded IRAs without any income limits, we are concerned that it could result in wealthy people shifting existing savings into tax-preferred investment vehicles, rather than creating new savings. In addition, the limited description of the proposal does not state whether it would expand eligibility for deductible, front-loaded IRAs, which we believe many middle-income taxpayers would prefer over back-loaded IRAs.

- The proposed safe-harbor for independent contractor status may undermine essential worker protections. Assuming the proposal is similar to the independent contractor safe harbor proposal in S. 460 (the Bond bill) or last year's Christensen bill, we are concerned that it could lead to widespread shifting of employees to independent contractor status, resulting in loss of worker protections, particularly if the standard would apply for all tax purposes (thereby directly affecting pension and health coverage) or for wage and hour protections..
- The alternative minimum tax (AMT) provisions are not correctly targeted. We strongly support individual AMT relief. Individual AMT relief is not for the wealthy; it is largely a middle-class relief provision. The bill, however, includes only a small, back-loaded relief provision for individuals. By contrast, the bill contains a provision for corporate AMT relief that loses twice as much revenue over ten years as does the proposal for individual AMT relief (the corporate provision costs \$34 billion over 10 years; the individual provision costs \$15 billion over 10 years). We believe that the corporate AMT relief is both too expensive and unnecessary in the current economic environment.
- The proposal would Impose Federal tax on all commercial activities (including gaming) of Indian tribes or related entities. Under this proposal, Indian tribes would be subject to the unrelated business income tax on all income earned from commercial activities, including gaming activities. Contrary to long-established United States policy, this tax fails to respect the sovereignty of Indian tribes and their special status as domestic dependent nations. This lack of respect for sovereignty is particularly apparent in the difference the proposal would create between tribes and States. The Code long has treated them much the same way because of their similarities as governments. However, under this proposal, States would continue to receive revenue from lotteries, liquor stores and recreational licenses tax free while tribes would be forced to pay tax on the same kinds of revenue. In addition, the proposal would be extremely difficult to administer.
- Provisions proposed by Administration not included in Chairman's mark:
 - No provision to allow a special deduction for certain environmental expenses (Brownfields) is provided.
 - No provision allowing equitable tolling is included.
 - No provision to allow mark-to-market for section 8 housing is included.
 - No expansion of empowerment zones or enterprise communities is provided.
- Additional concerns. The revenue table for the Chairman's Mark Relating to Revenue Reconciliation Provisions is 13 pages long and contains only a summary of the proposals included. Based on these summaries, we expect that we will have policy, revenue, and administrative concerns about a number of other proposals. We are likely to identify additional problems when the full description of the proposals are released.

Treasury materials
6/10/97

DRAFT

**SUMMARY OF
CHAIRMAN ARCHER'S MARK
RELATING TO REVENUE RECONCILIATION PROVISIONS**

The mark contains a net tax cut of \$84.6 billion through 2002, and \$249.7 billion through 2007 (all revenue estimates are JCT scoring). The gross tax cuts are about \$132 billion through 2002 and about \$359 billion through 2007.

CHILD CREDIT AND DEPENDENT CARE CREDIT -- \$71.3 billion through 2002; \$148.3 billion through 2007

- \$500 nonrefundable credit (\$400 in 1998) for children under age 17, phased out beginning at AGI of \$75,000 (\$110,000 for joint returns)
- Index dependent care tax credit expense limit for inflation

EDUCATION TAX INCENTIVES --\$31.0 billion through 2002; \$75.5 billion through 2007

- HOPE scholarship credit with modifications, including
 - Drop B average requirement
 - Credit is 50% of up to \$3000 out-of-pocket tuition expenses
- Tuition tax deduction: in lieu of President's across-the-board \$10,000 tuition tax deduction, includes a \$10,000 deduction for expenses paid through State-sponsored prepaid tuition programs
- Penalty-free withdrawals from all IRAs for undergraduate, post-secondary vocational, and graduate expenses
- Education savings account proposal
 - Permit unlimited contributions to education investment account for child under 18
 - Create private prepaid tuition plans
 - Allow \$10,000 annual (\$40,000 per-student aggregate) deduction for post-secondary expenses paid through either education investment account or private prepaid tuition plan
- Other education incentives, including extension of section 127 exclusion for employer-provided education assistance only through 1997 and only for undergraduates

IRAs -- \$519 million through 2002; \$13.0 billion through 2007

- Create American Dream (back-loaded) IRAs
- Other changes, including penalty-free rollovers and special-purpose withdrawals for first-time home purchase

CAPITAL GAINS -- \$2.7 billion through 2002; \$35.0 billion through 2007

- 20/10 percent rate structure
- Indexing for inflation beginning 2001
- Exclude \$500,000 gain on home sales (\$250,000 singles)
- Corporate capital gains relief (phased-in rate reduction from current 35% to 30% in 2000)
- Other changes, including depreciation recapture for real estate at 26 percent

ALTERNATIVE MINIMUM TAX (AMT) RELIEF -- \$19.2 billion through 2002; \$50.0 through 2007

- Individual AMT relief -- increase current \$45,000 exemption by \$1000 every other year through 2007, index thereafter
- Corporate AMT relief -- initially exempt small corporations, then gradually repeal AMT for all corporations by 2006. This item alone costs \$17.3 billion through 2002; \$33.8 billion through 2007.

ESTATE TAX RELIEF -- \$3.6 billion through 2002; \$20.5 billion through 2007

- Increase unified credit (currently \$600,000) by \$20,000 per year until it eventually reaches \$1 million (in 17 years)
- Liquidity relief for small businesses (somewhat similar to Administration Budget proposals)
- Miscellaneous items, including some simplification measures included in Administration package

EXPIRING PROVISIONS -- \$4.0 billion through 2002; \$4.2 billion through 2007

- 18-month extensions of research tax credit and contributions of appreciated stock to private foundations
- One-year extension of work opportunity tax credit
- Permanent extension of orphan drug credit

DISTRICT OF COLUMBIA TAX INCENTIVES -- \$321 million through 2002; \$571 million through 2007

- Create new Enterprise Zones in District. In addition to current-law EZ benefits:
 - 0% capital gains rate on D.C. Enterprise Zone business property held at least 5 years
 - Reduce 15% income tax bracket to 10% for zone residents

- \$75 million in tax credits for providing equity and loans to certain D.C. businesses

WELFARE-TO-WORK CREDIT -- \$199 million through 2002; \$216 million through 2007

- Similar to Administration proposal, except wage credit is 35% (instead of 50%) on first \$10,000 of wages in first years of employment, increasing to 50% in second year

MISCELLANEOUS PROVISIONS -- \$3.6 billion through 2002; \$7.2 through 2007

Most notable in this long list of items are:

- Independent contractor safe harbor
- Home office deduction liberalization

REVENUE RAISERS -- raise \$47.1 billion through 2002; \$109.2 billion through 2007. Many of these items are derived from Administration Budget proposals. Most notable:

- Extend and modify Airport Trust Fund ticket tax
 - Reduces rate generally while partially converting to user fee by imposing new taxes on flight segments, and increasing various other components of the taxes
- Ethanol subsidies -- phase down and phase out entirely by 2001
- Indian tribes -- impose income tax on all commercial activities (not just gaming)
- Repeal exemption for TIAA/CREF (retirement fund for teachers)

SIMPLIFICATION -- \$1.7 billion through 2002; \$4.7 billion through 2007

Includes many items from Administration simplification package as well as a number of Member items. Notable additions:

- Permit payment of taxes by credit card
- Increase dollar limit on section 911 exclusion and index for inflation

Major Tax Cut Provisions in the Ways and Means Chairman's Mark (1)

(1998 Income Levels)

Family Economic Income Quintile (2)	Number of Families (millions)	Average Tax Change (\$)	Total Tax Change		Tax Change as a Percent of:	
			Amount (3) (\$M)	Percent Distribution (%)	Current Federal Taxes (4) (%)	Family Economic Income (%)
Lowest (5)	21.6	-17	-357	0.5	-2.84	-0.17
Second	22.2	-76	-1691	2.4	-2.75	-0.31
Third	22.3	-295	-6574	9.2	-4.17	-0.69
Fourth	22.3	-623	-13856	19.5	-4.49	-0.86
Highest	22.3	-2172	-48354	67.9	-5.31	-1.17
Total (5)	111.3	-640	-71191	100.0	-4.90	-0.96
Top 10%	11.1	-3089	-34406	48.3	-5.20	-1.18
Top 5%	5.6	-4577	-25517	35.8	-5.22	-1.21
Top 1%	1.1	-12247	-13741	19.3	-5.29	-1.30

Department of the Treasury
Office of Tax Analysis

June 11, 1997

- (1) This table distributes the estimated change in tax burdens due to the major tax cut proposals in the Ways and Means Chairman's Mark which include the following: i) child and dependent care tax credits, ii) a modified HOPE scholarship tax credit, iii) a deduction for education expenses paid through State-sponsored prepaid tuition programs; iv) education investment accounts and private prepaid tuition programs; v) American Dream IRAs; vi) Capital gains provisions (lower individual and corporate rates, indexing of individual gains, and \$500,000 exclusion for gains on a principal residence); v) individual AMT change and corporate AMT repeal; vi) District of Columbia tax incentives; and vii) safe harbor for independent contractors.
- (2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and under-reported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.
- (3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the American Dream and education accounts, the change is measured as the present value of the tax savings from one year's contributions. The effect of the capital gains provision is based on the level of capital gains realizations under current law.
- (4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.
- (5) Families with negative incomes are excluded from the lowest quintile but included in the total line.

NOTE: Quintiles begin at FEI of: Second \$16,950; Third \$32,563; Fourth \$54,758; Highest \$93,222; Top 10% \$127,373; Top 5% \$170,103; Top 1% \$408,551.

Major Tax Cut Provisions in the Ways and Means Chairman's Mark (1)

(1998 Income Levels)

Family Economic Income Class (2) (000)	Number of Families (millions)	Average Tax Change (\$)	Total Tax Change		Tax Change as a Percent of:	
			Amount (3) (\$M)	Percent Distribution (%)	Current Federal Taxes (4) (%)	Family Economic Income (%)
0 - 15	18.5	-14	-268	0.4	-2.87	-0.17
15 - 30	21.8	-62	-1363	1.9	-2.72	-0.28
30 - 40	12.1	-167	-2014	2.8	-3.24	-0.48
40 - 50	9.7	-333	-3234	4.5	-4.43	-0.74
50 - 60	7.9	-453	-3567	5.0	-4.54	-0.83
60 - 75	9.4	-548	-5159	7.2	-4.30	-0.82
75 - 100	11.7	-837	-9794	13.8	-4.88	-0.97
100 - 200	15.6	-1492	-23269	32.7	-5.37	-1.13
200 & over	3.9	-5663	-22164	31.1	-5.24	-1.23
Total (5)	111.3	-640	-71191	100.0	-4.90	-0.96

Department of the Treasury
Office of Tax Analysis

June 11, 1997

- (1) This table distributes the estimated change in tax burdens due to the major tax cut proposals in the Ways and Means Chairman's Mark which include the following: i) child and dependent care tax credits, ii) a modified HOPE scholarship tax credit, iii) a deduction for education expenses paid through State-sponsored prepaid tuition programs; iv) education investment accounts and private prepaid tuition programs; v) American Dream IRAs; vi) Capital gains provisions (lower individual and corporate rates, indexing of individual gains, and \$500,000 exclusion for gains on a principal residence); v) Individual AMT change and corporate AMT repeal; vi) District of Columbia tax incentives; and vii) safe harbor for independent contractors.
- (2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and under-reported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.
- (3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the American Dream and education accounts, the change is measured as the present value of the tax savings from one year's contributions. The effect of the capital gains provision is based on the level of capital gains realizations under current law.
- (4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.
- (5) Families with negative incomes are included in the total line but not shown separately.

Democrat's Package (1)

(1998 Income Levels)

Family Economic Income Quintile (2)	Number of Families (millions)	Average Tax Change (\$)	Total Tax Change		Tax Change as a Percent of:	
			Amount (3) (\$M)	Percent Distribution (%)	Current Federal Taxes (4) (%)	Family Economic Income (%)
Lowest (5)	21.6	-82	-1779	4.9	-14.16	-0.87
Second	22.2	-263	-5842	16.1	-9.48	-1.07
Third	22.3	-338	-7523	20.7	-4.77	-0.79
Fourth	22.3	-424	-9431	25.9	-3.05	-0.59
Highest	22.3	-520	-11578	31.8	-1.27	-0.28
Total (5)	111.3	-327	-36383	100.0	-2.50	-0.49
Top 10%	11.1	-742	-8268	22.7	-1.25	-0.28
Top 5%	5.6	-1249	-6966	19.1	-1.43	-0.33
Top 1%	1.1	-3966	-4449	12.2	-1.71	-0.42

June 8, 1997

- (1) This table distributes the estimated change in tax burdens due to the tax proposals in the following illustrative baseline tax package:
 - i) Hope Scholarship credit (\$1,100 1998-1999, \$1,200 in 2000, \$1,500 in 2001 indexed beginning in 2002; no B minus rule; and no Federal grant offset) and 20% tuition credit (\$4,000 in 1997 to 2000 and \$7,500 thereafter); ii) Permanent extension of Section 127; iii) \$500 child credit which is refundable against the employee share of payroll taxes (\$250 in 1998, \$300 1999 to 2000, and \$500 in 2001, indexed beginning in 2002); iv) 18% maximum capital gains rate on non-publicly traded assets (\$600,000 lifetime cap (joint), 3 year holding period); v) Allow deductibility on losses on sale of principal residence; vi) \$500,000 exclusion of gains on the sale of principal residence (President's FY1998 Budget proposal); and vii) distressed areas initiative and other tax incentives in the President's FY1998 Budget (equitable tolling, Section 936, and FSC software).
- (2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and under-reported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.
- (3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. The effect of the capital gains proposal is based on the level of capital gains realizations under current law.
- (4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.
- (5) Families with negative incomes are excluded from the lowest quintile but included in the total line.

NOTE: Quintiles begin at FEI of: Second \$16,950; Third \$32,563; Fourth \$54,758; Highest \$93,222; Top 10% \$127,373; Top 5% \$170,103; Top 1% \$408,551.

Democrat's Package (1)

(1998 Income Levels)

Family Economic Income Class (2) (000)	Number of Families (millions)	Average Tax Change (\$)	Total Tax Change		Tax Change as a Percent of:	
			Amount (3) (\$M)	Percent Distribution (%)	Current Federal Taxes (4) (%)	Family Economic Income (%)
0 - 15	18.5	-67	-1238	3.4	-13.27	-0.79
15 - 30	21.8	-246	-5372	14.8	-10.70	-1.11
30 - 40	12.1	-304	-3659	10.1	-5.89	-0.87
40 - 50	9.7	-342	-3323	9.1	-4.55	-0.76
50 - 60	7.9	-408	-3208	8.8	-4.08	-0.74
60 - 75	9.4	-443	-4175	11.5	-3.48	-0.66
75 - 100	11.7	-388	-4537	12.5	-2.26	-0.45
100 - 200	15.6	-273	-4262	11.7	-0.98	-0.21
200 & over	3.9	-1629	-6377	17.5	-1.51	-0.35
Total (5)	111.3	-327	-36383	100.0	-2.50	-0.49

June 8, 1997

- (1) This table distributes the estimated change in tax burdens due to the tax proposals in the following illustrative baseline tax package: i) Hope Scholarship credit (\$1,100 1998-1999, \$1,200 in 2000, \$1,500 in 2001 indexed beginning in 2002; no 8 minus rule; and no Federal grant offset) and 20% tuition credit (\$4,000 in 1997 to 2000 and \$7,500 thereafter); ii) Permanent extension of Section 127; iii) \$500 child credit which is refundable against the employee share of payroll taxes (\$250 in 1998, \$300 1999 to 2000, and \$500 in 2001, indexed beginning in 2002); iv) 18% maximum capital gains rate on non-publicly traded assets (\$600,000 lifetime cap (joint), 3 year holding period); v) Allow deductibility on losses on sale of principal residence; vi) \$500,000 exclusion of gains on the sale of principal residence (President's FY1998 Budget proposal); and vii) distressed areas initiative and other tax incentives in the President's FY1998 Budget (equitable tolling, Section 936, and FSC software).
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- (4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.
- (5) Families with negative incomes are included in the total line but not shown separately.

"Friday" Baseline Tax Package Without Capital Gains Exclusion and Without Raisers (1)

(1998 Income Levels)

Family Economic Income Quintile (2)	Number of Families (millions)	Average Tax Change (\$)	Total Tax Change		Tax Change as a Percent of:	
			Amount (3) (\$M)	Percent Distribution (%)	Current Federal Taxes (4) (%)	Family Economic Income (%)
Lowest (5)	21.6	-114	-2468	6.7	-19.65	-1.20
Second	22.2	-312	-6931	18.9	-11.25	-1.27
Third	22.3	-383	-8512	23.2	-5.40	-0.89
Fourth	22.3	-498	-11072	30.2	-3.59	-0.69
Highest	22.3	-339	-7548	20.6	-0.83	-0.18
Total (5)	111.3	-330	-36684	100.0	-2.52	-0.50
Top 10%	11.1	-313	-3489	9.5	-0.53	-0.12
Top 5%	5.6	-377	-2099	5.7	-0.43	-0.10
Top 1%	1.1	-896	-1005	2.7	-0.39	-0.10

Department of the Treasury
Office of Tax Analysis

June 9, 1997

- (1) This table distributes the estimated change in tax burdens due to the tax proposals in the following illustrative baseline tax package:
- i) Hope Scholarship credit (\$1000 through 1999, \$1,500 in 2000, indexed beginning in 2001; no B minus rule; and no Federal grant offset) and tuition tax deduction (\$5,000 in 1998 and 1999, \$10,000 thereafter); ii) Permanent extension of Section 127; iii) Kidsave credit: a \$500 refundable child credit (\$2,000 earnings test) for children under 18 with an optional maximum \$500 back-loaded IRA for education or retirement; iv) individual AMT reform (includes elimination of personal credits and standard deduction preferences, does not include indexing); v) small business capital gains preferences; vi) \$500,000 exclusion of gains on the sale of principal residence (President's FY1998 Budget proposal); and vii) distressed areas initiatives and other tax incentives in the President's FY1998 Budget (equitable tolling, Section 936, and FSC software).
- (2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and under-reported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.
- (3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the Kidsave proposal, the change is measured as the present value of the tax savings from one year's contributions.
- (4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.
- (5) Families with negative incomes are excluded from the lowest quintile but included in the total line.

NOTE: Quintiles begin at FEI of: Second \$16,950; Third \$32,563; Fourth \$54,758; Highest \$93,222; Top 10% \$127,373; Top 5% \$170,103; Top 1% \$408,551.

"Friday" Baseline Tax Package Without Capital Gains Exclusion and Without Raisers (1)

(1998 Income Levels)

Family Economic Income Class (2) (000)	Number of Families (millions)	Average Tax Change (\$)	Total Tax Change		Tax Change as a Percent of:	
			Amount (3) (\$M)	Percent Distribution (%)	Current Federal Taxes (4) (%)	Family Economic Income (%)
0 - 15	18.5	-94	-1737	4.7	-18.62	-1.11
15 - 30	21.8	-297	-6492	17.7	-12.93	-1.34
30 - 40	12.1	-346	-4171	11.4	-6.71	-1.00
40 - 50	9.7	-387	-3758	10.2	-5.14	-0.86
50 - 60	7.9	-461	-3628	9.9	-4.62	-0.84
60 - 75	9.4	-517	-4871	13.3	-4.06	-0.77
75 - 100	11.7	-469	-5481	14.9	-2.73	-0.54
100 - 200	15.6	-298	-4654	12.7	-1.07	-0.23
200 & over	3.9	-444	-1737	4.7	-0.41	-0.10
Total (5)	111.3	-330	-36684	100.0	-2.52	-0.50

Department of the Treasury
Office of Tax Analysis

June 9, 1997

- (1) This table distributes the estimated change in tax burdens due to the tax proposals in the following illustrative baseline tax package:
 - i) Hope Scholarship credit (\$1000 through 1999, \$1,500 in 2000, indexed beginning in 2001; no B minus rule; and no Federal grant offset) and tuition tax deduction (\$5,000 in 1998 and 1999, \$10,000 thereafter); ii) Permanent extension of Section 127; iii) Kidsave credit: a \$500 refundable child credit (\$2,000 earnings test) for children under 18 with an optional maximum \$500 back-loaded IRA for education or retirement; iv) individual AMT reform (includes elimination of personal credits and standard deduction preferences, does not include indexing); v) small business capital gains preferences; vi) \$500,000 exclusion of gains on the of principal residence (President's FY1998 Budget proposal); and vii) distressed areas initiatives and other tax incentives in the President's FY1998 Budget (equitable tolling, Section 936, and FSC software).
- (2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and under-reported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.
- (3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the Kidsave proposal, the change is measured as the present value of the tax savings from one year's contributions.
- (4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.
- (5) Families with negative incomes are included in the total line but not shown separately.

"Friday" Baseline Tax Package without Raisers (1)

(1998 Income Levels)

Family Economic Income Quintile (2)	Number of Families (millions)	Average Tax Change (\$)	Total Tax Change		Tax Change as a Percent of:	
			Amount (3) (\$M)	Percent Distribution (%)	Current Federal Taxes (4) (%)	Family Economic Income (%)
Lowest (5)	21.6	-122	-2627	5.9	-20.91	-1.28
Second	22.2	-327	-7267	16.3	-11.80	-1.33
Third	22.3	-408	-9075	20.4	-5.75	-0.95
Fourth	22.3	-538	-11963	26.9	-3.87	-0.75
Highest	22.3	-597	-13283	29.9	-1.46	-0.32
Total (5)	111.3	-400	-44453	100.0	-3.06	-0.60
Top 10%	11.1	-771	-8588	19.3	-1.30	-0.29
Top 5%	5.6	-1185	-6604	14.9	-1.35	-0.31
Top 1%	1.1	-3735	-4191	9.4	-1.61	-0.40

Department of the Treasury
Office of Tax Analysis

June 9, 1997

- (1) This table distributes the estimated change in tax burdens due to the tax proposals in the following illustrative baseline tax package: i) Hope Scholarship credit (\$1000 through 1999, \$1,500 in 2000, indexed beginning in 2001; no B minus rule; and no Federal grant offset) and tuition tax deduction (\$5,000 in 1998 and 1999, \$10,000 thereafter); ii) Permanent extension of Section 127; iii) Kidsave credit: a \$500 refundable child credit (\$2,000 earnings test) for children under 18 with an optional maximum \$500 back-loaded IRA for education or retirement; iv) individual AMT reform (includes elimination of personal credits and standard deduction preferences, does not include indexing); v) 40% capital gains exclusion and 24% AMT; vi) small business capital gains preferences; vii) \$500,000 exclusion of gains on the sale of principal residence (President's FY1998 Budget proposal); and viii) distressed areas initiatives and other tax incentives in the President's FY1998 Budget (equitable tolling, Section 936, and FSC software).
- (2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and under-reported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.
- (3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the Kidsave proposal, the change is measured as the present value of the tax savings from one year's contributions. The effect of the capital gains proposal is based on the level of capital gains realizations under current law.
- (4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.
- (5) Families with negative incomes are excluded from the lowest quintile but included in the total line.

NOTE: Quintiles begin at FEI of: Second \$16,950; Third \$32,563; Fourth \$54,758; Highest \$93,222; Top 10% \$127,373; Top 5% \$170,103; Top 1% \$408,551.

"Friday" Baseline Tax Package without Raisers (1)

(1998 Income Levels)

Family Economic Income Class (2) (000)	Number of Families (millions)	Average Tax Change (\$)	Total Tax Change		Tax Change as a Percent of:	
			Amount (3) (\$M)	Percent Distribution (%)	Current Federal Taxes (4) (%)	Family Economic Income (%)
0 - 15	18.5	-101	-1862	4.2	-19.95	-1.19
15 - 30	21.8	-312	-6806	15.3	-13.56	-1.40
30 - 40	12.1	-367	-4420	9.9	-7.11	-1.05
40 - 50	9.7	-413	-4006	9.0	-5.48	-0.92
50 - 60	7.9	-492	-3876	8.7	-4.93	-0.90
60 - 75	9.4	-555	-5223	11.7	-4.35	-0.83
75 - 100	11.7	-515	-6026	13.6	-3.00	-0.59
100 - 200	15.6	-387	-6043	13.6	-1.39	-0.29
200 & over	3.9	-1521	-5953	13.4	-1.41	-0.33
Total (5)	111.3	-400	-44453	100.0	-3.06	-0.60

Department of the Treasury
Office of Tax Analysis

June 9, 1997

- (1) This table distributes the estimated change in tax burdens due to the tax proposals in the following illustrative baseline tax package:
 - i) Hope Scholarship credit (\$1000 through 1999, \$1,500 in 2000, indexed beginning in 2001; no B minus rule; and no Federal grant offset) and tuition tax deduction (\$5,000 in 1998 and 1999, \$10,000 thereafter); ii) Permanent extension of Section 127; iii) Kidsave credit: a \$500 refundable child credit (\$2,000 earnings test) for children under 18 with an optional maximum \$500 back-loaded IRA for education or retirement; iv) individual AMT reform (includes elimination of personal credits and standard deduction preferences, does not include indexing); v) 40% capital gains exclusion and 24% AMT; vi) small business capital gains preferences; vii) \$500,000 exclusion of gains on the sale of principal residence (President's FY1998 Budget proposal); and viii) distressed areas initiatives and other tax incentives in the President's FY1998 Budget (equitable tolling, Section 936, and FSC software).
- (2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and under-reported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.
- (3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the Kidsave proposal, the change is measured as the present value of the tax savings from one year's contributions. The effect of the capital gains proposal is based on the level of capital gains realizations under current law.
- (4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.
- (5) Families with negative incomes are included in the total line but not shown separately.

Preliminary Assessment of Major Provisions of Competing Tax Packages, June 9, 1997 (Scoring through 2002)

Item	Administration Package	Chairman Archer's Package	W&Ms Democrats (<u>Preliminary</u>)
Education	\$1,500 (phased in, initially at \$1,200) HOPE scholarship and \$10,000 (phased in) tuition deduction (\$34.4b)	Modified HOPE scholarship (50% of expenses up to \$3,000) (\$22.3b); deduction for undergraduate expenses paid through state-sponsored prepaid tuition program of up to \$10,000/yr., \$40,000 max. per student (\$0.9b)	\$1,500 (\$1,100 in 1998-9, \$1,200 in 2,000, indexed after 2001) HOPE scholarship, 20% tuition credit up to \$7,500 (\$4,000 in 1997-2000) (\$32.3b) <i>\$10,000 1st 2002</i>
School construction	Allocable K-12 school finance credits (\$3.0)	None	New public-private school academy construction bonds (\$5.0b)
Section 127	Permanent extension of Section 127 (\$3.7)	Six month extension of Section 127 (\$0.2)	Permanent extension of Section 127 (\$3.7)
Student loans	Student loan interest deductibility (\$1.8)	None	None
IRA withdrawals	No change in IRA rules	Penalty-free IRA withdrawals for undergraduate, post-secondary vocational, and graduate education expenses (\$0.8)	No change in IRA rules
Education saving incentives	Included as part of the Kidsave proposal	Bob Dole education investment accounts for children under 18, private prepaid tuition plans; deduction for undergraduate and post-secondary vocational expenses of up to \$10,000/yr., \$40,000 max. per student (\$7.0)	None

Middle-Class Tax Relief	Refundable Kidsave Credit under 13 (\$77.8), stacked <u>before</u> the EITC	\$500 (\$400 in 1998) child credit, non-refundable, under 17 (\$71.3), stacked <u>after</u> the EITC, 50% offset with child care credit	\$500 (\$250 in 1998, \$300 in 1999-2000) child credit, partially refundable, under 18 (\$68.7), Stacked <u>before</u> the EITC
	None	Index dependent care tax credit expense limit, \$75,000-\$100,000 AGI phaseout (\$0.1)	None
Alternative Minimum Tax	Minor reform of individual AMT, phased in starting 2003	Increase individual AMT exemption amount by \$1,000 every other year from 1999 through 2007, index thereafter (\$1.2)	None
Corporate AMT	Part of Administration Simplification Proposal	Exemption from AMT for small corporations (\$0.6)	None
	None	Phaseout of AMT for business activities: depreciation for assets placed in service after 1997, most other adjustments after 2000, repeal after 2005 (\$17.3)	None
Capital Gains Provisions	No broad-based proposal	Separate 20/10.5 rate schedule, depreciation recapture, <u>indexing starting in 2001</u> (raises \$2.7)	18% rate on non-publicly traded assets with \$600k lifetime cap (\$16.1)
Home Provisions	President's Home Sales Provision (\$1.4)	President's Home Sales Provision (included above)	President's Home Sales Provision (\$1.4)
	None	None	Allow deductibility of losses on sales of principal residences (\$1.7)

Small Business Provisions	Bumpers-Matsui targeted small business relief (\$0.4)	None	None
IRAs	none	American Dream IRA's, <u>penalty free rollovers</u> from IRA (which raises money), special purpose withdrawals for first time home purchase (\$0.0)	None
Home Office	Increase availability of home office deduction (\$0.6)	Unspecified home office provision (\$1.1)	None
Estate Tax	Daschle estate tax relief (\$2.3)	Increase unified credit to \$1.0 million by 2015 (\$3.1)	Modified Daschle proposal with smaller exemption increase (\$1.3)
Urban Initiatives	Distressed areas and welfare-to-work (\$2.9)	Modified welfare-to-work provision (\$0.2)	Distressed areas and welfare-to-work (\$2.9)
Other Presidential Initiatives	Equitable tolling, Puerto Rico, FSC software, and DC (\$1.3)	D.C. package (\$0.3)	Equitable tolling, Puerto Rico, FSC software, and DC (\$1.3)
One-year extensions	R&E, contributions of appreciated stock to private foundations, WOTC and orphan drug credit (\$2.2)	R&E, contributions of appreciated stock to private foundations, WOTC and permanent orphan drug credit (\$3.3). Scoring difference reflects JCT/Treasury differences	R&E, contributions of appreciated stock to private foundations, WOTC and orphan drug credit (\$2.2)
Independent contractors	None	Liberalized independent contractor rules (\$1.0)	None

Illustrative Baseline Tax Package: Preliminary Treasury Estimates (except where noted)

Dollar amounts in millions, June 8, 1997

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	1998-07
Education package													
HOPE scholarship, \$1000; Tuition Deduction, \$10,000 ¹¹	-78	-3,714	-5,556	-6,677	-9,219	-9,962	-10,113	-10,473	-10,732	-11,281	-11,447	-35,128	-89,174
K-12 allocable school finance credits	0	-400	-500	-600	-700	-800	-1,000	-1,000	-1,000	-1,000	-1,000	-3,000	-8,000
Make Section 127 Permanent ¹²	-82	-645	-670	-730	-796	-833	-874	-914	-951	-988	-1,042	-3,674	-8,443
Student Loan Interest deductibility	-15	-370	-322	-348	-376	-406	-439	-475	-513	-555	-600	-1,822	-4,404
Middle-Class Tax Relief and Saving Provisions													
Refundable Kidsave Credit ¹³	-732	-11,855	-14,049	-17,382	-17,302	-17,242	-19,891	-22,450	-22,287	-24,479	-26,520	-77,830	-193,457
Individual AMT reform, start in 2003 ¹⁴	0	0	0	0	0	0	-382	-760	-1,013	-1,412	-1,969	0	-5,536
Capital Gains, Estate Tax Relief and Business Relief													
Bumpers-Matsui Targeted Small Business Capital Gains Relief ¹⁵	-10	-40	-43	-68	-96	-118	-146	-217	-287	-316	-347	-365	-1,678
President's Home Sales Provisions ¹⁵	-10	-90	-241	-228	-214	-199	-183	-165	-147	-127	-106	-972	-1,700
Daschle Estate Tax Proposals (JCT)	0	-440	-540	-640	-740	-840	-1,000	-1,200	-1,400	-1,600	-1,800	-3,200	-10,200
Home Office Provision	-26	-90	-103	-118	-133	-150	-169	-189	-211	-234	-257	-594	-1,654
Urban Initiatives													
Distressed Areas Initiatives ¹⁶	-40	-426	-505	-509	-478	-421	-368	-326	-292	-260	-230	-2,339	-3,815
Welfare-to-Work	0	-68	-137	-163	-122	-61	-20	-5	-1	0	0	-551	-577
Other Tax Incentives ¹⁷	-10	-141	-214	-257	-301	-369	-345	-387	-429	-1,395	-2,405	-1,282	-6,243
One-year Extensions of Expiring Provisions	-438	-968	-747	-330	-145	-52	-8	0	0	0	0	-2,242	-2,250
Gross Tax Cut	-1,441	-19,247	-23,627	-28,050	-30,622	-31,453	-34,938	-38,561	-39,263	-43,647	-47,723	-132,999	-337,131
Revenue Offsets	623	8,488	9,073	9,951	10,411	12,078	11,202	11,679	12,080	12,538	12,988	50,001	110,488
Total Net Cut	-818	-10,759	-14,554	-18,099	-20,211	-19,375	-23,736	-26,882	-27,183	-31,109	-34,735	-82,998	-226,643

¹¹ The proposal drops the B- rule and Pell offset to HOPE. Effective 7/1/97. The HOPE credit is \$1,000 in 1998 - 1999 and \$1,500 in 2000 and indexed thereafter. The tuition deduction is \$5,000 in 1998 and 1999 and \$10,000 thereafter.

¹² Includes 10% employer credit for small business training.

¹³ A refundable child credit for children under 13 with an optional \$500 nondeductible IRA for education or retirement. The credit is refundable only to taxpayers with earnings of \$2,000 or more in 1997. The earnings test is indexed beginning in 1998. The nondeductible IRA is available for each child credit allowed. The credit is \$200 in 1997, \$300 in 1998, and \$500 in 1999 and indexed thereafter. The credit is phased-out between \$60,000 and \$75,000 of AGI. The phase-out range is indexed beginning in 2000.

¹⁴ Assumes the enactment of the refundable Kidsave proposal. Among other things, it eliminates several inappropriate AMT preference items (most importantly the standard deduction), and allows personal credits to offset AMT liability.

¹⁵ The expansion of Section 1202 provides a 75 percent exclusion on up to \$20 million of gain for companies with aggregate capitalization of less than \$100 million.

¹⁶ Expand Empowerment Zones and Enterprise Communities, Brownfields, and CDFI

¹⁷ Equitable tolling, Puerto Rico Tax Credit, FSC software, and DC incentives

HOPE Scholarship Tax Credit, Tuition Deduction and Education Savings Incentives from Chairman Archer's Mark

HOPE Scholarship Tax Credit

Administration Proposal Taxpayers could claim a nonrefundable credit of up to \$1500 in two taxable years for tuition and required fees incurred during the first two years of postsecondary education on behalf of the taxpayer, her spouse or dependents. To be eligible for the credit, a student must be enrolled at least half-time in a degree or certificate program at a qualified institution and must not have been convicted of a drug-related felony. In addition, the student must show satisfactory academic progress in the first year in order to qualify for the credit in the second year. (The B- average requirement has been dropped, and the maximum credit would NOT be reduced by federal grants.) The maximum credit would be indexed beginning in 1998. The credit would be phased out for individual taxpayers with agi between \$50,000 and \$70,000 and for joint filers with agi between \$80,000 and \$100,000. The thresholds would be indexed beginning in 2001. Taxpayers would have to choose either the HOPE credit or the tuition deduction for a student's expenses in a single year.

Chairman's Mark Taxpayers could claim a nonrefundable 50% credit for up to \$3,000 in two taxable years for tuition, required fees and books incurred during the first two years of postsecondary education on behalf of the taxpayer, her spouse or dependents. To be eligible, the student must be enrolled at least half-time in a degree or certificate program at a qualified institution and not have been convicted of a drug-related felony. The maximum credit amount would be indexed for inflation beginning in 1998. The proposal would be effective for expenses paid after December 31, 1997 for education furnished in academic periods beginning after that date. The credit would be phased out for individual taxpayers with agi between \$40,000 and \$50,000 and joint filers with agi between \$80,000 and \$100,000. The thresholds would be indexed beginning in 2001. A taxpayer would have to choose either the HOPE credit or the tuition deduction for a student's expenses in a single year, provided the expenses were paid from a prepaid tuition plan or education investment account and were, therefore, eligible for the deduction.

Recommended Position Support, but only with significant modifications.

Revenue Estimate JCT: [\$22b] over 5 years, [\$49b] over 10 years.

Deduction for Expenses Paid from State-Sponsored or Private Tuition Program or Education Investment Account

Current Law A taxpayer who saves for higher education through a qualified state tuition program that meets the requirements of section 529 may defer tax on the earnings in the account until the time of withdrawal. When the funds are withdrawn, they are taxable to the party who withdraws them. Usually, this will be the student who is using the account to pay for school. However, it may be the parent or other account holder who wants a refund. If the

designated beneficiary of an account is changed, and the new designated beneficiary is an ancestor, spouse, sibling, child, grandchild or other lineal descendant of the current beneficiary, or a spouse of any of the foregoing, including the beneficiary, the change will not be treated as a distribution and will not trigger tax or a penalty. Generally, a state's educational savings plan will qualify under section 529 if the state establishes and maintains the plan, allows it to be used to save only for tuition, required fees and books, prohibits investment direction by participants and imposes a more than de minimis penalty on withdrawals not used for higher education expenses. Section 529 does not impose income limits or contribution limits, other than a general limit on funding the plan in excess of reasonable educational needs.

Chairman's Mark Taxpayers that paid tuition, required fees, books, room and board with money withdrawn from a state-sponsored tuition program, private tuition program (meaning one sponsored by an educational organization) or an education investment account could take an above-the-line deduction for up to \$10,000 a year per student for those expenses. Also, the deduction cannot exceed the portion of the distribution that represents earnings, rather than contributions. A deduction would be available for room and board even if the student lives at home. The student can be the taxpayer, her spouse or her dependents. The deductions taken for a student could not exceed \$40,000 for all taxable years. Deductions could not be taken for a student once the student completed the first four years of post-secondary education. If a parent claims a student as a dependent and takes a deduction for the student's expenses, the distribution from the state tuition program would be included in the parent's income rather than the student's. To be eligible, the student must be enrolled at least half-time in a degree or certificate program at an educational institution eligible to participate in federal student aid programs. The deduction would not be a preference item for the AMT.

In addition, the requirements of section 529 would be changed so that taxpayers could use state tuition programs and private tuition programs to save not only for tuition, fees and books, but also for room and board. Ways and Means intends to limit the maximum amount of deductible room and board to the amount the school allows when calculating costs of attendance for financial aid purposes. A technical correction later in the bill -- that is arguably not a technical -- would allow existing plans to continue accepting contributions on contracts that cover room and board made before section 529 was enacted.

Recommended Position Oppose.

Revenue Estimate JCT: [\$889m] over 5 years, [\$2.4b] over 10 years

Education Investment Accounts

Current Law Income earned in a prepaid tuition program established and maintained by anyone other than a state is not guaranteed to receive tax deferred treatment. Taxpayers who save for education expenses must pay tax annually on any income they earn on their savings.

Chairman's Mark Taxpayers would be permitted to establish education investment accounts in the same trust form used for IRAs. Up to \$50,000 in aggregate cash contributions can be made

on behalf of a single beneficiary. Earnings would accumulate tax free. Distributions would be eligible for the same tuition deduction available for distributions from state tuition programs. Contributions cannot be made after the beneficiary reaches age 18, and all amounts must be withdrawn by the time the child for whom the account is established reaches 30 or completes the first four years of post-secondary education. A 10% additional tax would generally apply on distributions not used for higher education expenses.

Recommended Position Oppose

Revenue Estimate JCT [\$6.9b] over 5 years, [\$22.4b] over ten years

Talking Points

Objections to Higher Education Proposals in Ways and Means Chairman's Mark

- As compared to the Administration's budget, the Chairman's mark redirects a large portion of benefits to higher income families that can afford to save for higher education expenses. For families who need grants and loans to afford school, benefits are diminished in the first two years of higher education and taken away entirely for later years.
- Under the Chairman's mark, a middle-income student who works all summer, saves her salary and uses it to pay her junior year tuition would receive no assistance. However, her classmate who spent the same summer on vacation could get up to a \$10,000 deduction when she pays her tuition out of the educational investment account her well-to-do parents were able to fund. *
- The Chairman's HOPE credit is less generous for students at community colleges and other low-price schools.
- The Chairman's package provides no support for education beyond the first four years of college and very little for workers and others who may return to school later in life. An older student cannot start an educational investment account -- contributions cannot be made after the beneficiary reaches 18 -- and cannot benefit from employer-provided educational assistance after 1997. ?
- The education investment account proposal creates a potential for abuse that will be difficult to prevent. Although aggregate contributions on behalf of a single beneficiary are limited to \$50,000, financial institutions will have no way of knowing whether an account holder has other accounts elsewhere, and the IRS will find it difficult to keep a running total of contributions over many years. The IRA system works because it sets a maximum annual contribution that can be policed with simple annual information reporting.

Major Tax Cut Provisions in the Ways and Means Chairman's Mark (1)

(1998 Income Levels)

Family Economic Income Quintile (2)	Number of Families (millions)	Average Tax Change (\$)	Total Tax Change		Tax Change as a Percent of:	
			Amount (3) (\$M)	Percent Distribution (%)	Current Federal Taxes (4) (%)	Family Economic Income (%)
Lowest (5)	21.6	-17	-357	0.5	-2.84	-0.17
Second	22.2	-76	-1691	2.4	-2.75	-0.31
Third	22.3	-295	-6574	9.2	-4.17	-0.69
Fourth	22.3	-623	-13856	19.5	-4.49	-0.86
Highest	22.3	-2172	-48354	67.9	-5.31	-1.17
Total (5)	111.3	-640	-71191	100.0	-4.90	-0.96
Top 10%	11.1	-3089	-34406	48.3	-5.20	-1.18
Top 5%	5.6	-4577	-25517	35.8	-5.22	-1.21
Top 1%	1.1	-12247	-13741	19.3	-5.29	-1.30

Department of the Treasury
Office of Tax Analysis

June 11, 1997

- (1) This table distributes the estimated change in tax burdens due to the major tax cut proposals in the Ways and Means Chairman's Mark which include the following: i) child and dependent care tax credits, ii) a modified HOPE scholarship tax credit, iii) a deduction for education expenses paid through State-sponsored prepaid tuition programs; iv) education investment accounts and private prepaid tuition programs; v) American Dream IRAs; vi) Capital gains provisions (lower individual and corporate rates, indexing of individual gains, and \$500,000 exclusion for gains on a principal residence); vii) Individual AMT change and corporate AMT repeal; viii) District of Columbia tax incentives; and ix) safe harbor for independent contractors.
- (2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and under-reported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.
- (3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the American Dream and education accounts, the change is measured as the present value of the tax savings from one year's contributions. The effect of the capital gains provision is based on the level of capital gains realizations under current law.
- (4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.
- (5) Families with negative incomes are excluded from the lowest quintile but included in the total line.

NOTE: Quintiles begin at FEI of: Second \$16,950; Third \$32,563; Fourth \$54,758; Highest \$93,222; Top 10% \$127,373; Top 5% \$170,103; Top 1% \$408,551.

Major Tax Cut Provisions in the Ways and Means Chairman's Mark (1)

(1998 Income Levels)

Family Economic Income Class (2) (000)	Number of Families (millions)	Average Tax Change (\$)	Total Tax Change		Tax Change as a Percent of:	
			Amount (3) (\$M)	Percent Distribution (%)	Current Federal Taxes (4) (%)	Family Economic Income (%)
0 - 15	18.5	-14	-268	0.4	-2.87	-0.17
15 - 30	21.8	-62	-1363	1.9	-2.72	-0.28
30 - 40	12.1	-167	-2014	2.8	-3.24	-0.48
40 - 50	9.7	-333	-3234	4.5	-4.43	-0.74
50 - 60	7.9	-453	-3567	5.0	-4.54	-0.83
60 - 75	9.4	-548	-5159	7.2	-4.30	-0.82
75 - 100	11.7	-837	-9794	13.8	-4.88	-0.97
100 - 200	15.6	-1492	-23269	32.7	-5.37	-1.13
200 & over	3.9	-5663	-22164	31.1	-5.24	-1.23
Total (5)	111.3	-640	-71191	100.0	-4.90	-0.96

Department of the Treasury
Office of Tax Analysis

June 11, 1997

- (1) This table distributes the estimated change in tax burdens due to the major tax cut proposals in the Ways and Means Chairman's Mark which include the following: i) child and dependent care tax credits, ii) a modified HOPE scholarship tax credit, iii) a deduction for education expenses paid through State-sponsored prepaid tuition programs; iv) education investment accounts and private prepaid tuition programs; v) American Dream IRAs; vi) Capital gains provisions (lower individual and corporate rates, indexing of individual gains, and \$500,000 exclusion for gains on a principal residence); v) individual AMT change and corporate AMT repeal; vi) District of Columbia tax incentives; and vii) safe harbor for independent contractors.
- (2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and under-reported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.
- (3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the American Dream and education accounts, the change is measured as the present value of the tax savings from one year's contributions. The effect of the capital gains provision is based on the level of capital gains realizations under current law.
- (4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.
- (5) Families with negative incomes are included in the total line but not shown separately.

Democrat's Package (1)

(1998 Income Levels)

Family Economic Income Quintile (2)	Number of Families (millions)	Average Tax Change (\$)	Total Tax Change		Tax Change as a Percent of:	
			Amount (3) (\$M)	Percent Distribution (%)	Current Federal Taxes (4) (%)	Family Economic Income (%)
Lowest (5)	21.6	-82	-1779	4.9	-14.16	-0.87
Second	22.2	-263	-5842	16.1	-9.48	-1.07
Third	22.3	-338	-7523	20.7	-4.77	-0.79
Fourth	22.3	-424	-9431	25.9	-3.05	-0.59
Highest	22.3	-520	-11578	31.8	-1.27	-0.28
Total (5)	111.3	-327	-36383	100.0	-2.50	-0.49
Top 10%	11.1	-742	-8268	22.7	-1.25	-0.28
Top 5%	5.6	-1249	-6966	19.1	-1.43	-0.33
Top 1%	1.1	-3966	-4449	12.2	-1.71	-0.42

June 8, 1997

This table distributes the estimated change in tax burdens due to the tax proposals in the following illustrative baseline tax package:

i) Hope Scholarship credit (\$1,100 1998-1999, \$1,200 in 2000, \$1,500 in 2001 indexed beginning in 2002; no B minus rule; and no Federal grant offset) and 20% tuition credit (\$4,000 in 1997 to 2000 and \$7,500 thereafter); ii) Permanent extension of Section 127; iii) \$500 child credit which is refundable against the employee share of payroll taxes (\$250 in 1998, \$300 1999 to 2000, and \$500 in 2001, indexed beginning in 2002); iv) 18% maximum capital gains rate on non-publicly traded assets (\$600,000 lifetime cap (joint), 3 year holding period); v) Allow deductibility on losses on sale of principal residence; vi) \$500,000 exclusion of gains on the sale of principal residence (President's FY1998 Budget proposal); and vii) distressed areas initiative and other tax incentives in the President's FY1998 Budget (equitable tolling, Section 936, and FSC software).

- (2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and under-reported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.
- (3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. The effect of the capital gains proposal is based on the level of capital gains realizations under current law.
- (4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.
- (5) Families with negative incomes are excluded from the lowest quintile but included in the total line.

NOTE: Quintiles begin at FEI of: Second \$16,850; Third \$32,563; Fourth \$54,758; Highest \$93,222; Top 10% \$127,373; Top 5% \$170,103; Top 1% \$408,551.

Democrat's Package (1)

(1998 Income Levels)

Family Economic Income Class (2) (000)	Number of Families (millions)	Average Tax Change (\$)	Total Tax Change		Tax Change as a Percent of:	
			Amount (3) (\$M)	Percent Distribution (%)	Current Federal Taxes (4) (%)	Family Economic Income (%)
0 - 15	18.5	-67	-1238	3.4	-13.27	-0.79
15 - 30	21.8	-246	-5372	14.8	-10.70	-1.11
30 - 40	12.1	-304	-3659	10.1	-5.89	-0.87
40 - 50	9.7	-342	-3323	9.1	-4.55	-0.76
50 - 60	7.9	-408	-3208	8.8	-4.08	-0.74
60 - 75	9.4	-443	-4175	11.5	-3.48	-0.66
75 - 100	11.7	-388	-4537	12.5	-2.26	-0.45
100 - 200	15.6	-273	-4262	11.7	-0.98	-0.21
200 & over	3.9	-1629	-6377	17.5	-1.51	-0.35
Total (5)	111.3	-327	-36383	100.0	-2.50	-0.49

June 8, 1997

This table distributes the estimated change in tax burdens due to the tax proposals in the following illustrative baseline tax package: i) Hope Scholarship credit (\$1,100 1998-1999, \$1,200 in 2000, \$1,500 in 2001 indexed beginning in 2002; no B minus rule; and no Federal grant offset) and 20% tuition credit (\$4,000 in 1997 to 2000 and \$7,500 thereafter); ii) Permanent extension of Section 127; iii) \$500 child credit which is refundable against the employee share of payroll taxes (\$250 in 1998, \$300 1999 to 2000, and \$500 in 2001, indexed beginning in 2002); iv) 18% maximum capital gains rate on non-publicly traded assets (\$600,000 lifetime cap (joint), 3 year holding period); v) Allow deductibility on losses on sale of principal residence; vi) \$500,000 exclusion of gains on the sale of principal residence (President's FY1998 Budget proposal); and vii) distressed areas initiative and other tax incentives in the President's FY1998 Budget (equitable tolling, Section 836, and FSC software).

- (2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and under-reported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.
- (3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. The effect of the capital gains proposal is based on the level of capital gains realizations under current law.
- (4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.
- (5) Families with negative incomes are included in the total line but not shown separately.

"Friday" Baseline Tax Package Without Capital Gains Exclusion and Without Raisers (1)

(1998 Income Levels)

Family Economic Income Quintile (2)	Number of Families (millions)	Average Tax Change (\$)	Total Tax Change		Tax Change as a Percent of:	
			Amount (3) (\$M)	Percent Distribution (%)	Current Federal Taxes (4) (%)	Family Economic Income (%)
Lowest (5)	21.6	-114	-2468	6.7	-19.65	-1.20
Second	22.2	-312	-6931	18.9	-11.25	-1.27
Third	22.3	-383	-8512	23.2	-5.40	-0.89
Fourth	22.3	-498	-11072	30.2	-3.59	-0.69
Highest	22.3	-339	-7548	20.6	-0.83	-0.18
Total (5)	111.3	-330	-36684	100.0	-2.52	-0.50
Top 10%	11.1	-313	-3489	9.5	-0.53	-0.12
Top 5%	5.6	-377	-2099	5.7	-0.43	-0.10
Top 1%	1.1	-896	-1005	2.7	-0.39	-0.10

Department of the Treasury
Office of Tax Analysis

June 9, 1997

- (1) This table distributes the estimated change in tax burdens due to the tax proposals in the following illustrative baseline tax package: i) Hope Scholarship credit (\$1000 through 1999, \$1,500 in 2000, indexed beginning in 2001; no B minus rule; and no Federal grant offset) and tuition tax deduction (\$5,000 in 1998 and 1999, \$10,000 thereafter); ii) Permanent extension of Section 127; iii) Kidsave credit: a \$500 refundable child credit (\$2,000 earnings test) for children under 18 with an optional maximum \$500 back-loaded IRA for education or retirement; iv) individual AMT reform (includes elimination of personal credits and standard deduction preferences, does not include indexing); v) small business capital gains preferences; vi) \$500,000 exclusion of gains on the sale of principal residence (President's FY1998 Budget proposal); and vii) distressed areas initiatives and other tax incentives in the President's FY1998 Budget (equitable tolling, Section 936, and FSC software).
- (2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and under-reported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.
- (3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the Kidsave proposal, the change is measured as the present value of the tax savings from one year's contributions.
- (4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.
- (5) Families with negative incomes are excluded from the lowest quintile but included in the total line.

NOTE: Quintiles begin at FEI of: Second \$16,950; Third \$32,563; Fourth \$54,758; Highest \$93,222; Top 10% \$127,373; Top 5% \$170,103; Top 1% \$408,551.

"Friday" Baseline Tax Package Without Capital Gains Exclusion and Without Raisers (1)

(1998 Income Levels)

Family Economic Income Class (2) (000)	Number of Families (millions)	Average Tax Change (\$)	Total Tax Change		Tax Change as a Percent of:	
			Amount (3) (\$M)	Percent Distribution (%)	Current Federal Taxes (4) (%)	Family Economic Income (%)
0 - 15	18.5	-94	-1737	4.7	-18.62	-1.11
15 - 30	21.8	-297	-6492	17.7	-12.93	-1.34
30 - 40	12.1	-346	-4171	11.4	-6.71	-1.00
40 - 50	9.7	-387	-3758	10.2	-5.14	-0.86
50 - 60	7.9	-461	-3628	9.9	-4.62	-0.84
60 - 75	9.4	-517	-4871	13.3	-4.06	-0.77
75 - 100	11.7	-469	-5481	14.9	-2.73	-0.54
100 - 200	15.6	-298	-4654	12.7	-1.07	-0.23
200 & over	3.9	-444	-1737	4.7	-0.41	-0.10
Total (5)	111.3	-330	-36684	100.0	-2.52	-0.50

Department of the Treasury
Office of Tax Analysis

June 9, 1997

This table distributes the estimated change in tax burdens due to the tax proposals in the following illustrative baseline tax package:

i) Hope Scholarship credit (\$1000 through 1999, \$1,500 in 2000, indexed beginning in 2001; no B minus rule; and no Federal grant offset) and tuition tax deduction (\$5,000 in 1998 and 1999, \$10,000 thereafter); ii) Permanent extension of Section 127; iii) Kidsave credit: a \$500 refundable child credit (\$2,000 earnings test) for children under 18 with an optional maximum \$500 back-loaded IRA for education or retirement; iv) individual AMT reform (includes elimination of personal credits and standard deduction preferences, does not include indexing); v) small business capital gains preferences; vi) \$500,000 exclusion of gains on the of principal residence (President's FY1998 Budget proposal); and vii) distressed areas initiatives and other tax incentives in the President's FY1998 Budget (equitable tolling, Section 936, and FSC software).

- (2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and under-reported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.
- (3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the Kidsave proposal, the change is measured as the present value of the tax savings from one year's contributions.
- (4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.
- (5) Families with negative incomes are included in the total line but not shown separately.

"Friday" Baseline Tax Package without Raisers (1)

(1998 Income Levels)

Family Economic Income Quintile (2)	Number of Families (millions)	Average Tax Change (\$)	Total Tax Change		Tax Change as a Percent of:	
			Amount (3) (\$M)	Percent Distribution (%)	Current Federal Taxes (4) (%)	Family Economic Income (%)
Lowest (5)	21.6	-122	-2627	5.9	-20.91	-1.28
Second	22.2	-327	-7267	16.3	-11.80	-1.33
Third	22.3	-408	-9075	20.4	-5.75	-0.95
Fourth	22.3	-538	-11963	26.9	-3.87	-0.75
Highest	22.3	-597	-13283	29.9	-1.46	-0.32
Total (5)	111.3	-400	-44453	100.0	-3.06	-0.60
Top 10%	11.1	-771	-8588	19.3	-1.30	-0.29
Top 5%	5.6	-1185	-6604	14.9	-1.35	-0.31
Top 1%	1.1	-3735	-4191	9.4	-1.61	-0.40

Department of the Treasury
Office of Tax Analysis

June 9, 1997

- (1) This table distributes the estimated change in tax burdens due to the tax proposals in the following illustrative baseline tax package: i) Hope Scholarship credit (\$1000 through 1999, \$1,500 in 2000, indexed beginning in 2001; no B minus rule; and no Federal grant offset) and tuition tax deduction (\$5,000 in 1998 and 1999, \$10,000 thereafter); ii) Permanent extension of Section 127; iii) Kidsave credit: a \$500 refundable child credit (\$2,000 earnings test) for children under 18 with an optional maximum \$500 back-loaded IRA for education or retirement; iv) individual AMT reform (includes elimination of personal credits and standard deduction preferences; does not include indexing); v) 40% capital gains exclusion and 24% AMT; vi) small business capital gains preferences; vii) \$500,000 exclusion of gains on the sale of principal residence (President's FY1998 Budget proposal); and viii) distressed areas initiatives and other tax incentives in the President's FY1998 Budget (equitable tolling, Section 936, and FSC software).
- (2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and under-reported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.
- (3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the Kidsave proposal, the change is measured as the present value of the tax savings from one year's contributions. The effect of the capital gains proposal is based on the level of capital gains realizations under current law.
- (4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.
- (5) Families with negative incomes are excluded from the lowest quintile but included in the total line.

NOTE: Quintiles begin at FEI of: Second \$16,950; Third \$32,563; Fourth \$54,758; Highest \$93,222; Top 10% \$127,373; Top 5% \$170,103; Top 1% \$408,551.

"Friday" Baseline Tax Package without Raisers (1)

(1998 Income Levels)

Family Economic Income Class (2) (000)	Number of Families (millions)	Average Tax Change (\$)	Total Tax Change		Tax Change as a Percent of:	
			Amount (3) (\$M)	Percent Distribution (%)	Current Federal Taxes (4) (%)	Family Economic Income (%)
0 - 15	18.5	-101	-1862	4.2	-19.95	-1.19
15 - 30	21.8	-312	-6806	15.3	-13.56	-1.40
30 - 40	12.1	-367	-4420	9.9	-7.11	-1.05
40 - 50	9.7	-413	-4006	9.0	-5.48	-0.92
50 - 60	7.9	-492	-3876	8.7	-4.93	-0.90
60 - 75	9.4	-555	-5223	11.7	-4.35	-0.83
75 - 100	11.7	-515	-6026	13.6	-3.00	-0.59
100 - 200	15.6	-387	-6043	13.6	-1.39	-0.29
200 & over	3.9	-1521	-5953	13.4	-1.41	-0.33
Total (5)	111.3	-400	-44453	100.0	-3.06	-0.60

Department of the Treasury
Office of Tax Analysis

June 9, 1997

- (1) This table distributes the estimated change in tax burdens due to the tax proposals in the following illustrative baseline tax package: i) Hope Scholarship credit (\$1000 through 1999, \$1,500 in 2000, indexed beginning in 2001; no B minus rule; and no Federal grant offset) and tuition tax deduction (\$5,000 in 1998 and 1999, \$10,000 thereafter); ii) Permanent extension of Section 127; iii) Kidsave credit: a \$500 refundable child credit (\$2,000 earnings test) for children under 18 with an optional maximum \$500 back-loaded IRA for education or retirement; iv) individual AMT reform (includes elimination of personal credits and standard deduction preferences, does not include indexing); v) 40% capital gains exclusion and 24% AMT; vi) small business capital gains preferences; vii) \$500,000 exclusion of gains on the sale of principal residence (President's FY1998 Budget proposal); and viii) distressed areas initiatives and other tax incentives in the President's FY1998 Budget (equitable tolling, Section 936, and FSC software).
- (2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and under-reported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.
- (3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the Kidsave proposal, the change is measured as the present value of the tax savings from one year's contributions. The effect of the capital gains proposal is based on the level of capital gains realizations under current law.
- (4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.
- (5) Families with negative incomes are included in the total line but not shown separately.

Example 1.

**Change in Income Tax: Comparison of Current Law With
The Administration Proposal and Ways & Means Committee Chairman's Mark**

**Couple with Income of \$15,000 and Children 2 and 8
(1999 Tax Parameters)**

	Current Law	Administration Proposal	Ways & Means Committee Chairman's Mark
Adjusted Gross Income (AGI)	15,000	15,000	15,000
Standard Deduction	7,300	7,300	7,300
Personal Exemptions	<u>11,200</u>	<u>11,200</u>	<u>11,200</u>
Taxable Income	0	0	0
Income Tax Before Credits	0	0	0
Child Credits	0	1,000 *	0 **
Earned Income Credit (refundable)	3,148	3,148	3,148
Income Tax After Credits	(3,148)	(4,148)	(3,148)
Tax Savings Compared to Current Law		1,000	0

Department of the Treasury
Office of Tax Analysis

June 10, 1997.

* refundable

** nonrefundable and calculated after EITC

Example 2.

Change in Income Tax: Comparison of Current Law With The Administration Proposal and Ways & Means Committee Chairman's Mark

**Couple with Income of \$25,000 and Children 6 and 12
(1999 Tax Parameters)**

	Current Law	Administration Proposal	Ways & Means Committee Chairman's Mark
Adjusted Gross Income (AGI)	25,000	25,000	25,000
Standard Deduction	7,300	7,300	7,300
Personal Exemptions	<u>11,200</u>	<u>11,200</u>	<u>11,200</u>
Taxable income	6,500	6,500	6,500
Income Tax Before Credits	975	975	975
Child Credits	0	1,000 *	0 **
Earned Income Credit (refundable)	1,042	1,042	1,042
Income Tax After Credits	(67)	(1,067)	(67)
Tax Savings Compared to Current Law		1,000	0

Department of the Treasury
Office of Tax Analysis

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* refundable

** nonrefundable and calculated after EITC

Example 3.

**Change in Income Tax: Comparison of Current Law With
The Administration Proposal and Ways & Means Committee Chairman's Mark**

**Couple with Income of \$40,000 and Children 6 and 12
(1999 Tax Parameters)**

	Current Law	Administration Proposal	Ways & Means Committee Chairman's Mark
Adjusted Gross Income (AGI)	40,000	40,000	40,000
Standard Deduction	7,300	7,300	7,300
Personal Exemptions	<u>11,200</u>	<u>11,200</u>	<u>11,200</u>
Taxable Income	21,500	21,500	21,500
Income Tax Before Credits	3,225	3,225	3,225
Child Credits	0	1,000	1,000
Income Tax After Credits	3,225	2,225	2,225
Tax Savings Compared to Current Law		1,000	1,000

Example 4.

**Change in Income Tax: Comparison of Current Law With
The Administration Proposal and Ways & Means Committee Chairman's Mark**

**Couple with Income of \$40,000 and Children 8 and 14
(1999 Tax Parameters)**

	Current Law	Administration Proposal	Ways & Means Committee Chairman's Mark
Adjusted Gross Income (AGI)	40,000	40,000	40,000
Standard Deduction	7,300	7,300	7,300
Personal Exemptions	<u>11,200</u>	<u>11,200</u>	<u>11,200</u>
Taxable Income	21,500	21,500	21,500
Income Tax Before Credits	3,225	3,225	3,225
Child Credits	0	500 *	1,000
Income Tax After Credits	3,225	2,725	2,225
Tax Savings Compared to Current Law		500	1,000

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Office of Tax Analysis

June 10, 1997

* The Administration proposed child credit is indexed after 1999 and would apply to children under age 18 after 2002, so thereafter would exceed the unindexed child credit proposed in the Ways and Means Committee Chairman's mark,

Example 5.

**Change in Income Tax: Comparison of Current Law With
The Administration Proposal and Ways & Means Committee Chairman's Mark**

**Couple with Income of \$60,000 and Children 12 and 18
18 Year Old Enrolled in College
Tuition of \$1,500 and Book Expenditures of \$500
(1999 Tax Parameters)**

	Current Law	Administration Proposal	Ways & Means Committee Chairman's Mark
Adjusted Gross Income (AGI)	60,000	60,000	60,000
Itemized Deductions (18% of AGI)	10,800	10,800	10,800
Personal Exemptions	<u>11,200</u>	<u>11,200</u>	<u>11,200</u>
Taxable Income	38,000	38,000	38,000
Income Tax Before Credits	5,700	5,700	5,700
Child Credits	0	500	500
HOPE Credit	<u>0</u>	<u>1,500</u>	<u>1,000</u>
Income Tax After Credits	5,700	3,700	4,200
Tax Savings Compared to Current Law		2,000	1,500

Example 6.

**Change in Income Tax: Comparison of Current Law With
The Administration Proposal and Ways & Means Committee Chairman's Mark**

**Couple with Income of \$60,000 and Children 12 and 20
20 Year Old Enrolled in Third Year of College
Tuition of \$4,000 and Book Expenditures of \$500
(1999 Tax Parameters)**

	Current Law	Administration Proposal	Ways & Means Committee Chairman's Mark
Adjusted Gross Income (AGI) Before Tuition Deduction	60,000	60,000	60,000
Tuition Deduction*	0	4,000	0
Itemized Deductions (18% of AGI before tuition deduction)	10,800	10,800	10,800
Personal Exemptions	<u>11,200</u>	<u>11,200</u>	<u>11,200</u>
Taxable Income	38,000	34,000	38,000
Income Tax Before Credits	5,700	5,100	5,700
Child Credits	0	500	500
HOPE Credit	<u>0</u>	<u>0</u>	<u>0</u>
Income Tax After Credits	5,700	4,600	5,200
Tax Savings Compared to Current Law		1,100	500

Department of the Treasury
Office of Tax Analysis

June 10, 1997

* Tuition is assumed to be paid from current earnings and borrowing.

Example 7.

**Change in Income Tax: Comparison of Current Law With
The Administration Proposal and Ways & Means Committee Chairman's Mark**

**Couple with Income of \$75,000 and Children 6 and 12
(1999 Tax Parameters)**

	Current Law	Administration Proposal	Ways & Means Committee Chairman's Mark
Adjusted Gross Income (AGI)	75,000	75,000	75,000
Itemized Deductions (18% of AGI)	13,500	13,500	13,500
Personal Exemptions	<u>11,200</u>	<u>11,200</u>	<u>11,200</u>
Taxable Income	50,300	50,300	50,300
Income Tax Before Credits	8,429	8,429	8,429
Child Credits	<u>0</u>	<u>0</u>	<u>1,000</u>
Income Tax After Credits	8,429	8,429	7,429
Tax Savings Compared to Current Law		0	1,000

Example 8.

**Change in Income Tax: Comparison of Current Law With
The Administration Proposal and Ways & Means Committee Chairman's Mark**

**Couple with \$5,000 of Capital Gains and \$45,000 of Other Income
(1999 Tax Parameters)**

	Current Law	Administration Proposal*	Ways & Means Committee Chairman's Mark
Capital Gains**	5,000	5,000	5,000
Other Income	45,000	45,000	45,000
Adjusted Gross Income (AGI)	50,000	50,000	50,000
Itemized Deductions (18% of AGI before exclusion)	9,000	9,000	9,000
Personal Exemptions	5,600	5,600	5,600
Taxable Income	35,400	35,400	35,400
Income Tax Before Reduced Rate on Capital Gains	5,310	5,310	5,310
Savings from Reduced Rate on Capital Gains	0	0	250
Income Tax	5,310	5,010	5,060
Tax Savings Compared to Current Law		0	250

Department of the Treasury
Office of Tax Analysis

June 10, 1997

- * The Administration proposal provides capital gains preferences only for sales of homes and qualified small business stock.
- ** Gains are assumed to be from sale of capital assets other than homes or qualified small business stock,

Example 9.

**Change in Income Tax: Comparison of Current Law With
The Administration Proposal and Ways & Means Committee Chairman's Mark**

**Couple with \$50,000 of Capital Gains and \$150,000 of Other Income
(1999 Tax Parameters)**

	Current Law	Administration Proposal*	Ways & Means Committee Chairman's Mark
Capital Gains **	50,000	50,000	50,000
Other Income	<u>150,000</u>	<u>150,000</u>	<u>150,000</u>
Adjusted Gross Income (AGI)	200,000	200,000	200,000
Itemized Deductions Before Limitation (18% of AGI)	36,000	36,000	36,000
Reduction from Limitation on Itemized Deductions	<u>2,160</u>	<u>2,160</u>	<u>2,160</u>
Itemized Deductions After Limitation	33,840	33,840	33,840
Personal Exemptions Before Phaseout	5,600	5,600	5,600
Reduction from Phaseout	<u>448</u>	<u>448</u>	<u>448</u>
Personal Exemptions After Phaseout	5,152	5,152	5,152
Taxable Income	161,008	161,008	161,008
Income Tax Before Reduced Rate on Capital Gains	41,141	41,141	41,141
Savings from Reduced Rate Tax on Capital Gains	<u>1,538</u>	<u>1,538</u>	<u>5,538</u>
Income Tax	39,603	39,603	35,603
Tax Savings Compared to Current Law		0	4,000

Department of the Treasury
Office of Tax Analysis

June 10, 1997

- * The Administration proposal provides capital gains preferences only for sales of homes and qualified small business stock.
- ** Gains are assumed to be from sale of capital assets other than homes or qualified small business stock,

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**DESCRIPTION OF CHAIRMAN'S MARK
RELATING TO
REVENUE RECONCILIATION PROVISIONS**

Scheduled for Markup
Before the
HOUSE COMMITTEE ON WAYS AND MEANS
on June 11, 1997

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

June 9, 1997

JCX-20-97

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INTRODUCTION

The House Committee on Ways and Means has scheduled a markup of revenue reconciliation provisions, beginning on June 11, 1997. This document,⁽¹⁾ prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's mark for the revenue reconciliation provisions: (I) child and dependent care tax credits and health care for children of high-risk individuals; (II) education tax incentives; (III) savings and investment tax incentives; (IV) alternative minimum tax provisions; (V) estate, gift, and generation-skipping tax provisions; (VI) extension of certain expiring tax provisions; (VII) District of Columbia tax incentives; (VIII) welfare-to-work tax credit; (IX) revenue-increase provisions; (X) miscellaneous provisions; (XI) foreign tax provisions; (XII) earned income credit compliance; and (XIII) increase in the public debt limit.

Separate documents provide descriptions of tax simplification and technical corrections provisions of the Chairman's mark. Also, a separate document contains estimated budget effects of the revenue reconciliation, tax simplification, and technical corrections provisions.

I. CHILD AND DEPENDENT CARE TAX CREDITS;

HEALTH CARE FOR CHILDREN

A. Child Tax Credit For Children Under Age 17

Present Law

In general

Present law does not provide tax credits based solely on the taxpayer's number of dependent children. Taxpayers with dependent children, however, generally are able to claim a personal exemption for each of these dependents. The total amount of personal exemptions is subtracted (along with certain other items) from adjusted gross income ("AGI") in arriving at taxable income. The amount of each personal exemption is \$2,650 for 1997, and is adjusted annually for inflation. In 1997, the amount of the personal exemption is phased out for taxpayers with AGI in excess of \$121,200 for single taxpayers, \$151,500 for heads of household, and \$181,800 for married couples filing joint returns. These phaseout thresholds are

adjusted annually for inflation.

Dependent care credit

A nonrefundable credit against income tax liability is available for up to 30 percent (phased down to 20 percent for individuals with AGI above \$28,000) of a limited dollar amount of employment-related child and dependent care expenses. Eligible employment-related expenses are limited to \$2,400 if there is one qualifying individual and \$4,800 if there are two or more qualifying individuals. Employment-related expenses are expenses for household services and the care of a qualifying individual, if incurred to enable the taxpayer to be gainfully employed. Employment-related expenses are reduced to the extent the taxpayer has employer-provided dependent care assistance that is excludable from gross income.

Description of Proposal

The proposal would allow taxpayers a maximum nonrefundable tax credit of \$500 (\$400 for taxable year 1998) for each qualifying child under the age of 17. A qualifying child would be defined as an individual for whom the taxpayer can claim a dependency exemption and who is a son or daughter of the taxpayer (or a descendent of either), a stepson or stepdaughter of the taxpayer or an eligible foster child of the taxpayer. The credit amount would not be indexed for inflation.

For taxpayers with AGI in excess of certain thresholds, the sum of the otherwise allowable child credit and the otherwise allowable dependent care credit would be phased out. Specifically, the sum of the otherwise allowable child credit and then the otherwise allowable dependent care credit would be reduced by \$25 for each \$1,000 of AGI (or fraction thereof) in excess of the threshold ("the AGI phase-out"). The reduction would be applied first to the child credit and then to the dependent care credit. For married taxpayers filing joint returns, the threshold would be \$110,000. For taxpayers filing single or head of household returns, the threshold would be \$75,000. For married taxpayers filing separate returns, the threshold would be \$55,000. These thresholds would not be indexed for inflation.

Beginning after 2001, after application of the AGI phase-out to both the child credit and the dependent care credit, the otherwise allowable child credit would be reduced by one-half of the amount of the taxpayer's dependent care credit. The maximum amount of the child credit for each taxable year (after the reduction, if any, for the dependent care credit after 2001) could not exceed an amount equal to the excess of: (1) the taxpayer's regular income tax liability (net of applicable credits) less (2) the sum of the taxpayer's tentative minimum tax liability (determined without regard to the alternative minimum foreign tax credit) and the earned income credit allowed.

Effective Date

Generally, the child tax credit would be effective for taxable years beginning after December 31, 1997. The proposal to reduce the otherwise allowable child credit by one-half of the amount of the taxpayer's dependent care credit would be effective for taxable years beginning after December 31, 2001.

B. Indexing of the Dependent Care Credit;

Phase Out for High-Income Taxpayers

Present Law

A nonrefundable credit against income tax liability is available for up to 30 percent of a limited dollar amount of employment-related child and dependent care expenses. The credit may be claimed by an individual who maintains a household that includes one or more qualifying individuals. A qualifying individual is a dependent of the taxpayer who is under the age of 13, a physically or mentally incapacitated dependent, or a physically or mentally incapacitated spouse.

A married couple must file a joint return in order to claim the credit.

Employment-related expenses are expenses for household services and the care of a qualifying

individual, if incurred to enable the taxpayer to be gainfully employed. The amount of employment-related expenses that may be taken into account in computing the credit generally may not exceed an individual's earned income or, in the case of married taxpayers, the earned income of the spouse with the lesser earnings. Thus, if one spouse is not employed, no credit is generally allowed. Eligible employment-related expenses are limited to \$2,400 if there is one qualifying individual, and \$4,800 if there are two or more qualifying individuals. The amount of employment-related expenses is reduced by the aggregate amount of employer-provided dependent care assistance excluded from the taxpayer's income.⁽²⁾

The 30-percent credit rate is reduced by one percentage point for each \$2,000 (or fraction thereof) of adjusted gross income ("AGI") above \$10,000. A married couple's combined AGI is used for purposes of this computation. Individuals with more than \$28,000 of AGI are entitled to a credit equal to 20 percent of allowable employment-related expenses.

Description of Proposal

The dollar limits on eligible employment-related expenses (\$2,400 if there is one qualifying individual and \$4,800 if there are two or more qualifying individuals) would be indexed for inflation.

The sum of the otherwise allowable dependent care credit and the otherwise allowable child credit would be phased out for taxpayers with AGI in excess of certain thresholds. Specifically, the sum of the otherwise allowable child credit and then the otherwise allowable dependent care credit would be reduced by \$25 for each \$1,000 of AGI (or fraction thereof) in excess of the threshold. The reduction would be applied first to the child credit and then to the dependent care credit. For married taxpayers filing joint returns, the threshold would be \$110,000. For taxpayers filing single or head of household returns, the threshold would be \$75,000. These thresholds would not be indexed for inflation.

Effective Date

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

C. Expand Definition of High-Risk Individuals with Respect to Tax-Exempt

State-Sponsored Organizations Providing Health Coverage

Present Law

Present law provides tax-exempt status to any membership organization that is established by a State exclusively to provide coverage for medical care on a nonprofit basis to certain high-risk individuals, provided certain criteria are satisfied.⁽³⁾ The organization may provide coverage for medical care either by issuing insurance itself or by entering into an arrangement with a health maintenance organization ("HMO").

High-risk individuals eligible to receive medical care coverage from the organization must be residents of the State who, due to a pre-existing medical condition, are unable to obtain health coverage for such condition through insurance or an HMO, or are able to acquire such coverage only at a rate that is substantially higher than the rate charged for such coverage by the organization. The State must determine the composition of membership in the organization. For example, a State could mandate that all organizations that are subject to insurance regulation by the State must be members of the organization.

Present law further requires the State or members of the organization to fund the liabilities of the organization to the extent that premiums charged to eligible individuals are insufficient to cover such liabilities. Finally, no part of the net earnings of the organization can inure to the benefit of any private shareholder or individual.

Description of Proposal

The proposal would expand the definition of high-risk individuals to include a child of an individual who meets the present-law definition of a high-risk individual, subject to certain requirements. The requirements would be: (1) the taxpayer is allowed a deduction for a personal exemption for the child for the taxable year; (2) the child has not attained the age of 17 as of the close of the calendar year in which the taxable year of the taxpayer begins; and (3) the child is a son or daughter or the taxpayer (or a dependent of either), a stepson or stepdaughter of the taxpayer, or an eligible foster child of the taxpayer.

Effective Date

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

II. EDUCATION TAX INCENTIVES

A. Tax Benefits Relating to Education Expenses

1. HOPE credit for higher education tuition expenses

Present Law

Deductibility of education expenses

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

Exclusion for employer-provided educational assistance

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

For purposes of the special exclusion, educational assistance means the payment by an employer of expenses incurred by or on behalf of the employee for education of the employee including, but not limited to, tuition, fees, and similar payments, books, supplies, and equipment. Educational assistance also includes the provision by the employer of courses of instruction for the employee (including books, supplies, and equipment). Educational assistance does not include tools or supplies which may be retained by the employee after completion of a course or meals, lodging, or transportation. The exclusion does not apply to any education involving sports, games, or hobbies.

In the absence of the special exclusion, employer-provided educational assistance is excludable from gross income and wages as a working condition fringe benefit (sec. 132(d)) only to the extent the education expenses would be deductible under section 162.

Exclusion for interest earned on savings bonds

Another special rule (sec. 135) provides that interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.⁽⁴⁾ "Qualified higher education expenses" include tuition and fees (but not room and board expenses) required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at certain colleges, universities, or vocational schools. The exclusion provided by section 135 is phased out for certain higher-income taxpayers, determined by the taxpayer's modified AGI during the year the bond is redeemed. For 1996, the exclusion was phased out for taxpayers with modified AGI between \$49,450 and \$64,450 (\$74,200 and \$104,200 for joint returns). To prevent taxpayers from effectively avoiding the income phaseout limitation through issuance of bonds directly in the child's name, section 135(c)(1)(B) provides that the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are at least 24 years old.

Qualified scholarships

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

Student loan forgiveness

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

Qualified State prepaid tuition programs

Section 529 (enacted as part of the Small Business Job Protection Act of 1996) provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of

qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. "Qualified higher education expenses" are defined as tuition, fees, books, supplies, and equipment required for the enrollment or attendance at a college or university (or certain vocational schools). Qualified higher education expenses do not include room and board expenses. Section 529 also provides that no amount shall be included in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary (e.g., when the beneficiary attends college) will be included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent receives a refund) will be included in the contributor's gross income to the extent such amounts exceed contributions made by that person.⁽⁵⁾

Description of Proposal

In general

Individual taxpayers would be allowed to claim a non-refundable HOPE credit against Federal income taxes up to \$1,500 per student per year for 50 percent of qualified tuition and related expenses (but not room and board expenses) paid for the first two years of the student's post-secondary education in a degree or certificate program. The qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent. The HOPE credit would be available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education. Beginning in 1998, the maximum credit amount of \$1,500 would be indexed for inflation, rounded down to the closest multiple of \$50.

The HOPE credit amount that a taxpayer could otherwise claim would be phased out ratably for taxpayers with modified AGI between \$40,000 and \$50,000 (\$80,000 and \$100,000 for joint returns). Modified AGI would include amounts otherwise excluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions). Beginning in 2001, the income phase-out ranges would be indexed for inflation, rounded down to the closest multiple of \$5,000.

The HOPE credit would be available in the taxable year the expenses are paid, subject to the requirement that the education commence or continue during that year or during the first three months of the next year. Qualified tuition expenses paid with the proceeds of a loan generally would be eligible for the HOPE credit (rather than repayment of the loan itself).⁽⁶⁾

Dependent students

A taxpayer could claim the HOPE credit with respect to an eligible student who is not the taxpayer or the taxpayer's spouse (e.g., in cases where the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent by the parent or other taxpayer, the eligible student him- or herself would not be entitled to claim a HOPE credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student would be treated as paid by the parent (or other taxpayer) for purposes of the proposal.

Election of HOPE credit or proposed deduction for qualified higher education expenses

For each taxable year, a taxpayer may elect with respect to an eligible student either the HOPE credit or the proposed deduction for qualified higher education expenses (described below). Thus, for example, if a parent claims a child as a dependent for a taxable year, then all qualified tuition expenses paid by both the parent and child would be deemed to be paid by the parent, and the parent may claim the HOPE credit (assuming that the AGI phaseout does not apply) on the parent's return. As an alternative, the parent could elect for that taxable year the proposed deduction for qualified higher education expenses with respect to the dependent child (as described below).⁽⁷⁾ On the other hand, if a child is not claimed

as a dependent by the parent (or by any other taxpayer) for the taxable year, then the child him- or herself will have the option of electing either the HOPE credit or proposed deduction for qualified higher education expenses paid during that year.

Qualified tuition expenses

The HOPE credit would be available for "qualified tuition and related expenses," meaning tuition, fees, and books required for the enrollment or attendance of an eligible student at an eligible educational institution. Charges and fees associated with meals, lodging, student activities, athletics, insurance, transportation, and similar personal, living or family expenses would not be included. The expenses of education involving sports, games, or hobbies would not be qualified tuition expenses unless this education is part of the student's degree program.

Qualified tuition and related expenses generally would include only out-of-pocket expenses. Qualified tuition expenses would not include expenses covered by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total tuition and related expenses would be reduced by scholarship or fellowship grants excludable from gross income under present-law section 117 and any other tax-free educational benefits. No reduction of qualified tuition expenses would be required for a gift, bequest, devise, or inheritance within the meaning of section 102(a). Under the proposal, a HOPE credit would not be allowed with respect to any education expenses for which a deduction is claimed under section 162 or any other section of the Code.⁽⁸⁾

Eligible student

An eligible student would be one who is enrolled in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution. The student must pursue a course of study on at least a half-time basis. (In other words, for at least one academic period which begins during the taxable year, the student must carry at least one-half the normal full-time work load for the course of study the student is pursuing.) An eligible student could not have been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

Eligible educational institution

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

Regulations

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

Effective Date

The proposal would be effective for expenses paid after December 31, 1997, for education furnished in academic periods beginning after such date.

2. Deduction for qualified higher education expenses and tax treatment of qualified tuition programs and education investment accounts

Present Law

Deductibility of education expenses

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

Exclusion for employer-provided educational assistance

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

For purposes of the special exclusion, educational assistance means the payment by an employer of expenses incurred by or on behalf of the employee for education of the employee including, but not limited to, tuition, fees, and similar payments, books, supplies, and equipment. Educational assistance also includes the provision by the employer of courses of instruction for the employee (including books, supplies, and equipment). Educational assistance does not include tools or supplies which may be retained by the employee after completion of a course or meals, lodging, or transportation. The exclusion does not apply to any education involving sports, games, or hobbies.

In the absence of the special exclusion, employer-provided educational assistance is excludable from gross income and wages as a working condition fringe benefit (sec. 132(d)) only to the extent the education expenses would be deductible under section 162.

Exclusion for interest earned on savings bonds

Another special rule (sec. 135) provides that interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.⁽⁹⁾ "Qualified higher education expenses" include tuition and fees (but not room and board expenses) required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at certain colleges, universities, or vocational schools. The exclusion provided by section 135 is phased out for certain higher-income taxpayers, determined by the taxpayer's modified AGI during the year the bond is redeemed. For 1996, the exclusion was phased out for taxpayers with modified AGI between \$49,450 and \$64,450 (\$74,200 and \$104,200 for joint returns). To prevent taxpayers from effectively avoiding the income phaseout limitation through issuance of bonds directly in the child's name, section 135(c)(1)(B) provides that the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are at least 24 years old.

Qualified scholarships

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

Student loan forgiveness

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

Qualified State prepaid tuition programs

Section 529 (enacted as part of the Small Business Job Protection Act of 1996) provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. "Qualified higher education expenses" are defined as tuition, fees, books, supplies, and equipment required for the enrollment or attendance at a college or university (or certain vocational schools). Qualified higher education expenses do not include room and board expenses. Section 529 also provides that no amount shall be included in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary (e.g., when the beneficiary attends college) will be included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent receives a refund) will be included in the contributor's gross income to the extent such amounts exceed contributions made by that person.⁽¹⁰⁾

Contributions made to a qualified State tuition program are treated as incomplete gifts for Federal gift

tax purposes (sec. 529(c)(2)). Thus, any Federal gift tax consequences are determined at the time that a distribution is made from an account under the program. The waiver (or payment) of qualified higher education expenses of a designated beneficiary by (or to) an educational institution under a qualified State tuition program is treated as a qualified transfer for purposes of present-law section 2503(e). Amounts contributed to a qualified State tuition program (and earnings thereon) are includible in the contributor's estate for Federal estate tax purposes in the event that the contributor dies before such amounts are distributed under the program (sec. 529(c)(4)).

Individual retirement arrangements ("IRAs")

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

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

An individual generally is not subject to income tax on amounts held in an IRA, including earnings on contributions, until the amounts are withdrawn from the IRA. Amounts withdrawn from an IRA are includible in gross income (except to the extent of nondeductible contributions). In addition, a 10-percent additional tax generally applies to distributions from IRAs made before age 59-1/2, unless the distribution is made (1) on account of death or disability, (2) in the form of annuity payments, (3) for medical expenses of the individual and his or her spouse and dependents that exceed 7.5 percent of AGI, or (4) for medical insurance of the individual and his or her spouse and dependents (without regard to the 7.5 percent of AGI floor) if the individual has received unemployment compensation for at least 12 weeks, and the withdrawal is made in the year such unemployment compensation is received or the following year.

Description of Proposal

In general

Individual taxpayers would be allowed a deduction of up to \$10,000 per student per year for qualified higher education expenses paid by the taxpayer during the taxable year for education furnished to the taxpayer, the taxpayer's spouse, or a dependent. The deduction would be allowed regardless of whether the taxpayer otherwise itemizes deductions or claims the standard deduction.⁽¹¹⁾ A deduction would not be allowed under the proposal with respect to an otherwise eligible student if the proposed HOPE credit (as described previously) is claimed with respect to that student for the same taxable year.⁽¹²⁾

The deduction would be allowed only to the extent that the taxpayer is required to include in gross income for the taxable year amounts distributed from a "qualified tuition program" or "education investment account." In other words, amounts distributed from a qualified tuition program or education investment account that are includible in the taxpayer's gross income (i.e., earnings) and that are used to pay for qualified higher education expenses during the taxable year would be deductible under the proposal (subject to the \$10,000 annual limit per student). Amounts distributed from qualified tuition programs or education investment accounts generally would be includible in the gross income of the distributee in the same manner as provided under present-law section 72 (to the extent not excluded under any other section, such as section 117).⁽¹³⁾

Under the proposal, the deduction would be limited to \$10,000 per student for each taxable year. Aggregate deductions under the proposal with respect to any one student could not exceed \$40,000 for all taxable years. A deduction would not be permitted with respect to a student after that student completes the equivalent of the first four years of post-secondary education at an eligible educational institution.

Dependent students

If a parent (or other taxpayer) claims a student as a dependent for a taxable year, then only the parent (or other taxpayer)--and not the student--could claim the deduction for qualified higher education expenses for that taxable year. In such a case where the parent claims the proposed deduction for qualified higher education expenses, amounts includible in gross income by reason of a distribution from a qualified tuition program or education investment account would be includible in the parent's (or other taxpayer's) gross income for that taxable year.⁽¹⁴⁾ If a parent (or other taxpayer) claims a student as a dependent for a taxable year, then all qualified higher education expenses paid that year by both the parent (or other taxpayer) and the student would be deemed to be paid by the parent (or other taxpayer). If the student is not claimed as a dependent by another taxpayer, then only the student him- or herself could claim the proposed deduction (or, as an alternative, the proposed HOPE credit described above) on the student's own tax return for the taxable year.

Eligible students

To be eligible for the proposed deduction, a student would have to be at least a half-time student in a degree or certificate program at an eligible educational institution. For this purpose, a student would be at least a half-time student if he or she is carrying at least one-half the normal full-time work load for the course of study the student is pursuing. A student would no longer be an eligible student once he or she has completed the equivalent of the first four years of post-secondary education at an eligible educational institution. An eligible student could not have been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

Eligible educational institution

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

Qualified higher education expenses

Under the proposal, the definition of "qualified higher education expenses" would include tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a student at an eligible education institution, and also would include reasonable costs (as determined for purposes of Federal financial aid programs) incurred by the student for room and board while attending such institution. Qualified higher education expenses would not include expenses for any graduate level course of a kind normally taken by an individual pursuing a program leading to a law, business, medical, or other advanced academic or professional degree.

Qualified higher education expenses generally would include only out-of-pocket expenses. Qualified higher education expenses would not include expenses covered by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified higher education expenses would be reduced by scholarship or fellowship grants excludable from gross income under present-law section 117 and any other tax-free educational benefits. In addition, no deduction would be allowed under the proposal for expenses paid with amounts that are excludable under section 135. No reduction of qualified tuition expenses would be required for a gift, bequest, devise, or inheritance within the meaning of section 102(a). If a student's education expenses

for a taxable year are deducted under section 162 or any other section of the Code, then no deduction would be available for such expenses under the proposal.

Qualified tuition programs and education investments accounts

Under the proposal, a "qualified tuition program" would mean any qualified State tuition program, generally as defined under present-law section 529, as well as any program established and maintained by one or more eligible educational institutions (which could be private institutions that are not State-owned) that satisfy the requirements under section 529 (other than present-law State ownership rule). An "education investment account" would mean a trust which is created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of the account holder and which satisfies certain other requirements.

Contributions to qualified tuition programs or education investment accounts could be made only in cash.⁽¹⁵⁾ Such contributions could not be made after the designated beneficiary or account holder reaches age 18. Any balance remaining in a qualified tuition program or education investment account must be distributed within 30 days after the earlier of the date that the beneficiary or account holder becomes 30 years old (or dies) or the date that the beneficiary or account holder completes the equivalent of the first four years of post-secondary education at one or more eligible institutions. Transfers or rollovers of credits or account balances from one account benefiting one beneficiary to another account benefiting another beneficiary would not be considered a distribution from a qualified tuition program or education investment account (nor would a change in the designated beneficiary or account holder) if the new beneficiary is a member of the family of the old beneficiary.⁽¹⁶⁾ In the case of an education investment account, additional contributions could not be made into such an account on behalf of the account holder after aggregate contributions made to the account (plus all other contributions made to educational investment accounts and qualified tuition programs on behalf of the account holder) equal \$50,000.⁽¹⁷⁾

Qualified tuition programs and education investment accounts (as separate legal entities) would be exempt from Federal income tax, other than taxes imposed under the present-law unrelated business income tax (UBIT) rules.⁽¹⁸⁾

Under the proposal, an additional tax of 10 percent would be imposed on distributions from qualified tuition programs or education investment account to the extent the distribution exceeds qualified higher education expenses paid by the taxpayer (and is not made on account of the death, disability, or scholarship received by the designated beneficiary or account holder).

Estate and gift tax treatment

For Federal estate and gift tax purposes, any contribution to a qualified tuition program or education investment account would be treated as a completed gift of a present interest from the contributor to the beneficiary at the time of the contribution. Thus, annual contributions of up to \$10,000 per donor per beneficiary would be eligible for the present-law gift tax exclusion provided by Code section 2503(b), and also would be excludable for purposes of the generation-skipping transfer tax. Such contributions would not, however, be eligible for the educational expense exclusion provided by Code section 2503(e). In no event would a distribution from a qualified tuition program or education investment account be treated as a taxable gift.

Transfers or rollovers of credits or account balances from an account benefiting one beneficiary to an account benefiting another beneficiary (or a change in the designated beneficiary) would not be treated as a taxable gift to the extent that the new beneficiary is: (1) a member of the family of the old beneficiary (as defined above), and (2) assigned to the same generation as the old beneficiary (within the meaning of Code section 2651). In all other cases, a transfer from one beneficiary to another beneficiary (or a change in the designated beneficiary) would be treated as a taxable gift from the old beneficiary to the new beneficiary to the extent it exceeds the \$10,000 present-law gift tax exclusion. Thus, a transfer of an account from a brother to his sister would not be treated as a taxable gift, whereas a transfer from a father to his son would be treated as a taxable gift (to the extent it exceeds the \$10,000 present-law gift

tax exclusion).

For estate tax purposes, the value of any interest in a qualified tuition program or education investment account would be includible in the estate of the designated beneficiary. In no event would such interests be includible in the estate of the contributor.

Effective Date

The proposed deduction for qualified higher education expenses (and the expansion of the definition of qualified higher education expenses under sec. 529 to cover room and board expenses) would be effective for expenses paid after December 31, 1997, for education furnished in academic periods beginning after such date. The provisions governing the tax-exempt status of qualified tuition plans and education investment accounts generally would be effective for taxable years beginning after December 31, 1997. The gift tax provisions would be effective for contributions (or transfers) made after the date of enactment, and the estate tax provisions would be effective for decedents dying after June 8, 1997.

3. Penalty-free withdrawals from IRAs for higher education expenses

Present Law

An individual may make deductible contributions to an individual retirement arrangement ("IRA") for each taxable year up to the lesser of \$2,000 or the amount of the individual's compensation for the year if the individual is not an active participant in an employer-sponsored qualified retirement plan (and, if married, the individual's spouse also is not an active participant). In the case of a married couple, deductible IRA contributions of up to \$2,000 can be made for each spouse (including, for example, a homemaker who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount.

If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the \$2,000 deduction limit is phased out over certain adjusted gross income ("AGI") levels. The limit is phased out between \$40,000 and \$50,000 of AGI for married taxpayers, and between \$25,000 and \$35,000 of AGI for single taxpayers. An individual may make nondeductible IRA contributions to the extent the individual is not permitted to make deductible IRA contributions. Contributions cannot be made to an IRA after age 70-1/2.

Amounts held in an IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Amounts withdrawn prior to attainment of age 59-1/2 are subject to an additional 10-percent early withdrawal tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, is used to pay medical expenses in excess of 7.5 percent of AGI, or is used to purchase health insurance of an unemployed individual.

Description of Proposal

The proposal would provide that the 10-percent early withdrawal tax would not apply to distributions from IRAs⁽¹⁹⁾ if the taxpayer used the amounts to pay qualified higher education

expenses (including those related to graduate level courses) of the taxpayer, the taxpayer's spouse, or any child, or grandchild of the individual or the individual's spouse.

The penalty-free withdrawal would be available for "qualified higher education expenses," meaning tuition, fees, books, supplies, equipment required for enrollment or attendance, and room and board at a post-secondary educational institution (defined by reference to sec 481 of the Higher Education Act of 1965). Qualified higher education expenses would be reduced by any amount excludable from gross income under section 135 relating to the redemption of a qualified U.S. savings bond and certain scholarships and veterans benefits.

Effective Date

The proposal would apply to distributions after December 31, 1997, which respect to expenses paid after such date for education furnished in academic periods beginning after such date.

B. Other Education-Related Tax Provisions

1. Extension of exclusion for employer-provided educational assistance

Present Law

Under present law, an employee's gross income and wages do not include amounts paid or incurred by the employer for educational assistance provided to the employee if such amounts are paid or incurred pursuant to an educational assistance program that meets certain requirements. This exclusion is limited to \$5,250 of educational assistance with respect to an individual during a calendar year. The exclusion does not apply to graduate level courses beginning after June 30, 1996. The exclusion expires with respect to courses beginning after June 30, 1997. In the absence of the exclusion, educational assistance is excludable from income only if it is related to the employee's current job.

Description of Proposal

The proposal would extend the exclusion for employer-provided educational assistance to courses of instruction beginning before December 31, 1997. As under present law, the exclusion would not apply to graduate-level courses.

Effective Date

The proposal would be effective with respect to taxable years beginning after December 31, 1996.

2. Modification of \$150 million limit on qualified 501(c)(3) bonds other than hospital bonds

Present Law

Interest on State and local government bonds generally is excluded from income if the bonds are issued to finance activities carried out and paid for with revenues of these governments. Interest on bonds issued by these governments to finance activities of other persons, e.g., private activity bonds, is taxable unless a specific exception is included in the Code. One such exception is for private activity bonds issued to finance activities of private, charitable organizations described in Code section 501(c)(3) ("section 501(c)(3) organizations") when the activities do not constitute an unrelated trade or business.

Present law treats section 501(c)(3) organizations as private persons; thus, bonds for their use may only be issued as private activity "qualified 501(c)(3) bonds," subject to the restrictions of Code section 145. The most significant of these restrictions limits the amount of outstanding bonds from which a section 501(c)(3) organization may benefit to \$150 million. In applying this "\$150 million limit," all section 501(c)(3) organizations under common management or control are treated as a single organization. The limit does not apply to bonds for hospital facilities, defined to include only acute care, primarily inpatient, organizations.

Description of Proposal

The \$150 million limit would be increased annually in \$10 million increments until it is \$200 million. Specifically, the limitation would be \$160 million in 1998, \$170 million in 1999, \$180 million in 2000, \$190 million in 2001, and \$200 million in 2002 and thereafter.

Effective Date

The proposal would be effective on January 1, 1998.

3. Enhanced deduction for corporate contributions of computer technology and equipment

Present Law

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair market value of property contributed to a charitable organization.⁽²⁰⁾ However, in the case of a charitable contribution of inventory or other ordinary-income property, short-term capital gain property, or certain gifts to private foundations, the amount of the deduction is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, a taxpayer's deduction is limited to the adjusted basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose (sec. 170(e)(1)(B)(i)).

Special rules in the Code provide augmented deductions for certain corporate⁽²¹⁾ contributions of inventory property for the care of the ill, the needy, or infants (sec. 170(e)(3)) and certain corporate contributions of scientific equipment constructed by the taxpayer, provided the original use of such donated equipment is by the donee for research or research training in the United States in physical or biological sciences (sec. 170(e)(4)).⁽²²⁾ Under these special rules, the amount of the augmented deduction available to a corporation making a qualified contribution is equal to its basis in the donated property plus one-half of the amount of ordinary income that would have been realized if the property had been sold. However, the augmented deduction cannot exceed twice the basis of the donated property.

Description of Proposal

The proposal would expand the list of qualified contributions that would qualify for the augmented deduction currently available under Code section 170(e)(3) and 170(e)(4). Under the proposal, qualified contributions would include gifts of computer technology and equipment (i.e., computer software, computer or peripheral equipment, and fiber optic cable related to computer use) to be used within the United States for educational purposes in any of grades K-12.

Eligible donees would mean (1) any educational organization that normally maintains a regular faculty and curriculum and has a regularly enrolled body of pupils in attendance at the place where its educational activities are regularly carried on; and (2) Code section 501(c)(3) entities that are organized primarily for purposes of supporting elementary and secondary education. A private foundation also could be an eligible donee, provided that, within 30 days after receipt of the contribution, the private foundation contributes the property to an eligible donee.

Qualified contributions would be limited to gifts made no later than two years after the date the taxpayer acquired or substantially completed the construction of the donated property. Such donated property could be computer technology or equipment that is inventory or depreciable trade or business property in the hands of the donor. The proposal would permit payment by the donee organization of shipping, transfer, and installation costs.⁽²³⁾ The proposal would apply only to donations made by C corporations; as under present law section 170(e)(4), S corporations, personal holding companies, and service organizations would not be eligible donors.

Effective Date

The proposal would be effective for contributions made in taxable years beginning after 1997.

4. Phase out qualified tuition reduction exclusion

Present Law

Under present law, a "qualified tuition reduction" is excluded from gross income (sec. 117(d)). A "qualified tuition reduction" means any reduction in tuition provided to an employee of an educational organization for the education of the employee,⁽²⁴⁾ the employee's spouse, and dependent children at that organization or another such organization. For this purpose, qualifying educational organizations are those that normally maintain a regular faculty and curriculum and normally have a regularly enrolled

body of pupils or students in attendance at the place where the educational activities are regularly carried out. In general, the qualified tuition reduction is limited to education below the graduate level; however, this limitation does not apply to graduate students engaged in teaching or research activities. The exclusion does not apply to any amount that represents payment for teaching, research, or other services rendered by the student in exchange for receiving the tuition reduction.

Description of Proposal

The proposal would phase out the special rule contained in section 117(d) that excludes qualified tuition reductions from gross income. For 1998, 80 percent of a qualified tuition reduction would be excluded from gross income. For 1999, the excludable percentage would be 60 percent; for 2000, the excludable percentage would be 40 percent; and for 2001, the excludable percentage would be 20 percent. No exclusion for a qualified tuition reduction would be permitted after 2001.

Educational benefits provided that are not excludable under the proposal could be eligible for the proposed HOPE credit or proposed deduction for qualified higher education expenses, described above.

Effective Date

The proposal would be effective for qualified tuition reductions with respect to courses of instruction beginning after December 31, 1997 (subject to the phaseout described above).

III. SAVINGS AND INVESTMENT TAX INCENTIVES

A. American Dream IRAs

Present Law

Under present law, an individual may make deductible contributions to an individual retirement arrangement ("IRA") up to the lesser of \$2,000 or the individual's compensation if the individual is not an active participant in an employer-sponsored retirement plan (and, if married, the individual's spouse also is not an active participant in such a plan). In the case of a married couple, deductible IRA contributions of up to \$2,000 can be made for each spouse (including, for example, a homemaker who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount.

If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the \$2,000 deduction limit is phased out over certain adjusted gross income ("AGI") levels. The limit is phased out between \$40,000 and \$50,000 of AGI for married taxpayers, and between \$25,000 and \$35,000 of AGI for single taxpayers. An individual may make nondeductible IRA contributions to the extent the individual is not permitted to make deductible IRA contributions. Contributions cannot be made to an IRA after age 70-1/2.

Amounts held in an IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Amounts withdrawn prior to attainment of age 59-1/2 are subject to an additional 10-percent early withdrawal tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, is used to pay medical expenses in excess of 7.5 percent of AGI, or is used to purchase health insurance of an unemployed individual.

In general, distributions from an IRA are required to begin at age 70-1/2. An excise tax is imposed if the minimum required distributions are not made. Distributions to the beneficiary of an IRA are generally required to begin within 5 years of the death of the IRA owner, unless the beneficiary is the surviving spouse.

A 15-percent excise tax is imposed on excess distributions with respect to an individual during any calendar year from qualified retirement plans, tax-sheltered annuities, and IRAs. In general, excess distributions are defined as the aggregate amount of retirement distributions (i.e., payments from applicable retirement plans) made with respect to an individual during any calendar year to the extent

such amounts exceed \$160,000 (for 1997) or 5 times that amount in the case of a lump-sum distribution. The dollar limit is indexed for inflation. A similar 15-percent additional estate tax applies to excess retirement accumulations upon the death of the individual. The 15-percent tax on excess distributions (but not the 15-percent additional estate tax) does not apply to distributions in 1997, 1998 or 1999.

Description of Proposal

In general

The proposal would replace present-law nondeductible IRAs with new American Dream IRAs ("AD IRAs") to which all individuals could make nondeductible contributions of up to \$2,000 annually. Contributions to an AD IRA would be in addition to any contributions that can be made to a deductible IRA under the present-law rules. No income limitations would apply to AD IRAs. An AD IRA would be an IRA which is designated at the time of establishment as an AD IRA in the manner prescribed by the Secretary. Qualified distributions from an AD IRA would not be includible in income.

Contributions to AD IRAs

The maximum annual contribution that could be made to an AD IRA would be the lesser of \$2,000 or the individual's compensation for the year. As under the present-law rules relating to deductible IRAs, a contribution of up to \$2,000 for each spouse could be made to an AD IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The \$2,000 contribution limit would be adjusted annually for inflation beginning after 1998. Inflation adjustments would be rounded to the nearest \$50.

Contributions to an AD IRA could be made even after the individual for whom the account is maintained has attained age 70-1/2.

Taxation of distributions

Qualified distributions from an AD IRA would not be includible in gross income, nor subject to the additional 10-percent tax on early withdrawals. A qualified distribution would be a distribution that (1) is made after the 5-taxable year period beginning with the first taxable year in which the individual made a contribution to an AD IRA⁽²⁵⁾

, and (2) which is (a) made on or after the date on which the individual attains age 59-1/2, (b) made to a beneficiary (or to the individual's estate) on or after the death of the individual, (c) attributable to the individual's being disabled, or (d) for first-time homebuyer expenses.

Distributions from an AD IRA that are not qualified distributions would be includible in income to the extent attributable to earnings, and subject to the 10-percent early withdrawal tax (unless an exception applies). The same exceptions to the early withdrawal tax that apply to IRAs would apply to AD IRAs. Thus, the following distributions from an AD IRA would not be subject to the 10-percent early withdrawal tax: (1) distributions after age 59-1/2; (2) distributions after death or disability of the AD IRA owner; (3) certain periodic distributions; (4) distributions for medical expenses in excess of 7.5 percent of adjusted gross income; (5) distributions for medical insurance of unemployed individuals; and (6) distributions for higher education expenses.⁽²⁶⁾ In addition, the 10-percent early withdrawal tax would not apply to amounts withdrawn from an AD IRA used to pay first-time homebuyer expenses.⁽²⁷⁾

An ordering rule would apply for purposes of determining what portion of a distribution that is not a qualified distribution is includible in income. Under the ordering rule, distributions from an AD IRA would be treated as made from contributions first, and all an individual's AD IRAs would be treated as a single AD IRA. Thus, no portion of a distribution from an AD IRA would be treated as attributable to earnings (and therefore includible in gross income) until the total of all distributions from all the individual's AD IRAs exceeds the amount of contributions.

The pre-death minimum distribution rules that apply to IRAs would not apply to AD IRAs, and amounts

in AD IRAs would not be taken into account for purposes of the excise tax on excess distributions or the additional estate tax on excess accumulations.

Distributions from an AD IRA could be rolled over tax free to another AD IRA.

Conversions of IRAs to AD IRAs

All or any part of amounts in a present-law deductible or nondeductible IRA could be converted into an AD IRA after December 31, 1997, and before January 1, 1999. The amount that would have been includible in gross income if the individual had withdrawn the converted amounts would be included in gross income ratably over the 4-taxable year period beginning with the taxable year in which the conversion is made. The early withdrawal tax would not apply to such conversions.⁽²⁸⁾

A conversion of an IRA into an AD IRA could be made in a variety of different ways and without taking a distribution. For example, an individual could make a conversion simply by notifying the IRA trustee. Or, an individual could make the conversion in connection with a change in IRA trustees through a rollover or a trustee-to-trustee transfer. If a part of an IRA balance is converted into an AD IRA, the AD IRA amounts would have to be held separately.

Effective Date

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

B. Capital Gains Provisions

1. Maximum rate of tax on net capital gain of individuals

Present Law

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of capital assets, the net capital gain is taxed at the same rate as ordinary income, except that individuals are subject to a maximum marginal rate of 28 percent of the net capital gain. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, or (5) certain U.S. publications. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances that would have been available under the straight-line method of depreciation.

Description of Proposal

The proposal generally would reduce the maximum rate of tax on the net capital gain of an individual from 28 percent to 20 percent. Net capital gain presently taxed to an individual at a 15-percent rate would be taxed at a 10 percent rate. These rates also would apply for purposes of the alternative minimum tax.

The tax on the net capital gain attributable to any long-term capital gain from the sale or exchange of collectibles would remain at a maximum rate of 28 percent; any long-term capital gain from the sale or exchange of section 1250 property (i.e., depreciable real property) which would be treated as ordinary income if the property were section 1245 property (i.e. depreciable personal property) would be taxed at

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1

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Background on Chairman Archer's Tax Plan

June 10, 1997

The Clinton Administration's goal is to increase the amount of tax relief going into the pockets of working families. Chairman Archer's plan strays from that goal. It provides too little tax relief for working families in order to provide unnecessary tax cuts to those who least need them:

Completely Denies the Child Tax Credit to 4 Million Working Families. Under the Archer plan, the child tax credit is figured only after the earned income tax credit is taken against a family's tax bill. The Center on Budget and Policy Priorities has estimated that this will deny the credit to 4 million families. For example: A family of four with two children and \$25,000 of income would receive no child tax relief under the Archer plan. Under the President's plan, this family would get \$1,000 -- just as much as a family earning twice that much. The President's overall child tax credit would provide \$193 billion to working families over ten years -- \$45 billion more than Archer's would.

Singles Out and Penalizes 6 Million Families who Pay for Child Care and Gives them Less of a Tax Cut. The child tax credit is designed to help hard working families raise their children. Instead of helping families pay for child care, the Archer plan reduces the tax cut for 6 million families. Beginning in 2003, more than 6 million families who receive a tax credit for child care expenses would lose 50 cents for each dollar of the child tax credit. For example: A family with two working parents making \$45,000 who pay for child care for their two children would seemingly be eligible for a \$1,000 child tax credit. But under the Archer plan, they would also lose \$480 of their child tax credit.

Dramatically Cuts the HOPE Scholarship Tax Credit to Students Going to Community Colleges. While we're pleased Chairman Archer has included a version of the President's HOPE scholarship, it is less fair than the President's plan. For example: A student from a working family who goes to a community college with a \$1,200 tuition would have his or her entire tuition paid for under the President's plan. Under the Archer plan, that same student would receive only \$600. The Archer plan fails to advance the President's goal of making the first two years of college universal. Under the Archer plan, a student attending an expensive private school would receive the full \$1,500 credit, but the student attending community college would be short changed.

Over 250 college presidents -- from community colleges to public and private colleges and universities -- support the President's proposals. The President of the American Council of Education says: *"The Hope tax credit is a giant step in the direction of making the first two years of college a universal benefit."* And the American Association of State Colleges and Universities stated about the Archer plan on June 9th, that *"instead of improving the Administration's education-related tax proposals, it accomplishes just the opposite. It is more regressive and does nothing to expand access to higher education."*

INSTEAD OF MAXIMIZING TAX RELIEF FOR WORKING FAMILIES, THE ARCHER PLAN PROVIDES EXTENSIVE TAX CUTS FOR CORPORATIONS AND HIGHER-INCOME PEOPLE:

Allows Profitable Corporations to Pay not a Penny in Income Taxes. In 1986, Citizens for Tax Justice surveyed 250 of the nation's largest and most profitable corporations and found that 130, more than half, paid no income taxes during at least one of the five years 1981-1985. During those years when they paid no income taxes, these companies earned a combined \$73 billion in pretax domestic profits. That is why there is a corporate alternative minimum tax. The Archer plan would return us to the days when some giant corporations didn't pay a penny in income taxes -- costing \$34 billion over ten years.

Capital Gains Tax Cuts Would Explode the Deficit. On top of a broad-based capital gains tax cut, the Archer plan includes indexing of capital gains beginning in 2001. This proposal, which would be enormously difficult to administer, would threaten to undo much of the progress of bringing down the deficit. That's why the President insisted that the Republican leadership commit that the tax cut "shall not cause costs to explode in the outyears."

\$35 Billion Tax Cut To Make College More Affordable for America's Families

June 5, 1997

The historic bipartisan balanced budget agreement reserves \$35 billion for President Clinton's \$1,500 tax credit and \$10,000 tuition deduction to make college more affordable for America's families. We must not lose this historic opportunity to open wide the doors of college for every American willing to work for it. Now is the time to enact this carefully designed and targeted tax credit and tuition deduction to prepare America to navigate the 21st century.

On the Bipartisan Balanced Budget Agreement: "...the package must include tax relief of roughly \$35 billion over five years for post-secondary education, including a deduction and a tax credit. We believe this package should be consistent with the objectives put forward in the HOPE scholarship and tuition tax proposals contained in the Administration's FY 1998 budget to assist middle-class parents."

-- Letter to the President from House Speaker Gingrich and Senate Majority Leader Lott

\$1,500 Tax Credit to Make the First Two Years of College "Universally Available"

- Up to a \$1,500 tax credit for tuition and fees paid for in the first two years of college.
- Students must make "satisfactory progress" in the first year to get a second tax credit (instead of a "B-" average requirement).
- Low-income students may benefit from both the full tax credit and a Pell Grant.
- Makes the average community college *free* for those who finished high school.
- Will make at least two years of college as universal as the first 12 years of school.
- Expected to help more than 4 million students in 1998.
- Available for most working and middle-income families. Phased out for joint filers with incomes between \$80,000 and \$100,000, and single filers with incomes between \$50,000 and \$70,000.

\$10,000 Tuition Deduction to Help Americans "Learn for a Lifetime" and Update Their Skills

- Allows families to deduct tuition and fees -- up to \$10,000 a year each year -- for higher education at any time in one's life. The deduction would be phased in.
- Covers tuition for job training and retraining as well as traditional college and graduate school. *It will help teachers, auto mechanics, nurses, computer specialists and any American seeking to update his or her skills and get the training needed to get ahead.*
- Lets families deduct their investments in education in the same way that corporations can deduct their investments in machinery and equipment.
- Tax-relief while the student is in school -- not years later.
- Tax-relief for families who save for college or training, regardless of whether they borrow.
- Expected to help about 8 million students in 1998.
- Available for most working and middle-income families. Families do *not* need to itemize. Deduction would be phased out for joint filers with incomes between \$80,000 and \$100,000, and single filers with incomes between \$50,000 and \$70,000.

Largest Pell Grant Expansion in Two Decades: The Budget Agreement also contains the President's proposal to increase the maximum Pell Grant by \$300 to \$3,000, to make more college affordable for millions of deserving, low-income students, including older, low-income students.

Supported by Over 250 College Presidents: Over 250 college presidents -- from community colleges, and public and private colleges and universities -- support the President's proposals. The President of the American Council on Education says "The Hope tax credit is a giant step in the direction of making the first two years of college a universal benefit." [6/4/97 letter to Secretary Riley]

CLINTON ADMINISTRATION HIGHER EDUCATION TAX PACKAGE

June 4, 1997

The Clinton Administration is proposing several changes in its higher education tax proposals that will make them more progressive, simpler, and respond to concerns raised by others. The President's HOPE Scholarship Tax Credit for the first two years of college and \$10,000 Tuition Deduction for life-long education and training will cost \$35 billion over 5 years. The additional education and training tax proposals will be paid for outside this \$35 billion. The Administration is making the following changes in its higher education tax package:

1. Allow more students to receive both a HOPE Scholarship and a Pell grant.

To allow lower-income students to benefit more from the HOPE tax credit, their HOPE tax credit will not be reduced by the amount of their Pell or other federal grants.

2. Require satisfactory progress rather than a B average to receive a second HOPE tax credit.

To allay concerns about grade inflation and IRS intrusion into academic affairs, this package eliminates the requirement that students maintain a B average in order to be eligible for a second HOPE tax credit, and instead requires students to meet the current satisfactory progress requirements used for eligibility for existing federal student aid programs.

3. Pay for changes by phasing in the proposals more slowly.

The total cost of the \$1,500 HOPE tax credit and \$10,000 tuition deduction will be \$35 billion over 5 years.

4. Restore Student Loan Interest Deduction

To provide additional assistance to families borrowing money for higher education, the package reinstates the tax deductibility of interest on any student or parent higher education loan. This deduction was eliminated by the 1986 Tax Reform Act.

5. Provide Tax Relief for Employer-Provided Education: Extend Section 127 & Establish a New Small Business Tax Credit

President Clinton's FY98 Budget proposed extending the exclusion of the first \$5,250 of employer-provided graduate or undergraduate educational assistance from employee taxable income (Section 127) and establishing a new 10% tax credit for small businesses that provide their employees with education and training. This package extends Section 127 through at least 2002 and establishes the President's small business tax credit.

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FALSE CLAIMS ABOUT THE PRESIDENT'S HIGHER EDUCATION TAX PROPOSALS

June 7, 1997

Some have characterized a recent Congressional Research Service report ("Tax Subsidies for Higher Education: An Analysis of the Administration's Proposal") as concluding that the Administration's HOPE Scholarship and tuition deduction proposals will result principally in a "windfall" to families and will prompt only a limited percentage of students to pursue additional education. In fact, the report's findings are supportive of the objectives of the Administration's education initiatives. Below we address the claims being made about the CRS report, and we address other false claims that have recently been made about the President's higher education tax cut proposals.

FALSE CLAIM #1: TAX CUTS WILL ONLY SPUR TUITION INFLATION

- **The CRS report strongly contradicts the claims of some critics who have charged that the Administration's education tax proposals would only result in higher tuition.**

The most important conclusion of the CRS report is that only a very small part of the tax subsidies will feed higher tuitions. The vast majority will therefore either pay for additional education or provide a tax cut for hard-working American families. According to the CRS report, less than 1/3 and perhaps even less than 1/10 of the value of the tax subsidies would manifest itself in higher tuitions:

"Overall, this analysis suggests that only a small portion of the subsidy will appear as a tuition increase, probably less than a third of the subsidy value and perhaps even less than ten percent." [CRS, 5/30/97, page 19]

- **The limited effect on tuitions means that the vast majority of the tax subsidy would pay for either more (or higher quality) education or a middle-class tax cut to make college less expensive.** This confirms what the Administration has been arguing all along: that the HOPE Scholarship and the tuition deduction will provide tax relief to middle class families at a time when they need it most -- when they are putting themselves or their children through college.
- **Any program to boost higher education has the potential to put upward pressure on tuition. But the evidence suggests that Federal aid does not have much effect on tuition costs.**

College tuition rose rapidly in the 1980's, but real Federal aid fell during that period -- by about 1 percent per year, according to data from the College Board and the Department of Education. During the 1970's, on

the other hand, real Federal aid rose by 7 percent per year -- while real tuition levels remained flat.

- **Georgia's experience may illustrate the effects of competition in limiting price increases from scholarship programs.** In Georgia, where the Hope Scholarship was introduced in 1993, tuition costs at public 2-year community colleges rose 13 percent -- from \$937 to \$1,062 -- between the 1992-3 academic year, and the 1995-6 academic year. In the nation as a whole, tuition rose 21 percent -- from \$1,026 to \$1,245.

FALSE CLAIM #2: CRS REPORT FINDS LARGE "WINDFALLS" FROM PROPOSALS

- **Our education tax proposals were always intended to be a targeted tax cut for middle-income families.** We want to cut taxes for families who would have struggled to put their children through college even without the tax break.
 - **The "windfalls" identified in the CRS report are actually tax cuts for hard-working American families to make college less expensive.** The report concludes that some of the tax subsidy will benefit families that are already paying for a family member to attend college. But there's nothing wrong with that -- it is a stated goal of the proposal. The so-called "windfall" is a tax cut for middle-class American families with someone already in college or planning to attend college.
- **The shares of the tax subsidy paying for pure middle-income tax cuts and for additional education vary from scenario to scenario in the CRS report.**
- **One highlighted scenario finds that the benefits of the tax cut will be almost evenly split between these two outcomes.** The scenario, highlighted in the second paragraph of the summary, finds that:
 - 48 percent of the tax subsidy for the first two years of college would be used for more (or higher quality) schooling, and
 - 42 percent of the tax subsidy would provide tax relief for middle-class families squeezed by the higher costs of college.

Other scenarios find a larger share going to tax relief, which is misleadingly labeled a "windfall."
- **The scenarios in the CRS report do not take account of the Administration's proposed Pell increase, and therefore understate the likely increase in educational output.** The study projects effects from the HOPE Scholarship and tuition deduction without taking account of the proposed increase in Pell grants that is a very important part of our package. The authors acknowledge that if they had taken

the Pell increase into consideration, they would have projected a *greater increase* in educational output and less of a pure middle-class tax cut than their study found.

FALSE CLAIM #3: PROPOSALS HELP UPPER-INCOME FAMILIES THE MOST

- **Criticism, such as in the CRS report, often fails to reflect the proposed expansion in Pell grants -- the largest increase in two decades.** Four million students could receive a grant of up to \$3000, an increase of \$300 in the maximum grant.
- **The CRS report also pre-dates, and therefore fails to reflect, the Administration's changes that make the Hope scholarship more progressive.** Removing the Pell offset from the Hope program means that more low-income students will be able to benefit from both the Pell grant and the Hope Scholarship.
- **Even without the Administration's recent changes and the Pell grant expansion, the report's findings indicate that the education tax proposals are relatively well-balanced -- and much more so than many other tax proposals.**

The report concludes that more than half the benefits go to the 58 percent of families in the lowest tax bracket (less than \$39,000 in taxable income on a joint return) -- even ignoring the expansion in the Pell grant program. The rest goes to the 42 percent of families who face marginal tax rates of 28 percent or more. [CRS, 5/30/97, page 22]

By comparison, the Citizens for Tax Justice concluded that 68 percent of the benefits from a 19.6 maximum capital gains tax rate would go to the top 1 percent of households. [Citizens for Tax Justice, May 1997.]

- “It hits me in the face every day of my life that a very significant number of people are able to go to technical institutions and get training because financing is no longer a burden to them,” said Ken Breeden, who supervises that part of the Georgia Hope Scholarship program. [Quoted in the *New York Times*, 3/3/97]

FALSE CLAIM #4: ADMINISTRATION'S PACKAGE IS NOT SUPPORTED BY THE EDUCATION COMMUNITY

- **Over 300 college presidents have expressed support for the Administration's higher education initiatives.**
- **Support is even stronger given the recent changes to the Administration's proposals.** Stanley Ikenberry, the President of the American Council of Education, recently wrote to Secretary Riley noting that the Administration's proposals “*represent a much improved package that will do a great deal to help families*

finance higher education. The Hope tax credit is a giant step in the direction of making the first two years of college a universal benefit."

- **The President's education package will have a positive psychological effect.** By highlighting the importance of education, the HOPE Scholarship and the tuition deduction will draw continuing national attention to the idea that more Americans should seek post-secondary educational opportunities.

CRS Report for Congress

Tax Subsidies for Higher Education: An Analysis of the Administration's Proposal

May 30, 1997

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Tax Subsidies for Higher Education: An Analysis of the Administration's Proposal

SUMMARY

Three economic rationales often are cited to justify public subsidy of postsecondary education: capital market failure that leads to inequality of opportunity; external benefits that accrue to society rather than the individuals who invest; and nonneutral taxation of human capital. Human capital is more, not less, favorably taxed than is physical capital. Furthermore, federal and state-local subsidy of higher education that exceeds \$60 billion per year probably has gone a long way toward compensating for inadequate investment due to capital market failure and external benefits. It may be true that additional subsidy of some students would reduce remaining capital market failures or generate external benefits, but these subsidies need to be carefully targeted if they are to be productive and avoid windfall gains to some students.

The extent to which the federal revenue loss from the proposed tax preferences appears as windfall gains to students or higher tuition depends upon the number of students whose price for an additional dollar of investment is lowered and the responsiveness of both students and schools to this reduced price (tuition). This study finds that almost 43 percent of subsidy recipients would not experience a reduced price. If both demand and supply are relatively more responsive (middle and higher-income students sensitive to price change, schools able to increase supply), about 48 percent of the tax subsidy for the first two years of college would appear as increased education, 52 percent would be lost—10 percent in higher tuition, 42 percent in windfall gains. For the entire program, tuition would rise by two percent, education by 10 percent.

If demand and supply are less responsive (middle and higher-income students not responsive to price change, schools able to increase supply only with difficulty), about 10 percent of the tax subsidy would appear as increased education, about 90 percent would be lost—10 percent in higher tuition, 80 percent in windfall gains. For the entire program, both tuition and education would rise by three percent.

This study finds the Administration's proposal is structured in a way that does not change the price for the last dollar of investment for many students, and would subsidize many middle and higher-income students who already attend school and may not be responsive to a price reduction. Congress could opt to improve targeting and provide more social benefits by eliminating the deduction and providing a refundable partial (e.g. 50 percent) rather than 100 percent credit. This would provide a marginal benefit for a larger share of eligible students, include more lower-income students, and restrain school incentives to raise tuition. A more far-reaching option would forego a tax benefit and expand direct benefits targeted to students for whom the subsidy is likely to satisfy the economic rationales for public subsidy—lower and moderate-income students who are price sensitive. States might be encouraged to restructure their pricing system to raise tuition and use the increased revenue to provide increased aid focused on lower and moderate-income students who continue to suffer from capital market failures.

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The authors thank Richard Apling and Bob Lyke of the Education and Public Welfare Division for many helpful suggestions and their assistance with data.

Tax Subsidies for Higher Education: An Analysis of the Administration's Proposal

Introduction

Federal subsidy of higher education investment is accomplished through a variety of programs. The Administration has proposed an additional five-year subsidy totalling \$35 billion through a system of tax credits and tax deductions for individuals' tuition expenses. This proposal implicitly accepts the proposition that existing federal subsidies are too small or too narrow.

It is not possible for economic analysis to provide an answer about whether additional subsidies are desirable; too much of the necessary information is nonquantitative and subjective. This report explains the economic rationales for federal subsidy of higher education and what these rationales suggest about the need for more subsidy for some students and what some would consider wasted subsidies for other students.

Within that context, this report analyzes the potential economic effects of the Administration's proposed tax subsidies on education investment, tuition, and windfall gains. Options are identified for restructuring the tax subsidies to provide more educational output and help correct remaining market failures in exchange for the revenue loss.

The Administration proposal also would increase spending subsidies for higher education, particularly \$1.7 billion in fiscal year 1998 for additional Pell Grants for lower-income students.¹ This report estimates the effect of the tax subsidies assuming the spending subsidies are not increased. Were the Pell Grant proposal to pass, the estimated impact of the combined package of tax and spending subsidies on educational output would rise slightly and the share of the subsidy received as a windfall gain would decrease somewhat.

Economic Rationales

Federal subsidy of higher education has three potential economic justifications: a capital market failure; external benefits; and nonneutral federal

¹ A more detailed description of the proposal, including the Pell Grant changes, can be found in U.S. Library of Congress. Congressional Research Service. *Tuition Tax Credit and Deduction: Who Benefits from the President's Proposal?* CRS Report 97-567 EPW by James B. Stedman, Bob Lyke, and Margot Schenet, 55 p.

income tax treatment of physical and human capital. Subsidies that correct these problems are said to provide taxpayers with "social benefits."

Capital Market Failure

Many students find themselves unable to finance their postsecondary education from earnings and personal or family savings. Student mobility and a lack of property to pledge as loan collateral require that commercial lenders charge high interest rates on loans for postsecondary education to reflect their high risk of default. As a result, students often find themselves unable to afford postsecondary loans from the financial sector.² By definition, this financial constraint bears more heavily on lower-income groups than on higher-income groups and leads to inequality of opportunity.³ It is also inefficient because these students on average might be expected to earn a rate of return on postsecondary education loans that is higher than the rate of return earned on the alternative loans made by the financial sector.

This "failure" of the capital markets is attributable to the legal restriction against pledging an individual's future labor supply as loan collateral, that is, against indentured servitude. Since allowing indentured servitude is something modern society rejects, the federal government pursues an alternative strategy to correct this market failure—it provides a guarantee to absorb most of the financial sector's default risk associated with postsecondary loans to students.⁴ This financial support is provided through the Federal Family Education Loan Program and the Direct Loan Program. These programs guaranteed approximately \$34 billion of loans for postsecondary education in FY 1997. Outlays in 1997 for the default costs of guaranteed loans made in prior years totalled almost \$3 billion.

This guarantee is an entitlement and equalizes the financing cost for some portion of most students' education investment.⁵ When combined with Pell

² An early discussion of this issue appears in chapter VI of Friedman, Milton. *Capitalism and Freedom*. Chicago: The University of Chicago Press, 1962.

³ In economic terms, promoting equality of opportunity means ensuring that the cost of financing any given dollar of human capital investment is equal for all individuals. It does not mean ensuring equal returns from that investment. Becker, Gary. *Human Capital*, New York: National Bureau of Economic Research, 1975.

⁴ Through the mid-1980s, regulatory restrictions on interstate banking limited loan availability for students in states with poorly developed capital markets. This situation was cited to justify postsecondary loan guarantees both at the state and federal level. Deregulation of the banking system in the 1980s established regional branch-banking networks and bank holding companies that reduced the extent of this problem. A summary and compendium of the states' interstate banking laws is available in U.S. Library of Congress. Congressional Research Service. *Nationwide (Interstate) Banking: An Update*. CRS Report 95-749 E by William Jackson, 9 p.

⁵ The financing cost is actually lower for lower-income students, for whom in-school interest payments are paid by the federal government

Grants for lower-income students, it appears that some portion of the capital market failure has been corrected and equality of opportunity has been improved. But these sources of funding fall below education expenses for many students, suggesting that in some instances the market failure has been moderated but not eliminated. In other instances, loans are guaranteed for students who do not produce social benefits and, therefore, are wasted.

By definition, the social benefits to be obtained from these loans occur only if the student increases his or her education investment. But many students who receive guaranteed loans are insensitive to price and do not increase their education in response to the federal guarantee. Chief among these are students whose families do have the resources to finance college attendance without taking out loans, and would do so in the absence of the federal program. Providing loans to such students does not correct a market failure and does not increase equality of opportunity. Other students who do face financial constraints are demonstrably good risks for obtaining loans from the private sector; that is, their probability of default is so low and their expected returns so high that private lenders would make loans to them without the federal guarantee. For example, an additional 3.8 percentage points charged on nonguaranteed loans made to graduate and professional students in 1989 would have earned lenders the same return they earned on federally guaranteed loans to those students.⁶

Finally, default rates are relatively high for first-year students, suggesting some of these students are poorly prepared for higher education and have very little chance of successfully completing postsecondary education and contributing to the social benefits the subsidies are intended to generate. In effect, no capital market failure exists. The problem here may be inadequate investment in elementary and secondary education, not higher education. Because the student loan program is an entitlement, no effort is made to identify and deny loans to these high-risk first-year students. One way to rectify this problem would be to make each school share in the cost of defaults imposed by its students. This risk sharing would provide schools with an incentive to assess the likelihood of success for their entering students, and deny loans to those who carry the highest risk and produce few social benefits.

External Benefits

Some benefits from postsecondary education may accrue not to the individual being educated, but rather to the members of society at large. These external benefits are not valued by individuals, causing them to invest less than is optimal for society (even assuming no capital market imperfections). External benefits are variously described as taking the form of better citizenship and increased productivity generated by knowledge.

⁶ U.S. Library of Congress. Congressional Research Service. *Reducing Federal Student Loan Costs: The Options Are Narrowing*, CRS Report 97-255 E by Barbara Miles and Dennis Zimmerman, 29 p.

Society surely must benefit enormously, for example, when greater supplies of educational capital create a scientific environment conducive to more successful research and development activities. And the general population surely must gain when rising levels of education create better neighborhoods and more alert citizens ... In our judgment, the evidence strongly favors the existence of numerous externalities ... ⁷

Public subsidies to postsecondary education that are at least partially motivated by these external benefits, as opposed to the capital market failure addressed by the federal student loan and Pell Grant programs, are considerable. The state-local sector is by far the major contributor here, spending \$50 billion on public (and some private) higher education systems in 1993-94 that provide relatively uniform subsidies to all student participants. The federal government provided \$2.7 billion of interest subsidies through the student loan program in 1997 over and above the value of the guarantee being provided and several billion in work-study grants and a variety of other assistance programs.

Thus, federal and state-local subsidies to higher education that arguably can be said to be designed to increase external benefits total tens of billions of dollars per year. Are these external benefits large enough to justify this magnitude of public subsidy? Are even greater subsidies needed? Although the value of external benefits is largely undocumented, a discussion of the two major types of benefits might be useful in clarifying the issues.

The vast majority of individuals who receive a subsidy for their educational investment probably make little, if any, contribution to the first major category of external benefit—the advancement of knowledge that leads to more successful research and development activities and contributes to economic growth and increased society welfare. The subsidies received by many of these individuals do not contribute in terms of increasing this type of social benefit.

One can even question whether the subsidies given to those individuals who do contribute to this store of knowledge and research and development activity actually increase the supply of these social benefits. These students are among the most able and motivated individuals in each generation. They usually are identified and marked as college material during their secondary education. They are more likely to receive scholarships and grants. These individuals have access to the student loan program to ameliorate any further capital-access problems that might inhibit their pursuit of a higher education. To the extent

⁷ Douglass, Gordon K. "Economic Returns on Investments in Higher Education" in Bowen, Howard R. (ed), *Investment in Learning: The Individual and Social Value of American Higher Education*, San Francisco: Jossey-Bass, Inc, 385-86. Bowen also has three chapters in this book which attempt to explain the value of higher education to society. One of those chapters addresses the role of higher education in furthering equality of opportunity. The analysis in this report includes that societal benefit under the capital market failure.

these individuals would attend school without additional subsidies, their social benefit contributions are not dependent on the subsidy, which is wasted. If subsidies for increased knowledge are to be provided, they might be better targeted to schools for program enrichment that will increase the stock of physical and human capital available to the relatively small pool of potential knowledge-enhancing students.

The other major category of external benefits focuses on the proposition that rising levels of education help create better neighborhoods and more alert citizens. All who have studied these issues agree that education plays an important role in cementing the social fabric by teaching civic responsibilities and enhancing each citizen's ability to appreciate and share a common culture and history.⁸ The real question here is whether this job is (or should be) accomplished by elementary and secondary education, a level of education common to virtually all neighborhoods and citizens.

This argument seems to suggest that working class communities in cities or small towns populated primarily by high-school graduates are somehow deficient in creating neighborhoods and citizens that meet minimum standards of civic responsibility and culture. One must be careful about the evidence brought to bear on this question. Communities of more educated citizens probably do enjoy an enhanced appreciation of music and art, a greater facility and pleasure in debating public policy issues, etc. It is not clear, however, how these cultural and civic assets generate external benefits consumed by the general public beyond the community's borders. They appear to be more properly classified as nonmonetary private consumption benefits individuals receive from their own higher education, not as external benefits.

More relevant evidence is the correlation between college attendance and various indicators of civic responsibility (lower crime rates, higher voting rates, reduced likelihood of receiving public subsidies). But it is not at all clear what the causality is. It may well be that individuals who have traits that lead to greater levels of civic responsibility are also likely to take steps to enhance their lives in other ways, including college attendance. It may be that the individuals who would be induced to attend college with an additional subsidy are those high school graduates most likely to be responsible citizens and least likely to be involved in socially dysfunctional behavior or behavior that is costly to others. Additional programs, particularly targeted to poor performers in the public elementary and secondary school system, arguably are more likely to target this externality.

Again, it seems not unreasonable to argue that some amount of the substantial public subsidy devoted to increasing external benefits may be wasted.

⁸ In addition to Friedman (1962) and Bowen (1977), these issues have been discussed by Hansen, W. Lee and Weisbrod, Burton. *Benefits, Costs, and Finance of Public Higher Education*. Chicago: Markham Publishing Co., 1969; and Leslie, Larry L. and Brinkman, Paul T. *The Economic Value of Higher Education*. New York: Macmillan Publishing Company, 1988.

Should higher subsidies be needed for some students who do produce external benefits, some funds might be available through reform of existing subsidy structures. In this regard, attention might be focused on state-local subsidies which are structured to provide virtually identical price reductions to all students. It is obvious that many of these students would attend college with no or a smaller subsidy, and therefore provide no increase in social benefits. The adoption of pricing strategies that differentiate between the price sensitivity of various student groups might be adequate to fund higher subsidies for those students whose college attendance would produce incremental social benefits and who require a larger subsidy in order to attend.

Nonneutral Taxation of Human Capital

A third potential justification sometimes advanced for providing subsidies to human capital investment is the possibility that investment in human capital is more heavily taxed than is investment in physical capital. Some believe this to be true because individuals are not allowed to recover education expenses such as tuition costs over their lifetime.

But any analysis of whether the tax system discriminates against human capital investment also must consider those aspects of the current tax system that discriminate in favor of human capital investment. Foregone earnings, scholarships, and government grants represent a larger share of an individual's human capital investment than do most students' direct outlays such as tuition. These investments are effectively deducted when incurred because they are never included in income in the first place.

Under a proportional tax system with no exclusions or deductions, this tax treatment imposes a zero tax on the return on this part of human capital investment. (The present value of taxes collected on earnings is equal to the value of the up-front benefit of taxes not paid on foregone earnings, with the net present value of taxes equal to zero.) This favorable tax treatment is limited by personal exemptions and the standard deduction which exempt part of the foregone earnings, scholarships, and grants, and by the progressive rate system which may tax future earnings at a higher rate than the tax rate at which investments are initially deducted.

Table 1 compares the effective marginal tax rates on investment in physical and human capital. Overall, it seems unlikely that investment in human capital is excessively taxed compared to physical capital. The effective marginal tax rate on physical capital investment is estimated to be about 33 percent.⁹ This is a

⁹ See Jane G. Gravelle, *The Economic Effects of Taxing Capital Income*. Boston: MIT Press, 1994. The effective marginal tax rate estimates take into account not only the statutory tax rates on capital income at the corporate and individual levels but any other tax subsidies and penalties that cause the statutory and effective tax rates to differ (e.g. accelerated depreciation). The analysis assumes the average marginal statutory tax rate on individual capital income is 23 percent. The same assumption will be made in the (continued...)

weighted average of individuals' average marginal effective tax rate of 22 percent on their noncorporate business capital; the relatively high 43 percent marginal tax rate on the return to corporate equity capital (which is subject to both the higher corporate tax rate as well as the individual rate); and the low four percent rate imposed on owner-occupied housing.

Table 1. Effective Marginal Tax Rates on Physical and Human Capital	
Investment Type	Average Marginal Tax Rate
Physical Capital Investment	33
Corporate Business Capital	43
Noncorporate Business Capital	22
Owner-Occupied Housing	4
Human Capital Investment	
100 Percent Expensed	15
75 Percent Expensed	21
50 Percent Expensed	26
25 Percent Expensed	32
0 Percent Expensed	37
Source: Tax rates on physical capital are from Jane G. Gravelle, <i>The Economic Effects of Taxing Capital Income</i> , Cambridge, MA: MIT Press, 1994, p. 294. Tax rates on human capital are calculated by authors.	

An illustration shows that the tax on human capital investment is likely to be lower. Assume the average marginal statutory tax rate when earnings are increased due to education is 23 percent, and the marginal tax rate on earnings when a student is 15 percent. Also assume that the return is paid in equal increments over a 40 year period, that the pretax real rate of return is 7 percent, and that the inflation rate is 3 percent.¹⁰

⁹(...continued)

calculation of the tax on human capital investment. This reported tax rate of 33 percent may be slightly overstated because it does not account for intangibles which, while only a small part of the capital stock, are favorably taxed. Today's lower inflation rate is also likely to lower the tax rate slightly. The effective marginal tax rate might be as low as 30 percent.

¹⁰ This effective tax rate is measured by determining the increment of additional income per dollar of education investment necessary to yield the pretax return, and then
(continued...)

The fraction of investment that is expensed will vary across students, but as a rough example, assume that a high school student with a good record and skills (likely to attend college) will make over the next four years an average of \$8.50 an hour for 40 hours a week and 50 weeks a year, for an annual total income of \$17,000. According to data to be used subsequently, the average college tuition is approximately \$1500 (after accounting for grants). Fifty-eight percent of this \$18,500 investment is expensed (all except for tuition and the portion of earnings that is exempt because of the student's personal exemptions and standard deduction). The tax on this investment is 25 percent, actually lower than the tax on physical capital.

Of course, these results do not hold true for every student, and table 2 shows how the effective tax rate increases as the share of the investment that is expensed decreases. In addition, students who go to more expensive universities will experience a higher tax rate (although, at the same time, they are more likely to be earning a higher return on their investment and be less sensitive to changes in competing after-tax returns). In general, however, taxes on human capital investment do not appear to be high compared to taxes on physical capital.

These effective tax rates depend critically upon the relative size of foregone earnings (not taxed) and the net tuition (taxed). Some might argue the earnings figure is too high and should be adjusted downward to reflect summer earnings of the student. Others might argue for a higher tuition to be used. Both of these adjustments would raise the effective tax rate on human capital. But other factors would act to lower the rate. The estimates do not account for existing nontax subsidies such as grants and the value of loan guarantees (and the failure to include them in income), nor do they account for the portion of the return to education attributable to nonmonetary consumption benefits that are not taxed.¹¹

Summary: Economic Rationales and Additional Subsidies

The return from investment in human capital receives more favorable treatment from the federal income tax than does the return from investment in physical capital. Thus, nonneutral income taxation cannot be used to justify subsidy of postsecondary education. The existence of a capital market failure and the presence of external benefits from higher education investment do provide justifications for public subsidy of higher education.

¹⁰(...continued)

solving a discounted cash flow model with those earnings for the internal after-tax return. The effective tax rate is the difference between the pretax and after-tax returns, divided by real (inflation-adjusted) return. Seven percent is roughly the average pre-tax return on physical capital in the United States.

¹¹ See Leslie and Brinkman (1988) and Bowen (1977) for discussions of these nonmonetary consumption benefits enjoyed by those who invest in education.

The federal student loan program and Pell Grants have partially corrected the capital market failure, and \$50 to \$60 billion of annual state-local and federal subsidies have probably gone a long way toward compensating for the existence of external benefits. It is probably true that additional subsidy of some students would further reduce remaining capital market failures or generate additional external benefits. But the subsidies need to be targeted carefully to reach those students who continue to suffer from capital market failures or are likely to respond to subsidies (price reductions) if they are to increase external and social benefits.

Analysis of President's Proposal

This section of the report evaluates whether the President's proposal targets aid to those students who are likely to generate social benefits.

Description

The Administration proposal would provide a federal income tax credit and deduction for postsecondary education tuition and fees paid by taxpayers for themselves, their spouse, or their dependents. Taxpayers could choose either the credit or the deduction, whichever is more advantageous, with respect to each student. Thus, both the credit and the deduction might be claimed if payments were made for more than one student.

The proposed credit, called the HOPE Scholarship, would be limited to \$1,500 a year for each student for whom the taxpayer pays tuition and fees. Payments made by the student could be counted by the taxpayer. The credit would be available with respect to an individual student for 2 taxable years, provided the student pursues a course of study at least half-time, has not completed the first 2 years of postsecondary education, and has not been convicted of a felony drug offense. To be eligible for the second taxable year, students must have at least a B-minus average for all previous postsecondary education. The credit would equal payments made for qualified higher education expenses (generally, tuition and fees after subtracting tax-exempt scholarships and certain other tax-exempt assistance) or the maximum credit amount, whichever is less. The maximum credit amount would be \$1,500 (indexed for inflation beginning in 1998) less any federal grants (such as Pell Grants) the student receives. The credit would not be refundable: it could not exceed the taxpayer's tax liability.

The proposed tax deduction would be limited to \$10,000 a year (\$5,000 prior to 1999) for each taxpayer, not each student. It would be taken in calculating adjusted gross income; thus the taxpayer would not have to itemize deductions on his or her tax return. The deduction would be based on qualified higher education expenses paid by the taxpayer (including amounts paid by the student), i.e., tuition and fees after subtracting tax-exempt scholarships, certain other tax-exempt assistance, and federal grants. It would be allowed for undergraduate, graduate, or postgraduate education without regard to the

number of years it had been claimed previously; it would also be allowed for students taking single courses to acquire or improve job skills. The grade average restriction would not apply.

Both the credit and the deduction would be phased out for taxpayers with modified adjusted gross incomes between \$50,000 and \$70,000 (\$80,000 to \$100,000 in the case of married taxpayers filing joint returns).

Identifying Students Experiencing Marginal Effects

If a tuition deduction or credit applied to every dollar of tuition for existing and prospective students, it would affect the demand for investment in education in a straightforward way. The price of an additional dollar of spending (investment) is reduced. For the deduction, the size of the price reduction depends upon a student's marginal tax rate. Thus, a student (or family) in the 15 percent marginal tax bracket would experience a 15 percent price reduction; one in the 28 percent bracket a 28 percent reduction; and so on. Those taking advantage of a credit would experience a 100 percent price reduction.

This price reduction lowers the price of education relative to all other goods and services, thus inducing more spending on education and less on all other goods and services.¹² This occurs in two ways: some students who previously did not invest in postsecondary education will now decide to attend school (the participation effect); and some students who already invest in postsecondary education will decide to increase their investment (the marginal effect), by attending more expensive schools, taking more courses, or remaining in school longer. Both of these effects depend upon how sensitive students' demand for education is to a change in the relative price of education.

Students induced by the President's proposal to begin participating in postsecondary education all are affected by the relative price change. But the proposal is structured in such a way that many students already investing in postsecondary education are not affected by the relative price change because the cost of their marginal investment dollar will not be affected by the deduction or credit. To the extent that margins are not affected, the potential increase in the quantity of investment generated by any given federal revenue loss is reduced.

Thus, assessing the effect of the Administration proposal on the demand for education requires identifying those students who do not experience a relative price effect. The spectrum of incentives and groups created by the President's

¹² The quantity of education purchased will also rise slightly because students purchasing any given amount of education at a lower price have money left over, that is, their after-tax incomes rise. The effect of this income increase is likely to be fairly small because the family is free to save it or spend it on any goods, whether it be food, entertainment, clothing, shelter, or college education. This income effect is not discussed separately in this report, but subsumed under the price effect.

proposal is summarized in table 2. Those groups whose economic position is not affected are identified in table 2 as "None."¹³ Those who will not experience a decrease in the price of marginal tuition expenditure are identified as $p = 1$, signifying no price reduction. Those who will experience a decrease in the price of their marginal tuition expenditure are identified as $p = 0.85$ (15 percent marginal tax rate taking a deduction), $p = 0.72$ (28 percent marginal tax rate taking a deduction), or $p = 0$ (taking a credit), signifying a price reduction of 15 percent, 28 percent, or 100 percent.

Students (and their families) first are classified by two characteristics, federal income tax liability and Pell Grant status (the term "Pell Grant" is used as a proxy for all federal grants). Students (and families) without income tax liability cannot take either the credit or the deduction, and thus have no incentive effect (this is calculated prior to the Earned Income Tax Credit). All these groups, regardless of Pell Grant status, are identified in row 1 as "None" for incentives.

Income limits placed on participation in this program restrict its use primarily to students (or families) whose income is taxed at the 15 percent or 28 percent marginal tax rate. Any student (or family) whose income exceeds these limits cannot participate. These groups are identified in row 2 as "None."

Columns 1 and 2 focus on those students who do not receive Pell Grants. For every dollar of qualified tuition expenses up to \$1500, students in the 15 percent or 28 percent marginal tax brackets can receive a tax benefit of \$1 from the credit or \$0.15 or \$0.28 from the deduction. Thus, students whose qualified tuition is less than \$1500 will choose the credit and experience a marginal price of zero. They are identified in row 3, columns 1 and 2 as $p = 0$.

When the net tuition of a student in the 15 percent tax bracket reaches its maximum allowable amount of \$10,000, the tax benefit from taking a deduction would equal the \$1500 tax credit earned from the first \$1500 of tuition. Thus, students in these brackets whose tuition exceeds \$1500 will choose the credit rather than the deduction to maximize their tax benefits. Students in the 28 percent marginal tax bracket with tuition between \$1500 and \$5,357 will also maximize tax benefits by choosing the credit rather than the deduction. But these choices mean that the last dollar of tuition payment receives no subsidy, and these groups of students experience no marginal price effect. Thus, Row 4, column 1, and row 5, column 2, set the value of p to 1.

Students in the 28 percent marginal tax bracket with qualified tuition greater than \$5,347 but less than \$10,000 receive a tax benefit that increases by \$0.28 with each additional dollar of deduction. This group of students chooses the deduction and experiences a marginal price effect. Thus, in row 6, column 2, p is set to 0.72. Students in the 28 percent marginal tax bracket whose qualified tuition exceeds \$10,000 receive no tax benefits for tuition payments in

¹³ That is, they experience neither the relative price effect nor the small effect from an increase in after-tax income.

excess of \$10,000. This group experiences no marginal price effect. Accordingly, row 7, column 2 shows p to be 1.

Table 2. Incentive Effects of Tuition Deduction and Credit for Students with Various Characteristics				
	(1)	(2)	(3)	(4)
	<u>No Pell Grants</u>		<u>Pell Grants</u>	
	15% MTR	28% MTR	15% MTR	28% MTR
(1) No tax liability	None	None	None	None
Tax Liability				
(2) Income > Limits	None	None	None	None
Net Tuition				
(3) < \$1500	p=0	p=0	na	na
(4) > \$1500	p=1	na	na	na
(5) > \$1500, < \$5357	na	p=1	na	na
(6) > \$5357, < \$10,000	na	p=.72	na	na
(7) > \$10,000	na	p=1	na	na
Pell Grant ≥ \$1500				
(8) Net tuition < \$10,000	na	na	p=.85	p=.72
(9) Net tuition > \$10,000	na	na	p=1	p=1
Pell Grant < \$1500				
Choose deduction				
(10) marginal	na	na	p=.85	p=.72
(11) non marginal	na	na	p=1	p=1
Choose credit				
(12) marginal	na	na	p=0	p=0
(13) non marginal	na	na	p=1	p=1
(14) Tax benefits exceed tax liability	p=1	p=1	p=1	p=1
1. na -- not applicable 2. None -- no incentive, neither income effect nor price effect 3. p=1 (or .85, .72, 0) -- student pays 100% (85%, 72%, 0%) of the last dollar of tuition Note: Assumes students earn a B average and only one student per family.				

Columns 3 and 4 focus on those students who receive Pell Grants. Their marginal effects are complicated by the existence of a one dollar credit reduction for every dollar of Pell Grant. Students whose Pell Grant is greater or equal to \$1500 are ineligible for the credit, but can take the deduction for all qualified tuition net of Pell Grants and other tax-exempt scholarships up to \$10,000. This group experiences a marginal price effect. Row 8, columns 3 and 4 show p equal to 0.85 and 0.72. Those whose net tuition exceeds \$10,000 experience no marginal price effect; p is set to 1 in row 9.

Students whose net tuition exceeds a Pell Grant of less than \$1500 must choose between deducting the difference between net tuition and the Pell Grant or taking a credit for the difference between \$1500 and the Pell Grant. Those who choose the deduction experience a marginal price effect (provided the excess of net tuition over the Pell Grant does not exceed \$10,000). Thus, row 10, columns 3 and 4 show p to be 0.85 and 0.72. Row 11, columns 3 and 4 show p set to 1 for no marginal price effect.

Those who choose a credit do not experience a price effect unless net tuition is less than the difference between \$1500 and the Pell Grant. For example, a \$1200 Pell Grant and \$1600 tuition leaves net tuition of \$400. The student will choose a \$300 credit rather than a deduction of \$400 times either 0.28 or 0.15. No marginal price effect exists, and p is set to one in row 13, columns 3 and 4. Were net tuition \$1400, the student would choose a credit of \$200. However, an additional dollar of tuition would also be eligible for the credit, and p is set to zero in row 12, columns 3 and 4.

Row 14 contains those students who would have been in table cells with a marginal price effect, but whose tax liability proved to be less than the size of the credit or the tax benefit from the deduction. These students do not experience a marginal price effect.

In addition, the table would be further complicated if it reflected the phase out of the tax benefits as income increases.

Finally, the categories in the table are based on the assumption that there is only one student in a family and that students earn a B average. More than one student in the family eligible for a credit would increase the number of instances in which the credit is chosen and therefore the instances in which the tax benefit is not marginal. Students with less than a B average would only be able to take a deduction, which would increase the number of instances in which the tax benefit is marginal.

Determining Windfall Gains, Tuition Increases, and Quantity Increases

The price changes are the basic building blocks necessary to determine how much of these subsidies appear as price (tuition) increases, quantity (education investment) increases, and windfall gains (income transfers). One must also know the percentage of students contained in each group identified in table 2,

their average expenditures, the sensitivity of students' demand for education to increases in income and price, and the responsiveness of education supply to price changes. These measures of sensitivity or responsiveness are called demand and supply elasticities.

The analysis here uses data adjusted to 1997 levels from the National Postsecondary Student Aid Survey (NPSAS) to distribute students across the categories identified in table 2, and therefore assumes the proposal is effective in 1997.¹⁴ These assignments are based on averages across a variety of income levels and sizes of Pell Grants. Thus, some cells are empty. For example, there is no cell for the table 2 category "net tuition > \$10,000," not because no tuition exceeds \$10,000, but because the average tuition in any income class does not exceed \$10,000. Furthermore, for the purpose of determining tax liability, dependent students were assumed to be from families filing joint returns with three exemptions and independent students were assumed to be filing single returns. The calculation does incorporate the standard deduction, but does not reflect the Earned Income Tax Credit. A microsimulation would permit more precise placement of students in these cells.

The results of sorting the NPSAS data by category are presented in table 3. These calculations indicate that approximately 43 percent of students will not be subject to a marginal effect.

Using the price change and marginal effects data to estimate the portion of the subsidy going to windfalls, tuition increases, and investment increases requires three steps: (1) determining the appropriate demand elasticities, divided into participation and marginal responses; (2) determining the appropriate supply elasticity; and (3) incorporating these elements into a model to estimate price, quantity, and windfall effects.

Demand Elasticities

In order to separate the demand elasticity into the participation response and the marginal price response, we contrast demand elasticities associated with a particular university and those associated with the country as a whole.

If the Clinton proposal were structured in a way that provided a relative price effect to all present and prospective students, a price elasticity estimated for one university would be appropriate. Such an elasticity includes the impact of the relative price effect on participation and on the quantity consumed per

¹⁴ This U.S. Department of Education data set, which is based upon a nationally representative sample of postsecondary education students, is the most comprehensive source of data on types and amounts of student aid received by undergraduates. Data from the 1992-93 survey are the most recent available. These data were collected prior to the Higher Education Act Amendments of 1992, which, among other things, changed the need analysis formula for Pell grants and the definitions of dependent and independent students. The data set excludes some higher tuition schools that declined to participate.

student who is in school. Leslie and Brinkman report an elasticity for one university of 1.3.¹⁵

But this would overestimate the impact. As shown in table 3, a substantial portion of students in school will not experience a relative price effect due to the complex set of limits and phaseouts, and it is important that these students not be assigned a price-induced quantity adjustment with respect to the tax subsidy. It is necessary to obtain an estimate of the relative price effect restricted to existing students so that the 1.3 elasticity estimate can be adjusted downward (as noted above, students not yet participating all experience a relative price effect).

Table 3: Percentage of Existing Students
Who Experience a Relative Price Effect

	Marginal	Non-marginal
No Tax Liability		13.0
Income Greater Than Limits		3.4
No Pell Grant		
Tuition < \$1500, 15% MTR	23.6	
Tuition > \$1500, 15% MTR		8.0
Tuition < \$1500, 28% MTR	25.5	
Tuition > \$1500, <\$5347, 28% MTR		7.8
Tuition > \$5347, <\$10000, 28% MTR	2.4	
Pell Grant > \$1500		
Tuition less than \$10000		
15% MTR		5.8
28% MTR		1.1
Tuition more than \$10000		0.0
Pell Grant < \$1500		
Deduction, marginal, 15% MTR	0.1	
Deduction, marginal, 28% MTR	0.1	
Credit, marginal, 15% MTR	4.1	
Credit, marginal, 28% MTR	0.7	
Credit, non-marginal, 15% MTR		1.4
Credit, non-marginal, 28% MTR		0.4
Tax Benefits Exceed Tax Liability		2.4
Total	56.5	43.3

¹⁵ Leslie and Brinkman (1988), "Student Price Response in Higher Education."

We obtain the relative price effect restricted to existing students by subtracting from the 1.3 elasticity an estimate of the responsiveness of students to attending school (the participation elasticity). The extensive literature on the price elasticity of participation is reviewed by St. John and Leslie and Brinkman. The latter study estimates an overall tuition participation elasticity of 0.6 based on their survey of twenty-five studies, using the mode (most common finding).¹⁶ If 0.6 is used for the participation elasticity and 1.3 for the combined participation and marginal elasticity, the marginal elasticity for those already in school would be 0.7.

But the 0.6 participation elasticity estimate (and the 1.3 total elasticity estimate to which it is related) is too high because it is estimated for a population that includes many lower-income students who are totally or largely excluded from the tuition tax program either because of low tax liability or low tuition. (According to our data, 15 percent of the existing student population will be excluded due to lack of tax liability, while only 3 percent will be excluded because they exceed the income limits. A much larger fraction of the potential student population is likely to be unaffected by the tax plan).

McPherson and Schapiro estimate a participation elasticity of 0.47 for low-income students,¹⁷ and St. John estimates elasticities for all students that aggregate 0.28 for tuition increases and 0.43 for grants.¹⁸ The elasticities differ across income brackets, with quite high ones at low income levels and quite low ones at high levels. The elasticities are between 0.3 and 0.4 at middle incomes and are as low as 0.14 at higher incomes. In other work, McPherson and Schapiro found no evidence of a participation response for middle and upper-income students.¹⁹ Based on this evidence about participation response across the income brackets, we lower the participation elasticity in the Leslie/Brinkman study by 0.3, from 0.6 to 0.3. Subtracting the same amount from the 1.3 estimate for the single university study leads to total demand

¹⁶ The elasticity is the percentage change in participation divided by the percentage change in price, and the sign is negative, that is, a rise in price leads to a fall in participation. These studies typically report a percentage point change in participation per \$100 change. Since about a third of students participate, this results in a percentage change about three times as large. To convert it to an elasticity, however, that percentage change should be divided by the percentage change in price. In this particular case, these effects are almost exactly offsetting, so that the participation per \$100 is the same as the elasticity. Use of the mean estimate rather than the mode estimate would raise the elasticity to 0.7.

¹⁷ McPherson, Michael S. and Schapiro, Morton Owen, *Keeping College Affordable*, Washington, D.C.: The Brookings Institution, 1991.

¹⁸ St. John, Edward P. "Untangling the Web: Using Price-Response Measures in Enrollment Projections," *Journal of Higher Education*, Vol. 64, No. 6, Nov/Dec, 1993, pp. 675-695.

¹⁹ McPherson, Michael S. and Schapiro, Morton Owen. "Does Student Aid Affect College Enrollment? New Evidence on a Persistent Controversy," *American Economic Review*, vol. 81, no. 1, March 1991, 309-18.

elasticity of 1, composed of a 0.3 participation elasticity and a 0.7 marginal elasticity. These adjustments maintain the difference between the two estimates reported by Leslie and Brinkman, but lower the participation response to reflect the higher-income group affected by the tax proposals.

In addition, we consider a second case that provides some idea of the sensitivity of the estimates to the magnitude of the demand elasticity. The participation rate elasticity for middle and upper-income students is set to zero and the marginal response elasticity is reduced by half to reflect the possibility that these middle and upper-income students' quantity adjustments are also less responsive.

Supply Elasticities

The ability of any industry to increase supply in the short run depends on whether any excess capacity exists. Over time, capacity can be adjusted, and the supply in any industry therefore is quite elastic in the long run. For a permanent program, the long-run elasticity is more important. A relatively elastic supply representative of the long run is appropriate in this case for two reasons. First, the need for increased capacity will be known immediately upon adoption of the tuition subsidy, but its impact on postsecondary facilities will be delayed because many college-age students and high school seniors have already made choices about whether to attend and what college to attend. Second, increasing capacity is likely to have relatively little impact on prices because a small industry such as postsecondary education probably can attract resources from the rest of the economy without substantial price increases.

Most demand-side studies appear to assume a perfectly elastic supply function and there is some evidence for such a function.²⁰ However, due to the lack of direct evidence on this subject, results are reported for supply elasticities ranging from 1 (unitary elastic) to 5 (verging on perfectly elastic).

Modeling Supply and Demand

The appendix derives the formula for determining the percentage change in price in response to a subsidy:

$$\% \text{ Change in price} = \frac{(E_p + aE_m)}{(E_d + E_s)} \text{ Times Subsidy divided by Price}$$

and

$$\% \text{ Change in quantity} = \frac{E_s(E_p + aE_m)}{(E_d + E_s)} \text{ Times Subsidy divided by Price}$$

²⁰McPherson, Michael S. and Schapiro, Morton Owen, "Measuring the Effects of Student Aid: An Assessment of Some Methodological and Empirical Problems," in *Paying the Piper*, Eds. McPherson, Schapiro, and Gordon C. Winston. U of Mich, Ann Arbor, 1993.

where:

- a is the share of the subsidy that is marginal
- E_s is the supply elasticity
- E_p is the participation elasticity
- E_m is the marginal elasticity
- E_d is the total demand elasticity (the sum of the participation and marginal elasticities)

All elasticities are in absolute values.

The first term of each formula, the ratio that reflects the responsiveness of consumer demand and producer supply, determines the share of a subsidy that is reflected in price and the share that is reflected in quantity. If the supply elasticity is infinitely large, no portion of the subsidy will appear as a price increase, while if the supply elasticity is zero, all of the subsidy, except any portion that is not marginal, will appear as a price increase.

The NPSAS data set is used to estimate the value of " a " for the first two years, which was found to be 0.4. (Note that in calculating this value, the categories were weighted by net tuition rather than by number of students shown in table 3, since some students have very small tuition.) Only 40 percent of the subsidy is estimated to have a marginal effect in the first two years.

Since the credit is available only in the first two years, the value of " a " is set at 1 in the second two years because the deduction almost always is marginal.

Table 4 first reports the share of the subsidy that appears as price effects, quantity effects, and windfall effects (the residual share) for various supply elasticities. Since the total demand elasticity is 1, the windfalls arise solely from the absence of a marginal effect for some students, not from the responsiveness of students, and is consistent across all elasticities. (A fully marginal subsidy creates windfalls only if the demand elasticity is less than one, and causes expenditure increases greater than the value of the subsidy if the demand elasticity is greater than one).

Considering the first two years alone, an estimated 42 percent of the subsidy is a windfall, and between 10 and 30 percent of the subsidy appears as a price increase as the supply elasticity decreases from 5 to 1. If one believes the supply elasticity is quite large, then the share of the subsidy that appears as a price effects would be quite small.

For the second two years, when only a deduction is allowed and all subsidies have marginal effects, the windfall effect disappears and the potential share of the subsidy that appears as a price effect is larger, ranging from 16 to 50 percent of the subsidy.

If the second two years are treated as having the same importance as the first (for someone with a four year college plan) and first two years are weighted

by two-thirds and the second two years by one-third to reflect the higher revenue cost for the first two years (estimated at 67 percent), the weighted estimates of the share of the subsidy appearing as a price rise range from 12 to 36 percent. These estimates would be higher if post-graduate education were included and lower if students only planning a two-year program were considered.

Table 4. Economic Effects of Administration Tuition Tax Subsidy Proposal for Various Supply Elasticities (numbers in percentages) $E_p = 0.3$ and $E_m = 0.7$			
	$E_s = 1$	$E_s = 2$	$E_s = 5$
Share of Subsidy Appearing As:			
Price Rise			
1st two years	29	19	10
2nd two years	50	33	16
weighted average	36	24	12
Quantity Increase			
1st two years	29	39	48
2nd two years	50	67	83
weighted average	36	48	60
Windfall Gains			
1st two years	42	42	42
2nd two years	0	0	0
weighted average	28	28	28
Percentage Increase in:			
Price	6	4	2
Quantity	6	8	10

Overall, this analysis suggests that only a small portion of the subsidy will appear as a tuition increase, probably less than a third of the subsidy value and perhaps even less than ten percent.

The last two rows of table 4 convert the share of subsidy effects into an impact on price (tuition) and quantity (investment) for the weighted average case. The share of the subsidy appearing as price and quantity increases just

estimated must be adjusted to reflect the fact that the subsidy represents only 17 percent of tuition (the second term in the two formulas—subsidy divided by price). For a supply elasticity of 5, tuition can be expected to increase by 2 percent (17 percent of 12 percent) and quantity can be expected to increase by 10 percent (17 percent of 60 percent). For a supply elasticity of 1, both price and quantity can be expected to increase by 6 percent.

Table 5 presents estimates based upon zero participation elasticities and half the marginal response elasticity used in table 4 for middle and upper-income students. A less responsive student population means that a much larger share of the subsidy is lost as windfall gains, 76 percent in the weighted average case for the most elastic supply curve. Price would increase only one percent and quantity only three percent.

Table 5. Economic Effects of Administration Tuition Tax Subsidy Proposal for Various Supply Elasticities (numbers in percentages) $E_p = 0$ and $E_m = .35$			
	$E_s = 1$	$E_s = 2$	$E_s = 5$
Share of Subsidy Appearing As:			
Price Rise			
1st two years	10	6	3
2nd two years	26	15	7
weighted average	15	9	4
Quantity Increase			
1st two years	10	12	13
2nd two years	26	30	33
weighted average	15	18	20
Windfall Gains			
1st two years	80	82	84
2nd two years	48	55	60
weighted average	70	73	76
Percentage Increase in:			
Price	3	2	1
Quantity	3	3	3

Some might claim that these estimates make no sense, particularly for prestigious institutions that face a very inelastic demand such that they can easily raise their tuition. (An inelastic demand normally implies large price effects.) In thinking about this issue, it is important to recognize that if schools were free to raise their prices to obtain some objective, they could have already done so. Each institution presumably has some balance with respect to the nature of their student body, the potential rents earned by administrators and faculty, and other factors that influence their setting of tuition. Assuming that these institutions are acting rationally, the supply and demand analysis that is described here should hold.

There is an important caveat to this analysis, however, for which some evidence exists. Institutions may act in a way to maximize the receipt of federal tax benefits.²¹ For example, they may shift costs between tuition and costs of room and board, or they may simultaneously increase tuition and increase grants. Their scope for doing so is limited by various constraints (not all students are residents, not all students receive grants). Quantifying this effect is very difficult and is not undertaken here.

In addition, it is possible that state and local governments may decide to reduce their own subsidies to public institutions.

Policy Implications

The first section of this report suggested a significant share of existing federal subsidies is provided to students who provide no increased social benefits and is, therefore, lost; that additional subsidies might be productive for some carefully targeted groups of students who continue to suffer from capital market failures and inequality of educational opportunity; and that funds for these additional subsidies might be found by restructuring existing public subsidies. The preceding analysis of the tuition tax credit/deduction proposal (available in the first two years) suggests it would not have very much "bang-for-the-buck" because it would subsidize many students who are not likely to increase their educational investment.

Although the aggregate demand elasticity of 1.3 might be expected to produce a significant increase in education investment per dollar of revenue loss, the increase will be cut by more than half for two reasons. First, rather than focusing the subsidy on lower-income individuals who do not attend school and have a high participation response, much of the subsidy is given to middle and upper-income students who already attend school and have a low participation response. Second, the subsidy is structured in such a way that it will have no marginal effect on many students' spending who already participate. As a result, the windfall gains (subsidies provided to groups who have no response)

²¹ McPherson, Michael S., "How Can We Tell if Federal Student Aid is Working?," in *Paying the Piper*, suggests that schools may raise their tuition to increase the receipt of student aid, but finds evidence of this effect only in four year public schools.

were estimated to be 42 percent of the total program cost for students in the first two years of school.

This lack of focus on lower-income individuals not only reduces the responsiveness of students to subsidies but also neglects individuals for whom subsidies are probably most economically justified (because their capital market failures are more severe). Moreover, it is possible that the lowest-income students will be made worse off. States might reduce their support of postsecondary education in response to the broad grant made by the tuition credit (which would represent a windfall gain for many students). Should this occur, the minority of students who lack federal tax liability (the prerequisite for taking advantage of the tax subsidies) would find college more costly and would be expected to reduce their participation (remember, this is the relatively price sensitive group).

The tax provision has marginal effects for investment in the last two years of college because it is restricted to a deduction, except for students who have insufficient tax liability to absorb the tax benefit. The benefits of this provision are more concentrated among higher-income individuals because the value of the deduction rises with a higher marginal tax rate. A taxpayer in the 15 percent bracket receives only 15 cents of tax saving for an additional dollar of spending, while a taxpayer in the 28 percent bracket receives a benefit that is twice as large. (For a joint return, the 15 percent tax bracket extends to taxable income of \$39,000; the 28 percent bracket to taxable income of \$94,250.)

These distributional effects may be made more concrete with some simple distributional shares from our data base. In the general population, only 25 percent of the population has a marginal tax rate above 15 percent. In the student data base, about 42 percent of families are in this higher bracket (reflecting the fact that the total population that attends college is more affluent than the population as a whole). The tax proposal excludes, or reduces the benefits, at both the bottom and the top of the income distribution (because of inadequate tax liability at the bottom and the phaseout at the top). The dollar amount per family is also affected by the amount of tuition.

As a result, the 42 percent of families in the higher brackets receive 48 percent of the benefits for the credit/deduction proposal. In the remaining years of school when only the deduction is allowed, these families receive 60 percent of benefits. (These numbers are approximate because they do not differentiate between participation in the first two years and the remaining years.) Thus, even though the shift to a deduction in the third and following years has the effect of making the provision more marginal, it further increases the share of the subsidy going to higher-income families.

If Congress chooses to use the tax system to provide additional subsidies, it has many options, most of which relate to how the benefit is targeted. One option would be to accept the Administration's proposal. Another would be to restructure the proposal to improve its targeting and provide social benefits. An alternative would be to eliminate the deduction and provide a less than 100

percent credit against a higher tuition base. For example, allowing a 50 percent credit for somewhat more than \$3,000 of net tuition expenses would provide a marginal effect throughout the distribution except for those with inadequate tax liability to use the full credit. This approach would redistribute the benefits more towards higher-income individuals (who tend to have higher tuition costs), a trade-off for altering the credit to make it more marginal.

The benefits from this percentage credit could be tilted more toward lower-income individuals and increased participation by making the credit refundable and offsetting the revenue cost by choosing a lower phase-out income level. The incentive of schools to convert a refundable 100 percent credit to higher tuition is curtailed substantially for a 50 percent credit.

Another option would be to combine the program with an expansion of relief for lower-income individuals. The Administration proposal already includes some expansion of grant and loan programs. Since subsidies channeled through the tax system are essentially no different from those channeled through the spending side, it would be important to consider the entire package.

The set of current subsidies could also be restructured. For example, Pell Grants could be allowed on the basis of tuition costs at the state university, rather than the actual costs at the institution to be attended. This would prevent subsidies going to reasonably affluent families for their children to attend elite schools, and make more money available for students from families with more modest means. Similarly, income eligibility for student loans could be further tightened.

A more far-reaching option would be to forego a tax benefit and expand direct benefits to students for whom the subsidy is likely to satisfy the economic rationales discussed earlier. This would mean targeting any increased subsidy to the lower and moderate-income students who are price sensitive. States and their public postsecondary schools could be encouraged with grants and other incentives to price discriminate by raising their tuition and restructuring their aid programs to focus assistance on lower-income and moderate-income students who continue to suffer from capital market failures. These are the students for whom additional public subsidy is likely to provide additional social benefits.

Appendix

This section demonstrates how the formulas for change in price and quantity are derived. Equations (1) and (2) express supply and demand as a function of price and subsidy, with s as a shift parameter.

$$(1) Q = A(P(1-s))^{-E_p} (P(1-as))^{-E_m}$$

$$(2) Q = B P^{E_s}$$

where:

Q is quantity

P is price normalized at 1

s is the induced change in demand due to tax changes

a is the fraction of the average subsidy that appears as a marginal subsidy

A and B are constants

E_p is the participation demand elasticity

E_m is the marginal demand elasticity

E_s is the supply elasticity

$E_p + E_m = E_d$, the total demand elasticity

If we differentiate these equations:

$$(3) \hat{Q} = -E_d \hat{P} + (E_p + aE_m) s$$

$$(4) \hat{Q} = E_s \hat{P}$$

where the $\hat{}$ symbol refers to percentage change.

By combining (3) and (4), we can obtain:

$$(5) \hat{P} = \frac{(E_p + aE_m) s}{(E_d + E_s)}$$

and

$$(6) \hat{Q} = \frac{E_s (E_p + aE_m) s}{(E_d + E_s)}$$

The percentage changes in this analysis have been expressed as percentage changes in gross tuition rather than net tuition.

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