Budget - Tax

THE WHITE HOUSE

WASHINGTON

May 22, 1997

TO: BRUCE REED

FROM: MARK MAZUR Mark

SUBJECT: EDUCATION TAX INCENTIVES AND ADMINISTRATION STRATEGY

Gene Sperling chaired a meeting on tax issues on Monday and a follow-up meeting was held on Thursday, chaired by Chief of Staff Bowles to discuss the Administration's strategy regarding the upcoming tax bill (part of the budget reconciliation process). An area of emphasis was the education tax incentives contained in the Administration's FY 1998 Budget. This memo summarizes the discussion. Please let me know if you wish to go over this material in more detail.

As you know, the Administration fought hard for assurances from the Republican leadership that the tax bill considered by Congress this year would incorporate the Administration's proposed tuition tax deduction and HOPE scholarship tax credit at a revenue cost of about $35 billion over 5 years. One issue addressed in the meetings is whether the Administration should help Congressional Democrats develop an alternative to the Republican tax package. In general, the answer was "yes" but that the Administration should be careful not to unravel the bipartisan approach to enacting a budget reconciliation bill. Different strategies are called for in the House and the Senate.

In the House, Treasury and Education are working with a proposal from Mr. Rangel to see if there are items consistent with Administration priorities. One possibility involves the Rangel proposal for "tax credit bonds" to finance construction, rehabilitation, and operation of "Education Zone Academies". This proposal could be modified to address many of the goals of the Administration's school construction initiative, but with the interest subsidy paid through the Tax Code. Another proposal from Rep. Rangel would expand the work opportunity tax credit to cover graduates of the Academies (which Education is trying to modify into a school-to-work tax credit). Treasury's Office of Tax Policy is trying to come up with proposals along these lines that would provide a distinct Democrat approach to a tax bill.

In the Senate, the Democrats on the Senate Finance Committee are less cohesive and less interested in supporting the Administration's education tax initiatives. Treasury has been developing proposals to combine the proposed child-based tax credit and IRA expansions into a "Kidsave" proposal, similar to the one developed by Senator Lieberman. (The idea behind "Kidsave" is to provide a tax credit for taxpayers with children and then to provide a match, or increased credit, if the funds are deposited into a tax-favored account used to pay for the child's post-secondary education or to support the child's retirement.) Treasury (especially Deputy Secretary Summers) is not enamored with the Breaux/Lieberman approach (because of its emphasis on saving for retirement) and so is unlikely to come up with proposals the "Kidsave" advocates will strongly support. However, the proposals may be similar enough to the original "Kidsave" proposals to generate some interest in working with the Administration.

The current plan is to have preliminary packages available for the President to look at Thursday night. These packages will provide distinct choices about the overall direction of a Democrat tax package. They will also highlight some issues for the President to decide, where disagreements between Treasury and Education need to be resolved. One issue is whether the maximum HOPE scholarship credit or tuition deduction amount should be reduced to provide a revenue offset for dropping the B- requirement and/or the Pell grant offset in the HOPE scholarship. Treasury is in favor of dropping the entire grade requirement while Education prefers to substitute a requirement that the second-year student have reached "sophomore" status (this would likely be an administrative nightmare, at least as difficult as checking grades). In addition, Treasury would prefer reducing the maximum HOPE scholarship amount to as little as $1,200, while Education would place a cap on the total tax benefit available through the tuition tax deduction at $1,500 per year. A second issue is whether a proposal for a deduction for student loan interest should be added (Education is in favor and Treasury was unsure about this item). Undoubtedly, other issues will arise as the packages are constructed and the revenue totals required to meet the agreed-upon targets.

cc: EK, PW

Document No. Budget - Tax

WHITE HOUSE STAFFING MEMORANDUM

DATE: 5/22/97 ACTION/CONCURRENCE/COMMENT DUE BY:

SUBJECT: Sperling Memo on Tax Cut Options

	ACTION	FYI		ACTION	FYI
VICE PRESIDENT	☐	☑	McCURRY	☐	☑
BOWLES	☐	☑	McGINTY	☐	☐
McLARTY	☐	☐	NASH	☐	☐
PODESTA	☐	☑	RUFF	☐	☐
MATHEWS	☐	☑	SMITH	☐	☐
RAINES	☐	☑	REED	☐	☑
BAER	☐	☐	SOSNIK	☐	☐
ECHAVESTE	☐	☐	LEWIS	☐	☐
EMANUEL	☐	☑	YELLEN	☐	☑
GIBBONS	☐	☐	STREETT	☐	☐
HALE	☐	☐	SPERLING	☐	☐
RADD	☐	☐	TARULLO	☐	☐
HIGGINS	☐	☐	VERVEER	☐	☐
HILLEY	☐	☑		☐	☐
KLAIN	☐	☑		☐	☐
BERGER	☐	☐		☐	☐
LINDSEY	☐	☐		☐	☐

REMARKS:

This has been forwarded to the President.

RESPONSE:

Staff Secretary

'97 MAY 22 PM11:05

THE WHITE HOUSE

WASHINGTON

May 22, 1997

MEMORANDUM TO THE PRESIDENT

FROM: **GENE SPERLING**

SUBJECT: **Tax Cut Proposals for Budget**

Your economic team is meeting with you in the morning to go over options for going forward on the tax package. There are several processes, strategic and substantive issues we need to discuss with you in order for us to move forward.

1. Developing a Package: All of your advisors agree that we need to develop our sense of an overall $135 billion gross tax package. One reason for developing our tax package is that it allows us to work with Democrats to increase a commitment for our education tax package, by showing them that we can put together a package that could include their priorities. Currently, Republicans are telling Democrats that they could support other Democratic education tax cuts -- if they are paid for **within** our $35 billion tax cut. By putting together a package, we can show people like Breaux and Rangel that if they are committed to your higher education tax cuts, we could fit their priorities -- e.g., Kidsave, Rangel's initiatives, -- outside of the $35 billion.

2. Working with Democrats and Republicans: While part of the goal is putting together a set of ideas to get "buy-in" from the Democrats that unifies them, both Bob Rubin and John Hilley believe that the best way to proceed is to shop a $135 billion package with both Democrats and Republicans so that we are continuing to work in a bipartisan process. Therefore, while we would seek to unify Democrats with our $135 billion package, we would shop it and get input from all sides, as opposed to having a "Democratic package" that at this moment might alienate Republicans from working with us. As John states, this would be similar to our posture in March when we took the same one page budget summary and sought input and comments from both Democrats and Republicans.

Bob Rubin and his staff are already been involved in serious consultations. On Wednesday, Bob spoke with Archer for 30 minutes and met with Roth for over 45 minutes, while also speaking with Moynihan and Rangel and other House Ways and Means Democrats. Archer and Roth agreed with Bob to have their staffs meet with Treasury staff next so that they could review our $135 billion set of ideas for discussion.

3. Two Votes Strategy: Erskine cautions that all decisions should be considered against the backdrop of what best ensures that we preserve our two vote strategy.

4. Education Package: One of the main issues we need to decide is what alterations we need to make in our education proposals in order to garner adequate support from Democrats and the education community. Everyone agrees that we need to make the Hope Scholarship more progressive and in some way drop the B- requirement. Yet, in order to afford these changes, we need to decide whether and how to shave the Hope Scholarship or the $10,000 deduction. Attached is a decision memo that goes through the pros and cons of such choices.

5. New Education Ideas: Another decision is what additional ideas we may wish to consider, particularly from Charlie Rangel outside of the $35 billion.

6. Child Tax Credit/Kidsave: A major issue is whether to amend our child tax credit, to a "Kidsave" proposal, and whether we want to add refundability, or change the age or income limits. The current Treasury set of ideas does include a refundable Kidsave proposal.

7. Capital Gains Design: We must decide what capital gains proposal we want to present. This clearly involves not only where we want to end up on capital gains, but strategic questions of where we should start. Currently, the Treasury set of ideas includes a 50% exclusion, a Bumpers expansion, your home capital gains, and the Daschle estate tax cut.
One of the ideas you had mentioned was to include provisions with strong appeal to the small business and high technology community.

8. AMT Reform: Treasury believes there is strong policy rationale for AMT reform. In the current proposal, this is started in 2003. This allows more middle income tax relief to be included in the first five years, yet it fills the last five years with a sensible tax reform instead of an exploding capital gains tax cut. Is this something you are interested in proposing?

9. Additional Ideas: At your request, Treasury has also included a short description of a modified home office deduction and an increased health care deduction for the self-employed.

Attached are the following:

- **One Page Treasury Chart:** Following a meeting in Erskine's office, we agreed on a preliminary package to present you. The chart shows Treasury's estimates of what costs of the different proposals would be.

- **Treasury Background Paper:** Memo from Don Lubick that explains several of the provisions in the chart.

- **Education Tax Cut Pro/Con Memo:** This is a pro/con memo on the different options for reforming our tax proposals using ideas presented from both Secretary Riley, Treasury Department and other members of your economic team.

Illustrative Baseline Tax Package: Very Preliminary Treasury Estimates (except where noted)
Dollar amounts in millions, May 23, 1997

	1997	1998	1999	2000	2001	2002	1998-02	1998-07
Education package								
HOPE scholarship, $1,200; Tuition Deduction, $10,000 \1	-78	-4,242	-6,561	-8,461	-9,371	-10,198	-38,833	-94,560
Rangel K-12 school finance tax provision (not scored)								
Make Section 127 Permanent	-82	-645	-670	-730	-796	-833	-3,674	-8,443
Middle-Class Tax Relief and Saving Provisions								
Refundable Kidsave Credit \2	-568	-10,612	-10,930	-14,338	-17,889	-17,960	-71,729	-161,423
Individual AMT reform, start in 2003 \3	0	0	0	0	0	0	0	-37,472
Capital Gains and Estate Tax Relief								
50% CapGn Exclusion and 20% AMT	-702	-1,470	1,493	-1,643	-1,621	-1,549	-4,790	-11,009
Super-Bumpers Plug Number \4	0	-50	-150	-300	-400	-500	-1,400	-5,500
President's Home Sales Provisions \4	-60	-239	-222	-205	-187	-168	-1,021	-1,600
Daschle Estate Tax Proposals (JCT)	0	-440	-540	-640	-740	-840	-3,200	-10,200
Urban Initiatives								
Distressed Areas Initiatives (JCT) \5	-25	-172	-370	-464	-483	-487	-1,976	-4,063
Welfare-to-Work (JCT)	0	-41	-75	-95	-77	-41	-329	-353
Other Tax Incentives (JCT) \6	0	-57	-156	-285	-344	-420	-1,262	-9,422
One-year Extensions of Expiring Provisions (JCT)	-405	-958	-682	-398	-259	-127	-2,424	-2,459
Gross Tax Cut	-1,920	-18,926	-18,863	-27,559	-32,167	-33,123	-130,638	-346,504
Revenue Offsets	883	7,747	9,067	10,225	10,668	10,955	48,662	103,945
Total Net Cut	-1,037	-11,179	-9,796	-17,334	-21,499	-22,168	-81,976	-242,559

(Not including Rangel school construction program, expected to cost $3 billion through 2002 and $7 billion through 2007)

\1 The proposal drops the B- rule and Pell offset to HOPE.
\2 A refundable child credit for children under 13 with an optional $500 nondeductible IRA for education or retirement for each child credit allowed. The credit is $150 in 1997, $300 in 1998 and 1999, $500 in 2000 and indexed thereafter.
\3 Assumes the enactment of the Administration's child credit proposal. Among other things, it eliminates several inappropriate AMT preference items (most importantly, personal exemptions and the standard deduction), allows personal credits to offset AMT liability, and indexes the A
\4 Stacked after the 50% exclusion.
\5 Expand Empowerment Zones and Enterprise Communities, Brownfields, and CDFI.
\6 Equitable tolling, Puerto Rico Tax Credit, FSC software, and DC incentives.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

May 22, 1997

MEMORANDUM FOR SECRETARY ROBERT E. RUBIN
DEPUTY SECRETARY SUMMERS

FROM: **DONALD C. LUBICK** DCL
ACTING ASSISTANT SECRETARY (TAX POLICY)

SUBJECT: Possible Tax Package

The attached table presents an illustrative budget package that fits within the recent budget agreement under very preliminary Treasury scoring. The package includes a number of features that will appeal to Congressional Democrats and some Republicans and reflects our current judgment about the outlines of a sound and politically popular package.

This memo highlights decisions that need to be considered if tax package recommendations are to be made publicly. The memo concludes with brief descriptions of several tax ideas appealing to small business that the President has asked about.

Education

- o The current education package contains a $1,200 HOPE credit, a $10,000 tuition deduction, drops the B- grade requirement and no longer offsets the HOPE credit by Pell grants and other federal aid that a student receives. This package costs $3.8 billion more than the $35 billion for education that is allocated within the budget agreement.

Alternatives

- o The Education Department has suggested an alternative with a $1,500 HOPE credit, with no B- and no Pell grant offset with a $10,000 tuition deduction that is either capped at $1,500 of tax reduction (so, for example, a family in the 28 percent bracket could deduct no more than $5,357) or converted into a credit equaling 15 percent of all higher education expenses, up to $10,000. In addition, the second year of the HOPE credit could only be received by students who have completed their full freshman year of school. We believe this package will cost roughly the same amount as the first package.

- o Either the amount of the tuition deduction, HOPE credit or both must be scaled back to meet the $35 billion revenue target, particularly under JCT scoring. In addition, many potential allies strongly urge us to alter or drop the B- requirement and eliminate the Pell grant offset.

Additional features of the education package

- With money outside the $35 billion, we propose to make permanent the exclusion of employer-provided educational assistance from taxable income (Section 127). This is a cause that has been championed by Senator Moynihan and others in the House and the Senate.

Additional Education Proposals that Could be Considered to Attract Support of Key Members of Congress

- School Construction: We have designed a tax proposal to aid school construction (and other activities) in poor neighborhoods, as urged by Congressman Rangel among others. The States and the District of Columbia would be permitted to allocate a fixed annual amount of tax credits (based on population), much as they do currently with low-income housing tax credits. The States could allocate the credits for projects in public schools located in empowerment zones, enterprise communities or that have a high percentage of low-income students. The schools could use the credits to help pay for construction and renovation projects by giving them as partial payment to developers who perform the construction work or by selling them. Each school would be allocated credits equal to a specified portion of construction costs with the balance to be covered by the State or the school districts.

- Expansion of the Work Opportunity Tax Credit: In addition to extending the credit for at least one year, it would be expanded so that employers hiring graduates of schools that have a high percentage of low-income students within one year of their graduation would be eligible to receive the work opportunity tax credit.

- Exemption for Withdrawals from State Prepaid Tuition Plans: Families that invest in plans that allow them to prepay college tuition not only would receive tax deferral on the annual increase in value of their investment as provided under current law but also an exemption from tax when the funds are applied to the child's tuition. The exemption would apply to plans like Florida's and Virginia's that allow parents to pay in full in advance for tuition, but not to some other states' plans that operate like mutual funds.

- Position on Deductibility of Student Loan Interest: We prefer our tuition credit and tuition deduction, which do not favor borrowing over saving to pay for college, to a student loan interest deduction, which does favor borrowing. A student loan interest deduction would provide relief, however, to many middle-income students and is administrable. Such a proposal is popular with certain Senators (e.g., Moseley-Braun) and thus may be included in a Congressional budget package.

Middle Class Tax Relief and Saving Provisions

- The baseline package contains a refundable "Kidsave" credit based on the child credit in your FY98 Budget. Kidsave proposals combine a child tax credit with a tax-preferred saving vehicle that can be used for the child's education and for retirement (of the taxpayer). Kidsave is popular with many moderate Senators, particularly Breaux and Kerry. The particular version shown in the baseline package is refundable, which would help draw a striking contrast between the distributional effect of likely Congressional taxes packages and ours.

Alternatives

- An alternative would drop refundability and instead extend the child credit in your FY98 budget to children under 18 (the Budget proposal gives a credit for children under 13).

- Kidsave proposals cleverly combine an education saving mechanism with the child credit (our version would make contributions to the education saving account optional). An alternative would be to have separate child credit and IRA proposals, as was done in the FY98 Budget. IRAs, particularly backloaded IRAs, are very costly in years beyond 2002. Adding our IRA Budget proposals would cost about $15 billion through 2002 under JCT scoring.

Additional features of the Middle-Class tax relief package

- The large tax cuts agreed to in the second five years of the package provide an excellent opportunity to reform the individual Alternative Minimum Tax in a sound tax policy way and better distributed to the middle class. Currently only 600,000 taxpayers are affected by the AMT. By 2007, however, as many as 9 million taxpayers may be affected by the AMT, many of whom will be ordinary taxpayers since even the personal exemptions, standard deduction and state and local taxes are treated as preference items. The AMT will also start to claw back HOPE credits and the child credit. Fixing the AMT is important for the long-run health of the income tax, but is very expensive since the costs of doing so increase sharply beyond 2002. We propose to tackle this problem when the AMT problem becomes important, namely after 2002.

Small Business and Capital Gains Tax Relief

- The baseline package contains a 50 percent exclusion for long-term capital gains (so the maximum tax rate is 20 percent); a small business/venture capital proposal for capital gains relief, supported particularly by the biotech and computer industry; and the home sales provision in your FY98 budget. Note that Treasury and JCT scoring of capital gains has differed substantially in the past.

More Detail on Special Rules for Small Businesses and Small Business Investment Companies

- o Individuals' long-term capital gains would be taxed at one half of the statutory rate applicable to ordinary income -- the maximum rate would be reduced from 28 to 19.8 percent. Correspondingly, the maximum rate on the sale of small business stock held for more than five years would be reduced from approximately 14 percent to 9.9 percent (from 21 percent to 15 percent for taxpayers subject to the alternative minimum tax).
  - The size of companies eligible for these special rules would be increased from $50 million of gross assets to $100 million of gross assets and the limitation on the amount of gain that could be excluded (currently $10 million) would be eliminated.
  - This proposal would also adopt some of the changes to the 1993 small business stock provision previously suggested by Senators Daschle, Lieberman and Hatch and by Congressman Matsui (among others). This proposal is particularly favored by venture capital and biotechnology firms.
- o Under a separate proposal, a specialized small business investment company (SBIC) would be allowed under special rules to qualify for an exemption from entity-level corporate tax to the extent it distributed its income currently. Alternatively, during a specified period, any SBIC would be permitted to convert tax-free to a partnership. In addition, the rules that provide for exclusion of gain on securities when there is a roll-over to a SBIC would be liberalized for individuals, and would be extended to corporations. These rules would increase the exclusion for capital gains on SBIC stock from 50 to 60 percent, extend the preference for corporate taxpayers, and liberalize certain other rules.
  - These changes have been proposed by Congressman Jefferson who has advocated them as a means of improving capital access for minority-owned businesses.
- o This package should receive wide political support, yet is designed to not unduly favor very high-income taxpayers and cause the net tax cut to explode in years beyond 2002.

Estate Tax Relief for Family Farms and Closely-Held Small Businesses

- o The baseline package includes the estate tax proposals for special relief to farms and small businesses sponsored by Senator Daschle. They would create an estate tax exemption for the first $900,000 of value in a "qualified family-owned business interest" (in addition to the $600,000 unified credit). The proposal would also increase the amount of estates eligible for the special 4 percent interest rate on deferred payments, as in your FY98 Budget.

Urban initiatives and other Budget items

- The baseline package contains a complete set of FY98 Budget initiatives, including the expansion of EZs and ECs, Brownfields, CDFI and the welfare-to-work tax credit and tax incentives for PSC software, D.C., and Puerto Rico, and the equitable tolling provision. It extends expiring provisions that we do not make permanent, including the R&E tax credit, deduction for contributions of appreciated stock to private foundations, the work opportunity tax credit and the orphan drug tax credit.

Increase Deduction for Self-Employed Health Insurance

- You have asked us to think about increasing the deduction for the purchase of health insurance for the self-employed. The Small Business Job Protection Act of 1996 gradually increases the deduction for self-employed health insurance costs from 30 percent in 1996 to 80 percent in 2006 and thereafter. It has been proposed that the deduction should be increased to 100 percent. The proponents argue that the proposal would provide parity with the employer-provided health insurance deduction, which is 100 percent. However, most employers do not cover 100 percent of their employees' insurance costs. Thus, current law is closer to parity so the proposal to increase the deduction for self-employed health insurance is overly generous. It should also be noted that no tax subsidy is presently provided to encourage employees without employer-provided insurance to purchase their own health insurance. There are approximately nine million employees who purchase their own insurance, as compared to three million self-employed individuals who claim the self-employed health insurance deduction.

Modification to the Home Office Deduction

- You also asked us to think about modifications to the home office deduction. A home office business expense deduction could be allowed where substantial and essential administrative or management activities of the taxpayer's business are conducted on a regular basis in the taxpayer's home, provided the taxpayer has no other location for performing these activities. The current-law limitation that the deduction is available only with respect to that portion of the home that is used exclusively for business purposes, and is so used on a regular basis, would also continue to apply. This proposal has been estimated to cost roughly $650 million through 2002, assuming a January 1, 1997, effective date.

THE WHITE HOUSE

WASHINGTON

May 22, 1997

MEMORANDUM TO THE PRESIDENT

FROM: GENE SPERLING

SUBJECT: Education Tax Package

This memo describes two basic approaches to changing the HOPE Scholarship and $10,000 tuition tax deduction proposals in order to (1) fit within the $35 billion allocation over 5 years, (2) address, to varying degrees, the concerns about possible grade inflation and tuition inflation raised by pundits, and (3) address issues of progressivity raised by key Democrats and education groups. The memo also describes other education tax items that could be included in an Administration tax package *outside* of the $35 billion that was reserved for your credit and deduction

Inside the $35 billion: HOPE and the Deduction

Treasury's estimate of the revenue loss from your two higher education tax proposals is $36.2 billion, with roughly half the cost associated with each proposal (the credit costs $18.6 billion and the deduction cost $17.6 billion).[1]

Both options 3 and 4 below are attempts to regain costs that would be the result of changes to the grade requirement and Pell offset, as described in 1 and 2.

1. Grade Requirement

The reasons for changing the grade requirement include: (1) administrative concerns raised by colleges, (2) "grade inflation" arguments from pundits, and (3) concerns that the requirement would not be applied equally across families, because middle income families at traditional colleges could still get as valuable a tax benefit through the tuition deduction (which has no grade requirement) even if ineligible for the credit. There are two possible alternatives:

[1]Joint Tax estimates have been higher -- a total of $40.6 billion, with $28.9 attributable to the credit, and $11.6 attributable to the deduction. The cooperative efforts between Joint Tax and Treasury, agreed to in the budget deal, may reduce this disparity.

1a. Satisfactory Academic Progress. Federal student aid programs currently require that, in order to continue receiving aid, the students must maintain "satisfactory academic progress." This roughly equates to "passing," and is defined and policed by the schools. This option is roughly equivalent to eliminating the grade requirement.

Pro: This is the measure that the colleges prefer, since it is already in use.

Con: This is not a rigorous requirement. We would not be able to argue that we are encouraging students to excel.

1b. Achieving Sophomore status. Under this approach, a student could not receive a second HOPE Scholarship until she had successfully completed one full academic year. (This would incorporate satisfactory academic progress as well).

Pro: A full-time start in college is strongly associated with retention and attaining a degree. This would encourage students to do more than take a few classes, or to continue with their studies beyond a semester or two. It provides an argument that we are not completely backing away from an accountability component within HOPE.

Con: This could be confusing to students and taxpayers who, based on information provided by the school, would have to switch from the credit to the deduction until they fully completed one year, then would switch back to the credit.

Eliminating the grade requirement (option 1a) costs \$2.2 billion (assuming no other changes). Option 1b would probably cost slightly less, but has not been estimated.

2. Offset of Federal Grants ("Pell Offset")

In order to stretch the \$1,500 credit further into the middle class, your HOPE Scholarship proposal currently makes Pell Grant recipients (and other Federal grant aid recipients) ineligible for the HOPE Scholarship if they receive \$1,500 or more in Federal grants. Higher education organizations and Democrats in Congress have argued that this unfairly excludes low-income families from HOPE, leading to a more regressive proposal.[2]

There are two alternatives for the Pell Grant offset:

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[2] Ignoring the full \$3,000 that the lowest income students can receive in Pell Grants, they argue that your Budget provides only \$300 for the poor students (the Pell Grant *increase*), but \$1,500 (HOPE) or even \$2,800 (maximum \$10,000 deduction at 28% bracket) for higher-income families.

2a. Eliminate offset entirely. A student with a $3,000 Pell Grant could also receive a $1,500 HOPE Scholarship, if the taxpayer paid enough tuition and fees and had tax liability to which to apply the credit. This option costs $3 billion when considered alone.

Pro: Makes the credit more progressive, addressing concerns of key Members of Congress and constituency groups (who have been reluctant to fight for the details of our proposal as currently drafted). Reduces the amount of data that the taxpayer and IRS will need to compute the credit.

Con: Cost which must be absorbed through other changes to the proposals.

2b. Offset grants by 50%. With this approach, a student's eligibility for the HOPE Scholarship would be reduced by half of the Federal grants received. This approach costs $0.9 billion when considered alone.

Pro: Costs less than eliminating the offset entirely.

Con: Excludes the *poorest* students from HOPE (those with maximum Pell Grants). Will not completely satisfy key Democrats and constituency groups. Would still require a "Federal grants" data element to be reported by colleges, and used by taxpayers and the IRS in computing the credit eligibility.

3. Education's approach: $1,500 Credit, Deduction capped at $1,500

The maximum HOPE Scholarship would remain at $1,500. The tax deduction would still apply to up to $5,000 of tuition and fees through 1998 and up to $10,000 thereafter. However, the value of the deduction would be reduced by either capping it at $1,500 or turning it into a 15% credit. With either approach, in the first two years of college, the HOPE Scholarship would never be less valuable than the deduction.

Education argues that this approach would (1) equalize the benefits between the credit and the deduction, addressing a criticism from some Democrats and higher education groups, and (2) maintains the commitment to provide access to the average community college.

The two approaches for achieving these objectives are:

I. Cap value at $1,500. The value of the deduction (tax bracket times applicable tuition and fees) could not exceed $1,500. A family in the 28% tax bracket would reach the cap at tuition and fees of $5,357. For tuition and fees up to that level, the deduction would continue to be more valuable for higher income families than for lower income families, because of their different tax brackets.

Pro: Middle class families in the 28% bracket, with a child at a public university or lower-cost private institution, would continue to get the full benefit of the deduction.

Con: Students at higher-cost private colleges would not benefit as much as under the current proposal..

ii. Set value of deduction at 15% of tuition and fees. The deduction would essentially be turned into a credit valued at 15% of the tuition and fees charged. The value of the deduction would not vary according to the family's tax bracket (except to the extent that a low-income family lacks tax liability to reduce).

Pro: More likely to be embraced by key Democrats and the education groups.

Con: Less helpful to middle-income families at moderate-cost colleges.

Neither of the approaches above would save enough to fully offset the elimination of the grade requirement and the Pell offset. One or both of them might offset a partial elimination of the grade requirement and Pell offset, as described in 1b and 2b.

4. Treasury's approach: $1,200 credit, $10,000 deduction.

The tax deduction would be unchanged: it would apply to up to $5,000 of tuition and fees through 1998 and up to $10,000 thereafter. The HOPE Scholarship would be reduced to a maximum of $1,200.

Pro: One benefit of reducing the HOPE credit is that it reduces any potential tuition inflation at community colleges, because fewer community colleges would have tuition and fees below that level.

Con: Increases the disparity between the value of the credit ($1,200) and the value of the deduction for a higher-income family ($2,800). The credit would not cover average community college tuition (now at $1,500).

This approach also would not save enough to fully offset the elimination of the grade requirement and the Pell offset. One or both of them might offset a partial elimination of the grade requirement and Pell offset, as described in 1b and 2b.

5. Reduce both the deduction and the credit

If you decide to completely eliminate both the grade requirement and the Pell offset (1a and 2a), it may be necessary to explore options that would reduce both the deduction and the credit in order to offset those costs. For example, a $1,200 HOPE Scholarship, and an $8,000 deduction, capped at a value of $1,200 or 15%, might yield the necessary savings.

Education tax items outside the $35 billion

The Administration's tax package could include several education-related tax items outside of the $35 billion allocation. While Chairman Archer's staff clearly want to use some of these other items in place of your HOPE Scholarship and tuition tax deduction, I strongly feel that we must hold firm to our strict interpretation of the letter, which reserves the roughly $35 billion for "postsecondary education, including a deduction and a credit. . . consistent with the objectives put forward in the HOPE scholarship and tuition tax proposals contained in the Administration's FY 1998 budget to assist middle-class parents." If we open up the $35 billion to other items this early in the process, we risk losing the HOPE Scholarship and tuition deduction.

The larger tax package could include:

- **A Rangel elementary-secondary provision.** Rep. Rangel has been helpful on HOPE Scholarships and the tax deduction, and very much wants to see some of his ideas incorporated into the Administration's tax package. Some possible directions are described below. Cost: perhaps $3-5 billion.

- **Student loan interest deduction**. Different proposals have been put forward by Senate Republicans, Senate Democrats, and House Democrats. Strongly supported by the higher education community. Cost ranges from less than $1 billion to $3 billion, depending on design (caps, income ranges, new versus old loans, and whether parents or just students are eligible).

- **Extending Section 127** (tax deduction for employer-paid education assistance). Senate Republicans have proposed making it permanent, while your 1998 Budget extended it through the year 2000. Sen. Moynihan is a strong supporter of this provision.

- **Education savings incentives**, loosely based on the Lieberman-Breaux "KidSave" proposal.

- **Community Service/Income Contingent Loan Forgiveness**. Exclusion from income of loans forgiven by a non-profit entity for community service, or loans forgiven under the Direct Loan Program's income-contingent repayment provisions. Part of your 1998 Budget, costs only $15 million.

- **Work-Study income exclusion**. Senate Republicans have proposed excluding income from the Federal Work-Study program from taxation. This costs $0.4 billion.

- **Pre-paid tuition plans**. Exempt withdrawals from taxation. This costs $0.6 billion.

<u>Rangel's Education Empowerment Zones</u>

Rep. Rangel recently introduced legislation that includes his version of the HOPE Scholarship (refundable), as well as his own proposal aimed at helping public elementary and secondary schools in poor areas. Rangel's legislation includes (1) a tax credit to subsidize bonds for construction, renovation, teacher training, and curriculum development for "academies" based on school-business partnerships in empowerment zones and empowerment communities or high-poverty schools in other areas, and (2) an expansion of the Work Opportunity Tax Credit to benefit employers who hire graduates within six months of leaving an academy.

There are a number of problems with the design of these proposals. However, we do feel that there are some useful concepts in the legislation, and that we can work with Mr. Rangel on one or more of the following approaches:

School Construction in EZ/ECs: A tax benefit to help reduce the cost of borrowing or other financing of school construction or renovation in high-poverty areas. This could include some of Rep. Rangel's conditions for business contributions and involvement, though that would be an awkward design.

Charter School Construction in EZ/ECs: A tax benefit to help reduce the cost of borrowing or other financing for the construction or renovation of public charter schools in high-poverty areas.

School-Business Partnerships in EZ/ECs: A tax benefit for contributions of money, equipment, or time associated with a partnership between a business and a school in a high-poverty area.

WOTC expansion to EZ/EC graduates: Like Mr. Rangel's proposal, expand the Work Opportunity Tax Credit to graduates of schools in EZ/ECs, or to schools that meet certain criteria (such as the Rangel "academies").

WOTC expansion for high school apprenticeships: expand the Work Opportunity Tax Credit to businesses that hire participants in school-business partnerships *while they are in school.*