

## EDUCATION TAX CREDITS:

### *Great Idea, But Do It Right*

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President Bush proposes a new federal tax credit, giving parents of children in failing schools a credit up to \$2,500 on their income tax for the costs (including tuition, fees, and transportation) of sending their child to a better public or private school. This new Bush initiative is designed to inject some free-market incentives into the new education reform law (No Child Left Behind).

The President is working off the sound principle that parents know what is best for their children. Most parents, like most Americans, pay an exorbitant price in taxes for government-run schools (with no refund if they send their children to a private school); yet they have virtually no say in how those schools are run, or what is taught. So the President has to be congratulated for taking this principled step forward. But he could make a much more compelling case for his idea by combining the best principles of tax policy with his notion of enhancing education freedom.

#### **TAX REFORM = EDUCATION REFORM**

Tax policy, like education policy, requires a back-to-basics mentality. Our tax system, encrusted by decades of special-interest carve-outs, taxing ever more Americans at exorbitant rates, can only be reformed with a blunt instrument. Anything that introduces new complexity has a strike against it. Anything that puts social policy ahead of revenue generation should be subject to the closest scrutiny.

From this tax reform perspective, President Bush's proposed education tax credit could use some improvement. For one thing, it is limited to students in schools certified as not making adequate academic progress under the new education law. The more limited a tax benefit is, the more complexity it introduces, and those who don't qualify argue it's inequitable. In addition, the President's credit is refundable, offered even to parents

who do not pay taxes. For budget purposes, that makes it a grant program (rightly so, since that's what it is). Mixing tax policy with spending policy is not exactly a reform-minded concept.

Is there a better way?

#### **BUILD ON SUCCESS**

Rather than further complicate the tax code for a limited number of families, President Bush could build on the many exciting innovations going on at the state level. Here's how: offer a federal credit for taxpayer expenditures on *state* tax benefit programs, which give deductions or credits for certain precollege education costs. This idea is both consistent with a consumption-based, reformed federal tax system, and reinforces state-level innovations that can really make a difference.

For example, in 1997 Arizona adopted a tax credit up to \$500 (\$625 for joint returns) for donations to nonprofit organizations that provide scholarships for children attending private school. This unique approach to giving parents and students more educational options received heightened attention in 1999, when the Arizona Supreme Court found it passed constitutional muster against a claim of church-state entanglement.

#### **THE GOOD NEWS AND THE BAD**

The Arizona tax credit uses the American tradition of charitable self-help, and requires minimal government oversight or paperwork on the part of taxpayers, scholarship organizations, and schools. It encourages people to contribute to the education of all children, not just family members. No taxpayer dollars go (even indirectly) to private or religious schools, since the contributions qualified for the credit 1. Never get into the state's coffers in the first place, and 2. Are controlled by

scholarship organizations, which award them to families who *then* can use them for tuition aid.

But the Arizona approach has limitations: it doesn't give parents relief from the expenses of educating their own children, although they can enroll those children at schools participating in tax-favored scholarship programs. And while the Arizona program requires scholarship organizations to award 90% of their revenue in scholarships, there is no income standard guaranteeing a certain percentage of scholarships go to the neediest families.

#### OTHER VARIATIONS

Legislators across the country have tried to improve upon the Arizona model in various ways. Only Pennsylvania and Florida (both in 2001) actually enacted new laws adapted from Arizona's. Each state took a different tack by creating tax credits for businesses, but not individuals, that contribute to scholarship organizations (Arizona's credit is for individuals only). Each state also places restrictions, caps, and eligibility rules on the scholarship funds generated.

Both programs limit scholarships to schools in state and cap the amount of the credits per taxpaying business. Florida imposes auditing, anti-discrimination, and health and safety compliance rules. The Florida statute also has a somewhat puzzling rule limiting the amount *raised* by scholarship organizations to what is needed to aid 'identified' students 'for which vacancies ... have been identified.' Such a restrictive rule will likely prohibit expansion of these programs, regardless of the fact that scholarship programs usually are oversubscribed and have long waiting lists.

#### SOME IMPLICATIONS

Many states have some form of tax benefits or credits for education. The special virtue of the scholarship credit approach is that, like the President's refundable credit, it gives financial support to lower-income families (who may not pay taxes) without setting up a massive new grant program.

A federal tax credit that piggybacked on state-level innovations would help on the legal front: letting states develop plans relieves Washington of tripping over the ever-shifting line of church-state separation. The federal government isn't locked into a single approach to enhancing education freedom—state laws are easier to change than federal entitlements, whether tax-based or appropriated.

#### SOME LESSONS

Tax benefits have an inherent advantage over spending programs (voucher or otherwise). As Andrew Coulson reminds us, the best government benefit for families is

broad-based tax relief, which frees up family income for better education or other investments. (See *Toward Market Education: Are Vouchers or Tax Credits the Better Path?*, a Cato Institute Policy Analysis released February 23, 2001.) But even tax benefits designed to reduce financial barriers to attending private and religious schools can get bogged down in regulatory and constitutional issues if we're not careful.

Lower tax rates, child credits, and even tax rebates are the most straightforward kind of government support for enhancing educational freedom. And tax-reform considerations make tax rate cuts far and away the preferred option, as Coulson would surely agree. Advocates of greater freedom and choice in education should join hands with the tax reform movement. Any government incentive for educational choice, whether charter schools, tax breaks, or vouchers, should stick to the principle that people making their own decisions know best, and minimize rules and regulations that could undermine the very private and religious educational options they're designed to support.

This means advocates of school choice must have the courage to walk away from legislation that might do more harm than good. So should tax reformers. It's always tempting to 'do something' and cut a legislative deal, rather than hold out for a superior idea. In any event, it is much more prudent for states to experiment with these concepts, reinforced by Washington, than for Washington to jump in prematurely with a one-size-fits-all solution. The national government should give us tax rates as low as possible, and education freedom as great as possible. To advance these two great goals, President Bush should propose broad federal tax relief for precollege education costs, keyed in to the expanding universe of state-based education tax relief programs.

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