An LAO Report

Taking Advantage of New Federal Higher Education Tax Credits

Introduction

Last August, President Clinton signed into law the Taxpayer Relief Act of 1997. Part of the act creates the "Hope Scholarship" and "Lifetime Learning" tax credits, which will dramatically lower the after-tax price of higher education fees for most middle-income students (or their parents) by lowering their federal taxes. The credits create some unintended problems for the state, but also create opportunities to increase the effective federal subsidy of California's higher education programs.

Problems

- The credits result in a much higher federal subsidy per student in other states than in California—particularly, for community college students.
- The Hope Scholarship credit will unintentionally shift enrollment away from our community colleges to the universities, at potentially great cost to the state and at cross-purposes to the state's higher education master plan.
- Due to interactions between the credits and recent state fee reductions, the state is unintentionally sending monies intended for students back to the federal government.

Opportunities

The federal act opens up opportunities for the Legislature to increase the effective federal subsidy of our higher education programs and use the additional resources to improve those programs and improve higher education access. This strategy would require at least some fee increases. These increases, however, would be offset substantially—in some cases completely—by higher federal tax credits for students. For low-income students, fee increases could be offset fully by increased financial aid.

Options

This brief identifies several revenue and spending options that the Legislature has in responding to the problems and opportunities posed by the new tax credits.

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BACKGROUND

Last August, President Clinton signed into law the Taxpayer Relief Act of 1997. The act creates several new higher education-related tax incentives, including the "Hope Scholarship" and "Lifetime Learning" tax credits. These tax credits will dramatically reduce the after-tax price of tuition and fees for most middle-income California students (or their parents) by lowering their federal taxes. Figure 1 summarizes the key features of these credits. As the figure shows, the Hope Scholarship credit allows taxpayers to claim an annual credit of up to $1,500 per student for tuition and fee expenses paid on behalf of the taxpayer, the taxpayer's spouse, and/or dependents for the first two years of college. Thus, the credit would reduce taxes by up to $1,500 per student per year (see Figure 2). The Lifetime Learning credit covers a smaller percentage of costs, but it can be used by part-time students and by part-time and full-time students beyond the first two years of college.

Figure 1

Key Features of the Hope Scholarship and Lifetime Learning Tax Credits

	Hope Scholarship	Lifetime Learning
What years of college are covered?	First two years only.	Any year.
What students are eligible?	Must be at least half-time.	Part-time or full-time.
What costs are covered?	Tuition and fees only.	
What does the credit cover?	100% of first $1,000 in costs ($1,000). 50% of next $1,000 in costs ($500).	20% of up to $5,000 in costs (up to $10,000 in 2003).
What is the maximum credit amount?	$1,500 per *student.*	$1,000 per *tax return.*
Effective dates	Academic terms beginning after December 31, 1997.	Academic terms beginning after June 30, 1998.
Are there income limits?	Credits begin to phase out at $80,000 adjusted gross income (AGI) and phase out completely at $100,000 for joint tax returns. For single returns, phase out begins at $40,000 and is complete at $50,000 AGI.	
Will poor students benefit?	Generally not. Poor students (and their parents) tend not to have the federal tax liability needed to receive the credits. The credits generally benefit middle-class students and parents.	

The new tax credits present California with novel opportunities to effectively increase federal resources for the state's higher education programs in ways that can improve the quality of instruction and poor Californians' access to higher education. Given the state's current fee structure for the higher education segments, however, the passage of the federal tax credits also poses some problems.

Figure 2

Hope Scholarship Tax Credit Simple Example—UC Student

	1998-99
Systemwide resident fee	$3,609
Hope tax credit[a]	-1,500
Cost after taxes	**$2,109**

[a] Assumes student or parent qualities for full amount of credit.

PROBLEMS

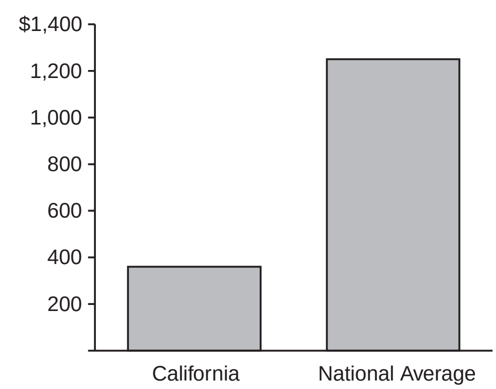
Hope Scholarship Credit Advantages Other States More Than California

The Hope Scholarship tax credit provides more advantage to other states—by providing a higher federal subsidy per student—than it does to California. This is most dramatically evident in the case of community colleges, as illustrated in Figure 3.

For the average state, the Hope Scholarship tax credit will pay $1,250 of the annual costs of a full-time community college student. For California, it will pay only $360 (starting in 1998-99). The reason for this significant discrepancy is that Congress designed the Hope Scholarship credit to largely (but not completely) offset the national average of community college fees—about $1,500 annually per full-time student. California's annual full-time fee level of $360 is far below the national average and, in fact, is the lowest of all 50 states. Since the federal credit pays no more than the actual fees paid by a student, California's per-student credit is effectively "capped" at $360 (for a student taking 30 units a year).

Figure 3

Community College Fees Paid by Federal Hope Scholarship Credit[a]



[a] Annual full-time fees. Assumes student or parent can fully claim credit.

Credit Will Unintentionally Shift Enrollment Away From Community Colleges

The Hope Scholarship credit will dramatically reduce the after-tax fee differentials between the California Community Colleges (CCC), California State University (CSU), and University of California (UC) (see Figure 4). For example, at the start of 1997-98, there was a substantial difference (almost $1,200) between CCC fees and CSU fees. With the credit, the differential is only $253.

Absent corrective action by the state, more students will choose the universities over the community colleges for their first two years of instruction because the extra price of the universities—after taxes—will become so small. This would undermine the state's efforts to bolster the community colleges' role in baccalaureate instruction, and potentially impose major costs on the General Fund.

State Will Unintentionally Send Money Back to the Federal Government

A significant portion of the benefits from the undergraduate fee reductions recently enacted by the Legislature in Chapter 853, Statutes of 1997 (AB 1318, Ducheny), will be lost to the federal treasury in a "reverse subsidy" effect. This is because the reductions, in most instances, will *reduce* the amounts of federal tax credit otherwise available to students and parents.

For example, although Chapter 853 reduces the "sticker price" of CCC courses from $13 per credit unit to $12 (or on an annual basis, from $390 down to $360), *the after-tax price to the student is exactly the same at either sticker price—zero*. Thus, the intended benefit of Chapter 853's CCC fee reduction, which will be paid by the state's General Fund, effectively will go to the federal treasury, not CCC students. Specifically, for each CCC student receiving a Hope Scholarship credit, the fee reduction means:

- Annual cost to the student after taxes is unchanged.
- Federal cost falls by $30 per student (full-time basis).
- State cost increases by $30 per student (full-time basis) as state backfills lost fee revenue.

Figure 4

Fees After Taxes for Full-Time Undergraduates— Effects of Hope Scholarship Tax Credit[a]

System	1997-98 (Pre-Credit)	1998-99 (With Credit)
Community colleges	$390	—
CSU	1,584	$253
UC	3,799	2,109

[a] Hope credit is restricted to first two years of college. Above examples assume student or parent is able to take full advantage of the tax credit. Figures for 1998-99 include the impact of Chapter 853, Statutes of 1997.

A similar reverse subsidy occurs with CSU fees. Chapter 853 interacts with the federal tax credit in a way that sends 50 percent of the nominal benefit of the CSU fee reduction back to the federal treasury. Thus, of the $78 reduction in the sticker price for a full-time academic year, students will enjoy an after-tax reduction of only $39. Chapter 853's fee reduction for full-time UC undergraduates using the Hope Scholarship credit is not dissipated. This is because UC's fees for a full-time academic year are well above the level at which the Hope Scholarship credit amount is maximized ($2,000).

OPTIONS

The new tax credits present California with opportunities as well as challenges. As a result of the federal Taxpayer Relief Act of 1997, the Legislature can increase the effective federal subsidy of California's higher education programs and use the additional resources to improve those programs and improve higher education access. This strategy would require at least some fee increases. These increases, however, would be offset substantially—in some cases completely—by higher federal tax credits for students and/or parents.

REVENUE OPTIONS

The Legislature could structure fee increases in various ways to meet multiple state objectives. These options include:

Maximizing State Resources. The state could raise fees at the three segments in a way that maximizes the effective federal subsidy of California's higher education programs. State programs would, in effect, "capture" much of the after-tax benefit provided to students and parents by the tax credits. Many students would pay either the same or less, after taxes, than they have in recent years, but part-time and higher-income students could pay substantially more. Effective federal resources for the state's higher education programs could increase by $500 million or more annually.

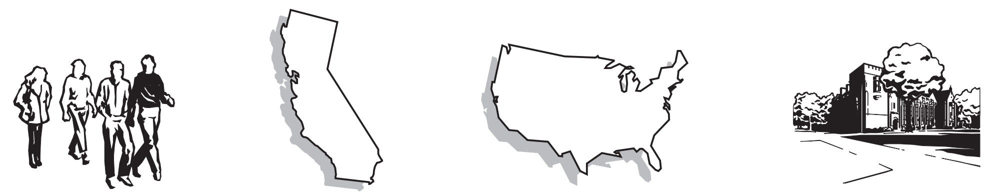
Protecting Community College Role in Baccalaureate Education. Alternatively, the state could restore the after-tax fee differentials between the community colleges, CSU, and UC—needed to avoid a costly shift of students from the colleges to the universities—by establishing a lower division fee surcharge at CSU and UC. The Legislature could offset the fee surcharge later in a student's career by, for example, granting a refund of senior-year fees when the student graduates. This would act as an additional incentive for graduation.

A Win/Win Approach: More State Resources at No Cost to Students. Finally, the state could raise community college fees in a way that increases California's federal subsidy yet at the same time leaves most, or all, of the after-tax benefit with students and parents. Under this approach the state could increase the flow of federal resources to

Figure 5

One State Option With the Federal Hope Scholarship Credit

What Is the Impact of Increasing CCC Fees to $1,000 Per Year?



	Full-Time Student	State Budget	Federal Budget	CCC System
Impact	Almost None	None	Increased Costs (Over $100 million annually)	Increased Funding (Over $100 million annually)
Comments	After taxes, almost all full-time students unaffected by fee increase. Low-income students would have fees waived, per current state policy.		Brings federal support for CCC more in line with other states.	Could Support: • Program improvements • Financial aid • Zero interest "bridge" loans to ease student cash-flow concerns

California (by $100 million a year or more), with little or no after-tax fee increase for most students. For example, if the state increased annual full-time fees from the $360 authorized for 1998-99 to as much as $1,000, students able to use the Hope Scholarship credit would still pay—after taxes—*nothing* for courses. This is because Congress designed the credit as a dollar-for-dollar offset for the first $1,000 of annual fees. Figure 5 shows the impact of such a fee increase.

Protecting Low-Income Students. Low-income students generally are unaffected by the tax credits because they lack the tax liability needed to use the credits. Generally, they also are unaffected by student fee changes (up or down) because current state policies (1) exempt them from fees—such is the case for 39 percent of all community college students—or (2) pay their fees with grants. The Legislature could readily modify these waiver and grant policies to make sure that no student who is too poor to use the tax credits would be affected by any fee increases.

Spending Options

The Legislature could spend the additional resources made possible by the combination of fee increases and federal tax credits in various ways, including:

- Increased financial aid for low-income California students unable to qualify for the federal tax credits (because they lack federal tax liability). This is the primary way the Legislature can enhance access with the added resources.
- Zero-interest loans to bridge student cash-flow problems that may exist between the time of fee payments and receipt of tax refunds.
- New program funding for the higher education segments linked to measured improvements in educational outcomes—such as improved retention of students, improved transfer of students from the CCC to the four-year colleges, and improved times-to-degree.

CONCLUSION

The new federal tax credits for higher education have, in a sense, "changed the landscape" of how higher education programs in California can be funded. They have created unintended problems that the Legislature should address. But they also present the Legislature with opportunities to boost the effective federal subsidy of California's higher education programs in ways that can enhance access for low-income students and improve student success at all income levels. To do this will involve thinking about student fees and program funding in creative, nontraditional, ways. In this paper, we have illustrated some basic problems and opportunities resulting from the tax credits.

Acknowledgments

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