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ABSTRACT

This study examined the impact of the HOPE Scholarship Program through the lens of several key players in the higher education financing process: students and their families; colleges and universities; the states; federal higher education policy; and federal tax policy. The HOPE Scholarship is a tax credit that allows taxpayers to reduce their tax liability by the amount of the credit, which is 100% of the first $1,000 of tuition and related college fees and 50% of the next $1,000, or $1,500 of the first $2,000 of qualifying tuition paid. Students, parents, or spouses may be eligible to take the credit when various tests are met. Data from various sources show that, contrary to the rhetoric of the Clinton administration when the Hope Scholarship was enacted, it does not increase enrollments in higher education of those who are qualified but would not otherwise attend. By its terms and its structure, the HOPE Scholarship does not really benefit students from low-income families. It is not refundable, and deducts tax-free educational assistance from the tuition and fees that count for HOPE Scholarship purposes, and it considers only tuition and fees among all educational costs. The HOPE Scholarship is not available at the time that higher education bills must be paid, and it increases the complexity of financial aid for higher education faced by students and their families. The HOPE Scholarship is not justified by either of the two basic rationales for federal support of students in higher education as it neither increases the enrollment of those who would not otherwise attend nor contributes to making the United States a more fair and equitable society. (Contains 71 references.) (SLD)

THE NEW MILLENNIUM PROJECT WORKING PAPER

The Institute for Higher Education Policy

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Rhetoric and Reality

Effects and Consequences of the HOPE Scholarship

Prepared by
Thomas R. Wolanin, Senior Associate
The Institute for Higher Education Policy

The New Millennium Project on Higher Education Costs, Pricing, and Productivity

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The Institute for Higher Education Policy is a non-profit, non-partisan organization whose mission is to foster access to and quality in postsecondary education. The Institute's activities are designed to promote innovative solutions to the important issues facing higher education. These activities include research and policy analysis, policy formulation, program evaluation, strategic planning, and implementation, and seminars and colloquia.

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Foreword

The use of federal tax policy for higher education financing has been high on the national agenda in the last several years. Federal tax policy's impact on institutions, communities, and students continues to garner a good deal of interest and action from policymakers. The specific connection between student financing and tax policy has received the most prominent—and in some ways the most controversial—attention. As college prices continue to rise above inflation rates and most measures of income, mechanisms to reduce the burden of paying for college gain greater support.

The passage of the Taxpayer Relief Act of 1997 represents a watershed event in the relationship between student support and tax policy. The Act's signature initiative, the HOPE Scholarship Program, provides annual benefits to students and their families rivaling the support provided through Pell Grants and other long-standing forms of federal student aid. Such a significant investment in taxpayer-funded support to aid students through the U.S. Tax Code is unprecedented.

Several months prior to the passage of the Act, The Institute for Higher Education Policy published a report entitled *Taxing Matters: College Aid, Tax Policy, and Equal Opportunity*. That report, supported by The Education Resources Institute (TERI), offered a sober analysis of the limits of student-based tax policy mechanisms on reducing the inequities in access to postsecondary education between low-income populations and other groups.

This report, authored by Thomas R. Wolanin, Senior Associate at the Institute, uses the actual experience of the HOPE Scholarship Program to reaffirm many of *Taxing Matters* cautions and to expand the analysis significantly. It takes a unique, comprehensive approach by examining the impact of the HOPE Scholarship Program through the lens of several key players in the higher education financing process: students and their families; colleges and universities; the states; federal higher education policy; and federal tax policy. The report offers a candid, forward-looking assessment of the HOPE Scholarship Program and its effects and consequences.

This is the latest in a series of reports and papers published under the aegis of The Institute for Higher Education Policy's *New Millennium Project on Higher Education Costs, Pricing, and Productivity*. Sponsored by The Institute, the Ford Foundation, and TERI, the project is a multi-year effort to improve understanding and facilitate reform of the complex system for financing higher education.

JAMIE MERISOTIS

The Institute for Higher Education Policy

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Introduction

In the summer of 1997, President Clinton signed omnibus legislation representing a comprehensive budget deal with the Republican-controlled Congress. At the traditional Rose Garden signing ceremony, only one remark by the President on the substance of the legislation stimulated applause from those assembled: "It opens the doors of college to a new generation, with the largest investment in higher education since the G.I. Bill 50 years ago."[1] The President was referring to a package of higher education tax benefits for individuals included in the Taxpayer Relief Act of 1997, a major component of the omnibus legislation.

In 2001, as the administration of President George W. Bush begins, education policy continues to be a high priority on the domestic policy agenda. Education and tax policy were major themes of the 2000 campaign. Given that tax policies affecting higher education are certain to be a part of the policy debate in the coming months, it is therefore an appropriate time to revisit the tax benefits provided by the Taxpayer Relief Act of 1997. Have they fulfilled the promise of their advocates? Have the dangers predicted by their opponents come to pass? Are these tax benefits a solid foundation on which future federal higher education policy should be built, or were they a step in the wrong direction that now should be reversed?

Under the Taxpayer Relief Act of 1997, the higher education tax benefits for individuals in higher education included:

- the HOPE Scholarship
- the Lifetime Learning Tax Credit
- a deduction for interest paid on student loans
- penalty-free withdrawal from Individual Retirement Accounts (IRAs) for education expenses
- an expansion of education IRAs
- an extension of the purposes for which state prepaid tuition plans that receive favorable tax treatment can be used
- an exclusion from income of employer-provided educational assistance; and
- an exclusion from income of the loan cancellation provided by nonprofit organizations for community service.

The highlight of these tax benefits was the HOPE Scholarship.[2] It was prominently featured in President Clinton's speeches during the 1996 presidential election campaign, in the administration's budget proposals, in the negotiations and bargaining over the shape of the omnibus budget legislation, and at the White House signing ceremony. It is by far the largest higher education benefit provided by the Taxpayer

1. "Statement on Signing Balanced Budget Act of 1997 and Taxpayer Relief Act of 1997," August 5, 1997, *Weekly Compilation of Presidential Documents*, 33, no. 32, p. 1177.
2. The conventional meaning of a "scholarship" is an award to a student to pay higher education expenses. The HOPE Scholarship is a tax credit available to a student or the family of a student because the student has paid specified higher education costs. It is not necessarily available to the student, and the credit need not be spent on higher education. Despite this semantic inconsistency, the term HOPE Scholarship will be used throughout this report.

Terms of the HOPE Scholarship

The effects and consequences of the HOPE Scholarship are a function of its specific terms. The following questions and answers describe the terms of the HOPE Scholarship.

What is a tax credit?

A tax credit, such as the HOPE Scholarship, allows taxpayers to reduce their tax liability (the amount they owe the federal government) by the amount of the credit.

What is the amount of the HOPE Scholarship?

The HOPE Scholarship is equal to 100 percent of the first $1,000 of tuition and related fees required to be paid for attendance at an institution of postsecondary education. In addition, it includes an amount equal to 50 percent of the next $1,000 of tuition and related fees. In other words, the HOPE Scholarship is $1,500 for those who have paid tuition and related fees of $2,000. Tuition and related fees above $2,000 do not increase the HOPE Scholarship.

At which institutions do the tuition and related fees count for purposes of the HOPE Scholarship?

The same universe of approximately 3,600 non-profit colleges and universities and 2,000 for-profit institutions at which students can use federal student aid are the ones whose tuition and related fees count for purposes of the HOPE Scholarship. In general, the HOPE Scholarship applies to the tuition and related fees paid for attending all two- and four-year public and private colleges and universities as well as at many proprietary institutions offering occupational training programs.

Who qualifies for the HOPE Scholarship?

Three types of taxpayers are eligible to claim the HOPE Scholarship: 1) a taxpayer who is a student, including "independent students" who are responsible for their educational expenses and whose parents are *not* responsible for a share of those expenses;[3] 2) a taxpayer whose spouse has tuition and related fees; and 3) a taxpayer who is a parent with a student who is claimed as a dependent for tax purposes—however, the parent (and only the parent) can claim the HOPE Scholarship based on the tuition and related fees paid for that student.

The HOPE Scholarship can be claimed only with respect to a person who is enrolled in a degree or certificate program leading to a recognized educational credential on at least a half-time basis for at least one academic period, such as a semester or trimester, during a year. This same requirement applies to all students who receive assistance through the federal student aid programs.

For how long can the HOPE Scholarship be claimed?

It can only be claimed for the first two years of postsecondary education (freshman and sophomore years).

3. The legislative definition of an independent student is one who has reached the age of 24, is an orphan or ward of the court, is a veteran of the U.S. Armed Forces, is a graduate or professional student, is married, has dependents other than a spouse, or is a student for whom a determination of financial independence is made by a financial aid officer based on unusual circumstances. Students who do not meet one of these conditions are considered dependent students. See Sec. 480(d) of the Higher Education Act of 1965.

Which tax year does the HOPE Scholarship apply to?

The HOPE Scholarship applies to the tax liability of the year in which the tuition and related fees are paid. It was first available for the 1998 tax year. Thus, if a student paid tuition in calendar/tax year 1998, the HOPE Scholarship could be claimed on the tax return for 1998, which would normally be filed by April 15, 1999.

Are there income limits for eligibility for the HOPE Scholarship?

Eligibility for the HOPE Scholarship is phased out for single tax filers with incomes between $40,000 and $50,000 and for joint tax filers with incomes between $80,000 and $100,000. For example, the credit is reduced by 10 percent for each $1,000 that a single tax filer's income exceeds $40,000 (reaching zero at $50,000) and by 10 percent for each $2,000 that a joint tax filer's income exceeds $80,000 (reaching zero at $100,000).[4]

What happens if a taxpayer qualifies for a HOPE Scholarship but has no income tax liability or has income tax liability that is less than the HOPE Scholarship for which the taxpayer qualifies?

A taxpayer can only receive a HOPE Scholarship up to the amount of the taxpayer's tax liability. Thus, if a taxpayer has no tax liability, the taxpayer receives no HOPE Scholarship despite having paid tuition and related fees. A taxpayer with a tax liability smaller than the HOPE Scholarship for which the taxpayer qualifies has only the smaller tax liability canceled.

The HOPE Scholarship is *not* refundable. A "refundable" tax credit would require the federal government to pay the taxpayer directly any amount by which the HOPE Scholarship exceeds the taxpayer's tax liability. Thus, if the taxpayer qualified for a $1,500 HOPE Scholarship but only had a $1,000 income tax liability, the $1,000 income tax liability would be canceled and the taxpayer would receive a $500 check from the federal government.

What if a student receives other grants or scholarships?

To determine the amount of the HOPE Scholarship, the tuition and related fees that have been paid are *reduced* by the amount of tax-free educational assistance received by the student. Tax-free educational assistance includes Pell Grants, scholarships, veterans' educational benefits, and employer-provided educational assistance. Take, for example, a student who pays $3,000 for tuition and related fees and also receives a $3,000 Pell Grant. For purposes of the HOPE Scholarship, the amount of the tuition and related fees is reduced by the amount of the Pell Grant, equaling zero, and the student therefore receives no HOPE Scholarship. For HOPE Scholarships, all tax-free educational assistance—including aid received from federal, state, institutional, and other sources—is attributed exclusively to reducing the amount of eligible tuition and related fees. For example, a student cannot claim that his or her Pell Grant is used for both tuition and related fees as well as for other educational expenses, such as books or room and board.[5]

4. The measure of income is the "modified adjusted gross income" as used for federal income taxes.
5. On the terms of the HOPE Scholarship, see Department of Treasury, Internal Revenue Service, *Tax Benefits for Higher Education* (Publication 970) and Joint Committee on Taxation, *Overview of Present Law and Issues Relating to Tax and Savings Incentives for Education* (JCX-12-99) March 2, 1999.

Relief Act of 1997: the HOPE Scholarship represented nearly two-thirds of these benefits in FY 1999.[6]

This report focuses on the HOPE Scholarship as the signature program of a major new direction in federal policies for providing aid to individuals in higher education. It offers an early survey of the effects and consequences of the HOPE Scholarship from several points of view: individuals and their families; colleges and universities; the states; federal higher education policy; and federal tax policy.

Effects and Consequences of the HOPE Scholarship on Individuals and Their Families

Going back several decades to the National Defense Education Act of 1958 and the Higher Education Act of 1965, the purpose of federal student aid has been to encourage those to attend who would not otherwise do so. A primary goal of federal aid was to increase enrollments of individuals who had the ability to profit from higher education but lacked the resources to pay for it.

There are two basic policy justifications for the federal government to provide aid to those who cannot otherwise afford higher education. The first is that the private market does not provide enough higher education to individuals to enable the society as a whole to benefit from the optimum amount of the positive "externalities" of higher education. These positive externalities or spillover effects on society as a whole include increased economic productivity, a more flexible workforce, a more informed democracy, less crime, more care for the environment, and a higher level of public health.[7]

The aid to individuals provided, for example, by the National Defense Education Act of 1958 aimed at producing more scientists, which would have the positive spillover of enhancing national defense and security, as the title of the Act suggests. In this case, the federal aid to individuals to attend higher education was to make up for the inefficiency or imperfection of the market in failing to produce a sufficient supply of educated persons to generate the desired amount of this positive spillover.

The second reason to provide federal aid to individuals is to share among all citizens the opportunities for personal advancement provided by higher education. In America, social equity or fairness means enabling individuals to advance beyond the status of their birth, and opportunity for higher education is one important means to achieve this goal.

The drive for equal opportunity for education beyond high school is one of the legacies of the 1960s, and it was one of the central purposes of the federal aid to individual students provided by the Higher Education Act of 1965.[8] In signing the Act, President Johnson remarked, "It (the Act) means that a high school senior anywhere in this great land of ours can apply to any college or any university in any of the 50 States and not be turned away because his family is poor."[9] In proposing the reauthorization of the Higher Education Act in 1970, which included what became the current Pell Grant program, President Nixon restated

6. The HOPE Scholarship and Lifetime Learning Credit are quite similar as benefits and as policies. Taken together, these two provisions account for 93% of all of the benefits to individuals in higher education provided by the Taxpayer Relief Act of 1997. See *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2001* (Washington, DC: Government Printing Office, 2000) p. 114.
7. See The Institute for Higher Education Policy, "Reaping the Benefits: Defining the Public and Private Value of Going to College" (March, 1998).
8. See Lawrence E. Gladieux and Thomas R. Wolanin, *Congress and the Colleges: The National Politics of Higher Education* (Lexington, Massachusetts: DC Heath and Company, 1976) pp. 15-20.
9. *Public Papers of the Presidents of the United States: Lyndon B. Johnson, 1965* (Washington, DC: Government Printing Office, 1966) p. 1102.

the equity goal of federal programs of aid to students: "No qualified student who wants to go to college should be barred by lack of money.... Something is basically unequal about opportunity for higher education when a young person whose family earns more than $15,000 a year is nine times more likely to attend college than a young person whose family earns less than $3,000."[10]

In proposing the HOPE Scholarship, President Clinton and members of his administration strongly implied that one result of the new tax credit would be that those currently not attending higher education would now be able to do so. The President spoke of making "two years of college as universal as four years of high school" and asserted that the HOPE Scholarship "will open the doors of college opportunity to every American, regardless of ability to pay."[11] Secretary of Education Richard Riley wrote, "We anticipate an enrollment boost from the national (HOPE) program...."[12]

HOPE Scholarships and Low-Income Students

Has the HOPE Scholarship increased enrollments among those who lack the ability to pay for higher education? Those who lack the ability to pay for higher education are primarily from low-income families. Reconfirming President Nixon's remarks of 30 years ago, young persons from low-income families are still significantly less likely to enroll or participate in higher education than those from high-income families. For example, in 1998 an 18- to 24-year-old from a family whose income was in the top quartile (above $75,000) was more than twice as likely to reach college than was an 18- to 24-year-old from a family whose income was in the lowest quartile (less than $25,000).[13] In addition, only 75 percent of high ability students from low-income families enroll in higher education compared to 95 percent of the high ability students from high-income families.[14] The nation is clearly not maximizing the use of its human resources if everyone does not have the same opportunity to enjoy the benefits of higher education based on their ability.

Since HOPE Scholarships only first applied to postsecondary education expenses incurred in 1998, it is too early to definitively judge the effects of the program on increasing the enrollments of low-income students. However, one can infer that these effects have been and will continue to be minimal or nonexistent. Put most simply, low-income students and students from low-income families do not qualify for the HOPE Scholarship. Therefore, it makes no contribution toward paying their higher education expenses. In 1997, David A. Longanecker, Assistant Secretary for Postsecondary Education, said it succinctly, "Most lower-income families will not benefit from the tax credit."[15]

These low-income students and families fail to qualify for the HOPE Scholarship because of the effects of three features of the program:

10. *Public Papers of the Presidents of the United States: Richard Nixon*, 1970 (Washington, DC: Government Printing Office, 1971) p. 276.
11. "Commencement Address, Princeton University," June 4, 1996, *Public Papers of the Presidents of the United States: Bill Clinton, 1996*, v. I (Washington, DC: Government Printing Office, 1997) pp. 855-856. See also, "Statement on Signing Balanced Budget Act of 1997 and Taxpayer Relief Act of 1997," and "Remarks by the President at the 126th Carleton College Commencement Exercises," June 10, 2000, *Public Papers of the Presidents of the United States: Bill Clinton, 2000*, v. I (Washington, DC: Government Printing Office, 2001).
12. "Smart Student Aid for the 21st Century," letter to the editor, *The Washington Post*, February 15, 1997.
13. *Postsecondary Education Opportunity*, no. 94 (April, 2000) pp. 1-4.
14. Michael S. McPherson and Morton Owen Shapiro, "Reinforcing Stratification in American Higher Education: Some Disturbing Trends," May, 1999, A Paper Written for the Macalester Forum on Higher Education Conference, Diversity and Stratification in American Higher Education, Table 7. See also, John B. Lee, "How Do Students and Families Pay for College," in Jacqueline E. King, ed., *Financing a College Education: How It Works, How It's Changing* (Washington, DC: American Council on Education, 1999) Table 1.3, p. 15.
15. Quoted in Stephen Martin, "Educators Pan Proposal to Link Tax Credit to Students' Grades," *The Chronicle of Higher Education*, February 17, 1997,

A Nonrefundable Credit

First, and most importantly, since the HOPE Scholarship is not refundable, those who have no tax liability receive no benefit from the program. In addition, those with tax liability that is less than the maximum HOPE Scholarship ($1,500) are eligible to receive less than the full HOPE Scholarship. The "typical family" pays no income taxes until its income reaches $19,000. Thus, families with incomes below $19,000 with a student in postsecondary education would not receive a HOPE Scholarship. As the income and tax liability of families increases, their eligibility for HOPE Scholarships also increases. As a result, families with incomes of $28,000 and above are eligible for the full $1,500 HOPE Scholarship.[16]

Approximately 40 to 45 percent of low-income first- and second-year students are *dependent*, meaning that they rely on their families for support.[17] Based on their income, the families of about half of these students—or approximately one million families—receive no benefit from the HOPE Scholarship. An additional half million families are eligible to receive less than the maximum HOPE Scholarship.

Independent students—students who are solely responsible for their higher education expenses—make up about 55 to 60 percent of low-income first- and second-year students. Nearly two-thirds of the independent students have children.[18] These independent students are part of a family and their tax situation is similar to that of the families who support dependent students.

The remaining third of the independent students are individuals, in some cases with a spouse but no children. An individual pays no income tax until his or her income reaches $9,000; his or her tax liability reaches $1,500 at $14,000 in income.[19] Thus, individuals with incomes below $9,000 receive no HOPE Scholarship, and for those with incomes between $9,000 and $14,000, eligibility for HOPE Scholarships increases as their income and tax liability increases.

The HOPE Scholarship is perfectly regressive, the more income you have, the more benefits you receive (up to the limit of the benefits). Those with incomes below $19,000 (or $9,000 in the case of single individuals) receive nothing.

As noted above, the families of approximately one million low-income first- and second-year dependent students and one million independent students currently in college are not eligible to receive the HOPE Scholarship. In addition, the families of nearly one million more low-income dependent youth between the ages of 18 and 24 who are not in college receive no incentive or assistance from the HOPE Scholarship to send these young people to postsecondary education. Furthermore, there is the group of approximately 10 million potential independent students who receive no assistance from the HOPE Scholarship. This group includes all individuals above the age of 25 who are low-income and have attended at least four years of high school but less than two years of college.[20]

16. The calculation is based on 1998 tax rates for a family with two parents filing a joint return with two children and standardized deductions.
17. See National Computer Systems, *1996-97 Title/IV Federal Pell Grant Program: End of Year Report* (Washington, DC: n.d.) Table 13, pp. 80-81. This assumes that all low-income first- and second-year students are Pell Grant recipients.
18. Technically these independent students have "dependents other than a spouse," which in most cases means that they have children and also may have a spouse. See National Computer Systems.
19. Assuming standard deductions and 1998 tax rates.
20. It probably makes sense to set an upper age limit on this hypothetical group, perhaps 60. See U.S. Department of Education, National Center for Education Statistics, *Digest of Education Statistics*, 1998 (Washington, DC: GPO, 1999) Table 9, p. 18.

Reduction of Educational Costs by the Amount of Financial Aid

The second feature of the HOPE Scholarship that limits the eligibility of low-income students and families is the reduction in the amount of tuition and related fees that can be counted towards the amount of a HOPE Scholarship by the amount of tax-free educational assistance received by a student. In practice this means that these educational costs to the student are reduced by the amount of grants and scholarships students received from federal, state, institutional, and other programs. In Academic Year (AY) 1998-99, this would include the $8.1 billion in federal Pell and other grants, $3.4 billion in state grants, and the $12.2 billion in grants from institutions and other sources.[21] Most of these grants are awarded on the basis of financial need, i.e. to students from low-income families. This means that low-income students and families, who have the least tax liability and therefore the least eligibility for HOPE Scholarships, also receive the largest amount of grants, which reduces or eliminates their eligibility for HOPE Scholarships.

In addition, low-income students tend to be concentrated in lowest price public two-year and four-year colleges. For example, students attending public two-year colleges, the lowest price postsecondary institutions, accounted for 32 percent of all first-year students in 1998 but 47 percent of the first-year students from families with incomes of less than $20,000.[22] Low-income students, disproportionately concentrated in low-price institutions, pay lower amounts of tuition and related fees, which are more likely to be more fully offset by tax-free educational assistance such as a Pell Grant, thus rendering these low-income students ineligible for a HOPE Scholarship.

Tuition and Fees Versus Total Cost of Education

The third feature of the HOPE Scholarship that limits the eligibility of low-income students and families is the calculation of the HOPE Scholarship eligibility based only on tuition and related fees rather than on total price of attendance, which also includes other expenses such as room, board, books, and transportation. In 1998-99 the average tuition and fees at a two-year public institution was $1,554, which implies that most students attending these institutions pay less than the $2,000 in tuition and fees needed to qualify for the maximum HOPE Scholarship.[23] Yet, the low-income students who disproportionately attend these institutions pay, on average, a total price of attendance in excess of $6,000, even for commuter students. If educational costs to the student beyond tuition and fees could be considered for the HOPE Scholarship, more students attending these low-cost institutions—largely low-income students—could enjoy the full benefit of the HOPE Scholarship.

Table One illustrates the interaction of these three features of HOPE Scholarships: lack of refundability, deduction of tax-free educational assistance from tuition and fees, and consideration of only tuition and fees among educational costs. As can be seen from Table One, students (or the families of students) with the least income, the largest Pell Grants, and the lowest price of attendance benefit *least* from HOPE Scholarships. Those with higher incomes, no Pell Grants, and higher price of attendance benefit *most* from HOPE Scholar-

21. *Trends in Student Aid 2000*, p. 6.
22. McPherson and Shapiro (May, 1999) Table 8.
23. The College Board, *Trends in College Pricing 2000* (New York: College Entrance Examination Board, 2000) p. 7.

Table One: Estimated HOPE Tax Credit, by Taxable Family Income, Pell Grant, and Educational Costs

Two-Year Public Colleges and Universities

Average Tuition: $1,500 • Total Price of Attendance: $4,500

Taxable Income ($)	Pell Grant ($)	Hope Tax Credit ($)
10,000	3,000	0
20,000	3,000	0
30,000	2,450	0
40,000	950	550
50,000	0	1,250
60,000	0	1,250
70,000	0	1,250
80,000	0	1,250
90,000	0	625
100,000	0	0

Four-Year Public Colleges and Universities

Average Tuition: $3,000 • Total Price of Attendance: $10,000

Taxable Income ($)	Pell Grant ($)	Hope Tax Credit ($)
10,000	3,000	0
20,000	3,000	0
30,000	2,450	550
40,000	950	1,500
50,000	0	1,500
60,000	0	1,500
70,000	0	1,500
80,000	0	1,500
90,000	0	750
100,000	0	0

Four-Year Private Colleges and Universities

Average Tuition: $13,000 • Total Price of Attendance: $20,000

Taxable Income ($)	Pell Grant ($)	Hope Tax Credit ($)
10,000	3,000	0
20,000	3,000	0
30,000	2,450	1,500
40,000	950	1,500
50,000	0	1,500
60,000	0	1,500
70,000	0	1,500
80,000	0	1,500
90,000	0	750
100,000	0	0

Note: Calculations are for full-time freshman, 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.
Source: Kristin D. Conklin, *Federal Tuition Tax Credits and State Higher Education Policy* (Washington, DC: The National Center for Public Policy and Higher Education, 1998) page 22.

ships.[24] Clearly the HOPE Scholarship represents a dramatic departure from previous federal policy that largely targeted aid on helping low-income persons meet the costs of higher education.[25]

HOPE Scholarships and Affordability

If the HOPE Scholarship is not serving the traditional federal role of broadening access to higher education for students from low-income families, it must be serving some other policy objective. As Clayton Spencer notes, "(T)he president and Congress have increasingly promoted 'affordability' of college for middle-class families—as distinct from access for low-income students—as the number-one concern of federal higher education policy."[26] This new policy concern invariably describes middle-income families as "struggling" with the "burden" of college costs. Previously, the main focus was on providing access by overcoming the financial barriers facing those who *do not* attend higher education. The new center of attention is affordability, the "burden" on those who *do* attend. The premise is that an excessive proportion of a family's income is now needed to pay college tuition.

Are middle-income families spending a higher proportion of their income to meet the price of higher education? Approximately two-thirds of the students attending four-year colleges and universities attend public institutions.[27] The burden on middle-income families to send their children to these public colleges and universities has increased somewhat but not dramatically. In 1972-73 middle-income families needed

24. These conclusions about the effects of HOPE Scholarships on students and families at various income levels had been widely noted before the program was adopted and have continued to be expressed since its adoption. See, for example, Lawrence E. Gladieux and Robert D. Reischauer, "Higher Tuition, More Grade Inflation," *The Washington Post*, September 4, 1996, p. A15; The Institute for Higher Education Policy, *Taxing Matters: College Aid, Tax Policy, & Equal Opportunity* (February, 1997) pp. 34-35; Christine L. Olson, "Clinton's FY 1998 Education Proposals: Building Bureaucracy for the 21st Century," *Heritage Talking Points* (Washington, DC: The Heritage Foundation, 1997) p. 8; William Greider, "Professor Feelgood," *Rolling Stone*, April 17, 1997, pp. 51-53; James B. Stedman, Bob Lyke, and Margot Schenet, "Tuition Tax Credit and Deduction: Who Benefits From the President's Proposals?," *CRS Report for Congress* (Washington, DC: Congressional Research Service, 1997) pp. 28-29; Arthur M. Hauptman and Lois D. Rice, "Coordinating Financial Aid with Tuition Tax Benefits," *The Brookings Institution Policy Brief*, no. 28 (December 1997) p. 6; Michael S. McPherson and Morton O. Shapiro, *The Student Aid Game: Meeting Need and Rewarding Talent in American Higher Education* (Princeton, NJ: Princeton University Press, 1998) p. 87; Kristin D. Conklin, *Federal Tuition Tax Credits and State Higher Education Policy* (Washington, DC: The National Center for Public Policy and Higher Education, 1998) pp. 4-6; Kristin D. Conklin and Joni E. Finney, "State Policy Response to the Taxpayer Relief Act of 1997," in King, pp. 155-157; A. Clayton Spencer, "The New Politics of Higher Education," in King, pp. 113-114; Sandy Baum, "Need Analysis: How We Decide Who Gets What," in King, p. 49; Thomas J. Kane, *The Price of Admission: Rethinking How Americans Pay for College* (Washington, DC: The Brookings Institution, 1999) p. 43; *Report of the Commission on New York State Student Aid* (December, 1999) p. 3; and Patrick Callan and Kati Haycock, "Best Intentions, Going Awry, *The Washington Post*, March 20, 2000, p. A17.
25. The Treasury Department has released only one analysis of the distribution of HOPE Scholarship benefits by income. This table, "Preliminary Data on Usage of Education Tax Credits in 1998 Tax Year," is dated January 12, 2000. It indicates that of the returns in the 1998 tax year claiming an education tax credit, 33 percent were from filers with incomes below $30,000, who received 25 percent of the education tax credit benefits. This table is not very useful for our discussion of the HOPE Scholarship because it does not distinguish between those who benefit from HOPE Scholarships and those who benefit from the Lifetime Learning Tax Credit. The Lifetime Learning Credit is available to those who incur tuition and related fees at all undergraduate and graduate levels of higher education, except that it cannot be claimed at the same time that a filer is claiming a HOPE Scholarship. Some significant proportion of those claiming the Lifetime Learning Credit are graduate and professional students who can no longer be claimed as dependents by their parents and who only temporarily have low incomes while they are in school. The presence of these "low-income" independent graduate and professional students claiming the Lifelong Learning Credit probably adds significantly to the proportion of those receiving an education tax credit with incomes below $30,000. Therefore, the proportion of filers who claim the HOPE Scholarship and whose income is below $30,000 is most likely even less than the 33 percent of filers with incomes below $30,000 who claim either the HOPE Scholarship or the Lifetime Learning Credit. These HOPE Scholarship filers with incomes below $30,000 most likely received even less than 25 percent of the benefits.
26. A. Clayton Spencer, "The New Politics of Higher Education" in King, p. 110. For examples of this new priority by the Clinton Administration see statements by David Longanecker, Assistant Secretary for Postsecondary Education during the consideration of the HOPE Scholarship, quoted in Stephen Burd, "President Pushes Tax Breaks to Help Families Afford College," *The Chronicle of Higher Education*, January 17, 1997, p. A33 and Richard W. Riley, "Give the Middle Class a Break on Education," *The Washington Post*, April 24, 1997.
27. *Digest of Education Statistics*, 1998, Table 173, p. 197.

13 percent of their income to meet the average price of attendance at a four-year public institution. In 1999-2000, they needed 16 percent. In comparison, in 1972-73 low-income families needed 42 percent of their income to meet the average price of attendance at a four-year public institution; by 1999-2000, they needed 62 percent.[28]

Private institutions enroll about one-third of the students attending four-year colleges and universities. In AY1972-73 middle-income families needed 27 percent of their income to meet the average cost of attendance at a four-year private institution. In AY1999-2000, they needed 43 percent. Clearly, the burden on middle-income families has increased more significantly at private colleges. In comparison, in AY1972-73 low-income families needed 87 percent of their income to meet the average price of attendance at a four-year private institution. In 1999-2000, they needed 163 percent.

It should be noted that families rarely in fact pay for higher education solely out of current income. As is the case with other major purchases, such as homes and cars, a college education is usually financed at least in part by loans. Thus, the relationship of college prices to annual family income is more useful for comparisons over time and between income groups rather than as a measure of the actual burden faced by families in a single year.

More importantly, the increase in the price of private four-year institutions relative to annual income of middle-income families has not led to the much feared "middle-income melt," the wholesale migration of students from middle-income families from higher-priced private institutions to lower-priced public institutions. Students from middle-income families have not significantly changed their patterns of enrollment in higher education in response to the increases in price relative to income over time. In fact, "(i)n 1980, some 19.7 percent of middle-income students ... were enrolled at private four-year colleges and universities; fourteen years later, 20.5 percent of middle-income students ... were in those institutions."[29]

However, the enrollment patterns of low-income students are more sensitive to increases in price. The substantial price increases faced by these students have both discouraged their enrollment in higher education and resulted in the increasing concentration of those who do enroll in the lowest price public two-year institutions.[30]

As noted above, college prices have increased relative to income more for low-income rather than middle-income families, and the "burden" (the ratio of price to income) has fallen more heavily on low-income than on middle-income families. In 1972, the burden of both the average price of four-year public and private colleges and universities was about three times greater for a low-income than for a middle-income family. By 2000, the burden on the low-income family was about four times greater than the burden on the middle-income family. Thus, it is clear that those with the greatest and most rapidly increasing burden of paying for college are low-income, not middle-income families. Although "affordability" has come to mean for some

28. *Trends in College Pricing 2000*, Figure 7, p. 14. "Low-income" and "middle-income" in this case refer to the "lowest income quintile" and the "middle-income quintile" respectively.
29. *The Student Aid Game*, pp. 46-47.
30. McPherson and Shapiro, "Stratification," May 1999.

the burden faced by middle-income families, it is actually low-income families that have the more severe and growing affordability problem.[31]

Putting aside the issue of how much the comparative burden of paying for college has increased for middle-income and low-income families, let us focus on how much this burden has been relieved by the HOPE Scholarship. As can be seen from Table Two, the burden of college prices is decreased only modestly for middle-income families who take advantage of the HOPE Scholarship. For those with incomes between $30,000 and $90,000, college costs as a percentage of income decrease by 0 to 5 percent. The average decrease for these income categories is 2 percent. Given what we know from the research, an average reduction in the burden of college prices by 2 percent of income is unlikely to make any significant difference in either the likelihood of attending college or the choice among institutions.[32] In short, the HOPE Scholarship is simply a windfall to middle-income families. On the other hand, low-income families, who face the greatest and most rapidly growing burden from college prices, receive no help from the HOPE Scholarship. Contrary to the intentions of the Clinton administration, there is no evidence to date that the HOPE Scholarship increases enrollments in higher education for any income category of students or potential students.

Middle-income families and students may not have a significant affordability problem, particularly in comparison to low-income families and students. However, they may think or feel or believe that they have an affordability problem to be concerned about, based on ignorance of college prices. For example, in a 2000 survey, adults estimated tuition at two-year public institutions to be three times the actual level and tuition at four-year public institutions to be twice the actual level; they estimated tuition at private four-year institutions to be 126 percent of the actual level. The same survey also found that adults are very concerned about paying the college expenses of their children; 60 percent of them believe that "a four-year college education is not affordable for most Americans."[33]

It may also be the case that the "burden" felt by middle-income families is not the real or perceived relationship between college prices and their income—their *ability* to pay—but that they are no longer *willing* to pay as much or as large a share of their income on higher education expenses. The mention of this possibility usually gets heads nodding affirmatively at gatherings of policy analysts interested in higher education, but there appears to be no evidence beyond the anecdotal to confirm it.[34]

Delivering Aid for College Through the Tax System

The utility of the HOPE Scholarship to individuals is also diminished by using the income tax system as the delivery mechanism. Taxpayers typically file their income tax returns by the April 15 deadline, realizing the benefits of the HOPE Scholarship at that point. However, they would have actually paid out of pocket the tuition and related fees that generated the HOPE Scholarship as long ago as 15 months previously, in January of the prior year. The HOPE Scholarship benefits

31. See Jerry Sheehan Davis, *College Affordability: Overlooked Long-Term Trends and Recent 50-State Patterns* (Indianapolis: USA Group Foundation, 2000) pp. 1 7–18 ("Trends in College Prices and Family Incomes").
32. See for example, Conklin and Finney in King, p. 154.
33. Stanley O. Ikenberry and Terry H. Hartle, *Taking Stock: How Americans Judge Quality, Affordability, and Leadership at U.S. Colleges and Universities* (Washington, DC: American Council on Education, 2000) pp. 8-13.
34. See Davis, p. 2.

Table Two: Estimated Price of Attendance Before and After Enactment of the HOPE Tax Credit, by Taxable Family Income

Four-Year Public Colleges and Universities

Average Tuition: $3,000 • Total Price of Attendance: $10,000

Taxable Family Income ($)	Price of Attendance before Tax Credit ($)	Price of Attendance as a % of Income	Price of Attendance after Tax Credit ($)	Price of Attendance as a % 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%

Four-Year Private Colleges and Universities

Average Tuition: $13,000 • Total Price of Attendance: $20,000

Taxable Family Income ($)	Price of Attendance before Tax Credit ($)	Price of Attendance as a % of Income	Price of Attendance after Tax Credit ($)	Price of Attendance as a % of Income
10,000	16,125	161%	16,125	161%
20,000	16,125	81%	16,125	81%
30,000	16,125	56%	15,175	51%
40,000	18,175	45%	16,675	42%
50,000	19,125	38%	17,625	35%
60,000	19,125	32%	17,625	31%
70,000	19,125	27%	17,625	26%
80,000	19,125	24%	17,625	23%
90,000	19,125	21%	18,375	21%
100,000	19,125	19%	19,125	19%

Note: Calculations are for full-time freshmen. Taxable family income is defined as adjusted gross income for taxpayer filing jointly with two dependents.

Source: Kristin D. Conklin, *Federal Tuition Tax Credits and State Higher Education Policy* (Washington, DC: The National Center for Public Policy and Higher Education, 1998) p. 23.

arrive long after the higher education bills have been incurred and paid, and are, therefore, not very useful to anyone who is trying to raise enough funds to pay the college bills. Nor are they an incentive in favor of college attendance for those who are considering the financial feasibility of attending higher education.[35]

The HOPE Scholarship is part of the large and complex calculation that goes into determining the amount of a family's tax liability including any amount owed or to be refunded from the government. There is, therefore, no reason to assume that the HOPE Scholarship will be perceived as a separate or earmarked amount that is to be devoted to higher education expenses. Further, in the case of *dependent* students, a HOPE Scholarship can only be received by the student's parents, who may spend the additional discretionary income for any purpose, despite the needs or wishes of the student for funds for higher education expenses.

Prior to the HOPE Scholarship, student aid was provided to students from a wide variety of sources that included grant, loan, and subsidized employment programs at the federal and state levels, at the institution the student chose to attend, and through various philanthropic organizations. A recent U.S. Department of Education report observes that the delivery of aid to students has become "an increasingly complex system of public/private financing that is difficult to understand and navigate."[36] The HOPE Scholarship exacerbates this situation. It requires filing a separate tax form. This form is far from being the "simple one-line entry" advertised by the advocates of tuition tax credits. It is, in fact, an 18-line supplemental tax form that has two pages of instructions and is accompanied by an 18-page publication.[37] The tax system through which the HOPE Scholarship is made available and the criteria by which eligibility and the size of the award are determined are separate and different from the systems and criteria used to award student aid from other sources.

Given this separate system and the complex eligibility rules for receiving the HOPE Scholarship on top of the existing complexities of the student financial aid system, it should not be surprising that there is substantial ignorance and misinformation about the HOPE Scholarship and that it is significantly underutilized. Only about 30 percent of middle-income parents with children expected to go on to college reported that they had heard of HOPE Scholarship.[38] A survey found that the two main reasons why undergraduates at the University of California did not claim a tax credit (including the HOPE Scholarship) were: "I did not think I was eligible" (48 percent) and "I didn't know about it" (32 percent).[39] In tax year 1998, only about a third of the families who were estimated to be eligible claimed a federal education tax credit (including the HOPE Scholarship) and only $3.4 billion was claimed of the $7 billion for which families were estimated to be eligible.[40]

In sum, the HOPE Scholarship does not put more money in the hands of the large numbers of low-

35. In principle, tax filers who are wage earners and subject to withholding could adjust their withholding in anticipation of the tuition and related fees they expected to pay and the HOPE Scholarship they further anticipated receiving as a result of having paid the tuition and related fees. If they set aside the increments to their take home pay that resulted from the adjustment to their withholding, they could have some cash in hand when the tuition bill was due. This sophisticated level of financial and tax planning is probably beyond a realistic expectation for the behavior of most families.
36. U.S. Department of Education, *Learning Without Limits: An Agenda for the Office of Postsecondary Education* (November, 2000), p. 24.
37. See IRS Form 8863, *Education Credits (HOPE and Lifetime Learning Credits)*, and IRS Publication 970, *Tax Benefits for Higher Education*.
38. In this case middle-income means having a family income of between $25,000 and $75,000. U.S. Department of Education, National Center for Education Statistics, *The Condition of Education* 2000 (Washington, DC: GPO, 2000) p. 105.
39. Barbara A. Hoblitzell and Tiffany L. Smith, "Utilization of the Hope Scholarship and Lifetime Learning Education Tax Credits," presentation prepared for the University of California, 2000.
40. Remarks as prepared for delivery by U.S. Secretary of Education Richard W. Riley, Association of American Colleges and Universities, Washington, DC, January 20, 2000.

income students qualified to attend higher education and therefore does not increase the likelihood of their attendance at a higher education institution. In fact, about 13 million persons either in higher education or potentially eligible to attend higher education receive no benefit from the HOPE Scholarship because they are low-income. The HOPE Scholarship also only marginally makes higher education more affordable or less burdensome for middle-income families. Therefore, it is highly unlikely that it has had or will have any substantial effect on increasing enrollments in higher education. Largely because of the exclusion of low-income families from its benefits, the HOPE Scholarship will not realize President Clinton's aspiration that the program will increase enrollments, particularly in two-year colleges.[41] The basic design of the HOPE Scholarship makes this goal unattainable.

Beth Macy summarizes the situation:

> ...(T)he real beneficiaries of his (Clinton's) latest college-financing program are...the middle- and upper-middle classes... the people who, by and large, do not fill out E-Z tax return forms. The plan won't increase by one student the number of kids attending college; it will just make it easier for the kids who are already going.[42]

Effects and Consequences of the HOPE Scholarship on Institutions of Higher Education

Institutions of higher education will not get more students as a result of the HOPE Scholarship, but they will get more regulations. Here we consider how costly and how extensive this regulatory burden is on institutions of higher education and how it will develop in the future.

IRS Regulations

During the fall of 1997, in its initial thinking about implementing the HOPE Scholarship as part of the Taxpayer Relief Act of 1997, the Internal Revenue Service (IRS) of the Treasury Department took a broad, literal view of data that institutions of higher education would be required to supply according to the law. The IRS considered having colleges supply information (such as addresses and Social Security numbers) for all students as well as all other persons who would be claiming a student as a dependent for federal income tax purposes as the law requires.[43] The IRS obviously wanted to ensure that the HOPE Scholarship was only claimed by those eligible, and therefore would have liked institutions of higher education to tell them who all the eligible claimants were. Such a requirement, however, would have caused substantial practical difficulties for the institutions since they often do not collect detailed information about all their students, especially those who do not receive federal student aid—about half of all students. Institutions also do not collect information about the parents of dependent students, particularly those who do not receive federal aid. In addition, institutions do not know who is claiming a student as a dependent for federal income tax purposes.

When higher education institutions and their Washington representatives voiced their strong objections, the IRS relented somewhat in late 1997. For tax year

41. See, "Commencement Address, Princeton University," pp. 855-856 and Stephen Burd, "President Pushes Tax Breaks to Help Families Afford College," *The Chronicle of Higher Education*, January 17, 1997, p. A33.
42. Beth Macy, "Working-class zero" Salon.com, February 16, 2000 (www.salon.com/books/it/2000/02/16/tax).
43. Stephen Burd, "New Tax Breaks for Students May Require Extensive Reporting by Colleges to the IRS," *The Chronicle of Higher Education*, October 10, 1997, p. A31.

1998, they required that institutions report to the IRS the names, addresses, and Social Security numbers of all their students as well as whether students are enrolled at least half time (Form 1098-T). The institutions also had to supply the student with a copy of this statement. While the IRS did not then require institutions to supply the names and Social Security numbers of those who are claiming a student as a dependent for federal income tax purposes and who may claim the HOPE Scholarship, they indicated that this information would be required in tax year 1999.[44]

While the institutions were pleased with this relief, they continued to be dismayed by the only one-year suspension of the broad data collection requirements as well as by the remaining data reporting requirements. Their view was that the IRS should rely on self-reporting by tax filers (both students and parents) of the information necessary to qualify for the HOPE Scholarship. If the IRS then had reason to suspect the veracity or accuracy of the data, it could seek to verify that data with the institution.

Early in 1998, Congressman Manzullo (R, Illinois) and others introduced the Higher Education Reporting Relief Act, which would have amended the Taxpayer Relief Act of 1997 to repeal the reporting requirements, in effect adopting the self-reporting approach favored by the higher education community.[45] The Treasury Department strongly opposed the Manzullo bill. It was not enacted, but the IRS extended the data reporting requirements for institutions of higher education that were in place for 1998 for tax year 1999.[46]

In 1999, the higher education institutions continued to complain about the administrative burden imposed by the HOPE Scholarship program. Stanley O. Ikenberry, President of the American Council on Education, wrote to Treasury Secretary Robert E. Rubin, "The burden imposed by the Hope ... tax credit ... far exceeds any federally imposed burden that we have encountered previously."[47] The institutions were concerned not only by the reporting requirements but also by the deluge of inquiries from students (and their families) who turned to the college and universities (rather than the IRS) to explain this new higher education tax benefit since the Form 1098-T came from the institutions.[48] In May Congressman Manzullo reintroduced his bill, and later in the year IRS extended the reporting status quo through tax year 2000.[49]

The National Association of College and University Business Officers (NACUBO) estimated that compliance with the full set of reporting requirements contained in the law would have cost institutions of higher education $137 million in 1999.[50] The IRS estimates the current annual reporting burden on institutions to produce Form 1098-T and to provide it to the IRS and 21 million taxpayers is 2.4 million hours.[51] This would seem to imply a current cost of compliance of approximately $100

44. Stephen Burd, "Treasury Department Explains Requirements for Colleges on New Tax Credits," *The Chronicle of Higher Education*, October 31, 1997, p. A46 and "Colleges Get Reprieve in Tax-Break Guidelines," *The Chronicle of Higher Education*, December 12, 1997.
45. "Manzullo Legislation Would Save Colleges Tens of Millions in Regulatory Costs," press release, Congressman Donald Manzullo, January 29, 1998.
46. "IRS Extends Limits on Student Data That Colleges Must Report," *The Chronicle of Higher Education*, September 4, 1998, p. A47.
47. Quoted in Sara Hebel, "2 New Tax Credits Create Costly Tasks for College Officials," *The Chronicle of Higher Education*, January 29, 1999, p. A35.
48. Ibid. and Sara Hebel, "2 New Tax Credits Spell Confusion as April 15 Arrives," *The Chronicle of Higher Education*, April 16, 1999, p. A41.
49. "Washington Almanac," *The Chronicle of Higher Education*, May 21, 1999, p. A35 and Sara Hebel, "IRS Delays Reporting Requirements for 2 New Tax Credits for College Costs," *The Chronicle of Higher Education*, August 6, 1999, p. A36.
50. NACUBO, "The Taxpayer Relief Act of 1997 Reporting Task Force: Highlights of Activities," prepared for the 1998 National Association of Student Financial Aid Administrators Conference, July 15-18, Chicago, Illinois, p. 3.
51. *Federal Register*, June 16, 2000, p. 37729.

million annually, a significant amount even when spread across all institutions of higher education.[52]

The cost of complying with federal regulations has been identified as one of the potential "cost drivers" that may explain, in part, the rapid increases in college costs.[53] However, there is no research that specifies the relative magnitude of the contribution of federal regulatory compliance to the rate or size of the growth in college costs.

To date, the compliance burden from HOPE Scholarship on institutions of higher education has been significant but not overwhelming. This burden has been held within tolerable limits primarily by two factors. First, in response to opposition from the higher education community and to political pressure from Congress, the IRS has now held off for three years on imposing the full reporting requirements contained in the law. In particular, the IRS has not yet required institutions to report the name, address, and Social Security number of any taxpayer who can claim a student as a dependent for federal income tax purposes.

Second, and most importantly, the IRS has thus far used the legislative and regulatory definitions that are used for the federal student aid programs by the Department of Education for such key terms as "undergraduate," "academic year" and "tuition." However, this already works imperfectly because the HOPE Scholarship is awarded on a calendar (tax) year basis (January 1 to December 31) while the federal student aid programs operate on an academic year (July 1 to June 30). For example, a tuition payment by a student usually applies to one academic year, but it may apply to two tax years, and the IRS expects the institution to keep track of it both ways.

In the longer term, it is likely that the regulatory burden will become significantly worse and the financial costs to institutions of higher education will increase, along with the threat to their flexibility, autonomy, and independence. The primary reason for this is the culture and mission of the IRS and the Treasury Department, which Paul R. McDaniel characterizes as "tax thinking." He argues:

> The IRS sees its mission primarily in terms of collecting revenues...IRS officials...are not likely to give expansive reading to tax expenditure programs (like HOPE Scholarship) because, in their view of the world, a reduction in revenues will result.... (T)he basic instinct of the IRS...is to interpret the tax expenditure program as narrowly as possible in order to maximize government revenues.[54]

In short, making higher education more affordable for middle-income families does not fit in the IRS' perception of its mission.

In June 2000, the IRS published the proposed formal regulations for the administration of the HOPE Scholarship and related education tax benefits.[55] This proposed

52. This estimate is derived from three calculations. First, it is less than the NACUBO estimate for the cost of implementing all the requirements of the HOPE Scholarship law. Second, it represents a back-of-the-envelope calculation of 2.4 million hours at an hourly wage of $18, a benefits rate of 40 percent of salary and an overhead rate of 60 percent. Third, it is a nice round number within the range of the first two calculations.

53. The National Commission on the Cost of Higher Education, *Straight Talk About College Costs and Prices* (Washington, DC: GPO, 1998) pp. 11 and 15.

54. Paul R. McDaniel, "Tax Expenditures As Tools of Government Action" in Lester M. Salamon, ed. *Beyond Privatization: The Tools of Government Action* (Washington, DC: The Urban Institute Press, 1989) p. 175.

55. "Information Reporting for Payments of Qualified Tuition and Payments of Interest on Qualified Education Loans, Magnetic Media Filing Requirements for Information Returns," *Federal Register*, 65, no. 117 (June 16, 2000) pp. 37728-738.

regulation contains two indicators of what lies ahead for institutions of higher education. First, it includes an IRS definition of "academic credit." The definition is unremarkable in itself except as a harbinger of IRS definitions separate from and paralleling those of the Department of Education already applicable to institutions through the federal student aid programs. Definitions and regulations devised by the IRS are also likely to be a particularly ill-fitting garment for institutions of higher education since they will be devised by tax experts interested in collecting revenue rather than experts in student aid concerned with serving students and institutions of higher education. Such duplicate, parallel, and ill-suited definitions would dramatically increase the complexity and costs of compliance for institutions.

The obvious solution would be to simply have the Treasury Department (and the IRS) continue to defer to the Education Department and not create separate and parallel regulations and definitions. However, given the power and importance of the Treasury's revenue collection mission and how substantially it differs from the Education Department's mission of supporting and promoting higher education, this is highly unlikely. The former implies a tight-fisted approach and the latter an open-handed and generous one. The hope for long-term Treasury deference to Education ignores the relatively greater size, stature, prestige, and self-importance of the Treasury Department compared to the Education Department.

The second indicator of future problems in the June 2000 proposed regulations is the inclusion of section titles requiring institutions of higher education to provide Form 1098-T to the IRS and to the taxpayer in the case of "any taxpayer who will claim the individual (student) as a dependent on the taxpayer's Federal income tax return."[56] These sections have no content and are marked "[Reserved]." This means that it is anticipated that the content of these sections—the full reporting requirements—can (will) be supplied at a later date, signaling that the IRS has not given up on full implementation of the reporting requirements of the law nor have they accepted the moratorium on full implementation of the law as permanent. The IRS is simply waiting for the opportune time to fill in these blanks.

A scenario can easily be imagined of a study by the IRS or by the General Accounting Office (GAO) concluding that erroneous or fraudulent self-reporting of information by tax filers claiming the HOPE Scholarship has resulted in a revenue loss of some tens or hundreds of millions of dollars annually. Full implementation of the reporting requirements already in the law would provide a ready response for IRS that would sweep aside the objections and concerns of the institutions of higher education and their allies in Congress. The costs and complexity of compliance will also greatly increase if (or when) such full implementation of the reporting requirements in the law takes place.

In November 2000, the IRS announced that the reporting status quo for institutions of higher education would be extended for a fourth year, through tax year 2001, pending the finalization of the proposed regulations of June, 2000.[57]

Incentives to Raise Tuition and Reduce Aid

While the HOPE Scholarship will not generate more students for colleges and universities, it does put more money in the hands of those students (and their families) who would be attending higher education already. Former Georgia Governor Zell Miller put it

56. Ibid., pp. 37734-35.
57. IRS Announcement, 2000-62.

succinctly, "(C)olleges will simply assume that all students have the tax credit in hand, and may reduce aid or raise tuition accordingly—negating the effect of the benefit."[58] Therefore, the effect of the availability of HOPE Scholarship resources for families on the prices and the availability of financial aid should be considered. The effects of the HOPE Scholarship at private colleges and universities are examined first, reserving the discussion of the effects on tuition and aid at public or state colleges and universities for the next section on the states.

HOPE Scholarship provides private institutions with an incentive to raise their tuition charges.[59] Simply having the HOPE Scholarship resources available enhances the opportunity for tuition increases and decreases the potential resistance to them. However, the incentive effect of HOPE Scholarship on tuition increases at private institutions of higher education is likely to be minor for two reasons. First, the size of the HOPE Scholarship as an addition to income is relatively small compared to the level of tuition at private institutions of higher education. Therefore, it is unlikely to be a strong force driving tuition increases. Second, only a small number of private colleges and universities have highly selective admissions. This small group have far more qualified applicants ready to pay the full price of tuition than they choose to admit. They need not worry about empty seats in classrooms or empty rooms in dormitories in reaction to tuition increases. However, most private colleges and universities do not enjoy this happy circumstance. This larger group operates in a highly competitive environment that is the major determinant of their tuition pricing policy, which is modified only marginally by the existence of the HOPE Scholarship.[60]

The HOPE Scholarship also gives private colleges and universities an incentive to decrease the financial aid made available to their students. This is essentially another way of making the same point that private institutions have an incentive to raise their tuitions. Financial aid at private colleges and universities generally takes the form of tuition discounting, charging the aided student less than the advertised or sticker price. Therefore, as aid to students is decreased, the amount of tuition revenue available to fund the operations of the institution increases.

Tuition increases and student aid decreases are analytically two sides of the same coin. However, the incentive effect of HOPE Scholarship is more likely to be manifest in decreases in the amount of student aid otherwise available. This is likely to be the case for three reasons:

- First, the rhetoric surrounding HOPE Scholarships has emphasized how they increase the ability of "hard-pressed" middle-income families to "afford" higher education costs. Thus, it follows that if students from these families can better afford higher education, they need less student aid.
- Second, most student financial aid from private colleges and universities is awarded on the basis of financial need. The logic of need-based student aid is that increases in the resources available to a student or a student's family should result in decreased aid for that student. Thus, students receiving the benefit of the HOPE Scholarship should receive less aid than students in identical circumstances who do not receive a HOPE Scholarship.
- Third, the culture of the student financial aid profession at private colleges and universities places

58. Zell Miller, "10 Crucial Things the Next President Should Do for Colleges," *The Chronicle of Higher Education*, July 14, 2000, p. B6.
59. See McPherson and Shapiro, *The Student Aid Game*, Chapter 8, "How Government Aid Shapes Colleges' Behavior."
60. See King and Thomas J. Kane, "Student Aid after Tax Reforms: Risks and Opportunities," in King.

> a premium on stretching institutional financial aid resources as far as possible, which is to say not giving students any more than necessary of what otherwise would be tuition revenue. One important way to accomplish that goal is to take into account as fully as possible all of the resources available to students and their families. This would obviously include taking into account the HOPE Scholarship.

The financial aid director at Bowdoin College was impolitic enough to give public voice to these sentiments. In early 1998, as the HOPE Scholarship was getting off the ground, he said, "My job is to make sure that those students at Bowdoin College who really need the money to attend get it.... The fact is that families that receive $1,500 from the federal government are better off than those that don't. And I don't think we can ignore that." He proposed treating the HOPE Scholarship as increased family income and reducing aid from the College.[61]

There would appear to be no reason to believe that the incentives provided by the HOPE Scholarship to increase tuition and to decrease financial aid to students would operate any differently at for-profit, proprietary institutions than they do at private, non-profit colleges and universities. If anything, proprietary institutions are more likely to be driven by market imperatives of revenue maximization and cost reduction and less likely to be constrained by public service norms than private colleges and universities.

Effects and Consequences of the HOPE Scholarship for the States

States generally play the critical, if not decisive role in setting the level of tuition at *public* colleges and universities and in devising student financial aid policies for students attending these institutions. As is the case for private colleges and universities, the HOPE Scholarship creates an incentive for states to increase tuition and reduce financial aid.[62] However, in this case, the incentive effects are stronger and the consequences are more important.

The effects are more consequential with respect to state colleges and universities because most of the students eligible for HOPE Scholarships attend these institutions: 77 percent of first-time freshmen in 1996 attended public institutions.[63] The HOPE Scholarship is a more powerful incentive for the states to raise tuition compared to private colleges and universities because state tuition levels are relatively low. Relative to the average public four-year, tuition level of $3,510 in 2000-2001, the maximum $1,500 HOPE Scholarship is a more attractive target to try to "capture" in comparison to the average private, four-year college tuition of $16,337.[64]

This effect is strongest at the two-year public institutions, which have an average tuition of $1,705 in 2000-2001.[65] Under the terms of the HOPE Scholarship, an individual receives one dollar of tax credit for each dollar of tuition up to $1,000, and one dollar of tax credit for each two dollars of tuition above $1,000, up

61. Stephen Burd, "Some Private Colleges May Cut Award to Students Receiving Hope Scholarships," *The Chronicle of Higher Education*, January 9, 1999, p. A48.
62. Conklin and Finney in King, pp. 158-59, Kane in King, pp. 141-42, and McPherson and Shapiro, *The Student Aid Game*, pp. 86-88.
63. *Digest of Education Statistics* 1998, Table 182, p. 207.
64. *Trends in College Pricing* 2000, p. 4.

to $2,000. Therefore, a state that charges a tuition of less than $1,000 at its public two-year institutions can have its taxpayers who qualify reimbursed dollar for dollar with the federal HOPE Scholarship tax credit by raising its tuition level to $1,000, and at a rate of $0.50 on the dollar for increasing its tuition to $2,000.

The HOPE Scholarship also provides an incentive for states to reduce their expenditures for need-based student financial aid for the same reason as in the case of private colleges and universities. The HOPE Scholarship gives students and their families additional resources as a consequence of attending institutions of higher education and paying tuition. It is standard practice to take into account these additional resources when either the state or a public institution of higher education determines the amount of financial aid for which a student is eligible.

Because the states and public colleges and universities are public institutions, their deliberative and decision-making processes are somewhat more transparent than those of private or proprietary institutions of higher education. There are several examples of state deliberations and actions that allow us a glimpse of the incentives for states to "capture" the federal resources represented by HOPE Scholarships by either raising tuition or reducing student financial aid.

Public bodies in New York, Minnesota, and Washington have considered how to "maximize limited state funds" by taking into account the HOPE Scholarship in devising state student financial aid policies.[66] Louisiana amended its Tuition Opportunity Program for Students (TOPS) in an attempt to substitute HOPE Scholarship funds for state funds in a scheme characterized as "blind greed" on the part of the state.[67] The Legislative Analysts Office in California and the Arizona legislature's budget analysts recommended that the state reconsider both its tuition and student aid policies in light of the HOPE Scholarship.[68] North Carolina revised its student financial aid policies to explicitly take into account the HOPE Scholarship.[69] North Carolina also substantially raised its two-year public college tuition level in large measure in response to the HOPE Scholarship.[70] One participant in the North Carolina policymaking process recalled that there was a determination not to "leave federal money on the table" and to "spend other people's (i.e. federal) money first." In other words, the state has consciously sought to capture the HOPE Scholarship funds and to build its state tuition and student aid policies on top of these resources.[71]

Missouri, on the other hand, has explicitly tried to equalize the resources available for college between those who qualify for the HOPE Scholarship and those

65. Ibid.
66. The quote is from Washington State Higher Education Coordinating Board, *2000 Master Plan for Higher Education*, p. 16. See also Conklin and Finney in King, pp. 158, 163 and Minnesota Higher Education Services Office, *Report to the Governor and 1999 Legislature*, p. 12.
67. Glenn E. Coven and Michael B. Lang, "No HOPE (Credits) For Louisiana Coffers," *Tax Notes*, July 10, 2000, pp. 275-277.
68. Legislative Analyst's Office, "Taking Advantage of New Federal Higher Education Tax Credits," An LAO Report, (February, 1998) and Julianne Basinger and Patrick Healy, "Will New Federal Tax Breaks Hurt California's Colleges," *The Chronicle of Higher Education*, March 6, 1998, p. A36.
69. *Report of the Task Force on Student Financial Aid to the Board of Governors of the University of North Carolina*, (1999). See also the comments of Jim Newlin, principal fiscal analyst for the North Carolina General Assembly, quoted in Sara Hebel, "Dashed Hopes for Increasing Access to Higher Education," *The Chronicle of Higher Education*, October 22, 1999, p. A36.
70. "Significant Tuition Increase Is Set for N.C. Community Colleges," *The Chronicle of Higher Education*, July 16, 1999, p. A30.
71. Personal interview.

who do not, according to Kala Stroup, the Commissioner of Higher Education.[72] Missouri has a program that is the mirror image of the HOPE Scholarships, providing need-based grants of up to $1,500 to low-income students who do not qualify for the HOPE Scholarship.[73]

These examples of state deliberations and decisions that take HOPE Scholarships into account in setting state tuition and student aid policies are probably representative of what has gone on and is going on in all states. States have become accustomed to shaping their policies to maximize the state benefits and minimize the state losses from changes in federal law. This is particularly true in the case of changes in federal tax law. Thirty-nine of the 43 states with a state income tax pattern their income tax policies in significant measure after the federal income tax system.[74] Thus, a significant change in the federal income tax, like the HOPE Scholarship, triggers an automatic assessment in most states of the impact of the change on state revenues and the options for benefits to the state. McPherson and Shapiro believe that the incentives are so strong for the states and public institutions to capture the federal resources from the HOPE Scholarship that this program, in fact, is essentially "an intergovernmental transfer, a federal effort to relieve overstressed state budgets."[75]

The Clinton administration was certainly aware of the incentive effects of the HOPE Scholarship on the behavior of colleges, universities, and states in setting tuition, and on student financial aid policies. Secretary Richard W. Riley, for example, in a December 3, 1998 letter to college presidents stated, "I urge colleges, universities, and State legislatures to follow our lead in ensuring that the new tax credits truly reduce families' college expenses..."[76]

Decisions by public and private institutions of higher education and by states in setting tuition and student financial aid policies are very complex. It would, therefore, be difficult to conclusively demonstrate or prove a cause and effect relationship between the availability of HOPE Scholarship and changes in tuition or student financial aid. It would be even more difficult, if not impossible, to assign a specific dollar value to the effects of HOPE Scholarship on tuition levels and student financial aid amounts. Careful, finely grained case studies of decision making on tuition and student financial aid at the institutions and state level would enable one to identify the role of HOPE Scholarships in these decisions. However, such case studies would, in the final analysis, only show whether HOPE Scholarships contributed to the institutional or state decision and provide an idea of the magnitude of its importance among a plethora of other factors.

It is fair, nevertheless, to say that HOPE Scholarships have provided an incentive to both institutions and states to increase tuition and to reduce student financial aid, substituting funds from the HOPE Scholar-

72. Testimony before the Advisory Committee on Student Financial Assistance, February 20, 2001, Washington, DC.
73. The Missouri program is the Charles Gallagher Student Financial Assistance Program.
74. See Conklin, Table 7, pp. 26-27.
75. McPherson and Shapiro, *The Student Aid Game*, pp. 87-88. From a policy point a view having the federal government, in effect, pay for a share (or a larger share) of state higher education might be desirable since the federal government is able through its tax system to collect more revenue, more efficiently and more equitably than most state tax systems. This was the argument for federal revenue sharing with the states three decades ago.
76. Quoted in Stephen Burd, "Riley Urges Colleges Not to Raise Tuition Or Lower Aid in Response to Tax Credits," *The Chronicle of Higher Education*, December 18, 1998, p. A30. See also the comments of Assistant Secretary for Postsecondary Education David A. Longanecker quoted in Stephen Burd, "Some Private Colleges May Cut Awards to Students Receiving Hope Scholarships, *The Chronicle of Higher Education*, January 9, 1998, p. A48.

ship for institutional or state funds. The HOPE Scholarship is certainly a shoulder to the wheel turning in the wrong direction.[77]

Effects and Consequences of the HOPE Scholarship on the Goals and Process of Federal Higher Education Policymaking

When the federal student financial assistance programs were created during the Johnson and Nixon administrations in the 1960s and 1970s, their primary goal was to increase access to higher education for students from low-income families who would not otherwise have the opportunity to attend. The enactment of the HOPE Scholarship (and related tax benefits to individuals in higher education) represents a fundamental shift away from this objective. The new coequal or, perhaps preeminent, policy objective is now to provide benefits to middle-income families. [78] David Longanecker, the Assistant Secretary for Postsecondary Education at the U.S. Department of Education during the Clinton administration, said, "Who says every aid and scholarship program should be limited to poor people? The middle class deserves some relief."[79]

One measure of this policy shift is the magnitude of the federal funds devoted to students from low-income families versus the funds devoted to students from middle-income families. Prior to the enactment of the HOPE Scholarship, federal expenditures for student financial aid were predominantly for aid to students from low-income families, although some aid (e.g. unsubsidized loans) reached students from middle-income families as well. The tax expenditures for individuals in higher education provided by the Taxpayer Relief Act of 1997 totaled $7.3 billion in FY 1999.[80] This represents a 55 percent increase in *federal outlays* for generally available aid to students in higher education. And, it represents a 16 percent increase in the generally available *aid awarded through federal programs* to students in higher education and their families.[81] When the HOPE Scholarship (and related tax-benefits from the Taxpayer Relief Act of 1997) are fully used by taxpayers, their cost to the federal government "... is projected to equal the cost of *all other existing federal financial aid programs combined.*" [82] The HOPE Scholarship and other tax-benefits almost exclusively serve middle-income families.

In addition to representing a shift in the intended beneficiaries of federal aid to students, the HOPE Scholarship also embodies a change in the process for delivering higher education benefits. These benefits are now delivered substantially through the federal tax code rather than through the student financial aid system.

77. A carefully calibrated institutional or state policy can be imagined that captures federal resources from the non-needy who benefit from HOPE Scholarships through tuition increases while offsetting these tuition increases for low-income students who do not benefit from HOPE Scholarship or even absolutely increasing student aid awards for these low-income students. This is, in effect, the "WIN/WIN APPROACH" suggested by the California Legislative Analyst's Office, pp. 5-6. However, in general such policies probably exceed both the ingenuity and the altruism of both institutional and state decision makers.

78. See Spencer, pp. 109-114; D. Bruce Johnstone, "Introduction," in King, pp. 3-6 and Jacqueline E. King, "Conclusion," in King.

79. Quoted in Greg Jaffe, "Georgia Scholarships Are Open to Everyone, And That's A Problem," *The Wall Street Journal*, June 2, 1997, p. A1.

80. *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2001* (Washington, DC: GPO, 2000) p. 114.

81. Federal outlays for generally available aid to students in higher education was $13.3 billion in FY 1999 and in FY 1999 $45.3 billion in generally available aid was awarded to students and their families. See The College Board, *Trends in Student Aid 2000* (New York: College Entrance Examination Board, 2000) pp. 17 and 6. The amount of aid awarded includes the total value of the loans to students and parents and not only the federal expenditures that support these programs. Therefore, the amount of aid awarded is substantially larger than the amount of the federal outlays.

82. Conklin, p. vii. Emphasis in the original.

Prior to enactment of the HOPE Scholarship, federal policymaking for student aid was concentrated in the House Education and Workforce Committee, the Senate Health, Education, Labor and Pensions Committee, the Labor, Health and Human Services and Education subcommittees of the House and Senate Appropriations Committees, and the Department of Education. Because the HOPE Scholarship is a *tax* benefit, the primary players in its enactment were the Senate Finance Committee, the House Ways and Means Committee, and the Treasury Department, particularly the IRS. Thus, policymaking for aid to students has now been separated into two policy tracks each with a different set of players and institutions.

This fragmentation of the federal student aid policy arena is likely to have consequences that will reinforce the new tilt and the new priority toward aid to students from middle-income families. Prior to the enactment of the HOPE Scholarship, federal student aid for students from low-income families *and* for students from middle-income families was considered by the single set of institutions noted above. Indeed, federal student aid to these two groups was largely imbedded in the same programs, the guaranteed and direct loan programs. Now, aid to students from low-income families and aid to students from middle-income families are considered by different institutions (e.g. the Department of Education versus the Department of Treasury) and as part of different programs and legislative contexts (HOPE Scholarships in the tax code versus grants, loans, and work-study in the Higher Education Act).

In the legislative debates from the origin of the Higher Education Act in 1965 through the middle of the 1990s, aid to middle-income students and their families was often employed as the engine to pull the larger train of aid to students from low-income families, making aid to students from low-income families more palatable. It was the glue that held together a broad and successful political coalition in support of student aid. This mutually beneficial political relationship has now been fractured. The largest program to serve middle-income students (HOPE Scholarships and other tax benefits) and the largest programs to serve low-income students (Title IV of the Higher Education Act) are no longer linked in the same legislation and they are no longer acted upon and implemented by the same institutions. It follows that these programs will follow separate paths of growth and development in the future rather than being joined in a collective trajectory. It also follows that whatever opportunity, albeit imperfect, existed to coordinate and integrate student aid policies across multiple programs has now become much more complicated. Since the HOPE Scholarship and other tax benefits will be considered in separate institutions, in different legislative context and on different legislative and political timetables than the Higher Education Act programs, it is much less likely that these programs and policies will be harmonized.

Given the nature of American politics and its priorities, it is predictable that the programs that serve students from middle-income families are likely to grow faster and to prosper compared to the programs that serve students from low-income families. The programs that serve middle-income interests are likely to win in any competition for political, fiscal, and administrative resources. McPherson and Shapiro make this point quite effectively:

> Perhaps our greatest reservation about tax subsidies for higher education is this: opening up a channel by which revenue can flow through the tax system to subsidize college expenses is like opening up a new, steeper path that a river can follow to the sea. We suspect that tax credits...

> once in the code, would undergo broadening and deepening to allow favored constituencies to benefit more easily. Dollars headed for the tax side will grow over time, and the traditional student aid programs, which are much better vehicles for providing access and choice, will gradually wither away.[83]

It is also foreseeable that in future macro budget debates and priority setting, the tax benefit programs serving middle-income students are more likely to be sheltered from the budget ax more than the student aid programs serving students from low-income families. Compounding the favored political status of the student aid programs serving students from middle-income families is their favored status in the federal budget process. The tax-benefit programs are, in effect, entitlements. This means that the benefits annually flow automatically unless the tax code is modified to change the terms of the programs. No annual appropriations are required to fund these programs. In contrast, most of the student aid programs in Title IV of the Higher Education Act, which largely serve students from low-income families, require annual appropriations. With respect to the benefits to students from middle-income families, if no law is passed, the benefits continue to flow. With respect to the benefits for students from low-income families, if no law is passed every year, the benefits stop.[84]

The Changing Language of Policy

One of the least noticed but perhaps most pernicious effects of the HOPE Scholarship on the policy process is the distortion and debasement of common policy terms. We have an Orwellian policy "newspeak" in which policy terms have been "deliberately constructed for political purposes" and drained of their common sense and conventional meaning.[85] HOPE Scholarships are not "scholarships."[86] They are tax credits, tax benefits, or tax expenditures. HOPE Scholarships, despite the endless protestations of the Clinton Administration, are not modeled on the Georgia HOPE Scholarship program, which is, in fact, a scholarship and not a tax credit.[87] By common usage, "affordability" of higher education should mean the relationship between family income and college costs.[88] By this common sense definition, it is students from low-income families who have the greatest "affordability" problem. However, instead of its common sense meaning, "affordability" has become a code word for political sensitivity to the perceived needs of middle-income families. This perversion of common policy terms makes discussions of important issues of public policy more difficult, and it particularly hinders engaging the broader public in the consideration of these issues.

83. The Student Aid Game, p. 139.
84. See McDaniel, p. 172; "Send Money," *The Washington Post*, December 29, 1997, p. A16; Spencer, p. 116 and Joni Finney and Kristin Conklin, "Enough of Trickle-Down: It's Time for a Flood of Aid for Needy Students," *The Chronicle of Higher Education*, May 5, 2000, p. A68.
85. George Orwell, 1984 (New York: Signet Classics, The New American Library of World Literature, 1961) p. 249.
86. See note 2.
87. The reason for calling this program the HOPE Scholarship was probably because it was one of the signature education initiatives of President Clinton (the Man from Hope) and one of the centerpieces of his 1996 reelection campaign. In short, the HOPE Scholarship name was a thinly disguised way to name the program Clinton Scholarships without doing so in so many words. The existence of the popular and successful Georgia HOPE Scholarship and the claim to be modeling this program after the one in Georgia provided an argument with at least some surface plausibility for naming the new program the HOPE Scholarship.
88. See The Institute for Higher Education Policy, *What is Opportunity?: Defining, Operationalizing, and Measuring the Goal of Postsecondary Opportunity* (December, 1999) p. 7.

Effects and Consequences of the HOPE Scholarship on Federal and State Tax Policy

The HOPE Scholarship has important effects and consequences on higher education, student financial aid, and higher education finance policy. It also has broad, important implications for tax policy.

Private, non-profit higher education has always received favorable tax treatment. This practice dates from the middle ages when higher education was a church function and all colleges and universities were church institutions.[89] One aspect of the accommodation reached between church and state in the middle ages was that the state (king) would not tax church institutions and the churches in turn would provide public benefits and services including higher education. The basic idea was that the king did not tax God.[90] In the context of the American federal income tax system, these benefits to higher education have historically taken the form of benefits to the *institutions* of higher education, such as their tax-exempt status and the incentives for charitable contributions. In recent decades, however, the tax benefits to higher education are increasingly targeted to the *individual consumers* of education, students and their families, rather than the institutions. The apogee of this new trend was the array of tax benefits for individuals contained in the Taxpayer Relief Act of 1997, including the HOPE Scholarship.[91]

Ideally, the tax system should collect the "appropriate" amount of revenue to cover government spending. It should be simple and fair, and it should be conducive to economic prosperity and market efficiency.[92] The HOPE Scholarship weakens each of these characteristics of a "good" tax system.[93]

- As a tax credit, the HOPE Scholarship reduces the tax base and the amount of revenue collected by the government with a given set of tax rates. Thus, it provides an incentive to increase tax rates or to keep them high in order to produce sufficient revenue. Increases in tax rates, in turn, are a disincentive for productive economic activity. Higher tax rates also provide an incentive for taxpayers to avoid or evade their taxpaying obligations, further threatening revenues.

- The HOPE Scholarship compromises the fairness of the tax system. Particularly in the absence of refundability, the HOPE Scholarship is regressive, providing more benefits to taxpayers as their incomes increase. It also provides a windfall for many who benefit from it. Since the HOPE Scholarship does not result in any significant increase in higher education enrollment, it is basically paying taxpayers to do what they would do anyway.

- As noted previously, the HOPE Scholarship adds another layer of complexity to the tax code. The income tax system relies very heavily on volun-

89. Public institutions of higher education, on the other hand, are not taxed as a function of their status as state entities in the U.S. federal system.
90. John D. Colombo, "Why Is Harvard Tax Exempt: (And Other Mysteries of Tax Exemption for Private Educational Institutions)," *Arizona Law Review,* 35, no. 4 (Winter, 1993) p. 857.
91. These programs are described in Joint Committee on Taxation and IRS Publication 970. Tax benefits to individual students and their families is itself part of a growing trend to achieve social policy objectives through tax benefits. The home mortgage interest deduction and the Earned Income Tax Credit (EITC) are other examples of such social benefits now being delivered through the tax code. See, Christopher Howard, *The Hidden Welfare State: Tax Expenditures and Social Policy in the United States* (Princeton, NJ: Princeton University Press, 1997).
92. Henry J. Aaron, William Gale and James Sly, "The Rocky Road to Tax Reform" in Henry Aaron and Robert Reischauer, eds., *Setting National Priorities: The 2000 Election and Beyond* (Washington, DC: Brookings Institutions Press, 1999) p. 211.
93. This is, of course, true as well for other tax preferences and benefits, which are often collectively known as "tax loopholes."

tary compliance by taxpayers. Increased complexity is a disincentive for voluntary compliance and threatens revenues. A more complex tax system is also more difficult and more costly for the IRS to administer.

- Finally, tax benefits by definition "distort free market decisions and thus misallocate economic resources by encouraging funds to be placed in investments or activities that, in the absence of the tax subsidy, would not be financially attractive."[94]

In short, from a tax policy point of view: "It would usually be far better to run subsidies the old-fashioned way—as spending programs. The tax base would be broader. The tax form would be shorter. And tax rates would be lower and clearer, permitting taxpayers and their representatives to understand better the costs and benefits of policy choices." The tax policy defects of tax benefits, such as the HOPE Scholarship, lead to periodic attempts to "reform"[95] the tax code by eliminating these breaks or loopholes in order to provide a simpler tax code with lower rates for everyone.[96]

If the 43 states with a state income tax conformed their state income tax to the new federal HOPE Scholarship, the problems of revenue loss, unfairness, complexity, and market inefficiency in the federal income tax system caused by the HOPE Scholarship would be compounded at the state level.[97] Thus far, states have not jumped on the bandwagon to emulate the HOPE Scholarship.

However, even by not adopting the HOPE Scholarship, states still pay a tax policy price. To the extent that a state income tax system does not mirror the federal system, such as by not adopting a state HOPE Scholarship benefit, that state tax system is more complex, and more difficult and expensive to administer.

Why Was the HOPE Scholarship Adopted?

The preceding analysis strongly suggests that the HOPE Scholarship has undesirable consequences in terms of not increasing the enrollment in higher education of those who would not otherwise attend, and by imposing regulatory burdens on institutions of higher education, providing incentives for private and public institutions of higher education to increase tuition or reduce student aid, and compromising the federal higher education policy process as well as federal and state tax systems. One commentator characterized the HOPE Scholarship as "harebrained and irresponsible."[98] So, why was the HOPE Scholarship adopted? It is a clear case of good politics trumping good policy.[99]

The HOPE Scholarship is good politics from two points of view. First, tax benefits for social purposes, like the HOPE Scholarship, are generally politically easier

94. McDaniel, p. 182. Generally, on the negative aspects of tax benefits like the HOPE Scholarship from a tax policy point of view, see Aaron et al, pp. 211-240 and McDaniel, pp. 167-196.
95. Aaron et al, p. 237.
96. The most recent successful episode of such tax reform was the *Tax Reform Act of 1986*. See, Jeffrey H. Birnbaum and Alan S. Murray, *Showdown at Gucci Gulch: Lawmakers, Lobbyists, and the Unlikely Triumph of Tax Reform* (New York: Vintage Books, 1988).
97. See Conklin especially Table 7, pp. 26-27.
98. Virginia I. Postrel, "Clinton's College Plan: Educational Inflation," *The Washington Post*, March 30, 1997, pp. C1 and C5.
99. On the politics of the development and enactment of the HOPE Scholarship see, Douglas Lederman, "The Politicking and Policy Making Behind a $40-Billion Windfall: How Clinton, Congress, and the colleges battled to shape Hope Scholarships," *The Chronicle of Higher Education*, November 28, 1997 and Dick Morris, *Behind the Oval Office: Winning the Presidency in the Nineties* (New York: Random House, 1997) pp. 82-88 and pp. 223-225.

to enact and defend than comparable direct expenditures for the same purpose.[100] They provide assistance to various categories of putatively needy citizens, in this case, middle-income families "struggling" with college costs. Most importantly, these benefits are portrayed as tax reductions or "tax cuts," and therefore as more desirable than conventional government programs that require "spending," bureaucracy, and regulations.[101] Furthermore, tax expenditures, like HOPE Scholarship, have a lower political profile. As entitlements, they are not systematically reviewed annually or even periodically through the budget, appropriations, and authorizations processes in the executive or the legislative branches.

The HOPE Scholarship was good politics from a second point of view, the immediate political needs of the Clinton administration in the 1996 presidential campaign and in the budget debates with Congress in 1997. In the 1996 campaign Clinton needed a tax cut he could support to counter the tax cuts proposed by his Republican opponent, Senator Dole. He also needed a tax cut that was *different* from the across-the-board and capital gains cuts proposed by Dole. The HOPE Scholarship was also attractive because it targeted benefits on the middle class, always a key electoral constituency. The HOPE Scholarship responded to the anxieties and concerns of middle-income families about financing the higher education of their children. The HOPE Scholarship had the special merit of providing the middle-class tax cut that Clinton had promised in the 1992 campaign but been unable to deliver, a fact which the Republicans often and gleefully reminded the voters. The HOPE Scholarship also fit within the priority placed on education in the Clinton campaign and within the Clinton theme of rewarding personal responsibility, in this case by providing a tax benefit for those who went to college or sent their children to college. It became a centerpiece of the President's reelection campaign.[102]

During the budget debates with Congress leading up to the historic balanced budget agreement and the Taxpayer Relief Act of 1997, the HOPE Scholarship again provided a tax cut that Clinton could support and that was different from the Republican's proposed across-the-board and capital gains cuts. Once more the HOPE Scholarship also fit within the Clinton administration's themes of support for education, the middle class, and those who behaved responsibly. Particularly in the context of Republican control of both houses of Congress, the HOPE Scholarship was a politically feasible means to advance Clinton's policy and political objectives, given the political predisposition of the Republicans to support "tax cuts" and to oppose "spending" programs.

For President Clinton, the political attractiveness of the HOPE Scholarship was cemented by the fact that the HOPE Scholarship generated very positive responses in public opinion polls.[103] Speaking of the 1996 campaign, Clinton's key advisor, Dick Morris, recalls that the

100. From an analytic and budgetary perspective, the HOPE Scholarship is a tax expenditure. The revenue foregone though the HOPE Scholarship is an expenditure of government resources in the same way as a direct grant. The difference is that the HOPE Scholarship uses the income tax as the method to pay subsidies rather than providing them through direct appropriations. On the concept of "tax expenditures," see Howard, pp. 3-4 and 104-105.

101. These political benefits of tax expenditures for social policy purposes are suggested by Howard, p. 11. On the political attractiveness of tax expenditures generally see, McDaniel, pp. 170-72 and Aaron et al, pp. 235-39.

102. Morris, p. 225. See also E. J. Dionne, Jr., "Election-Year Tax Gimmicks," *The Washington Post*, June 7, 1996, p. A23.

103. On the importance to President Clinton of polling data in policymaking, see John F. Harris, "Policy and Politics by the Numbers: For the President, Polls Became a Defining Force in His Administration," *The Washington Post*, December 31, 2000, pp. A1 and A10.

> idea for tax deductions for college tuition had resonated deeply with the public at a visceral level, with 55 percent saying they strongly supported it and another 25 percent somewhat supporting it, far better numbers than any other tax-cut proposal we'd tested.... Thus, President Clinton opposed the Dole tax-cut plan with his own targeted cut, relying on our polling data.[104]

Given the multiple political benefits of the HOPE Scholarship proposal, as confirmed by the polling data, Clinton placed it among his highest priorities in the budget negotiations with Congress and insisted on its inclusion in the final agreement.[105]

Summary and Conclusions

The HOPE Scholarship represents a major departure in federal policy with respect to providing assistance to students for higher education. It shifts the primary target of this assistance from students from low-income families to students from middle-income families. In addition, it delivers this assistance through the federal tax system rather than through the established channels of the current student financial aid programs—grants or loans directly to individuals or aid distributed through the institutions of higher education or the states.

Contrary to the rhetoric of the Clinton administration, the HOPE Scholarship does not increase enrollments in higher education of those who are qualified but would not otherwise attend. This is the case because by its terms and its structure, the HOPE Scholarship does not benefit students from low-income families. It is these students for whom the lack of financial resources is a major barrier to enrollment in higher education.

In particular, the HOPE Scholarship is not refundable. It deducts tax-free educational assistance (such as Pell Grants) from the tuition and fees that count for HOPE Scholarship purposes. And, it considers only tuition and fees among all educational costs. The HOPE Scholarship also is not available at the time that higher education bills must be paid, and it increases the complexity of financial aid for higher education faced by students and their families.

Therefore, the HOPE Scholarship is not justified by either of the two basic rationales for federal support of students in higher education. Since it does not increase the enrollments of those who would not otherwise attend, the HOPE Scholarship does not contribute to positive spillover benefits or externalities, such as a more economically productive workforce. The HOPE Scholarship also does not contribute to making the United States a more fair and equitable society by making more broadly available opportunities to more fully enjoy its benefits. Instead, the HOPE Scholarship provides a windfall to students from middle-income families who would have enrolled in higher education without the HOPE Scholarship. It neither expands access to, nor the opportunity for, higher education.

The HOPE Scholarship imposes a substantial burden of regulatory compliance on institutions of higher education. This burden is likely to substantially escalate as the IRS and the Treasury Department seek to minimize the revenue loss that results from the HOPE Scholarship. These compliance costs will contribute to the costs of institutions of higher education that may be passed on to students and their families as tuition increases.

104. Morris, pp. 85-86.
105. Lederman.

The HOPE Scholarship puts increased resources in the hands of middle-income students (and their families). These increased resources are an incentive for private and public institutions of higher education to increase tuition or to reduce aid to students. Indeed, the HOPE Scholarship benefits institutions of higher education or states *only if* they raise tuition or decrease student aid. Several states have considered or undertaken strategies to capture the HOPE Scholarship through either tuition increases or aid reductions.

At the federal level, the HOPE Scholarship fragments higher education policymaking since the new tax benefits are considered by political and institutional players different from those dealing with financial aid programs. This separation is likely to result in growth in benefits to students from middle-income families and decline in aid to students from low-income families.

As a tax preference or "loophole," the HOPE Scholarship narrows the base of the federal tax system and makes it less fair and more complex. This makes the collection of adequate revenues more difficult, distorts market efficiency and threatens economic prosperity.

The HOPE Scholarship squanders a substantial sum of federal tax resources by its failure to produce significant benefits for individuals, institutions of higher education, the states, the federal higher education policy process, or the federal and state tax systems. In fact, it has negative consequences in each of these areas. The HOPE Scholarship is a wrong road taken. It is also a cautionary tale that should inform future discussions about federal higher education policy.

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