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Abstract
The Taxpayer Relief Act of 1997 (TRA 1997) is the largest single increase in federal funding for higher education since the GI Bill. This chapter explores the impact of this new federal law on state higher education policy and offers options and recommendations for state response. These recommendations are based on the belief that programs which support both *access* and *affordability* are necessary to advance the larger national policy of *college opportunity*, but that affordability should not be allowed to supersede access as a policy goal.

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CHAPTER 9

State Policy Response to the Taxpayer Relief Act of 1997

Kristin D. Conklin and Joni E. Finney

The Taxpayer Relief Act of 1997 (TRA 1997) is the largest single increase in federal funding for higher education since the GI Bill. This chapter explores the impact of this new federal law on state higher education policy and offers options and recommendations for state response. These recommendations are based on the belief that programs which support both *access* and *affordability* are necessary to advance the larger national policy of *college opportunity*, but that affordability should not be allowed to supersede access as a policy goal.

The definitions of access and affordability used in this chapter differ somewhat from those used elsewhere in this volume. At the federal level, the general assumption is that programs to support access are targeted and need-based, such as the Pell Grant program. In contrast, programs to support affordability, such as Stafford unsubsidized loans, are those made available to all students regardless of income. With these definitions, it usually is an easy matter to distinguish programs and policies that support access from those that promote affordability.

At the state level, however, these distinctions do not apply—there, affordability and access typically are linked. For example, low tuition policies have been implemented by many states to address these paired goals. Similarly, many state need-based financial aid programs address both access and affordability; for example, California, New York, and Illinois use broad income parameters for student aid eligibility and provide aid dollars for students to attend private institutions. Thus, because we are concerned with state policy

in this chapter, we make the basic assumption that access and affordability are inextricably linked.

Despite states' traditional coupling of access and affordability, over the past two decades, affordability has become an increasingly important policy goal. Tuition increases outpacing growth in family incomes, along with the public's growing perception of higher education as essential, have led to political pressure for state policies that explicitly address the affordability concerns of the middle class—a focus that usually does not consider the needs of low-income students. State college savings and prepaid tuition plans are examples of this new priority. At the federal level, the shift from grants to loans as the centerpiece of student aid is the most striking example of a long-term change in priorities, from supporting college access for the needy to promoting college affordability for the middle class. TRA 1997 is only the most recent evidence of this shift in policy focus. Whether TRA 1997 will trigger further movement by the states in the direction of emphasizing affordability remains to be seen.

This chapter hopes to influence state policy decision making by describing the arguments for and against various policy options. It begins with a description of the provisions of TRA 1997 and a discussion of which students and families will benefit from them. We then discuss interactions between TRA 1997 and state policy and outline options for state policy response, along with our own recommendations. The chapter closes by describing a scenario under which states might use TRA 1997 as an opportunity to build a new consensus about how responsibility for paying for higher education ought to be shared among students and their families, colleges and universities, and government.

THE TAXPAYER RELIEF ACT OF 1997

In 1997, the federal government paid attention to college access and affordability—but not in balanced measure. Combining the one-year costs of the tuition tax credits with the Stafford unsubsidized loan program, federal financial aid policies directed solely at affordability now make up 50 percent of all federal aid. Just six years ago, in the 1992–93 academic year, federal financial aid was almost entirely focused on access—non-need-based aid provided by the federal government comprised just 1 percent of all federal aid.[1] TRA 1997 is a noteworthy new direction for federal higher education policy, both in terms of the magnitude of the investment and its design; Table 9.1 summarizes its seven major provisions.[2]

In magnitude of new resources, the federal government shifted its emphasis from providing access to making college more affordable. Just months after passing TRA 1997, Congress and President Bill Clinton also expanded eligibility for the federal government's largest need-based program designed to provide college access, the Pell Grant. Specifically, the maximum award and

TABLE 9.1

MAJOR PROVISIONS OF THE TAXPAYER RELIEF ACT OF 1997

Provision	General Description	Income Too Low for Any Benefits	Income Too Low for Full Benefits	Income Too High for Full Benefits	Income Too High for Any Benefits
Hope Tax Credit	Worth up to $1,500 for the first two years of college, at least part-time	$17,500 dependent $6,800 independent	$27,500 dependent $16,800 independent	$80-$100,000 file joint $40-$50,000 file single	$100,000+ file joint $50,000+ file single
Lifetime Learning Tax Credit	Worth up to $1,000 a year for college past first two years, or less than part-time until 2002	$17,500 dependent $6,800 independent	$24,100 dependent $13,450 independent	$80-$100,000 file joint $40-$50,000 file single	$100,000+ file joint $50,000+ file single
Education IRA	Deposit up to $500 a year; interest earned tax-free; deductions excluded from beneficiary's income			$150-$160,000 file joint $95-$110,000 file single	$160,000+ file joint $110,000+ file single
Traditional IRA	Early withdrawal penalty waived if funds used for college				
Prepaid College Tuition Plan	Extends savings in state plans to room and board costs				
Student Loan Interest Deduction	Interest paid deductible for first 60 months of repayment ($1,000 in 1998)			$80-$100,000 file joint $40-50,000 file single	$100,000+ file joint $50,000+ file single
Student Loan Forgiveness	Loans forgiven for work in high-need areas are excluded from taxable income				

Note: Figures for dependent students assumes a family of four with married parents filing jointly.

Sources: U.S. Department of the Treasury 1997; 1998.

the number of students who can receive Pell Grants were increased. The Pell Grant maximum was increased by $300 to a new maximum award of $3,000. The income protection allowance was increased for both independent students and dependent students who work, allowing more students to qualify for grants. Combined, these new changes to the Pell Grant Program cost approximately $650 million for FY 1998, or 7 percent of the expected cost in 1998 for the tuition tax credits ($9 billion).

In design, TRA 1997 moves away from the historical role the federal government has played in providing access to college for students from low-income families. It contains a set of nonrefundable tax credits designed to reduce the cost of college attendance—measures that will not stimulate new college enrollment to any great extent. Research on student enrollment responses to price changes resulting from financial aid has consistently shown sizable increases for low-income students when prices decline and either small or nonexistent changes for middle- and high-income students (Manski and Wise 1983; Schwartz 1986; and McPherson and Schapiro 1991).[3] With the low-income population benefiting least from the price reductions that result from the new tuition tax credits, it is unlikely that enrollment response will be great.

Three aspects of TRA 1997 are of particular importance.

- There is no cap on the possible "cost" of the tax credits in foregone tax revenue. The Hope and Lifetime Learning tax credits are projected to cost approximately $40 billion over five years, but changes in state and institutional policy can quickly increase these costs. Already, the tax credits are projected to equal the cost of all other federal financial aid combined, including Pell Grants, State Student Incentive grants, and student loan interest subsidies.
- Income tax benefits accrue in the current year for tax-related activities of the prior year. Under TRA 1997, the tax credit benefits are realized only after the student is enrolled in a postsecondary institution. The delay between tuition payment and receipt of the tax credit can be up to 15 months, assuming tuition is paid in January of one tax year and taxes are filed in April of the next year. Traditional price incentives, such as outright grants, scholarships, or loans, are, for practical purposes, realized directly at the time of enrollment. This new, deferred, and less-direct delivery method will cloud assessment of the credits' impact. That is, it will be difficult to evaluate the extent to which a particular benefit has accomplished its primary objective of helping taxpayers pay for college, as opposed to helping pay for other, noneducational items.
- The tax credit benefits of TRA 1997 are tax expenditures and, as such, will not be subjected to review in the annual appropriations

process as are most other federal student aid programs, or in the periodic reauthorization that all federal aid programs undergo. As a result, the regular examination of college access and affordability policies will exclude one of the federal government's largest financial aid programs.

Student and Family Beneficiaries of the New Federal Affordability Policy

Middle- and upper-middle income students and their families benefit most from the federal Hope and Lifetime Learning tax credits. The new tax credits reduce federal taxes for eligible students (or for the families of dependent eligible students). Table 9.2 shows how families and students at different income levels can use federal student aid programs to help pay for college. In general, families who qualify for a Pell Grant cannot receive the maximum tax credit from the Hope Scholarship.[4] For instance, a family with a student in a four-year public college and with a taxable income of $30,000 or less will not receive the maximum Hope tax credit.

TABLE 9.2

ESTIMATED BENEFITS OF FEDERAL STUDENT AID, FOR UNDERGRADUATES AT FOUR-YEAR PUBLIC COLLEGES AND UNIVERSITIES, BY TAXABLE INCOME

Taxable Income	Pell Grant	Loan Subsidy	Hope Tax Credit	Total Aid
$10,000	$3,000	$875	$0	$3,87
$20,000	$3,000	$875	$0	$3,875
$30,000	$2,450	$875	$550	$3,875
$40,000	$950	$875	$1,500	$3,325
$50,000	$0	$875	$1,500	$2,375
$60,000	$0	$0	$1,500	$1,500
$70,000	$0	$0	$1,500	$1,500
$80,000	$0	$0	$1,500	$1,500
$90,000	$0	$0	$750	$750
$100,000	$0	$0	$0	$0
Average Tuition = $3,000		Average Total Price = $10,000		

Notes: Calculations are for full-time freshmen, and income is defined as adjusted gross income for joint filers with two dependents. Pell Grants are for families of four with one child in college. Loan subsidy is based on maximum subsidized loan for freshmen, $2,625. Eligibility for tax credit is determined by calculating tuition less all grants, scholarships, and other tax-free educational assistance. Tax credit is $0 if family income is less than $30,000 or net tuition is negative. Maximum allowable tax credit is $1,250 for 2-year colleges and $1,500 for 4-year colleges.

Source: Hauptman and Rice 1997.

As shown in Table 9.3, families with taxable income between $40,000 and $90,000 a year will find that the Hope tax credit can reduce the percent of income needed to pay for a four-year public university by between one and three percentage points. In contrast, families earning $30,000 a year or less will not benefit from the tuition tax credits.

TABLE 9.3

ESTIMATED TOTAL PRICE OF ATTENDANCE BEFORE AND AFTER ENACTMENT OF THE HOPE TAX CREDIT, BY TAXABLE FAMILY INCOME, FOR UNDERGRADUATES AT FOUR-YEAR PUBLIC COLLEGES AND UNIVERSITIES

Taxable Income	Total Price before Tax Credit	Total Price as % of Income	Total Price after Tax Credit	Total Price as % of Income
$10,000	$6,125	61%	$6,125	61%
$20,000	$6,125	31%	$6,125	31%
$30,000	$6,125	20%	$6,125	20%
$40,000	$8,175	20%	$6,675	17%
$50,000	$9,125	18%	$7,625	15%
$60,000	$10,000	17%	$8,500	14%
$70,000	$10,000	14%	$8,500	12%
$80,000	$10,000	13%	$8,500	11%
$90,000	$10,000	11%	$9,250	10%
$100,000	$10,000	10%	$10,000	10%
Average Tuition = $3,000			Average Total Price = $10,000	

Notes: Calculations are for full-time freshmen. Taxable family income is defined as adjusted gross income for taxpayer filing jointly with two dependents. Pell grants are for families of four with one child in college. Loan subsidy is based on the maximum subsidized loan for freshmen, $2,625. Eligibility for tax credit is determined by tuition less all grants, scholarships, and other tax-free educational assistance. Tax credit is $0 if family income is less than $30,000 or net tuition is negative. Maximum allowable tax credit is $1,250 for two-year colleges and $1,500 for four-year colleges. Total price equals tuition, required fees, and room and board—minus scholarships, grants, and other tax-free educational assistance received by the student.

Source: Hauptman and Rice 1997.

Students at higher-priced institutions benefit more than students at lower-priced institutions, particularly community colleges. Students at public community colleges who are from low-income familes can get some or all of their tuition and fees paid by federal need-based Pell Grants. Community college students are eligible for the maximum Hope tax credit only if their family income is between $50,000 and $80,000; students with family income of $40,000 receive a partial credit. This occurs because Pell Grants, and other grant assistance, cover most or all of tuition for community college students

with income below $40,000. In contrast, students attending more expensive private four-year colleges can receive the maximum Hope tax credit when their family income falls between $30,000 and $80,000 because Pell Grants pay only a fraction of the higher tuition and fees.

In addition, community colleges are at a disadvantage because they enroll a large proportion of the students whose income is too low to qualify for the tax credit. In 1994, between one-third and one-half of all college students whose families made $30,000 or less attended a public community college (Horn and Berkhold 1998). Under TRA 1997, community college students who receive Pell Grants and whose families make $30,000 or less are not eligible to receive any tax credit.

Many of the students eligible for the Hope and Lifetime Learning tax credits are also most likely to participate in the new savings programs. Findings from an August 1995 U.S. General Accounting Office study of state prepaid tuition programs showed that these plans most benefit middle- and upper-income families (U.S. General Accounting Office 1995). In Kentucky, 61 percent of the participating families had income over $50,000, while only 10 percent of participants were from families with income under $25,000. In Florida, 51 percent of the participating families had income above $100,000, and another third had income between $50,000 and $100,000; only 5 percent of participants were from families with income less than $25,000.

Nearly all students and families who borrow money to pay for college will benefit to some extent from the student loan interest deduction. The U.S. General Accounting Office (1998) reports that students whose family income is below $45,000 are 2.5 times more likely to borrow than students whose family income falls between $60,000 and $100,000. However, it also found that students with higher income tend to borrow more when they do borrow; their large interest payments would qualify them to file for larger income tax deductions. Income caps will disqualify some students, and loan volume and tax rates will determine variation in the absolute dollar value of the benefit. Nonetheless, this provision benefits students from across the income spectrum.

Traditional college-age students (ages 18 to 24) and their families are the primary beneficiaries of the Hope Scholarship and Lifetime Learning tax credits. Younger students are classified as dependent for purposes of financial aid and are expected to rely on their family income to help pay for college. In 1995–96, the average dependent student was 20 years old. In comparison, independent students, who are on average 33 years old, tend to pay for college with their own income and, as result, have lower income on average. Even though independent students who are single filers qualify for the Hope tax

credit at lower income levels than dependent students whose parents file jointly, they are still less likely to be eligible for some or all of the tax credits. Based on income data from 1995–96, 47 percent of independent undergraduates would be ineligible for any tax credit, compared with 26 percent of dependent undergraduates (TERI 1997).

The Interaction of New Federal Policy and Existing State Policies

Although the federal income tax credits flow directly to taxpayers, they have significant implications for state policy. Specifically, TRA 1997 creates incentives for states to capture federal tax credit dollars by implementing measures that also have the effect of weakening access. States could, by reducing need-based aid or by increasing tuition, gain a larger share of the tax credit dollars. In general, the total dollar amount of the benefit for each state from TRA 1997 will vary based on the income levels of college students and their families in that state, distribution of students among lower-priced and higher priced institutions, amount of state-sponsored financial aid, and the number of college students or their families who file in a state.

In the prior section, we examined the impact of student and family income levels on the benefits to be expected from the 1997 act. Here, we evaluate how these benefits vary because of differences in state policies.

States with large financial aid programs of their own will find that residents at some income levels will not qualify for the full federal tax credit if they receive state support. This is because tax credit eligibility is based on tuition and required fees *minus all grants and scholarships*, whether they are awarded on a need or merit basis. New York, for instance, provides its residents with need-based financial aid through its Tuition Assistance Program. Under this entitlement program, which costs about $630 million annually, New York families with a student in a four-year public college would not be eligible for the maximum Hope tax credit unless their taxable income is $45,000 or higher. Based on national averages, most families would be eligible for the full Hope tax credit if their annual taxable income is $40,000. This aspect of TRA 1997 has caused the New York State Higher Education Services Corporation to recommend studying whether federal funds can be substituted for state funds (New York State 1998). Similarly, Pennsylvania has a significant need-based scholarship program, $240.5 million in 1996–97, which will offset eligibility for a federal tax credit dollar-for-dollar, and will lower the average tax credit per student.

In contrast, Montana, which has one of the smallest state-sponsored scholarship programs in the country with total expenditures of just $316,000 a year, will see larger than average tax credits. The average tax credit per

student projected for Montana is one of the largest among the states—$712, compared with the national average of $698.[5]

Some states have historically supported access through low tuition and fees. These states will be tempted to increase tuition. In California, for example, 60 percent of the college population attend community colleges, where fees are less than $400 per year; thus, none of these students are eligible for the maximum credit. The California's Legislative Analyst's Office has recommended that community college fees be raised to capture the full value of the tuition tax credit, while, at the same time, increasing financial aid for those students ineligible for the tax credits (California Legislative Analyst 1998). The latter component is critical. California and other states with similar policies should not raise fees simply to capture the federal tax credits of eligible taxpayers without ensuring access for those who are ineligible.

POLICY OPTIONS AND RECOMMENDATIONS FOR THE STATES

We believe that governors and state legislatures should explicitly establish, in advance, that any measures they adopt because of TRA 1997 will not diminish the overall level of state support for higher education. Further, we urge that they make sure that the affordability problems of middle-income students and families are not addressed at the expense of access to college for low-income students. Indeed, TRA 1997 creates an opportunity for many states to assist middle-income families *and* address the financial needs of low-income families.

Options are available to the states because TRA 1997 adds a major new revenue stream to the public financing of higher education. In 1998–99, the first year of the new tax provisions, California's students and families are expected to receive $1.2 billion in Hope and Lifetime Learning tax credits—the highest state total. In comparison, they received $785 million in 1995–96 for *all other federal financial aid combined*. Alaska will receive the lowest state total, and its students and families are projected to receive $19 million annually in federal tax credits, in comparison with $4.6 million in 1995–96 for all other federal financial aid.

If budget numbers were the only consideration, the federal program creates a golden "opportunity" for a state to reduce its financial commitment to higher education. By substituting federal dollars, a state could shift costs to the federal government by increasing tuition or by reducing need-based financial aid, or both. But money is not the only consideration; meeting the access and affordability needs of all citizens should remain the fundamental state policy objective.

Because of the sheer size of this new federal investment, most states should examine and review their financing of higher education. Specifically, they

should evaluate the impact of state and federal policies on existing and prospective student populations using current, state-level data. This examination should enable states to determine the impact of the new federal tax policies on existing state policy, not only in terms of dollars, but also in terms of the access and affordability needs of all state citizens. State policymakers should then ask how any proposed response to TRA 1997 will reinforce the state's particular policy goals.

After such examination, a state may take action—or it may choose not to do anything. The latter alternative—no action—deserves consideration. TRA 1997 does not require that states change existing policies or enact new policies and, as we write, most states are waiting to see how the new federal program is implemented.[6] By taking no action, policymakers can endorse the federal objective of making college more affordable for middle-income families; however, since this option may have adverse implications for the state's access policies, states should explore these implications before a final decision is made.

If a state government chooses to take action, many policy options are available. We have already noted the opportunity to change tuition policies to capture revenue from the new federal tax credits. Because low-income students do not benefit from the new federal tax provisions, and would be harmed disproportionately by a tuition increase, the primacy of access as a state policy objective dictates that a state should *never* increase tuition and fees for the *sole* purpose of capturing federal revenue. Tuition should be increased if—and only if—the needs of low-income students are met by sufficient increases in need-based aid.

The particular circumstances in each state will determine how, if at all, a state responds to the new federal law. Depending on the circumstances, the major options and recommended actions are as follows:

- States could consider treating the federal tax credits as income when calculating state student aid eligibility. Some middle-income students who would have previously qualified for state financial aid programs will no longer qualify because of their participation in the federal tax credit program. Savings gained in the state financial aid programs would then be available to target state resources toward lower-income students not eligible for any or all of the federal tax credits. Or, savings gained could be used to enhance or initiate college preparation programs in the public schools.
- State policymakers could react to TRA 1997 by restraining the growth of new state grant programs aimed at addressing the affordability concerns of middle- and upper-income parents. Such programs convey benefits on the same students and families eligible to receive

federal tax credits and, because the tax credits are based on tuition less all grants and scholarships, would substitute state funds for the federal tuition tax credits.

- States should conform their state tax codes to incorporate the new provision for making interest on student loans deductible for state income tax purposes. Conformation will maintain simplicity for both the state and the taxpayer and will facilitate auditing of state tax returns by keeping the definition of adjusted gross income comparable.
- States should *not* conform state tax codes to accommodate the federal tuition tax credits. Conformation would duplicate the benefits already afforded to middle-income students and their families by the federal tax credits. Conforming the state tax code to the new federal tax credit provisions would further complicate state income tax returns because filing for a duplicate state tuition tax credit would add an additional line to the tax form.
- States without a state-sponsored prepaid tuition plan should consider establishing one. TRA 1997 expanded eligible expenses for which withdrawals can be made to include reasonable costs of room and board. This increased exclusion of interest earnings is a new incentive for states to develop prepaid plans.
- States could encourage use of the federal tax credits by making "bridge" loans available at the beginning of the academic year, to be repaid when the tax credit is received.

As states examine the impact of TRA 1997 on their own student financial aid programs, other options undoubtedly will emerge. Although states may defer changes in their policies, all states should encourage maximum knowledge and use of the new, federal tax benefits by making information about them widely available—at a minimum through public service announcements, high schools, and guidance counselors.

POLITICS, ACCESS, AND AFFORDABILITY

Historically, higher education has been less subject to federal and state political intervention—partisan or otherwise—than have other state services. Nevertheless, colleges and universities—both public and private—have been greatly influenced by federal policy initiatives and state policy responses; the land-grant act and the GI Bill are prime examples of such influence. The Taxpayer Relief Act of 1997 is the latest and one of the most significant federal policies supporting higher education. Its emphasis on tax benefits for middle-class families is based on a political reality: middle-class families pay

taxes and are a critical class of voters whom politicians must attract to be elected.

While TRA 1997 provides an opportunity for states to address both access and affordability, it also provides an opportunity—and incentives—for states to reduce their overall financial commitment to higher education. The true test of this grim scenario likely will come within the next 10 years when states experience a normal cyclical recession and turn to students and families to fill any "budget gap" created by decreases in state appropriations. The federal tax credits provide an opportunity to compensate for lost state dollars. We strongly urge that states not reduce their overall financial commitment to higher education but, instead, redirect resources to other areas of need within higher education.

With no intent to disparage the needs of the middle class, we urge that this new federal initiative be used by governors and state legislators as a catalyst for reaffirming and expanding college access policies for all citizens. Polls and surveys show that middle-class voters are not narrowly focused on their own children. Rather, they are equally concerned with educational opportunity for all qualified students, regardless of their financial circumstances. Neither the middle class nor most Americans have forgotten that college opportunity must comprise both access *and* affordability. The findings of a 1998 national survey are relevant: roughly twice as many respondents believed that students from low-income families had less opportunity for college than did those either from minority racial or ethnic backgrounds or from middle-class families. Perhaps the major finding of the survey was:

> Because higher education has become so important, Americans are convinced that no qualified and motivated student should be denied an opportunity to go to a college or university merely because of the price. (Immerwahr 1998)

Most urgently needed by states is the development of a new consensus on how the costs of higher education ought to be shared among government, students and their families, and institutions. While it was not the original intention of TRA 1997 to further such a policy agenda, if it provides such an occasion in the states—and we hope it will do so—state policies supporting accessible *and* affordable higher education need not be separated, but joined to ensure the traditional commitment to educational opportunity for the next generation.

NOTES

1. Figures are projected costs for generally available federal aid for 1997–98, including Pell Grants, SSIG, work-study, Perkins loans, Ford direct loans, and Family Education

loans. Excludes $2.3 billion in specially directed financial aid, such as aid to veterans and the military.

2. The provisions of the 1997 act are described in detail by Thomas J. Kane in "Student Aid after Tax Reform: Risks and Opportunities" in this volume.
3. These studies focused on receipt of traditional grants and scholarships; the expected enrollment response to financial aid delivered through the income tax system may be lower.
4. Grants and scholarships reduce eligibility for either of the tuition tax credits, but loan subsidies do not affect eligibility.
5. All projections of foregone federal tax revenue and estimated number of beneficiaries by state were produced by the U.S. Department of Education and are based on enrollment, income, and tuition data from the 1995–96 academic year. A full account of projected tuition tax credit revenue by state and average credit per recipient is provided in Tables 1 and 2 of the National Center for Public Policy and Higher Education's Report 98-6 "Federal Tuition Tax Credits and State Higher Education Policy."
6. A full accounting of state activity as of June 1998 is provided in Table 6 of the National Center for Public Policy and Higher Education's Report 98-6 "Federal Tuition Tax Credits and State Higher Education Policy."

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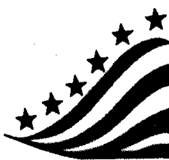
Financing a College Education
How It Works, How It's Changing

Edited by
Jacqueline E. King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