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The Promise and Limits of Tuition Tax Credits

*An examination of the fiscal impact
of proposed tax credits for New Jersey*

By Joseph L. Bast

The United States may be the greatest capitalist nation in the world, but 87 percent of its K-12 students attend schools that are owned, operated, and staffed by the government. It is a paradox that has not escaped the attention of the best and brightest of each generation.

The modern debate over privatizing education in the U.S. dates to 1962, when Milton Friedman proposed giving parents vouchers worth the current average per-pupil spending of public schools, which they could use to pay tuition at the public or private school of their choice. Friedman thought by allowing for-profit and nonprofit enterprises to compete for the public funds already being allocated for schooling, the blessings of markets – efficiency, accountability, and freedom – could be brought to schooling.

Efforts to implement vouchers waxed and waned since 1962. The U.S. Supreme Court invalidated some early programs on the grounds that they were intended to advance religion or to circumvent court-ordered racial integration programs. The courts' views have become more favorable toward parental choice of late, as the motives of voucher proponents have become more progressive. Recent court decisions make clear that a well-designed voucher plan would pass constitutional muster.

Vouchers or Tax Credits?

Proposals to expand competition and choice through tax credits have long been advanced alongside vouchers. Some tax-credit advocates claim they hold several advantages over vouchers, including political feasibility, a less negative effect on parental motivation (since they require some financial sacrifice by parents), and less likelihood of causing increased regulation of private schools.

Voucher proponents dispute all three of the supposed advantages of tax credits (a subject for another time, perhaps) and point to two alleged flaws: tax credits seldom generate enough money to spur much competition or choice, and they specifically fail to empower poor families who pay little or no taxes.

Both voucher and tax credit proponents can point to some small (but only small) victories in recent years. Pilot voucher programs operate in Milwaukee and Cleveland, and Florida recently became the first state to adopt a state-wide voucher program though it covers only students attending the state's worst public schools. Tuition tax credits were recently adopted in Arizona and Illinois and expanded in Minnesota.

Tax Credits for New Jersey

Research I recently concluded on two proposed tuition tax credit plans for the state of New Jersey provides an opportunity to put tax credits' alleged flaws to the test. The tax credit plans, introduced by Assemblyman Guy Gregg and endorsed by Jersey City mayor and gubernatorial candidate Brett Schundler, are called the Educational Options Act (EOA) and the Parental Control and Involvement Act (PCIA).

The EOA would allow individuals, estates, trusts, and companies to receive a credit against state income and corporate income taxes of not more than 75 percent of the amount they contribute to "qualifying entities" that provide educational scholarships to children attending nonpublic schools. For individuals, estates, and trusts, the credit is limited to \$10,000; for companies, it is limited to 10 percent of the company's annual corporate income tax liability.

The PCIA would give parents credits against their state income tax liability equal to 50 percent of qualified educational expenses, up to a maximum credit of \$500 per dependent child. All parents of school-age children would also be eligible to receive a 100 percent tax credit for up to \$150 per household for spending on computer hardware and software related to curriculum or instruction.

Projected results

Tax credits influence the ratio of public and private school enrollment by lowering the after-tax price of private school tuition. The degree to which prices are reduced depends on family income and tax liability, student's grade level, type of school selected (parochial schools charge less than independent private schools), and how much is raised by the EOA's scholarship-granting entities and how they choose to disburse those funds.

The EOA would most likely raise less funds than needed to pay the tuition of every child who wishes to attend private schools. Using reasonable estimates of participation and gift size suggests EOA would raise between \$340 million to \$530 million a year, enough to provide scholarships to between 57 percent and 89 percent of students wishing to attend private schools.

The PCIA allows tax credits of up to \$500 a year, but many families wouldn't qualify for the entire amount. Because the tax credit for education-related computer hardware and software would be 100 percent of expenses (up to \$150), many parents would apply for this credit before

or instead of applying for the 50 percent tax credit against tuition and other expenses. Families earning \$40,000 a year or less would “zero out” their entire state income tax liabilities before reaching the tax credit cap for a single student, meaning zero tax relief for additional children enrolled in private schools.

I found that EOA and PCIA would reduce private school tuition for one child per household by between 32 percent (for nonpoor families enrolling their children in independent secondary schools) and 95 percent (for “poor” families enrolling their children in parochial elementary schools). Economists estimate that a 10 percent decrease in the price of private schooling increases the probability of a family choosing private schooling by 4.8 percent. The tuition price reductions I forecast would cause total private school enrollment to increase 40 percent.

Most of the increase would occur at the elementary school level (largely because elementary-school enrollment, spanning nine years, is much larger than secondary-school enrollment, spanning only four years). Some 37 percent of the new students (30,518 out of 83,683) would be from “poor” families. Public school enrollment would decline by 6.97 percent as students transfer from public to private schools.

The impact of the two programs on the state’s treasury (not on the state’s taxpayers, because there is no assurance the money will be returned to taxpayers) is calculated by subtracting the total loss of revenue caused by tax credits from the avoided cost of educating students who otherwise would have attended public schools.

PCIA would cost the state \$200 million a year in lost revenue, with approximately half that amount going to parents choosing to send their children to private schools, one quarter to parents purchasing computer hardware and software for their children’s education, and one quarter to parents of children attending public schools who pay school fees. Homeschoolers would receive \$4.4 million in tax credits.

EOA would cost the state \$384 million, with about half of that amount going to individuals each contributing about \$1,000, one quarter to corporations, and one quarter going to wealthy individuals and trusts contributing the maximum of \$10,000. The total revenue loss therefore comes to \$584 a year.

Avoided costs were calculated by multiplying state per-pupil spending by the number of students expected to shift from public to private schools. Common estimates of per-pupil spending exclude capital costs and state contributions to teachers pensions, along with many other cost factors. Adjusting spending for only these two omissions produced per-pupil annual spending estimates for urban students of \$13,504 and for nonurban students, \$12,279. Annual avoided costs came to \$1.064 billion, for net savings of \$480 million a year.

This estimate is most likely to represent savings several years after the programs’ start, assuming the availability of tax credits is well known and that they are easy to apply for and that no new developments or trends arise that significantly influence the price or supply of private schooling.

What tax credits deliver

This analysis shows both the good as well as the bad sides of using tax credits to promote school privatization. One promise that tax credits deliver on is allowing the children of families from all income levels to attend private schools of their own choosing. The New Jersey tax credit plans would enable some 30,000 students from “poor” families to escape some of the nation’s worst public schools. For this reason alone they are a great improvement over the status quo and deserve a try.

A second promise is tax relief. The \$1 billion in costs avoided by having 7 percent of students shift from public to private schools makes it possible to finance not only the \$585 million in tax relief delivered to parents and donors under the two tax credit plans, but also to reduce public spending by an *additional* \$480 million without reducing per pupil spending. This would, at a minimum, significantly reduce the pressure on state and local governments to raise taxes to cover the costs of building and maintaining new schools.

This analysis confirms, though cautiously, what the preamble of an early draft of EOA claims: “It is possible for low income children to attend privately managed schools while simultaneously saving State taxpayers many hundreds of millions of dollars annually.”

Tax credit problems

However, the limits of the tax-credit approach are also on display in New Jersey. Only 7 percent of students shift from public to private schools, hardly the kind of sweeping privatization hoped for by many market advocates. The 50 percent tax credit for parents capped at \$500 provides too little tax relief to have any effect on private school enrollment.

The scholarship-granting entities created by EOA are responsible for most of the students who would shift to private schools. I project they would fund up to 226,414 full tuition scholarships or 259,344 partial scholarships. These numbers seem impressive until you consider that 207,000 students *already* attend private schools. Fully funded, EOA would provide scholarships to between 16 percent and 21.6 percent of all students in New Jersey.

Increasing the parental tax credit to 100 percent of expenditures and capping the credit at \$5,000 would increase the number of students switching to private schools by only 9 percent, from 6.97 percent of public school enrollment to 7.60 percent. All of these students would come from relatively well-to-do families. This is not much of an improvement for changes that would probably generate wails of protest from liberals and egalitarians.

A second problem with tax credit plans revealed by this research is that it would not “empower the poor,” or indeed, any consumers of schooling. The EOA raises four times as much money to apply to private school tuition as does PCIA. Those dollars are doled out to schools selected by

the scholarship-granting entities, not by parents (except in the secondary sense that they might be able to choose among multiple scholarship-granting entities). Why would parents be any more motivated if their children's tuition is paid for by a charitable foundation than by a government agency? Either way, there is no financial sacrifice and little exercise of choice.

It might be the case that the scholarship-granting entities, unlike a government agency, can require financial sacrifice from parents by offering only partial scholarships. And private organizations may be flexible enough to discover problems or opportunities, make distinctions, and offer counseling in situations where government agencies can't or don't. Perhaps offsetting these advantages, though, are the facts that the scholarship-granting entities can offer only a narrow range of choices; are essentially third-party payers for educational services, with all the problems that entails; and as regulated nonprofit entities may be no more accountable to their "customers" than are government agencies and perhaps even less.

A third problem is that tax credits do not force schools to compete for students or cause more than a handful of new schools to be started. The 50 percent, \$500 tax credit is just token tax relief and irrelevant to creating a competitive education marketplace, though it may be justified on other grounds. Even a 100 percent, \$5,000 tax credit would be irrelevant to a genuine privatization effort: it moves just .63 percent more students into the private sector.

The scholarship-granting entities won't award scholarships that are big enough or available in sufficient numbers to prompt education entrepreneurs to start new schools. Part of this is due to the design of the New Jersey tax credit plan, which limits scholarships to two-thirds of average public school spending, but mostly it is due to the sheer size of the task. State and local governments in New Jersey spend approximately \$15.6 billion a year on K-12 schooling. EOA can be expected to raise just 3.4 percent of this amount. Private philanthropy, even with generous state tax credits, won't and probably shouldn't do more than a small fraction of that job.

The scholarship-granting entities, in the tax credit model, are the actual buyers of education services. What incentives do they have to monitor the efficiency or performance of schools? How will they discover parental concerns? Philanthropy, like government, does not operate according to the rules of markets (which is not to say they both cannot be studied using the tools of economics). So it would not necessarily be the case that competition among scholarship-granting entities would lead to only the best or most efficient surviving.

It is not clear, finally, how tax credits move us any closer to the goal of privatizing schooling in the U.S. The New Jersey tax credits, like other plans, do not *defund* public schools. A dollar donated to a scholarship-granting entity, or deducted from one's personal income taxes, does not result in a dollar less being spent on public schools. There is no provision for returning to taxpayers any of the \$480 million in savings that the tax credit plan makes possible.

It is difficult to see, in this philanthropy-driven model, where any pressure would arise to force governments to spend less on public schools as their enrollments decline. By leaving tax dollars

in the public school system each time a parent chooses private schools, tax credits reward public sector incompetence and makes the status quo even harder to change.

In light of the limited impact of even ambitious tax credit programs, advocates of privatization who think they have found an approach superior to vouchers would do well to reconsider.

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Joseph L. Bast is president of The Heartland Institute, a nonprofit research organization based in Chicago, Illinois. The complete study of New Jersey's proposed tax credits can be found on Heartland's Web site at www.heartland.org.

New Jersey Tax Credits Summary of Findings

Impact of tax credits on enrollment		
Number	Percent of total student population	
207,275	14.8%	Current private school enrollment
83,683	6.0%	Projected increase
290,958	20.8%	New private school enrollment
Fiscal impact of tax credits		
Totals	Subtotals	PCIA
	\$92,000,000	50% tax credits for parents of children attending private schools
	\$56,000,000	100% computer hardware and software tax credits
	\$48,000,000	50% tax credits to parents of children attending public schools
	\$4,400,000	50% tax credits to homeschoolers
\$200,400,000		Revenues lost due to PCIA
		EOA
	\$272,800,000	75% tax credits to persons contributing gifts averaging \$1,000
	\$58,500,000	75% tax credits to corporations giving to scholarship-granting entities
	\$53,000,000	75% tax credits to donors contributing gifts averaging \$10,000
\$384,300,000		Revenues lost due to EOA
\$584,700,000		Total revenues lost
		Costs avoided due to falling public school enrollment
	\$652,813,035	Non-urban students transferring from public schools
	\$412,115,072	Urban students transferring from public schools
\$1,064,928,107		Total costs avoided
\$480,228,107		Net savings to state treasury

Source: Joseph L. Bast, "Fiscal Impact of Proposed Tuition Tax Credits for the State of New Jersey," *Policy Study # 96* (Chicago, IL: The Heartland Institute, April 2001).