Education Tax Credits for America's Schools

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This Spring, the Colorado Senate is debating 'A Bill for an Act Concerning a Credit against State Income Tax for Contributions to Nonprofit Organizations that Provide Resources for Education', i.e. an Education Tax Credit for schools. If passed, the Bill would make Colorado the fifth state to create an Education Tax Credit within the last five years.

Introduction: What are Education Tax Credits (ETCs)?

Tax credit reforms take one of two forms. In the first form, states grant tax credits to parents for their education-related expenses (i.e., Illinois, Iowa, Minnesota). In the second form, states grant tax credits to persons, groups or businesses that contribute money to an organization that then distributes the contributions in the form of student scholarships or public school grants (i.e., Arizona, Florida, Pennsylvania). In both cases, such credits reduce the cost of and increase the demand for private education services for schooling (not for college).

Why are ETCs Attractive?

Advocates see many advantages from ETCs. Such credits may enhance educational choices, by encouraging new education provision. They may improve the productive efficiency of the school system (as good schools are rewarded with higher enrollments and more funds). And, they may save public funds if families are induced – by a relatively small subsidy – to switch from public schooling into the private sector. For businesses, an ETC is useful way to reduce tax payments and to make donations to a worthy cause in the local community.

ETCs – because they are not government funds – are less likely to face legal barriers compared to reforms such as educational vouchers. For policymakers, they are also a flexible type of education reform, both in terms of financing and regulation. Key financial questions are:

- What is the maximum size of the credit?
- What proportion of tuition costs is covered?
- Is the credit refundable when families spend nothing on education?

Key regulatory questions are:

- Who is eligible– families, only some families, individuals or businesses?
- What specific educational services can be claimed as tax expenditures?

Which States have ETCs?

At the beginning of 2003, there are tax credit programs for K-12 education in six US states (a Federal Tax Credit has also been proposed, but so far not enacted). Four of these tax credits have been introduced since 1997 (AZ, FL, IL, PA). Further details are given in the Box below.

BOX 1: TAX CREDITS FOR K-12 SCHOOLS

For families:

Arizona: Credit of $200/$500 for tuition or materials at public/private schools; funds must be given to tuition organizations or public schools.

Illinois: Credit of $500 for tuition, materials or lab fees; funds can be given to either public or private schools.

Iowa: Credit of $250 for tuition or materials; funds must be given to private schools.

Minnesota: Credit of $2000 for educational materials, only for families with incomes less than $37,500; funds can be allocated either to public or private schools, but credit is refundable for zero expenditures.

For businesses:

Florida: Credit may extend to 75% of tax liability for expenditures on tuition or materials; funds must be given to private schools or non-profit scholarship funding organizations.

Pennsylvania: Credit of $100000 for tuition and materials allocated by tuition or educational improvement organizations.

What Do We Know About ETCs?

Economic models of ETCs indicate two clear conclusions. First, the immediate effect of such tax credits is to fund private schooling for families, many of whom would have paid the fees independently. Based on the best available evidence, for every student newly induced into the private sector by such a tax credit, there would be on average another 6 or 7 students who would have chosen the private sector anyway and receive the tax break as a windfall. States lose significant tax revenue when the number of new families taking advantage of this choice option is not substantial. Second, most tax credits involve a significant reduction in overall tax revenues as funds are diverted to private and public schools and non-profit organizations. For a Federal ETC of $500, for example, net reductions in tax revenue are estimated at over $600 million (Belfield, 2001). This lost revenue could have a profound impact on the quality of public schooling. This credit would take tax revenue – once fully earmarked for public education – and divide it between public and private education in the form of education tax credits.

Given their novelty, however, there have been few direct evaluations of these state-level ETCs, although there is some information about the amount of and flow of funds. In 1997, the Arizona tax credit claims were $1.8m for the private school tuition tax credit and $8.9m for the public school extra-curricular activity credit; by 2000, these amounts were $17.6m and $17.5m, respectively (Wilson, 2001). From data on the public school tax credits in Arizona, the primary claimants are the well-off: families with incomes above the median made three-quarters of the donations. These funds are almost exclusively routed through religious student tuition organizations. However, when averaged across all students in public schools, the donation amounts were trivial, at less than $10 per student.

Data from 2000 for the Illinois tuition tax credit shows that claims were made for $61.2m by over 165,000 taxpayers. Similarly, this tax credit is skewed toward wealthier families. Almost half of the total amount claimed was by families with gross incomes of over $80,000; these families claimed on average $405 each. In contrast, families with incomes below $20,000 claimed on average $189 each. Data from other states is not yet available.

What is the Future of ETCs?

Essentially, there are two types of ETCs. There are tax credits that families with school-aged children can claim for education-related expenses (i.e., IL, IA, MN); and there are tax credits that individuals and businesses can claim, for donations to eligible non-profit educational organizations, who then redistribute these funds as scholarships (AZ, FL, PA).

Of these two types, the one for individual and business contributions to nonprofit organizations could be very popular: it gives individuals and businesses an incentive to contribute funds – of reasonably large amounts in the case of businesses – to the local schools and the educational community, and the funds could justifiably be regarded as a windfall to the schools. In particular, businesses would gain valuable approbation for 'doing good'. The tuition organizations could be required to focus on low-income communities, as in Florida, or students with special needs. Politically, such ETCs could be very popular.

The tax credit to families as reimbursement for their education-related expenses is likely to be less popular. Unless the eligibility terms are narrowly defined, this credit would mainly serve as a windfall to families who would send their children to private school regardless of the tax incentive. As these families are mainly in high-income groups, the credit would appear regressive. Also, such a credit could raise the revenues of private schools, without prompting them to increase educational quality. Since more families could afford to choose to send their children to private schools and businesses would have an incentive to donate funds, private schools would experience increased revenue from the ETC without having to make any real improvements.

For a policymaker faced with these two options the obvious choice is the tax credit for contributions to nonprofit organizations. It encourages investment in schooling, without switching funds from public to private school parents. But, for those wanting to give tax relief to parents and private schools, it is possible to bundle the two credits together. This is the case for the Bill being debated in Colorado, where both individuals and corporations can claim tax relief.

Now, then, voters are presented with a dilemma: a program that both supports and threatens public schools, yet with no obvious clues as to which effect will dominate.

References

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